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Clearing and Trade Execution Requirements for OTC Derivatives Swaps Under the Frank-Dodd Wall Street Reform and Consumer Protection Act

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**CLEARING AND TRADE EXECUTION REQUIREMENTS FOR OTC DERIVATIVES
SWAPS UNDER THE FRANK-DODD WALL STREET REFORM AND CONSUMER
PROTECTION ACT**

Willa E. Gibson*

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Abstract

This paper examines Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the “Wall Street Transparency and Accountability Act of 2010” (the “Act”). The Act provides a comprehensive regulatory framework for swap transactions that designates the Commodities Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) as the primary regulators of the OTC derivatives swap market. The Act provides a very broad definition of swaps to include most OTC derivatives transactions, and it grants the CFTC regulatory jurisdiction over them with the exception of security-based swaps to which the SEC is granted regulatory jurisdiction. The hallmark of the legislation is the clearing, trade execution, and reporting requirements for OTC derivatives contracts modeled after similar regulatory requirements for securities and commodities to protect against systemic loss. Effectively, standardized OTC derivatives swaps contracts will be the only swap transactions subject to the clearing and trade execution requirements. The potential downside of the regulation is that customized contracts are not subject to clearing in light of the individualized nature of the terms of such contracts. Thus, traders of customized contracts are subject to certain margin and capital requirements along with reporting requirements to protect against systemic loss in trading customized contracts. The question is whether the alternative regulatory system for customized contracts can prevent against systemic loss in a manner comparable to the protections that the clearing, payment, settlement, and trade execution systems bring to trading in standardized contracts. Moreover, will the bifurcated regulatory system for swap transactions incentivize traders to customize contracts to avoid the clearing and to avoid the transparency associated with exchange trading? The Act grants broad authority to the CFTC and the SEC to promulgate rules and provide interpretative guidelines to implement the regulatory provisions of the Act. Ultimately, the effectiveness of the Act to prevent systemic loss and to protect the financial system against the type of market crisis experienced in 2008 will depend on the breadth and depth of the rules the agencies promulgate and the diligence with which they oversee and enforce those rules.

I. Introduction

In July 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Wall Street Reform Act) which among other things, provides a regulatory framework for the over-the-counter (OTC) derivatives swaps market.¹ The stated purpose of the Dodd-Frank Wall Street Reform Act is to “promote the financial stability of the United States by improving accountability and transparency in the financial system . . . to protect American taxpayers by ending bailouts, to

¹ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

protect consumers from abusive financial services providers, and for other purposes.² The legislation was prompted by numerous calls for more stringent regulation of the financial markets after the 2008 market crisis, which resulted in a \$700 billion bailout package to numerous investment and commercial entities funded by the American taxpayer.³ Most notably, the voluminous trades in credit default swaps, a form of OTC credit derivatives utilized by financial institutions as insurance against defaults on mortgage securities collateralized by subprime mortgages, have been viewed by many as instrumental in precipitating the systemic market failure that created negative externalities in the form of constricted credit and massive taxpayer bailouts.⁴

² *Id.*

³ John Maggs, *A Primer of Financial Reform*, Nat'l Law J. Magazine, Nov. 21, 2009, http://www.nationaljournal.com/njmagazine/ad_200911218350.php; Barney Frank, *A Comprehensive Solution to Combustible Markets*, The Boston Globe, Nov. 11, 2009, http://www.boston.com/bostonglobe/editorial_opinion/opinion/oped/articles/2009/11/11.

⁴ Mooray Choudry, *In Introduction to Credit Derivatives* 11 (2004). A credit default is a type of OTC credit derivative that parties use to hedge against loss related to credit obligations such as loans or bonds. *Id.* The most common form of a credit default swap is "vanilla" credit default swap, which allows a party holding a credit obligation referred to as the "protection buyer" to purchase a credit default swap to shift the risk associated with the credit obligation to a "protection seller," a party willing to assume the risk of loss.

Prior to the enactment of the Dodd-Frank Wall Street Reform Act, OTC swap trades were largely exempt from state and federal regulation in accordance with the Commodities Futures Modernization Act of 2000 (CFMA).⁵ In 2000, Congress' enacted the CFMA to exempt such trades to prevent the migration of OTC derivatives business to foreign markets with less regulation with the possible result that the U.S. would lose its competitive position.⁶ Yet, the absence of comprehensive regulation for the OTC derivatives market resulted in market participants making huge, inefficient trades in opaque markets without sufficient capitalization.

The Dodd-Frank Wall Street Reform Act repeals the CFMA exemption setting forth a comprehensive regulatory framework for OTC derivatives swaps trades.⁷ The hallmark of the Act is the clearing, exchange trading, and real-time data reporting requirements for OTC derivatives swap contracts. This aspect of the regulation mimics the regulation of the securities and commodities markets. Particularly, the clearing, payment, settlement, and trade execution components of the

⁵ Commodities Exchange Act, 7 U.S.C. § 2 (2009)

⁶ *Id.*

⁷ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

securities and futures market have created well-functioning, transparent and disciplined markets. The expectation is that the same results will be achieved in OTC derivatives swap market with the adoption of similar regulation.

The results may differ however in the OTC derivatives market since the Dodd-Frank Wall Street Reform Act does not impose clearing and exchange trading requirements on all OTC derivatives swap transactions. Unlike securities and commodities, not all OTC derivatives swap contracts are fungible or standardized. The fungible nature of securities and commodities renders them all suitable to clearing. OTC derivatives contracts vary however from those with strictly standardized terms to those with highly specialized terms.

Standardized OTC derivative swap contracts can clear with relative ease because they are fungible in nature.⁸ Recently, Gary Gensler, Chairman of the Commodities Futures Trading Commission (CFTC), stated that “[o]ne of the primary goals of the Dodd-Frank Act was to lower [systemic] risk by requiring that standardized swaps to be centrally cleared.”⁹ In fact, Congress, relying on the U.S.

⁸ International Money Fund, Sovereigns, Funding, and Systemic Liquidity: Global Financial Stability Report 10 (2010) [hereinafter IMF Report].

⁹ Process for Review of Swaps for Mandatory Clearing, 75 Federal Register 211 (proposed Nov. 2, 2010) (to be codified at 17 C.F.R. pts. 39 and 140).

Treasury estimates, enacted the clearing requirements with the understanding that “plain vanilla, standardized, high volume contracts – which according to the Treasury Department are about 90 percent of the \$600 trillion swaps market –will be subject to mandatory clearing.”¹⁰ Plain vanilla swap contracts contain standardized terms which clearinghouses can clear with relative ease through multilateral netting of exposures. Interest rate swaps, credit default swaps based on indices, and more recently single name credit default swaps are sufficiently standardized for clearing purposes; and currently, a significant number of these swaps clear through clearinghouses.¹¹

Contracts with truly specialized or individualized terms, referred to as “customized contracts,” are less suitable for clearing.¹² These contracts are privately negotiated and their popularity among

¹⁰ Cong. Rec., July 15, 2010, p. S5921. Senator Lincoln indicates that 1200 standardized swaps and security-based swaps are already clearing through clearinghouses registered with the CFTC and the SEC. *Id.*

¹¹ IMF Report, *supra* note at 10. In 2009, forty-five percent of “OTC interest rate derivatives were centrally cleared by U.K.-based LCH.Clearnet, [while] almost all other OTC derivatives were bilaterally cleared.” *Id.* at 10; see also PRNewswire, *Ice Trust Successfully Launches Customer Solution for CDS Clearing: Over \$4.3 Trillion in CDS Cleared to Date Globally*, December 14, 2009.

¹² Testimony of Gary Gensler, Chairman of the Commodities Futures Trading Commission, Before the Senate Committee on Agriculture, Nutrition and Forestry, June 4, 2009 [*hereinafter*, Gensler Testimony]

businesses stems from the ability to use such contracts to manage specific risk within their financial portfolio.¹³ In the year 2009, it was reported that “more than 90% of Fortune 500 companies” used customized contracts on a daily basis, and that legislation requiring the standardization of all OTC derivatives contracts could limit the ability of companies to manage their risk.¹⁴ To the extent that at least one of the counterparties to a customized contract is a non-financial entity utilizing OTC derivatives swap contracts for mitigating or hedging risks, the contract is exempted from clearing.¹⁵ But for those counterparties whose customized swap contracts do not qualify for an exemption, clearing such contracts would require “specialized pricing and risk models and one-off infrastructure solutions” rendering the process more difficult and costly.¹⁶ This is particularly a problem with customized OTC

¹³ Point of View, *OTC Derivatives: Should all Customized derivatives be standardized?* Price Waterhouse July 2000, <http://www.pwc.com/us/en/point-of-view/OTC-derivatives.jhtml> hereinafter Point of View); see also Antonio N. Bomfim, *Understanding Credit Derivatives and Related Instruments* 29-31 (2002).

¹⁴ *Id.*

¹⁵ Dodd Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1678 (to be codified at 7 U.S.C.A. § 2 and 15 U.S.C.A § 78c-3). The Act allows that counterparty utilize a clearing agency if it so chooses. *Id.*

¹⁶ IMF Report, *supra* at 10.

credit default swaps contracts which “have historically been nonfungible along business, legal, and operational dimensions.”¹⁷

To account for the varying nature of OTC derivatives swap contracts, the Dodd-Frank Wall Street Reform Act creates a bifurcated regulatory system that effectively subjects counterparties with standardized contracts for which a liquid market exists to clearing requirements, while subjecting counterparties that trade customized OTC derivatives swap contracts to certain capital and margin requirements and reporting requirements. The alternative regulatory system for customized contracts presumably was designed with the expectation that the capital and margin requirements and the reporting requirements would suffice to manage the systemic as well as counterparty risk that has historically threatened the integrity and stability of the OTC derivatives market. Certainly, real-time data reporting, capital, and margin requirements for non-cleared swaps will provide greater protection against systemic loss and greater transparency than customized contracts have experienced historically.

The question is whether the alternative regulatory system for customized contracts can prevent against systemic loss in a manner comparable to the protections that the clearing, payment, settlement,

¹⁷ *Id.*

and trade execution systems bring to trading in standardized contracts.¹⁸ Moreover, will the bifurcated regulatory system for OTC derivatives swap contracts incentivize market participants to customize their contracts to avoid the clearing requirements to which standardized trades are subject and to avoid the added transparency of exchange trading to which most cleared trades will be subject?

If the volume of customized contracts increases in response to the bifurcated regulatory system, the CFTC and SEC (collectively “the regulators”), which Dodd-Frank Wall Street Reform Act has designated to regulate OTC derivatives swaps, will be called on increasingly to examine each swap, category of swap, and group of swap to determine if they pose systemic risk. In addition, the regulators will have to implement necessary safeguards to protect the financial system from the systemic and counterparty risks such swap contracts may pose. This places tremendous responsibility on financial regulators that were previously viewed by many as very slow to respond to the market crisis the country experienced in 2008. It remains to be seen if they can fulfill these added responsibilities in a manner that will ensure the safety and soundness of our financial system. Ultimately, the effectiveness of the bifurcated regulatory system will depend on the teeth of the rules the regulators promulgate under the

¹⁸ IMF Report, *supra* note at 2 (noting that during the 2008 market crisis OTC derivatives contracts that cleared through central counterparties (CCP) or clearing agencies functioned relatively well, while those contracts for which “CCPs were not involved, there were difficulties in unwinding derivatives contracts.”).

Dodd-Frank Wall Street Reform Act and the diligence with which they oversee the market and enforce the rules promulgated.

This Paper examines the regulatory framework established by the Dodd-Frank Wall Street Reform Act and discusses the impact of that framework on the OTC derivatives swap market. Part II provides a general discussion of Title VII of the Dodd-Frank Wall Street Reform Act entitled the “Wall Street Transparency and Accountability Act of 2010,” which contains the regulatory framework for OTC derivatives swap market. Part III discusses the clearing requirements and policy considerations underlying the requirements along with the procedures that regulators must undertake to determine which swaps should be subject to clearing. It also examines a recent mandatory clearing rule proposed by the Commodities Futures Trading Commission. Part IV is the Conclusion to the Paper.

II. The Wall Street Transparency and Accountability Act of 2010

A. Introduction

Title VII of the Dodd-Frank Wall Street Reform Act entitled The Wall Transparency and Accountability Act of 2010 (the “Act”) provides the regulatory framework for the OTC derivatives swap

market.¹⁹ Rather than creating a new agency to regulate OTC derivatives, the Act allocates the jurisdiction of OTC derivatives swaps between the Securities Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) (collectively referred to as the “regulators”) with the exception of identified banking products, which are within the regulatory jurisdiction of prudential banking regulators.²⁰ Congress chose primarily to allocate jurisdiction between the two agencies following the principles of the Shad Johnson Accord²¹ implemented in 1982 to resolve jurisdictional

¹⁹ Dodd-Frank Act, 124 Stat. at 1641 (to be codified at 15 U.S.C.A § 8301).

²⁰ Dodd-Frank Act, 124 Stat. at 1672 (to be codified at 7 U.S.C.A § 2). A prudential regulator means federal banking regulators including the Board, the Federal Reserve Board, the Office of Comptroller, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency. Dodd-Frank Act, 124 Stat at 1665 (to be codified at 7 U.S.C.A 1a). The Gramm-Leach-Bliley Act defined an identified banking product to include “any swap, including credit and equity swaps” except equity swaps sold to a person other than a qualified investor. Gramm-Leach-Bliley Act, 15 U.S.C. 78c note (2004). Such products are exempt from the regulatory jurisdiction of the SEC or CFTC unless the appropriate Federal banking agency that regulates them exempts them from its jurisdiction after consulting with the CFTC and SEC and determining that the product “would meet the definition of a swap or security-based swap” and that it “has become known to trade as a swap or security-based swap, or otherwise has been structured as an identified banking product for the purpose of evading” the federal commodities or securities laws. Dodd-Frank Act, 124 Stat. at 1694 (to be codified at 7 U.S.C.A § 27a).

²¹ Commodities Exchange Act, 7 U.S.C.A. § 2a (1999).

battles between the SEC and CFTC concerning financial products possessing both commodities' and securities' characteristics.²²

B. Regulatory Jurisdiction of Swap Transactions

The Act grants exclusive jurisdiction of swaps²³ to the CFTC with the exception of those swaps that are "security-based" over which the SEC has jurisdiction.²⁴ Security-based swaps are defined to include all swaps based on single name securities and narrow-based securities indices.²⁵ Swaps based on broad-based securities indices are subject to the exclusive jurisdiction of the CFTC.²⁶ Allocating the

²² Dodd Frank Act, 124 Stat. at 1672 (to be codified at 7 U.S.C.A § 2a). See Cong. Rec., July 15, 2010, p. S5920; see also CCH Attorney Editor Staff, Securities and Derivatives Reform in 2010: A Guide to the Legislation 212 (2010).

²³ The Dodd-Frank Act provides an extensive definition of swaps to include certain types of puts, calls, caps, floors, or similar options as well as swap agreements including, among other transactions, an interest rate swap, a rate floor, a rate cap, a currency swap, a basis swap, an equity swap, a debt swap, a credit spread, a credit default swap, a weather swap, a commodity swap. See Dodd-Frank Act, 124 Stat. at 1666-67 (to be codified at 7 U.S.C.A. § 1a).

²⁴ Dodd Frank Act, 124 Stat. at 1672 (to be codified at 7 U.S.C.A § 2); see also Cong. Rec., July 15, 2010, p. S5920.

²⁵ See id. at 1756 (to be codified at 15 U.S.C.A § 78(c)

²⁶

CFTC regulatory jurisdiction over such swaps is consistent with Shad Johnson Accord, which granted the CFTC jurisdiction over futures and options products based on broad-based securities indices.²⁷

The CFTC also has exclusive jurisdiction over security-based swap agreements, which are different from “security-based” swaps.²⁸ Security-based swap agreements include any swap agreement as defined by Section 206A of the Gramm-Leach Bliley Act in “which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.”²⁹ Senator Blanche Lincoln referred to the term “security-based swap agreement” as a hold-over from the CFMA, which excluded such agreements from regulation.³⁰ The one exception to the regulatory exclusion was that such “security-based swap agreements” were subject to the anti-fraud

²⁷ Cong. Rec., July 15, 2010, p. S5920.

²⁸ Dodd Frank Act, 124 Stat. at 1667 (to be codified at 7 U.S.C.A § 1a) (defining a swap to include ‘security-based swap agreements’).

²⁹ *Id.*

³⁰ Cong. Rec., July 15, 2010, p. 5920, 5921.

provisions of the federal securities laws.³¹ At that time, the SEC was granted regulatory jurisdiction over “security-based swap agreements” because it, unlike the CFTC, had extensive anti-fraud and anti-manipulation provisions.³²

With the passage of the Dodd-Frank Wall Street Reform Act, “security-based swap agreements” are considered swaps rather than security-based swaps, thus rendering them subject to the jurisdiction of the CFTC.³³ To ensure that such agreements remain subject to anti-fraud and anti-manipulation laws, the Dodd-Frank Wall Street Reform Act amends the anti-manipulation provisions of the commodities laws. The Act mandates that the CFTC promulgate anti-fraud and anti-manipulation rules comparable to the securities laws under which “security-based swap agreements” were subject prior to the passage of the Act.³⁴ Senator Lincoln suggests that swaps qualifying as “security-based swap agreements” under the Dodd-Frank Act are limited to swaps based on broad-based indices and credit default swaps.³⁵

³¹ Securities Exchange Act, 15 U.S.C. 78j (2006).

³² Cong. Rec., July 15, 2010, p. S5921

³³ See Dodd-Frank Act, 124 Stat. at 1667 (to be codified at 15 U.S.C.A. § 78c Note) (repealing the prohibition of regulation of security-based swap agreements); *see also id.* at 1759 (to be codified at 15 U.S.C.A. 78c) (noting that the “term ‘security-based swap agreement’ does not include any security-based swap.”).

³⁴ Dodd-Frank Act, 124 Stat. (to be codified at 7 U.S.C.A. §); *see also* Cong. Rec., July 15, 2010, p. S5921.

Hybrid swaps that possess characteristics of both commodities and securities are classified as “mixed swaps.”³⁶ The Act indicates that mixed swaps are security-based swaps, but requires that the CFTC and SEC engage in joint rulemaking concerning such products.³⁷ Senator Lincoln posited however that the regulators promulgate rules jointly in a manner that ensures that the jurisdictional authority over such products will be determined based on whether their predominant characteristics are commodity or security-based.³⁸ She indicated that the determination should be “based on clear and unambiguous criteria like a primarily test.”³⁹

³⁵ Cong. Rec., July 15, 2010, p. S5920-21.

³⁶ Dodd Frank Act, 124 Stat. at 1668 (to be codified at 7 U.S.C.A § 1a).

³⁷ Dodd Frank Act, 124 Stat. at 1668, 1756 (to be codified at 7 U.S.C.A § 1a and 15 U.S.C.A 78c).

³⁸ Cong. Rec., July 15, 2010, p. S5920-21.

³⁹ Cong. Rec., July 15, 2010, p. S5921. Senator Lincoln stated that “[a] de minimis amount of security-based swap attributes should not bring a swap into the SEC’s jurisdiction just as a de minimis of amount of swap attributes should not bring a security-based swap into the CFTC’s jurisdiction. *Id.*

With respect to the swaps and security-based swaps generally, each regulator has exclusive authority to promulgate rules and issue orders for swaps within its regulatory jurisdiction.⁴⁰ The regulators must consult however with each other and with prudential regulators before promulgating rules and issuing orders to ensure “regulatory consistency and comparability, to the extent possible.”⁴¹ Consistent and comparable rules across the swap and security-based swap markets dissuade traders from engaging in regulatory arbitrage.

For the most part, the regulatory framework for OTC derivatives swaps consists of amendments to the federal commodities and securities laws in a fashion that imposes regulatory provisions on swap market participants similar to those imposed on participants in the securities and commodities markets.⁴² The amendments establish entities such as derivatives clearing organizations⁴³ swap data

⁴⁰ Dodd-Frank Act, 124 Stat. at 1641 (to be codified at 15 U.S.C.A. § 8302).

⁴¹ *Id.*

⁴² Testimony of Gary Gensler, Chairman of the Commodities Futures Trading Commission, Before the Senate Committee on Agriculture, Nutrition and Forestry, June 4, 2009. Chairman Gensler testified that subjecting all derivatives dealers to capital and margin requirements would “help prevent the types of systemic risks that AIG created.” *Id.* [*hereinafter*, Gensler Testimony]

repositories⁴⁴ and security-based swap data repositories,⁴⁵ and swap execution facilities⁴⁶ and security-based swap execution facilities⁴⁷ to create a more transparent market with disciplined trading and well

⁴³ Dodd-Frank Act, 124 Stat. at 1685, 1768 (to be codified at 7 U.S.C.A 7a-1 and 15 U.S.C.A. § 78c).

⁴⁴ A swap data repository “means any person that collects and maintains information or records with respect to transactions or positions in, or the terms and conditions of, swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for swaps.” Dodd-Frank Act, 124 Stat. at 1669-70 (to be codified at 7 U.S.C.A 1a).

⁴⁵ A security-based swap data repository “means any person that collects and maintains information or records with respect to transactions or positions in or the terms and conditions of, security-based swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for security-based swaps.” Dodd-Frank Act, 124 Stat. at 1758 (to be codified at 15 U.S.C.A 78c).

⁴⁶ A swap execution facility “means a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that (A) facilitates the execution of swaps between persons; and (B) is not a designated contract market.” Dodd-Frank Act, 124 Stat. at 1670 (to be codified at 7 U.S.C.A 1a).

⁴⁷ A security-based swap execution facility “means a trading system or platform in which multiple participants have the ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that (A) facilitates the execution of security-based swaps between persons; and (B) is not a national securities exchange.” Dodd-Frank Act, 124 Stat. at 1758-59 (to be codified at 15 U.S.C.A 78c).

functioning clearing, payment, and settlement systems. Moreover, swap dealers⁴⁸ and security-based swap dealers⁴⁹ as well as major swap participants⁵⁰ and security-based swap participants⁵¹ are subject to certain registration,⁵² reporting and record keeping requirements.⁵³ Overall, the amendments

⁴⁸ A swap dealer includes “any person who: (1) holds itself out as a dealer in swaps; (ii) makes a market in swaps; and (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account” Dodd-Frank Act, 124 Stat. at 1669 (to be codified at 7 U.S.C.A § 1a).

⁴⁹ A security-based swap dealer includes “any person who: (i) holds himself out as a dealer in security-based swaps; (ii) makes a market in security-based swaps; (iii) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account” Dodd-Frank Act, 124 Stat. at 1756 (to be codified at 15 U.S.C.A. § 78c).

⁵⁰ A major swap participant “means 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 [Commodities Futures] Commission excluding (I) positions held for hedging or mitigating commercial risk” Dodd-Frank Act, 124 Stat. at 1663 (to be codified at 7 U.S.C.A § 1a).

⁵¹ A major security based major swap participant includes “any person: (i) who is not a security-based swap dealer; and (ii) who maintains a substantial position in security-based swaps for any of the major security-based categories, as such categories are determined by the Commission, excluding both positions held for hedging or mitigating commercial risk” Dodd-Frank Act, 124 Stat. at 1755 (to be codified at 15 U.S.C.A. § 78c).

⁵² Dodd-Frank Act , 124 Stat. at 1703-04, 1784-85 (to be codified at 7 U.S.C.A § 6s and 15 U.S.C.A. 78o-8)

implement a regulatory framework designed to protect against systemic failure that could cripple the financial system.

II. Clearing and Trade Execution Requirements

A. Introduction

At the heart of the regulation is the clearing requirement for swaps and security-based swaps.⁵⁴

Clearing is essential to achieving the type efficiency, integrity, and discipline in the market necessary to prevent systemic risk and to manage counterparty and operational risk. Derivatives clearing

organizations can insulate counterparties to swaps transactions from each others' default by interposing themselves between the counterparties serving as a buyer to the seller and a seller to the buyer of a

swap contract.⁵⁵ Clearinghouses can match and verify the terms and conditions of a swap contract and

“transfer funds and ownership of instruments per the terms and conditions of a swap trade.”⁵⁶ Serving

⁵³ *Id.*

⁵⁴ Dodd-Frank Act, 124 Stat. at 1676, 1768 (to be codified at 7 U.S.C.A. § 2 and 15 U.S.C.A 78q-1).

⁵⁵ IMF Report, *supra* note at 3.

⁵⁶ IMF Report, *supra* note at 2.

in that capacity, they can reduce systemic risk by “multilateral netting of exposures, the enforcement of robust risk management standards, and the mutualization of losses resulting from clearing member failures.”⁵⁷ The exchange trading requirement complements the clearing requirement by providing transparency and greater price discovery to swap transactions which historically have traded in opaque markets incentivizing dealers to charge supra-competitive prices.

B. Clearing and Trade Execution Mandates

The Act makes it unlawful to trade in swaps or security-based swaps without clearing such transactions through a derivatives clearing organization unless the swap transaction is exempted from clearing.⁵⁸ Those counterparties subject to clearing requirements must execute their swap transaction either “on a board of trade designated as a contract market” or a “swap execution facility.”⁵⁹ Similarly,

⁵⁷ *Id.*

⁵⁸ Dodd-Frank Act, 124 Stat. at 1676, 1762 (to be codified at 7 U.S.C.A. § 2 and 15 U.S.C.A. § 78c-3). The clearing requirements do not apply to swaps and security-based swaps if at least one counterparty to the transaction is “(i) is not a financial entity; (ii) is using swaps to hedge or to mitigate commercial risk; and (iii) notifies [the Securities and Exchange Commission or the Commodities Futures] Commission . . . how it generally meets its financial obligations associated with entering into non-cleared swaps.” *Id.*

⁵⁹ Dodd-Frank Act, 124 Stat. at 1681 (to be codified at 7 U.S.C.A. § 2)

counterparties to security-based swap contracts must execute their transactions either on an exchange or security-based swap facility.⁶⁰ The exchange trading requirements is not applicable if no exchange or trade execution facility will accept the swap transaction.⁶¹ One reason for creating the exception was to exempt swap transactions for which a liquid market does not exist.⁶²

Derivatives clearing organizations are required to submit to the appropriate regulator any swap that they accept for clearing to obtain approval to clear the swap.⁶³ Regulators must review the swaps

⁶⁰ *Id.* at 1767 (to be codified at 15 U.S.C.A. § 78c-3).

⁶¹ *Id.* at 1681, 1767 (to be codified at 7 U.S.C.A § 2 and 15 U.S.C.A § 78c-3). A swap or security-based swap is exempt from trading on a trade execution facility if the financial product is exempt from clearing. *Id.*

⁶² Cong. Rec., July 10, 2010, p. S5923. Congress provided the exception because it wanted the regulators to “take a practical approach rather than formal or legalistic approach” in determining whether a swap or security-based swap trade on a board of trade, an exchange, or swap execution facility. *Id.* In determining whether it is practical for the swap transaction to trade on a board of trade, an exchange, or swap execution facility, Congress wanted the regulators to consider “whether there was a minimum amount of liquidity such that the swap can actually be traded on the facility.” *Id.* Congress indicated that “[t]he mere ‘listing’ of the swap by a swap execution facility, in and of itself, without a minimum amount of liquidity to make trading possible, should not be sufficient to trigger the Trade Execution Requirement.” *Id.*

⁶³ *Id.*

submitted⁶⁴ and to facilitate the review process, regulators must promulgate rules to create procedures for reviewing swaps submitted.⁶⁵ The Act requires that the swap transactions submitted by derivatives clearing organizations be disclosed to the public to “provide at least a 30-day comment period regarding its determination” of whether the swap should be required to be cleared.⁶⁶

In addition, regulators must initiate, on an ongoing basis, a review of “each swap, or any group, category, type, or class of swap” that was not submitted to derivatives clearing organizations to determine if they should be cleared.⁶⁷ As part of their ongoing initiated review, regulators must also review swaps not accepted for clearing by derivatives clearing organizations to determine whether they

⁶⁴ Dodd-Frank Act, 124 Stat at 1676, 1762 (to be codified at 7 U.S.C.A. § 2 and 15 U.S.C.A. 78c-3)*Id.* The Dodd-Frank provides “open access” provisions mandating that the rules of derivatives clearing organizations provide that swaps and security-based swaps with the “same terms and conditions are economically equivalent within the derivatives clearing organization and may be offset with each other within the derivatives clearing organization.” *Id.*

⁶⁵ *Id.* at 1677, 1763 (to be codified at 7 U.S.C.A. § 2 and 15 U.S.C.A. 78c-3).

⁶⁶ *Id.*

⁶⁷ *Id.*

should be cleared.⁶⁸ After completing their initiated review, regulators must determine what actions should be taken to prevent systemic risk in trading swaps not accepted for clearing.⁶⁹ These actions include mandating a derivatives clearing organization clear a swap if the regulator deems it should be subject to the clearing requirement.⁷⁰ The ongoing agency-review mandate was considered by senior members of the Senate Agriculture Committee as essential to prevent clearinghouses from blocking a mandatory clearing determination made by either the CFTC or SEC.⁷¹

In determining whether to mandate clearing for swap transactions submitted by derivatives clearing organizations or to mandate clearing for those swaps subject to the regulators' initiated-review process, the regulators are required to consider statutory factors contained within the Act.⁷² The

⁶⁸ *Id.* See also Cong. Rec., July 15, 2010, p. S5921.

⁶⁹ See Cong. Rec., July 15, 2010, p. S5921; see also CFTC Mandatory Clearing Proposed Rule, *supra* note at 67279

⁷⁰ See Cong. Rec., July 15, 2010, p. S5921.

⁷¹ *Id.*

⁷² Dodd Frank Act, 124 Stat. at 1677, 1763 (to be codified at 7 U.S.C.A § 2 and 15 U.S.C.A. § 78c-3). The statutory factors include:

(l) "The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.

statutory factors were included to avoid conflicts of interest that may arise as the CFTC and SEC make clearing determinations for swaps transactions within their respective regulatory jurisdictions.⁷³ In that respect, the statutory factors provide objective standards against which both regulators can determine whether swap transactions are required to be cleared. Overall, the factors are directed toward ascertaining the liquidity and legal certainty of the swap contracts and the systemic risk posed by them.

C. CFTC Mandatory Clearing Proposal

Recently, the CFTC proposed rules for comment regarding mandatory clearing for swaps.⁷⁴ The proposed rule sets forth procedures for reviewing swaps submitted by derivatives clearing organizations and for reviewing swaps identified by regulators as part of their initiated review process.⁷⁵ The rule proposes that derivatives clearing organizations submitting swaps for clearing provide the agency with

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- (II) The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is traded.
 - (III) The effect of the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the derivatives clearing organization available to clear the contract.
 - (IV) The effect on competition, including appropriate fees and charges applied to clearing
 - (V) The existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organization or 1 or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property. *Id.*

⁷³ Cong. Rec., July 15, 2010 p. S5921

⁷⁴ See CFTC Mandatory Clearing Proposed Rules, *supra* note at 67277.

⁷⁵ *Id.* at 67278-79

information to assist it in its “quantitative and qualitative assessment of [the] five specific [statutory] factors that the Dodd-Frank Act requires the Commission to take into account when reviewing a swap submission.”⁷⁶ If the agency determines that a swap submitted should be cleared, the CFTC will “impose [the] terms and conditions” of the clearing as it deems appropriate.⁷⁷

The proposed rule indicates that the CFTC would initiate its own review for swap contracts that have not been accepted for clearing by a derivatives clearing organization.⁷⁸ The rule proposes that the CFTC, as required by the Dodd-Frank Act, would initiate an investigation of swap transactions that have not been accepted for clearing to determine “whether they should be required to be cleared.”⁷⁹ In undertaking its review, the agency will utilize information it receives “pursuant to Commission

⁷⁶ *Id.* at 67278. Among other things, “[t]he proposed regulation would require the DCO [derivatives clearing organization] to provide specific information relating to product specifications; participant eligibility standards; pricing sources, models, and procedures; risk management procedures; measures of market liquidity and trading activity; the effect of a clearing requirement on the market for the swap; applicable rules, manuals, policies, or procedures; and terms and trading conventions on which the swap is currently traded.” *Id.*

⁷⁷ *Id.* at 67279.

⁷⁸ *Id.*

⁷⁹ *Id.*

regulations from swap data repositories, swap dealers, and major swap participants, and any other available information in undertaking” reviews of such swaps.⁸⁰ Once it completes its investigation, the CFTC would issue a report detailing the results of its investigation and take whatever actions “necessary and in the public interest” including imposing “margin or capital requirements” for the swap at issue.⁸¹

Interestingly, the CFTC’s position in the proposed rule regarding non-cleared swaps is not completely consistent with the Act’s mandate for the imposition of margin and capital requirements for *all* non-cleared swaps. The Act mandates that the regulators “shall adopt rules for swap dealers and major swap participants . . . imposing (i) capital requirements; and (2) both initial and variation margin requirements on *all* (emphasis added) that are not cleared by a registered derivative clearing organization . . . to offset the greater risk to the swap dealer and major swap participant and the financial system arising from the use of swaps not cleared.”⁸² The proposed CFTC rule suggests however that the CFTC can exercise its discretion in determining whether a swap dealer or major swap

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² Dodd-Frank Act, 124 Stat. 1705, and 1786 (to be codified at 7 U.S.C.A §6s and 15 U.S.C.A. § 78o-8.)

participant whose swap is not accepted for clearing should be subject to capital *or* margin requirements.⁸³

The difference between the proposed rule and the Act could create uncertainty concerning the imposition of margin and capital requirements in non-cleared swap trades. Ultimately, allowing regulators to make piecemeal determinations whether swap dealers or swap market participants trading in non-cleared swaps should be subject margin and capital requirements could result in insufficient protection against counterparty default. Since the Act evidences Congress' intent to apply margin and capital requirements to all non-cleared swaps to offset counterparty and systemic risk, the rules proposed by the regulators should reflect that intent.

Moreover, the proposed rules could provide more guidance on how the agency intends to address swaps that it determines should not be cleared. Presumably, a regulator could determine a swap, category of swap, or group of swaps should not be cleared because they are:

- (1) Exempted from clearing pursuant to the Act;
- (2) Ineligible for clearing because of:
 - (a) Their customized nature;
 - (b) Their lack of market liquidity; or
 - (c) The under-capitalized nature of the derivatives clearing organization; or

⁸³ CFTC Mandatory Clearing Proposed Rule, *supra* note at 67279.

- (3) Restricted from trading altogether because the systemic risk they pose individually or in conjunction with outstanding swap trades far outweighs any financial or economic benefits that could be realized by the trade.

Presumably, swaps satisfying Category 2a or 2b would not be suitable for clearing, thereby subjecting the swap trader to margin and capital requirements along with requiring traders to report certain information about such swap transactions to a swap depository. Regulators could require that traders whose swap transactions satisfy Category 2c clear their swap transactions through a derivatives clearing organization with sufficient capital and resources to manage the systemic, counterparty, and operational risk associated with the trade. Swaps satisfying Category 3 should not be allowed to trade.

A. Prevention of Evasion of Clearing Requirements

As part of the initiated review process, regulators should also assess swaps to determine whether traders have slightly altered standardized contracts to render them customized. Last year, CFTC Chairman Gensler testifying before the Senate expressed concern that dealers and traders might try to evade the clearing requirements by changing “a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and electronic trading systems.”⁸⁴ To prevent

⁸⁴ Testimony of Gary Gensler, Chairman of the Commodities Futures Trading Commission, Before the Senate Committee on Agriculture, Nutrition and Forestry, June 4, 2009 [*hereinafter*, Gensler Testimony]

evasion of the clearing requirement, Chairman Gensler proposed a presumption that OTC derivatives contracts accepted by a clearinghouse must be cleared.⁸⁵ The House bill⁸⁶ included that presumption, but the Senate discussion draft⁸⁷ did not. The final version of the Act does not include such a presumption, but it does require the CFTC and the SEC to promulgate rules and issue interpretations of those rules as “necessary to prevent evasion of the mandatory clearing requirements.”⁸⁸

III. Conclusion

Overall, the Act seeks to protect the financial system against the type of systemic risk that the country faced during the 2008 financial crisis by amending the federal commodities and securities laws. The amendments require that traders clear swaps if required to do so by regulators, and if accepted, execute trades for such swaps on the appropriate trading facility. Congress enacted such regulation however cognizant that not all OTC derivatives swaps would be subject to it. While clearing is

⁸⁵ Testimony of Gary Gensler, Chairman of the Commodities Futures Trading Commission, Before the Senate Committee on Agriculture, Nutrition and Forestry, June 4, 2009.

⁸⁶ The Wall Street Reform Act, H.R. 4173, 111th Cong. § 3101 (2009)

⁸⁷ Staff of S. Comm. On Banking, Housing, and Urban Affairs, Report On Financial Reform Law (Comm. Print 2010)

⁸⁸ Frank-Dodd Act, 124 Stat. at 1677, 1764 (to be codified at 7 U.S.C.A. § 2 and 15 U.S.C.A. 78c-3).

mandated for standardized contracts it remains to be seen whether the alternative mechanisms implemented by the Act for customized contracts – the posting of capital and margin requirements, the real-time price reporting requirements, and the establishment of swap repositories – can protect against the type systemic and counterparty losses that clearinghouses are designed to manage. Ultimately, the effectiveness of the legislation will turn on the rulemaking, oversight, and enforcement efforts of the financial regulators to sustain a bifurcated system that provides two different regulatory approaches to protect against systemic loss.