

## **Over-the-Counter Derivatives and The Dodd-Frank Wall Street Reform and Consumer Protection Act**

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The over-the-counter (OTC) derivatives industry is poised for significant changes as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Because of the nature of the participants in this market- sophisticated financial and commercial institutions- the OTC derivatives market has historically been left mostly free from governmental regulation. However, since July 21, 2010 when the Dodd-Frank Act was signed into law, OTC derivatives transactions have fallen within the purview of the Commodities Futures Trading Commission (CFTC) (swaps) and the Securities and Exchange Commission (SEC) (securities-based swaps).

The legislation however, is just the first step. The impact on the industry will be determined through the rules established by the CFTC, the SEC and certain prudential regulators such as the Federal Reserve Board and the Office of the Comptroller of Currency. Both the CFTC and the SEC (together the “Agencies”) are expected to write rules in nearly 30 new topic areas that will determine the scope and specifics of the new requirements related to the swaps that fall within their respective jurisdictions. These Agencies are required to promulgate most of these rules within 360 days of the Dodd-Frank Act’s passage, although some rules must be completed sooner. In a departure from their customary practice, the agencies have requested public comments prior to the publishing of the proposed rules. Once the rules are promulgated they will become effective no less than 60 days after publication of the final implementing regulation.

The rules will affect the trading of swaps for all market participants however, the impact of the rules will vary depending on the type of entity trading, the types and volume of trade entered into and the purpose of the trades. While there is much to digest in the Dodd-Frank Act, in this article we will simply provide a high-level overview of the most significant new concepts which may be applicable to alternative asset managers transacting in swaps and the rulemaking which is necessary to determine the extent to which these concepts will apply.

### ***Major Swap Participants***

The Dodd-Frank Act defines a group of participants in the OTC derivatives markets as “Major Swap Participants”. A Major Swap Participant is defined in the Dodd-Frank Act as any person who is not a swap dealer and:

(i) maintains a “substantial position” in swaps for any of the major swap categories as determined by the CFTC (excluding positions held for hedging or mitigating commercial risk ); or

(ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

(iii) (I) is a financial entity that is highly leveraged relative to the amount of capital it holds that is not subject to capital requirements established by a Federal banking regulator; and

(II) maintains a substantial position in outstanding swaps in any major swap category.

Through rulemaking the CFTC will determine which entities meet the definition of Major Swap Participant by defining “substantial position” at the threshold of what the CFTC determines to be prudent for the effective oversight of systemically relevant entities. In determining which entities fall within the scope of the definition of Major Swap Participant, the CFTC will take into consideration an entity’s cleared and uncleared positions and the value and quality of the collateral it holds against counterparty exposure. An entity can be classified as a Major Swap Participant for one or more classes of swaps without being qualified as a Major Swap Participant for all swaps.

An entity that falls within the definition of Major Swap Participant will be subject to clearing, margin, minimum capital and reporting requirements.

### ***Clearing of OTC Derivatives Contract***

An OTC contract entered into by a Major Swap Participant will have to be cleared if the Agencies designate such a trade as a “clearable” trade. The Agencies will determine which contracts must be cleared. Once the Agencies have designated a trade as a trade that must be cleared and it is accepted by a derivatives clearing organization for clearing, it must also be executed on a designated contract market or a “swap execution facility”. “Swap execution facility” is a new concept and the rulemaking will clarify which entities qualify as “swap execution facilities”.

Certain trades will be exempt from the clearing requirement. The rulemaking will clarify whether such exemptions will be based on the counterparty entering into the trade (e.g., a trade entered into with a commercial end-user) or the type of trade entered into (non-standardized trades). In any event, even when Major Swap Participants are able to enter into trades that are exempt from clearing those trades may be subject to additional financial and reporting requirements.

### ***The Financial Requirements***

- *The Margin and Capital Requirements*

The Agencies, or the appropriate prudential regulator if any, will set minimum margin and capital requirements for Major Swap Participants entering into uncleared trades.

The margin and capital requirements will be set in an amount adequate for the risk associated with the uncleared contract. In setting the margin and capital requirements the regulators will do so in order to ensure the safety and soundness of the Major Swap Participant and offset the greater risk from uncleared contracts.

- *Reporting Requirement*

Major Swap Participants are required to report all uncleared swaps to a swap data repository and if no such repository will accept the swap, to the CFTC or the SEC, as applicable. The Agencies are also expected to establish other reporting and record keeping requirements for Major Swap Participants.

In the hopes of increasing transparency, mitigating systemic risk and alleviating counterparty-credit risk, the Dodd-Frank Act is adding an unprecedented level of complexity and rigidity to what has historically been an industry governed by bilateral contracts negotiated between sophisticated parties. Alternative asset professionals who have been operating in the OTC derivatives industry without constraints will, if they find themselves falling under the definition of Major Swap Participants, be subject to a set of new operational, financial and administrative requirements. In the coming months as the Agencies issue their rules, the industry will get a better sense of just how onerous these new requirements will be.

GuyLaine Charles is a Partner at the law firm Teigland-Hunt LLP. She represents financial institutions, hedge funds and major corporations in the negotiation and documentation of physical and financial over-the counter (OTC) derivatives and commodities transactions pursuant to ISDA Master Agreements as well as industry specific agreements. GuyLaine also represents hedge funds in the negotiation of prime brokerage agreements, master repurchase (repo) agreements, master securities agreements, master securities forward transaction agreements, lending agreements and futures agreements. GuyLaine has recently been advising clients on the implications of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* on the OTC derivatives market.