

KIRKLAND ALERT

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Dodd-Frank on Derivatives: The New World of Swap Regulation

On June 30, 2010, the U.S. House of Representatives passed (237-192) the Dodd-Frank Wall Street Reform and Consumer Protection Act. In mid-July, the U.S. Senate is scheduled to consider, and is likely to approve, this legislation, which President Barack Obama is expected sign into law shortly thereafter.

Title VII of Dodd-Frank (AKA, the Wall Street Transparency and Accountability Act “WSTAA”) concerns derivatives and would subject swaps to market-style federal regulation for the first time. This alert will highlight the contours of Title VII. Our Derivatives Group will publish a more comprehensive analysis once the bill becomes law.

Who Regulates What?

WSTAA defines “swap” broadly and then divides swaps in two. Swaps deriving their value from the fortunes of a single company or a group of nine or fewer companies, including single issuer credit default swaps, will be considered “security-based swaps” (SBS). SBS will be “securities” under the Securities Act of 1933 and the Securities Exchange Act of 1934 and will be regulated by the Securities and Exchange Commission (SEC).

All other swaps — WSTAA lists 22 swap “flavors,” including interest rate, equity, credit default (involving 10 or more companies), foreign currency (unless exempted by the Secretary of the Treasury), energy and commodity — will be regulated by the Commodity Futures Trading Commission (CFTC) under the Commodity Exchange Act (CEA). The CFTC also regulates the futures markets under the CEA. It is no surprise that WSTAA borrows heavily from the futures regulatory model for its approach to swaps.

The SEC and CFTC have roughly parallel regulatory authority over SBS and swaps, respectively. As a result, WSTAA calls for the SEC and CFTC to coordinate their regulatory actions to a greater extent than ever before. In some instances, WSTAA also provides a regulatory role for federal bank regulators. For purposes of simplicity, the balance of this overview will refer to swaps and the CFTC alone, unless noted. Because most of the core WSTAA provisions for SBS and swaps mirror each other, the reader should substitute “SBS and SEC” for “swaps and CFTC” whenever they appear.

Swap Regulatory Outline

All swaps are subject to the CFTC’s antifraud, antimanipulation, registration, reporting, and record-keeping authority. Certain details of every swap transaction, including the parties, price and notional amount, must be reported to either the CFTC, or more likely, a CFTC-licensed body. Most standardized swaps will be required to be traded on a CFTC-licensed exchange or execution platform and submitted to a CFTC-licensed clearing entity that will remove the counterparty credit risk from the transaction. Companies that use swaps to hedge “commercial risk” (often referred to as “end users”) will be exempt from these requirements and will therefore have a choice — to exchange-trade and clear their swaps, or not. Customized swaps may be entered into with registered swap dealers subject to special regulatory protections and requirements. Financial integrity provisions of the CEA and CFTC regulations will operate to protect the funds of swap counterparties in a manner similar to the protections available for futures transactions.

New Regulatory Players

WSTAA creates new categories of CFTC registrants with different roles in the swap business and regulatory process.

Swap Dealers — Entities that hold themselves out as dealers, make markets in swaps or enter into swaps as part of their regular business operations. Swap Dealers must be registered with the CFTC and must meet capital, margin and business conduct standards imposed by the CFTC. (If the Swap Dealer is a bank, its federal bank regulator will impose the specified regulation.)

Major Swap Participants (MSPs) — Non-Swap Dealer entities that maintain a “substantial” position in swaps as determined by the CFTC. MSPs face the same regulation as Swap Dealers; they must be registered with the CFTC and must meet capital, margin and business conduct standards imposed by the CFTC. End users that use swaps to hedge, as well as pension plans, are exempted from MSP regulation.

Swap Data Repositories (SDRs) — Entities that provide a centralized recordkeeping facility for swaps, including their terms and conditions. SDRs must be registered with the CFTC and must comply with data collection and management standards adopted by the CFTC. SDRs must maintain the confidentiality of the data collected.

Swap Execution Facilities (SEFs) — Facilities for trading or processing swaps that must be registered with the CFTC. SEFs are alternatives to traditional exchanges and may only be used by CEA-defined “Eligible Contract Participants.” SEFs must comply with 15 core regulatory principles subject to CFTC oversight.

Standardized Swaps

Two inter-related mandates apply — clearing and exchange trading.

Clearing. If a swap is accepted for clearing by a CFTC-registered derivatives clearing organization (DCO) and the CFTC approves that DCO to clear that swap, all transactions in that type of swap must be cleared, either on that DCO or on another DCO that accepts the swap for clearing, unless exempted. (The DCO will have to specify the terms and conditions of the “type” of swap it will clear.) An entity is exempt from the clearing mandate (and therefore may choose whether to clear) if it uses swaps to hedge commercial risk, notifies the CFTC how the entity generally meets its financial obligations associated with non-cleared swaps, and is not a defined “financial entity.” Many financing entities of manufacturing companies are not considered financial entities. The CFTC may exempt smaller banks from the financial entity definition.

Exchange-trading. If a swap is subject to the clearing mandate, it must be traded on either a traditional futures exchange or an SEF unless no exchange or SEF lists the swap for trading. Any swap entered into by a party that is exempt from the clearing mandate set forth above is also exempt from the exchange-trading mandate.

Non-Standardized Swaps

WSTAA contemplates that non-standardized, so-called bilateral swaps (and standardized swaps where one party is exempt from the clearing and exchange-trading mandates), will be entered into through Swaps Dealers and MSPs subject to special business conduct and financial integrity requirements. All non-cleared swaps must be reported to an SDR or the CFTC to allow the CFTC to monitor market-wide conditions and trends. The CFTC (or the bank regulators) will impose capital and margin requirements on Swap Dealers and MSPs. According to a House floor colloquy, the CFTC (or the bank regulators) will not be empowered to impose margin requirements on end users of swaps; those end users that currently use non-cash collateral to secure swaps should be able to continue this practice.

Position Limits

The CFTC is authorized to impose speculative position limits on swaps that perform a price discovery function, akin to futures trading. In theory, this position limit authority applies both to cleared and non-cleared swaps. In accordance with existing statutory standards, the CFTC will consider whether to impose position limits on both futures (including certain futures traded on foreign exchanges) and swaps in physical commodities like energy and metals. Hedging positions are exempt from those limits under standards that largely mimic longstanding CFTC regulations.

Effective Date and Implementing Regulations

WSTAA's provisions generally take effect on the later of 360 days after enactment or 60 days after publication of final CFTC regulations implementing the WSTAA provision. Thus, if the CFTC must adopt regulations to implement provisions of WSTAA, the effective date of those provisions will likely be determined by the CFTC's regulatory time table. The CFTC (and the SEC) will have dozens of rulemakings to complete under WSTAA in the next year and beyond.

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