XII. Regulation of Swap Markets under the Dodd-Frank Act

A. Introduction

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Act") creates a system to regulate both over-the-counter and securities-based swap markets.[1] This development article will look into several aspects of swap markets, including the perceived need to regulate, the regulations expressly established by Title VII and likely future actions of regulating agencies and market participants. It will begin with a brief introduction to swaps and their role in the financial crisis of 2008. The article will then discuss the effects of Title VII, focusing on three parts of the new regulatory regime: the regulation of swap dealers and other swap market participants, the clearing and exchange trading of swaps and the Swap Pushout Rule. For each major provision, the article will comment on how Title VII will affect swaps and those who participate in swap markets. In doing so, it will also address how markets might react and how federal agencies might choose to use the powers and uphold the responsibilities they have been delegated.

B. An Introduction to Swaps and Their Role in the Financial Crisis of 2008

In a typical swap, two parties exchange future cash flows that have the same net present value.[2] For example, in an interest rate swap, party A might agree to pay party B interest for two years on some principal value at a variable reference rate such as the LIBOR. In an exchange, party B might agree to pay party A interest at a fixed rate for the same duration on another principal value such that the parties' obligations have the same net present value.[3] The principal values are notional; they are not exchanged and need not exist.[4] Interest rate swaps have many uses. These uses include: hedging

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1, 124 Stat. 1376, 1379-80 (2010).
[2] JOHN HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVES 147 (7th ed. 2008).
[3] *See id.* at 147-50 (providing an in-depth explanation of interest rate swaps).
[4] *Id.* at 147.

against an unfavorable change in interest rates[5]; taking advantage of a comparative advantage a company has in either fixed or variable rates[6]; and engaging in credit arbitrage.[7]

However, not all swaps are this straightforward. For example, in a credit default swap ("CDS"), one party accepts periodic payments in exchange for assuming some or all of the risk of default on an underlying credit obligation.[8] The debtor in the underlying obligation is not a party to the swap.[9] If a creditor buys a CDS on a credit obligation owed to her, she is in a similar position as she would be if she had sold some or all of the credit obligation; in this way, CDS and similar credit derivatives allow the hedging and diversification of credit risk.[10] However, an investor can also enter into a CDS without having an interest in the underlying obligation, effectively using the CDS to speculate or to concentrate risk.[11] Financial companies heavily invested in CDS transactions contribute to systemic risk, for if one party to a CDS cannot meet its obligations, its counterparty may then find itself unable to meet other financial obligations.[12] In 2008, Bear Stearns and AIG found themselves in this position.[13]

C. Regulation of Swap Markets under Title VII of the Dodd-Frank Act

Title VII of the Act establishes a comprehensive regulatory regime on swap markets and those who participate in them.[14] Important provisions subject swap dealers, security-based swap

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[5] James Bicksler & Andrew H. Chen, *An Economic Analysis of Interest Rate Swaps*, 41 J. FIN. 645, 647-48 (1986).
[6] Robert H. Litzenberger, *Swaps: Plain and Fanciful*, 47 J. FIN. 831, 839-41 (1992).
[7] *Id.* at 839.
[8] David Mengle, *Credit Derivatives: An Overview*, 92 ECON. REV., no. 4, at 1-2.
[9] *Id.* at 2.
[10] *Id.* at 16.
[11] *Id.* at 17.
[12] Hal S. Scott, *The Reduction of Systemic Risk in the United States Financial System*, 33 HARV. J.L. & PUB. POL'Y 671, 674-75 (2010).
[13] *Id.* at 675.
[14] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1, 124 Stat. 1376, 1379-80 (2010) (to be codified at 12 U.S.C. § 5301).

dealers, major swap participants and major security-based swap participants[15] to capital requirements and require them to publicly report swap transaction data.[16] Most swaps will no longer be traded over-the-counter. Instead, they must be traded at exchanges after being cleared by a derivatives clearing organization.[17] Federal agencies will not be permitted to provide financial "bailout" assistance to certain swap dealers and swap market participants.[18] Each of these aspects will be discussed in detail below.

1. Regulation of Banks, Swap Dealers and Others

Under the Dodd-Frank Act, swap dealers and major swap participants are required to register with the SEC or CFTC.[19] These agencies will establish requirements pertaining to minimum capital, marginal capital, bookkeeping, reporting, conduct standards and other concerns with which swap dealers and major swap participants must comply.[20] The Act does not detail many of these provisions, instead giving the SEC and CFTC a lot of leeway as to how closely they regulate.[21] Swap dealers and major swap participants must comply with new business conduct requirements that require disclosure to counterparties of material risks and conflicts of interests, although these standards are more lenient than the fiduciary

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[15] The Act distinguishes between "swaps" and "security-based swaps;" between "swap dealers" and "security-based swap dealers;" and between "major swap participants" and "major security-based swap participants." *Compare*, *e.g.*, § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(47)) (definetion of "swap") with § 721(a)(19) (to be codified as 7 U.S.C. § 1(a)(42)) (definition of "security-based swap"). The primary difference is that the Securities and Exchange Commission is the relevant regulator with respect to anything "security-based," while the Commodity Futures Trading Commission regulates anything not "security-based." § 712(a). Hereinafter, this article will not distinguish between anything "security-based" and not.
[16] § 731 (to be codified at 7 U.S.C. § 6s).
[17] § 723(a) (to be codified at 7 U.S.C. § 2).
[18] § 716 (to be codified at 15 U.S.C. § 8305).
[19] § 731 (to be codified at 7 U.S.C. § 6s).
[20] *Id.*
[21] *Id.*

duty that Title VIII imposes on brokers and dealers.[22] Swap dealers and major swap participants that enter into swaps with states, localities, governmental agencies and some other "Special Entities" are subject to additional requirements to be established by regulators.[23]

The Act defines a "swap dealer" as:

> *any person who—*
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> > *(i) holds itself out as a dealer in swaps;*
> > *(ii) makes a market in swaps;*
> > *(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or*
> > *(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps,*
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> *provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.*[24]

There are additional exceptions for entities who engage in de minimis swap transactions made on behalf of customers[25] and for people who enter into swaps for their own accounts.[26] The typical "major swap participant" will be a nonbank entity that "maintains a substantial position in swaps."[27] The qualifications for classification as a swap dealer or a major swap participant are vague, and even if agencies establish brighter lines, there will likely be much litigation resulting from banks and other institutions that deal in swaps while maintaining that they are not swap dealers or major swap participants under the language of the Act. The Chairman of the CFTC has

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[22] *Compare* § 731 (to be codified at 7 U.S.C. § 6s(h)(3)) (business conduct standards for swap dealers) *with* § 913 (to be codified at 15 U.S.C. § 780) (fiduciary duty for brokers and dealers).

[23] § 731 (to be codified at 7 U.S.C. §§ 6s(h)).

[24] § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(49)(A)).

[25] Regulators will establish guidelines as to who qualifies for the de minimis exemption. § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(49)(D)).

[26] § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(49)(C)).

[27] *See* § 721(a)(16) (to be codified at 7 U.S.C. § 1(a)(33)(A)) (providing the full definition of "major swap participant").

indicated that foreign firms that enter into swaps with U.S. counterparties can be treated as swap dealers or major swap participants, and will be subject to the same requirements as domestic firms.[28]

Additionally, the Volcker Rule of Title VI prohibits insured banks and their affiliates from acting as a principal with respect to some transactions involving swaps and other derivatives.[29] Although the Rule is primarily concerned with acting as a principal in speculative short-term investments, the SEC and CFTC are permitted to extend this ban to also cover longer-term investments.[30]

2. Clearing and Trading of Swaps

In an effort to reduce counterparty risk, the Act requires most swaps to be cleared by a derivatives clearing organization ("DCO").[31] The Act defines an extensive set of criteria for registration as a DCO, including requirements regarding financial recourses, risk management and reporting.[32] Title VII defines "swap" broadly to include not only instruments typically referred to as swaps, but also most other derivatives, including put and call options.[33] However, the Act expressly excludes instruments regulated by the Securities Act of 1933 and the Securities Exchange Act of 1934.[34] In effect, most derivatives that are currently traded over-the-counter will be subject to the clearing requirements. Swap transactions entered into before these regulations go into effect will have to be reported but not cleared.[35] Swaps are exempt from the clearing requirement if one party is not a financial entity, is using the swap to hedge against risk, or gets special permission from

[28] Asjylyn Loder, *Foreign Banks Selling Swaps in U.S. to Face Dodd-Frank Rules, Gensler Says*, BLOOMBERG, Oct. 21, 2010, http://www.bloomberg.com/news/2010-10-21/foreign-banks-selling-swaps-in-u-s-to-face-dodd-frank-rules-gensler-says.html.
[29] § 619 (to be codified at 12 U.S.C. § 1851).
[30] *Id*. For a more extensive analysis of the Volcker Rule, *see* William J. Sweet, Jr. & Brian D. Christiansen, *The Volcker Rule*, *in* THE DODD-FRANK ACT, COMMENTARY AND INSIGHTS 31, 31-36 (Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates ed., 2010).
[31] § 723(a) (to be codified at 7 U.S.C. § 2).
[32] § 725(c) (to be codified at 7 U.S.C. § 7a).
[33] § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(47)(A)).
[34] § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(47)(B)(iii)).
[35] § 723(a)(3) (to be codified at 7 U.S.C. § 2(h)).

regulators.[36] Foreign exchange swaps and forwards are also subject to regulation, although the Secretary of the Treasury has the power to exclude them from regulation.[37] European and other foreign regulators have been communicating with American regulators to try to ensure that swap market regulation will be as consistent as possible worldwide.[38]

Cleared swaps must be traded at a contract market, such as an existing securities exchange, or at a swap execution facility ("SEF").[39] Except for "eligible contract participants," no one may enter into a swap not traded on an exchange.[40] The Act provides requirements for registering SEFs, which are regulated by the SEC and the CFTC. A DCO differs from an exchange in that market making is more complicated for swaps than for many securities, since "many [swaps] require some element of customization or negotiation on terms, or are too specialized to trade on exchanges."[41] Although regulators have not yet come up with the rules, many major exchanges have already expressed their intent to register as SEFs.[42] The Chairman of the SEC has expressed her desire to make swap markets more like other securities markets, and it is likely that agency rules will move swap markets in this direction.[43] Exchange trading of swaps should increase transparency, reduce counterparty risk and remove some comparative advantage currently enjoyed by

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[36] § 723(a) (to be codified at 7 U.S.C. § 2).
[37] § 722(h) (to be codified at 7 § U.S.C. § 1b).
[38] Brai Odion-Esene, *US CFTC Gensler: Sees Rise in Swap Dealers due to Dodd-Frank*, MARKET NEWS, Sept. 16, 2010, http://imarketnews.com/node/19351.
[39] § 723(a)(2) (to be codified at 7 U.S.C. § 2(d)).
[40] *Id.* "Eligible contract participants" include financial institutions, federally-regulated investment companies, and state-regulated insurance companies. 7 U.S.C § 1(a)(12). However, section 721(a)(9) of the Act will make the present definition more stringent.
[41] Roberta Rampton, Q+A-What's at stake for swap-execution facilities?, REUTERS, Sept. 7, 2010, http://www.reuters.com/article/idUSN0722464520100907.
[42] *Id.*
[43] Rachelle Younglai & Jonathan Spicer, *New Swaps Market Needs to be Like Stock Market: SEC*, REUTERS, Sept. 22, 2010, http://www.reuters.com/article/idUSTRE68L5ZQ20100922.

large firms and those with superior access to information.[44] Critics suggest that swap exchanges will attract hedge funds and other high-frequency traders, who will provide liquidity but increase volatility.[45] Leaders in the oil, airline and other industries fear the new trading system will increase the cost of hedging, despite a CFTC commissioner's statement that the overhaul will not make "legitimate hedge activities" more expensive.[46]

3. The Swap Pushout Rule

After the bailouts of Citigroup, Bank of America and others, there was public outcry that taxpayers were assuming the liabilities of banks and other financial institutions involved in risky transactions. In response, Congress included the Swap Pushout Rule in the Dodd-Frank Act. Under the Act, "no Federal assistance may be provided to any swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity."[47] Swaps entities include swap dealers and major swap participants.[48] Exceptions are made for major swap participants that are insured depository institutions, as well as swaps entities that limit their swap activities to hedging and other specially permitted activities.[49] Here, "Federal assistance" refers only to the Federal Reserve's abilities; however, later in the section, a broader statement is made: "Taxpayers shall bear no losses from the exercise of any authority under this title."[50] The Act does not define "losses," and the directive seems impossibly vague. If the government invests in or "bails out" a financial firm, it

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[44] John Carney, *Will Dodd-Frank Help High Frequency Traders Crash the Bond Market Too?*, CNBC.COM, Sept. 29, 2010, http://www.cnbc.com/id/39419371.
[45] *Id.*
[46] Aaron Clark & Asjylyn Loder, *Overhaul Won't Raise 'Legitimate' Hedging Costs, Chilton Says*, BLOOMBERG, Oct. 25, 2010, http://www.bloomberg.com/news/2010-10-25/overhaul-won-t-raise-legitimate-hedging-costs-chilton-says.html.
[47] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716(a), 124 Stat. 1376, 1648 (2010) (to be codified at 15 U.S.C. § 8305).
[48] § 716(b)(2) (to be codified at 15 U.S.C. § 8305).
[49] § 716(d), § 716(g) (to be codified at 15 U.S.C. § 8305).
[50] § 716(i)(3) (to be codified at 15 U.S.C. § 8305).

may be years before the government knows whether it has gained or lost on the transaction.[51]

The Act also prohibits the use of taxpayer funds to prevent the receivership of swaps entities that are FDIC insured or that pose a systemic risk.[52] For all other swaps entities, taxpayer resources cannot be used in the liquidation of such entities.[53] This gives FDIC insured swaps entities the same treatment in liquidation proceedings as that enjoyed by other financial companies under Title II of the Act, whereas swaps entities that are not FDIC insured are singled out for worse treatment.[54]

D. Conclusion

Title VII, like the rest of the Dodd-Frank Act, is bold and comprehensive. It will bring to swap markets a level of regulation comparable to that seen in other securities markets. Assuming the regulatory regime is successful in preventing financial institutions from taking speculative swap positions, it remains to be seen whether this will meaningfully improve the soundness of these institutions, or whether they will be able to develop more opaque financial instruments in pursuit of the greatest returns. One way or another, the next few years will be interesting.

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[51] For example, as of October 2010, the government has made significant net gains in its 2008 "bailout" investments in Citigroup, Goldman Sachs, and Morgan Stanley, although many contemporaneous bailouts still show losses. Yalman Onaran & Alexis Leondis, *Wall Street Bailout Returns 8.2% Profit Beating Treasury Bonds*, BLOOMBERG, Oct. 20, 2010, http://www.bloomberg.com/news/2010-10-20/bailout-of-wall-street-returns-8-2-profit-to-taxpayers-beating-treasuries.html.
[52] § 716(i)(1) (to be codified at 15 U.S.C. § 8305).
[53] *Id.*
[54] *Compare id.* (liquidation of swaps entities) *with* § 214 (liquidation of financial companies).
[55] Student, Boston University School of Law (J.D. 2012).