



The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title VII, Derivatives

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Summary

The financial crisis implicated the unregulated over-the-counter (OTC) derivatives market as a major source of systemic risk. A number of firms used derivatives to construct highly leveraged speculative positions, which generated enormous losses that threatened to bankrupt not only the firms themselves but also their creditors and trading partners. Hundreds of billions of dollars in government credit were needed to prevent such losses from cascading throughout the system. AIG was the best known example, but by no means the only one.

Equally troublesome was the fact that the OTC market depended on the financial stability of a dozen or so major dealers. Failure of a dealer would have resulted in the nullification of trillions of dollars worth of contracts and would have exposed derivatives counterparties to sudden risk and loss, exacerbating the cycle of deleveraging and withholding of credit that characterized the crisis. During the crisis, all the major dealers came under stress, and even though derivatives dealing was not generally the direct source of financial weakness, a collapse of the \$600 trillion OTC derivatives market was imminent absent federal intervention. The first group of Troubled Asset Relief Program (TARP) recipients included nearly all the large derivatives dealers.

The Dodd-Frank Act (P.L. 111-203) sought to remake the OTC market in the image of the regulated futures exchanges. Crucial reforms include a requirement that swap contracts be cleared through a central counterparty regulated by one or more federal agencies. Clearing houses require traders to put down cash (called initial margin) at the time they open a contract to cover potential losses, and require subsequent deposits (called maintenance margin) to cover actual losses to the position. The intended effect of margin requirements is to eliminate the possibility that any firm can build up an uncapitalized exposure so large that default would have systemic consequences (again, the AIG situation). The size of a cleared position is limited by the firm's ability to post capital to cover its losses. That capital protects its trading partners and the system as a whole.

Swap dealers and major swap participants—firms with substantial derivatives positions—will be subject to margin and capital requirements above and beyond what the clearing houses mandate. Swaps that are cleared will also be subject to trading on an exchange, or an exchange-like “swap execution facility,” regulated by either the Commodity Futures Trading Commission (CFTC) or the Securities and Exchange Commission (SEC), in the case of security-based swaps. All trades will be reported to data repositories, so that regulators will have complete information about all derivatives positions. Data on swap prices and trading volumes will be made public.

The new law provides exceptions to the clearing and trading requirements for commercial end-users, or firms that use derivatives to hedge the risks of their nonfinancial business operations. Regulators may also provide exemptions for smaller financial institutions. Even trades that are exempt from the clearing and exchange-trading requirements, however, will have to be reported to data repositories or directly to regulators.

This report describes some of the new requirements placed on the derivatives market by the Dodd-Frank Act. It will not be updated.

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Introduction

Prior to the financial crisis that began in 2007, over-the-counter (OTC) derivatives were generally regarded as a beneficial financial innovation that distributed financial risk more efficiently and made the financial system more stable, resilient, and resistant to shocks. The crisis essentially reversed this view. The Dodd-Frank Act (P.L. 111-203) attempts to address the aspect of the OTC market that appeared most troublesome in the crisis: the market permitted enormous exposure to risk to grow out of the sight of regulators and other traders. Derivatives exposures that could not be readily quantified exacerbated panic and uncertainty about the true financial condition of other market participants, contributing to the freezing of credit markets. Under Dodd-Frank, risk exposures of major financial institutions must be backed by capital, minimizing the shock to the financial system should such a firm fail. In addition, regulators will have information about the size and distribution of possible losses during periods of market volatility.

Background

Derivative contracts are an array of financial instruments with one feature in common: their value is linked to changes in some underlying variable, such as the price of a physical commodity, a stock index, or an interest rate. Derivatives contracts—futures contracts, options, and swaps¹—gain or lose value as the underlying rates or prices change, even though the holder may not actually own the underlying asset.

Thousands of firms use derivatives to manage risk. For example, a firm can protect itself against increases in the price of a commodity that it uses in production by entering into a derivative contract that will gain value if the price of the commodity rises. A notable instance of this type of hedging strategy was Southwest Airlines' derivatives position that allowed it to buy jet fuel at a low fixed price in 2008 when energy prices reached record highs. When used to hedge risk, derivatives can protect businesses (and sometimes their customers as well) from unfavorable price shocks.

Others use derivatives to seek profits by betting on which way prices will move. Such speculators provide liquidity to the market—they assume the risks that hedgers wish to avoid. The combined trading activity of hedgers and speculators provides another public benefit: price discovery. By incorporating all known information and expectations about future prices, derivatives markets generate prices that often serve as a reference point for transactions in the underlying cash markets.

Although derivatives trading had its origins in agriculture, today most derivatives are linked to financial variables, such as interest rates, foreign exchange, stock prices and indices, and the creditworthiness of issuers of bonds. The market is measured in the hundreds of trillions of dollars, and billions of contracts are traded annually.

Derivatives have also played a part in the development of complex financial instruments, such as bonds backed by pools of other assets. They can be used to create “synthetic” securities—

¹ For a description of the mechanics of these contracts, see CRS Report R40646, *Derivatives Regulation in the 111th Congress*, by Mark Jickling and Rena S. Miller.

contracts structured to replicate the returns on individual securities or portfolios of stocks, bonds, or other derivatives. Although the basic concepts of derivative finance are neither new nor particularly difficult, much of the most sophisticated financial engineering of the past few decades has involved the construction of increasingly complex mathematical models of how markets move and how different financial variables interact. Derivatives trading is often a primary path through which such research reaches the marketplace.

Since 2000, growth in derivatives markets has been explosive (although the financial crisis has caused some retrenchment since 2008). Between 2000 and the end of 2008, the volume of derivatives contracts traded on exchanges,² such as futures exchanges, and the notional value of total contracts traded in the over-the-counter (OTC) market³ grew by 475% and 522%, respectively. By contrast, during the credit and housing booms that occurred over the same period, the value of corporate bonds and home mortgage debt outstanding grew by only 95% and 115%, respectively.⁴

Pre-Dodd-Frank Act Market Structure and Regulation

The various types of derivatives are used for the same purposes—avoiding business risk, or hedging, and taking on risk in search of speculative profits. Prior to the Dodd-Frank Act, however, the instruments were traded on different types of markets. Futures contracts are traded on exchanges regulated by the Commodity Futures Trading Commission (CFTC); stock options on exchanges under the Securities and Exchange Commission (SEC); and all swaps (and security-based swaps, as well as some options) traded OTC, and were not regulated by anyone.

Exchanges are centralized markets where all the buying and selling interest comes together. Traders who want to buy (or take a long position) interact with those who want to sell (or go short), and deals are made and prices reported throughout the day. In the OTC market, contracts are made bilaterally, typically between a dealer and an end user, and there was generally no requirement that the price, the terms, or even the existence of the contract be disclosed to a regulator or to the public.

Derivatives can be volatile contracts, and the normal expectation is that there will be big gains and losses among traders. As a result, there is an issue of market integrity. How do the longs know that the shorts will be able to meet their obligations, and vice versa? A market where billions of contracts change hands is impossible if all traders must investigate the creditworthiness of the other trader, or counterparty. The exchange market deals with this credit risk problem in one way, the OTC market in another way. How this risk—often called counterparty risk—must be managed was a key element of the reforms implemented by the Dodd-Frank Act.

² See Bank for International Settlements (BIS), Table 23B, for year 2000 turnover for derivative financial instruments traded on organized exchanges, available at http://www.bis.org/publ/qtrpdf/r_qa0206.pdf. For December 2008 figures for derivatives traded on organized exchanges, see BIS Quarterly Review, September 2009, International Banking and Financial Market Developments, available at http://www.bis.org/publ/qtrpdf/r_qt0909.pdf.

³ See Bank for International Settlements (BIS), Statistical Annex, Table 19, December, 2000 figure for notional amount of total OTC contracts, available at http://www.bis.org/publ/qtrpdf/r_qa0206.pdf. See Bank for International Settlements (BIS), BIS Quarterly Review, September 2009, Statistical Annex, Table 19, for December 2008 figure for notional amount of total OTC contracts, available at http://www.bis.org/publ/qtrpdf/r_qa0909.pdf.

⁴ Federal Reserve, *Flow of Funds Accounts of the United States*, September 17, 2009, accessible at <http://www.federalreserve.gov/releases/z1/Current/z1r-1.pdf>.

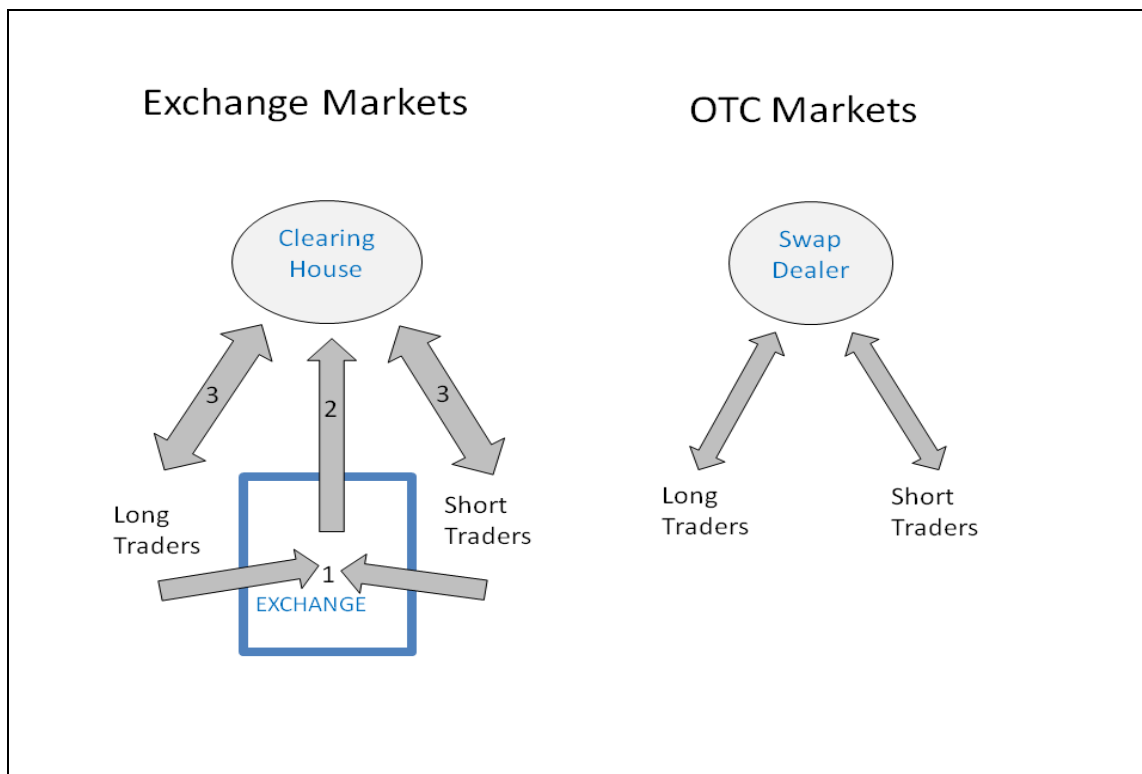
Market Structure for Cleared and Exchange-Traded Derivatives

The exchanges deal with the issue of credit risk with a clearinghouse.⁵ The process is shown in **Figure 1** below: (1) two traders agree on a transaction on the exchange floor or on an electronic platform. (2) Once the trade is made, it goes to the clearinghouse, which guarantees payment to both parties. (3) In effect, the original contract between long and short traders is now two contracts, one between each trader and the clearinghouse. Traders then do not have to worry about counterparty default because the clearinghouse stands behind all trades.

But the credit risk remains: how does the clearinghouse ensure that it can meet its obligations? Clearing depends on a system of margin, or collateral. Before the trade, both the long and short traders have to deposit an initial margin payment with the clearinghouse to cover potential losses. Then at the end of each trading day, all contracts are repriced, or “marked to market,” and all those who have lost money (because prices moved against them) must post additional margin (called variation or maintenance margin) to cover those losses before the next trading session. This is known as a margin call: traders must make good on their losses immediately, or their broker may close out their positions when trading opens the next day. The effect of the margin system is that no one can build up a large paper loss that could damage the clearinghouse in case of default: it is certainly possible to lose large amounts of money trading on the futures exchanges, but only on a “pay as you go” basis.

⁵ Also referred to as a central counterparty or as a derivatives clearing organization (DCO).

**Figure 1. Pre-Dodd-Frank Act Derivatives Market Structures:
Exchange and Over-the-Counter (OTC)**



Source: CRS.

Market Structure for OTC Derivatives

In the OTC market, as shown on the right side of **Figure 1**, the long and short traders do not interact directly. Instead of a centralized marketplace, there is a network of dealers who stand ready to take either long or short positions, and make money on spreads and fees. The dealer absorbs the credit risk of customer default, while the customer faces the risk of dealer default. In this kind of market, one would expect the dealers to be the most solid and creditworthy financial institutions, and in fact the OTC market that emerged was dominated by two or three dozen firms—very large institutions like JP Morgan Chase, Goldman Sachs, Citigroup, and their foreign counterparts. Before 2007, such firms were generally viewed as too well diversified or too well managed to fail; in 2008, their fallibility was well established, and the pertinent question now is whether the government would still consider them to be too big to fail. (Title II of Dodd-Frank seeks to ensure that it will not.⁶)

In the OTC market, some contracts required collateral or margin, but not all. There was no standard practice: all contract terms were negotiable. A trade group, the International Swaps and Derivatives Association (ISDA), published best practice standards for use of collateral, but compliance was voluntary.

⁶ See CRS Report R41350, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Issues and Summary*, coordinated by Baird Webel.

Because there was no universal, mandatory system of margin, large uncollateralized losses could (and did) build up in the OTC market. Perhaps the best known example in the crisis was AIG, which wrote about \$1.8 trillion worth of credit default swaps guaranteeing payment if certain mortgage-backed securities defaulted or experienced other “credit events.”⁷ Many of AIG’s contracts required it to post collateral as the credit quality of the underlying referenced securities (or AIG’s own credit rating) deteriorated, but AIG did not post initial margin, as this was deemed unnecessary because of the firm’s triple-A rating. As the subprime crisis worsened, AIG faced margin calls that it could not meet. To avert bankruptcy, with the risk of global financial chaos, the Federal Reserve and the Treasury put tens of billions of dollars into AIG, the bulk of which went to its derivatives counterparties.⁸

A key reform in Dodd-Frank is a mandate that many OTC swaps be cleared, which means that they will be subject to margin requirements. This will have the effect of combining features of the two market structures shown in **Figure 1**.

The Dodd-Frank Act’s Clearing and Reporting Requirements

In order to provide more stability to the OTC derivatives market, the Dodd-Frank Act requires that most derivatives contracts formerly traded exclusively in the OTC market be cleared and traded on exchanges. Thus, traders in these previously unregulated products will be required to post margin in the fashion described above and have their contracts repriced at the close of each trading day. This system likely will have the effect of regulating trade in these contracts more closely and providing greater transparency to the participants in the market and to the government regulators. Furthermore, the Dodd-Frank Act presumes that some derivatives contracts will still be traded in the OTC market; however, it grants regulators broader powers to obtain information about these derivatives and impose margin and capital requirements on them as well.

Clearing Requirement

Title VII of the Dodd-Frank Act creates largely parallel clearing and exchange trading requirements for swaps and security-based swaps as those terms are defined by Title VII and will be further defined by the CFTC and the SEC. Section 723 creates the clearing and exchange trading requirements for swaps over which the CFTC has jurisdiction.⁹ Section 763 creates largely parallel requirements for security-based swaps over which the SEC has authority.¹⁰

If a swap or security-based swap is required to be cleared, the final version of the Dodd-Frank Act makes it unlawful for parties to enter into swaps or security-based swaps unless the transaction

⁷ The credit events that trigger credit swap payments may include ratings downgrades, debt restructuring, late payment of interest or principal, as well as default.

⁸ For an account of this process, see Office of the Special Inspector General for the Troubled Asset Relief Program (“SIGTARP”), *Factors Affecting Efforts to Limit Payments to AIG Counterparties*, November 17, 2009.

⁹ Section 723 of the Dodd-Frank Act (to be codified at 7 U.S.C. §2).

¹⁰ Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*).

has been submitted for clearing.¹¹ There are two ways in which a swap or security-based swap may become subject to the clearing requirement.¹² In the first way, the agency of jurisdiction is required to engage in an ongoing review of the products it has jurisdiction over to determine whether a particular swap, security-based swap, group, or class of such contracts should be subject to the clearing requirement. In the House-passed version of the clearing requirement, determinations made by the agency in this manner would not have resulted in those transactions becoming subject to the clearing requirement, because in order to be subject to the clearing requirement, the agency had to make its determination pursuant to a submission of the transaction by a derivatives clearing organization or a clearing agency.¹³ The Senate passed version was more similar to the eventual statutory language in that determinations made by the agency of its own initiative regarding transactions required to be cleared may have been subject to the clearing requirement, without having to first be submitted to the agency as a transaction a derivatives clearing organization or clearing agency intended to offer for clearing.¹⁴ Determinations made on the initiative of the commissions will be discussed further in the “Prevention of Evasion” section below.

The second way in which a swap or security-based swap may become subject to the clearing requirement under the Dodd-Frank Act is upon submission to the CFTC or the SEC. When a derivatives clearing organization¹⁵ (swaps) or clearing agency¹⁶ (security-based swaps) decides to accept a swap or security-based swap for clearing, the act requires the organization to submit the transactions to the relevant Commission for a determination as to whether the transactions should be required to be cleared. Furthermore, upon enactment of the Dodd-Frank Act, all swaps and security-based swaps that were listed for clearing by derivatives clearing organizations and clearing agencies at the time of passage were deemed submitted to the SEC and the CFTC for a determination of whether the clearing requirement should apply.

Following submission to the agencies, the agencies have 90 days to determine whether the swaps or security-based swaps are subject to the clearing requirement, unless the submitting organization agrees to an extension. When making that determination, the agencies must consider (1) “the existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data”; (2) “the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms consistent with material terms and trading conventions on which the contract is then traded”; (3) “the effect on the mitigation of systemic risk ...”; (4) “the effect on competition, including appropriate fees and charges ...”; and (5) “the existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organization or 1 or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.”¹⁷ In the process

¹¹ Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(1)) (swaps); Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*)(security-based swaps).

¹² Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(2)) (swaps); Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*)(security-based swaps).

¹³ Sections 3103 and 3203 of H.R. 4173 (as passed by the House).

¹⁴ Sections 723(a) and 763 of H.R. 4173 (as passed by the Senate).

¹⁵ Rules for the registration and regulation of derivatives clearing organizations are enacted by Section 725 of the Dodd-Frank Act (to be codified at 7 U.S.C. §7a-1).

¹⁶ Rules for the registration and regulation of clearing agencies were enacted by Section 763(b) of the Dodd-Frank Act (to be codified at 15 U.S.C. §78a-1).

¹⁷ Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)) (swaps); Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*)(security-based swaps). Similar considerations were mandated by (continued...)

of making these determinations, the agencies are also required to allow the public to comment on whether the clearing requirement should apply.

Should the CFTC or the SEC determine that a particular swap or security-based swap is required to be cleared, counterparties to that type of transaction may apply to stay the clearing requirement until the relevant agency “completes a review of the terms” of the swap or security-based swap and the clearing requirement.¹⁸ Under the act, upon completing the review, the relevant agency may require the swap or security-based swap to be cleared, either unconditionally or subject to appropriate conditions. The relevant agency may also determine that the swap or security-based swap is not required to be cleared.

With certain exceptions, counterparties to swaps and security-based swaps that are required to be cleared must either execute the transactions on exchanges or specialized execution facilities.¹⁹

The Exchange-Trading Requirement

With certain exceptions, swaps and security-based swaps that are required to be cleared must also be executed on a regulated exchange or on a trading platform defined in the act as a swaps execution facility (SEF) or a security-based swaps execution facility (SBSEF). Such facilities must permit multiple market participants to trade by accepting bids or offers made by multiple participants in the facility.

The goal of the trading requirement is “to promote pre-trade price transparency in the swaps market.”²⁰ Because the old OTC market was notably opaque, with complete price information available only to dealers, swaps customers were limited in their ability to shop for the best price or rate. The expectation is that as price information becomes more widely available, competition will produce narrower spreads and better prices.

SEFs and SBSEFs must comply with a number of core principles set out in the act. While these are somewhat less prescriptive than the regulation of exchanges where public customers are allowed to trade,²¹ the new trading facilities have regulatory and administrative responsibilities far beyond what applied to OTC trading desks in the past. Among other things, SEFs and SBSEFs must

- establish and enforce rules to prevent trading abuses and to provide impartial access to the trading facility;
- ensure that swap contracts are not readily susceptible to manipulation;

(...continued)

the Senate passed version of the bill, but those considerations were to be applied to the agencies’ rulemakings to identify other classes of transactions that should be subject to the clearing requirement that had not been submitted to the agency. Section 723(a) of H.R. 4173 (as passed by the Senate).

¹⁸ Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(3)) (swaps); Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*)(security-based swaps).

¹⁹ Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(8)); Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*)(security-based swaps).

²⁰ Section 723 of the Dodd-Frank Act (new section 5h(e) of the Commodity Exchange Act to be codified after 7 U.S.C. §7b-2).

²¹ Only eligible contract participants will be able to trade on SEFs and SBSEFs.

- monitor trading to prevent manipulation, price distortion, and disruptions in the underlying cash market;
- set position limits;
- maintain adequate financial and managerial resources, including safeguards against operational risk;
- maintain an audit trail of all transactions;
- publish timely data on prices and trading volume;
- adopt emergency rules governing liquidation or transfer of trading positions as well as trading halts; and
- employ a chief compliance officer, who will submit an annual report to regulators.

During consideration of Dodd-Frank, a central issue of debate was the extent to which existing OTC derivatives trading platforms and mechanisms could be accommodated under the new regulatory regime. OTC trading practices ranged from individual telephone negotiations to electronic systems accessible to multiple participants. One concern was that if SEFs were too much like exchanges, the existing futures and securities exchanges would monopolize trading. On the other hand, if the SEF definition were too vague or general, the OTC market might remain opaque.

The bill reported by the Senate Banking Committee defined SEF as “an electronic trading system with pre-trade and post-trade transparency.”²² The explicit reference to “pre-trade” transparency does not appear in the final legislation, in part because of concerns that such a requirement was not compatible with the business models of a number of intermediaries, such as interdealer swap brokers providing anonymous execution services.²³

As is the case with the clearing requirement, Dodd-Frank provides exceptions to the exchange-trading mandate. If no exchange or SEF or SBSEF makes a swap available for trading, the contract may be traded OTC. A swap that meets the end-user clearing exemption is likewise exempt from the trading requirement. We now discuss the end-user exemption.

End-User Exemption

Sections 723 and 763 of the Dodd-Frank Act provide exceptions to the clearing requirement for swaps and security-based swaps when one of the counterparties to the transaction is not a financial entity, is using the transaction to hedge or mitigate its own commercial risk; and notifies the relevant agency “how it generally meets its financial obligations associated with entering into non-cleared swaps.”²⁴ This has been widely referred to as the end-user exemption because it applies only to transactions where at least one counterparty is “not a financial entity.”²⁵ A

²² Section 720 of S. 3217, as reported by the Senate Committee on Banking, Housing, and Urban Affairs, Apr. 15, 2010.

²³ Section 720 of the Dodd-Frank Act, P.L. 111-203.

²⁴ Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(7)) (swaps); Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*) (security-based swaps).

²⁵ *Id.*

financial entity for the purposes of this section is defined as a swap dealer, a security-based swap dealer, a major swap participant (MSP), and major security-based swap participant, a commodity pool, a private fund, an employee benefit plan, or a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature.²⁶ Who is and who is not a financial entity is discussed further in the section describing MSPs.

The definition of who is eligible for the exception is more similar here to the House-passed version than to the Senate-passed version. However, one important change was made. The House passed version allowed any parties who were not swap dealers or MSPs, who were using the transaction to hedge commercial risk, and who notified the relevant agency properly to qualify for the exemption.²⁷ The final version narrowed the availability of the exemption to parties who were not financial entities, as defined above, and the definition of financial entities arguably includes more parties than only those who are not dealers or MSPs. Furthermore, the definition of “financial entity” in the act appears to be more narrow than the definition of “financial entity” contained in the Senate-passed version, because the Senate bill’s definition would have included “a person that is registered or required to be registered with the Commission.”²⁸ Moreover, the act allows regulators to exclude depository institutions, farm credit institutions, and credit unions with \$10 billion or less in assets from the definition of “financial entity.” Thus, the final definition of end-users represented by the act appears to fall somewhere between the House and Senate definitions in the number of entities that may qualify.

The application of the clearing exemption provided by Sections 723 and 763 of the Dodd-Frank Act are at the discretion of the counterparty that qualifies for the exemption. Eligible counterparties may elect to clear the transaction, and may choose which derivatives clearing organization or clearing agency shall clear the transaction. Under the act, eligible counterparties may also use an affiliate (“including affiliate entities predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the person”) to engage in swaps or security-based swaps under the condition that the affiliate “act on behalf of the person [qualifying for the exemption] and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity.”²⁹ The CFTC and SEC may also prescribe rules to prevent abuse of this exception to the clearing requirement.

²⁶ The CFTC and SEC must consider whether to exempt small banks, savings associations, farm credit systems institutions, and credit unions from the definition of financial entity in this section. Such a determination could make the end-user exemption available to these entities. Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(7)) (swaps); Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*) (security-based swaps). (page 822 and 1060).

²⁷ Sections 3103 and 3203 of H.R. 4173 (as passed by the House).

²⁸ Sections 723(a) and 763 of H.R. 4173 (as passed by the Senate).

²⁹ Affiliates of persons qualifying for the end user exception are not eligible to engage in swaps or security-based swaps on the behalf of qualifying persons if the affiliate is a swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, companies that would be investment companies under section 3 of the Investment Company Act of 1940 but for the exceptions provided in subparagraphs (c)(1) or (c)(7) of that section (15 U.S.C. §80a-3), a commodity pool, or a bank holding company with over \$50, 000,000,000 in consolidated assets. Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(3)) (swaps); Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*) (security-based swaps).

Prevention of Evasion

The CFTC and SEC are required by the Dodd-Frank Act to promulgate rules the Commissions determined to be necessary to “prevent evasions of the mandatory clearing requirements under this Act.” However, this rulemaking authority, while broad, carries additional nuance described below.

As noted above, the statutory scheme of Dodd-Frank creates two ways in which a swap or security-based swap may become subject to the clearing requirement. In one scenario, derivatives clearing organizations and clearing agencies submit the swaps and security-based swaps they intend to clear to the CFTC or SEC and the agency determines whether to apply the clearing requirement to the transactions. In the other scenario, the CFTC and SEC are required to engage in an ongoing independent review of swaps and security-based swaps under their jurisdiction to determine whether those transactions should be subject to the mandatory clearing requirement. It is thus possible that the CFTC and SEC could identify swaps and security-based swaps that “would otherwise be subject to the clearing requirement” but for the fact that no derivatives clearing organization or clearing agency accepts them for clearing.

In that event, the relevant agency (CFTC for swaps, and SEC for security-based swaps) is required to investigate the relevant facts and circumstances, issue a public report of its investigation, and “take such actions as the Commission determines to be necessary and in the public interest, which may include requiring the retaining of adequate margin or capital by parties to the swap [or security-based swap], group, category, type, or class of swaps [or security-based swaps].”³⁰ However, neither the CFTC nor the SEC may “adopt rules requiring a derivatives clearing organization [or clearing agency] to list for clearing a swap, group, category, type, or class of swaps if the clearing of the swap, group, category, type, or class of swaps would threaten the financial integrity of the derivatives organization.”³¹ Eliminated from the Dodd-Frank Act was a requirement in the Senate-passed version that the agencies exempt swaps and security-based swaps from the clearing and exchange trading requirements if no derivatives clearing organization or clearing agency accepts the transactions for clearing.³² The removal of this proposed exemption from the act may grant the agencies more flexibility in determining how to treat transactions they identify for clearing, but that are not yet accepted for clearing by any derivatives clearing organization or clearing agency as the agencies begin to implement the clearing requirement of the Dodd-Frank Act.

Reporting of Swaps and Security-Based Swaps

Swaps must be reported to registered swap data repositories or the CFTC.³³ Security-based swaps must be reported to registered security-based swap data repositories or to the SEC.³⁴ The Dodd-

³⁰ Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(4)) (swaps); Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*)(security-based swaps).

³¹ Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(4)) (swaps); Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*)(security-based swaps).

³² Sections 723(a) and 763 of H.R. 4173 (as passed by the Senate).

³³ Section 723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(5)).

³⁴ Section 763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. § 78a *et seq.*).

Frank Act requires all swaps to be reported.³⁵ Swaps and security-based swaps entered into prior to the date of the enactment of Dodd-Frank Act are exempt from the clearing requirement if they are reported in accordance with the act. Swaps and security-based swaps entered into after the enactment of the Dodd-Frank Act, but prior to the imposition of the clearing requirement, are exempt from the clearing requirement if they are reported in accordance with the act.

Section 727 of Dodd-Frank outlines the public availability of swap transaction data.³⁶ The CFTC is required to promulgate rules regarding the public availability of such data. Swaps that are subject to the clearing requirement, and swaps that are not subject to the clearing requirement, but are nonetheless cleared at registered derivatives clearing organizations, must have real-time reporting for such transactions. Real-time reporting means to report data relating to a swap transaction, including price and volume, as soon as technologically practicable after the time at which the swap transaction has been executed. For swaps that are not cleared and are reported pursuant to subsection (h)(6) (requiring reporting prior to the implementation of the clearing requirement), real-time reporting is required in a manner that does not disclose the business transactions and market positions of any person. Lastly, swaps that are determined to be required to be cleared under subsection (h)(2) (outlining the two ways, discussed above, in which swaps may become subject to the clearing requirement), but are not cleared, real-time public reporting is required as well. There is no parallel requirement in the act for security-based swaps, presumably because national securities exchanges upon which these transactions will be executed already provide comparable reporting.³⁷

The act also creates reporting obligations for uncleared swaps and security-based (including swaps and security-based swaps that qualify for the end user exemption).³⁸ Swaps entered into prior to the enactment of the act will be subject to reporting and recordkeeping requirements for uncleared swaps and security-based swaps.³⁹ The purpose of these requirements, presumably, is to give the relevant Commissions access to a more complete picture of the derivatives market, even for swaps that are not required to be cleared.

Major Swap Participant Definition

A basic theme in Dodd-Frank is that systemically important financial institutions should maintain capital cushions above and beyond what specific regulations require in order to compensate for the risk that their failure would pose to the financial system and the economy. In addition to the margin requirements that apply to individual derivatives contracts, major participants in derivatives markets will become subject to prudential regulation in Title VII. Two categories of regulated market participants are enumerated: swap dealers and major swap participants (together with the security-based swap equivalents).

Since the OTC dealer market is highly concentrated, the proposal that swap dealers be subject to additional prudential regulation was not controversial. Only a few dozen of the largest financial

³⁵ Sections 3103 and 3203 of H.R. 4173 (as passed); Sections 723(a) and 763 of S. 3217 (as passed).

³⁶ Section 725 of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(a)).

³⁷ See 15 U.S.C. § 78f.

³⁸ Section 729 of the Dodd-Frank Act (to be codified at 7 U.S.C. §60-1) and Section 766 of the Dodd-Frank Act (to be codified at 15 U.S.C. §78a *et seq.*).

³⁹ *Id.*

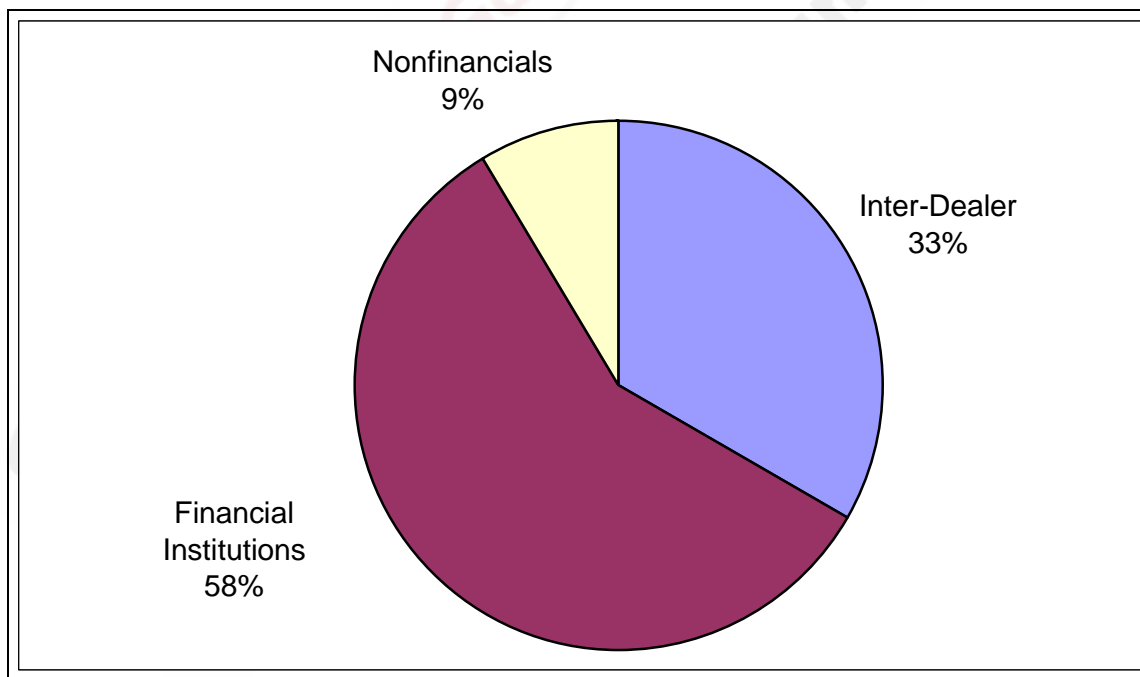
institutions will be affected. The question of how many firms should be included in the definition of major swap participant (MSP), however, was contentious. How many non-dealer and non-bank firms should become subject to prudential regulation?

Several MSP definitions were considered in the House; the version of H.R. 4173 that passed the House in December 2009 defined MSP as a non-dealer holding a “substantial net position” in swaps, excluding positions held to hedge commercial risk, or whose counterparties would suffer “significant credit losses” in the event of an MSP default.⁴⁰ Neither “substantial net position,” “significant loss,” nor “commercial risk” was defined in the bill. However, the bill provided guidance to regulators: first two terms were linked to “systemically important entities” that can “significantly impact the financial system through counterparty credit risk.”

The MSP definition in the bill that passed the House in December 2009 sought to prevent regulators from defining the key terms (“substantial position,” “significant loss,” etc.) in a way that imposed prudential regulation on most firms that used derivatives to hedge risk. In addition, MSPs are required to clear their swap contracts, and the cost of clearing was regarded as burdensome for end-users. Under the House definition, it seemed plausible that relatively few firms would be defined as MSPs—Fannie Mae and Freddie Mac, a few large non-dealer banks and insurance companies, and perhaps a few large hedge funds.

Figure 2. OTC Derivatives Contracts by Type of Counterparty

(Based on notional value of contracts as of December 2009)



Source: Bank for International Settlements, *Regular OTC Derivatives Market Statistics*, May 2010.

Notes: Includes interest rate, foreign exchange, equity, and credit default swaps.

⁴⁰ Section 3101 of H.R. 4173, as passed the House of Representatives, Dec. 11, 2009.

There was an opposite concern: that if the end-user exemption were too broad, and the MSP definition too narrow, significant volumes of OTC trading might escape the new regulatory scheme. **Figure 2** above suggests that if mandatory clearing were applied only to inter-dealer trades, two-thirds of the market would be unaffected. Nearly 60% of OTC contracts were between a dealer and another financial institution: how many of these would be covered? While less than 10% of transactions involved nonfinancial counterparties, was it possible that risky trading activities could migrate from banks to nonfinancial firms if the exemption for hedging commercial risk were not in some way circumscribed?

Two versions of the MSP definition were considered in the Senate. The Banking Committee approved S. 3217 on April 15, 2010, including an MSP definition without the references to systemic importance that appeared in the House bill.⁴¹ In other words, the regulators were given wide discretion to designate as MSPs firms that were not systemically important. The Senate Agriculture Committee produced another MSP definition, which was included in the bill that passed the Senate. It included “systemically significant” language generally similar to the House’s, but added new prongs to the definition: an MSP would be any financial institution with a substantial position in any major swap category, or any financial entity that was highly-leveraged.⁴² This approach (together with changes to the clearing exemption limiting the exemption to nonfinancial entities) appeared likely to capture many swaps between dealers and other financial institutions, which make up more than half the swap market.

Eliminating the clearing exemption for financial entities and bringing more financial firms under the MSP definition, as the Senate-passed bill did, had the virtue of bringing nearly all of the swaps trading under the new regulatory regime—the 33% of trades between dealers and the 58% between dealers and other financial institutions. This approach did raise questions of equity, that is, should a small community bank or credit union be subject to more stringent regulation than a giant nonfinancial corporation with a much greater volume of swaps outstanding?

The final version of the legislation made several changes to the MSP definition and the clearing requirement. The “highly leveraged” prong of the MSP definition was amended to clarify that it did not apply to regulated depository institutions, which are normally highly leveraged. In addition, as noted above, regulators were given discretion to exempt certain financial institutions with less than \$10 billion in assets from the mandatory clearing requirement. The precise number of firms that are named MSPs (and the proportion of swaps that is ultimately cleared) depends on the SEC and CFTC rulemakings required by the act.

Section 716—Prohibition on Federal Assistance to Swaps Entities

Section 716 originated in the Senate Agriculture Committee and was included in the bill that passed the Senate in May 2010. The section prohibited federal assistance, defined as the use of any funds to loan money to, buy the securities or other assets of, or to enter into “any assistance

⁴¹ Section 711 of S. 3217, as reported by the Senate Committee on Banking, Housing, and Urban Affairs, Apr. 15, 2010.

⁴² This was not a “net” position, and applied to individual categories of swaps, as opposed to the institutions aggregate swaps book.

arrangement” with, a “swaps entity.” Swaps entities included swap dealers and major swap participants (and the equivalents in security-based swaps), securities and futures exchanges, SEFs, and clearing organizations registered with the CFTC, the SEC, or any other federal or state agency.

The intent of the provision was to ensure that taxpayers would not have to bail out financial institutions engaged in risky derivatives trading. Such activity was deemed too risky to be under the federal safety net that covers insured depository institutions. As Agriculture Committee Chairwoman Lincoln explained it this way,

This provision seeks to ensure that banks get back to the business of banking. Under our current system, there are a handful of big banks that are simply no longer acting like banks.... In my view, banks were never intended to perform these [derivatives] activities, which have been the single largest factor to these institutions growing so large that taxpayers had no choice but to bail them out in order to prevent total economic ruin.⁴³

Supporters of the original version of Section 716 described it as an appropriate means to compel banks to spin off their swap dealings, or to “push them out” into separately capitalized affiliates. Opponents of the measure argued that the definitions of federal assistance and swaps entity were so broadly drafted that there might be unanticipated consequences. For example, if Citigroup sold off its swap dealer operations, it would still have hundreds of billions of loans and other risky assets on its balance sheet, which it would need to hedge with interest rate swaps and other derivatives. This hedging activity would likely put the bank into the major swap participant category, and thus foreclose access to the discount window, FDIC insurance, and other features of the safety net. Similarly, if the Federal Reserve were supplying liquidity to the financial system during a future crisis, would it be prudent to deny such support to clearing houses which represent concentrations of risk?

The conference committee adopted a modified version of Section 716, which narrowed the definitions of swaps entity and permitted banks to act as swap dealers under some circumstances. In the final legislation, exchanges, SEFs, and clearing organizations are not swaps entities. In addition, the term “swaps entity” does not include a major swap participant or major security-based swap participant that is an insured depository institution.

The final version clarifies that the prohibition on aid does not prevent a bank from creating an affiliate that is a swaps entity, provided that the affiliate complies with sections 23A and 23B of the Federal Reserve Act and other requirements of the Fed, the SEC, and the CFTC. Moreover, the bank itself may continue to act as a swaps dealer for contracts involving rates or reference assets that are permissible for investment by a national bank. This means that banks can continue as dealers in swaps linked to interest rates, currencies, government securities, and precious metals, but not other commodities or equities. Credit default swaps are treated as a special category: banks may deal in them if they are cleared by a derivatives clearing organization regulated by the SEC or CFTC. Dealing in uncleared credit default swaps, however, is not deemed to be a permissible bank activity.

Finally, Section 716 mandates that no taxpayer funds may be used to prevent the liquidation of a swaps entity. Any funds expended in such a liquidation proceeding, and not covered by the swaps entity’s assets, may be recouped through assessments on the financial sector.

⁴³ Remarks of Senator Blanche Lincoln, *Congressional Record*, May 5, 2010, p. S3140.

Enhanced CFTC Authority over Commodities Markets

In 2008, as energy and grain prices set new records, speculators in derivatives were blamed by some for price volatility and for price levels that many observers believed were not justified by the underlying economic fundamentals. Although the CFTC maintained that markets were functioning normally and that the price discovery process was not being distorted, the 110th Congress considered legislation intended to insulate commodity prices from the impact of excessive speculation and manipulation. Title VII includes a number of the specific provisions that appeared in those bills:

- **Margin.** The CFTC is given authority to set margin levels on the futures exchanges. (Previously, CFTC could change margins only in emergencies.) *Section 736.*
- **Position Limits.** The CFTC is directed to establish position limits for both swaps and futures. (CFTC has long had authority to set limits on the size of futures positions, but has generally delegated this function to the exchanges.) *Section 737.*
- **Anti-manipulation Authority.** New prohibitions against manipulation by means of false reporting or false information. *Section 753.*
- **Foreign Boards of Trade.** Foreign futures exchanges offering direct electronic access to their trading systems to U.S. persons must maintain rules regarding manipulation and excessive speculation comparable to those in U.S. law and regulation and must provide the CFTC with full market information.

Beyond these specific provisions, the increased transparency Dodd-Frank will bring to the OTC markets responds to a frequently-heard criticism of the regulatory regime in 2008: that regulators could not be sure that price manipulation was not occurring because they lacked information about the volume of OTC trades and the identities of the big players in that market.

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