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# NEW RULES UNDER DODD-FRANK LAW TO IMPACT DERIVATIVES TRADING AND MARKET PARTICIPANTS

This Alert is the third in a series of Alerts that examine key aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which was signed into law by President Obama on July 21, 2010. The Act contains numerous provisions which attempt to regulate the over-the-counter derivatives market, both by establishing new requirements and removing exemptions that had been previously codified. This alert summarizes some key points likely to impact your business.

## A. Clearing and Exchange Trading Requirements

- The Act requires central clearing and exchange trading for certain common derivative transactions.

- Regulatory agencies (the Securities and Exchange Commission and Commodity Futures Trading Commission, as applicable) are charged to determine which transactions are subject to these new clearing rules.

- Factors taken into account as to whether a transaction needs to be cleared may include: (1) the existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data; (2) the frameworks, infrastructure and resources available; (3) systemic risk; and (4) the effect on competition.

- If the regulatory agency determines the swap is subject to mandatory clearing, it must be submitted to a registered (or otherwise exempt from registration) derivatives clearing organization.

- Typical "end-users" – i.e., entities which engage in swap transactions as an ancillary part of their business, not entities whose business is dealing in derivatives – are exempt from the clearing requirements if they meet the following criteria: (1) they are not a financial entity; (2) they are using the swap to hedge or mitigate commercial risks; and (3) they provide notice to the relevant regulatory agency as to how they meet the financial obligations associated with non-cleared OTC swaps.

- Swaps entered into prior to the Act's effective date must be reported to a registered swap data repository within 180 days of enactment. Swaps initiated after enactment must be reported within 90 days or as otherwise specified by the regulatory agencies.

B. Reporting Requirements

- The Act requires real-time reporting information related to OTC transactions. All swaps (cleared or uncleared) must be reported to a registered swap data repository. The Act defines real-time to be as soon as technologically practicable, and data reported must include information relating the price and volume.

- For specified transactions, the information disclosed shall not identify the participants' identities, may be delayed for block trades and must take into consideration whether public disclosure will materially reduce market liquidity. Furthermore, swaps entered into prior to the effectiveness of the Act are to be reported in a manner that does not disclose business transactions and market positions of any entity.

C. Margin Requirements

- The Act requires "swap dealers" and "major swap participants" to segregate initial margin with an independent third-party custodian at the request of a counterparty.

- Moreover, each swap dealer and major swap participant will be required to meet certain minimum capital requirements as well as minimum initial and variation margin requirements, to be determined by the regulatory agencies.

- After much confusion and media attention, it appears that end-users will remain exempt from margin requirements in most circumstances.

D. "Push-out" Rule

- The Act prohibits federal assistance to swaps entities. Federal assistance is defined to include advances from the Federal Reserve credit facility or discount window as well as FDIC insurance.

- Consequently, this prohibition effectively requires subject entities to "spin-off" or "push-out" their riskiest derivatives trading operations into subsidiaries or affiliates.

- The compromises reached on this controversial section of the Act include an exemption for risk-mitigating activities, including bona-fide hedging.

- Entities subject to this requirement will have two years to achieve compliance, by either spinning off their swaps entities into separate affiliates or ceasing OTC derivative trading activities.

E. "Volcker" Rule

- The Act has also adopted the controversial "Volcker Rule," which prohibits insured depository institutions from participating in proprietary trading or investing in hedge funds or private equity funds, subject to a range of exceptions.

- For example, financial institutions required to comply with this rule are still permitted to: (1) make *de minimus* investments limited to 3% or less of their tier 1 capital; (2) invest in small investment companies; (3)

engage in risk-mitigating hedging activities designed to reduce the bank's specific risks related to individual or aggregated positions, contracts or other holdings; and (4) make purchases and sales of securities and other instruments on behalf of customers.

F. Expansion of Fiduciary Duties

- The Act establishes a heightened standard of conduct for all registered swap dealers and major swap participants when advising a swap entity.

- All swap dealers must verify that their counterparty meets certain eligibility standards and disclose to the counterparty any information about material risks, characteristics or conflicts of interest in connection with the transaction.

- When swap dealers are acting as counterparties to any federal, state, or municipal entity or to any pension or endowment fund, they are required to have a reasonable basis to believe that the counterparty has an independent representative acting in their best interests.

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