Clearing and Trade Execution Requirements for OTC Derivatives Swaps Under the Frank- Dodd Wall Street Reform and Consumer Protection Act

38 Rutgers L. Rec. 227 (2011) | WestLaw | LexisNexis | PDF

This article examines Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the ?Wall Street Transparency and Accountability Act of 2010? (the ?Act?). The Act provides a comprehensive regulatory framework for swap transactions that designates the Commodities Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) as the primary regulators of the over-the-counter (OTC) derivatives swap market. The Act provides a very broad definition of swaps to include most OTC derivatives transactions, and it grants the CFTC regulatory jurisdiction over them with the exception of security-based swaps to which the SEC is granted regulatory jurisdiction. The hallmark of the legislation is the clearing, trade execution, and reporting requirements for OTC derivatives contracts modeled after similar regulatory requirements for securities and commodities to protect against systemic loss. Effectively, standardized OTC derivatives swaps contracts will be the only swap transactions subject to the clearing and trade execution requirements. The potential downside of the regulation is that customized contracts are not subject to clearing in light of the individualized nature of the terms of such contracts. Thus, traders of customized contracts are subject to certain margin and capital requirements along with reporting requirements to protect against systemic loss in trading customized contracts. The question is whether the alternative regulatory system for customized contracts can prevent against systemic loss in a manner comparable to the protections that the clearing, payment, settlement, and trade execution systems bring to trading in standardized contracts. Moreover, will the bifurcated regulatory system for swap transactions incentivize traders to customize contracts to avoid the clearing and to avoid the transparency associated with exchange trading? The Act grants broad authority to the CFTC and the SEC to promulgate rules and provide interpretative guidelines to implement the regulatory provisions of the Act. Ultimately, the effectiveness of the Act to prevent systemic loss and to protect the financial system against the type of market crisis experienced in 2008 will depend on the breadth and depth of the rules the agencies promulgate and the diligence with which they oversee and enforce those rules.

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