

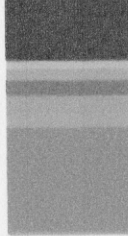


American
Bankers
Association

Financial Regulatory Reform – Part III: Derivatives

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Swaps Regulation: New Regulatory Framework

- The Dodd-Frank Act (Dodd-Frank) mandates:
 - Central clearing
 - Exchange trading
 - Transaction reporting
 - Registration and regulation of swap dealers and major swap participants
 - Capital and margin for uncleared swaps
- Purpose:
 - Intended to reduce counterparty risk
 - Increase market transparency

Swaps Regulation: New Regulatory Framework (cont.)

Swaps markets were largely unregulated

- Transactions generally done over-the-counter (OTC) rather than on an exchange
- In the future, cleared swaps will have to be exchange traded

How central clearing works:

- (1) Rather than one contract between two parties, the transaction is split into two contracts with a clearinghouse in between the parties; and
- (2) Clearinghouses manage default risk primarily by requiring members to post cash or U.S. Treasury securities as collateral, including initial and daily mark-to-market margin.

Swaps Regulation: Clearing Mandate

Clearing will be mandatory if:

1. Applicable regulator determines it must be cleared; and
2. Clearing organization accepts swap for clearing.

End-User exception to clearing mandate:

- If one swap counterparty is:
 1. Not a financial entity; and
 2. Is using swaps to hedge or mitigate commercial risk
 3. Notifies regulator how it meets financial obligations for uncleared swaps
- CFTC and SEC also required to consider an end-user exception for small banks

Swaps Regulation: Product Definitions

- Swaps and security-based swaps (together “swaps”):
 - Exchange of payments tied to the value of interest rates, foreign exchange, commodities, securities, or other instruments
- Regulatory jurisdiction:
 - CFTC has jurisdiction over swaps, including interest rate and foreign exchange (fx) swaps
 - Interest rate swaps are by far the largest segment of the market
 - FX swaps are a distant second
 - SEC has jurisdiction over security-based swaps

Swaps Regulation: Treasury's FX Determination

- The Treasury Department has authority to exempt FX swaps from most Dodd-Frank regulations
- Treasury has issued a proposed determination for public comment
 - Appears likely that Treasury will exercise its exemptive authority
 - If adopted as proposed, it would provide the broadest exemption possible under Dodd-Frank
 - Does not include FX options, currency swaps, and non-deliverable forwards

Swaps Regulation: Market Participants

- Swap Dealer:
 - Holds itself out as a dealer
 - Makes a market in swaps
 - Regularly enters into swaps with counterparties as an ordinary course of business for its own account
- Swap Dealer Exemptions:
 - Insured depository institutions that enter into swaps in connection with originating loans (IDI exemption)
 - *De minimis* swap dealing activities
- Major Swap Participant (MSP):
 - Maintains substantial swaps position, except hedging or risk mitigating
 - Whose outstanding swaps create substantial counterparty exposure



Swaps Regulation: Market Participant Regulation

Swap dealers and MSPs will have to comply with new requirements for:

- Registration
- Business conduct, including stringent requirements for transactions involving pension funds and other special entities:
 - If advisor, then duty to act in the best interest of the special entity;
 - If counterparty, then may have duty to have reasonable basis to believe special entity has qualified independent representative
- Recordkeeping and reporting
- Capital and margin for uncleared swaps

Swaps Regulation: Margin for Uncleared Swaps

CFTC, SEC, and banking regulators are required to establish minimum initial and variation margin requirements for swap dealers and MSPs

- Purpose: Offset the greater risk of uncleared swaps to the market participant and the U.S. financial system
- CFTC proposal would: (i) exempt commercial end-users from posting margin; and (ii) not exempt banks
- Banking regulator proposal would: (i) require commercial end users to post margin over a threshold set by the swap dealer; and (ii) not exempt banks
- SEC has not yet issued proposed rule

Swaps Regulation: Rulemaking

CFTC and SEC have rapidly proposed dozens of rules

- Had a one year statutory deadline to finalize these groundbreaking rules
- Extending timeline to ensure appropriate opportunity for public notice and comment
- Roundtable discussions, thousands of comment letters, and hundreds of meetings
- “Substantially complete mosaic” of proposals
 - Continuing to accept comments as public analyzes the framework
 - SEC has still not issued its proposal on margin and capital for uncleared swaps

Swaps Regulation: Effective Dates

- Generally effective:
 - No earlier than 60 days after final rulemaking; or
 - July 16, 2011 if no rulemaking required
- CFTC and SEC issued temporary exemptive relief before July 16 for “self-effective” provisions
 - Primary industry concern was potential private litigation
 - Some concern over regulatory supervision/enforcement
 - Highlighted the tight statutory deadlines
 - CFTC proposed amendment would extend to July 16, 2012

Swaps Regulation: Push-Out Rule

- No swap dealers or major swap participants can receive federal assistance (DFA Section 716)
 - Includes FDIC insurance, the Federal Reserve discount window, or guarantees
- Exceptions for insured depository institutions that are only:
 - Hedging or mitigating risk
 - Engaging in swaps involving rates or other investments permissible by national banks (including FX and cleared credit default swaps)
- Conformance period
 - Two years after enactment of Dodd-Frank
 - Transition period of up to 24 months
 - Possible one year extension

Swaps Regulation: Pending and Draft Legislation

- House Agriculture Committee
 - Swap dealer IDI exemption and small bank end user clearing exemption
 - Swap dealer definition for commercial end users and *de minimis* exemption
 - Margin exemption for end users
 - CFTC cost-benefit analysis
 - Exempt inter-affiliate swaps
 - Refine swap execution facility (SEF) definition
 - Business conduct for special entities
- House Financial Services Committee
 - International jurisdiction
 - Repeal of push-out rule
 - Refine swap execution facility definition
 - Exempt inter-affiliate transactions
 - Ensure pension plans can use swaps



Swaps Regulation: Pending and Draft Legislation

- Senate Banking Committee -- emphasis on:
 - Margin exemption for end users
 - International jurisdiction and harmonization
 - Exempt inter-affiliate transactions
 - Implementation and sequencing
 - CFTC cost-benefit analysis

Swaps Regulation: Impact

- Current uncertainty about impact on swaps business
 - Thousands of pages of rule proposals to analyze
 - Many banks and members of the public have been assuming the rules will only apply to largest and most active dealers
 - Potentially subject to supervision by new regulator
 - Cost-benefit analysis
 - May need to reorganize corporate structure
- Concerns about implementation phasing/sequencing
 - Goal is a successfully functioning market
 - CFTC rule proposals on: (1) documentation and margining; and (2) mandatory clearing and trading
- International implications for global firms
 - Potential duplicative and inconsistent regulation
 - Potential competitive imbalances