

# **Dodd-Frank Wall Street Reform and Consumer Protection Act - Title VII: “Wall Street Transparency and Accountability Act”**

**Frankfurt am Main, 2 February 2011**

The views expressed herein do not necessarily reflect those of the European Central Bank

# Overview of Dodd-Frank Act (DFA)

- **DFA signed into law on 21 July 2010**
- **Designed to become effective over time**
- **Wide-ranging reform of US financial system; includes many new statutes, and amends others**
- **Billed as “comprehensive” reform, but:**
  - **No reform of GSEs; will this happen in 2011?**
  - **Financial Crisis Inquiry Commission report; potential implications for DFA?**



# Implementation of DFA will be complicated and time-consuming

- Implementation requires:
  - Up to 421 follow-up actions by various persons
  - 250+ new rules
  - Preparation of studies and consultations
  - Already behind schedule on implementation
- US politics likely to affect final implementation
  - DFA passed without bipartisan support
  - Effect of the new political balance in Washington?
    - » non-implementation (by denying funding)?
    - » potential repeals or modifications?
- Timing of implementation/First mover:
  - Will US implement DFA before international partners/competitors implement “equivalent” laws?
    - » Most US rules must be *issued* (not effective) by July 2011
    - » EMIR in EU: all negotiations must be complete by end-2011
    - » G-20 deadline: rules operational by end-2012

# CFTC Commissioner O'Malia on CFTC output

- Since August of last year, the Commission has published in the **Federal Register four Advance Notices of Proposed Rulemaking, 33 Notices of Proposed Rulemaking, two interim rules, one order, one notice, and two requests for comment** pursuant to the Dodd-Frank Act. That equates to **732 Federal Register pages (and you know how dense those tri-column, 9-point font pages are)**—and we're still counting. We have more than a few in the hopper, including the position limits proposal. **If you were to lay those pages end-to-end lengthwise, they would stretch for 671 feet. That is more than twice the height of the Statue of Liberty from its base to the tip of the torch, and more than half the height of the Empire State Building.** And with comment periods ranging from 30 to 60 days, if you took those comment periods consecutively, you'd end up with 2,154 days or just short of 6 years. **I'm not even going to get into how many hours it takes to review and respond to these releases or the costs associated** with hiring a top-notch attorney to take it on at a modest rate of up to \$1000 bucks an hour.
- **Frankly, the schedule set by Congress for the Commission to implement the Dodd-Frank Act is unrealistic. I am aware of four statutory deadlines the Commission has missed to date.**
- <http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-3.html>

# Overall effect of DFA on derivatives

- **DFA:**
  - Imposes central control on all “OTC” derivatives, and
  - Increases central control over exchange-traded derivatives
- **Basic intention: abolish current OTC derivatives markets in three steps:**
  - 1. Forwards and swaps, and OTC options, moved onto regulated market venues (exchanges or SEFs)**
    - Current forwards and swaps assimilated to futures, thus perceived weaknesses in current OTC model addressed
    - Central clearing essentially becomes mandatory
  - 2. Rules of exchanges enhanced**
    - Perceived weaknesses in current futures model thus addressed
  - 3. Exchanges/SEFs need regulatory approval to amend rules/offer new products in the future. No new derivative except if:**
    - approved
    - traded on an exchange/SEF, and
    - (probably) cleared centrally



# OTC derivatives before and after DFA: Contracts/products that can be traded and how

## Before - i.e. current OTC

1. **Bilateral contracts**
  - Any number of counterparts
2. **Standardisation/customisation**
  - Contract terms private
  - Trades on any product two parties wish to trade in
  - Master agreements introduce much standardisation, but still allow some customisation, e.g.,
    - One-way arrangements (margin)
    - Specific maturities/sizes
3. **Documentation issues:**
  - Undocumented trades?
  - Incomplete documentation?

## After i.e., under DFA

1. **All contracts “with” exchange or SEF – have to be entered into a “Designated Contract Market” (DCM)**
  - 16 DCMs now, CFTC estimates 20-30 more
  - Must trade through exchange members, and clear through clearing brokers
2. **All terms standardised – no customisation possible**
  - DCM issues terms
  - Parties only agree price, #
  - Information is public (except identity of parties)
  - No new product except with *ex ante* regulatory approval
3. **OTC documentation issues?**
  - No/incomplete documentation=no trade

# OTC derivatives before and after DFA: Credit risk

## Before - i.e. current OTC

1. Credit risk vis a vis each counterparty
2. Risk management
  - Due diligence needed on each counterparty in each relevant jurisdiction
  - Rely on enforceability of contractual terms, for each counterparty, on:
    - Collateral management?
    - Netting?
    - A central clearer?
    - Threshold?
    - Margin practice?
3. Risk of build-up of unrealised losses/gains?
  - One-way margin/CSA
  - Choice to close-out if extra margin not paid-in

## After i.e., under DFA

1. Credit risk vis a vis clearinghouse
2. Risk management
  - Clearinghouse manages risk by
    - Marking to market
    - Margin (performance bond) practice
    - Margin measured and settled at least daily
    - All losses and gains settled daily
    - Clearinghouse calculates net position daily
3. Unrealised losses/gains settled in cash daily
  - No on-way margin
  - Exchange closes out if variation margin not paid-in timely

# OTC derivatives before and after DFA: Market risk

## 1. Exit trade by:

- Agreement with counterparty – but will they be willing to agree? OR
- Agreement with a new counterparty – but then have credit risk to two entities

## 2. Liquidity

- Market makers have incentive (but no obligation) to buy/sell (they make the spread)
- Will anyone buy/sell if big move?

## 3. Effect of customisation

- Less liquid?
- More maturity dates possible
- End-users can hedge very accurately

## 1. Exit trade by:

- Enter off-setting agreement with clearinghouse
  - Trade on exchange (floor brokers or FCMs)
  - Traders have a/cs at clearinghouse
  - Clearinghouse nets open positions

## 2. Liquidity

- Market makers formally obliged to provide liquidity
- Circuit breakers close markets on big moves
- Market might gap up/down on re-opening

## 3. Effect of standardisation

- More liquid?
- Less maturity dates available
- Imperfect risk management





# OTC derivatives before and after DFA:

## Legal risk

- **Insolvency of counterparty:**
  - Each counterparty,
  - Every relevant jurisdiction
- **Are (a) netting agreements and (b) set off rights enforceable everywhere they need to be enforced?**
- **Is collateral realisable everywhere?**
- **Due diligence current everywhere?**
- **How many applicable laws?**
- **Insolvency of clearinghouse**
  - Is reserve fund of clearinghouse adequate?
  - Set-off/netting/collateral rules of each clearinghouse?
  - Insolvency regime of clearinghouse?
- **Due diligence re clearinghouse?**
- **Any applicable law other than that of clearinghouse?**

# FX forwards and swaps (sec. 721(a)(21))

- DFA adds a definition of swap to Commodity Exchange Act, basically by deleting the word “not” from the pre-existing law
- Now the statutory definition of swap expressly includes:
  - “any agreement, contract, or transaction commonly known as—
  - (I) an interest rate swap; (II) a rate floor; (III) a rate cap; (IV) a rate collar; (V) a cross-currency rate swap; (VI) a basis swap; **(VII) a currency swap; (VIII) a foreign exchange swap;** (IX) a total return swap; (X) an equity index swap; (XI) an equity swap; (XII) a debt index swap; (XIII) a debt swap; (XIV) a credit spread; (XV) a credit default swap; (XVI) a credit swap; (XVII) a weather swap; (XVIII) an energy swap; (XIX) a metal swap; (XX) an agricultural swap; (XXI) an emissions swap; and (XXII) a commodity swap.

NB proposed EU Regulation does not cover spot FX and the European Commission has interpreted the EU definition to exclude commercial forward foreign exchange transactions

# There can be exemptions to the definition of a swap

- “(E) TREATMENT OF FOREIGN EXCHANGE SWAPS AND FORWARDS.—
- “(i) IN GENERAL.—Foreign exchange swaps and foreign exchange forwards shall be considered swaps under this paragraph **unless the Secretary makes a written determination under section 1b that either foreign exchange swaps or foreign exchange forwards or both—**
- “(I) **should be not be regulated as swaps** under this Act; and
- “(II) are **not structured to evade the Dodd-Frank** Wall Street Reform and Consumer Protection Act in violation of any rule promulgated by the Commission pursuant to section 721(c) of that Act.

# Process for UST Secretary's determination

- “(ii) CONGRESSIONAL NOTICE; EFFECTIVENESS.—The Secretary **shall submit any written determination** under clause (i) to the appropriate **committees of Congress, including** the Committee on Agriculture, Nutrition, and Forestry of the Senate and the Committee on Agriculture of the House of Representatives. Any such written determination by the Secretary shall **not be effective until it is submitted** to the appropriate committees of Congress.
- “(iii) REPORTING.—Notwithstanding a written determination by the Secretary under clause (i), **all foreign exchange swaps and foreign exchange forwards shall be reported to either a swap data repository**, or, if there is no swap data repository that would accept such swaps or forwards, to the Commission pursuant to section 4r within such time period as the Commission may by rule or regulation prescribe.
- “(iv) BUSINESS STANDARDS.—Notwithstanding a written determination by the Secretary pursuant to clause (i), **any party to a foreign exchange swap or forward that is a swap dealer or major swap participant shall conform to the business conduct standards** contained in section 4s(h).

# SEC. 728. SWAP DATA REPOSITORIES

- The Commodity Exchange Act is amended by inserting after section 20 (7 U.S.C. 24) the following:
- **SEC. 21. SWAP DATA REPOSITORIES.**
- (a) REGISTRATION REQUIREMENT.—
- ...
- (2) INSPECTION AND EXAMINATION.—Each registered swap data repository shall be **subject to inspection and examination by any representative of the Commission.**
- (3) COMPLIANCE WITH CORE PRINCIPLES.—
  - (A) IN GENERAL.—To be registered, and maintain registration, as a swap data repository, the **swap data repository shall comply** with—
    - (i) the **requirements and core principles** described in this section; and
    - (ii) any **requirement that the Commission may impose by rule or regulation** pursuant to section 8a(5).
  - (B) REASONABLE DISCRETION OF SWAP DATA REPOSITORY.—
- Unless otherwise determined by the Commission by rule or regulation, a swap data repository described in subparagraph (A) shall have reasonable discretion in establishing the manner in which the swap data repository complies with the core principles described in this section.
- (b) STANDARD SETTING.—
- (1) DATA IDENTIFICATION.—
- (A) IN GENERAL.—In accordance with subparagraph (B), the **Commission shall prescribe standards that specify the data elements for each swap that shall be collected and maintained by each registered swap data repository.**
- (B) REQUIREMENT.—In carrying out subparagraph (A), the Commission shall prescribe consistent data element standards applicable to registered entities and reporting counterparties.
- (2) DATA COLLECTION AND MAINTENANCE.—The Commission shall prescribe data collection and data maintenance standards for swap data repositories.

# Substance of UST Secretary's determination (Sec 722(h))

- **REQUIREMENTS OF SECRETARY OF THE TREASURY REGARDING EXEMPTION OF FOREIGN EXCHANGE SWAPS AND FOREIGN EXCHANGE FORWARDS FROM DEFINITION OF THE TERM 'SWAP'.**
- (a) **REQUIRED CONSIDERATIONS.**—In determining whether to exempt foreign exchange swaps and foreign exchange forwards from the definition of the term 'swap', the Secretary of the Treasury (referred to in this section as the 'Secretary') shall consider—
- (1) whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards **would create systemic risk, lower transparency, or threaten the financial stability of the United States;**
- (2) whether foreign exchange swaps and foreign exchange forwards are **already subject to a regulatory scheme that is materially comparable** to that established by this Act for other classes of swaps;
- (3) the extent to which bank regulators of participants in the foreign exchange market provide **adequate supervision, including capital and margin requirements;**
- (4) the extent of **adequate payment and settlement systems;** and
- (5) the use of a potential exemption of foreign exchange swaps and foreign exchange forwards to **evade otherwise applicable regulatory requirements.**

# Sec 722(h) continued

- (b) DETERMINATION.—If the Secretary makes a determination to exempt foreign exchange swaps and foreign exchange forwards from the definition of the term ‘swap’, the Secretary shall submit to the appropriate committees of Congress a determination that contains—
  - (1) an **explanation regarding why foreign exchange swaps and foreign exchange forwards are qualitatively different** from other classes of swaps in a way that would make the foreign exchange swaps and foreign exchange forwards ill-suited for regulation as swaps; and
  - (2) an identification of the **objective differences** of foreign exchange swaps and foreign exchange forwards with respect to standard swaps that warrant an exempted status.
- (c) EFFECT OF DETERMINATION.—A determination by the Secretary under subsection (b) shall **not exempt** any foreign exchange swaps and foreign exchange forwards traded on a designated contract market or swap execution facility **from any applicable antifraud and antimanipulation** provision under this title.”.



# UST Request for Comments (Fed. Register /Vol. 75, No. 209 /, October 29, 2010 /Notices 66829)

- “Although not required under the Dodd-Frank Act, the Department of the Treasury invites comment on whether such an exemption for foreign exchange swaps, foreign exchange forwards, or both, is warranted and on the application of the factors that the Secretary must consider in making a determination regarding these instruments.”
- ...
- In making the determination whether to exempt foreign exchange swaps and/or foreign exchange forwards, the Secretary of the Treasury must consider the ... factors [set out in sec 722(h)] ...
- The Treasury Department is soliciting comments on the above factors, and any relevant information that may bear on the regulation of foreign exchange swaps and foreign exchange forwards as “swaps” under the CEA, to assist in the Secretary’s consideration of whether to issue a determination under section 1a(47) of the CEA.
  
- **Notice:**
- <http://www.federalregister.gov/articles/2010/10/29/2010-27437/determination-of-foreign-exchange-swaps-and-forwards>
- **Responses:** <http://www.regulations.gov/#!docketDetail;rpp=10;so=DESC;sb=postedDate;po=0;D=TREAS-DO-2010-0006>



# SIFMA, AFME and ASIFMA response 15-XI-10

- For the reasons discussed in this letter, we **strongly believe that an exemption is warranted.**
- The Global FX Division agrees with the Secretary's statement made before the Senate Committee on Agriculture, Nutrition and Forestry in December of 2009: **“The FX markets are different. They are not really derivative in a sense and they don't present the same sort of risk and there is an elaborate framework in place already to limit settlement risk. These markets actually work quite well. We have a basic obligation to do no harm, to make sure that as we reform we don't make things worse and our judgment is because of the protection that already exists in these foreign exchange markets and because they are different from derivatives, have different risks and require different solutions, they require a different approach.”**
- The Global FX Division's position is entirely consistent with Secretary Geithner's statement. This letter sets forth in detail the basis for our concurrence.

# ISDA's response 23 November 2010:

- “For the reasons outlined in detail below, **ISDA strongly believes that Treasury should exercise its authority to exempt** foreign exchange swaps (“FX Swaps”) and foreign exchange forwards (“FX Forwards”) from the definition and related regulation of swaps.
- Specifically, ISDA is concerned that clearing and execution requirements related to the failure to exempt such transactions would, among other things:
  - significantly increase the cost and difficulty of hedging currency risk, leading to greater credit, settlement and market risk for companies and investors;
  - increase systemic risk and threaten overall U.S. financial stability; and
  - lower overall liquidity and market transparency.

# FX Committee (29 November 10)

- As the responses outlined below reflect, the FXC believes that changing market practice by mandating central clearing and trading through swap execution facilities will have the **potential unintended consequence of increasing systemic risk and possibly driving the market to other jurisdictions.**

# CLS Bank (23 November 2010)

- Effective financial systems depend on safe and efficient payment systems and, in the context of FX, our settlement system has been structured to minimize the economic disturbances that could otherwise disrupt domestic and international financial markets. We are pleased that the members of the Global FX Division of SIFMA, AFME and ASIFMA agree with our view that CLS is a global, well-developed settlement system that has effectively mitigated settlement risk as the largest source of systemic risk for the FX market. **We view the position of and supporting arguments presented by the members of the Global FX Division in favor of exempting these FX transactions from such clearing and trading requirements as compelling and persuasive. The position and arguments are consistent with our discussions with members of our settlement service and various industry groups** (including the Foreign Exchange Committee in New York, and the Foreign Exchange Joint Standing Committee in London), the information in our systems regarding FX market activity, **and the broader policy considerations raised by central banks** regarding the impact of clearing of over-the-counter (OTC) FX for central counterparties (CCPs) and CLS. **The application of clearing and trading requirements of the Dodd-Frank Act to FX swaps and FX forwards would not address settlement risk. It is highly unlikely CCPs will be able to guarantee settlement of these transactions given the sheer values associated with FX, a market which is essentially a global cross-border payment system.**