

**Legal Update**

**Title VII — Wall Street Transparency and Accountability  
Regulation of Over-the-Counter Swaps Markets**

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## Title VII — Wall Street Transparency and Accountability Regulation of Over-the-Counter Swaps Markets

*By V&E lawyer Dan Nossa*

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) introduces a regulatory framework that will have a significant impact on the over-the-counter (OTC) derivatives market and its participating entities. The Act requires most derivative transactions to be cleared, exchange traded, subject to mandatory capital and margin requirements, and reported to regulatory authorities. However, the Act includes end user exemptions with respect to the clearing and exchange trading requirements. Many of the participants in the derivatives market will be subject to new regulations that will require, among other things, registration with Federal regulators, frequent reporting, and position limits. The Act does not provide all details that market participants need to know to assess the operational and economic impact the reforms will have on their businesses. Details, such as the magnitude of margin requirements, position limits and further exemptions, will be clarified by the Commodity Futures Trading Commission (CFTC) and Securities Exchange Commission (SEC) through regulations and rules that each Commission will promulgate over the next year.

### Definitions

This Title introduces a variety of terms. The definitions below are summaries of terms used in this review of Title VII; they do not represent an exhaustive list.

*“derivatives clearing organization”* or *“DCO”* is a clearinghouse, clearing association, clearing corporation, or similar entity that enables each party to an agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the DCO for the credit of the parties; arranges or provides, on a multilateral basis, for the settlement or netting of obligations; or otherwise provides clearing services or arrangements that mutualize or transfer credit risk among participants.

*“major security-based swap participant”* has the meaning specified in section 3(a) of the Securities Act of 1934 (the “Securities Exchange Act”).

*“major swap participant”* means any person who is not a swap dealer, and

- (i) maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC or SEC, as applicable, excluding:
  - (I) positions held for hedging or mitigating commercial risk; and
  - (II) positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (“ERISA,”

29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

- (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- (iii) (I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency; and
  - (II) maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC or SEC, as applicable.

The CFTC or SEC, as applicable, shall define by rule or regulation the term “substantial position” at the threshold that the CFTC or SEC, as applicable, determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can impact the U.S. financial system significantly. In setting the definition under this subparagraph, the CFTC or SEC, as applicable, shall consider the person’s relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures. A person may be designated as a major swap participant for one or more categories of swaps without being classified as a major swap participant for all classes of swaps. This definition shall not include an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or one of its subsidiaries.

“*prudential regulators*” refers to the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Administration.

“*security-based swap*” or “*SBS*” has the meaning specified in section 3(a) of the Securities Exchange Act. Typically, an SBS is an SEC-regulated security-related derivatives product.<sup>1</sup>

“*security-based swap dealer*” has the meaning specified in section 3(a) of the Securities Act.

“*special entity*” means (i) a federal agency; (ii) a state, state agency, city, county, municipality, or any other state’s political subdivision; (iii) any employee benefit plan, as defined in section 3 of ERISA; (iv) any government plan, as defined in section 3 of ERISA; or (v) any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986.

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<sup>1</sup> In order to facilitate this summary of Title VII, unless otherwise specified in this section, reference to “swap,” “swap dealer,” and “major swap participant” are also intended to refer to security-based swap, security-based swap dealer, and major security-based swap participant.



“*swap*” is defined as any agreement, contract, or transaction with various characteristics and gives various examples of swaps, including interest rate swaps, foreign exchange swaps, energy swaps, emissions swaps, commodity swaps, and those transactions that use swap master agreements. It excludes futures, forwards, securities options, single-name securities, security based swaps, certain transactions involving securities, other securities as defined, and any agreement where the Federal Reserve, the U.S. government, or a federal agency is a counterparty.

“*swap data repository*” means any person that collects, calculates, prepares, or maintains information or records with respect to transactions or positions in, or the terms and conditions of, swaps entered into by third parties.

“*swap dealer*” means any person who is a dealer in swaps, makes a market in swaps, regularly engages in the purchase and sale of swaps to customers in the ordinary course of business, engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer. A person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities. The term “swap dealer” does not include a person that enters into swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

“*swaps entity*” means any swap dealer or major swap participant that is registered under the Commodity Exchange Act or the Securities Exchange Act.

“*swap execution facility*” means a trading facility providing multiple participants the ability to execute/trade swaps or a confirmation facility that facilitates the execution of swaps between persons and is not a designated contract market.

### **Regulatory Authority**

The CFTC and the SEC are required to consult and coordinate with each other and the prudential regulators to assure regulatory consistency and comparability before the start of any rulemaking or issuing of any order regarding swaps, SBS, and entities that are to be regulated under the Act. The regulations prescribed by the Act must be issued by the CFTC and SEC in final form within 360 days of enactment of the Act. Although the CFTC and SEC are granted joint jurisdiction over “mixed swaps” (*i.e.*, derivatives that contain characteristics of both swaps and SBS), the Act indicates that the CFTC will have jurisdiction over swaps and the SEC will have jurisdiction over SBS.

### **Clearing**

The CFTC and the SEC must require every swap to be cleared through a DCO, unless such swap is determined to be incapable of being cleared or is exempt. A swap is determined to be subject to clearing through a process that can be initiated by a DCO that submits the swap



for review and approval for clearing by the CFTC or SEC. In addition, the CFTC or SEC can initiate the review and approval process for mandatory clearing. Neither Commission can adopt rules requiring a DCO to clear a swap or any group, category, or class thereof that would threaten the DCO's financial integrity. Nevertheless, the CFTC and SEC must adopt rules that will prohibit the evasion of mandatory clearing.

### ***End User Exemption***

Title VII provides an important exemption to the mandatory clearing requirement that will apply to many end users of OTC derivative contracts. The requirement to clear will not apply to a swap if one (1) of the parties to the swap:

- (i) is not a financial entity;
- (ii) is using swaps to hedge or mitigate commercial risk; and
- (iii) notifies the CFTC or SEC, as applicable, in a manner set forth by the relevant Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.

For the purposes of the End User Exemption, a financial entity is defined as (i) a swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap participant; (v) a commodity pool; (vi) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940; (vii) an employee benefit plan as defined in ERISA; or (viii) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in the Bank Holding Company Act of 1956. It should be noted that the items included in the definition of financial entity are themselves defined in a way that may create ambiguity as to whether a particular entity falls under that definition and would thereby be a financial entity. For example, a major swap participant includes entities whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets. This definition could include a whole host of entities that are not conventionally thought of as financial entities.

Additionally, an affiliate of an entity that qualifies for this clearing exemption (including any affiliate predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the exempt entity) may qualify for this exemption only if it is acting on behalf of the exempt entity and as an agent, uses the swap to hedge or mitigate the commercial risk of the exempt entity or other affiliate of the exempt entity that is not a financial entity. An affiliate of an exempt entity may not benefit from the exemption, however, if it is any of the following: a swap dealer; a major swap participant; an issuer that would be an investment company but for paragraph (1) or (7) of subsection (c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)); a commodity pool; or bank holding company with more than \$50 billion in consolidated assets.



With respect to any swap that is not subject to the mandatory clearing requirement and entered into by a swap dealer or a major swap participant with a counterparty that is not a swap dealer or a major swap participant, the counterparty:

- (i) may elect to require clearing of the swap; and
- (ii) will have the sole right to select the DCO at which the swap will be cleared.

### **Trade Execution**

Transactions involving swaps subject to the clearing must be executed on a (i) board of trade designated as a contract market or (ii) a swap execution facility.

#### ***Exemption***

This trade execution requirement will not apply if no board of trade or swap execution facility makes the swap available to trade or if the swap transaction is subject to the clearing exemption. End users exempt from clearing will be exempt from the trade execution requirement.

### **Committee Approval for Public Companies**

Exemptions from the clearing and trade execution requirements are available to a counterparty that is an issuer of securities registered under section 12 of the Securities Exchange Act (15 U.S.C. 781) or that is required to file reports pursuant to section 15(d) of the Securities Exchange Act (15 U.S.C. 78o) (*i.e.*, public companies) only if an appropriate committee of the issuer's board or governing body has reviewed and approved the decision to enter into swaps that are subject to such exemptions.

### **Margin and Capital**

Swap dealers and major swap participants that are banks will be required to meet the minimum capital requirements and minimum initial and variation margin requirements that the applicable prudential regulator will prescribe by rule or regulation.

Swap dealers and major swap participants that are not banks will be required to meet the minimum capital requirements and minimum initial and variation margin requirements that the CFTC, or SEC, as applicable, will prescribe by rule or regulation.

#### ***End User Exemption***

The margin requirement provision was the subject of debate when the House and Senate Conference first released its Conference Report because it did not include an explicit exemption for end users who are parties to derivative contracts with swap dealers and major swap participants. Previous drafts of derivatives legislation included explicit exemptions from the margin requirement for end users that entered into swaps with dealers or major swap participants. Therefore, the Act's current language potentially could expose end users



to the possibility of posting margin on derivative transactions entered into with swap dealers or major swap participants. In response to criticism about the lack of an explicit exemption for end users from the margin requirement, the House and Senate Conference confirmed in a letter from the ranking members in the Senate Committee to the ranking members in the House Committee, that the “legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk.”<sup>2</sup> Notwithstanding the confirmation from the House and Senate Conference that end users are not *intended* to be subject to the margin requirement, without further clarification in the form of an amendment to the Act or concrete rules/regulations from the CFTC or SEC that provide explicit exemptions for end users, the Act still could expose end users to margin requirements if they enter into swaps with dealers or major swap participants.

### Reporting

The Act imposes new reporting requirements for entities that participate in the derivatives market. Counterparties to swaps that are subject to clearing will be subject to reporting as soon as technologically feasible following the execution of a swap. Reporting will include data regarding price and volume and will be made public to enable more efficient regulation of the market by regulators and to provide more transparency to the market participants. Even swap transactions that are not cleared will be subject to reporting to swap data repositories, the CFTC, or the SEC.

### Grandfathering

Generally speaking, swaps that are entered into before enactment will be exempt from the Act’s clearing and trade execution requirements, provided that swaps entered into before enactment are reported to the relevant swap data repository, CFTC, or SEC. However, there are no apparent grandfathering provisions for the reporting and margin requirements.

### Registration and Regulation of Market Participants

To participate in the derivatives market, entities like swap dealers, major swap participants, DCOs, swap data repositories, and swap execution facilities will be required to register with the CFTC or the SEC. These registered entities will be subject to various reporting, recordkeeping, managerial, and capital regulations. While end users are not required to register, their swaps will be subject to reporting requirements.

### Business Conduct Requirements

The Act mandates the CFTC and SEC adopt business conduct requirements that would impose a duty for a swap dealer or major swap participant to verify that its counterparty satisfies the requirements to be an eligible contract participant. In addition, swap dealers and major swap participants will be required to disclose to each of their counterparties

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<sup>2</sup> Letter from Sen. Chris Dodd (Chairman of the Senate Committee on Banking, Housing, and Urban Affairs) and Sen. Blanche Lincoln (Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry) to Rep. Barney Frank (Chairman of the House Financial Services Committee) and Rep. Colin Peterson (Chairman of the House Committee on Agriculture) dated June 30, 2010.



“(i) information about the material risks and characteristics of the swap; (ii) any material incentives or conflicts of interest that the swap dealer or major swap participant may have in connection with the swap; and (iii) (I) for cleared swaps, upon the request of the counterparty, receipt of the daily mark of the transaction from the appropriate derivatives clearing organization; and (II) for uncleared swaps, receipt of the daily mark of the transaction from the swap dealer or the major swap participant.” Swap dealers and major swap participants will have a general duty to communicate in a fair and balanced manner based on principles of fair dealing and good faith. Further, the CFTC and SEC will have discretion to establish other business conduct requirements that “are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act.”

### ***Special Entities***

When advising or entering into transactions with special entities, swap dealers and major swap participants must adhere to additional business conduct requirements. Swap dealers will have the duty to act in the best interests of the special entity when acting as an adviser to a special entity. When either a swap dealer or major swap participant enters into a swap with a special entity, it must comply with any duty established by the relevant Commission to have a reasonable basis to believe that the special entity counterparty has an independent representative that (i) has sufficient knowledge to evaluate the transaction and risks; (ii) is not subject to statutory disqualification; (iii) is independent of the swap dealer or major swap participant; (iv) undertakes a duty to act in the best interests of the counterparty it represents; (v) makes appropriate disclosures; (vi) will provide written representation to the special entity regarding fair pricing and the appropriateness of the transaction; and (vii) in the case of employee benefit plans subject to ERISA, is a fiduciary as defined in section 3 of ERISA (29 U.S.C. 1002). Before the initiation of a transaction with a special entity, a swap dealer must disclose to the special entity in writing the capacity in which the swap dealer is acting.

### **Position Limits**

The CFTC and the SEC will establish aggregate position limits with respect to swaps that perform or affect a significant price discovery function by restricting the number or amount of positions that may be held by any person, including any group or class of traders.

### **Prohibition Against Federal Government Bailouts of Swaps Entities**

The Act prohibits any federal assistance with respect to any swap or other activity of a swaps entity. This provision is generally referred to as the “pushout” rule and had been the subject of significant focus because, as drafted originally, the provision would have required banks to spin out or divest themselves of their lucrative derivatives businesses. The final version of this provision is the result of compromise among many parties. The “federal assistance” that is prohibited under this provision refers to “any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act, Federal Deposit Insurance Corporation insurance or guarantees for the purpose of (i) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity; (ii) purchasing the assets of



any swaps entity; (iii) guaranteeing any loan or debt issuance of any swaps entity; or entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity.”

### *Exemptions*

- Major swap participants that are insured depository institutions are exempt from the term “swaps entity.”
- Insured depository institutions acting as swap dealers are exempt from the federal assistance prohibition provided that their swap activities are limited to (i) hedging and other similar risk mitigating activities or (ii) swaps involving rates or reference assets that are permissible for investment by a national bank.

The pushout rule will become effective two (2) years following the date the Act becomes law. It provides for an additional two (2) year extension of insured depository institutions with the possibility of another one (1) year extension.

### **Open Issues**

As mentioned at the beginning of this summary, the Act provides a framework for OTC derivative reform, but many of the details that market participants need in order to determine the impact the new derivatives regulatory regime will have on their businesses are yet to be determined. The CFTC and the SEC have 360 days from enactment of the Act to promulgate many of the regulations mandated by the Act.

*For more information regarding the Dodd-Frank Wall Street Reform and Consumer Protection Act, please contact Vinson & Elkins lawyers [Paris Theofanidis](#) or [Dan Nossa](#). Visit our website to learn more about V&E's [Finance](#), [Energy](#), and [Tax](#) practices.*

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