

Dodd-Frank Wall Street Reform and Consumer Protection Act Calls for Sweeping Oversight of Derivatives

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The Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) are beginning the process of producing the extensive rules that will be required to implement the new regulatory framework for over-the-counter swaps markets required by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In particular, the CFTC and SEC have adopted rules effective immediately requiring all market participants to keep records of any swaps in effect on or after July 21, 2010, in anticipation of new reporting requirements to be implemented under Dodd-Frank.

Title VII of Dodd-Frank, among other things:

- divides regulatory authority over swaps between the SEC and the CFTC (with the SEC having regulatory authority over security-based swaps, the CFTC having regulatory authority over all other swaps, and joint regulatory authority over mixed swaps);
- creates new categories for market participants who are subject to new registration, capital and margin requirements, record keeping, reporting and other regulatory requirements; and
- requires that certain swaps be accepted by a clearing organization for clearing.

Categories of Market Participants

Dodd-Frank defines a “Swap Dealer” as any person or entity that: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

Dodd-Frank defines a “Major Swap Participant” as any person or entity that is not a Swap Dealer and: (i) maintains a substantial position in swaps (except for positions that are held for hedging or mitigating commercial risk); (ii) whose swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United State banking system or financial markets; or (iii) is highly leveraged relative to the amount of capital it holds.

The SEC and the CFTC will flesh out the meanings of these terms through rule making. However, although it is unlikely that hedge funds or other large investors will be considered “Swap Dealers,” the definition of Major Swap Participant may be broad enough to include some hedge funds and other large investors. The extent to which other derivatives users will be deemed Major Swap Participants based on “substantial counterparty exposure” or their degree of leverage remains an open issue.

Regulatory Requirements

Dodd-Frank requires that all Swap Dealers and Major Swap Participants register with the CFTC, and that all security-based Swap Dealers and Major Swap Participants register with the SEC.

In addition to meeting minimum capital requirements and minimum initial and variation margin requirements, each Swap Dealer and Major Swap Participant is required to maintain daily trading records of swaps and all related records (including related cash or forward transactions) and recorded communications, including electronic mail, instant messages, and recordings of telephone calls. Each Swap Dealer and Major Swap Participant also must maintain an audit trail for conducting accurate trade reconstructions.

Clearing Requirements

Article VII requires that all swaps, absent an exemption by the appropriate regulators, must be cleared by a derivatives clearing organization that is registered under Dodd-Frank or exempt from such registration. All swaps that are subject to the mandatory clearing requirement must be reported in real time. All swaps (cleared or uncleared) are required to be reported to trade repositories.

Implementation

Unless otherwise indicated in Dodd-Frank, the provisions become effective 360 days after enactment of Dodd-Frank or, if a provision requires rule making, at least 60 days after such rules are published.

On October 10, 2010, the CFTC adopted an interim rule for reporting pre-enactment non-security-based swaps (swaps in place prior to the enactment of Dodd-Frank on July 21, 2010). The interim rule requires that certain information related to such transactions be reported by Swap Dealers or Major Swap Participants to a registered swap data repository or to the CFTC within 60 days of the registration of the appropriate swap data repository or by the compliance date to be set by the CFTC, whichever occurs first. At this time, no swap data repositories have been registered; however, a note to the interim rule advises that counterparties to a pre-enactment unexpired swap should retain transaction data in anticipation of reporting.

On October 15, 2010, the SEC adopted a substantially similar interim rule for reporting pre-enactment security-based swaps.

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