

Global Banking and Markets Legal Presentation

## The Hangover: the Morning After the Effective Date of Title VII of the Dodd-Frank Act

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# Title VII of the Dodd-Frank Act (DFA) – Key Themes

- New Definitions
- Registration of Swaps Entities
- Clearing
- Execution
- Reporting
- Margin and Capital Requirements
- Business Conduct Standards
- Documentation and Recordkeeping
- Push-Out Provision
- Repeal of CFMA Exemptions in CEA
- Jurisdiction and Enforcement Authority
- Trading and Market Protections
- Legal Certainty

# Timing

- In general, effective date of Title VII of the DFA is the later of:
  - July 16, 2011, and
  - to the extent a provision requires a rulemaking, 60 days after publication in the Federal Register of the final rule or regulation implementing such provision (DFA § 754)
- Many key provisions of Title VII of the DFA require further rulemaking from the CFTC, SEC, the Fed, OCC, FDIC and others
  - CFTC has reopened comment periods for many rules until June 2011
- Certain key provisions, however, are "self-executing" (i.e. require no subsequent rulemaking) and will become effective on July 16, 2011

# New Definitions

- The DFA amends the Commodity Exchange Act (**CEA**) and the Securities Exchange Act of 1934 (**Exchange Act**) to include a variety of new terms relating to swaps and security-based swaps (**SBS**)
  - These amendments are generally effective as of July 16, 2011 (DFA §§ 721 and 761)
- However, certain key terms are subject to further rulemaking, including:
  - swap and SBS;
  - swap dealer (**SD**) and security-based swap dealer (**SBSD**);
  - major swap participant (**MSP**) and major security-based swap participant (**MSBSP**);
  - eligible contract participants (**ECP**); and
  - security-based swap agreement (**SBSA**)
- It is unclear whether or how other DFA provisions that refer to these terms will have effect prior to the issuance of the final definitional rules

# Registration of Swaps Entities

- The DFA requires the registration of SDs, SBSDs, MSPs, and MSBSPs (collectively, **swaps entities**) (DFA §§ 731 and 764)
- The CFTC has proposed rules around the registration process for SDs and MSPs, relying on the National Futures Association (**NFA**)
  - The CFTC's proposed rules originally contemplated provisional registration of SDs and MSPs starting April 15, 2011
  - On April 11, 2011, the NFA announced it would **not** be allowing provisional registration until the CFTC issues its final registration rules (expected in early Summer 2011 at the earliest)
- The SEC has yet to propose **any** rules regarding the registration of SBSDs and MSBSPs

# Clearing

- The DFA requires the clearing of swaps and SBS that are "required to be cleared" (DFA §§ 723 and 763)
- Both the CFTC and SEC have proposed, but have yet to finalize, rules describing:
  - how derivatives clearing organizations (**DCO**) and clearing agencies (**CA**) may submit swaps and SBS for review to become subject to mandatory clearing;
  - core principles and registration requirements for DCOs and CAs; and
  - the requirement that client funds must be held by a FCM if swaps are going to be cleared for customers
- We expect regulators to finalize clearing rules as a matter of priority (Summer 2011 at the earliest), but market infrastructure may continue to lag
- Market participants will need time to negotiate and document new clearing arrangements

# Execution

- The DFA requires, subject to certain exceptions, that swaps and SBS subject to the mandatory clearing requirement that are "made available to trade" be executed on either:
  - a designated contract market (**DCM**) or swap execution facility (**SEF**), for swaps; or
  - an exchange or security-based swap execution facility (**SBSEF**), for SBS (DFA §§ 723 and 763)
- There is a natural staggered effect for the execution requirements:
  - first, the product needs to be a swap or SBS;
  - then, the product must be subject to the mandatory clearing requirement; and
  - finally, the product must be "made available to trade"

# Execution

- The CFTC and SEC have proposed, but have yet to finalize, rules regarding registration requirements and core principles of SEFs and SBSEFs
  - CFTC has indicated that SEF rule will only be finalized by mid-Summer 2011 at the earliest
- The CFTC has proposed but not yet finalized rules regarding registration requirements and core principles of DCMs
- Transactions with Non-ECPs
  - Swaps entered into with non-ECPs must be entered into on a board of trade designated as a contract market (DFA § 723(a))
  - SBS entered into with non-ECPs must be entered into on a registered national securities exchange (DFA § 763(e))
  - SBS offered or sold to non-ECPs must have an effective registration statement (DFA § 768(b))



# Reporting

- The DFA requires real-time reporting of swaps and SBS data to swap and security-based swap data repositories (collectively, **SDRs**), who would publicly disseminate such data
  - The CFTC and SEC have issued proposed rules regarding the registration of SDRs and real-time reporting, but have yet to finalize such rules
  - Regulators do not appear likely to require real-time reporting prior to the establishment and registration of SDRs, with real-time reporting being potentially phased in starting in 2012
- The DFA exempts swaps and SBS entered into prior to the DFA's enactment from the clearing requirement, if reported to a SDR or the relevant regulator
  - The CFTC and SEC have published interim final rules, in effect **today**, that mandate retention of swap and SBS transaction data
  - The final compliance date for reporting of pre-enactment swaps and SBS data is still to be determined

# Margin and Capital Requirements

- The DFA requires the Prudential Regulators (including the Fed, OCC and FDIC), CFTC and SEC to establish margin and capital requirements for swaps entities (DFA §§ 731 and 764).
- The Prudential Regulators have proposed rules regarding margin and capital requirements for prudentially regulated swaps entities, but have not indicated when such rules will be finalized
- The CFTC has proposed rules regarding margin and capital requirements for non-bank SDs and MSPs, but does not expect to finalize these rules until Fall 2011 at the earliest
- The SEC has yet to propose **any** rules regarding margin and capital requirements for non-bank SBSDs and MSBSPs

# Business Conduct Standards

- The DFA requires the CFTC and SEC to establish business conduct standards for swaps entities (DFA §§ 731 and 764)
- The CFTC has proposed rules regarding both external and internal business conduct standards for SDs and MSPs
  - Rules for SDs and MSPs dealing with counterparties are unlikely to be finalized prior to mid-Summer 2011
  - Chief compliance officer and risk management rules will be finalized by mid-Summer 2011 at earliest
- The SEC has yet to propose any rules regarding business conduct standards for SBSDs and MSBSPs

# Documentation and Recordkeeping

- The DFA requires the CFTC and SEC to prescribe standards for swaps entities related to the timely and accurate confirmation, processing, netting, documentation and valuation of swaps and SBS (DFA §§ 731 and 764)
  - The CFTC's proposed trading relationship documentation rule will likely require SDs and MSPs to amend existing trade documentation, including ISDA master agreements
- The CFTC has proposed rules regarding trading relationship documentation and recordkeeping for SDs and MSPs, but will not finalize the rules until mid-Summer 2011 at earliest
- The SEC has yet to propose any similar rules for SBSDs and MSBSPs

# Push-Out Provision

- The "Push-Out" provision provides that entities engaged in certain swaps activities are prohibited for receiving "federal assistance" (DFA § 716(a))
  - Banks with FDIC insurance will not be able to engage in swaps activities and must "push-out" their swaps desks to an affiliate
- The "Push-Out" provision does not apply to an insured depository institution that limits its swap or SBS activities to:
  - hedging or other similar risk mitigating activities directly related to its activities; or
  - acting as a swaps entity for swaps or SBS involving rate or reference assets that are permissible for investment by a national bank

# Push-Out Provision

- Timing
  - The prohibition will become effective on July 16, 2013 at the earliest (DFA § 716(h))
  - Subsequent one-year transition extensions may be granted at the regulators' discretion (DFA § 716(f))
- As of July 16, 2011, the Financial Stability Oversight Counsel may prohibit **registered** swaps entities from accessing federal assistance with respect to any swap, SBS or other activities when other provisions of the DFA are insufficient to effectively mitigate systemic risk and protect taxpayers (DFA § 716(l))

# Repeal of CFMA Exemptions in CEA

- As of July 16, 2011, the DFA will repeal certain exemptions from the CEA contained in the Commodity Futures Modernization Act of 2000 (**CFMA**), including:
  - an exemption from § 2(d) of the CEA for a transaction in an “excluded commodity” (i.e. an interest rate, exchange rate, currency, security, security index or any other rate or measure of economic or commercial risk that is not susceptible to measures of influence or manipulation) between ECPs executed over-the-counter;
  - an exemption from § 2(e) of the CEA for electronic trading facilities for transaction entered into between ECPs trading for their own accounts;
  - an exemption from § 2(g) of the CEA for individually negotiated swap transactions between ECPs executed over-the-counter; and
  - an exemption from § 2(h) of the CEA for transactions in commodities that are not excluded commodities or agricultural commodities between ECPs executed over-the-counter (DFA § 723)

## Expanded Jurisdiction of CFTC: Retail Products and FBOTs

- CFTC has already issued a final rule regarding retail commodity transactions (including retail FX transactions), effective October 18, 2010 (DFA § 742)
  - Implications of regulation by CFTC: (i) only certain entities (e.g. financial institutions, broker-dealers and bank holding companies) can enter into retail FX transactions with non-ECPs; (ii) issuance restrictions apply; and (iii) certain business conduct standards apply
- Foreign boards of trade that provide US members with access to electronic trading and order matching will become subject to the CFTC's jurisdiction on July 16, 2011 (DFA § 738)



# Regulation of SBS as Securities

- Effective July 16, 2011, the Securities Act of 1933 (**Securities Act**) and Exchange Act definitions of "security" will be amended to include SBS (DFA § 768)
- SBS will become subject to Securities Act and Exchange Act provisions, including:
  - anti-fraud and anti-manipulation prohibitions;
  - disclosure requirements;
  - solicitation rules;
  - private rights of action
- As of July 16, 2011, engaging in SBS activity could, absent an applicable exemption, require registration as a broker or an issuer

# Enforcement Authority of CFTC

- As of July 16, 2011, CFTC will have enforcement authority with respect to the regulation of swaps under Title VII of the DFA (DFA § 714)
  - CFTC will have anti-fraud enforcement powers similar to those provided under the Exchange Act
  - Uncertainty remains, however, as SEC will retain authority to enforce anti-fraud and anti-manipulation requirements of the Exchange Act with respect to swaps that also constitute SBSAs such as index credit default swaps
- As of July 16, 2011, the CFTC is authorized to seek certain equitable remedies for violations of the CEA, including restitution and disgorgement (DFA § 744)

# Enforcement Authority of SEC

- As of July 16, 2011, the Exchange Act's anti-fraud provisions expressly apply to security-based swaps
- As of July 16, 2011, any CA, SBSB or MSBSP that knowingly or recklessly evades, participates in or facilitates an evasion of requirements of section 3C of the Exchange Act (e.g. clearing, open-access, etc...) may be liable for a civil money penalty in twice the amount otherwise applicable for such violation (DFA § 773)

# Trading and Market Protections

- Anti-Disruptive Practices under CEA (DFA § 747): effective July 16, 2011, it will be unlawful for any person to engage in any transaction, practice or conduct on or subject to the rules of a registered entity that:
  - (i) violates bids or offers;
  - (ii) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period;  
or
  - (iii) is, is of the character of or is commonly known as "spoofing."
- Whistleblower policies and incentives will be established in connection with violations of the CEA (DFA § 748) and Exchange Act (DFA § 922)
  - The DFA required the CFTC and SEC to issue final rules 270 days after the date of DFA enactment
  - This deadline has passed without final rules being issued, leaving the present effectiveness of the whistleblower provisions uncertain

# Authority to Ban Certain Foreign Swaps Entities

- As of July 16, 2011, the CFTC and the SEC may prohibit a foreign-based entity from participating in the US in any swap or SBS activities if the regulation of swaps or SBS markets in such foreign country undermines the stability of the US financial system (DFA § 715)

# Legal Certainty

- Legal Certainty for Swaps (DFA § 739)
  - No transaction between ECPs shall be void or unenforceable and no party thereto shall be entitled to rescind or recover any payment made with respect to such transaction based solely on the failure of the transaction to meet the definition of a swap or be cleared
  - Unless specifically reserved in the relevant swap documentation, the DFA and regulations promulgated thereunder will not constitute a termination event, force majeure, illegality, increased cost, regulatory change or similar event that would permit a party to terminate, renegotiate, modify, amend or supplement the swap
- Effective July 16, 2011, the DFA will preempt state insurance laws (for both swaps and SBS) and gaming and bucket shop laws (for SBS) (DFA §§ 722, 767); DFA actually **removes** existing CEA provision preempting state bucket shop laws with respect to swaps

## Important notice

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