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## WALL STREET TRANSPARENCY AND ACCOUNTABILITY ACT OF 2010: WHAT THIS LAW WOULD MEAN TO HEDGE FUNDS THAT TRADE DERIVATIVES

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**On June 30, 2010, the House approved the Dodd-Frank Wall Street Reform and Consumer Protection Act, of which Title VII is the Wall Street Transparency and Accountability Act of 2010 (the "Act"). Subtitles A and B of the Act (the "Derivatives Provisions") deal with the regulation of over-the-counter derivatives (in the Act, "swaps" or "security-based swaps," and together, "swaps" or "derivatives"). While Senate approval will be required before the bill is presented to President Obama for signature, it is widely believed that, after particular provisions regarding margin requirements are modified, as discussed below, Senate and Administration approval will occur within the next few weeks, and the bill will become law. Assuming this happens, and the Act becomes effective, many derivatives market participants likely will experience a radical and costly change in the way they trade, and in the consequences of their trading, derivatives.**

The Act represents a "never again" reaction to the economic crisis we have endured for the past two years. Both bank and nonbank major participants in the derivatives markets will be designated as either Swap Dealers or Major Swap Participants (or Security-based Swap Dealers and Major Security-based Swap Participants in the case of a security-based swap), and will be subject to registration, capital, margin, clearing, reporting and recordkeeping requirements.

Unless otherwise provided in the Derivatives Provisions:

- such provisions will become effective 360 days after enactment or, if a provision requires rulemaking or regulation, not less than 60 days after such implementing rules and regulations are published;
- when implementing rulemaking is required, such rules and regulations must be promulgated within 360 days after the Act's enactment; and
- when the Derivatives Provisions require the Commodity Futures Trading Commission (the "CFTC")

and the Securities and Exchange Commission (the "SEC," and together with the CFTC, the "Commissions") to promulgate joint rules but they fail to do so in a timely manner, then the Financial Stability Oversight Council is required to resolve the dispute in a timely manner.

### **Swap Dealer Or Security-based Swap Dealer**

A Swap Dealer is a financial entity that engages in swap transactions, other than transactions that reference an underlying security. A Security-based Swap Dealer is a financial entity that engages in swap transactions that do reference an underlying security.

A hedge fund that previously was considered to be a bank customer will now be categorized as a Swap Dealer if, among other alternative criteria, it "regularly enters into swaps with counterparties as an ordinary course of business for its own account." The inclusion of the word "regularly" in

the definition would seem to bring under the Act those hedge funds that are major players in the derivatives market and to exclude those hedge funds with strategies that rarely involve derivatives transactions. The term “for its own account,” although originally directed at banks’ proprietary trading, could be interpreted to include hedge fund trades.

**Major Swap Participant Or Major Security-based Swap Participant (together, “Major Swap Participant”)**

If a hedge fund with a substantial derivatives trading book is not categorized as a Swap Dealer, it will fall within the Major Swap Participant bucket if: (i) it maintains a Substantial Position (as discussed below) in swaps, excluding positions held for hedging or mitigating commercial risk; or (ii) its outstanding swaps create substantial counterparty exposure that could have a serious adverse effect on the financial stability of the U.S. banking system or financial markets; or (iii) it is highly leveraged relative to its capital and not subject to regulatory capital requirements *and* maintains a Substantial Position in swaps, excluding positions held for hedging or mitigating commercial risk or, in the case of an employee benefit plan, risk associated with the plan’s operation.

The term “Substantial Position,” which is key to the determination of whether a hedge fund would be categorized as a Major Swap Participant, will not be defined until the CFTC, in the case of swaps, or the SEC, in the case of security-based swaps, promulgates a rule or regulation that includes this definition. The Act does provide that the definition, which the applicable

regulator is required to promulgate within 360 days after the law’s enactment, must capture entities that could significantly impact the stability of the financial system, factoring in (i) the entity’s relative position in cleared versus uncleared swaps and (ii) at the discretion of the CFTC or the SEC, as applicable, the collateral held by the entity to secure counterparty exposures.

Based on a plain reading of the Major Swap Participant definition, including the Act’s guidance as to the regulation defining Substantial Position, an argument can be made that hedge funds, by their very nature, do not fit within the Major Swap Participant category because they do not have “main street” investors. We know from the lengthy legislative history of the Act, however, that the Major Swap Participant classification was drafted to include hedge funds with substantial derivatives portfolios. It can be expected that the relevant forthcoming regulations will clear up any ambiguity regarding whether a hedge fund can be categorized as a Major Swap Participant.

While it seems more likely that hedge funds that actively trade and have large derivatives portfolios will be categorized as Major Swap Participants rather than as Swap Dealers, this is a distinction without a difference because the requirements for both classifications are the same. Hedge funds that do not hold Substantial Positions in swaps and do not regularly engage in swap trades may want to take the position that they do not fit within either the Swap Dealer or Major Swap Participant category. Hopefully, the forthcoming regulations will provide guidance on how such funds are to be categorized.

**Hedge Funds That Regularly Trade Swaps Or That Hold A Substantial Position In Swaps Need To Be Prepared To Comply With The Swap Dealer/Major Swap Participant Requirements**

The Act provides that it will be unlawful for any person to act as a Swap Dealer or Major Swap Participant unless it is registered as such with the CFTC. The Act also provides that it will be unlawful for any person to act as a Security-based Swap Dealer or Security-based Major Swap Participant unless it is registered as such with the SEC. Financial entities that trade in both swaps and security-based swaps must register with both the CFTC and the SEC. The registration requirement takes effect within one year after the Act’s passage. In addition to the registration requirements, a Swap Dealer or Security-based Swap Dealer, as applicable (together, a “Swap Dealer”) and a Major Swap Participant or Security-based Major Swap Participant, as applicable (together, “Major Swap Participant”) will be obligated:

- to reserve regulatory capital and obtain variation and initial margin from its swap counterparties; and
- to comply with:
  - o clearing, execution and reporting requirements with respect to its swap positions;
  - o documentation, back office and business conduct standards related to its swaps business;
  - o position limits rules; and
  - o rules applicable to employee benefit plans and municipalities.

All of these requirements will be clarified by and made subject to rules and

regulations to be adopted separately or jointly by the CFTC and/or the SEC.

### **Capital And Margin Requirements**

The Commissions are directed to adopt comparable rules setting forth the capital and margin requirements for uncleared swaps, in both cases taking into account that uncleared swaps pose a greater threat to the financial system than do cleared swaps.

**Capital Requirements.** The CFTC and/or the SEC are obligated to adopt rules and regulations imposing capital requirements on nonbank Swap Dealers and Major Swap Participants. This will mean that hedge funds, which previously have not had to reserve capital against their swap exposures, will have less money available for investment opportunities.

**Margin Requirements.** Hedge funds also will be required to post initial and variation margin for uncleared swaps in accordance with the rules to be promulgated by the Commissions. For cleared swaps, Derivatives Clearing Organizations (“DCOs”) will determine the amount of initial and variation margin required to be pledged by Swap Dealers and Major Swap Participants. Collateral other than USD cash will be permitted only if the appropriate rulemaking agencies allow it. Because dealers rarely post initial margin to their over-the-counter counterparties, this initial margin requirement represents a new cost to dealers engaging in cleared swaps, which cost is likely to be passed along to their hedge fund counterparties.

When the clearing regulations are finalized, all uncleared swaps will be required to be collateralized at levels that will be prescribed by the Commissions. It is uniformly believed

and implied in certain sections of the Derivatives Provisions that swaps entered into and still outstanding on the effective date of the Derivatives Provisions will be required to be margined. The section of the Act on “Legal Certainty,” however, appears to mean that, with respect to swaps existing on the enactment date, the margin and other requirements under the Derivatives Provisions will not permit a party unilaterally to terminate or renegotiate a swap. It is widely believed that the legislative intent was to exempt commercial end-users from the margin requirements just as they are exempt from the clearing requirements, and that clarification will be made either through regulation or by passing a separate bill dealing only with this issue. In any event, it is highly unlikely that the exemption will include hedge funds.

### **Margin Segregation Requirements**

**Uncleared Swaps.** A Swap Dealer or Major Swap Participant must notify its counterparty of its right to request the segregation of any initial margin posted to secure its obligations to such Swap Dealer or Major Swap Participant under a swap or security-based swap. After such notice, at the request of its counterparty, the Swap Dealer or Major Swap Participant must segregate, with an independent third-party custodian, any funds or property pledged as initial margin to such Swap Dealer or Major Swap Participant to margin, guarantee or secure the counterparty’s obligations under a swap that is not submitted for clearing. If the counterparty does not request the segregation of its collateral, the Swap Dealer or Major Swap Participant must confirm to its counterparty, on a quarterly basis, that the collateral is being held in accordance with their agreement.

Because a dealer’s pricing likely will be affected by whether its counterparty chooses to require or to waive its right to collateral segregation with an independent third-party, hedge funds will need to weigh the pricing differential against, among other factors, its overall relationship with the dealer, the dealer’s creditworthiness and the risk tolerance of the fund.

**Cleared Swaps.** DCOs are responsible for ensuring that initial margin posted by a counterparty to secure its obligations under a cleared swap is segregated from its dealer’s other assets. A DCO must be registered with the CFTC and/or the SEC, and must comply with the core principles set forth in the Derivatives Provisions as well as other rules and requirements that may be imposed by the CFTC and/or the SEC, as applicable.

### **Mandatory Clearing And Execution**

Swaps that would be accepted for clearing and that the CFTC or the SEC, as applicable, approves for clearing, are required to be cleared, except if one of the swap parties: (i) is not a “financial entity,” which term includes, among other things, Swap Dealers and Major Swap Participants; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the CFTC and/or the SEC, as applicable, as to how it generally meets its financial obligations associated with entering into non-cleared swaps. This means that the clearing requirements apply to any swap where both parties are either Swap Dealers or Major Swap Participants, such as a swap between a dealer and a hedge fund categorized as either a Swap Dealer or a Major Swap Participant.

Swaps that are required to be cleared may be traded only on a board of trade

or swap execution facility, unless no board of trade or swap execution facility is available for such trading.

Swaps entered into before the Act's enactment will be exempt from the clearing requirements if they are reported to a registered swap data repository or the appropriate regulatory authority not later than 180 days after the clearing requirements become effective. Swaps entered into after the Act's enactment but before the clearing requirements become effective will be exempt from such requirements if reported within the time frame for reporting as specified below.

### **Reporting Requirements**

All swaps, including those outstanding on the date the Act is passed, will be required to be reported to a registered swap data repository or, if not accepted by such a repository, by the appropriate regulatory authority. A registered swap data repository is an entity that is required to register with the appropriate regulatory authority and to comply with rules regarding data compliance and maintenance, and the sharing of certain information with government entities.

The deadline for reporting swaps entered into on or after the Act becomes law is the later of (i) 90 days after the effective date of the clearing and reporting requirements, and (ii) at such other time as the appropriate regulatory authority may prescribe. Swaps entered into before and still outstanding on the date of enactment must be reported within 180 days after such effective date.

Within 30 days after the date the Act becomes law, the CFTC and the SEC each must promulgate an "interim final

rule" as to how uncleared pre-enactment swaps are to be reported. Uncleared swaps entered into before the date of the Act's enactment but that have not yet expired as of such date shall be reported to a repository or regulatory authority not later than 30 days after the issuance of the interim final rule or other period as the applicable regulator deems appropriate.

If only one of the parties to the swap is a Swap Dealer or a Major Swap Participant, then such Swap Dealer or Major Swap Participant shall be required to report the swap. If the swap is between a Swap Dealer and a Major Swap Participant, the Swap Dealer must report the swap. In all other cases, the counterparties to the swap must select one party to report the swap.

### **General Reporting And Recordkeeping Requirements**

Swap Dealers and Major Swap Participants will be obligated:

- to issue reports to the CFTC and/or the SEC, as applicable, regarding their swap transactions and positions and their financial condition pursuant to rules and regulations to be issued by the CFTC and/or the SEC, as applicable;
- to keep books and records relating to their swap activities open for inspection by the CFTC and/or the SEC; and
- to maintain daily trading and related records (for each counterparty and as identifiable for each swap transaction), recorded communications (including electronic mail and recordings of telephone conversations) and other information

as may be required, and for such time periods as may be required, by rules and regulations to be issued by the CFTC and/or the SEC, as applicable.

### **Position Limits**

The CFTC will be required to adopt regulations to provide limits with respect to certain transactions, other than bona fide hedging transactions, and any swap execution facility that is a trading facility will have to adopt such position limits as the CFTC shall require to address its concerns over market manipulation and congestion.

The SEC will be required, as a means to prevent fraud and manipulation, to establish position limits with respect to security based swaps, also subject to a bona fide hedging exemption. The SEC also may issue regulations directing a self-regulatory organization to adopt position limits.

The Act provides that the position limits rules will not apply to positions acquired in good faith prior to the effective date of any rule, regulation or order that establishes the applicable position limit.

### **Trading With Employee Benefit Plans And Municipalities**

The Act will create new responsibilities for Swap Dealers and Major Swap Participants that enter into over-the-counter trades with "Special Entities." Special Entities include, among other entities, (i) employee benefit plans, government plans and endowments, and (ii) federal and state agencies, states and municipalities. While it is unusual for a hedge fund to be trading with an employee benefit plan or a municipality, the hedge fund itself may be considered to be a "plan" for these purposes if a portion of its assets consists of employee

benefit plan assets. Under this scenario, the hedge fund's counterparty would be the Swap Dealer/Major Swap Participant facing the hedge fund Special Entity in the trade.

A Swap Dealer or Major Swap Participant entering into a swap with a Special Entity will be obligated reasonably to believe that its Special Entity counterparty has an independent representative (e.g., the investment manager of a plan assets hedge fund) who, among other necessary qualifications, (i) has sufficient knowledge to evaluate the transaction and its risks, (ii) is acting in the best interests of the Special Entity, (iii) makes appropriate disclosures and will provide written representations to the Special Entity regarding the pricing and appropriateness of the trade, and (iv) in the case of a Specified Entity that is an employee benefit plan subject to the Employee Retirement Income Security Act of 1974, qualifies as a fiduciary. In addition, such Swap Dealer or Major Swap Participant will have to comply with the standards and requirements set forth in regulations to be promulgated by the Commissions.

### **Other Provisions of Significance to Hedge Funds**

#### **Portfolio Margining and Netting**

Portfolio margining is intended to reduce the amount of initial margin that hedge funds post to their prime brokers by taking advantage of risk-reducing correlations in its portfolio, including off-sets between derivatives and cash instruments. The Act's clearing requirements significantly impair the benefits of portfolio margining because (i) each hedge fund's portfolio will be split into sub-portfolios of cleared and non-cleared trades, with each sub-

portfolio independently collateralized, and (ii) off-setting or risk-reducing cash instruments and non-clearable derivatives will not be factored in to the margin requirements set by DCOs.

It may be possible for a hedge fund to regain some of the benefits of portfolio margining through a bridging agreement under which the fund's designated clearing member (a "DCM") would continue to perform portfolio margin tests on both the cleared and uncleared trades in the portfolio and to collect initial margin equal to the greater of (i) the DCO's margin requirement and (ii) the margin amount required by the fund's DCM based on the results of its portfolio margin tests. It probably will be not possible, however, to reduce the initial margin requirements by offsetting, against cleared trades, uncleared trade positions or cash positions. For example, if a hedge fund is long a bond in the cash market and short an index that includes that bond's issuer on a cleared trade, there is no mechanism for a DCM to reduce the initial margin requirement for the fund's cleared trades to reflect the actual risk in the portfolio. This problem is exacerbated when a fund clears its trades through different DCOs.

#### **Spin-off Requirements**

The Act may significantly disadvantage U.S. banks by requiring, after a transition period of up to 24 months, that certain types of derivatives trading, notably equity derivatives, non-cleared credit default swaps and most commodity derivatives, be transacted only by newly spun-off derivatives trading affiliates that most likely will not be able to offer their counterparties credit enhancements in the form of a guaranty or other credit support from its parent or other banking affiliate. U.S.

banks still will be able to enter into hedging and other similar risk mitigating transactions intended to minimize the bank's own risk exposure, as well as interest rate, foreign exchange and cleared credit default transactions. Hedge funds therefore will continue to be permitted to enter into trades involving these products directly with U.S. banks.

If a hedge fund trades a broad range of derivatives instruments, it may now be required to face two or more entities that have been spun-off from the same U.S. bank, each of which must be separately capitalized. The hedge fund counterparty will not be able to benefit from cross guarantees or cross affiliate netting. In this situation, the hedge fund's initial margin requirement likely will be greater than it would be if, instead, the hedge fund were facing a single counterparty. Further, should the bank or a spun-off bank affiliate become insolvent, the hedge fund's trades with each of its counterparties would be closed-out individually due to the absence of setoff and netting. The effect of this could be even more dramatic if the hedge fund's derivatives portfolio were to consist of both cleared and uncleared transactions with both the bank itself and its spun-off swap affiliate, or if the bank were to spin off more than one affiliate to take advantage of reduced regulatory capital charges in a non-U.S. jurisdiction. As the collateral buckets multiply, the setoff and netting benefits decrease for the hedge fund counterparty.

**Now for some good news.** The Act explicitly states that swaps and security-based swaps cannot be regulated as insurance under State law, which means that state insurance departments will not be able to rule that the seller of

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certain types of credit default swaps must be a licensed insurer. The Act also prohibits any state gaming or bucket shop law from invalidating any security-based swap, except as otherwise provided by the SEC.

None of the provisions in the Act dealing with derivatives should come as a surprise to derivatives market participants. Nonetheless, if and when the Act becomes law, hedge funds will have to assess the likelihood that they will be categorized as Swap Dealers or Major Swap Participants. Hedge funds that regularly engage in large-scale derivatives trading may assume their categorization as one of these two, based solely on the language in the Derivatives Provisions without the benefit of clarifying rules and regulations. Similarly, other hedge funds may be able to assume, based on the relevant sections of the Derivatives Provisions, that they will not be categorized as Swap Dealers or Major Swap Participants, but still will need to analyze the added costs of trading with counterparties that are classified as such. Many hedge funds, however, will fall into the middle ground of uncertainty and will need to consider whether, as both a practical and legal matter, they can and should await interpretive rules and regulations before attempting to determine in which bucket they fall;

should they pursue a “what if” plan and spend time and money preparing for responsibilities they may not have to assume, or await the clarifying regulations and risk coming up against a demanding time frame for compliance?

Each of these determinations requires a facts-and-circumstances analysis that will be different for each hedge fund. The lawyers in Lowenstein Sandler’s Investment Management Group and Derivatives Practice Group are available to help hedge funds navigate these difficult decisions.

**If you have any questions regarding the Act or would like to discuss further any of the matters covered in this Alert, please contact Sherri Venokur (212 204 8698), Matthew A. Magidson (646 414 6952) or any of the attorneys listed below.**

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