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presents

Derivatives Oversight Under the Financial Reform Legislation

Preparing to Comply With the Sweeping Federal Regulation of the Derivatives Market

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

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Tuesday, September 14, 2010

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12 pm Central

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Impact of Financial Reform Legislation on Derivatives Market



Michael Griffin
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**GENERAL OVERVIEW OF DERIVATIVES
LEGISLATION
(TITLE VII of the Dodd-Frank Reform and
Consumer Protection Act)**

GENERAL OVERVIEW OF DERIVATIVES LEGISLATION

- The most far reaching and substantial regulation of the over-the-counter derivatives.
- Requires exchange trading and clearing for most standardized swaps products.
- Affects various types of financial entities including:
 - Banks
 - Large Hedge Funds
 - Insurance Companies
 - Finance Companies

NEW REQUIREMENTS

- Types of requirements for dealers and major participants in derivatives and swaps trades include:
 - Registration requirements
 - Posting of margin for trades
 - Capital requirements
 - Reporting and record-keeping
 - Business Conduct Standards

- As a result of the above requirements financial costs of derivatives transactions will increase substantially for many of the affected financial entities that participate in the derivatives markets.

- Title VII of the Dodd-Frank Act provides for a very general regulatory framework for the regulation of the derivatives.
- Most of the substance of the new derivatives regulation will come from the upcoming rulemakings in connection with Title VII.
- Most of the Rulemakings for Title VII are due 360 days after enactment of the Dodd-Frank Act (July 16, 2011).
- The CFTC has identified 30 areas of the Title VII in which rules will be necessary. Although the rules are not due to be published for public comment until July 2011, CFTC Chairman Gensler has proposed an ambitious timeframe of having all of the rules published by Thanksgiving 2010.

ISSUES THAT WILL AFFECT BANKS IN TITLE VII

Swap Dealer Registration:

- The Dodd-Frank Act defines a swap dealer as an entity that: holds itself out as a dealer; makes a market in swaps; regularly enters into swaps with counterparties as an ordinary course of business for its own account; or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

Exemptions for Swap Dealers

- Exemptions for swap dealers under the Dodd-Frank Act include:
 - entities that are entering into the swaps to hedge their own accounts; or
 - entities that engage in swaps in a "de minimis" quantity. "De minimis" is yet to be defined by the CFTC, and thus it is not yet known what amount of swaps will fit within the exception.

MAJOR ISSUE: HOW BROAD WILL THIS BE DEFINED? *Does a bank or other OTC participant that simply enters into a small number of swaps with to clients fit within the definition? If a bank offers retail FOREX products to customers wishing to hedge their currency risks qualify as a swap dealer?*

MAJOR SWAP PARTICIPANTS

- MAJOR SWAP PARTICIPANT:
- Section 721 (a) Definition of Major Swap Participant: “End-User” Exemption:
- Major Swap Participants (entities such as banks and insurance companies that could be subject to requirements of the Act) include entities that:
 - maintain a “substantial position” in swaps for any of the major swap categories as determined by the Commission;
 - whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or markets; or

- MAJOR SWAP PARTICIPANT (cont'd):
 - 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 maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission.

MAJOR ISSUE: HOW BROADLY WILL THIS TERM BE DEFINED? *While many commentators believe this term was supposed to simply include larger participants in the derivatives markets such as the larger bank institutions, possibly large hedge funds or insurance companies that hold a substantial over-the-counter derivatives position, it is still not clear if smaller institutions will also be affected. (e.g. mid-size banks that simply provide various swaps for customers, for example in the FOREX market). Therefore, derivatives participants at all levels may want to become involved in the upcoming rulemakings on MSPs to ensure they are not unnecessarily included.*

END USER EXEMPTION

“End User” Exemption: If an entity holds:

- positions held for hedging or mitigating commercial risk;
 - positions maintained for any employee benefit plan
-
- “Substantial Position” still needs to be defined by the CFTC in a rulemaking. Final definition will have an impact on types of entities are included.
 - **MAJOR ISSUE:** *What is substantial position? What type of trade volume will be included? What entities will be considered end users that are simply hedging business risk rather than speculating? Again, final rulemakings are essential.*

Bank Push Out Provision:

- Initial legislative proposal would have forced banks to divest all swaps activities to an affiliate.
- Last minute compromise: Banks may maintain their derivatives business in products that are tied to hedging for the banks own risk.
 - Such products would likely include interest rate and foreign exchange instruments as well as certain credit products
 - However, trades in agriculture products, energy swaps, and uncleared commodities would likely have to be spun off to the bank's affiliates
 - If such trades are not spun off to the bank's affiliate, the bank will not have access to the Federal Reserve discount window or the federal credit facility

Bank Push Out Provision (cont'd):

- Also of note in Section 716: Any credit default swaps that remain in the bank, must go through a central clearinghouse.

MAJOR ISSUES: *What types of products will be considered products that the bank is hedging for its own risk? Substantial amount? Limited amount? Some commentators have speculated that hedging products would include interest rate swaps, gold and silver as well as credit products. However, trades in agriculture products, energy swaps, and un-cleared commodities would have to spun off to the bank's affiliates.*

What types of entities are considered affiliates? Rulemaking is essential.

Volcker Rule (Title VI of Dodd-Frank):

- Under these provisions, subject to certain exemptions, federal regulators must issue regulations to prohibit “banking entities” (i.e., insured depository institutions, their holding companies, non-US banks with branches or agency offices in the US, and any affiliate or subsidiary of such entities) from engaging in proprietary trading, sponsoring or investing in hedge funds and private equity funds, and having certain financial relationships with those hedge funds or private equity funds for which they serve as investment manager or investment adviser.

Volcker Rule (Title VI of Dodd-Frank) (cont'd):

- A systemically significant non-bank financial company supervised by the Federal Reserve that engages in such activities would be subject to rules establishing enhanced capital standards and quantitative limits, but such activities would not be prohibited.

MAJOR ISSUE: OVERLAP WITH DERIVATIVES LEGISLATION? *What will be the scope of permitted activities? What additional capital or other requirements, if any, will be imposed on permitted activities?*

**Other Major Issues
Concerning Banks, Hedge Funds,
Insurance Companies and Derivatives
Participants.**

Clearing Requirements:

- Attempt to Increase Transparency: Mandatory Clearing of Swaps and Security Based Swaps for those swaps that are eligible for clearing.
 - Title VII of the Dodd-Frank Act mandates that both clearinghouses and regulators (CFTC and SEC) must determine which type of swaps are eligible for clearing. Clearinghouses are entities that are separate from exchanges and are responsible for settling trading accounts, clearing trades, collecting and maintaining margin, regulating delivery and reporting trade data.
 - Most of the types of swaps that will be eligible for clearing will likely be **standardized** swaps; swaps that are liquid and not too complex. More complex swaps with customized terms will probably be permitted to trade bilaterally, but must be publicly reported.

MAJOR ISSUES: *What types of products will be considered clearable and subject to mandatory clearing? Will the agencies provide clear guidance through rulemakings or will they leave much of the determination of products that must be cleared to the registered clearinghouses?*

Exchange Trading Requirements:

- Mandatory Trading on Registered Exchanges:
 - If a contract is listed for trading and required to be cleared, it must also trade on a registered exchange. Registered Exchanges include Designated Contract Markets or:
 - Newly created Swap Execution Facility.

MAJOR ISSUES: *What types of products will be traded or accepted on exchanges? Will there be categories of trades that are clearable but not exchange traded? What will it mean to be executed on a Swap Execution Facility?*

Swap Execution Facilities:

- A SEF is defined in the Dodd-Frank Act as:
 - a facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that facilitates the execution of swaps between two persons and is not a designated contract market.

MAJOR ISSUES: *How broad will the CFTC and SEC define Swap Execution Facilities? Specifically, how will facilitation be defined? Will the agencies permit individual negotiation? Will they require pre-trade transparency?*

Position Limits:

- Position limits are required to be imposed by the regulators on any swaps on nonfinancial commodities (e.g. energy, metals, agricultural commodities) that provide a “significant price discovery function”: considerations for significant price discovery include:
 - price linkage to traded contracts
 - liquidity; and
 - the potential for price arbitrage between the swap and a contract on the traded platform.

MAJOR ISSUES: *How will regulators set the position limits? Will they have sufficient market information to devise sensible limitations? How broadly will the exemption for hedging be defined?*

Enforcement Authority In OTC Context:

- Title VII substantially increases the CFTC's enforcement authority in the context of derivatives trades
- New Liability Provisions for OTC trades
- New fraud liability provisions that parallel Section 10(b) of the Exchange Act with respect to securities. Section 4b of the Commodity Exchange Act amended, adding language that prohibits derivatives participants from:
 - employing any device, scheme, or artifice to defraud;
 - making any untrue statement of material fact or omitting any statement of material fact necessary in order to make the statements made misleading;
 - or engaging in any act, practice or course of business which operates as a fraud or deceit upon any person.

Enforcement Authority In OTC Context (cont'd):

- “Disruptive Practices”: Dodd-Frank provides the CFTC with enforcement authority over market participants that engage in “disruptive practices.” The Act defines such disruptive practices to include: activities violating bids or offers; intentional or reckless disregard for the orderly execution of transactions during the closing period of a market; and “spoofing” (bidding or offering with the intent to cancel the bid or offer before execution).
- Anti-Manipulation: Dodd-Frank also expands the CFTC’s anti-manipulation authority, and broadens the types of activities that are considered manipulation. For instance, it reduces the scienter requirement for manipulation in the reporting context by changing the standard of such conduct to include acting in *reckless* disregard of the fact that such report is false, misleading, or inaccurate.

MAJOR ISSUES: *Will the CFTC and SEC provide greater guidance on what kind of trading is actionable. How best can traders be counseled to avoid new enforcement pitfalls?*

OTC FOREX UNDER DODD-FRANK

OTC FOREX=SWAPS

- If it's OTC and it's not spot, Dodd-Frank calls it a swap by implication
 - The definition of “swaps” expressly excludes forward contracts on non-financial commodities and securities intended to be physically settled
 - OTC Forex would be subject to same regulatory regime applicable to other swaps (including swaps dealer/major swap participant registration and regulation, capital requirements, margin rules, disclosure requirements, position limits, clearing, ECP counterparty restrictions, etc.)
 - Treasury Secretary's authority to exclude Forex forwards and swaps from the statutory definition of “swaps”

OTC RETAIL FOREX

- What is “retail” Forex
 - Dodd-Frank amends the definition of “eligible contract participant” and ups the ante
 - Hedge funds/commodity pools as retail Forex customers: the new look-through requirement
 - Repapering accounts and supplemental documentation/due diligence
- The problem for Non-US banks
 - The uneven playing field: Dodd-Frank amends the Commodity Exchange Act “financial institution” retail Forex exemption and limits its scope to “US” financial institutions
 - Will US branches qualify as US financial institutions

OTC RETAIL FOREX (cont'd)

- The problem for all banks (US and Non-US) and registered broker-dealers.
 - Dodd-Frank extends the Commodity Exchange Act ban on retail Forex transactions to the otherwise regulated and enumerated entities unless the applicable Federal regulating agency issues authorizing retail Forex transactions
 - The Federal agency rules must include requirements relating to disclosure, documentation, recordkeeping, reporting, business conduct, capital and margin
 - 90-day effective date
- The CFTC issues its retail Forex rules-a template for Dodd-Frank compliance

COMMODITY POOL REGULATION UNDER DODD-FRANK

- Dodd-Frank amends the Commodity Exchange Act to define “commodity pool”
 - Broad definition includes investment funds that trade or invest in exchange-traded commodity futures and options contracts, securities futures and options, retail Forex and swaps
 - Hedge funds that engage in swaps but no futures are covered
 - Hedge funds that engage in retail Forex but no futures are covered
 - Commodity pool operator exclusions and registration exemptions continue to apply
- “Pure” commodity pools are not “private funds” under Dodd-Frank.
 - Pure commodity pools are excluded by the private investment company litmus test--the 3(c)(1) and 3(c)(7) exemptions and escape addition private fund regulation

POTENTIAL COMPLICATIONS OF SWAPS DEALER/MAJOR SWAP PARTICIPANT STATUS FOR HEDGE FUNDS AND COMMODITY POOLS

- Registration Issues
 - Investment fund, controlling entity registration or both
 - Individual registrations, proficiency tests and security/fingerprinting clearances
 - NFA membership

- Capital Requirements
 - All capital is not likely to count as good regulatory capital
 - Broker/dealer/FCM models and joint back office precedents
 - Investor investment capital
 - Equity and subordinated debt
 - Withdrawal restrictions and liquidity impact.

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