



LEARNING CURVE®

Hedge Funds & The Wall Street Act— Part I

The Wall Street Transparency and Accountability Act of 2010 is Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Subtitles A and B of the Act deal with the regulation of over-the-counter derivatives. Hedge funds that meet certain specified criteria will experience a radical and costly change in the way they trade derivatives.

Under the derivatives provisions, both bank and nonbank major participants in the derivatives markets, which include hedge funds, will be designated as either swap dealers or major swap participants. They will also be made subject to registration, capital, margin, clearing, reporting and recordkeeping requirements.

Swap Dealer

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.

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: (1) it maintains a substantial position in swaps, excluding positions held for hedging or mitigating commercial risk, (2) 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 (3) it is highly leveraged relative to its capital and not subject to regulatory capital requirements.

Swaps Trading

The Act states 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 **Commodity Futures Trading Commission** or the **Securities and Exchange Commission**. Financial entities

that trade in both swaps and security-based swaps will be required to register with both the CFTC and the SEC. The registration requirements will take effect within 360 days after the Act's passage.

In addition to the registration requirements, a swap dealer or major swap participant will be obligated to reserve regulatory capital and obtain variation and initial margin from its swap counterparties and to comply with (1) clearing, execution and reporting requirements with respect to its swap positions, (2) documentation, back office and business conduct standards related to its swap business, and (3) special requirements when dealing with an employee benefit plan or municipality. All of these requirements will be clarified by and made subject to rules and regulations to be adopted separately or jointly by the Commissions.

Capital and Margin Requirements

The Commissions are directed to adopt comparable rules and regulations 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. The regulations specifying the capital requirements will apply to both bank and 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.

Hedge funds also will be required to post initial and variation margin for uncleared swaps in accordance with rules to be promulgated by the Commissions. For cleared swaps, Derivatives Clearing Organizations will determine the minimum levels of initial and variation margin. Collateral other than U.S. dollar denominated cash will only be permitted 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.

DCOs must be registered with the CFTC and/or the SEC, and must comply with the Derivatives Provisions as well as other rules and requirements that may be imposed by the CFTC and/or SEC.

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 the margin requirements will apply to all swaps entered into and still outstanding on the effective date of the derivatives provisions. 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.

Mandatory Clearing and Execution

Swaps that would be accepted for clearing and that the CFTC or SEC, as applicable, approves for clearing, are required to be cleared, except if one of the swap parties: (1) is not a “financial entity,” which term includes, among other things, swap dealers and major swap participants; (2) is using swaps to hedge or mitigate commercial risk; and (3) 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 will 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.

Unfortunately, the Act’s clearing requirements significantly impair the benefits of portfolio margining to hedge funds and other nonbank swap dealers and major swap participants. Portfolio margining is intended to reduce the amount of initial margin that a hedge fund posts to its prime brokers by taking advantage of risk reducing correlations in its portfolio, including off-sets between derivatives and cash instruments.

The clearing requirements will reduce substantially or eliminate these benefits because (1) each hedge fund’s portfolio will be split into sub-portfolios of cleared and non-cleared trades, with each sub-portfolio independently collateralized and (2) offsetting or risk reducing cash instruments and non-clearable derivatives will not be factored in to the margin requirements set by each DCO.

It may be possible for a hedge fund to regain some of the benefits of portfolio margining through a bridging agreement with its designated clearing member, but it likely will be not possible for the hedge fund to reduce its initial margin requirements by offsetting, against cleared trades, uncleared trade positions or cash positions. This problem multiplies when a fund clears its trades through different DCOs.

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 no 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 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.

This week’s Learning Curve was written by Sherri Venokur, chair of Lowenstein Sandler’s derivatives practice group, assisted by Matthew A. Magidson, vice chair in the group, and by Karen R. Abraham, Christine S. Boyle and Melissa Sullivan, associates in the corporate group.

Next week’s Learning Curve will discuss other requirements for Swap Dealers and Major Swap Participants, as well as the position limits rules and possible unintended consequences of the spin-off requirements.