Dodd-Frank Wall Street Reform and Consumer Protection Act to Significantly Impact Derivatives Trading of Banks

The United States Congress has passed new financial reform legislation entitled the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act). Title VII of the Act provides for sweeping reforms that include substantial regulation of the over-the-counter (OTC) derivatives market. These new regulations could have a significant impact on banks that participate in derivatives trading as part of their business. Banks that fit within the Act's definition of "swap dealer" or "major swap participant" (MSP) would be subject to new requirements that could include: registration, capital and margin, reporting and record-keeping, as well as new business conduct standards. Participants in derivatives trades could also be required to clear many or all of their swaps through a central clearing house. As a result of such changes, financial costs of derivatives transactions could increase substantially. One study estimates that the increased capital and liquidity requirements in the derivatives market could increase derivatives participants' collateral needs by hundreds of billions of dollars.[1]

Banks must, therefore, be aware of these new requirements and determine whether they would be subject to the new requirements as either a swap dealer or major swap participant or if they would be exempted pursuant to one of the definitional exclusions. The current definitions and exclusions in the Act are far from a model of clarity. Through the upcoming rulemaking process, the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and federal banking agencies will have to determine if

1 "US Companies May Face $1 Trillion in Additional Capital and Liquidity Requirements as a Result of Financial Regulatory Reform, According to ISDA Research," *ISDA News Release*, New York, NY, June 29, 2010 at 1.

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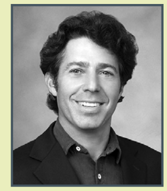

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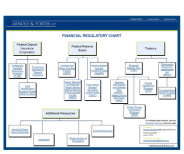

Financial Regulatory Chart

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the definitions of swap dealers and MSPs should be interpreted in a broad or narrow fashion. It would be prudent for banks to participate in the rulemaking process to help ensure that these definitions are not unnecessarily expansive.

Another issue banks must consider is the "push out" provision of the Act. As discussed in more detail below, the push out provision would force banks to remove certain types of derivatives activities from the bank and divest them to their affiliates in order to maintain eligibility for federal assistance including access to the federal discount window and Federal Deposit Insurance Corporation insurance. This requirement would likely increase the overall costs and regulatory burdens associated with derivatives transactions. The push out provision does provide for an exemption for those products that are related to hedging the bank's own commercial risks. The CFTC and SEC will make the final determination as to which products will be considered legitimate hedging instruments and thus eligible to be traded within the bank.

Swap Dealer Definition and its Potential Implications for Banks

The Act defines a swap dealer as an entity that: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties; or (iv) is commonly known in the trade as a dealer or market maker in swaps. The CFTC and the SEC determination of the meaning of "holding oneself out as a dealer in swaps" or "regularly entering into swaps with counterparties," will be critical in deciding whether banks engaged in certain swaps business with customers may be excluded. As noted above, the implications of being considered a "swaps dealer" are significant. A dealer will be subject to registration with the CFTC and possibly the SEC, capital, and margin requirements on their swaps activities, reporting, recordkeeping, and business conduct standards. A dealer will also be subject to mandatory clearing and exchange trading requirements.

The swap dealer definition provides a carve out for banks that enter into a swap with a customer in connection with originating a loan with the same customer. This carve out, depending on how it is interpreted by the agencies, may provide certain banks and thrifts an exclusion from the swap dealer definition for some of their traditional swap activities. The exclusion from the swap dealer definition could then in turn provide such banks and thrifts an exclusion from the divestiture requirement discussed in more detail below. How broadly this carve out will be interpreted, however, remains very much in doubt.

Major Swap Participant Definition and its Potential Implications for Banks

The Act defines an MSP as an entity, that is not a swap dealer, and that: (i) maintains a "substantial position in swaps" for any of the major swaps categories; (ii) whose 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) is "highly leveraged relative to the amount of capital it holds." These terms and criteria are exceedingly vague and leave room for much interpretation.

The CFTC and the SEC are also tasked with the responsibility of determining which types of entities are "highly leveraged" in the MSP context. Specifically, the agencies will likely have to consider factors such as: the types of positions the entities hold; the amount of leverage the entities maintain in such positions; and the liquidity and volatility of the entities positions.

The MSP definition in the Act provides for an exclusion for positions that are held for hedging or mitigating commercial risk. It is possible, to the extent a bank's swaps activities are solely for the purpose of hedging banking risk (e.g., interest rate swaps, credit swaps, etc.), that a bank may be permitted to claim an exclusion from the definition of MSP. Again, the rulemaking process by the agencies will be essential in determining what types of banking activities will lead to MSP requirements and whether potential exclusions may be available.

Banks Divesting Certain Swaps Activities

One of the most contentious and important sections of the

Act forces banks to move certain types of swaps activity out of the bank and to their affiliates. Specifically, the Act provides that banks would have to push out trading in any products that are not related to "hedging and other similar mitigating activities directly related to the insured depository institution activities." As a result, banks will most likely be able retain operations in products such as interest rate swaps and foreign exchange swaps, related to the bank's lending activities. By contrast, it is also likely that banks would have to cease trading in products such as un-cleared commodities, most metals, energy swaps, and agricultural products. Title VII permits depository institutions up to 24 months after the Title's enactment to comply with the push out provisions and move their swaps activities to their affiliates if necessary. Again, the CFTC and SEC will be tasked with determining what types of activities and products will be considered legitimate hedging and which ones will be required to be divested. The bank affiliates that house the non-hedging swaps activities will likely be required to maintain their own capital and adhere to the various regulatory requirements of the Act applicable to swap dealers and MSPs.

Also of note, the swap push out section provides that banks are not subject to the divestiture requirement if they are simply MSPs and not swap dealers. This is further evidence that the breadth of both the MSP and swap dealer definition will have a significant impact on how banks will need to structure their derivatives trading.

Banks Must be Proactive in the Rulemaking Process

The new legislation of the OTC markets will substantially change the costs associated with trading derivatives products as well as regulatory requirements for participants in OTC transactions. As discussed, the extent to which costs and regulatory requirements will increase will depend on how the CFTC, SEC and federal banking regulators decide to interpret the new legislation. Rulemakings on most of the provisions of Title VII are required to be released by the agencies no later than 360 days after Title VII's enactment. If the agencies determine to take an expansive approach in drafting the rules many participants, including banks, may be required to register with the CFTC or SEC to participate actively in the derivatives market. The costs and ongoing regulatory compliance associated with OTC trades will also likely increase substantially for banks. Therefore, banks would be advised to consider participating in the rulemaking process to help ensure that agencies adopt a reasonable and balanced approach to implementing these new regulatory requirements.

Arnold & Porter is available to respond to questions raised by recent or forthcoming legislation, or to help guide your business towards legislative and regulatory solutions. We can assist in determining how pending bills and regulations may affect your business and industry. For further information, please contact your Arnold & Porter attorney or:

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