Chapter 9

Current Developments

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§ 9:1 General Review of Systemic Risk and Regulatory Developments

The financial crisis resulting in the collapse of Lehman Brothers in September 2008 led to intense scrutiny of over-the-counter (OTC) derivative transactions and has resulted in the adoption of numerous regulations by foreign and U.S. regulators to mitigate the perceived systemic risk posed by OTC derivatives.

As we have discussed throughout this book, the systemic risk that concerns regulators relates to the counterparty exposure risk that each party to a derivative transaction has to the other party in the transaction. Counterparty exposure risk is essentially the risk that a party to

a derivative transaction will not perform its obligations. Given the numerous OTC derivative transactions executed globally among vast multiples of counterparties, global systemic risk in derivative transactions is created directly as a result of the multiplication of this counterparty exposure risk. The failure of a major derivative participant to perform on its derivative transactions in turn increases the risk that other parties will be unable to perform on their derivative transactions. For example, if one party based in the United States enters into two offsetting derivative transactions with one party located in Europe and another located in Asia, and the party in Europe fails to perform its obligations to the U.S. party, the U.S. party, in turn, may be unable to perform on its offsetting derivative transaction with the Asian party. This systemic risk was illustrated by the bankruptcy of Lehman Brothers Holdings Inc. and its subsidiaries ("Lehman") who were major participants in the OTC derivatives market. Its bankruptcy caused a cascading chain of global reactions and financial market distress in no small part due to the size of its OTC derivatives trading book.

As we have also discussed throughout this book, there are many legal risk mitigation techniques that parties can utilize to reduce counterparty risk exposure and, in turn, systemic risk through the use of payment netting, collateral arrangements, and close-out netting in derivatives documentation. The effectiveness of these risk mitigation techniques was tested in the Lehman case. While many Lehman counterparties suffered significant losses due to the insolvency proceedings, the close-out netting process effected by Lehman's counterparties mitigated the losses suffered by these parties. See chapter 8 for a review of best practices recommendations to mitigate counterparty exposure risk.

Nevertheless, the Lehman Brothers insolvency proceedings and the credit crisis of 2008 led to many proposals by both foreign and U.S. regulators for greater regulation of, and transparency in, OTC derivative transactions. These events and their cumulative effect have led to a wide range of efforts by countries and global regulators to overhaul the current regime of financial regulations relating to OTC derivatives, and to impose broad regulatory authority over OTC derivatives and other financial instruments that were believed to be a major cause of the financial crisis.

In July 2010, in response to this regulatory effort, the United States adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") which, among other significant regulatory reforms of the financial services industry, now regulates OTC derivative transactions in the United States.[1] The Wall Street Transparency

1. H.R. 4173, 111th Cong. (2010).

and Accountability Act of 2010 is the portion of Dodd-Frank that relates to the regulation of the OTC derivatives market in the United States (attached as Appendix C1). Meanwhile, in Europe, European Securities and Markets Authority (ESMA) adopted the European Market Infrastructure Regulation (EMIR) to regulate OTC derivative transactions (attached as Appendix C9). The implementing regulations relating to EMIR are attached as Appendices C10–C18.

With passage of the Dodd-Frank Act, the United States became the first country to enact significant legislation relating to the regulation of OTC derivatives. The European Union closely followed with EMIR. While Dodd-Frank and EMIR have many similar provisions, one of the main issues still to be resolved with these two major pieces of legislation is the applicability of these regulations to global market participants. The extra-territorial aspect of Dodd-Frank and EMIR must still be coordinated between the United States and the European Union. In July 2012, the Commodities Futures Trading Commission (CFTC) issued interpretive guidance as to what circumstances would cause Dodd-Frank to apply to derivative transactions outside of the United States and when a non-U.S. person would be considered a U.S. person for purposes of compliance with Dodd-Frank.[2]

However, until further regulations are enacted under EMIR and Dodd-Frank, there are still unresolved issues relating to the application of these overlapping regulations to swap transactions, such as harmonization of these regulations for cross-border financial corporations. This chapter will briefly examine the Dodd-Frank Act, EMIR and their implications on the OTC derivatives market in the future.

§ 9:2 Dodd-Frank Act and OTC Derivatives

In July 2010, the United States enacted the Dodd-Frank Act, which substantially amends and alters the regulation of financial services in the United States. Within the Dodd-Frank Act, the Wall Street Transparency and Accountability Act[3] contains sweeping new proposals for the regulation of the OTC derivatives market in the United States.

The Dodd-Frank Act delegates authority to the Securities and Exchange Commission (SEC) and the CFTC to regulate OTC derivatives and requires these agencies to issue new regulations relating to OTC derivatives. While the Dodd-Frank Act required the full implementation of the new regulatory regime for derivatives in

2. 78 Fed. Reg. 45,292 (July 26, 2013), www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf.
3. H.R. 4173, 111th Cong. (2010). Section 701 *et seq.*

2011, at the time of this publication, full implementation has not yet occurred. Full implementation is now anticipated to be delayed well into 2014.

The main principles relating to OTC derivatives under the Dodd-Frank Act include the following:

§ 9:2.1 Regulator

Under the Dodd-Frank Act, two regulators have jurisdiction over OTC derivative transactions. The SEC has exclusive jurisdiction to enact regulations over all "security-based swap" transactions, such as equity derivative swaps or credit default swaps. In essence, the SEC regulates all swaps which reference an underlying stock or bond security of an issuer. The CFTC has exclusive jurisdiction to enact regulations over all other swap transactions including foreign exchange currency swaps, interest rate swaps and commodities swaps. While the SEC has always asserted jurisdiction over swap transactions relating to securities, such as equity swaps, its exclusive role as regulator of "security-based swap" transactions under the Dodd-Frank Act provides express legislative authority for this role. A swap transaction may be regulated by both the SEC and the CFTC if it is a "mixed swap" which contains both a "security-based" swap component as well as a non-security-based swap component, such as an equity derivative transaction with an embedded foreign exchange component. Swaps on which the underlying reference asset is based on a broad securities index such as a swap on the S&P 500 are regulated by the CFTC while a swap on a narrowly based index is regulated by the SEC.

§ 9:2.2 Key Dodd-Frank Swap Definition

The Dodd-Frank Act creates categories for swap transactions and swap participants. These key categories and definitions under Dodd-Frank are as follows:

> ***SECURITY-BASED SWAP*** means (A) any agreement, contract, or transaction that—
>
> (i) is a swap, as that term is defined under section 1a of the commodity Exchange Act (without regard to paragraph (47)(b)(x) of such section); and
>
> (ii) is based on—
>
> > (I) an index that is a narrow-based security index, including any interest therein or on the value thereof;
> >
> > (II) a single security or loan, including any interest therein or on the value thereof; or

(III) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.

(B) RULE OF CONSTRUCTION REGARDING MASTER AGREEMENTS.—The term 'security-based swap' shall be construed to include a master agreement that provides for an agreement, contract, or transaction that is a security-based swap pursuant to subparagraph (A), together with all supplements to any such master agreement, without regard to whether the master agreement contains an agreement, contract, or transaction that is not a security-based swap pursuant to subparagraph (A).

(C) EXCLUSIONS.—The term 'security-based swap' does not include any agreement, contract, or transaction that meets the definition of a security-based swap only because such agreement, contract, or transaction references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under paragraph (12), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in paragraph (29) as in effect on the date of enactment of the Futures Trading Act of 1982), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as a put, call, or other option.

(D) MIXED SWAP.—The term 'security-based swap' includes any agreement, contract, or transaction that is as described in subparagraph (A) and also is based on the value of 1 or more interest or other rates, currencies, commodities, instruments or indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than an event described in subparagraph (A)(ii)(III)).

(E) RULE OF CONSTRUCTION REGARDING USE OF THE TERM INDEX.—The term 'index' means an index or group of securities, including any interest therein or based on the value thereof.

MAJOR SECURITY-BASED SWAP PARTICIPANT means (A) any person:

(i) who is not a security-based swap dealer; and

(ii) (I) who maintains a substantial position in security-based swaps for any of the major security-based swap categories, as such categories are determined by the Commission, excluding both positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(II) whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

(III) that is a financial entity that:

(aa) is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and

(bb) maintains a substantial position in outstanding security-based swaps in any major security-based swap category, as such categories are determined by the Commission.

(B) DEFINITION OF SUBSTANTIAL POSITION.—For purposes of subparagraph (A), the Commission shall define, by rule or regulation, the term 'substantial position' at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States. In setting the definition under this subparagraph, the Commission shall consider the person's relative position in uncleared as opposed to cleared security-based swaps and may take into consideration the value and quality of collateral held against counterparty exposures.

(C) SCOPE OF DESIGNATION.—For purposes of subparagraph (A), a person may be designated as a major security-based swap participant for 1 or more categories of security-based swaps without being classified as a major security-based swap participant for all classes of security-based swaps.

SECURITY-BASED SWAP DEALER means (A) any person who:

- (i) holds themselves out as a dealer in security-based swaps;
- (ii) makes a market in security-based swaps;
- (iii) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or
- (iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps.

(B) DESIGNATION BY TYPE OR CLASS.—A person may be designated as a security-based swap dealer for a single type or single class or category of security-based swap or activities and considered not to be a security-based swap dealer for other types, classes, or categories of security-based swaps or activities.

(C) EXCEPTION.—The term "security-based swap dealer" does not include a person that enters into security-based swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of regular business.

(D) DE MINIMIS EXCEPTION.—The Commission shall exempt from designation as a security-based swap dealer an entity that engages in a de minimis quantity of security-based swap dealing in connection with transactions with or on behalf of its customers. The Commission shall promulgate regulations to establish factors with respect to the making of determination to exempt.

SWAP means (A) 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 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interest or property of any kind;

(ii) that provides for any purchase, sale payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurence, or the extent of the occurrence of an 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, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interest 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 associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including 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;

(iv) that is an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap;

(v) including any security-based swap agreement which meets the definition of 'swap agreement' as defined in section 206A of the Gramm-Leach-Bliley Act (15 U.S.C. 78c note) of which a material term is based on the price, yield, value or volatility of any security or any group of index of securities, or any interest therein; or

(vi) that is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v).

MAJOR SWAP PARTICIPANTS means (A) any person who is not a swap dealer and:

(i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding:

(I) positions held for hedging or mitigating commercial risk; and

(II) positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraph (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

(iii) (I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not

subject to capital requirements established by an appropriate Federal banking agency; and

(II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission.

SWAP DEALER means any person who:

(A) IN GENERAL.—The term 'swap dealer' means any person who:

(i) holds itself out as a dealer in swaps;

(ii) makes a market in swaps;

(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.

(B) INCLUSION.—A person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.

(C) EXCEPTION.—The term 'swap dealer' does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

(D) DE MINIMIS EXCEPTION.—The Commission shall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers. The Commission shall promulgate regulations to establish factors with respect to the making of this determination to exempt.

§ 9:2.3 *Categorization of Swap Counterparties*

Different regulations will apply to swap dealers, security-based swap dealers, major security-based swap participants, and major swap participants than to other swap participants, such as hedge funds, or to end-users engaged in hedging derivative transactions. Swap dealers will be subject to a more robust regulatory regime and higher capital requirements than major swap participants who will

in turn be subject to a more robust regulatory regime and higher capital requirements than an entity that is not classified as either a swap dealer or a major swap participant.

Under SEC and CFTC rules, the determination of whether parties are swap dealers, security-based swap dealers, major security-based swap participants or major swap participants will be made in each of four categories of derivatives.[4] These categories are (i) rate swaps; (ii) credit swaps; (iii) equity swaps; and (iv) commodities swaps. Rate swaps include interest rate swaps and FX swaps. Credit swaps include credit default swaps. Equity swaps include equity-derivative transactions. Commodity swaps include all swaps which are not included in the other three categories. Security-based swap dealers and security-based major swap participants will be determined solely on the basis of their activities in security-based swaps.

For each of these swap categories, swap participants must determine whether they are swap dealers or major swap participants. A company may be a swap dealer in one category of swaps and a major swap participant in another category of swaps while being in neither category for the other categories of swaps. Additionally, each of these four categories will apply to particular classes of derivative transactions identified by the SEC and the CFTC. For example, a hedge fund could be classified as a "swap dealer" for FX derivative transactions and a "major security-based swap participant" for equity derivative transactions, but not fit into any of these four categories for commodity derivative transactions or fixed income derivatives. However, unless a swap dealer or major swap participant applies for, and receives, specific exemptive relief from the SEC or CFTC, a swap dealer or major swap participant will be treated as a swap dealer or major swap participant for all categories of swaps that it enters into even if it is not a swap dealer with respect to a certain category of swaps.[5]

The legislative definition of swap dealer is broad enough to encompass entities that would not normally be viewed as swap dealers, such as hedge funds or large corporate end-users. Under proposed SEC and CFTC regulations, a swap dealer is defined as an entity who:

(i) Holds itself out as a dealer in swaps;

(ii) Makes a market in swaps;

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4. Further Definitions of *"Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant"* and *"Eligible Contract Participant,"* 75 Fed. Reg. 80,174 (Dec. 21, 2010).
5. *Id.* at 80,212.

(iii) Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

(iv) Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.[6]

The term *"swap dealer"* does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of regular business. A similar definition applies to *"security-based swap dealer"* except that the references to swaps are to security-based swaps.[7]

The determination of whether an entity is a *"major security-based swap participant"* or a *"major swap participant"* involves difficult numerical calculations that must be made for each of the four swap categories. A major swap participant is defined as any person:

(i) That is not a swap dealer; and

(ii) (A) That maintains a *substantial position* in swaps for any of the major swap categories, excluding both positions held for hedging or mitigating commercial risk, and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(B) Whose outstanding swaps create *substantial counterparty exposure* that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

(C) That is a financial entity that: (1) Is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency (as defined in Section 1a(2) of the Commodity Exchange Act); and (2) Maintains a substantial position in outstanding swaps in any major swap category.[8]

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6. *Id.*
7. *Id.* at 80,218. A list of swap dealers registered with the CFTC can be found at the following link: http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer.
8. *Id.* at 80,212.

There are two key definitions for purposes of determining whether an entity is a major swap participant. The first is what constitutes "*a substantial position in swaps*" and the second is what is "*substantial counterparty exposure*." These definitions will require complex numerical computations by entities engaged in significant swap transactions.

A "*substantial position in swaps*" must be determined for each category of swaps. For each category, a substantial position is as follows:

- **Rate swaps**

  $3 billion in "*daily average aggregate uncollateralized outward exposure*";

  OR

  $6 billion in "*daily average aggregate uncollateralized outward exposure*" PLUS "*daily average aggregate potential outward exposure.*"

- **Credit swaps**

  $1 billion in "*daily average aggregate uncollateralized outward exposure*";

  OR

  $2 billion in "*daily average aggregate uncollateralized outward exposure*" PLUS "*daily average aggregate potential outward exposure.*"

- **Equity swaps**

  $1 billion in "*daily average aggregate uncollateralized outward exposure*";

  OR

  $2 billion in "*daily average aggregate uncollateralized outward exposure*" PLUS "*daily average aggregate potential outward exposure.*"

- **Commodity swaps**

  $1 billion in "*daily average aggregate uncollateralized outward exposure*";

  OR

> $2 billion in "*daily average aggregate uncollateralized outward exposure*" PLUS "*daily average aggregate potential outward exposure.*"[9]

The "*aggregate uncollateralized outward exposure*" for purposes of the first portion of the test is calculated by determining the sum of the current exposure, using industry standards, of each entity's swap positions with negative value in a major swap category, less the value of the collateral the entity has posted in connection with those positions. In chapter 3, we examined the method of determining exposure under OTC documentation and the use of collateral arrangements which will now become central in making these swap determinations under the Dodd-Frank Act. Moreover, the use of netting agreements, which we discussed in chapter 3 and in chapter 8, will also lessen an entity's outward exposure on swap transactions which should significantly increase their use.

The second portion of the first test for a major swap participant requires an examination of "*aggregate potential outward exposure*." The determination of this amount depends on whether swaps are cleared on a clearinghouse or subject to daily mark-to-market margining. For swaps that are not cleared on a clearinghouse and are not subject to daily mark-to-market margining, the aggregate potential outward exposure is calculated by multiplying the notional amount of each swap transaction by the conversion multiplier table set forth below depending on the type of swap and the remaining term of maturity of the swap.[10] If a swap is subject to daily mark-to-market or is cleared on a clearinghouse, then the notional amount is multiplied by 0.2. There are also various methods of reducing exposure for purposes of this calculation.

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9. *Id*. at 80,213.
10. *Id*. at 80,214.

Table 9-1
Conversion Multiplier Table

Residual maturity	Interest rate	Foreign exchange rate and gold	Precious metals (except gold)	Other commodities	Credit	Equity
One year or less	0.000	0.01	0.07	0.10	0.10	0.06
Over one to five years	0.005	0.05	0.07	0.12	0.10	0.08
Over five years	0.015	0.075	0.08	0.15	0.10	0.10

Finally, a calculation must be made of what constitutes *"substantial counterparty exposure."* Substantial counterparty exposure is defined as:

- $5 billion in *"daily average aggregate uncollateralized outward exposure"*;

  OR

- $8 billion in *"daily average aggregate uncollateralized outward exposure"* PLUS *"daily average aggregate potential outward exposure."*[11]

"Uncollateralized outward exposure" and *"aggregate potential outward exposure"* is calculated in the same manner as described above for purposes of determining whether an entity has *"a substantial exposure to swaps."*

A "major security-based swap participant" is similarly defined as a "major swap participant" but only "security-based swaps" are taken into account for purposes of making the determinations above. Security-based swaps are basically equity swaps and credit default swaps on single name reference entities. A *"substantial position in security-based swaps"* is identical to the calculation set forth above for equity swaps. The calculation table for calculating *"uncollateralized outward exposure"* is as follows:

11. *Id.* at 80,215.

Table 9-2

Calculation Table

Residual maturity	Credit	Equity	Other
One year or less	0.10	0.06	0.10
Over one to five years	0.10	0.08	0.12
Over five years	0.10	0.10	0.15

Finally, "substantial counterparty exposure in security-based swaps" is calculated as:

- $2 billion in "*daily average aggregate uncollateralized outward exposure*";

  OR

- $4 billion in "*daily average aggregate uncollateralized outward exposure*" PLUS "*daily average aggregate potential outward exposure*."[12]

As of March 1, 2013, only two entities were registered as major swap participants with the CFTC.[13]

§ 9:2.4 Swap Repositories

Even if a swap is deemed by the SEC or the CFTC to be a non-cleared swap that will be executed outside of the clearinghouses, all relevant data regarding the non-cleared swap transactions must be submitted to specially designated swap repositories. EMIR contains similar provisions that require the submission of executed swaps to registered swap repositories. At the time of this publication, there are three registered swap repositories under the Dodd-Frank Act: DTCC Data Repository, the Chicago Mercantile Exchange, Inc., and ICE Trade Vault.[14]

The information that must be submitted to a swap repository includes:

(i) any information necessary to identify and value the transaction, including the spread and the LIBOR rate;

(ii) the date and time of execution;

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12. *Id*. at 80,217.
13. See list of major swap participants at the following link: www.cftc.gov/LawRegulation/DoddFrankAct/registermajorswappart.
14. A list of registered swap repositories in the United States can be found at the following link: http://sirt.cftc.gov/sirt/sirt.aspx?Topic=DataRepositories.

(iii) all information from which the price of the transaction is derived;

(iv) whether the transaction has been accepted for clearing by a clearinghouse;

(v) any amendments to the transaction; and

(vi) the final confirmation for the transaction.

§ 9:2.5 Exempted Swaps Under Treasury Exemption

Pursuant to authority granted by Congress under the Dodd-Frank Act, the U.S. Department of Treasury had the option to waive the application of most of the Dodd-Frank provisions relating to derivatives to certain foreign exchange swap transactions. On November 16, 2012, the Secretary of the Treasury exercised this exemption (Treasury Exemption) and determined that foreign exchange swaps and foreign exchange forwards should not be regulated as swaps under the Dodd-Frank Act for mandatory clearing, trade execution, and margin purposes.[15]

However, foreign exchange options, currency swaps and non-deliverable forward contracts are not covered by the Treasury Exemption and are fully subject to the Dodd-Frank Act. Moreover, even exempted FX derivative transactions under the Treasury Exemption are still to be subject to trade-reporting requirements, business conduct standards (including the anti-fraud provisions) of the Commodities Exchange Act and the related regulations enacted by the CFTC.

§ 9:2.6 Clearing of OTC Derivatives

The Dodd-Frank Act requires that OTC swap transactions be cleared through a central derivatives clearinghouse (DCO) unless it is exempt from clearance such as FX swaps which are exempted pursuant to the Treasury Exemption or swaps executed utilizing the corporate end-user exemption. The DCOs are regulated by and registered with the CFTC and/or the SEC. By clearing transactions on DCOs, regulators believe that counterparty exposure risk would be negated because the DCOs guarantee the performance of the swap transactions. Furthermore, under the Dodd-Frank Act, new regulations will be issued by the CFTC and the SEC to encourage the use of standardized derivatives and thus utilization of central clearing organizations by imposing higher capital and margin requirements for non-cleared derivative OTC transactions. Swaps that are required to be cleared through DCOs must also be executed on "designated

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15. 77 Fed. Reg. 69,694 (Nov. 20, 2012) which can be accessed at the following link: www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf.

contract markets" (DCMs) or "swap execution facilities" (SEFs) to provide more transparent pricing to swap participants. However, while the rules governing the operations of DCMs and SEFs have been issued in final form, as of the date of this publication, swap execution is still not occurring on SEFs or DCMs although that is expected to occur in the near future.

In determining what would be cleared or not, each class of swaps, group of swaps or individual swap transactions will be reviewed by the SEC or the CFTC, as applicable. The SEC or the CFTC would then determine whether the swaps, class of swaps, or group of swaps would be subject to clearing on a clearinghouse. Under the Dodd-Frank Act, the SEC and the CFTC must consider the following factors in determining whether a particular swap, class of swaps or group of swaps are cleared or not:

(i) the liquidity and outstanding notional amount of such swaps;

(ii) the availability of infrastructure support for the clearing of such swaps;

(iii) the systemic risk mitigation that would be achieved in clearing such swaps;

(iv) the impact on competition for clearing such swaps; and

(v) the existence of reasonable legal certainty in the treatment of swap counterparty positions, funds and property in the event of an insolvency of a derivatives clearinghouse.

To encourage transparency, the central clearinghouses would also be required to publicly disclose the contractual terms of the swaps settled at these clearing organizations, as well as daily settlement prices, volume and open interest for derivative contracts cleared through such organizations.

As of the time of this publication, the SEC and CFTC have proposed rules that would effectively determine on a case-by-case basis which derivatives will be subject to mandatory clearing. These proposed rules do not offer any clarity on what will be required to be cleared or how the determinations will be made. As of the date of this publication, only the CFTC has issued a clearing order requiring certain interest rate swaps, rate forward agreements and certain credit default swaps to be cleared through a clearing organization unless an exemption exists.[16]

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16. 77 Fed. Reg. 74,284 (Dec. 13, 2012) which can be accessed at the following link: www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-29211a.pdf.

Moreover, derivatives utilized by end-users solely for hedging purposes will also be excepted if the end-user qualifies for the corporate end-user exemption. The CFTC issued its version of the corporate end-user exemption which is discussed below. (A copy of the CFTC's Corporate End-User Exemption is attached as Appendix C8.)

§ 9:2.7 CFTC External Business Conduct Rules/August 2012 Protocol

Pursuant to its authority under the Dodd-Frank Act, the CFTC issued final rules that imposed external business conduct rules on registered swap dealers as well as documentation, recordkeeping, reporting and risk disclosure requirements.[17] These CFTC rules require that existing swap agreements be amended to incorporate these rules between registered swap dealers and their U.S. counterparties. The effective date of these rules was May 1, 2013. Since the amendment of thousands of swap agreements was a logistically difficult task, the implementation of these rules and their incorporation into existing swap agreements was handled through the adoption of a protocol process through the auspices of the International Swaps and Derivatives Association, Inc. (ISDA).

The August 2012 Protocol[18] was an attempt by swap dealers and ISDA to streamline the amendment of thousands of swap agreements to incorporate new CFTC rules relating to swap dealers. By adhering to the August 2012 Protocol, parties are incorporating the CFTC rules applicable to swap dealers in their ISDA swap agreements.[19] The deadline for adherence to the August 2012 Protocol was also May 1, 2012. Adhering to the August 2012 Protocol is done electronically through

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17. These rules can be found in Appendices C3, C5 and C7.
18. The August 2012 Protocol can obtained at the ISDA website at www2.isda.org/functional-areas/protocol-management/protocol/8.
19. The CFTC rules which are incorporated into the August 2012 Protocol are: *the Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties*, 77 Fed. Reg. 9734 (Feb. 17, 2012); *the Large Trader Reporting for Physical Commodity Swaps*, 76 Fed. Reg. 43,851 (July 22, 2011); *the Position Limits for Futures and Swaps*, 76 Fed. Reg. 71,626 (Nov. 18, 2011); *the Real-Time Public Reporting of Swap Transaction Data*, 77 Fed. Reg. 1182 (Jan. 9, 2012); *the Swap Data Recordkeeping and Reporting Requirements*, 77 Fed. Reg. 2136 (Jan. 13, 2012); *the Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchant*s, 77 Fed. Reg. 20,128 (Apr. 3, 2012); and *the Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps,* 77 Fed. Reg. 35,200 (June 12, 2012).

the Markit process.[20] Some swap dealers enacted bilateral amendments to incorporate these rules in lieu of utilizing the August 2012 Protocol. However, for parties with multiple swap dealers, adherence to the August 2012 Protocol is the simplest way to comply in lieu of negotiating different bilateral amendments with various swap dealers.

For parties that are entering into new swap agreements, the August 2012 Protocol should not necessarily apply since the provisions in the protocol can actually be incorporated into new swap agreements in lieu of the time-consuming process of adhering to the protocol through the electronic Markit process. Many swap dealers have also adopted business conduct agreements which incorporate the provisions of these CFTC rules into new swap agreements without requiring adherence to the August 2012 Protocol. However, as of the date of this publication, many swap dealers are still insisting that counterparties adhere to the August 2012 Protocol instead of amending their swap agreement forms to incorporate the August 2012 Protocol materials.

§ 9:2.8 LEI Numbers

The CFTC also issued rules requiring American counterparties to obtain Legal Entity Identifier (LEI) numbers to comply with swap recordkeeping and swap data reporting requirements issued by the CFTC.[21] LEI numbers are a unique twenty-digit, alpha-numeric code whose purpose is to enable clear and unique identification of companies participating in the derivatives markets. LEI numbers are also required to adhere to the March 2013 Protocol or to any bilateral amendment that is executed in lieu of adhering to the March 2013 Protocol. Each legal entity that enters into a swap agreement must obtain an LEI number.

In August 2012, DTCC/SWIFT was approved by the CFTC to provide LEI numbers to American counterparties through its website.[22] On October 30, 2013, the CFTC announced that it would permit LEI numbers to be obtained from the Legal Entity Identifier Regulatory Oversight Committee (LEIROC)—a committee of global authorities tasked with coordinating and monitoring a global system of legal entity identification. In particular for European Union countries subject to EMIR, the CFTC has approved the use of LEI numbers from WM Datenservice upon approval by the European Securities and

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20. The Markit process can be accessed at the following link: www.markit.com/product/isda-amend.
21. *See* 17 C.F.R. § 45.6, 77 Fed. Reg. 2136, 2204 (Jan. 13, 2012) and 17 C.F.R. § 46.4, 77 Fed. Reg. 35,200, 35,229 (June 12, 2012).
22. A DTCC LEI Number may be obtained at www.ciciutility.org/.

Markets Authority of the use of LEI numbers obtained from DTCC for EMIR recordkeeping purposes.[23]

§ 9:2.9 Portfolio Reconciliation and Risk Disclosure/ March 2013 Protocol

Both the Dodd-Frank Act and EMIR require that swap dealers engage in portfolio reconciliation and portfolio compression with their counterparties.[24] The portfolio reconciliation procedures are substantively similar to the procedures under EMIR. The purpose of the portfolio reconciliation procedures is to ensure that both sides to an uncleared swap have identical information relating to the swap on their books and records by either exchanging information relating to their derivative trades or by having the swap dealer send the information for review to its swap counterparty. Some swap dealers utilize third-party services to perform portfolio reconciliation while others do not.

Unlike EMIR, which requires discrepancies to be resolved within five business days, discrepancies in material terms identified as part of a portfolio reconciliation process are required to be resolved immediately while discrepancies in valuation are required to be resolved within one business day. Under the CFTC rules, swap dealers must report material discrepancies to the CFTC which also helps the CFTC identify swap dealers who may not be keeping adequate records of their swaps.

If a U.S. counterparty executes less than 100 uncleared swap trades per year, the portfolio reconciliation must be done on an annual basis. For U.S. counterparties with more than 100 swap trades per year, portfolio reconciliation must be performed on a quarterly basis. Portfolio reconciliation may take place by exchanging information with a swap dealer or by reviewing information sent by a swap dealer. U.S. counterparties are not required to either exchange information or to review information provided by the swap dealer. However, if the swap dealer's records do not match the records of the American counterparty and the American counterparty does not dispute it within the required time frame because it did not review the information, then the swap dealer's records and information will control the terms of the relevant swap agreement.

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23. Once such approval has been obtained, LEI numbers may also be obtained at www.geiportal.org.
24. *Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants*, 77 Fed. Reg. 55,904 (Sept. 11, 2012).

The portfolio reconciliation rules, together with other CFTC rules, were incorporated in the ISDA March 2013 Protocol which, like the August 2012 Protocol, amends existing swap agreements to incorporate the provisions of these rules.[25] The deadline for adherence to the March 2013 Protocol was July 1, 2013. However, unlike the August 2012 Protocol, it is not legally required for swap dealers to require corporate end-users to adhere to the March 2013 Protocol to execute swap transactions with them. Even though the March 2013 Protocol provides a portfolio reconciliation process to which the parties are deemed to agree, additional work must be done after execution of the Protocol to implement the portfolio reconciliation procedures. Accordingly, adherence to the March 2013 Protocol does not eliminate the work involved in agreeing to different portfolio reconciliation procedures with different swap dealers. In lieu of having parties adhere to the March 2013 Protocol, some swap dealers have established procedures for corporate end-users while others have standardized procedures for all of their counterparties.

Since July 1, 2013 (the effective date of the March 2013 Protocol), in lieu of requiring adherence to the March 2013 Protocol, most swap dealers will now simply send a one-page disclosure letter in lieu of requiring adherence to the protocol. However, other dealers will still insist that adherence to the March 2013 Protocol is the easiest way to conform to the CFTC rules embedded in the protocol.

The information that is legally required to be delivered by swap dealers to their counterparties and that is contained in the March 2013 Protocol can be delivered through a letter from the swap dealer to an American counterparty which has the following disclosure notices:

(i) *Orderly Liquidation Authority Notification*—This legal notice discloses to a U.S. counterparty that if the swap dealer is an insured depository institution, certain limitations apply under the Dodd-Frank Act or the Federal Deposit Insurance Act of 1950, as amended, to the rights of the swap counterparty to terminate, liquidate, or net any swap agreement by reason of the appointment of the FDIC as receiver.

(ii) *Clearing Notification*—This legal notice discloses to a U.S. counterparty that if the swap must be cleared through a

25. The rules incorporated into the March 2013 Protocol are: *Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants*, 77 Fed. Reg. 55,904 (Sept. 11, 2012); *End-User Exception to the Clearing Requirement for Swaps*, 77 Fed. Reg. 42,559 (July 19, 2012) and *Clearing Requirement Determination Under Section 2(h) of the* CEA, 77 Fed. Reg. 74,284 (Dec. 13, 2012).

derivatives clearing organization, the original swap between the parties will be extinguished and replaced by equal and opposite swaps with the DCO.

Finally, U.S. swap dealers need a representation from their U.S. counterparty that the counterparty is not an insured depository institution. This representation is usually made by checking the box in the disclosure letter that is sent by the swap dealer setting forth the legal notices discussed above. While every swap dealer has slightly different letters and procedures for complying with these rules without forcing an American counterparty to adhere to the March 2013 Protocol, the procedures are substantially similar.

§ 9:2.10 Corporate End-User Exemption

As previously noted, one of the main provisions of Dodd-Frank is to require that swaps be executed on DCMs or SEFS and cleared through a DCO. The DCO guarantees the performance of the parties on the swap and the systemic risk posed by swaps to the financial system is deemed reduced.

For corporate end-users engaged in hedging transactions, clearing swaps through a DCO is economically inefficient because the corporate end-user would need to post collateral and margin directly with the DCO. In OTC derivative transactions, corporate end-users rarely post collateral directly with a swap dealer. Moreover, the DCO may change or alter the margin requirements with little notice to the corporate end-user. The end result is that the costs of hedging are significantly increased for corporate end-users. This concern from corporate end-users led Congress to adopt a corporate end-user exemption under the Dodd-Frank Act. The CFTC has further clarified the availability of this exemption under its Corporate End-User Exemption regulation (attached as Appendix C8).

This concern from corporate end-users led Congress to enact an exemption to the swap clearing requirements for corporate end-users under the Dodd-Frank Act. The CFTC implemented this congressional exemption through the "Corporate End-User Exemption" (attached as Appendix C8). Corporate end-users seeking to avoid the clearing of swaps with a DCO and posting collateral with a DCO will need to comply with the Corporate End-User Exemption. The Corporate End-User Exemption has the following requirements:

1. Swaps must be executed for hedging purposes only and not speculative purposes.
2. A corporation that receives hedge accounting treatment for a swap has dispositive proof that the swap is for hedging purposes.

3. If hedge accounting treatment is not received for a swap, other proof is permissible for purposes of establishing that a swap is for hedging purposes only (for example, the swap constitutes a *bona fide hedge* as defined under CFTC rules).

4. For public companies or subsidiaries of public companies in the United States, board resolutions (or resolutions of an existing committee that has board authorization to authorize derivative transactions) must be implemented to approve the use of non-cleared swap agreements.

5. A report must be filed to the CFTC regarding a corporation's eligibility to use the Corporate End-User Exemption on either an annual basis or on a swap-by-swap basis. This form indicates the purpose for which swaps are utilized by the corporation; an explanation as to how a corporation meets its financial obligations under its swaps; whether the parent company guarantees the swap of its subsidiaries or whether any collateral is posted by the corporation to secure its swaps. Alternatively, the election can be made on a swap-by-swap basis.

6. The corporation must not be a "financial entity" unless it is eligible to use the "Finance Subsidiary" exemption under the Corporate End-User Exemption or the CFTC Interpretive Guidance relating to "Treasury Affiliates."[26]

The most problematic determination under the Corporate End-User Exemption is whether a subsidiary is deemed to be a "financial entity." Subsidiaries that are actual operating companies engaged in manufacturing or other operating activities are generally not financial entities. However, subsidiaries that are not operating companies must be analyzed to determine whether they are "financial entities." Subsidiaries that are "predominantly engaged in activities that are financial in nature" will be deemed to be "financial entities." This definition is unfortunately extremely broad and many subsidiaries that would not otherwise be considered financial entities may fall within this extremely broad definition. If a subsidiary is determined to be a "financial entity," an exemption from clearing is only available if the Finance Subsidiary Exemption or the Treasury Affiliate Exemption is available. The Finance Subsidiary Exemption is only available to subsidiaries that engage in financing activities relating to the manufacture of the parent company's products and has stringent conditions.

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26. No-Action Relief from the Clearing Requirement for Swaps Entered into by Eligible Treasury Affiliates, CFTC Letter No. 13-22 (June 4, 2013).

The Treasury Affiliate Exemption is available to certain subsidiaries that engage in treasury activities on behalf of the entire corporation and also has stringent conditions.

§ 9:2.11 Inter-Affiliate Exemption

Swaps between affiliates of the same company are also subject to the clearing requirements of a DCO under the Dodd-Frank Act unless the conditions set forth in the CFTC Inter-Affiliate Exemption are implemented.[27] The Inter-Affiliate Exemption also has stringent conditions designed to prevent multi-national conglomerates from executing swap transactions with a non-U.S. subsidiary in unregulated jurisdictions and allocating the economics of the swap agreement to its American companies. Accordingly, if a corporate end-user executes any swaps between themselves or any of their foreign subsidiaries, the Inter-Affiliate Exemption must be implemented to the extent it is available for the swap transaction, or another exemption must be implemented to avoid clearing the swap through a DCO.

§ 9:3 Implications of the Dodd-Frank Act and EMIR

One of the key implications of both the Dodd-Frank Act and EMIR in terminating derivative transactions will be the different regime that will apply in terminating swaps cleared on a central clearinghouse and terminating swaps that are not so cleared. As a result, the close-out process in terminating swap transactions will differ between swaps that are cleared on a central clearinghouse and those that are not. Swaps that are not cleared through a central clearinghouse will retain the same substantive close-out netting process that is described in this book as well as the same substantive termination events and events of default.

However, another key issue arising under the Dodd-Frank Act and EMIR for OTC derivative transactions is how Dodd-Frank will impact close-out netting involving financial companies. One of the provisions of the Dodd-Frank Act establishes a new liquidation regime for "financial companies." Under these provisions, the Secretary of the Treasury has the authority to appoint the Federal Deposit Insurance Corporation (FDIC) as the receiver for "financial companies" in certain circumstances. Banks and insurance companies are clearly contemplated to be "financial companies" for the purposes of these provisions. Non-bank financial companies may also be included if they are deemed to be engaged in primarily financial activities.

27. 17 C.F.R. § 50 *et seq.*

However, for such a determination to be made, at least 85% of the total consolidated revenues of a company must be attributable to financial activities.

The scope of this new liquidation proceeding and the procedural steps for its implementation are beyond the scope of this book, but assuming a financial company has been designated as being subject to this new liquidation authority and such company is in danger of default, the Secretary of the Treasury may appoint the FDIC as a receiver after completing various procedural steps. The question is then how would the appointment of the FDIC impact any existing OTC derivatives to which such financial company is a party.

Under this new insolvency regime, OTC derivatives would constitute qualified financial contracts under the Dodd-Frank Act that can still be closed out and netted in spite of the appointment of the FDIC as a receiver. However, a one-business-day stay would apply even to qualified financial contracts such as derivative transactions. During this one-business-day grace period, the FDIC would have the power to transfer all of the derivative transactions of a single counterparty to a third party. If the FDIC exercises this authority, the derivative contracts may not be terminated unless another independent event of default has occurred. *Accordingly, under this new insolvency procedure, a one-business-day stay would apply to the termination of derivative contracts, whereas under the Bankruptcy Code, no such stay applies*.

The FDIC would also have the power to repudiate derivative contracts, and damages would be calculated on the date of repudiation instead of the date on which the FDIC is appointed as receiver. The FDIC is not permitted to set aside any security interest that a party may have with a company under FDIC receivership, so a secured derivative transaction could not be made unsecured by the FDIC. The FDIC generally recognizes setoff rights arising under state law.

At the time of this publication, it is uncertain as to how this new insolvency regime will interact with existing insolvency regimes. Further regulations and studies by relevant governmental agencies should clarify some of the outstanding questions relating to this new insolvency proceeding, particularly which parties will be subject to it. For OTC derivative parties, this new regime only heightens the need for adequate security and collateral arrangements to secure derivative transactions and mitigate counterparty risk exposure since the FDIC has no power to overturn security arrangements. Setoff rights should also be drafted into all derivatives documentation. In fact, all the legal risk mitigation procedures that have been discussed in this book should continue to be utilized, notwithstanding the additional measure of uncertainty that has been added to the close-out netting process by these new insolvency provisions in the Dodd-Frank Act.

The key legal uncertainty under the Dodd-Frank Act and EMIR for OTC derivatives is which derivative transactions must be cleared on a central clearinghouse. While there are already exchange-listed derivatives that parties can purchase through central clearinghouses, OTC derivatives provide a level of customization to parties that exchange-listed derivatives cannot. Currently, only credit default swaps and certain interest rate swaps are subject to mandatory clearing in the United States.

Even a simple interest rate derivative transaction, the most plain vanilla OTC derivative transaction and one normally utilized solely for hedging purposes, is specifically tailored to the terms of the debt that a party wishes to hedge. A standardized derivative cannot be specifically tailored to the terms of the debt that a party wishes to hedge. The debt may contain amortization features or payment features that cannot be procured through an exchange-listed derivative. An exchange-listed derivative would likely not provide a completely efficient hedge to a party's debt because the terms of the derivative could not be customized to the terms of the debt.

Furthermore, current accounting regulations require that derivatives be marked-to-market by derivative participants. Marking-to-market a derivative means that, on a quarterly basis, companies with derivative transactions must determine the current fair market value of each derivative transaction and post the gain or loss since the last quarter on their financial statements. This type of marking-to-market of derivative transactions increases earnings volatility. Major derivative participants, such as financial institutions, typically mark-to-market their derivative positions, but companies that engage in derivative transactions solely for hedging purposes do not wish to suffer the earnings volatility that derivative transactions create.

For that reason, hedging transactions are subject to an End User Exception under the mark-to-market accounting rules, which require the derivative transaction be a fully effective hedge for the hedged obligation. This analysis of the effectiveness of a derivative transaction in hedging a hedged obligation, such as a debt financing, is time-consuming, but requires that the derivative transaction be exactly tailored to the terms of the hedged obligation. For example, to avoid a marking-to-market of an interest rate swap that has been entered into to hedge a debt financing, the terms of the interest rate swap transaction must exactly match the terms of the debt financing or the interest rate swap will not be deemed fully effective and the ineffective portion must be marked-to-market.

As a result, eligible end-users, such as corporations, who engage in derivative transactions purely for hedging purposes may face mark-to-market treatment of their derivative positions if they are required to purchase derivatives traded on a clearinghouse if they do not qualify

for the End-User Exception. Since the earnings volatility created by marking-to-market derivative positions is avoided by companies that engage in derivative transactions solely for hedging purposes, these companies must be eligible for, and implement, the End-User Exemption or be forced to choose between not hedging their interest rate risk or FX currency risk or being required to mark-to-market their positions as financial institutions do. Without a concurrent change in U.S. accounting rules, moving "standardized" OTC derivatives such as interest rate swaps or FX currency swaps to a central clearinghouse may actually increase the financial risk profile of companies forced to choose between hedging their exposure to interest rate risk or FX currency risk and marking-to-market their derivative hedging transactions if they are not eligible for, or cannot meet, all the conditions set forth in the End-User Exception.

§ 9:4 Conclusion

At the time of publication of this book, it is still uncertain what the final OTC derivatives landscape will be in the future under the Dodd-Frank Act or EMIR. The timetable for full implementation of these regulatory regimes through the finalization and effectiveness of regulations is unknown. The types of derivatives that will be subject to clearing and the exemptions available from clearing will determine whether the future of OTC derivatives is almost completely exchange-traded and standardized or still open to customization with different collateral and margin requirements.

Uncertainty also exists as to how the two main regulatory regimes—the Dodd-Frank Act and EMIR—will interact with one another as well as those that may be imposed by other jurisdictions. The extraterritorial application of these legislative regimes is one of the most controversial issues remaining to be decided by global regulators. These regulators will need to determine to what extent their substantially comparable, but not identical, regulatory regimes will regulate swap transactions that have peripheral connections to their jurisdictions or swap participants that are already regulated in their home jurisdictions.

The risk mitigation and close-out netting procedures described in this book will also be significantly different with cleared derivatives than with uncleared derivatives. However, at this time, there is little precedent to guide us into the nature of these differences given the unique nature of swap agreements. Will the guarantees by DCOs and clearinghouses in Europe of derivative transactions eliminate the risk of another Lehman? Or will these guarantees create other risks that cannot be quantified by concentrating the risk in clearinghouses? The answer will depend on the percentage of derivative transactions that

are eventually cleared through clearinghouses, which is unknowable at this time. Will exemptions from clearing and the use of futures markets in lieu of derivatives clearinghouses outnumber the swaps that are actually cleared? How will the new insolvency regime for financial companies under the Dodd-Frank Act impact close-out netting for OTC derivatives? How will the imposition of a limited stay on close-out netting in Europe impact counterparties? How will the legal precedents set by the Lehman Brothers bankruptcy proceedings alter the U.S. derivatives market? Will derivative transactions increasingly be governed by English law to avoid the uncertain application of the U.S. Bankruptcy Code and the undermining of the close-out netting process? The changing landscape for OTC derivatives will likely require parties to derivative transactions to implement changes in their derivative transactions and their derivative agreements to reflect the changing nature of the close-out netting process. The credit crisis of 2008 illustrated the potential for systemic risk in OTC derivative transactions. However, as we have tried to demonstrate in this book, proper risk mitigation techniques can be utilized to reduce or eliminate counterparty exposure risk. The reduction or elimination of counterparty exposure risk in turn reduces the systemic risk posed by OTC derivatives. While regulations adopted since the crisis are designed to enhance risk mitigation, parties to derivative transactions should consider implementing appropriate legal risk mitigation techniques in their OTC derivative transactions.