

# Dodd-Frank Derivatives Regulation

## Dodd-Frank Derivatives Regulation

Lavender Law 2015

Chicago, Illinois

August 2015

Greg Todd

Director & Associate General Counsel

This is a summary of select areas of financial regulatory reforms adopted or implemented by various U.S. regulatory agencies in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") enacted into U.S. federal law on July 21, 2010. This information represents Bank of America Merrill Lynch's current understanding of the reforms but is subject to change.



# What is a Derivative?

- **A derivative is a contract between two or more parties whose value is derived from the value of an agreed-upon underlying asset.**
- **Derivatives generally fall into one of two categories: Futures and OTC Derivatives.**
  - Futures are highly standardized contracts that are traded on an exchange and can reference an array of products from commodities (e.g., oil & orange juice) to short/long term interest rates
    - Futures are traded in many ways like stocks and bonds-they are centrally cleared in clearinghouses and traded on exchanges
- **OTC Derivatives are more customized instruments and are generally entered into on a bilateral basis.**
  - A classic example of an OTC Derivative is a swap, which is basically an agreement between two parties to exchange (or swap) cash flows at specified dates in the future over a fixed period of time based on the value of some underlying asset that is expected to change over time.
  - Like futures, parties can enter into swaps that reference a wide array of assets – such as interest rates and commodities or even the likelihood of a company to meet its obligations under a loan (i.e., credit default swaps)
  - Dodd-Frank’s derivative requirements apply to OTC derivatives and will require them to adopt many requirements applicable to futures, such as clearing and exchange trading
- **In order to account for the risk that one party to the contract may fail to perform, derivatives usually provide for the transfer or payment of collateral – also known as margin.**
  - Transfer of margin is mandatory for futures, but until recently has been optional for most OTC derivatives.

# Global Regulatory Landscape



# Objectives of the Dodd-Frank Act

---

## What are the Goals of the Recent Derivatives Regulatory Overhaul in the United States?

- **Increased Market Transparency**
  - Regulatory and real-time reporting of derivatives transactions
  - Execution of standardized derivatives transactions on exchanges and swap execution facilities (SEFs)
- **Increased Customer/Investor Protection**
  - New Business Conduct standards for financial institutions registered as Swap Dealers or Major Swap Participants (MSPs) with their clients and counterparties
    - These include:
      - Verifying counterparty's status as an "Eligible Contract Participant" or "Special Entity"
      - Disclosing material information about the swap to non-Swap Dealer/MSP counterparties
      - Disclosing to non-Swap Dealer/MSP counterparties various rights they have with respect to the swap
      - Dealing with counterparties in a fair and balanced manner
      - Undertaking reasonable diligence in connection with any recommendation provided to a non-Swap Dealer/MSP counterparty
  - Segregation requirements for collateral posted to Swap Dealers in connection with derivatives transactions
- **Reduction of Systemic Risk in the U.S. Financial System**
  - Mandatory clearing of standardized derivatives through authorized clearinghouses (e.g., CME or LCH)
  - New capital requirements for Swap Dealers and MSPs
  - Margin (e.g., collateral) requirements for derivatives transactions that are not cleared
  - Limiting the types of activities that banking institutions may engage in (e.g., proprietary trading)

- **Where Does Implementation of the Dodd-Frank Act Presently Stand?**

- Dodd-Frank Act entered into law in 2010 in response to the 2008 financial crisis.
- Dodd-Frank rulemaking process is still in progress as of the law's 5<sup>th</sup> anniversary.
  - **235 (60%)** of the 390 total required rulemakings have been finalized.
- The Commodity Futures Trading Commission (the "CFTC") has made the most progress in Dodd-Frank rulemaking.
- Key elements of the CFTC's rules under the Dodd-Frank Act that are currently effective include:
  - Registration requirements for Swap Dealers and MSPs
  - Regulatory and real-time public reporting by Swap Dealers and MSPs (and in limited instances, non-Swap Dealers/MSPs)
  - Mandatory clearing of certain standardized interest rate and credit default swaps between certain counterparties
  - Business conduct standards for Swap Dealers and MSPs when dealing with counterparties
  - Swap trading relationship documentation and portfolio compression and reconciliation rules
  - Final guidance on the applicability of the CFTC's swaps provisions to cross-border activities
- The Securities and Exchange Commission ("SEC") has finalized a handful of rules, including its cross-border rule, a rule governing the reporting and public dissemination of security-based swap information, and a rule on security-based swap data repositories.

- **What are Some of the Key Outstanding Items for Implementation of the Dodd-Frank Act?**

- Most final rules from SEC governing security-based swap transactions, security-based swap dealers, and major security-based swap participants
- Final rules from the SEC, CFTC and banking regulators for margin (e.g. collateral) requirements for uncleared swaps and security-based swaps

- **What are the Implications of the Volcker Rule?**

- The Volcker Rule generally prohibits certain banking entities from:
  - Proprietary trading
  - Sponsoring or taking an ownership interest in a hedge/private equity fund or “covered fund”
- Five Agencies (Fed, OCC, FDIC, SEC & CFTC) have oversight and enforcement responsibility
- This prohibition has led banks subject to this ban to shut down or spin-off proprietary trading desks.
- The rule does permit proprietary trading for certain activities *on behalf of clients*, such as underwriting, market making, hedging and trading in US and foreign government securities in certain circumstances, so long as the trading risk is borne by the bank’s clients.
  - Compliance determined by various risk-based metrics to be reported to regulators.
- Rules implementing the Volcker Rule were proposed in October 2011.
  - Regulators received over 17,000 comment letters in response to the proposed rules.
- Final rule released on December 10, 2013. Conformance period for compliance expired July 21, 2015.
- Collection of Volcker metrics to measure compliance began July 1, 2014 for impacted institutions; July data will be reported to regulators Sept. 2, 2014, and further metrics will be reported on a rolling monthly basis.

- 
- **Financial Institutions:**
    - Increased compliance and infrastructure costs – market participants will need to develop new systems and regimes in order to meet new requirements under the rules
    - Significant reliance on Legal and Compliance departments to ensure comprehension of and compliance with the new rules
  - **End-Users of Derivatives (both Financial and Corporate Entities):**
    - Higher costs associated with trading derivatives resulting from:
      - Mandatory clearing (in the case of end-users that are financial entities) – which entails additional initial and variation margin requirements as well as commission and other services fees
      - Passing on off costs incurred by Swap Dealers/MSPs as a result of new capital and/or other charges/requirements
    - Greater price transparency and possibly enhanced liquidity due to mandatory clearing and exchange-trading requirements as well as real-time public reporting
    - New documentation requirements regarding trading relationships with registered Swap Dealers and MSPs
    - Obligation to prepare and retain records of all swap transactions

- **How Do the Rules Adopted Under the Dodd-Frank Act Ease the Burden of New Requirements on End-Users?**
  - The Dodd-Frank Act (and many of the rules adopted thereunder) reflect Congress' intent to limit the law's impact on End-Users of derivatives – specifically, corporate entities that use derivatives to hedge or mitigate commercial risk.
    - **Clearing**
      - End-Users (that are not financial entities) are not required to clear or trade on an exchange swaps entered into for purposes of hedging or mitigating commercial risk.
      - Persons making use of this exception must satisfy certain reporting requirements to confirm eligibility.
    - **Margin**
      - The CFTC's proposed rule on margin for uncleared swaps provides that Swap Dealers and MSPs do not have to collect initial or variation margin from End-Users that are not financial entities.
      - However, the CFTC is not the only agency with jurisdiction in this area and it is possible that End-Users will have to start to pay margin in connection with uncleared swaps in the future.
    - **Inter-Affiliate Swaps**
      - The CFTC issued a rule exempting swaps between affiliates from the clearing requirement (subject to several conditions).
      - This exemption is available to all qualifying market participants (i.e., financial and corporate entities alike).
    - **Reporting Duties**
      - Based on the CFTC's and SEC's hierarchies for determining the reporting counterparty, End-Users will rarely have primary reporting responsibility.
      - This obligation is primarily borne by counterparties that are registered Swap Dealers or MSPs.



# Impact Matrix for Different OTC Derivatives Participants

	Clearing	Exchange Trading	Margin	Capital	Reporting	Position Limits	Business Conduct Rules	Registration
<b>Dealer or Major Swap Participant</b>	<ul style="list-style-type: none"> <li>Mandatory as determined by CFTC/SEC</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory for cleared swaps unless no exchange</li> </ul>	<ul style="list-style-type: none"> <li><b>Mandatory clearinghouse margin for cleared trades and regulator-imposed margin for non-cleared trades</b></li> </ul>	<ul style="list-style-type: none"> <li>Mandatory as imposed by prudential regulatory or CFTC/SEC</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory for all swaps (legacy &amp; new)</li> <li>Dealer/MSP reports if facing non-Dealer/non-MSP; Dealer reports if facing MSP</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory</li> </ul>	<ul style="list-style-type: none"> <li><b>Mandatory</b></li> </ul>
<b>Financial End-User</b>	<ul style="list-style-type: none"> <li>Mandatory as determined by CFTC/SEC</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory for cleared swaps unless no exchange</li> </ul>	<ul style="list-style-type: none"> <li><b>Mandatory clearinghouse margin for cleared trades and regulator-imposed margin for non-cleared trades</b></li> </ul>	<ul style="list-style-type: none"> <li>Capital exempt</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory for all swaps (legacy &amp; new)</li> <li>Dealer/MSP reports if facing non-Dealer/non-MSP; Dealer reports if facing MSP</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory</li> </ul>	<ul style="list-style-type: none"> <li>Subject to more due diligence, e.g., ECP status verification</li> </ul>	<ul style="list-style-type: none"> <li><b>None</b></li> </ul>
<b>Non – Financial / Corporate End-User</b>	<ul style="list-style-type: none"> <li>Exemption available only if (x) no CCP or (y) (i) using swaps to hedge or mitigate commercial risk, and (ii) notifies regulators how it generally meets its financial obligations for non-cleared swaps</li> </ul>	<ul style="list-style-type: none"> <li>Exempt if no exchange or not subject to clearing requirement</li> </ul>	<ul style="list-style-type: none"> <li><b>Mandatory clearinghouse margin for cleared trades; otherwise exempt from margin requirements but will be required to put credit support documentation in place</b></li> </ul>	<ul style="list-style-type: none"> <li>Capital exempt</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory for all swaps (legacy &amp; new)</li> <li>Dealer/MSP reports if facing non-Dealer/non-MSP; Dealer reports if facing MSP</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory</li> </ul>	<ul style="list-style-type: none"> <li>Subject to more due diligence, e.g., ECP status verification</li> </ul>	<ul style="list-style-type: none"> <li><b>None</b></li> </ul>

Eligible Contract Participants (ECPs)

# Notice to Recipient

"Bank of America Merrill Lynch" is the marketing name for the global banking and global markets businesses of Bank of America Corporation. Lending, derivatives, and other commercial banking activities are performed globally by banking affiliates of Bank of America Corporation, including Bank of America, N.A., member FDIC. Securities, strategic advisory, and other investment banking activities are performed globally by investment banking affiliates of Bank of America Corporation ("Investment Banking Affiliates"), including, in the United States, Merrill Lynch, Pierce, Fenner & Smith Incorporated, which is a registered broker-dealer and member of FINRA and SIPC, and, in other jurisdictions, locally registered entities.

**Investment products offered by Investment Banking Affiliates: Are Not FDIC Insured \* May Lose Value \* Are Not Bank Guaranteed.**

These materials have been prepared by one or more subsidiaries of Bank of America Corporation for the client or potential client to whom such materials have been received (the "Company") as a summary of certain provisions of, or rules published by certain regulators pursuant to, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted into U.S. federal law on July 21, 2010 and may not be used or relied upon for any purpose other than as specifically contemplated by a written agreement with us. These materials are based on information provided by or on behalf of the Company, from public sources or otherwise reviewed by us. We assume no responsibility for independent investigation or verification of such information (including, without limitation, data from third party suppliers) and have relied on such information being complete and accurate in all material respects. To the extent such information includes estimates and forecasts of future financial performance prepared by or reviewed with the managements of the Company and/or other potential transaction participants or obtained from public sources, we have assumed that such estimates and forecasts have been reasonably prepared on bases reflecting the best currently available estimates and judgments of such managements (or, with respect to estimates and forecasts obtained from public sources, represent reasonable estimates). No representation or warranty, express or implied, is made as to the accuracy or completeness of such information and nothing contained herein is, or shall be relied upon as, a representation, whether as to the past, the present or the future. These materials were designed for use by specific persons familiar with the business and affairs of the Company and are being furnished and should be considered only in connection with other information, oral or written, being provided by us in connection herewith. These materials are not intended to provide the sole basis for evaluating, and should not be considered a recommendation with respect to, any transaction or other matter. These materials do not constitute an offer or solicitation to sell or purchase any securities and are not a commitment by Bank of America Corporation or any of its affiliates to provide or arrange any financing for any transaction or to purchase any security in connection therewith. These materials are for discussion purposes only and are subject to our review and assessment from a legal, compliance, accounting policy and risk perspective, as appropriate, following our discussion with the Company. We assume no obligation to update or otherwise revise these materials. These materials have not been prepared with a view toward public disclosure under applicable securities laws or otherwise, are intended for the benefit and use of the Company, and may not be reproduced, disseminated, quoted or referred to, in whole or in part, without our prior written consent. These materials may not reflect information known to other professionals in other business areas of Bank of America Corporation and its affiliates.

Bank of America Corporation and its affiliates (collectively, the "BAC Group") comprise a full service securities firm and commercial bank engaged in securities, commodities and derivatives trading, foreign exchange and other brokerage activities, and principal investing as well as providing investment, corporate and private banking, asset and investment management, financing and strategic advisory services and other commercial services and products to a wide range of corporations, governments and individuals, domestically and offshore, from which conflicting interests or duties, or a perception thereof, may arise. In the ordinary course of these activities, parts of the BAC Group at any time may invest on a principal basis or manage funds that invest, make or hold long or short positions, finance positions or trade or otherwise effect transactions, for their own accounts or the accounts of customers, in debt, equity or other securities or financial instruments (including derivatives, bank loans or other obligations) of the Company, potential counterparties or any other company that may be involved in a transaction. Products and services that may be referenced in the accompanying materials may be provided through one or more affiliates of Bank of America Corporation. We have adopted policies and guidelines designed to preserve the independence of our research analysts. These policies prohibit employees from offering research coverage, a favorable research rating or a specific price target or offering to change a research rating or price target as consideration for or an inducement to obtain business or other compensation. We are required to obtain, verify and record certain information that identifies the Company, which information includes the name and address of the Company and other information that will allow us to identify the Company in accordance, as applicable, with the USA Patriot Act (Title III of Pub. L. 107-56 (signed into law October 26, 2001)) and such other laws, rules and regulations as applicable within and outside the United States.

**We do not provide legal, compliance, tax or accounting advice. Accordingly, any statements contained herein as to tax matters were neither written nor intended by us to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on such taxpayer. If any person uses or refers to any such tax statement in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to any taxpayer, then the statement expressed herein is being delivered to support the promotion or marketing of the transaction or matter addressed and the recipient should seek advice based on its particular circumstances from an independent tax advisor. Notwithstanding anything that may appear herein or in other materials to the contrary, the Company shall be permitted to disclose the tax treatment and tax structure of a transaction (including any materials, opinions or analyses relating to such tax treatment or tax structure, but without disclosure of identifying information or, except to the extent relating to such tax structure or tax treatment, any nonpublic commercial or financial information) on and after the earliest to occur of the date of (i) public announcement of discussions relating to such transaction, (ii) public announcement of such transaction or (iii) execution of a definitive agreement (with or without conditions) to enter into such transaction; provided, however, that if such transaction is not consummated for any reason, the provisions of this sentence shall cease to apply. Copyright 2013 Bank of America Corporation.**