July 21, 2010

Congress Enacts OTC Derivatives Reform

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act is comprehensive in scope, providing for significant changes to the structure of federal financial regulation and new substantive requirements that apply to a broad range of market participants, including public companies that are not financial institutions. Title VII of the Act, known as the Wall Street Transparency and Accountability Act of 2010, introduces significant direct regulation of the market for OTC derivatives and the market participants that use them.

New Regulatory Structure

The Act brings the OTC derivatives markets within the scope of the federal securities and commodities laws and divides the jurisdiction over them between the SEC and the CFTC.

CFTC Jurisdiction Over "Swaps"

The CFTC will have jurisdiction over "swaps," which are defined to include a broad range of OTC derivatives transactions based on interest rates, other rates, currencies, commodities, securities, debt instruments, indices, quantitative measures, or other financial or economic interests or property of any kind. The definition does not include futures contracts, physically-settled forward contracts, certain transactions that are subject to the federal securities laws, certain retail commodity transactions, foreign currency options that are listed on a national securities exchange, and any transaction where the Federal Reserve, the federal government or a federal agency is a counterparty. Foreign currency swaps and forwards are included in the definition, but may be exempted by the Treasury Secretary.

SEC Jurisdiction Over "Security-based Swaps"

Transactions that otherwise meet the definition of "swaps" but are based on a single security, a single loan or a narrow-based security index are referred to in the Act as "security-based swaps" and are subject to exclusive regulation by the SEC as "securities" for the purposes of the Securities Act and the Exchange Act. By contrast, the CFTC retains the jurisdiction over swaps based on multiple securities, such as a group, portfolio or basket of securities or a broad-based security index. Security-based swaps that are also based non-security reference assets—so-called "mixed swaps"—are regulated by the SEC, subject to joint rulemaking with the CFTC.[2]

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2 For ease of presentation, the terms "swaps," "swap dealers," "major swap participants," "swap data repositories," and "swap execution facilities" include references to "security-based swaps," "security-based swap dealers," "security-based major swap participants," "security-based swap data repositories" and "security-based swap execution facilities," respectively, unless otherwise specified. The term "Commission," as used herein, refers to

Scope of the New Regulatory Regime

Most of the substantive requirements in Title VII are fundamentally the same for swaps and security-based swaps. The CFTC and the SEC must consult and coordinate with each other to assure that their regulations with respect to swaps and security-based swaps are consistent and comparable. Substantively, the provisions of Title VII broadly fall into two categories:

- transaction-specific provisions that apply generally to any person that trades swaps—these provisions include clearing, trading, reporting, position limits, antifraud and market manipulation rules; and

- entity-specific provisions applicable only to particular market participants—these provisions include enhanced requirements for "swap dealers" and "major swap participants," primarily registration, margin and capital requirements, separation from deposit-taking activities and heightened business conduct standards.

Regulation of OTC Derivatives Markets

Mandatory Clearing

The Act provides that it is unlawful for any person to enter into a swap that is subject to mandatory clearing unless that person submits the swap for clearing through a clearinghouse. The Act requires the Commission to determine which swaps, or group, types or classes of swaps, should be subject to mandatory clearing, either based on a Commission initiated review or following the submission by a clearinghouse of a swap, or group, type or class of swap it plans to accept for clearing. Swap clearing involves the substitution of a clearinghouse as central counterparty to all cleared swap trades. The clearinghouse also acts as custodian of collateral posted by the parties, thereby mitigating counterparty risk among the clearinghouse members and participants. Parties to a cleared swap, including end-users, must post initial and variation margin to the clearinghouse, which is required to segregate the margin.

The Act does not require swap counterparties who intend to enter into a swap to submit the swap to the Commission for determination of whether mandatory clearing will apply. Rather, a clearinghouse that plans to accept any swap, or group, type or class of swaps for clearing must submit an application to the Commission for a determination whether such clearing should be mandatory. The Act does not require a clearinghouse to obtain the Commission's prior approval of the terms of the swaps it plans to clear, nor does the Act restrict clearinghouses from clearing a swap if the Commission subsequently determines that such clearing should not be mandatory.

The Commission is also authorized to determine on its own initiative that mandatory clearing should apply to a swap, based on a review of several factors, including the existence of

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the CFTC or, with respect to security-based swaps, the SEC, as the context requires. The term "clearinghouse," as used herein, refers to derivatives clearing organizations or, with respect to security-based swaps, clearing agencies, as the context requires. The term "exchange," as used herein, refers to designated contract markets or, with respect to security-based swaps, national securities exchanges, as the context requires.

significant outstanding notional exposures, mitigation of systemic risk, relative trading liquidity and the availability of adequate pricing data with respect to the swap, as well as the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract. The Act does not impose a duty on clearinghouses to accept any swap for clearing and expressly provides that nothing in the Act authorizes the Commission to require a clearinghouse to accept a swap for clearing if doing so would threaten the financial integrity of the clearinghouse.

While it is commonly understood that only swaps with standardized terms could be eligible for mandatory clearing, the Act does not expressly limit mandatory clearing to swaps with standardized terms. Rather, a clearinghouse is free to make its own determination of whether to accept a swap for clearing. That determination likely will be based on whether the clearinghouse could profitably clear the swap under its existing clearing technology as well as the existence of sufficient and reliable valuation data and valuation models, among other factors. Although it is possible that the Commission could mandate clearing of a swap that no clearinghouse is willing to accept, the structure of the Act implies that this is an unlikely scenario. The Act does not offer an exemption from the clearing requirement in such situation, but contemplates that under such circumstances the Commission would, rather than imposing mandatory clearing, investigate the reasons why no clearinghouse has accepted such swaps for clearing and take necessary actions, such as prescribing margin or capital requirements for parties to those swaps.

Commercial end-user exception. Mandatory clearing does not apply to a swap where (1) one of the counterparties is not a "financial entity," (2) uses the swaps to hedge commercial risk and (3) notifies the Commission how it generally meets its obligations under non-cleared swaps. A "financial entity" is defined to include swap dealers, major swap participants, commodity pools, private funds, employee benefit plans and other entities predominantly engaged in financial activities. The definition of "financial entity" excludes captive finance affiliates that use derivatives to hedge interest rate and foreign currency risk related to 90% or more to the financing or leasing of products, 90% or more of which are manufactured by its parent company or another subsidiary of the parent company. Mandatory clearing also does not apply to transactions of certain other affiliates of an exempt entity, including certain types of financial entities that use swaps to hedge the commercial risk of the exempt entity or the commercial risk of any of the exempt entity's other affiliates that are not financial entities. Most hedge funds and private equity funds, by contrast, likely will constitute private funds and therefore will not be able to rely on this exception.

The decision whether or not to rely on the exception is at the discretion of the commercial end-user, and the end-user may opt to have the relevant swaps cleared. If the end-user is a company with securities registered under Section 12 of the Exchange Act or required to file reports pursuant to Section 15(d) of the Exchange Act, the board of such company (or an appropriate committee) must first approve the decision to enter into OTC derivatives contracts that are subject to the commercial end-user exception.

The commercial end-user exception is aimed at providing relief from the cost of posting (additional) margin in connection with mandatory clearing. However, as discussed below, the benefits of the commercial end-user exception may be limited (at least under the current wording of the Act) since the final version of the Act does not explicitly exempt commercial end-users from having to post margin with respect to uncleared trades entered into with swap dealers and major swap participants. See further under *Regulation of Swap Dealers and Major Swap Participants—Capital and Margin Requirements* below.

Grandfathering. Swaps entered into before July 21, 2010 are exempt from the clearing requirement if reported to a swap data repository or to the Commission within 180 days of the effective date. The relevant effective date is the later of (1) July 16, 2011 and (2) 60 days after publication of the Commission's final rule or regulation implementing the clearing provisions of the Act (see further under *Regulatory Implementation* below). Swaps entered into on or after July 21, 2010 are exempt if reported within the later of 90 days of the effective date or such other time frame specified by the Commission.

Trade Execution

Swaps that are subject to mandatory clearing and that also are made available for trading on an exchange or swap execution facility must be executed on such exchange or facility. Since the Act does not actually require any swaps to be made available for trading, the trade execution requirement has the effect of prohibiting bilateral trading of a swap that is subject to mandatory clearing once such swap has been admitted to trading on an exchange or swap execution facility. A "swap execution facility" is a new type of "many-to-many" trading system or platform on which multiple participants have the ability to execute and trade swaps by accepting bids and offers made by other participants that are open to multiple participants on the system or platform. Swap execution facilities are subject to Commission regulation and must register with the Commission or be exempt from registration.

Position Limits

The Act expands the existing authority of the CFTC to establish speculative position limits to include swaps traded on an exchange or a swap execution facility or that perform a significant price discovery function. The Act also requires the CFTC to establish aggregate position limits on the number or amount of contracts based on the same underlying commodity held by any person (other than bona fide hedging positions) for each month across contracts traded on an exchange or a foreign board of trade that grants direct access to participants located in the United States, and for swaps that perform a significant price discovery function with respect to regulated entities. For security-based swaps, the SEC and any self-regulatory organization may impose position limits, regardless of trading venue, across security-based swaps and any other instrument correlated with, or based on the same security or group or index of securities as, security-based swaps. The position limits will not apply to positions acquired prior to the effective date of the relevant regulation establishing the position limit, but will be attributed to the trader if its position is increased after such effective date.

Reporting and Real-time Publication of Trade Data

One of the main objectives of the Act is to increase market transparency and regulatory oversight of swaps by requiring the collection and publication of swap transaction data by swap execution facilities and swap data repositories. Under the Act, the Commission is authorized and required to provide rules for the reporting and publication of swap transaction and pricing data. Trade data for swaps subject to mandatory clearing or that are otherwise

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cleared will be publicly disseminated on a real-time basis by the clearinghouse or as required by the Commission. As a result, trade volume and pricing information will be publicly available as soon as technologically possible following trade execution. In addition, the counterparties to a swap, whether or not cleared, must report the transaction to a swap data repository or, if no repository accepts the swap, to the Commission, within the time frames established by the Commission. Where one party is a swap dealer or a major swap participant, it is incumbent on such party to submit the trade for reporting. For uncleared swaps, the trade data reported to the repository will be made publicly available on a real-time basis in a manner that does not disclose the business transactions and market positions of any person. Trade reporting will not identify the counterparties and may be delayed for block trades. Large swap traders that enter into any swap with significant price discovery function involving an amount or resulting in a position above certain limits established by the Commission must file a separate report with the Commission and maintain detailed books and records concerning such transactions. Before October 19, 2010, the Commission must issue an interim final rule providing for the reporting of swaps that were entered into before July 21, 2010. Such swaps must be reported to a swap data repository or to the Commission by the later of 30 days after the issuance of the interim final rule or such other time frame specified by the Commission.

Segregation of Margin

Any entity that receives margin from a customer to secure a cleared swap must be registered as a futures commission merchant (or, with respect to security-based swaps, as a broker-dealer or a security-based swap dealer). The margin must be segregated from and may not be commingled with any proprietary funds and may not be rehypothecated. For uncleared swaps, a swap dealer or a major swap participant must segregate initial margin received from a counterparty with an independent third-party custodian if the counterparty so requests.

Regulation of Swap Dealers and Major Swap Participants

Definitions of “Swap Dealer” and “Major Swap Participant”

The Act introduces specific requirements applicable to swap dealers and major swap participants. “Swap dealer” is defined to include any person who holds itself out as a dealer in or makes a market in a particular kind of swap as well as any person who “regularly enters into swaps with counterparties as an ordinary course of business for its own account.” It is unclear whether the CFTC and SEC will interpret this definition broadly to include principal investors and traders, such as hedge funds, or whether they will develop a “trader exception” to the definition of “swap dealer” similar to the SEC’s exclusion of “traders” from the definition of “dealer” under the Exchange Act.

“Major swap participant” includes any person who is not a swap dealer and (1) who maintains a “substantial position in swaps” (excluding positions to hedge commercial risk and positions held by an employee benefit plan), (2) whose total outstanding swap positions create substantial counterparty exposure that could threaten the stability of the U.S. financial markets or (3) who is a highly leveraged non-bank financial entity that maintains a “substantial position in swaps” (including positions to hedge commercial risk or positions held by an employee benefit plan). The definition of “major swap participant” excludes captive finance affiliates that

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use derivatives to hedge interest rate and foreign currency risk related to 90% or more to the financing or leasing of products, 90% or more of which are manufactured by its parent company or another subsidiary of the parent company. The definition remains to be further developed by the Commission, but will include "systemically important" swap traders.

An entity may be a swap dealer or major swap participant with respect to certain types of swaps, and not others, such that the same entity may act in different capacities depending on the type of swap. Swap dealers and major swap participants are subject to substantially identical requirements (with very few exceptions).

Registration and Operational Requirements

Swap dealers and major swap participants must register with the Commission and are subject to an enhanced regulatory regime, including capital and margin requirements, reporting, recordkeeping, risk management, trade monitoring, documentation, conflict of interest, back-office operational standards, business conduct standards and disclosure requirements.

Business Conduct Standards

The Act raises the standard of care owed by swap dealers (but not major swap participants) that act as advisers to certain "special entities," including federal agencies (although, as mentioned above, swaps with federal agencies as counterparties fall outside the definition of "swap"), States (including political subdivisions of States), state agencies and pension plans, endowments and retirement plans, by imposing a duty to act in the best interests of such entities. In addition, swap dealers and major swap participants may only act as counterparties to such special entities if they have formed a reasonable belief that the special entity has an independent sophisticated representative that acts in the special entity's best interests. Swap dealers and major swap participants also will be required to verify counterparty eligibility standards and to disclose certain information to their counterparties, including risks, any material incentives or conflicts of interest associated with the trades and the daily marks of the transaction (in case of cleared transactions only upon request of the counterparty).

Capital and Margin Requirements

Swap dealers and major swap participants must meet minimum capital requirements and, in connection with uncleared swap transactions, minimum initial and variation margin requirements as determined by the Commission (or, with respect to swap dealers and major swap participants that are banks, by the relevant bank regulators). These capital and margin requirements are intended to take into account the greater risk for the swap dealer or major swap participant and the financial system arising from the use of uncleared swaps and to ensure the safety and soundness of the swap dealer or major swap participant.

As discussed above, the Act provides for an end-user exception from the clearing requirement, but does not contain an explicit exemption from margin requirements for commercial end-users that enter into uncleared swaps with a swap dealer or major swap participant. As a result, swaps that are customarily not cash collateralized may be swept up by the mandatory margin requirements imposed on swap dealers and major swap participants even though no clearing requirement applies, thereby potentially creating a significant

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additional capital and liquidity burden for commercial end-users. The Act does, however, permit the use of non-cash collateral as determined by the regulators. In addition, Senators Dodd and Lincoln in a letter to Chairmen Barney Frank and Colin Peterson following the enactment of the Act clarified their intention that the capital and margin requirements introduced by the Act are not to be imposed on end-users, and that margin requirements are not intended to result in the imposition of greater margin transfer obligations by end-users under exempt transactions

Prohibition on Federal Government Assistance to "Swaps Entities"

The Act includes a modified version of the "push-out rule" proposed by Senator Lincoln, which would have prohibited federally insured banks from directly operating or providing credit support to swap dealers. In a compromise worked out in the conference committee, the modified version of the provision prohibits the extension of certain federal assistance, including access to the Federal Reserve discount window and FDIC deposit insurance, to swap dealers or major swap participants that are not insured depository institutions. The prohibition also does not apply to FDIC-insured deposit institutions that constitute swap dealers to the extent they limit their swap activities to (1) hedging activities directly related to the insured depository institution's activities or (2) acting as a swap dealer for swaps involving rates or reference assets (excluding uncleared credit default swaps) that are permissible for investment by a national bank under the National Bank Act (Section 24(Seventh) of the National Bank Act permits national banks to invest in a wide range of assets including certain fixed income instruments, foreign exchange products and bullion). As a practical matter, the push-out rule prevents FDIC-insured depository institutions from engaging in any other type of swaps activities and forces these institutions to spin out such other swap dealer activities to separately capitalized entities (which may be an affiliate controlled by the same bank holding company) that are effectively ring-fenced from the depository institution in accordance with the requirements of Sections 23A and 23B of the Federal Reserve Act. Insured depository institutions that would be subject to the push-out rule are granted a transition period of up to 24 months following the effective date (which may be extended by another 12 months) to divest or limit their swap activities accordingly. The prohibition will be effective two years following the date of enactment of the Act. In addition, whether or not a swap dealer, any FDIC insured depository institution also is prohibited from engaging in proprietary trading in swaps under the Volcker rule.

Legal Certainty

The Act provides that no swap shall be unenforceable as a result solely of the failure to be cleared. Unless otherwise agreed to by the parties to a swap in their bilateral trading agreement, the enactment of the Act also will not constitute a termination event, force majeure, illegality or similar event under the trading agreement that would permit a party to terminate, renegotiate, modify, amend or supplement the trading agreement. In addition, the Act clarifies that swaps shall not be construed as insurance contracts and preempts any state law attempts at regulating swaps as such.

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Regulatory Implementation

The Act will take effect on the later of July 16, 2011 or, to the extent rulemaking is required by any provision of the Act, not less than 60 days after publication of the final rule or regulation implementing such provision. The Act can be expected to be followed by subsequent corrections bills to clarify and correct certain provisions of the Act. Many provisions of Title VII, including the definitions of "swap dealer" and "major swap participant" and other terms, the mechanics of clearing, the commercial end-user exception and the requirements for position limits, reporting, margin and segregation, will have to be detailed in the ensuing regulatory rulemaking process by the CFTC and the SEC. These agencies must jointly implement the provisions of the Act by July 16, 2011.

The Act introduces significant direct regulation of the market for OTC derivatives and the market participants that use them. The full impact of the new regulatory regime will depend in large part on how the Commission implements the provisions of the Act through its rules and regulations. Many conceptual issues still remain to be developed, including the possible scope and operational feasibility of mandated clearing. While the Act is designed to enhance financial stability and transparency and provides certain benefits to the users of OTC derivatives, it will also result in increased transaction and compliance costs. Once these costs become ascertainable, they likely will influence market behavior and the Commission's rulemaking, as will the financial reform efforts of competing jurisdictions.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Manuel S. Frey 212-373-3127

David S. Huntington 212-373-3124

Ian J. Pohl 212-373-3638

NEW YORK
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

LONDON
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

WASHINGTON, D.C.
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410