

The New Swaps Playing Field: Overview and Analysis of the Dodd-Frank Act's Derivatives Title

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The Dodd-Frank Act, among its other financial reform measures, brings the over-the-counter (OTC) derivatives markets under the regulatory umbrella of the CFTC and SEC. Although we must still wait for final regulations to be issued by the regulatory agencies, it is clear the landscape has changed: OTC derivatives—along with commodity futures products—are now regulated products, and their intermediaries and users are about to become regulated entities. This article details Title VII’s provisions regarding various types of derivatives transactions, and the division of regulatory authority between the federal agencies that will regulate them.

As the sun arose on June 25, 2010, by party-line votes of 20 to 11 and seven to five, conferees from the House of Representatives and the Senate separately approved the Conference Committee Report on the financial reform act, H.R. 4173—now known as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act).¹ House Financial Services Chairman Barney Frank presided over the seven days of hearings, which culminated in a 20-hour marathon session concluding at 5:39 a.m. on June 25. Perhaps ironically, based upon an ensuing negative reaction by several legislators to the so-called “bank tax” that was designed to fund the estimated \$22 billion cost of the Act over 10 years, the conferees reconvened on June 29 to adopt an alternative funding mechanism by a similar vote. Ultimately, the Act was approved by the House of Representatives on June 30 by a vote of 237 to 192, followed by the Senate on July 15 by a vote of 60 to 39. On July 21, 2010, President Barack Obama signed H.R. 4173 into law.

The Dodd-Frank Act represents the culmination of numerous executive, legislative, and industry proposals for over-the-counter (OTC) derivatives regulation that have been considered since the beginning of the 2007 financial crisis—a crisis that resulted in the collapse of Lehman Brothers, the quick-fire sales of Merrill Lynch and Bear Stearns, and the meltdowns of AIG, Fannie Mae, and Freddie Mac (and a host of others), all of which thrust the approximately \$600 trillion OTC derivatives market² into the crosshairs of the political and media arenas. In signing the bill into law, President Obama proclaimed that:

[T]he American people will never again be asked to foot the bill for Wall Street’s mistakes. There will be no more tax-funded bailouts—period. If a large financial institution should ever fail, this reform gives us the ability to wind it down without endangering the broader economy. And there will be new rules to make clear that no firm is somehow protected because it is ‘too big to fail,’ so we don’t have another AIG.³

¹ P.L. 111-203, 124 Stat. 1376 (2010). The law was initially proposed on December 2, 2009, in the U.S. House of Representatives by Barney Frank (D-Mass.), and on January 20, 2010, in the U.S. Senate Banking Committee by Chairman Chris Dodd (D-Conn.). The Act, among its many changes, makes revisions to the Commodity Exchange Act (“CEA”); the CEA is codified at 7 U.S.C. § 1, et seq. CEA sections generally do not correspond numerically to U.S.C. sections, so we follow industry convention and cite to the CEA sections, where applicable. However, with respect to other federal statutes (which generally do correspond to U.S.C. sections), we cite to the U.S.C.

² See Bank of International Settlements, Semiannual OTC derivatives statistics at end-December 2009 (December 2009), available at <http://www.bis.org/statistics/derstats.htm>.

³ “Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act”

Upon the passage of the Act, Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler—the architect of the derivatives title (Title VII, the “Wall Street Transparency and Accountability Act of 2010”)—declared that:

The Wall Street reform Act passed today is historic and comprehensive. Over-the-counter derivatives dealers will—for the first time—be subject to robust oversight for their derivatives activities. Standardized derivatives will be required to trade on open platforms and be submitted for clearing to central counterparties. This will greatly improve transparency and lower risk in the marketplace. I look forward to the President signing this crucial legislation. The CFTC stands ready to implement the Dodd-Frank Act to best protect the American public.⁴

While the derivatives title encompasses a “mere” 300 pages of the 2,300 page Act, the title will require a monumental regulatory implementation to accompany Congress’ mandate. As a result of the Act, the CFTC is required or authorized to issue 61 rulemakings with respect to 30 distinct areas (95 rulemakings for the Securities and Exchange Commission (SEC)) and six studies (17 for the SEC). The CFTC and SEC will thus enter an intense period of rulemaking over the next several years. Exhibit 1 sets out a list of the areas in which the CFTC is required or authorized to issue rules implementing provisions of the Act.

Title VII represents the first attempt to bring comprehensive regulation to the U.S. OTC derivatives markets since the Commodity Futures Modernization Act of 2000 (the CFMA)⁵ placed these markets largely beyond the regulatory authority of the CFTC and SEC. Indeed, the OTC derivatives community had successfully thwarted efforts by the CFTC, SEC, Federal Reserve, and other agencies to regulate OTC derivatives not only since the establishment of the CFTC in 1974, but since the enactment of the Commodity Exchange Act (CEA) in 1936⁶ and even its predecessor in 1922, which included an exclusion for forward contracts.

While the Act retains a forward contract exclusion (and now includes an additional one), it appears that little else remains the same. OTC derivatives have become regulated products, and their intermediaries and users are about to become regulated entities. The centerpieces of the derivatives title are mandates for traders to execute OTC derivative transactions on regulated exchanges and to submit those trades for clearing to regulated clearinghouses, as well as new regulatory regimes for swaps dealers and large swap market participants. While the primary target of the Act is OTC derivatives, the breadth of the Act ensures that many spot and futures products and

(White House Press Release, July 21, 2010), available at <http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-streetreform-and-consumer-protection-act>. An irreverent counter-opinion on the virtues of the Act is offered by the law firm of Jones Day: Dodd-Frank is indeed breathtaking, in its length, the silliness of many of the topics covered, its failure to come to grips with the root causes of the financial crisis (many, if not most, of which were Washington-mandated housing, monetary, and tax policies), and in the very fact that it cannot in any real sense be said to be likely to avert the next financial bubble. But the most breathtaking, truly tragic aspect of it is that its greatest effect will be to create pressures on nonfinancial companies across America to move to a more aggressive, short-term orientation. It makes you wonder what, or whether, the legislators who voted for its passage were thinking. Jones Day, “Short Title, Short Termism” (July 2010), available at <http://www.jonesday.com/dodd-frank>.

⁴ CFTC Press Release PR5854-10 (July 15, 2010).

⁵ P.L. 106-554 § 1(a)(5), title 1 §§ 103-106 (Dec. 21, 2000).

⁶ 49 Stat. 1491 (1936).

their market participants will also be engulfed by the Act's provisions.

STRUCTURE OF THE DODD-FRANK ACT

The derivatives title is divided into Subtitles A and B. Part I of Subtitle A primarily concerns the division of regulatory authority between the various federal regulators, particularly with respect to how the CFTC and the SEC are to resolve any differences between them as to the scope of their respective regulatory jurisdictions. Part II of Subtitle A sets forth the authority of the CFTC over those transactions that it regulates, namely swaps and certain security-based swaps. Subtitle B describes the authority of the SEC over certain security-based swaps.

REGULATION OF SWAPS AND SECURITY-BASED SWAPS—DEFINITIONS

Current Definitions Just a Starting Point. The Act provides for the comprehensive regulation of swaps and security-based swaps and includes definitions of key terms relating to such regulation (see discussion below). However, while establishing the skeletal contours of many key terms, the Act authorizes the CFTC, SEC, and others to give these terms "muscle." For example, Act Section 712(d) provides that the SEC and CFTC, in consultation with the Board of Governors of the Federal Reserve System, are required to jointly further define the terms "swap," "security-based swap," "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," "eligible contract participant," and "security-based swap agreement."

Moreover, Act Section 721(c) requires the CFTC to adopt a rule to further define the terms "swap," "swap dealer," "major swap participant," and "eligible contract participant." Act Section 761(b) requires the SEC to adopt a rule to further define the terms "security-based swap," "security-based swap dealer," "major security-based swap participant," and "eligible contract participant," with regard to security-based swaps, for the purpose of including transactions and entities that have been structured to evade Title VII of the Act. Finally, Act Section 712(a) provides that the SEC and CFTC, after consultation with the Board of Governors of the Federal Reserve System, shall jointly prescribe regulations regarding "mixed swaps."

On August 13, 2010, the CFTC and SEC issued a joint advance notice of proposed rulemaking requesting comment on the definitions of the foregoing key terms.⁷ Given the potential impact of these definitions, it is critical that market participants not only monitor these developments closely, but attempt to provide input where appropriate.

Definition of "Swap." The Act's cornerstone is the definition of the term "swap." Generally, if a transaction involves a swap, regulation follows—and the Act broadly defines a "swap" to include most types of OTC derivatives, subject to an exclusion for "security-based swaps" and certain other specified exceptions.⁸ The definition specifies several included categories, including:

- Options, including puts, calls, caps, floors, collars or similar options of any kind;
- Event contracts, i.e., contracts providing for the purchase, sale, payment, or

⁷ See CFTC Press Release PR5871-10 (Aug. 13, 2010).

⁸ See CEA § 1a(47)(A).

- delivery of an underlier (other than dividends on equity securities) that are dependent upon the occurrence, nonoccurrence, or extent of occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence;
- Traditional swap structures in which a fixed payment is exchanged for a floating payment on one or more scheduled dates, with payments linked to the value or level of one or more interest rates, other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind or interest therein or based on the value thereof, and which transfers risk, in whole or in part, associated with a future change in the value or level of the foregoing between the parties without also conveying a current or future ownership interest in an asset;
 - Instruments that become commonly known to the trade as swaps or by more specific names linked to an underlying commodity or financial measure (e.g., interest rate swaps, currency swaps, energy swaps, agricultural swaps, and emissions swaps);
 - Any agreement, contract, or transaction that is or in the future becomes known to the trade as a swap;
 - Security-based swap agreements; and
 - Any combination of, or option on, any of the foregoing.⁹

Exclusions From Swap Definition. While the definition of a swap is broad, it does specifically exclude the following:¹⁰

- *Futures and Other CEA Regulated Contracts.* Futures and options on futures, security futures products, leverage contracts authorized under CEA Section 19, retail spot foreign exchange (forex) transactions described in CEA Section 2(c)(2)(C)(i), and retail commodity transactions described in new CEA Section 2(c)(2)(D)(i) are all excluded contracts.
- *Physical Delivery Contracts.* Transactions for the sale of a *nonfinancial commodity or security* for deferred shipment or delivery (i.e., “forwards”) are excluded from the swap definition, provided that the parties *intend*¹¹ to physically settle the transaction.¹²

⁹ Id.

¹⁰ See CEA § 1a(47)(B).

¹¹ The Dodd-Frank Act does not provide any guidance as to how the term “intend” should be defined, or whether the treatment of a swap would change if the parties decided not to physically settle such swap on a later date. Historically, however, there has been significant confusion (and litigation) over the meaning of “intent” in the forward contract context. See, e.g., *CFTC v. Co Petro Mktg. Group*, 680 F.2d 573 (9th Cir. 1982); *In re Stovall*, Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,775 (Dec. 6, 1979). More recently, the CFTC had begun to trend away from an interpretation of the term “forward” that depended on whether the parties actually intended to settle by delivery. Rather, the CFTC moved to a position that a contract would be deemed to be a forward based on a party’s *ability* to make or take delivery, irrespective of intent. Moreover, in *CFTC v. Zelener*, 373 F.3d 861, 865 (7th Cir. 2004) *reh’g and reh’g en banc denied*, 387 F.3d 624 (7th Cir. 2004), the Seventh Circuit (and many courts that subsequently considered the issue) disregarded any intent or physical delivery consideration. Rather, the Seventh Circuit held that the relevant inquiry was whether the transaction involved “a sale of the commodity,” in which case it would be deemed to be a forward, or whether the contract was “a sale of the contract,” in which case it would be considered a futures contract. As a proxy for such an inquiry, the court looked at whether the contract was fungible or, absent fungibility, whether the seller promised to allow the buyer to enter into an offsetting contract on demand. If either condition applied, the contract would be regarded as a futures contract. Id. at 868.

¹² The CEA’s forward contract exclusion that excludes deferred delivery contracts from regulation as futures remains. However, although the forward contract exclusion still exists, the separate exclusion from the swap definition for the sale of a nonfinancial commodity or security for deferred shipment or delivery where the

- *Certain Options on Securities or Certificates of Deposit.* There is an exclusion for options on securities, certificates of deposit, groups or indexes of securities or interests therein or based on the value thereof, which are subject to the Securities Act of 1933¹³ (the Securities Act) and the Securities Exchange Act of 1934¹⁴ (the Exchange Act).
- *Foreign Currency Options Listed on a National Securities Exchange .* This exclusion is consistent with regulation of currency options traded on a national securities exchange as securities.
- *Securities-Related Contracts .* The types of securities- related contracts listed below are not considered to be swaps:
 - Contracts for the purchase or sale of one or more securities on a fixed basis that are subject to the Securities Act and the Exchange Act;
 - Contracts for the purchase or sale of one or more securities on a contingent basis that are subject to the Securities Act and the Exchange Act, unless predicated on the occurrence of a bona fide contingency reasonably expected to affect or be affected by the creditworthiness of a non-party;
 - Notes, bonds, or evidence of indebtedness that are securities as defined in the Securities Act; and Contracts that are based on a security and are entered into directly or through an underwriter by the issuer of the security for the purpose of capital raising, unless entered into to manage a risk associated with the capital raising.
- *Transactions Guaranteed by the U.S. Government.* Contracts expressly backed by the full faith and credit of the U.S. and to which a Federal Reserve Bank, the federal government, or a federal agency is a party are excluded.
- *Security-Based Swaps .* Any security-based swap other than a mixed swap is excluded.
- *Identified Banking Products.* Identified banking products are excluded under other provisions, but may under certain circumstances become regulated as swaps.¹⁵

Definition of “Security-Based Swaps.” Security-based swaps are swaps that are based on:

transaction is intended to be physically settled raises the prospect that commercial transactions may have to qualify for both the forward contract exclusion and the swap exclusion to safely fall outside of the CEA, since swaps include transactions that are economically equivalent to futures. The terms of the exclusion from the swap definition suggest that it is intended to be a counterpart to the forward contract exclusion from classification as a futures contract, although narrower in scope in that it is limited to nonfinancial commodities or securities. To minimize any disruption of the cash markets for nonfinancial commodities, the CFTC ideally will seek to interpret the two exclusions in the same manner. Notably, Senators Dodd and Lincoln explained that the exclusion from the swap definition “is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC’s established policy and orders on this subject, including situations where commercial parties agree to ‘book-out’ their physical delivery obligations under a forward contract.” Letter from Chairman Christopher Dodd, Senate Committee on Banking, Housing, and Urban Affairs, United States Senate and Chairman Blanche Lincoln, Senate Committee on Agriculture, Nutrition, and Forestry, United States Senate, to Chairman Barney Frank, Financial Services Committee and Chairman Colin Peterson, Committee on Agriculture, dated June 30, 2010 (“Dodd-Lincoln Letter”), at 3.

¹³ Codified at 15 U.S.C. § 77a et seq. (48 Stat. 74).

¹⁴ Codified at 15 U.S.C. § 78a et seq. (48 Stat. 881).

¹⁵ See CEA § 1a(47)(B).

- A narrow-based security index;¹⁶
- A single security; or
- A loan and the occurrence or nonoccurrence of an event relating to a single issuer of a security (or the issuers of a narrow-based security index).¹⁷

Security-based swaps are regulated by the SEC. To effect the SEC's new authority over security-based swaps, the Act makes the following changes to previous law:

- The definitions of "security" in the Securities Act and the Exchange Act are amended to include security-based swaps.
- The Securities Act is amended to provide that security-based swaps must be subject to a registration statement (prospectus) meeting the requirements of Section 10(a) if they are offered or entered into with any person that is not an eligible contract participant (ECP)¹⁸ notwithstanding the provisions of Securities Act Sections 3 (exempted securities) or 4 (exempted transactions). The practical effect of these amendments is (1) to require Securities Act registration of any security-based swap sold to a person that is not an ECP and (2) to permit national securities exchanges and security-based swap trading facilities to trade security-based swaps that have been registered under both the Securities Act and the Exchange Act.

Note: The definitions of "security" in the Investment Company Act of 1940¹⁹ and the Investment Advisers Act 1940²⁰ are *not* amended.

Exclusions From Security-Based Swap Definition. The definition of a security-based swap expressly excludes:²¹

- Options on securities or indexes of securities; and
- Swaps on Treasury securities and other exempted securities.

Note: Identified banking products are excluded under other provisions, but they may under certain circumstances become regulated as security-based swaps.

Mixed Swaps. A "mixed swap" is a security-based swap that also is based on the value of one or more interest or other rates; currencies; commodities; instruments

¹⁶ Subject to certain exceptions, a "narrow-based security index" is defined in CEA § 1a(35) as an index of securities (i) that has nine or fewer component securities; (ii) in which a component security comprises more than 30 percent of the index's weighting; (iii) in which the five highest weighted component securities, in the aggregate, comprise more than 60 percent of the index's weighting; or (iv) in which the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than \$50 million, or in the case of an index with 15 or more component securities, \$30 million (subject to a specified adjustment if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted 25 percent of the index's weighting).

¹⁷ See CEA § 1a(42).

¹⁸ The CEA definition of ECP has been amended (1) to increase the discretionary investment standard for a governmental entity to qualify from \$25 million to \$50 million; (2) to change the standard for an individual to qualify from a total assets test of \$10 million—or \$5 million if hedging—to a discretionary investments test at those levels; and (3) not to include for purposes of CEA §§ 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii), a commodity pool in which any participant is not otherwise an ECP. See CEA § 1a(18).

¹⁹ See 15 U.S.C. § 80a-1 through § 80a-64.

²⁰ See 15 U.S.C. § 80b-1 through 15 U.S.C. § 80b-21.

²¹ See 15 U.S.C. § 78c(a).

of indebtedness; indices; quantitative measures; other financial or economic interest or property of any kind (other than a single security or a narrow-based security index); or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence based on financial or economic interest or property of any kind (other than a single security or narrow-based security index).²² Mixed swaps will be subject to rules jointly promulgated by the CFTC and the SEC after consultation with the Board of Governors of the Federal Reserve System.

Identified Banking Products. The term “identified banking product” is defined in the Legal Certainty for Bank Products Act of 2000²³ by cross reference to Section 206(a)(1) through (5) of the Gramm-Leach-Bliley Act (GLBA).²⁴ The term includes: (1) deposit accounts, savings accounts, certificates of deposit, or other deposit instruments issued by a bank; (2) banker’s acceptances; (3) letters of credit issued or loans made by a bank; (4) debit accounts at a bank arising from a credit card or similar arrangements; and (5) certain loan participations offered to investors in which the bank or an affiliate participates. Identified banking products are excluded from regulation as swaps or security-based swaps, unless:

- The “appropriate federal banking agency”²⁵ determines otherwise or no such agency regulates the product;
- The product would otherwise be covered by the definition of swap or security-based swap; and
- The product has become known to the trade as a swap or security-based swap or is structured to evade the CEA or Exchange Act, as applicable.

Foreign Exchange. The definition of “swap” includes foreign exchange forwards²⁶ and foreign exchange swaps²⁷ that are cleared through a derivatives clearing organization (DCO)²⁸ or traded on a designated contract market (DCM) or swap execution facility (SEF).²⁹ However, OTC foreign exchange forwards or swaps that are not cleared or traded through one of these facilities may be excluded from the requirements of Act Title VII if the Treasury Secretary determines that they should not be regulated as swaps under Title VII and they were not structured to evade Title VII in violation of a rule adopted by the CFTC.³⁰ Such foreign exchange forwards and swaps must nevertheless be reported to a “swap data repository.”³¹ In addition, any swap dealer or major swap participant entering into such trades will be subject to business conduct rules.³² Agreements, contracts, or transactions in foreign currency offered or sold to retail investors will continue to be subject to existing CFTC requirements.³³

²² CEA § 1a(48)(D). Because most security-based swaps contain an interest rate component—i.e., where one party receives an equity related return while the other party receives a return based on LIBOR or other floating rate of interest—the amount of mixed swaps subject to CFTC and SEC jurisdiction could be substantial.

²³ P.L. 106–554, § 1(a)(5) [title IV, § 402], Dec. 21, 2000, 114 Stat. 2763, 2763A–457.

²⁴ P.L. 106–102 (113 Stat. 1338).

²⁵ See CEA § 1a(1).

²⁶ See CEA § 1a(24).

²⁷ See CEA § 1a(25).

²⁸ See CEA § 1a(15).

²⁹ See CEA § 1a(48)(E). SEFs are defined at CEA § 1a(50).

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ See CEA § 1a(48)(F).

SUMMARY OF JURISDICTIONAL GRANTS

The Dodd-Frank Act generally grants the CFTC jurisdiction over swaps and swap market participants and the SEC jurisdiction over security-based swaps and security-based swap market participants. The two commissions share jurisdiction over mixed swaps.³⁴ Participants in both swap and security-based swap markets are subject to regulation by both the SEC and the CFTC, as in the case of a dually registered broker-dealer/futures commission merchant (FCM). The Act prohibits swaps on agricultural commodities except to the extent specifically permitted by the CFTC pursuant to its general exemptive authority or a CFTC rule or order.³⁵

Subject to certain exceptions, such as those relating to orders in connection with a violation or potential violation of law, the SEC and the CFTC are required to consult and coordinate with each other and with the relevant “prudential regulators” (i.e., the applicable federal bank regulators)³⁶ prior to proposing a rulemaking or issuing an order on the matters within their respective jurisdiction under the Act in order to ensure regulatory consistency and comparability to the extent possible.

Swaps. Swaps based on commodities, broad-based securities indices, government securities, and other non-security reference assets are regulated by the CFTC.³⁷ While Congress did not amend the CEA to weave “swaps” into the definition of “transactions involving contracts of sale of a commodity for future delivery” (i.e., futures),³⁸ the CFTC is accorded broad general authority to regulate swaps and those who offer or trade swaps, just as it has jurisdiction over futures and their market participants. As a result, for example, funds and advisers that are participants in the swaps market must now consider whether they are within the amended definitions of a commodity trading advisor based upon the provision of advice with respect to swaps, or as a commodity pool operator based upon operating a fund that enters into swap transactions.

Security-Based Swaps. Security-based swaps—i.e., swaps based on single securities or loans, narrow-based securities indices, and events with respect to single issuers or the issuers in a narrow-based securities index—are regulated by the SEC.³⁹ Jurisdiction over some products, such as credit default swaps and total return swaps, is split between the SEC and the CFTC based upon the narrow-based/broad-based distinction. Options on securities and securities indices are neither swaps nor security-based swaps, but remain within the definition of a “security” under the Exchange Act and thus remain subject to regulation by the SEC.

The definition of a security-based swap excludes agreements, contracts, or transactions that only meet the definition of security-based swap due to referencing or being based on government securities and certain other “exempted securities.” The effect of this treatment is to allocate jurisdiction of swaps on government securities to the CFTC.

From a jurisdictional perspective, it is notable that the definition of “security”

³⁴ See CEA §§ 2(a)(1)(A) and 2(a)(1)(G).

³⁵ See CEA § 4(a).

³⁶ See CEA § 1a(39).

³⁷ See CEA § 2(a)(1)(A).

³⁸ See CEA § 2(a)(1)(A).

³⁹ See CEA § 2(a)(1)(G).

under the Securities Act and the Exchange Act has been amended to include security-based swaps. Thus, the implications of offering or trading in security-based swaps will be significant. For example, the Securities Act's applicable registration provision (Section 5)⁴⁰ and the Securities Exchange Act's antifraud provisions (e.g., Rule 10b-5), among many others, will apply to security-based swaps. However, in folding security-based swaps into the definition of a "security" under the Securities Act and the Exchange Act, an open question remains as to whether security-based swaps will be regulated as securities for all intents and purposes, or only to the extent the statutes have been expressly made applicable pursuant to the Act.

Mixed Swaps. The Act grants the CFTC and the SEC, in consultation with the Federal Reserve, joint rulemaking authority over "mixed swaps" that contain both swap and security-based swap characteristics.

Foreign Exchange Swaps and Forwards. Foreign exchange swaps and forwards are "swaps" subject to the jurisdiction of the CFTC *unless* the U.S. Treasury Department makes a written determination that either or both should not be regulated as swaps under the Act and are not structured to evade any rule promulgated by the CFTC under the Act.⁴¹ This treatment of institutional foreign exchange derivatives appears to reflect a compromise position regarding the extent to which these derivatives should be subject to regulatory scrutiny (the Treasury Department has long contended that such derivatives should be exempt from regulation, while other agencies have argued the converse).

However, even if a determination is made not to regulate foreign exchange swaps or foreign exchange forwards as swaps, all such products must be reported to a swap data repository (or, if no swap data repository will accept such reporting, to the CFTC), and any swap dealer or major swaps participant (as defined below) that is a party to such a contract is subject to the business conduct standards under the CEA as amended by the Act.⁴²

In addition, the exclusion from regulation as swaps, if made, would not exempt foreign exchange swaps or forwards that are listed and traded on or subject to the rules of a designated contract market or SEF, or cleared by a derivatives clearing organization, from any provision of the CEA as amended by the Act prohibiting fraud or manipulation, and would not affect the existing CFTC regulation of retail transactions.⁴³

Other Jurisdictional Allocations. The Act grants jurisdiction to the CFTC over puts, calls, and options on securities exempted by the SEC under Exchange Act Section 36(a)(1), and to the SEC over products exempted by the CFTC under CEA Section 4(c)(1). The CFTC and the SEC may also cede authority to each other without giving up antifraud authority in cases where jurisdiction may not be clear. The Financial Industry Regulatory Authority and the National Futures Association are generally prohibited from regulating swaps and security-based swaps, respectively.

⁴⁰ To give effect to this requirement, the definitions of "purchase" and "sale" under the Securities Act have been amended to include the execution, termination prior to final maturity, assignment, exchange, or other similar transfer or conveyance of a security-based swap, or the extinguishing of rights or obligations thereunder.

⁴¹ See CEA § 1b.

⁴² See § 1a(48)(E).

⁴³ See CEA § 1a(48)(F).

The Act provides for specific procedures to be followed in the case of a proposal to list or trade a novel derivative product that may have elements of both securities and futures. The exclusion from the CEA for qualifying hybrid instruments remains intact. Thus, structured products that contain elements of both commodities contracts and securities will likely continue to be regulated as securities and not be treated as swaps or security-based swaps under the Act.

CLEARING AND EXECUTION REQUIREMENTS FOR SWAPS

Clearing Requirement. The Act requires that a swap or security-based swap must be submitted for clearing if (1) a DCO or agency will accept the swap or security-based swap for clearing, and (2) the CFTC or SEC, as applicable, has determined that such swap or security-based swap should be cleared.⁴⁴

The Act includes an “open access” requirement, which (1) provides that a DCO’s rules must prescribe that all swaps submitted to the DCO with the same terms and conditions are “economically equivalent” within the DCO and may be offset with each other within the DCO, and (2) further provides for “nondiscriminatory clearing of a swap” (but not a futures contract) executed bilaterally or on or through the rules of an unaffiliated DCM or swap execution facility.⁴⁵

The Act also gives both the CFTC and SEC the authority, on their own initiative, to require that a particular swap or security-based swap, as applicable, be cleared.⁴⁶ This provision essentially gives the CFTC or SEC the power to ban the trading of any swap or security-based swap that either determines must be cleared, but which no registered clearing organization or agency is then ready to clear. In determining whether a swap or security-based swap should be cleared, the Act directs the CFTC and SEC to consider the following factors:

- The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data;
- The availability of a rule framework, capacity, operational expertise and resources, and credit;
- Whether there is support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded;
- The effect of such clearing on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the relevant derivatives clearing organization or agency to clear the contract;
- The effect on competition, including appropriate fees and charges applied to clearing; and
- The existence of reasonable legal certainty in the event of the insolvency of the relevant clearing organization or agency, or one or more of its clearing members, with regard to the treatment of customer and counterparty positions, funds, and property.⁴⁷

To prevent evasion of the clearing requirement, the Act vests the regulators with

⁴⁴ CEA § 2(h)(1)(A).

⁴⁵ CEA § 2(h)(1)(B).

⁴⁶ CEA § 2(h)(2)(A).

⁴⁷ CEA § 2(h)(2)(D).

the authority to prescribe rules necessary to prevent evasions under the CEA.⁴⁸

Several extant clearinghouses, such as CME Group and the Intercontinental Exchange (ICE), currently stand ready to clear such trades, and others have been quick to respond. For example, Goldman Sachs, just seven days after passage of the Act, launched its new “Derivatives Clearing Services” business to provide clients with a comprehensive global OTC clearing service for interest rates, credit, foreign exchange, equities, and commodities.

Importantly, to clear swaps that are designated for clearing, a member of a DCO will have to submit the swap to the DCO. However, not all swap counterparties are members of DCOs. If neither of the two counterparties is a member of a DCO, one of the parties will be required to “give up” the swap to a member of a DCO by entering into a form of “give-up” agreement with a DCO member, which will then submit the swap (presumably for a fee) to the DCO.

Execution Requirements. The Act provides that a swap or security-based swap that is subject to the clearing requirement cannot be traded except on a contract market or national securities exchange, as applicable, or on a swap or security-based SEF registered with the CFTC or SEC, as applicable.⁴⁹ Transactions with end users that are not subject to the clearing requirement are not subject to this trading requirement. The trading requirement also does not apply in a case where no contract market, national securities exchange, or swap or security-based SEF is ready to trade the relevant swap or security-based swap.

An SEF is a trading system or platform that is not an exchange but that allows multiple participants to execute or trade swaps (but not other types of contracts) by accepting bids and offers made by other participants and that is open to multiple participants. The Act requires swap or security-based SEFs to register with both the CFTC and the SEC. Registered SEFs must comply with certain core principles specified by the Act, which deal with such matters as compliance with rules, prevention of manipulation, monitoring of trading, position limits, financial integrity of transactions, emergency authority, timely publication of trading information, recordkeeping and reporting, conflicts of interest, and financial resources.

It is expected that new exchanges will challenge the dominance of CME Group and ICE with respect to the execution of OTC trades. One such new exchange—the Eris Exchange—was founded by five large proprietary trading firms, all of whom have committed to make markets on Eris in interest rate swaps and related products.

Exemptions for Certain End Users. The Act exempts certain end users of swaps from the clearing and execution requirements. An end user includes any counterparty that:

- Is not a financial entity;⁵⁰

⁴⁸ CEA § 2(h)(4).

⁴⁹ CEA § 2(h)(8).

⁵⁰ The term “financial entity” includes, among others: (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 Investment Advisers Act of 1940 § 202(a) (15 U.S.C. § 80b–2(a)); (vii) an ERISA plan; 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 Section 4(k) of the Bank Holding Company Act of 1956, P.L. 511; 70 Stat.

- Uses swaps to hedge or mitigate commercial risk; and
- Notifies the CFTC or SEC, as applicable, with respect to the manner by which it will meet its financial obligations associated with entering into non-cleared swaps.

An affiliate of an end user may rely on the end-user exception only if the affiliate, acting on behalf of the end user and as an agent, uses the swap to hedge or mitigate the commercial risk of the end user or other affiliate of the end user that is not a financial entity.⁵¹ However, the affiliate may not rely on the end-user exception if it is a swap dealer, a MSP, an issuer that would be an investment company but for Section 3(c) (1) or 3(c)(7) of the Investment Company Act of 1940, a commodity pool, or a bank holding company with more than \$50 million in consolidated assets.

The Dodd-Lincoln letter explains the purpose and scope of the end user exception in the following terms:

Congress . . . created a robust end user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk. These entities could be anything ranging from car companies to airlines or energy companies who produce and distribute power to farm machinery manufacturers. They also include captive finance companies, finance arms that are hedging in support of manufacturing or other commercial companies. The end user exception also may apply to our smaller financial entities—credit unions, community banks, and farm credit institutions. These entities did not get us into this crisis and should not be punished for Wall Street’s excesses.⁵²

The Act also authorizes the regulators to exempt small banks, savings associations, farm credit system institutions, and credit unions that do not exceed certain financial thresholds from treatment as financial entities. The “financial entity” definition does not include an entity whose primary business is providing financing, and which 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 the purchase or lease of products and 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.

Swaps entered into prior to enactment (or post-enactment, but prior to the effective date of the clearing requirement) will not be subject to the clearing or exchange trading requirements but will be subject to the reporting and recordkeeping requirements for uncleared swaps.

SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

The Act creates new regulatory regimes for swap dealers and major swap participants under the CEA, and for security-based swap dealers⁵³ and major security-based swap participants under the federal securities laws.⁵⁴ As used herein, swap

133. See CEA § 2(h)(7)(C). The term “private fund” is newly defined in Dodd-Frank Act § 402 (15 U.S.C. § 80b–2(a)).

⁵¹ See CEA § 2(h)(7)(D).

⁵² Dodd-Lincoln Letter, *supra* note 12, at 2.

⁵³ See CEA §§ 1a(43) (security-based swap dealers) and 1a(49) (swap dealers).

⁵⁴ See CEA § 1a(32).

dealers and security-based swap dealers are referred to as “swap dealers,” and major swap participants and major security-based swap participants are referred to as “MSPs.”

Definition of Swap Dealers. Under the Act, a swap dealer is an entity that:

- Holds itself out as a dealer in swaps or security-based swaps;
- Makes a market in swaps or security-based swaps;
- Regularly enters into swaps or security-based 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 or security-based swaps.⁵⁵

Note that a person may be designated as a swap dealer for a single class, type, or category of swaps and not considered to be a swap dealer for other types, classes, or categories. Further, the swap dealer definition does not include a person that buys or sells swaps for its own account and not as a part of a regular business.⁵⁶

The Act also provides that an insured depository institution may not be considered 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.⁵⁷ This latter exemption occurs in a “backwards” fashion, in that Act Section 716 prohibits a swap dealer from obtaining FDIC insurance and further prohibits the federal government from providing “federal assistance” to any “swaps entity.” Under the Act, “federal assistance” includes federal deposit insurance, and “swaps entity” includes a bank registered as a swap dealer. Because national banks, federal thrifts, and almost all state chartered banks and thrifts are required to maintain federal deposit insurance, these entities are effectively barred from operating as swap dealers.

Notably, the Act amends the definition of “dealer” under the Exchange Act, thereby providing that dealers in security-based swaps with ECPs need not register as broker-dealers. However, a similar exemption does not exist with respect to persons acting as brokers of security-based swaps.

The Act also introduces a *de minimis* exception, under which the regulators are required to exempt from designation as a swap dealer any entity that engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers. However, as the Act does not provide any guidance concerning the amount of swap dealing that constitutes *de minimis*; determination of the amount will be left to the discretion of the regulators.

Senators Dodd and Lincoln, in response to concerns raised by potential end users that the definition of “swap” is so broad as to encompass end users, attempted to assuage such concerns by explaining that:

Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage commercial risk associated with their business. For example, the Major Swap Participant and Swap Dealer definitions are not intended to

⁵⁵ CEA § 1a(49).

⁵⁶ *Id.*

⁵⁷ *Id.* The section is referred to the “push-out” provision and is discussed more fully below.

include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business. Congress incorporated a de minimis exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.⁵⁸

Definition of MSPs. Under the Act, an MSP is a person who is not a swaps dealer *and*

- Who maintains a “substantial position” in swaps for any major swap category (other than for hedging or mitigating its own commercial risks and excluding positions maintained by pension plans); *or*:
- Whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; *or*
- Who 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 regulator and that maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC or SEC, as applicable.⁵⁹

The Act requires the CFTC and SEC to define the term “substantial position” for purposes of swaps and security-based swaps, respectively, at a threshold that is prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States.⁶⁰ In establishing the standard, the CFTC or SEC, as applicable, shall consider the person’s relative position in non-cleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.

The definition of major swap participant excludes any entity whose primary business is providing financing, and which 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 and 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.⁶¹

The determination of what is an MSP—including the interpretation of such definitions as “substantial position,” “commercial risk,” “financial entity,” and “highly leveraged”—is subject to the discretion of the CFTC and SEC. As a result, the Act creates significant uncertainty as to the types of entities that will be regulated MSPs, and potentially these could include non-financial firms such as energy firms.

Regulation of Swap Dealers and MSPs. The Act imposes various registration, regulatory, capital, margin, business conduct, and other requirements on swap dealers

⁵⁸ Dodd-Lincoln Letter, *supra* note 12, at 3.

⁵⁹ See CEA §§ 1a(32) (major security-based swap participant) and (33)(A) (major swap participant).

⁶⁰ See CEA § 1a(33)(B).

⁶¹ See CEA § 1a(33)(D).

and MSPs.

Registration. All swap dealers and MSPs must register with the CFTC (with respect to swaps) or the SEC (with respect to security-based swaps).⁶² A swap dealer or MSP must register with the CFTC or SEC *even if* the swap dealer or MSP is otherwise regulated.

Regulatory Requirements. Swap dealers and MSPs must comply with:

- Financial reporting, annual compliance reporting and other reporting requirements;⁶³
- Recordkeeping requirements;⁶⁴
- Business conduct standards;⁶⁵
- Documentation and back office standards;⁶⁶ and
- Research-oriented conflicts of interest.⁶⁷

Capital and Margin Requirements. The Act authorizes the imposition of minimum capital requirements and minimum initial and variation margin requirements on both swap dealers and MSPs, which are to be designed to help ensure the safety and soundness of swap dealers and MSPs and to be appropriate for the risk associated with any noncleared transactions held by such swap dealers and MSPs.⁶⁸ According to the International Swaps and Derivatives Association (ISDA), U.S. companies may now be confronted with \$1 trillion in capital and liquidity requirements.⁶⁹ ISDA contends that approximately \$400 billion would be needed as collateral that firms may be required to post with their dealer counterparties to cover the current exposure of their OTC derivatives transactions, and another \$370 billion to cover the additional credit capacity that firms may need to maintain to cover potential future exposure of those transactions. If the financial markets return to levels prevailing at the end of 2008, additional collateral needs would bring the total to \$1 trillion.

With respect to swap dealers and MSPs that are banks, these capital and margin requirements are to be prescribed by federal banking regulators in consultation with the CFTC and the SEC. With respect to swap dealers and MSPs that are not subject to

⁶² See CEA § 4s(a) and (b).

⁶³ See CEA § 4s(e).

⁶⁴ See CEA § 4s(f). The CFTC and the SEC each have authority to establish books and records requirements as to those registrants over which they have authority. The CFTC and the SEC must require registrants to maintain daily records of their swaps and of related cash market and forward trades. Registrants would also be required to maintain recorded communications, including emails, instant messages, and recordings of phone conversations.

⁶⁵ The CFTC and the SEC are required to adopt "business conduct" rules relating to (i) fraud prevention, (ii) general supervision of a registrant's business, (iii) compliance with position limits, (iv) verifying the regulatory status of any counterparty, (v) disclosures of risks to counterparties, and (vi) anything else that the agencies believe appropriate.

⁶⁶ The CFTC and the SEC are required to adopt rules governing confirmations, processing, netting, documentation, and valuation of swaps.

⁶⁷ Registrants are required to establish "structural and information safeguards" between those within the firm engaged in (i) activities relating to research or analysis of the price or market for any asset underlying a transaction and (ii) those involved with clearing or trading activities.

⁶⁸ See CEA § 4s(e).

⁶⁹ See ISDA, "US Companies May Face US \$1 Trillion in Additional Capital and Liquidity Requirements as a Result of Financial Regulatory Reform, According to ISDA Research" (News Release, June 29, 2010), available at <http://www.isda.org/media/press/2010/press062910.html>.

regulation by federal banking regulators, the capital and margin requirements are to be prescribed by the CFTC. With respect to swap dealers and MSPs that are not subject to regulation by federal banking regulators and that engage in security-based swaps, the capital and margin requirements are to be prescribed by the SEC.

The Act specifically directs the regulators to impose initial and variation margin requirements on all swaps and security-based swaps that are not cleared by a registered derivatives clearing organization or clearing agency. The Act also directs the regulators to permit the use of noncash collateral to meet such regulatory margin requirements, to the extent that such use would be consistent with preserving the financial integrity of markets trading swaps and the integrity of the United States financial system.

Prior to the Act's final passage, critics of the margin provisions pointed out that imposition of margin requirements on end users could make it prohibitively expensive for them to use swaps to hedge or mitigate commercial risk. In response to these concerns, the Dodd-Lincoln Letter states that the Act:

does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk. If the regulators raise the costs of end user transactions, they may create more risk. It is imperative the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.⁷⁰

Importantly, relief from the imposition of margin requirements is not contained in the Act, and the CFTC and SEC have significant authority to impose requirements in this respect. Moreover, to the extent that such requirements are not imposed upon end users, it seems reasonable to expect that swap dealers and MSPs would attempt to pass along the economic value of such margin requirements to end users, given the high costs of capital.

Business Conduct Rules. The CFTC and SEC are authorized, as appropriate, to enact business conduct rules with respect to swap dealers and MSPs. Such rules are to provide for, among other things, the maintenance of records, disclosure of risks and conflicts of interest, reporting, appointment of a chief compliance officer, and the establishment of a standard of care. The Act does not authorize the imposition of any such requirements or standards on persons who are not swap dealers or MSPs.

Responsibilities to Special Entities. Any swap dealer or MSP that enters into a contract with, or advises a federal agency, state agency, city, county, municipality, pension plan, or endowment must act with a heightened standard toward such counterparty.⁷¹ A swap dealer or MSP that acts as advisor to such an entity is required to act in the best interest of such entity and make reasonable efforts to ensure that any swap recommended by such advisor is in the entity's best interests. A swap dealer that acts as a counterparty to such entity will be required (1) to disclose the capacity in which it is acting and (2) to have reasonable basis to believe that the entity has a qualified independent advisor that is independent, is sufficiently knowledgeable, is independent of the swap dealer, makes appropriate disclosures, and will provide written representations regarding fair pricing and the appropriateness of the transaction.

⁷⁰ Dodd-Lincoln Letter, *supra* note 12, at 1.

⁷¹ See CEA § 4s(h)(2).

Foreign Swap Dealers and MSPs. The Act does not contain explicit exemptions for non-U.S. swap dealers or non-U.S. MSPs. However, provisions of the Act relating to swaps will not apply to activities outside the U.S. unless such activities contravene rules adopted by the regulators or, for swaps but not security-based swaps, have a direct effect on the U.S.

Moreover, if the CFTC or SEC determines that regulation of swaps in a foreign country undermines the stability of the U.S. financial system, the CFTC or SEC may, in consultation with the U.S. Treasury, bar entities domiciled in such country from conducting swap activities in the U.S.

REGULATION OF DCOS, SEFS, AND SWAP REPOSITORIES

Clearing Organizations. All DCOs that clear swaps must be registered with the CFTC (or with the SEC in the case of security-based swaps). Clearing agencies that were registered with the SEC on the date of the enactment of the Act may be deemed to be registered as DCOs. The CFTC may exempt SEC registered and non-U.S. clearing organizations that are subject to similar scrutiny in their home jurisdictions; the SEC may also exempt CFTC registered and non-U.S. clearing organizations that are subject to similar scrutiny in their home jurisdictions. Each clearing organization is required to publicly disclose, on a daily basis, the settlement prices, volume, and open interest for each settled contract. In addition, clearing organizations will be required to comply with certain core principles, including:

- Maintaining adequate financial resources to withstand the default of the business participant that has the clearing organization's highest exposure and to cover its operating expenses for a year;
- Maintaining appropriate admission standards for members and swaps to be cleared and ways to monitor compliance with such standards; and
- Including market participants on its governing board.

SEFs. All systems or platforms that trade or process swaps (other than CFTC-designated contract markets) must be registered as SEFs with the CFTC, or with the SEC with respect to SEFs that execute trades in security-based swaps. Exchanges may also operate SEFs and may use the same electronic trade execution system, but they would be required to identify whether the trading occurs on the exchange or the SEF. SEFs are also subject to compliance with certain core principles, including:

- Establishing and enforcing trading and participation rules that would deter abuses;
- Establishing trading procedures and monitoring trading to prevent manipulation, price distortion, or disruption of the market;
- Establishing and enforcing rules to allow the SEF to collect information, which information will be shared with the CFTC and/or the SEC, as applicable;
- Establishing position limits, which shall be set no lower than any position limits established by the CFTC or SEC; and
- Maintaining adequate financial resources to cover operating expenses for a year.

At least one exchange—ICE—has announced its intention to register as an SEF, which would effectively put it in competition with many of its institutional customers. It

is also expected that the large swaps dealers will seek permission to turn their private swaps networks into SEFs so that they can continue to offer swaps trading.

Swap Data Repositories. Each entity that acts as a “swap data repository”⁷² or a security-based swap data repository (as used herein, “swap data repository” refers to both) must be registered with, and will be subject to examination by, the CFTC or SEC, as applicable; any entity that acts as both a swap data repository and a security-based swap data repository is required to register with both commissions. Clearing organizations will be permitted to register as swap data repositories. The CFTC and SEC, as applicable, are required to prescribe the data elements required to be collected by swap data repositories from each swap, as well as data collection and maintenance standards. Swap data repositories will be required to:

- Accept all data required to be collected by the SEC or the CFTC, as applicable;
- Confirm the accuracy of swap information with both counterparties;
- Maintain swap data in the form prescribed by the SEC or the CFTC;
- Provide electronic access to the SEC or the CFTC;
- Maintain privacy of swap data received; and
- Establish automated systems for monitoring and analyzing swap data.

Swap data repositories will be required to provide swap data to various regulators upon request (including foreign regulators), but only if such regulators agree to abide by the confidentiality provisions applicable to such swap data repository and agree to indemnify the swap data repository for any litigation expenses arising from the provision of any such information. Swap data repositories will also be subject to compliance with certain core principles, including (1) not adopting any rule that would be an unreasonable restraint on trade or impose an anti-competitive burden on trading, clearing, or reporting transactions; (2) establishing transparent governance arrangements that fulfill the public interest and support the aims of the federal government, and (3) establishing conflict of interest rules.

REPORTING OF UNCLEARED SWAPS

Uncleared swaps must be reported to a swap data repository—or to the CFTC or SEC if a swap data repository is unavailable.⁷³ For swaps entered into on or after the date of enactment, this reporting is to be done within a period of time after entering into the swap that the CFTC or SEC is to prescribe by rule or regulation. Pre-enactment swaps also must be reported to a swap data repository or to the CFTC or SEC if a swap data repository is unavailable. Uncleared swaps are to be reported by the swap dealer or MSP, as applicable, if the transaction involves only one swap dealer or MSP; or, if the transaction involves both a swap dealer and an MSP, the swap dealer must report the swap. In all other swaps, the counterparties must choose a reporting party.

If a swap is not cleared or accepted by a swap data repository, each counterparty must maintain books and records available to regulators on the swaps and, if requested in writing by the CFTC or SEC, provide reports as required. The reports will be open for inspection by the CFTC or SEC, the appropriate prudential regulator, and the Financial

⁷² See CEA § 1a(48) (defining term).

⁷³ See CEA § 4r.

PUBLIC REPORTING OF SWAP TRANSACTION DATA

The Act requires the CFTC or SEC, as applicable, to promulgate rules and regulations for “real-time public reporting” of swap transaction and pricing data in such form and such times as the regulatory agencies determine appropriate to enhance price discovery.⁷⁵ Real-time public reporting applies to swaps that are subject to the mandatory clearing requirement— including those that are exempted from the requirement pursuant to the end-user exemption—as well as swaps that are not subject to the mandatory clearing requirement but are cleared by a registered DCO or clearing agency. With respect to pre-enactment swaps (and post-enactment swaps entered into prior to the effective date of the clearing requirement) that are not cleared at a registered DCO or clearing agency, and are reported to a swap data repository or to the CFTC or SEC, the applicable regulator will require real-time public reporting of such transactions in a manner that does not disclose the business transactions and market positions of any person.

The CFTC or SEC is required to include provisions to ensure that participants are not identified and to specify criteria for determining what constitutes a large notional swap transaction (block trade) for particular markets in order to institute appropriate time delays of the reporting of such transactions. In promulgating these rules and regulations, the SEC or CFTC is required to take into account whether public disclosure would materially reduce market liquidity.

The CFTC or SEC may require registered entities to publicly disseminate the swap transaction and pricing data information required pursuant to this provision, and are to issue semiannual and annual reports on the trading and clearing of major swap categories and the market participants and development of new products.

THE LYNCH AMENDMENT – CLEARINGHOUSE OWNERSHIP

The final legislation did not adopt the House-proposed “Lynch Amendment,” which would have incorporated ownership restrictions on clearinghouses. However, the

⁷⁴ The Dodd-Frank Act establishes an interagency council (the “Oversight Council”) to identify and monitor systemic risks posed by financial firms and financial activities and practices. The Oversight Council comprises 10 voting members, who are the heads of the federal financial regulatory agencies, the new Bureau of Consumer Financial Protection, and an independent member with insurance expertise; and five nonvoting members, who are the heads of the new Office of Financial Research and the new Federal Insurance Office, a state insurance commissioner, a state banking supervisor, and a state securities commissioner. The Oversight Council is chaired by the Secretary of Treasury. Among other things, the Act grants the Oversight Council the authority to seek to mitigate systemic risks in the financial system, including: (1) to make recommendations to the Federal Reserve to issue rules for capital requirements, leverage limits, liquidity requirements, risk management and other requirements as companies grow in size and complexity to prevent companies from becoming “too big to fail”; (2) to identify and monitor emerging risks to the economy through the Office of Financial Research and make periodic reports and testimony to Congress; (3) to approve by a two-thirds vote a Federal Reserve decision to divest some of a financial company’s holdings “as a last resort” if the company poses a grave threat to the financial stability of the United States; (4) to authorize by a two-thirds vote a requirement that unregulated nonbank financial companies that pose systemic risk to the financial stability of the U.S. to be regulated by the Federal Reserve; (5) to ensure that the Federal Reserve establishes a floor for capital holdings that cannot be lowered below the standards in effect today; and (6) to identify systemically important nonbank financial companies to be regulated by the Federal Reserve.

⁷⁵ See CEA § 2. “Real-time public reporting” is the reporting of data relating to a swap transaction, including price and volume, as soon as technologically practicable after execution for swaps. *Id.*

Act requires the CFTC to adopt rules within 180 days from July 21, 2010, that limit (by means of numerical limits or voting rights) control of a clearinghouse, SEF, or board of trade by a bank holding company with total consolidated assets of \$50 million or its affiliates, a systemically significant nonbank financial company or its affiliates, a swap dealer, major swap participant, or associated person of a swap dealer or major swap participant. The CFTC must only adopt rules if it determines that such rules are necessary or appropriate to improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest. In making that determination, the CFTC is directed to consider conflicts of interest arising from the amount of equity owned by a single investor, the ability to control the vote entitled to be cast by the holders of the ownership interest, and the existing governance arrangements.

THE VOLCKER RULE

Proprietary Trading Ban on Banking Entities. The so-called “Volcker Rule”—named after its chief proponent, former Federal Reserve Chairman Paul Volcker—prohibits a banking entity and its affiliates from engaging in “proprietary trading,” acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund, and sponsoring a hedge fund or a private equity fund.⁷⁶

Key Definitions. The term “banking entity” means any insured depository institution (as defined in Section 3 of the Federal Deposit Insurance Act⁷⁷), any company that controls an insured depository institution or that is treated as a bank holding company for purposes of Section 8 of the International Banking Act,⁷⁸ and any affiliate or subsidiary of any such entity.⁷⁹

The term “proprietary trading” means engaging as a principal for the trading account of the banking entity in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate federal banking agencies, the SEC and the CFTC may, by rule, determine.⁸⁰

The term “trading account” means any account used for acquiring or taking positions in securities or instruments principally for the purpose of selling in the near term (or otherwise with intent to resell in order to profit from short-term price movements) and such other accounts as the appropriate federal banking agencies, the SEC, and the CFTC may determine.⁸¹

Exclusions from Ban. Under the Act, the following activities are excluded from the general ban on proprietary trading:

- The purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof; obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal

⁷⁶ See CEA § 4d.

⁷⁷ 12 U.S.C. § 1811 et seq.

⁷⁸ P.L. 95-369; 92 Stat. 614

⁷⁹ See 12 U.S.C. § 1851(f)(3).

⁸⁰ See 12 U.S.C. § 1851(h)(4).

⁸¹ See 12 U.S.C. § 1851(h)(6).

Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution; and obligations of any state or any political subdivision thereof;

- The purchase, sale, acquisition, or disposition of securities and other instruments in connection with underwriting or market-making-related activities to the extent such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties;
- Risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts, or other holdings;
- The purchase, sale, acquisition, or disposition of securities and other instruments on behalf of customers;
- Investments in small business investment companies, investments designed primarily to promote public welfare, and investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure;
- The purchase, sale, acquisition, or disposition of securities and other instruments by a regulated insurance company directly engaged in the business of insurance for the general account of the company and by any affiliate of such regulated insurance company;
- Proprietary trading conducted by a banking entity pursuant to Bank Holding Company Act Section 4(c) (9) or (13), provided that (1) the trading occurs solely outside the U.S. and (2) the banking entity is not directly or indirectly controlled by a banking entity organized under the laws of the United States or one or more states;
- Such other activity as the appropriate federal banking agencies, SEC, and CFTC determine, by rule, would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

Before assuming an activity is excluded from the Volker Rule ban, however, bear in mind that, notwithstanding the foregoing list, no transaction, class of transactions, or activity may be deemed a permitted activity if the transaction, class of transactions, or activity would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties;
- Result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;
- Pose a threat to the safety and soundness of such banking entity; or
- Pose a threat to the financial stability of the United States.

The appropriate federal banking agencies, the SEC and the CFTC are required to issue regulations implementing these limitations. Moreover, the Oversight Council is required to conduct a study and make recommendations concerning the implementation of these provisions. No later than nine months after the completion of this study, the appropriate federal banking agencies, SEC, and CFTC are to consider its findings and adopt rules to carry out these provisions.

THE "PUSH OUT" RULE

The Act provides that no federal assistance may be provided to any swap dealer,

MSP (other than any MSP that is an insured depository institution), SEF, or derivatives clearing organization.⁸²

The prohibition does not apply to an FDIC-insured depository institution that limits its swap activities to hedging and other risk management activities related to its own activities or acting as a swap dealer in transactions involving rates or reference assets that a national bank is allowed to invest. However, depository institutions are prohibited from acting as swap dealers for credit default swaps (CDSs) unless such swaps are cleared by a clearing organization. This effectively permits banks to act as dealers with respect to interest rate swaps, currency swaps, and certain CDSs. The term “federal assistance” is defined to include advances from the Federal Reserve and the use of FDIC funds for the purposes of purchasing debt, assets or equity, guaranteeing any debt, or entering into any other arrangements.⁸³

FOREIGN BOARDS OF TRADE

The CFTC may require any foreign board of trade (FBOT) to register with the CFTC if it provides its U.S. members with direct access to the electronic trading system of the foreign board of trade.⁸⁴ To determine whether to permit or exempt registration, the CFTC is required to consider whether the FBOT is subject to comparable regulation in its home jurisdiction and the CFTC’s previous decisions with respect to the FBOT.

Absent specified conditions, the Act prohibits direct market access by members or market participants located in the U.S. to any contract traded on an FBOT that settles to the price of one or more contracts traded on a U.S. exchange or cleared on a U.S. clearing house.⁸⁵ Under the conditions that apply to these linked contracts, the FBOT must:

- Make public daily trading information with respect to such linked contracts that is required to be made public by the U.S. market;
- Adopt speculative positions limits comparable to those that apply to the linked U.S. contract;
- Have authority to require direct market participants to limit, reduce, or liquidate a position that the FBOT or its regulator determines to be necessary to prevent or reduce the threat of price manipulation, excessive speculation, price distortion, or disruption of delivery or the cash settlement process;
- Agree to promptly notify the CFTC of any change to the information it makes available to the public with respect to the linked contracts or to speculative positions limits;
- Provide the CFTC with information on large traders in the linked contract comparable to the large trader reports filed with respect to positions in the U.S. market, including information that can be included in the CFTC’s aggregation of market information—i.e., the CFTC’s “Commitment of Traders” reports.⁸⁶

As long as a U.S. intermediary has reason to believe that a contract has been

⁸² See Dodd-Frank Act § 716 (n.b., this provision is *not* in the CEA and does not appear, after a fairly diligent search, to be

included in any other federal statute; it is strictly a “creature” of the Dodd-Frank Act).

⁸³ *Id.*

⁸⁴ See CEA § 4(b)(1)(A).

⁸⁵ See CEA § 4(b)(1)(B).

⁸⁶ *Id.*

entered into on, or subject to the rules of, an FBOT that has complied with the requirements of the Act, the intermediary will not be liable for a violation of the CEA's prohibition on trading off-exchange futures contracts.⁸⁷

Finally, the Act also provides that contracts traded on an FBOT shall not be void or voidable by the parties executing such contracts based on the failure of the FBOT to comply with these provisions.⁸⁸

POSITION LIMITS AND LARGE TRADER REPORTING

The CFTC is authorized to impose aggregate position limits across markets in order to (1) diminish, eliminate, or prevent excessive speculation; (2) deter and prevent market manipulation, squeezes, and corners; (3) ensure sufficient market liquidity for bona fide hedgers; and (4) ensure that the price discovery function of the underlying market is not disrupted.⁸⁹

Notably, in establishing the position limit provisions, the Act amends the CEA to provide that the CFTC:

strive to ensure that trading on foreign boards of trade in the same commodity will be subject to comparable limits and that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading on the foreign boards of trade."⁹⁰

CFTC-Set Limits. The Act requires the CFTC to impose aggregate position limits on non-securities-based swaps contracts traded on exchanges, SEFs, foreign boards of trade, and swaps that are not traded on an exchange or SEF, but which perform a significant discovery function, provided that bona fide hedges in physical commodities are excluded.⁹¹ In determining whether a swap performs a "significant discovery function," the CFTC is to consider price linkage, arbitrage, material price reference, and material liquidity. The CFTC has the authority to exempt any market participant or any type or class of swap from position limit requirements.⁹² The provisions regarding position limits with respect to commodities will be effective as of the date of the enactment of the Act, except with respect to excluded commodities and agricultural commodities.

SEC-Set Limits. The Act requires the SEC to impose limits on the size of positions in any security-based swap held by any person. The SEC may require a person or entity to aggregate his or its position in any security-based swap and any security, loan, or group of securities on which such security-based swap is based, or any security-based swap and any security (or securities) a term of which is the basis for a material term of such security-based swap. The SEC may exempt any person, swap, or transaction from position-limit requirements, and also may require self-regulating organizations to set aggregate position limits with respect to their members.

Large Traders. Any position in a swap that had a significant price discovery

⁸⁷ See CEA § 4(e).

⁸⁸ See CEA § 2 2(a)(6).

⁸⁹ See CEA § 4a(a).

⁹⁰ CEA § 4a(2)(C).

⁹¹ CEA § 4a(2).

⁹² CEA § 4a(4).

function and which exceeds a size specified by the SEC or the CFTC, as applicable, may not be entered into unless reported to the CFTC or SEC, as applicable.

SEGREGATION OF SWAP COLLATERAL; BANKRUPTCY TREATMENT

Cleared Swaps. Any person that holds margin for DCO-cleared swaps for customers is required to register with the CFTC as an FCM.⁹³ Any person that holds margin for clearing agency-cleared swaps for customers must be registered with the SEC as a broker-dealer or security-based swap dealer. The FCM (with respect to a swap) or the broker-dealer or security-based swap dealer (with respect to a security-based swap) must segregate property held as margin. The use and investment of segregated funds will be subject to such rules as the CFTC or SEC, as applicable, may promulgate.

A swap cleared through a DCO will be treated as a “commodity contract” for purposes of the U.S. Bankruptcy Code with respect to funds and property of a swap customer received by an FCM or a DCO (i.e., posted margin).

Margin posted by counterparties to “security-based swaps” will be held in a “securities account” by a broker, dealer, or security-based swap dealer registered with the SEC. These accounts would be subject to the liquidation procedures applicable to broker-dealers in the event of insolvency.

Uncleared Swaps. Uncleared swaps are not subject to the statutory requirements discussed above. However, with respect to uncleared swaps entered into with a swap dealer or a MSP, the swap dealer or MSP must notify the counterparty at the transaction’s commencement that the counterparty is entitled to require the segregation of funds or other property posted as initial margin. If the counterparty so elects, then the swap dealer or MSP must, in accordance with such rules and regulations as the CFTC or SEC may promulgate, maintain any initial margin posted by its counterparty in a segregated account separate from the assets and other interests of the swap dealer or MSP. If margin is not segregated, the swap dealer or MSP must report to the counterparty on a quarterly basis that the back-office procedures of the swap dealer or MSP relating to margin and collateral requirements are in compliance with the agreement of the counterparties. This option of the counterparty does not apply to variation margin.

LEGAL CERTAINTY FOR SWAPS

In an effort to remove doubt as to the legality or enforceability of contracts newly subject to regulation that may not meet certain requirements, including clearing requirements, under the CEA, the Act contains an amendment to CEA Section 22(a), entitled “Legal Certainty for Swaps.”⁹⁴ This clause seems to be directed at the standard “illegality” termination provision set forth in ISDA master agreements. Absent such a legal certainty provision, other Act provisions arguably could have provided a basis for terminating an ISDA-governed swap agreement. Ironically, the provision could create significant hardship to certain parties that would want to rely upon the “illegality” termination provision in ISDA agreements because they do not desire or cannot satisfy the Act’s many requirements, including potentially large capital requirements.

⁹³ See CEA § 4d.

⁹⁴ See CEA § 22(a).

SECURITIES LAW AMENDMENTS

Application of Securities Laws to Security-Based Swaps. Since the passage of the CFMA, the anti-fraud and anti-manipulation provisions of the Securities Act and the Exchange Act, as well as the insider-trading provisions of the Exchange Act, have applied to “security-based swaps” (as defined in GLBA Section 206B). However, the GLBA prohibited the SEC from otherwise regulating security-based swaps. Now, Dodd-Frank Act Section 762 repeals those GLBA and CFMA provisions that prohibited the SEC from regulating security-based swaps, and also significantly expands the regulation of security-based swaps under the Securities Act and the Exchange Act.

The definition of “security” has been amended, for purposes of the Exchange Act, to include “security-based swaps.”⁹⁵ In addition to the clearing and reporting requirements with respect to security-based swaps, the Act also effects numerous other amendments to the Exchange Act including:

- Subjecting security-based swaps to the prohibition on the manipulation of security prices under Exchange Act Section 9;⁹⁶ and
- Adding a new Section 10B to the Exchange Act, which authorizes the SEC to set limits on the size of positions in any security-based swap that may be held by any person.

Beneficial Ownership/Corporate Insider Rules. Additionally, the Act expands Exchange Act Sections 13 (which requires reporting of ownership of listed shares in excess of certain levels) and 16 (which sets requirements for transactions by corporate insiders). Prospectively, security-based swaps will be covered by these sections if the SEC, after consultation with prudential regulators and the Treasury Department, rules that the purchase of a security-based swap (or a type of security-based swap) confers beneficial ownership of the underlying security on the purchaser.⁹⁷

EXPANDED LIABILITIES FOR SWAP DEALERS

Business Conduct Standards. Act Sections 731 and 764 amend the CEA to subject swap dealers and security-based swap dealers to a comprehensive set of business conduct standards. These standards require swap dealers to:

- Verify the eligibility of swap transaction counterparties;
- Communicate based on the principles of “fair dealing and good faith”; and
- Disclose certain material information (including conflicts of interest).

The Act also imposes a fiduciary duty on swap dealers in their dealings with “special entities”—e.g., governmental entities and pension plans, endowments, and employee benefit plans as defined under Section 3 of ERISA.

When swap dealers act as advisers, there are additional new conduct

⁹⁵ See 15 U.S.C. § 78c(a).

⁹⁶ See 15 U.S.C. § 78a et seq.

⁹⁷ See 15 U.S.C. § 78m.

requirements. The Act expressly makes unlawful (1) the use of any “device, scheme, or artifice to defraud any Special Entity”; (2) the performance of “any transaction, practice, or course of business that operates as a fraud or deceit on any Special Entity”; and (3) “any act, practice, or course of business that is fraudulent, deceptive, or manipulative.”

Limited Private Rights of Action. There is no private right of action against swap dealers for breaches of new duties. Section 741 limits the power to enforce the substantive provisions of Subtitle A of Title VII (including the provisions creating business conduct standards and fiduciary duties) to the CFTC, and, in certain cases, a “prudential regulator” assigned to cover the specific swap dealer at issue.

However, there is a private right of action for market manipulation. Act Section 753 extends the private cause of action in CEA Section 22(a)(1) to claims for market manipulation in swap transactions. This liability provision also extends to aiders and abettors.

ABUSIVE SWAPS AND FOREIGN ENTITIES

The Act provides that the CFTC or SEC may, by rule or order, collect information and issue a report on which types of swaps, if any, either agency determines are detrimental to the financial stability of financial markets or financial market participants.⁹⁸ The intended purpose of such a report may be to regulate or ban any type of swap that the CFTC or SEC determines to be excessively risky or likely to create systemic risk concerns. Further, if either agency determines that the manner of regulation of swaps or swap markets in a foreign country undermines the stability of the U.S. financial system, the agency, in consultation with the Secretary of the Treasury, may prohibit an entity domiciled in the foreign country from participating in any swap activities in the U.S.

REVISIONS TO EXISTING CEA AND SECURITIES EXCHANGE ACT DEFINITIONS OF CERTAIN MARKET PARTICIPANTS

The CEA definitions for “futures commission merchant,” “introducing broker,” “commodity pool operator” and “commodity trading advisor” have been expanded to cover the same types of activities with respect to swaps that they perform with respect to futures, and also to cover any person that registers in that capacity.

The Act raises the standard for certain categories of ECPs as defined in the CEA, which term is relevant to the business conduct and exchange trading requirements described below, by requiring that:

- Government entities, political subdivisions, multinational or supranational government entities, and any instrumentality, agency, or department thereof must own or invest at least \$50 million on a discretionary basis in order to qualify as an ECP; and
- Individuals must invest at least \$10 million on a discretionary basis in order to qualify as an ECP, or at least \$5 million if the contract is entered into to manage a risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual.

⁹⁸ See, e.g., CEA § 1b.

The Exchange Act definition of “dealer” has also been revised, and now to excludes acting as a dealer for security-based swaps. This activity is now covered by the new definition for security-based swap dealer. (Note: There is no change to the Exchange Act definition of broker.)

RESTRICTIONS ON RETAIL MARKETS

Prohibition on Retail OTC Swaps. Any person that is not an ECP is prohibited from entering into a swap unless such swap trades on an exchange (but not an SEF). Notwithstanding the exemptions provided in Sections 3 and 4 of the Securities Act, the Dodd-Frank Act also prohibits the offer or sale of a security-based swap that is not registered with the SEC to a person who is not an ECP. An ECP currently includes an entity or an individual with over \$10 million in assets and an individual with over \$5 million in assets who enters into a swap for the purposes of risk management, and the Act provides regulatory authority to the CFTC and SEC to further define ECPs. The Act, however, revises the definition of ECP to:

- Increase the discretionary investment standard for a governmental entity to qualify from \$25 million to \$50 million; and
- Change the standard for an individual to qualify from a total assets test of \$10 million, or \$5 million if hedging, to a discretionary investment test at those levels.

Prohibition on Retail OTC Commodity Transactions. Act Section 742(a) prohibits any person from entering into, or offering to enter into, a transaction in any commodity with a person that is not an ECP or an eligible commercial entity, on a leveraged or margined basis. This provision essentially takes the narrow “Zelener fix” in the Farm bill,⁹⁹ which was targeted solely at retail forex transactions, and expands it to include virtually all retail cash markets products that involve leverage or margin.

The prohibition does not apply, among other things, if the transaction results in actual delivery within 28 days, or creates an enforceable obligation to deliver between a seller and a buyer that have the ability to deliver, and accept delivery of, the commodity in connection with their lines of business.

RETAIL FOREX TRANSACTIONS

Retail forex refers to OTC trading of foreign currency futures or of leveraged spot foreign currency transactions (including so-called “rolling spot” contracts) with persons that are classified as retail traders because they are not ECPs. The CEA requires that the counterparty to a retail customer on forex transactions must be covered by one of several enumerated categories of permissible counterparty. In 2008, the CFTC was given authority to adopt rules governing the retail forex activities of those counterparties subject to its regulation and certain other persons offering retail forex services. The Dodd-Frank Act amends certain parts of these provisions, as noted below.

Fewer Eligible Counterparties. The Act narrows the list of firms that are

⁹⁹ The Seventh Circuit held in *CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004), that certain OTC foreign currency contracts did not fall under the CFTC’s jurisdiction because they were “rolling spot” sales and not futures contracts.

permitted to be a counterparty to a retail customer on forex transactions. Non-U.S. financial institutions,¹⁰⁰ insurance companies and their regulated affiliates and subsidiaries, and investment bank holding companies have been removed from the list. Eligible counterparties now include:

- U.S. financial institutions;
- Broker-dealers registered with the SEC and material affiliates of such broker-dealers;
- Registered FCMs that are primarily engaged in traditional FCM activities and material affiliates of such FCMs;
- Financial holding companies (as defined in the Bank Holding Company Act); and
- Firms that register with the CFTC (pending adoption of the CFTC's retail forex rules) as retail foreign exchange dealers.

Rulemaking on Retail Forex Transactions and Potential Ban. In January 2010, the CFTC issued proposed rules for the regulation of retail forex transactions.¹⁰¹ In proposing the rules, the CFTC seeks to adopt a "comprehensive regulatory scheme" to implement the CFTC Reauthorization Act of 2008 (the CRA)¹⁰² with respect to off-exchange transactions in foreign currency with members of the retail public (i.e., "retail forex transactions").

In the release, the CFTC has proposed a regime that would establish requirements for, among other things, registration, disclosure, recordkeeping, financial reporting, minimum capital, and other operational standards. Notably—and the guiding theme of the proposal—the CFTC has "endeavored, wherever possible, to apply the principles that have guided it in the Rule of on-exchange instruments."¹⁰³ In other words, retail forex transactions will be subject to significant regulation comparable to that of commodity futures and options. The CFTC must publish a final rule within 90 days of July 21, 2010; if no such rule is published by that time, prohibition of most retail off-exchange foreign currency transactions will take effect.

CFTC ENFORCEMENT

The CFTC's enforcement authority has been significantly expanded. Generally, the CFTC is charged with enforcing the new liability provisions associated with the trading of swaps. First, the Act amends CEA Section 4b—the CEA's primary anti-fraud provision—by adding a fraud liability provision that mirrors Securities Exchange Act Section 10(b). Thus, in the same or similar manner as Section 10(b) and Rule 10b-5 operate with respect to securities transactions, new CEA Section 4b(e) will prohibit fraudulent activity and material misrepresentations in connection with commodity futures contracts and swaps.

Second, the Act expands liability for "manipulation" under the CEA by broadening the scope of manipulative conduct and adding swaps to the proscriptive ambit of the statute. The Act also broadens liability for providing false or misleading information to the CFTC, in that it eliminates the requirement that such information had to be provided

¹⁰⁰ The term "financial institution" is defined in CEA § 1a(21).

¹⁰¹ See 75 Fed. Reg. 3282 (January 20, 2010).

¹⁰² Food, Conservation, and Energy Act of 2008, P.L. 110-246, 122 Stat. 1651, 2189-2204 (2008).

¹⁰³ 75 Fed. Reg. at 3285.

in a registration statement or report filed with the CFTC.

Finally, the Act proscribes various practices, including forms of insider trading, newly defined “disruptive practices,” and fraudulent activity where a swap dealer acts as an advisor.

OTHER PROVISIONS OF INTEREST

Elimination of CFMA Regulatory Exemptions. The exemptions previously added to the CEA via the CFMA for bilateral transactions between ECPs (i.e., CEA Section 2(h)), involving excluded¹⁰⁴ or exempt¹⁰⁵ commodities have been repealed. As a result, the applicability of the CFTC’s Part 35 swaps exemption appears questionable. The Act, however, includes a grandfather provision: Within 60 days after passage of the Act, a person may submit to the CFTC a petition to remain subject to Section 2(h) as in effect on the day before the Act was signed into law, for an additional one-year period.

Extraterritorial Application. The Act specifies certain limitations on the potential extraterritorial scope of its provisions.¹⁰⁶ In particular, the provisions of the CEA relating to swaps (in this context, excluding security-based swaps) added by the Act do not apply to activities outside the U.S. unless those activities “(1) have a direct and significant connection with activities in, or effect on, commerce of the U.S., or (2) contravene such rules or regulations as the CFTC may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision” of the CEA enacted by the Act.¹⁰⁷

Further, the provisions of the Exchange Act added by the Act do not apply to any person “insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States,” unless that person “transacts such business in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate to prevent the evasion of any provision” of the Exchange Act added by the Act.¹⁰⁸

CFTC/FERC Jurisdictional Issues. The Act provides that nothing in the CEA limits or affects any statutory authority of the Federal Energy Regulatory Commission (FERC) with respect to an agreement, contract, or transaction that (1) is not executed, traded, or cleared on a registered entity¹⁰⁹ or trading facility; and (2) is entered into pursuant to a tariff or rate schedule approved by FERC.¹¹⁰

The CFTC and FERC must negotiate a memorandum of understanding to establish

¹⁰⁴ “Excluded commodities” generally refer to financial commodities with a virtually unlimited supply, such as currencies, securities, interest rates, and securities indices. See CEA § 1a(19).

¹⁰⁵ “Exempt commodities” generally refer to commodities that are not excluded commodities or agricultural commodities and include energy and metals. See CEA § 1a(20).

¹⁰⁶ See CEA § 2(a)(1).

¹⁰⁷ See CEA § 2(a)(1).

¹⁰⁸ See 15 U.S.C. § 78dd.

¹⁰⁹ See CEA § 1a(40)(a) (“registered entity” is defined as: (1) a board of trade designated as a contract market under CEA § 5; (2) a derivatives clearing organization registered under CEA § 5b; (3) a board of trade designated as a contract market under CEA § 5f; (4) a swap execution facility registered under CEA § 5h; (5) a swap data repository registered under CEA § 21; and (6) with respect to a contract that the CFTC determines is a significant price discovery contract, any electronic trading facility on which the contract is executed or traded).

¹¹⁰ See CEA § 2.

procedures for:

- Applying their respective authorities in a manner that ensures effective and efficient regulation in the public interest;
- Resolving conflicts concerning overlapping jurisdiction between the two agencies; and
- Avoiding, to the extent possible, conflicting or duplicative regulation.¹¹¹

Nothing in the Act limits or affects any statutory enforcement authority of FERC under the provisions of the Federal Power Act¹¹² and the Natural Gas Act¹¹³ that existed prior to enactment of the Dodd-Frank Act.¹¹⁴

Exemptions From State Gambling and Insurance Laws. Swaps and security-based swaps are exempted from state gaming and bucket-shop laws as well as state insurance laws.¹¹⁵ This provision appears designed to prevent state insurance commissioners from regulating CDSs as insurance. Notably, however, the preemption is not limited merely to CDSs, but applies to all swaps. The Act also exempts security-based swaps from state securities laws (other than general anti-fraud laws).

Ban on Futures and Options Based Upon Movie Box Office Receipts. Futures and options based on “motion picture box office receipts (or any index, measure, value, or data related to such receipts)” are expressly banned.¹¹⁶ This ban was included at the request of a coalition including the Motion Picture Movie Association, and was the subject of intense lobbying efforts. Movie box office revenues thus join onions as the only two products expressly banned in the CEA.

Special Procedures for Event Contracts. The Act provides that, with respect to the listing of agreements, contracts, transactions, or swaps in excluded commodities¹¹⁷ that are based upon the occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or levels of a commodity) by a designated contract market or SEF, the CFTC may determine that such agreements, contracts, or transactions are contrary to the public interest if they involve activity that is unlawful under any federal or state law; terrorism; assassination; war; gaming; or other similar activity determined by the CFTC, by rule or regulation, to be contrary to the public interest.¹¹⁸ If the CFTC makes such a finding, the contract may not be listed for trading or cleared by a registered entity.

Regulation of the Carbon Market. The Act creates an inter-agency working group directed to study oversight of existing and prospective carbon markets to assure efficient, secure and transparent spot and derivatives markets for carbon. The working group is comprised of the Chairman of the CFTC (the group’s chair), the Secretary of Agriculture, the Secretary of the Treasury, the Chairman of the SEC, the Administrator of the EPA, the Chairman of the FERC, and the Administrator of the Energy Information Administration. The working group is required to consult with exchanges,

¹¹¹ See CEA § 2(a).

¹¹² See 16 U.S.C. § 796.

¹¹³ See 15 U.S.C. § 717

¹¹⁴ See CEA § 2(a)(1)(I).

¹¹⁵ See CEA § 2(a)(1) and 15 U.S.C. § 78a et seq.

¹¹⁶ See CEA § 1a(9).

¹¹⁷ See CEA § 1a(19).

¹¹⁸ See CEA § 5c(c)(5)(C).

clearinghouses, self-regulatory organizations, major carbon market participants, consumers, and the general public as appropriate. The agency must submit its report to Congress within 180 days of enactment of the Act, including any recommendations for oversight of carbon markets.

Tax Issues. Act Section 1601 amends Section 1256 of the Internal Revenue Code to provide that “[S]ection 1256 contracts” do not include “any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.” If these swaps had been treated as Section 1256 contracts, they would have been required to be marked-to-market annually, and any gain or loss would have been 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.

International Harmonization. The Act provides that, in order to promote consistent global swap regulation, the SEC, CFTC and Treasury will consult and coordinate with foreign regulators and enter into information sharing agreements with foreign regulators as may be necessary to protect investors and swap counterparties.

Whistleblower Incentives. Strong monetary incentives have been provided to encourage whistleblowers to report securities and commodities law violations to the SEC and CFTC. Whistleblowers who provide the agencies with original information concerning violations of the securities or commodities laws are to be awarded a share of between 10 percent and 30 percent of any monetary sanctions ultimately imposed by the SEC or CFTC, to the extent that such sanctions exceed \$1 million.¹¹⁹ The Act also prohibits employer retaliation against whistleblowers who provide information to the SEC or CFTC, assist in any agency investigation or legal action related to such information, or engage in any other protected activity under the Sarbanes- Oxley Act.¹²⁰ An employee claiming retaliation under Dodd-Frank may bring an action in federal district court.¹²¹

The CFTC whistleblower section further provides that the agency’s rights and remedies “may not be waived by any agreement, policy, form, or condition of employment, including by a predispute arbitration agreement,” and that “[n]o predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section.” As a result, employers will not be able to compel arbitration of CFTC whistleblower claims, nor will they be able to include a release of CFTC whistleblower claims in their general releases or settlement agreements with employees.

Non-Financial Provisions. Alas, the Act is not all about financial provisions. For instance, one of the many studies it commissions is a study of the effect on residential foreclosures of the presence of drywall imported from China; another is a report on mine safety. The Act also devotes several pages conveying the sense of Congress with respect to the exploitation and trade of conflict minerals in the Democratic Republic of the Congo.

General Rulemaking Timeframe. Except as otherwise set forth in the Act, Title VII will become effective 360 days after July 21, 2010, or, to the extent the Act requires rulemaking to implement a particular derivative provision, no less than 60 days after

¹¹⁹ See CEA § 23.

¹²⁰ P.L. 107-204, 116 Stat. 745 (2002).

¹²¹ See CEA § 23(b).

publication of the final rule implementing such provision.

LOOKING FORWARD

There is little doubt that the Dodd-Frank Act will have major impacts on swaps trading in the U.S. The initial impact has been one of uncertainty. As of the time of this writing, numerous swaps participants are grappling with the notion of whether to continue to trade such products given the significant new burdens and costs. Others, primarily swap dealers, have begun to proceed apace to create the massive infrastructure to trade swaps under the new law. Yet others have simply adopted a “wait-and-see” posture until the CFTC and SEC resolve—or at least make progress with respect to—the plethora of open definitional issues.

Once the regulatory uncertainty abates, the Dodd-Frank Act’s next major impact is likely to center around whether swaps can maintain their economic utility and dynamic nature. By requiring that swaps be cleared, the bilateral, uniquely tailored nature of swaps may succumb to standardization—which is essentially required if the products are to be cleared in a mutualized fashion. Yet standardized swap products may not be much different than extant futures contracts, in which case futures contracts may eventually replace swaps based upon the same underlier (which seems to be objective of some congressional legislators).

As a result, the Dodd-Frank Act is not only about impending regulatory change, but the potential to alter fundamentally the economic structure and uses of swaps. The passage of time, of course, will ultimately determine whether such a governmental intervention is successful, but the input of market participants in shaping the contours of the new law should not be overlooked or conceded. Indeed, while the foundation has been set and the blueprint prepared, the house remains to be built.

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