

Hot Issues Alerts – Law Firms

Derivatives: One Key Focus Of The Dodd-Frank Wall Street Reform And Consumer Protection Act

The Editor interviews **Matthew Magidson**, Chair of the Derivatives Practice Group, Lowenstein Sandler PC.

Editor: Please describe your practice.

Magidson: My individual practice primarily involves representing hedge funds and end users in derivative transactions. I negotiate their overall trading relationships and help with any issues they might have, including structuring transactions.

Editor: Please define for the purposes of this interview the meaning of “derivatives” and of “swaps.”

Magidson: A derivative is a financial contract whose value is based upon or “derived” from some underlying security, asset or index. A swap is a type of derivative in which two entities trade payments based on underlying criteria – such as a fixed interest rate versus a floating interest rate.

Editor: What regulations were swaps subject to prior to the passage of the Dodd-Frank Act?

Magidson: Prior to Dodd-Frank, the primary regulation of OTC derivatives trading was in two areas. First, the CFTC had regulations on the size of an eligible contract participant (as somewhat of a proxy for financial sophistication). Second, derivatives were only marketed and sold by regulated entities to sophisticated end users and counterparties.

Editor: Please describe the new regulatory framework for swaps.

Magidson: The new regulatory framework has three basic elements. The first is the reporting of swaps. There will be aggregate reporting requirements for swaps, regardless of the size of the user and whether or not the transaction is cleared. So now, not only will all cleared transactions have to be reported, but also all un-cleared transactions. The second is the concept of central clearinghouses designed for clearing derivative transactions. For example, if you enter into your trade with your normal counterparty, it is then given up to a clearinghouse; the clearinghouse backstops the risks in the marketplace. The clearinghouse is made up of a pool of members who are dealers, who together provide some additional security. Lastly, cleared transactions are supposed to be executed on a swap exchange facility. However, I think we need to wait for the regulations to have a clear picture of exactly what that means.

Editor: It seems quite ambiguous. What can you tell us about the possible swap execution facilities?

Magidson: As of now, OTC derivatives generally are entered into over the telephone with someone on the trading desk and then confirmed either with feeds or in writing, either electronically or on paper. Obviously that is not going to be the case going forward for a cleared swap – which I envision being traded on some kind of electronic matching service, but that’s just

my understanding at this point.

Editor: Do we know what margin requirements will be?

Magidson: We do not know how much margin is going to be required, but we know that swaps are going to be required to be margined. The one exception is the end-user exemption, which is still being fleshed out. However, it’s fairly safe to say that if you are a corporation hedging your own FX exposure or hedging your interest rate exposure, those types of transactions will not need to be cleared or collateralized.

Editor: Will end-user transactions still have to be registered?

Magidson: They will still have to be reported, generally by the dealer, so it’s not necessarily going to be a significant burden on the end user.

Editor: When do the new provisions under the Act become effective?

Magidson: Generally speaking, they become effective in 360 days.

Editor: How are Swap Dealers and Major Swap Participants (MSPs) distinguished one from the other?

Magidson: It is not terribly clear what the real difference is. Although there is some distinction in the names, there really is very little difference in practice.

Generally speaking, the swap dealer sells swaps whereas the major swap participant (MSP) uses them. The practical impact of being categorized as either one is basically the same.

Editor: Is there a so-called black line that clearly designates which swaps will be regulated by the CFTC and which will be regulated by the SEC?

Magidson: Swaps that reference a security (called security-based swap agreements) will be regulated by the SEC. All other swaps will be regulated by the CFTC. So, for example, if you have an interest rate swap or commodities swap, those types of transactions are CFTC regulated. However, if you have an equity derivative or a total-return swap on an equities share, for example, that would be regulated by the SEC.

Editor: How much discretion is given to the SEC and CFTC in writing the regulations?

Magidson: I think there is probably more discretion than initially contemplated. The final bill was a bit more sweeping than the bill that was initially proposed, so there is more coverage of derivatives than people were expecting. Therefore, the regulations will need to soft pedal some of that coverage to make the legislation work.



Matthew Magidson

Editor: Will most swaps be required to be cleared and traded through designated contract markets, national securities exchanges or swap execution facilities?

Magidson: We do not know yet. Right now, most swaps would not be required to be cleared because the clearinghouses cannot accept them. Swaps only are going to be required to be cleared to the extent that there is a clearing organization that would allow their clearing. Initially, you will see some interest rate swaps and single-name CDS and CDS indexes being cleared. It will build over time, and hopefully you’ll see the regulations spell this out.

Editor: Some swaps entered into by end-users will be exempt from these requirements. Which commercial users do you expect to be exempt from these requirements, and will these end users also be exempt from margin and capital requirements?

Magidson: Clearly a traditional corporate entity that is hedging its interest rates or hedging FX exposure on a particular asset should qualify as an end user, and those end users would not have to collateralize their trades. However, the end-user definition still needs to be fleshed out.

Editor: Could the magnitude of the transaction be a key to the definition of an end user whose trade has to be collateralized?

Magidson: It’s not necessarily related to the size of a specific asset. For example, if I have a general view of the market, and I do a small swap on the S&P 500, it is probably not a hedge and thus would likely be required to be cleared and collateralized. Interestingly, there was a mistake in the bill itself where it appears that end-user trades have to be collateralized. Senator Lincoln and Senator Dodd put out a letter stating that it was not the intent of the bill’s drafters that nonfinancial swap counterparties be subject to margin requirements. I assume that will be cleared up in the regulations, or there will be a future amendment to the Act.

Editor: Are many hedge funds likely to be caught up in the requirements of registering and fulfilling the reporting, the margin and capital requirements required by the two governmental bodies?

Magidson: It is not clear how big a hedge fund will have to be to be considered a major swap participant (MSP) or a swap dealer because one of the unresolved issues is whether a privately funded hedge fund ever really has the kind of systemic risk that a bank has.

Editor: What is the likelihood that these regulations will decrease the flexibility and profitability of hedge funds?

Magidson: I think it is much more likely that these provisions and the clearing requirements will cut into the profitability and flexibility of the dealers prior to the funds. Hedge funds still can choose which products they use to achieve the invest-

ment objectives they desire, and it is the dealer who is marketing these products who may feel the pinch. To me the real question is how much is this going to cost the dealer to implement and execute? How is that going to impact the marketplace? It may nick the profitability for hedge funds, but I think it’s going to affect the dealers first.

Editor: Do you think the dealers will pass the costs along to the hedge funds?

Magidson: Only if they can. It’s very hard to know how this is going to develop. For example, if there are both clearable products and fairly similar un-cleared products, you may see a big shift toward the more heavily negotiated, un-cleared products because they are more cost effective. If a swap execution facility increases transparency in the market – so that you can see what kind of prices other people are getting – the power of a dealer to increase his fees to collect the additional costs evaporates.

Editor: So will these trades be published on a ticker?

Magidson: It’s not clear. I don’t think they will all be published on a ticker, but there clearly is going to be much more available information as to how much collateral is going into these trades and how much profit margin there is.

Editor: Will the capital requirements be published also?

Magidson: That will come in the rules and regulations (as well as clearinghouse rules).

Editor: What are the “push-out” requirements for depository institutions in terms of moving out derivative activities to affiliates?

Magidson: The idea is to limit certain risky activities at the banks (and any taxpayer guaranty of such activities).

Editor: Would this be an unconsolidated subsidiary of a bank?

Magidson: If they push it out, it would be an affiliate of the bank and unlikely to be consolidated – though there have been conflicting statements on this point. If you allow the subsidiary to be consolidated or guaranteed, then you have not really accomplished anything. It has to be a stand-alone affiliate to make sense.

Editor: How much time do institutions have to effect this divestiture?

Magidson: The push-out requirements are supposed to start in two years. Regulators have an ability to waive it for an additional year. We should learn more about this rule’s implementation a year or more from now. I do not think we will see the divestiture occurring any time soon – there are so many other steps that have to be taken to enact the rest of this legislation. There is another issue as to whether banks, dealers, and hedge funds, i.e., the market in general, has the resources to implement all of this in this short timespan.

Please email the interviewee at mmagidson@lowenstein.com with questions about this interview.