The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) will significantly change the oversight and structure of the US over-the-counter (OTC) derivatives markets. The aim of the legislation is to promote greater transparency and to moderate systemic risks in order to minimize the recurrence of operational stresses and excessive risk taking perceived by Congress to have occurred through OTC derivatives activities, and which contributed to the 2007–09 financial crisis. As regulatory implementation and supervisory determinations occur during the transitional periods over the next several years, the US derivatives markets’ scope, structure, execution mechanisms, pricing, margin/collateral requirements, and supervision will be reshaped. Several key features of Dodd-Frank will drive these changes:

- Certain OTC derivatives market participants—specifically swaps dealers and major swaps participants (MSPs)—will be subject to Commodities Futures Trading Commission (CFTC) and/or Securities and Exchange Commission (SEC) registration, regulation, and (if not otherwise prudentially supervised—e.g., by banking regulators) oversight

- Financial services firms will be required to centrally clear or trade on exchanges standardized OTC derivatives that are mandated to be cleared by the CFTC and SEC and accepted by a regulated clearing agency

- Insured deposit-taking institutions and other firms that receive federal support will be required to “push out” certain derivatives activities (e.g., commodities, equities, certain credit swaps)

- Enhanced prudential standards and transparency requirements—including margin, capital, and reporting requirements—will apply to swap dealers, MSPs, and, as applicable, regulated clearing agencies

- The Act gives the CFTC and SEC mandates to issue business conduct rules

This A Closer-Look provides some context and perspective on these key changes.
**To be or not to be a swap dealer or MSP**

Under Dodd-Frank, the activities of a swap dealer or MSP will be subject to greater oversight and regulation. By July 2011, the SEC and CFTC, in consultation with the Federal Reserve Board (as applicable), will issue regulations and guidance on such topics as:

- Designation and registration of swap dealers and MSPs
- Minimum capital and initial and variation margin requirements on swap dealers and MSPs that are non-banking entities for all non-cleared swaps
- Business conduct rules for swap dealers and MSPs
- Standards for swap confirmation, processing, valuation, netting, and documentation applicable to all swap dealers and MSPs and their counterparties, unless exempt

A swap dealer is a market-maker that regularly enters into swaps contracts. An MSP is a non–swap dealer that:

- Has a substantial position in swaps (to be defined by the CFTC and SEC)
- Has a substantial counterparty exposure that could have serious adverse effects on the stability of the US banking system or financial markets
- Is a highly leveraged financial entity not subject to the capital requirements of any federal banking regulator, and maintains a substantial swaps position

A firm may be a swap dealer or MSP for a certain swap category but not for others. The CFTC and SEC will have significant discretion to define and exempt firms from being designated as a swaps entity. Certain swap activities engaged in by non-financial institutions and captive finance subsidiaries, mainly for commercial purposes, are expected to be exempt or may be determined by the CFTC and SEC to be *de minimis* or exempt.

Assessing the financial and operational implications of being a swap dealer or MSP for certain products and not for others will be important for budgeting, pricing, and competitive purposes; however, the relative benefits and costs will likely become clearer as the rule-making process unfolds. This analysis is particularly important to banking organizations and organizations that will become subject to affiliate transactions rules. As discussed in the “Push-out” section below, insured depository institutions will be permitted (to continue) to engage in certain derivatives activities and to engage in transactions with affiliates that are swap dealers or MSPs, subject to certain affiliate transactions rules (which include collateral requirements, quantitative limits, and arm’s length pricing requirements).

Firms engaged in dealing in CFTC-regulated OTC products must register as swap dealers. Firms engaged in dealing in SEC-regulated OTC contracts must register as security-based swaps dealers. Any entity that serves as a swaps data repository must register as such with the CFTC. All derivatives clearing organizations must register with the CFTC and/or SEC. In addition, new derivatives products must be submitted to the SEC and/or CFTC for approval, classification, and jurisdiction determination.

**Derivatives clearing and exchange trading**

The SEC and CFTC will determine which contracts will be centrally cleared (e.g., standard, liquid, single-name contracts, and indices). All clearable swaps must be executed through a regulated exchange or central clearing entity unless there is no exchange that will list the swap or security-based swap, or the swaps qualify for end-user exceptions from mandatory clearing. A number of credit and interest rate swaps are currently eligible for central clearing. While financial services firms must centrally clear derivatives contracts, non-financial firms and certain captive finance companies may elect, but are not required, to participate in central clearing.

---

1 The Act provides authority to the CFTC and SEC respectively to define, register and oversee swap dealers and major swap participants and securities-based swaps dealers and major security-based participants. For purposes of this document, swap dealer refers to either swap dealer or securities-based swap dealer and MSP refers to either a MSP or SBMSP.
A Closer Look at Dodd-Frank Wall Street Reform and Consumer Protection Act

What is client clearing?

While a bilateral trade puts counterparty risk solely on the two parties to the trade, clearing mutualizes risk among clearing members. Client clearing reduces counterparty risk by providing buy-side access to central clearing counterparties (CCPs) for clearing and settlement.

<table>
<thead>
<tr>
<th>Bilateral model (existing process)</th>
<th>Client cleared model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Client → Executing broker</td>
<td>Client faces CCP through clearing member and executing dealer faces CCP (instead of client)</td>
</tr>
<tr>
<td>Client faces executing broker directly</td>
<td>Cleared trades as well as contribute to a guarantee fund.</td>
</tr>
</tbody>
</table>

OTC derivatives which can be centrally cleared must be centrally cleared, with limited exceptions for industrial and governmental end-users carrying out bona fide hedging.

Margin and capital requirements

Dodd-Frank mandates certain studies of capital adequacy and imposes capital requirements on swap dealers and MSPs in an effort to better understand and mitigate the systemic risk of derivatives markets. Swap dealers and MSPs will be subject to new minimum capital standards that are to be comparable to those applicable to banks, and with comparatively higher counterparty capital charges for non-cleared derivatives activities. Regulators will establish initial and variation margin requirements for non-cleared swaps between dealers/MSPs and end-users. Similarly, clearinghouse margin requirements will also be subject to review by regulators. Most major derivatives dealers currently engaged in central clearing are expecting some capital relief for centrally cleared or exchange-traded derivatives, but substantially increased margin requirements for many types of trades and counterparty clients.

Margin requirements will apply to all participants. In the case of trades where one party is a non-dealer customer, the clearing activity (e.g., receipt and payment of margin, etc.) must be conducted through a futures commission merchant (FCM) for CFTC-regulated products and through a broker-dealer for SEC-regulated swaps. In either case, Dodd-Frank directs that the derivative accounts and all margin must be treated as segregated client assets and not the property of the FCM or broker-dealer. Importantly, this should result in comparatively more favorable capital treatment of cleared positions from a clearing dealer perspective, relative to non-cleared trades.

Margin rules

- The CFTC and SEC will make margin rules for the central clearing counterparties (CCPs), OTC products, and swap dealers that they respectively or jointly regulate (for cleared trades, the CCPs may develop the margin schedules and ask the CFTC to approve/formalize)
- Any OTC product that can be cleared on a registered CCP must be, unless the customer is an exempt end-user and elects not to use central clearing
- Where central clearing is unavailable, a swaps dealer must collect initial margin and variation margin at levels to be set by CFTC and SEC rule-making (“not less than” comparable cleared trades, with the implication that these levels will be higher than those applicable to comparable cleared trades)
- Initial margin must be held in trust by a third party if any party to the trade so requests
A number of practical aspects will benefit from rule-making and interpretation. For example, there is uncertainty with regard to such aspects as margin arrangements on existing/grandfathered trades, whether portfolio margin requirements will apply to non-cleared trades, the extent of non-cash collateral that may be employed, and the extent to which corporate end-users may be exempt from margin requirements on non-cleared trades. This latter aspect could be among the topics for further legislative action.

Consequently, once the central clearing mandate becomes effective, bilateral trades executed with US-regulated swap dealers that cannot be centrally cleared or traded on an exchange will require posting (and probably third-party segregation) of initial margin in amounts to be determined by the CFTC and SEC. The impact on swap entities’ liquidity may be significant with this posting of collateral.

Certain derivatives participants—such as hedge funds, which are accustomed to posting significant collateral—will be least impacted by these requirements and most inclined to move to clearing as soon as the implementing regulations and infrastructure are in place. Among the advantages of doing so will be access to additional counterparties who’ll likely have increased appetite to trade with these participants (particularly those designated as MSPs), given the supervision, transparency, and margin requirements that should effectively translate to a nearly free “credit upgrade.”

Conversely, firms that are likely to be comparatively less advantaged include highly rated long-only entities and net buyers of protection (credit derivatives) and long-dated interest rate swaps. These parties will have to post substantive margin, where in the pre-Act environment they could post little or none.

For most institutions, clearing only a portion of positions within a portfolio will be economically and operationally unattractive. Expect firms and clients that must centrally clear or desire to centrally clear to move as much activity as possible into a central clearing arrangement. Directionally, mandatory clearing may cause modest short-term drop in OTC volumes as users re-adjust their models to recognize higher margin requirements and trade-offs between cleared and non-cleared, among other considerations. Longer-term central clearing could benefit markets as more parties become able and willing to use OTC products due to enhanced client money protection and less dealer risk.

**Exchange trading**

While the emphasis of Dodd-Frank is on central clearing of OTC derivatives, the Act requires all cleared swaps to be traded on a registered exchange or board of trade that has accepted the product “in accordance with the rules thereof;” however, Dodd-Frank permits exemptions for product types and block trades (at the discretion of the CFTC and SEC) if mandated exchange trading is deemed a threat to liquidity in a given instrument type or market.

Presently, no US exchanges support credit derivatives trading. Among the challenges to the feasibility of exchange trading is the willingness of dealers to make continuous two-sided markets (e.g., in credit swaps, where some “liquid” names trade five to ten times a week). What may be possible in the near term, for credit default swaps as an example, would be post-trade reporting on swap exchange facilities and vanilla rates becoming tradable on exchanges. The challenge also remains that the standardization required of exchange-traded contracts makes it difficult for users to execute hedge strategies and achieve effectiveness under hedge accounting rules. Expect significant industry and regulator dialogue around refinement of the exchange-trading mandate to make it practicable.

**Push-out: derivatives activities for the banks and thrifts**

A US insured depository institution that is a swap dealer will only be able to engage in derivatives transactions that reference interest rates, foreign currencies, certain metals (e.g., gold, silver), and cleared investment-grade credit default swaps (except for proprietary trading activities in derivatives prohibited under the Volcker Rule).
Transactions with certain financial subsidiaries and nonbank affiliates will be subject to the limitations of sections 23A and 23B of the Federal Reserve Act (Regulation W), together with other requirements that may be implemented by a prudential regulator as well as the CFTC and SEC. Dodd-Frank mandates that derivatives are covered transactions for affiliate transaction limitations purposes, including collateral requirements, quantitative limits, and arm’s length pricing requirements, subject to revisions to Regulation W by the Federal Reserve Board to implement these changes. The Dodd-Frank mandate also includes derivatives in calculating lending limits requirements. One of the considerations that the Federal Reserve may need to address is what quantities (e.g., fair value, expected potential exposure) best represent the exposure that should be included for these purposes.

Push-out becomes effective two years following enactment. Existing swaps as of the effective date are grandfathered. Derivatives product groups that will have to be conducted through a nonbank affiliate include:

- Equity contracts
- Commodities contracts
- Energy and metal contracts (gold and silver derivatives may be conducted in a bank)
- All agricultural derivatives
- Credit derivatives that are not centrally cleared or, as applicable, exchange traded
- Centrally cleared credit derivatives with underlying reference obligations that are below investment grade

Dodd-Frank includes foreign exchange derivatives within the definition of a swap, which drives the application of the provisions of the Act, such as triggering designation and registration as a swaps entity, margin requirements, and mandatory clearing. However, the secretary of the treasury is empowered to determine whether foreign exchange derivatives can be excluded from clearing, exchange trading, and margin regulation where prudential supervision is in effect. The treasury secretary’s determination to exempt foreign exchange derivatives would not apply to the Act’s requirements for exempt trades to be reported to a swap repository or to be subject to business conduct standards.

Uninsured banking institutions, such as certain state-chartered special-purpose banks and US branches of foreign banks that wish to become swap dealers, may not be able to engage in activities which under the Act may only be conducted by insured depository institutions. This inconsistency in treatment with US banks appears to have been a technical oversight.

Banking organizations that have historically engaged in derivatives activities through an insured banking subsidiary will need to assess the relative benefits and costs of engaging in derivative activities through the bank and/or a nonbank subsidiary. Subject to rule-making and interpretation, it appears that Dodd-Frank may:

- Complicate centralizing risk management of like exposures on a single legal entity, or optimizing multi-product netting groups with counterparties where such activities must be conducted in separate entities
- Prompt consideration of multiple memberships (if feasible) in one or more clearinghouses to moderate back-to-back trades that can adversely impact operations, hedge accounting, and/or capital management
- Affect the ability to centrally manage firm-wide liquidity as well as add complexity to contingency funding of derivatives activities
- Increase the potential for competitive inequality among firms that have authority to engage through a single legal entity structure that allows a “one-stop shop” (e.g., a foreign banking organization not so limited in its business outside the United States)

Directionally, the impact on banking organizations and their counterparties suggests banks and derivatives dealers will face higher capital requirements, higher usage of available credit limits, and lower profitability—which together may result in higher end-user costs. Funding costs and liquidity requirements of swaps intermediaries and end-users should be assessed for the impact of such changes as differences in collected and posted collateral margin and the effect of collateral segregation on re-hypothecation/secured funding programs.
**Volker Rule nexus: proprietary derivatives activities of banking organizations and systemically significant institutions**

The Volcker Rule is broadly drafted to capture as “banking entities” any affiliate or subsidiary of a bank or its holding company. The rule generally prohibits “banking entities” from engaging in “proprietary trading,” meaning engaging as principal in its own trading account, in purchasing or selling any security, derivative, futures contract for a commodity, any option on any of the foregoing, and any other financial instruments as the appropriate federal banking agencies and the SEC and CFTC may determine. The Act specifically requires an insured depository institution subject to the push-out rule to comply with the Volcker ban on proprietary trading of derivatives.

There are a number of exceptions to the rule. Such “permitted activities” include (i) underwriting and market-making activities to the extent such activities are designed not to exceed the reasonable expected near-term demands of clients, customers, and counterparties; (ii) risk-mitigating and hedging activities; and (iii) transactions for customers.

The Volcker Rule also limits banking entity involvement in sponsoring and investing in hedge funds and private equity funds.2

**Reporting and business conduct rules**

**Reporting.** The Dodd-Frank Act requires that the CFTC or SEC prescribe rules for execution facilities to make public timely information on price, trading volume, and other trading data. Alternative reporting will be required for trades not subject to clearing requirements. The reporting of trades will commence following the issuance of rules by the CFTC and/or SEC. The CFTC and SEC are given discretion to create exceptions from real-time requirements for “block transactions,” but these large trades would still have to be disclosed, for example at end-of-day. For certain products, reporting of price and volume information will be “real time” as soon as interim rules are published and become effective, and will include mandatory real-time public price reporting for certain trade types that are subject to clearing. All swap market participants are required to maintain daily swap trading records (including recorded communications) and supporting information to provide complete audit trails (including capacity to conduct comprehensive trade reconciliations).

**Business conduct.** The Act defines new sales practice obligations regarding sales of swaps to “Special Entities”—e.g., municipalities, governments, and Employee Retirement Income Security Act (ERISA) plans. Dodd-Frank establishes a new standard for transactions with counterparties that is framed with a mixture of fiduciary and suitability features, to be further defined by regulators. Among the features are:

- A mandate for disclosure of certain characteristics and material conflicts of interest, marks, etc.
- A requirement to “communicate” in accordance with good faith and fair dealing standards
- Special duties for swap dealers or MSPs toward any “Special Entities” counterparty (e.g., government, state and municipal governments and agencies, employee benefit plans, and tax-exempt endowments), which are divided depending on whether the swaps entity is acting in the capacity of an advisor
- No obligation with respect of any trade done through an exchange or swap execution facility where the swap entity does not know the identity of the counterparty

There is more to come on these and related topics concerning derivatives activities reform, pending the completion of studies, promulgation of regulations, issuance of supervisory interpretations, and propagation of further legislative actions and corrections.

---

While Dodd-Frank will have significant impact on the oversight and execution of the US OTC derivatives markets, many implementation issues are currently unclear and are subject to the SEC and other agencies’ rulemaking processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will be available at www.pwcregulatory.com.

Additional information

If you would like additional information on Dodd-Frank or about PwC’s Financial Services Regulatory practice, please contact:

Dan Ryan  
FS Regulatory Practice Chairman  
646-471-8488  
daniel.ryan@us.pwc.com

Gary Meltzer  
FS Regulatory Practice Managing Partner  
646-471-8763  
gary.c.meltzer@us.pwc.com

John Garvey  
FS Advisory Leader  
646-471-2422  
john.garvey@us.pwc.com

Gary Meltzer  
FS Regulatory Practice Managing Partner  
646-471-8763  
gary.c.meltzer@us.pwc.com

John Garvey  
FS Advisory Leader  
646-471-2422  
john.garvey@us.pwc.com

PwC’s Financial Services Regulatory Practice Leaders

Kenneth Albertazzi  
617-530-6237  
kenneth.albertazzi@us.pwc.com

Robert Nisi  
646-471-4027  
robert.nisi@us.pwc.com

Ellen Walsh  
646-471-7274  
ellen.walsh@us.pwc.com

David Albright  
703-918-1364  
david.albright@us.pwc.com

Ric Pace  
703-918-1385  
ric.pace@us.pwc.com

Dan Weiss  
703-918-1431  
dan.weiss@us.pwc.com

Thomas Biolsi  
646-471-2056  
thomas.biolsi@us.pwc.com

Richard Paulson  
646-471-2519  
richard.paulson@us.pwc.com

Gary Welsh  
703-918-1432  
gary.welsh@us.pwc.com

John Campbell  
646-471-7120  
john.w.campbell@us.pwc.com

Lori Richards  
703-610-7513  
lori.richards@us.pwc.com

Jeff Lavine  
703-918-1379  
jeff.lavine@us.pwc.com

David Sapin  
646-471-8481  
david.sapin@us.pwc.com

www.pwcregulatory.com

© 2010 PricewaterhouseCoopers LLP. All rights reserved. “PricewaterhouseCoopers” refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity. This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.