
A View From the Street

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Deutsche Bank 

Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or “the Act”)

Key Milestones

- | | |
|----------------------|--|
| June 17, 2009 | ■ President Obama proposes detailed financial reform proposals (89 pages) |
| Dec 11, 2009 | ■ U.S. House of Representatives votes 223-202 to pass its own U.S. financial regulatory reform bill (1,279 pages) |
| May 20, 2010 | ■ U.S. Senate votes 59-39 to pass its own U.S. financial regulatory reform bill (1,500 pages) |
| June 25, 2010 | ■ U.S. Senate-House Conference Committee reconciles differences and reaches final agreement on the Dodd-Frank Act (2,319 pages) |
| June 30, 2010 | ■ U.S. House of Representatives passes the Dodd-Frank Act by a 237-192 vote |
| July 15, 2010 | ■ U.S. Senate passes the Dodd-Frank Act by a vote of 60-39 |
| July 21, 2010 | ■ President Obama signs the Dodd-Frank Act into U.S. law (2,319 pages) |

“The Wall Street Reform and Consumer Protection Act of 2010 Boosts Main Street and Curbs Wall Street”

-- Fact Sheet, www.financialstability.gov

We've heard it so often we can say it in our sleep: *“The Dodd-Frank Act is the most comprehensive regulatory overhaul of the U.S. financial industry and markets since the Great Depression.”*

The stated goals of the legislation -- *financial stability and consumer protection*

- Establishes a new council of “systemic risk” regulators to monitor growing risks in the financial system, with the goal of ending “too big to fail” and preventing asset bubbles
- Creates a new consumer protection division charged with the responsibility for writing and enforcing new rules to protect consumers and strengthen rules for protection of investors
- Reforms institutional framework of regulation and oversight over banks and other financial institutions whose activities could pose “systemic risk” to the larger economy
- Establishes process for seizure and orderly liquidation of failing financial entities to protect taxpayers from future bailouts
- **Provides for comprehensive regulation of the OTC derivatives that can create substantial risk exposure among market participants**

Implementation of the Dodd-Frank Act

- While the Act establishes the key policies and broad outlines of OTC derivatives regulation, most of the details (which in this case are fundamental and critical elements of the new regulatory regime) are to be determined and implemented by the regulators in the months ahead
- Primary regulatory authorities with respect to the OTC derivatives market reform are the Commodity Futures Trading Commission and the Securities and Exchange Commission
- Substantial number of rulemakings to be completed over a limited timeframe (with respect to OTC derivatives, the Act generally requires rules within 360 days of enactment of the Act)
- Even after adoption of definitive rules, many provisions of the Act are subject to various transition periods and grandfathering clauses
- There is always the possibility of changes to the Act, including a “technical corrections bill” or other changes that are brought about as a result of the political process (i.e., results of mid-term elections and possible shift in Congressional leadership).
- For this reason, any interpretation of the Act in this presentation and any discussion of rulemakings or their impact on the markets or their participants is preliminary and represents the view of the speaker and not of Deutsche Bank.

Implementation of the Dodd-Frank Act – *cont'd*

Over 240 rules are required to be written by 11 different regulators, mostly within 18 months of passage

The U.S. Chamber of Commerce notes that the potential number of new rule makings and studies is actually well in excess of 500

US Chamber of Commerce Estimate

- 533 rulemakings
- 60 studies
- 70 reports

Summary of Mandated Rulemaking and Studies by Agency

Agency	Rulemaking	Studies
Bureau of Consumer Financial Protection	24	4
Commodities Futures Trading Commission (CFTC)	61	6
Financial Stability Oversight Council	56	8
Federal Deposit Insurance Corporation (FDIC)	31	3
Federal Reserve	54	3
Federal Trade Commission (FTC)	2	0
Government Accountability Office (GAO)	0	23
Comptroller of the Currency (OCC)	17	2
Office of Financial Research	4	1
Securities and Exchange Commission (SEC)	95	17
Treasury	9	1
Total	243	67

Key CFTC Rulemakings

In several areas of OTC derivatives reform, the CFTC shares rulemaking authority with the SEC. Upon enactment of the Act, the CFTC identified the following 30 areas for rulemaking

Regulation of Swap Dealers & Major Swap Participants

1. **Registration**
2. **Definitions** such as Swap Dealer, Major Swap Participant, Security-Based Swap Dealer and Major Security-Based Swap Participant (written with SEC)
3. **Business Conduct Standards with Counterparties**
4. **Internal Business Conduct Standards**
5. **Capital & Margin for Non-banks**
6. **Segregation & Bankruptcy** for both Cleared and Uncleared Swaps

Clearing

7. **DCO Core Principle Rulemaking, Interpretation & Guidance**
8. **Process for Review of Swaps for Mandatory Clearing**
9. **Governance & Possible Limits on Ownership & Control**
10. **Systemically Important DCO Rules Authorized Under Title VIII**
11. **End-user Exception**

Trading

12. **DCM Core Principle Rulemaking, Interpretation & Guidance**
13. **SEF Registration Requirements and Core Principle Rulemaking, Interpretation & Guidance**
14. **New Registration Requirements for Foreign Boards of Trade**
15. **Rule Certification & Approval Procedures** (applicable to DCMs, DCOs, SEFs)

Data

16. **Swap Data Repositories Registration Standards and Core Principle Rulemaking, Interpretation & Guidance**
17. **Data Recordkeeping & Reporting Requirements**
18. **Real Time Reporting**

Particular Products

19. **Agricultural Swaps**
20. **Foreign Currency (Retail Off Exchange)**
21. **Joint Rules with SEC**, such as “Swap” and “Security-Based Swap”
22. **Portfolio Margining Procedures**

Enforcement

23. **Anti-Manipulation**
24. **Disruptive Trading Practices**
25. **Whistleblowers**

Position Limits

26. **Position Limits**, including Large Trader Reporting, Bona Fide Hedging Definition & Aggregate Limits

Other Titles

27. **Investment Adviser Reporting**
28. **Volcker Rule**
29. **Reliance on Credit Ratings**
30. **Fair Credit Reporting Act**

Scope of OTC Derivatives Reform

- The Act provides for comprehensive regulation for most derivatives as “swaps.”
- The term “swap” is defined very broadly in the Act:
 - “any agreement, contract or transaction ... (i) that is a put, call, cap, floor, collar or similar option of any kind that is for the purchase or sale, or based on the value, of one or more interest or other rates, ... commodities, ... indices, quantitative measures, or other financial or economic interests or property of any kind; (ii) that provides for any purchase, sale, payment, or delivery ... that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of any event or contingency associated with a potential financial, economic, or commercial consequence; (iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, ... commodities, ... indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk ...” (See Sec. 721(a)47(A))
- Certain specified transactions are not swaps:
 - “(i) any contract of sale of a commodity for future delivery ...; (ii) any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled; ... (See Sec. 721(a)47(B)).

Key Elements of OTC Derivatives Reform

CFTC Chairman Gensler has identified three “critical reforms in the Dodd-Frank Act that will enhance the derivatives markets”:

- the bill lowers risk through comprehensive regulation of swap dealers.
- the bill moves the bulk of the swaps marketplace onto transparent trading facilities – either exchanges or swap execution facilities (SEFs).
- the bill requires clearing of standardized swaps by regulated clearinghouses to lower risk in the marketplace.

- *Remarks before the Institute of International Bankers, October 21. 2010*

Key Elements of OTC Derivatives Reform

1. Market Participants

2. Central clearing

3. Exchange trading/execution

4. “Push-out “ and “Volcker Rule”

5. Capital Requirements

6. Business Conduct

7. Margin requirements

8. Post trade reporting

9. CFTC Registration

10. Position Limits

1. Market Participants

•With respect to OTC Derivatives, the application of the Act to any particular market participant and its activities depends upon some basic determinations:

- are the derivatives “swaps” and “security-based swaps”?
- is the market participant an end user, a “swap dealer”, a “major swap participant”?

•While reference is often made to the “end user exemption” – and the treatment of “end users” was heavily debated -- the Act does not contain any such exemption, nor does it include a definition for “end user”:

- It cannot be a “financial entity” (swap dealer, major swap participant, commodity pool, a “private fund”, employee benefit plan, or a person predominantly involved in banking)
- It must use swaps to hedge or mitigate “commercial risk”
- It must notify the CFTC about how it will meet its financial obligations on non-cleared swaps;
- If a public company, it must have authorization of its board or other governing body

1. Market Participants – *cont'd*

- **A “swap dealer “ is any person who**

- Holds itself out as a dealer in swaps
- Makes a market in swaps
- Regularly enters into swaps with counterparties as an ordinary course of business for its own account
- Is commonly known in the trade as a dealer or market maker in swaps
- Two exceptions: a person who enters into swaps for its own account, and an entity that engages in *de minimis* activity

- **A “major swap participant “ is any person not a swap dealer**

- who maintains a substantial position in swaps other than positions held for hedging or mitigating commercial risk, or
- whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets, or
- who is a highly leveraged entity that maintains a substantial position in swaps

1. Market Participants – *cont'd*

- “End users” will not be subject to many of the elements of OTC derivatives reform that will be discussed in this presentation
- However, a substantial portion of market participants (those that will be characterized as swap dealers and major swap participants) will become subject to a substantially greater degree of regulatory oversight as a result of the Act, and that alone could have significant implications for end users and their activities in the markets to the extent that those market participants are counterparties to the end users
- Further definition of market participants and other relevant definitions is subject to rulemaking (via an ANOPR, the CFTC has already invited comments with respect to key definitions)

2. Clearing

- **The Act provides for mandatory clearing of “standardized” swaps**
 - Provisions for CFTC review of swaps markets to identify swaps that are subject to mandatory clearing, and CFTC review of swaps that DCOs propose to clear
 - Highly customized/structured swaps will probably not be subject to mandatory clearing
 - The Act includes an “anti-evasion” provision
- **If clearing is required, counterparties will be required to post initial margin, variation margin, and will likely need clearing brokers**
- **End users (non-financials) may elect NOT to clear swaps used to hedge commercial risk**
 - Must notify CFTC as to how it meets its financial obligations on non-cleared swaps
 - May not execute the swap through a prohibited affiliate
 - If a public company, must have approval from the appropriate committee of its board or governing body
- **There are some concerns around “systemic risk” associated with clearinghouses – rules for risk management and prudential standards**

3. Exchange Trading/Swap Execution Facilities

- **The Act contains a new regulatory regime for “swap execution facilities” or “SEFS”**
 - Registration requirements
 - SEFs will be subject to greater regulation than ECMs
 - Requires to comply with certain core principles over and above those applicable to ECMs
- **The Act does not clearly define “swap execution facility”**
 - A facility, trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids or offers made by other participants that are open to multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that (i) facilitates the execution of security-based swaps between persons; (ii) is not a designated contract market; (iii) regulated essentially like an exchange
- **If a swap transaction is subject to mandatory clearing, it must be traded on a board of trade or a SEF if one is available to accept the trade**

4. “Push-Out” and “Volcker Rule”

- **The “Swaps Push-Out” Rule (a/k/a the “Lincoln Amendment”) prohibits “federal assistance” to a “swaps entity”**
 - “swaps entity” includes a bank registered as a swap dealer
 - “federal assistance” includes advances from a Fed credit facility or discount window, or FDIC insurance or guarantees
 - may not apply to swaps entities that are eligible for but not receiving federal assistance
 - effectively requires that certain entities may have to move certain swaps trading operations into separately-capitalized, non-bank affiliates
- **The Rule is more limited than first proposed; over 90% of the swaps market is exempt from this Rule (rates, FX, investment grade CDS), but not commodities, equity-linked swaps, non-investment grade CDS**
- **Subject to rulemaking and a lengthy implementation period**

4. “Push-Out” and “Volcker Rule” – *cont’d*

- The “Volcker Rule” is intended to limit bank activity in higher-risk businesses; it prohibits insured depository institutions, their holding companies and foreign banking organizations with U.S. banking operations, and their affiliates and subsidiaries, from:
 - engaging in proprietary trading
 - sponsoring or (subject to certain limits) investing in hedge funds and private equity funds
- “Proprietary trading” is defined as “engaging as a principal for the trading account of a banking entity or systemically important nonbank financial company in purchasing or selling, or otherwise acquiring or disposing of, any security, derivative, futures contract, option thereon, or other security or financial instrument determined by rule.
- “Trading account” is defined as any account used to take positions principally for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements.
- exceptions include market making activities, risk-mitigating hedging activities, trading on behalf of customers
- Comparatively lengthy implementation period and subject to rulemaking

5. Bank Capital Requirements

- Federal Reserve to establish enhanced leverage and risk-based standards and capital requirements for banks within 18 months (this is likely to be linked to the Basel 3 process)
- Establishes a floor for capital that cannot be lower than standards currently in effect
- Fed to include off-balance sheet activities in calculating new capital requirements
- Must address risks relating to derivatives, securitized products, financial guarantees, securities borrowing and lending activities, repos, concentrations in assets where values are model-driven
- New capital rules must be countercyclical
- Will take several years to implement, but for banks, less profitability and higher capital requirements could reduce credit appetite
- Costs may be passed through to end users

6. Business Conduct Rules

- **Swap dealers are required to adopt certain business conduct rules**
 - Must certify that the counterparty is an eligible contract participant
 - Must disclose to the counterparty
 - Material risks and characteristics of a swap
 - Source and amount of fees
 - Material incentives and conflicts of interest
 - Daily marks
- **Special rules apply to “special entities”**
 - Federal agencies, states, state agencies, political subdivisions of states
 - Swap dealers acting as advisors to a special entity has a duty to act in the best interests of the agency
 - Swap dealer that enters into or offers to enter into a swap with a special entity must make certain determinations regarding the special entity’s access to an independent representative
- **At first glance, this would appear to be a very favorable development for counterparties of swap dealers**
 - Obviously raises concerns within swap dealers, particularly banks
 - Concerns about commercial disputes based on breach of swap dealer obligation to comply with business conduct rules

7. Margin Requirements

- The CFTC is mandated to prescribe margin requirements for DCOs to protect the financial integrity of the DCO and protect the financial integrity of transactions
- This is likely to result in more stringent minimum margin requirements for clearinghouses
- Regulators could technically set minimum margin requirements for non-cleared OTC swaps, but there have been indications that there is no intent to do so
- No explicit grandfathering from new margin requirements on existing derivative positions

8. Post-Trade Reporting

- Most swaps (both cleared and non-cleared) will be subject to “real-time” price and volume reporting requirements
- Details to be worked out in rulemaking
- This will likely result in more price transparency and downward pressure on bid-ask margins
- Could result in less liquidity in certain transactions
- The Act establishes a framework for the establishment of “swap data repositories”
- Registrants will be required to collect and maintain swaps data and make that data available to regulators

9. CFTC Registration

- **Section 731 of the Act provides for the registration and regulation of swap dealers and major swap participants**
- **Section 731 contemplates regulations to include:**
 - Reporting requirements
 - Capital and margin requirements
 - Maintenance of daily trading records
 - Compliance with business conduct standards
 - Back office/documentation standards
 - Monitoring of trading activity
 - Maintenance of risk management procedures
 - Obligations to Disclose information to CFTC
 - Maintenance of conflict of interest systems and procedures
 - Designation of Chief Compliance Officer

10. Position Limits

- **Position limit authority**
 - prior to the Act; CFTC January 2010 NOPR
 - following the Act
- **Section 737 extends CFTC authority to establish limits on**
 - futures contracts traded on a DCM or derivatives transaction execution facility
 - swaps traded on a DCM or SEF;
 - swaps not traded on a DCM or SEF that perform or affect a significant price discovery function
 - swaps that are economically equivalent to futures contracts and options on futures contracts traded on a DCM
 - a contract that settles against any price of one or more contracts traded on a registered entity and contracts traded on a FBOT
- **Required findings as a condition to establishing limits**
 - “necessary to diminish, eliminate, or prevent” the burden on interstate commerce caused by excessive speculation”
 - CFTC directed to consider potential price discovery shift to FBOTs and the effect of position limits on market liquidity and the price discovery function

10. Position Limits – *cont'd*

- CFTC also has certain discretion to establish limits
- There will be issues around “aggregation” principles
- Bona fide hedging transactions are exempt from any position limits established by the CFTC
- Unclear if “crowding out” provision will be included in this rulemaking
- Consideration of “interim limits”

Implications for “End Users”

In summary, market participants that qualify as “end users” will not be subject to many of the elements of the Act that will apply to swap dealers and major swap participants:

- No obligation to clear
- Not subject to the “Swap Push Out” or
- Not subject to mandated capital requirements
- Not subject to the business conduct rules, no specific duties to “special entities”
- Not required to register with the CFTC
- Not subject to mandated margin requirements (subject to one caveat)
- No post-trade reporting (but a counterparty such as a dealer may be)
- Possible impact from position limits
- Not subject to mandated back-office requirements or disclosure obligations to counterparties

Other Considerations

- The Act provides for certain “Whistleblower” protections that have recently received a great deal of attention
- The Act broadens CFTC authority to regulate market behavior
- Financial Stability Oversight Council
 - New agency to monitor systemic risk and make recommendations to regulators
 - Council of ten voting members
 - Responsible for identifying threats to financial stability and gaps in regulation
 - The CFTC Chairman is one of ten voting members

Conclusion -- What is the View From the Street?

- **The Act is without question a substantial overhaul of US financial markets regulation**
- **The Act as ultimately implemented will depend upon a variety of factors that cannot be predicted**
 - Key rulemakings have yet to be completed
 - Once completed, there is an extended timeline for implementation of the rules
 - Impact of the midterm elections – changing US political landscape
 - Results of EU regulatory reform initiatives/Basel III/other developments in other foreign markets
 - Changes in overall economic conditions
 - Market reaction to increased regulation
- **By what standards do we evaluate the impact?**
 - Market efficiency – costs, liquidity, transparency
 - Financial stability
 - Investor and consumer protection
 - Regulatory effectiveness, uncertainty, arbitrage