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**UNDERSTANDING THE NEW  
FINANCIAL REFORM ACT**

**The Dodd-Frank Wall Street Reform and Consumer Protection Act –  
Impact on Derivatives for End-Users**

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). Title VII of the Act includes a broad set of provisions to regulate derivatives transactions, including swaps. This bulletin highlights the provisions of Title VII that affect the use of derivatives transactions by non-financial businesses (“end-users”), including clearing and trade execution requirements and margin and capital requirements. While most of the Act’s provisions will more directly affect the way financial institutions conduct their derivatives business, the Act will likely have a significant impact for end-users on the process and cost of entering into derivatives transactions. The Act requires certain federal agencies, primarily the Commodity Futures Trading Commission (the “CFTC”) and the Securities and Exchange Commission (the “SEC”), to engage in more than 60 separate regulatory rulemaking processes in connection with Title VII alone.

**JURISDICTION AND TERMINOLOGY**

The Act grants the CFTC and the SEC jurisdiction over swaps and creates two new categories of regulated market participants.

The definition of a “swap” includes any agreement, contract, or transaction (i) that is an option to purchase or sell, or is based on the value of, one or more financial products (e.g., rates, currencies, commodities, securities, indices); (ii) that provides for any purchase, sale, payment, or delivery that is dependent on the occurrence (or non-occurrence) of an event associated with a potential economic consequence; or (iii) that is commonly known as a “swap.” The definition excludes any transaction relating to the sale of a non-financial commodity for deferred shipment or delivery that is intended to be physically settled (i.e., by taking delivery of the commodity).

The Act also introduces two types of institutions involved in swap transactions—“swap dealers” and “major swap participants”—that will be required to register with the CFTC and/or the SEC and be subject to regulation under the Act. The contours of those definitions, and consequently, the list of businesses drawn into those categories, will not begin to be clear until the SEC and CFTC release their proposed regulations. As currently defined by the Act, “swap dealers” primarily are entities that hold themselves out as such, that make a market in swaps, or that regularly enter into swaps for their own account. “Major swap participants” generally are those entities (i) that maintain a substantial position in swaps, excluding positions held for hedging purposes, (ii) whose outstanding swaps create substantial counterparty exposure that could seriously affect the stability of the banking system or financial markets, or (iii) that are highly leveraged financial entities not subject to capital requirements established by a federal banking agency and maintain a substantial position in outstanding swaps.

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## **CLEARING AND TRADE EXECUTION**

The Act requires that most swaps be traded on a regulated exchange or swap execution facility and cleared through a regulated clearing agency. The CFTC and the SEC are required to adopt rules for exchanges to make public certain swap trading data, including price and volume information. While the logistics of clearing swaps generally are expected to be handled by the swap dealers involved in the particular swap transaction, and while these requirements may increase price transparency, they are also expected to increase the transaction costs of entering into a swap.

The SEC and CFTC have broad authority to determine which swaps or groups of swaps are required to be cleared, based primarily on the purpose of mitigating systemic risk in the banking system and financial markets. Swaps will not be required to be cleared if they involve an end-user that is using the swaps to hedge or mitigate commercial risk and that end-user notifies the appropriate agency how the end-user generally meets its financial obligations that are incurred when it enters into uncleared swaps.

## **MARGIN AND CAPITAL REQUIREMENTS**

The Act imposes capital and margin (initial and variation) requirements for uncleared swaps on swap dealers and major swap participants. These limits are intended to ensure the stability of swap dealers and major swap participants and should be appropriate for the risk associated with their uncleared swaps. Non-cash collateral is permitted if consistent with the integrity of the swap trading markets and stability of the U.S. financial system. The CFTC, SEC and prudential regulators are required to consult at least annually on minimum capital and margin requirements and to harmonize these requirements to the maximum extent practicable.

A significant outstanding question that is not answered by Title VII is whether capital and margin requirements will be set for non-financial end-users. While the Act omits exceptions that were in both the original House and Senate legislation and that would exempt non-financial end-users from clearing and margin requirements, there have been reports that those exemptions will be reintroduced in a forthcoming technical corrections bill. Senators Lincoln and Dodd stated in a letter dated June 30 that the margin requirements do not apply to end users that use swaps to hedge or mitigate commercial risk. Additionally, in a Senate colloquy on July 15, 2010, Senators Collins and Dodd stated that end-users that enter into swaps to manage or hedge business risks should not be deemed swap dealers even if those swaps are entered into by the end-user's affiliate. Because of these uncertainties, the regulations will play a critical role in determining the impact the Act will have on end-users.

The Act is also ambiguous as to whether capital and margin requirements will be set for currently active swaps. Although the Act is unclear on this matter, the CFTC has stated that it does not believe it has the authority to set such requirements on existing swaps under the Act. It is also expected that the SEC will not upset existing agreements.



## **BUSINESS CONDUCT AND OTHER NOTABLE PROVISIONS**

There are several other provisions involving derivatives that are worth noting. The Act imposes new business conduct standards on swap dealers and major swap participants. Regulations to be adopted will require swap dealers and major swap participants to disclose to any counterparty that is not a swap dealer or major swap participant the material risks and characteristics of the swap, any material incentives or conflicts of interest, and the daily mark of the swap transaction. The Act also requires that such entities communicate with non-swap dealers and non-major swap participants “in a fair and balanced manner based on principles of fair dealing and good faith.” Additional, more stringent, business conduct standards will apply to swap dealers and major swap participants that do business with “special entities,” which include certain governmental entities, employee benefit plans, and tax-exempt endowments.

Swap dealers and major swap participants are required to appoint a Chief Compliance Officer and to maintain daily logs of swaps and related transactions, daily trading records for each customer or counterparty, and a record of all communications, including e-mail, electronic messages, and phone calls.

For public companies engaging in swap transactions, the company must receive the approval of an “appropriate committee” of the company’s board of directors (or similar body) before relying on an exemption from the Act’s clearing requirements or requirement to execute a swap through a securities exchange.

## **TIMELINE FOR REGULATIONS**

While most of the Act’s provisions give the SEC and CFTC 12 months to adopt rules, comments from CFTC and SEC officials on August 9, 2010 suggested that the CFTC may have its first regulatory proposals ready as soon as mid-November 2010 with the SEC following shortly thereafter. The SEC, CFTC, Federal Reserve, and other prudential regulators have already convened meetings with executives from banks, end-users, clearing houses, and other industry representatives. On August 20, 2010, the CFTC held its first public roundtable discussion regarding which swaps should be required to be cleared and how to address conflicts of interest in the clearing system.<sup>1</sup> The comments at the roundtable highlighted for the CFTC the tension between maximizing access to clearinghouses to spread risk and the need for members of the clearinghouses to be able to control the risks assumed by the clearinghouse. While the roundtable was effective at generating discussion among a diverse group of representatives from banks, clearinghouses, and academic institutions, among others, the CFTC and SEC representatives did not announce or suggest any decisions regarding forthcoming regulations.

The CFTC and SEC have encouraged members of the public to submit comments to public mailboxes regarding derivatives regulations. In particular, the agencies have requested comments regarding the definitions of terms, including “swap,” “swap dealer,” and “major swap participant.”<sup>2</sup>



## FOR MORE INFORMATION

For more information on the Dodd-Frank impact on derivatives, please contact:

Arik A. Sherk	937.443.6757	<b><a href="mailto:Arik.Sherk@ThompsonHine.com">Arik.Sherk@ThompsonHine.com</a></b>
Robert A. Selak	513.352.6663	<b><a href="mailto:Bob.Selak@ThompsonHine.com">Bob.Selak@ThompsonHine.com</a></b>
David J. Naftzinger	216.566.5625	<b><a href="mailto:David.Naftzinger@ThompsonHine.com">David.Naftzinger@ThompsonHine.com</a></b>
Beth J. Freemal	513.352.6629	<b><a href="mailto:Beth.Freemal@ThompsonHine.com">Beth.Freemal@ThompsonHine.com</a></b>

or any member of our **Commercial & Public Finance** practice group for more information.

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<sup>1</sup> A transcript of the roundtable is available at <http://sec.gov/spotlight/regreformcomments.shtml>

<sup>2</sup> Information regarding submission of comments to the SEC and CFTC is available at <http://www.cftc.gov/LawRegulation/PublicComments/HowtoSubmit/index.htm>