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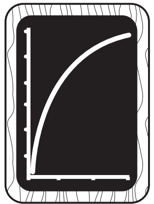

LEARNING CURVE®

Hedge Funds and the Wall Street Act Part II

In last week's *Learning Curve*, we highlighted certain provisions in the Wall Street Transparency and Accountability Act of 2010 that will impose new requirements and restrictions on a hedge fund that is categorized as a swap dealer or a major swap participant when the various provisions of Subtitles A and B of the Act become effective. In this issue, we discuss the Act's additional requirements for swap dealers and major swap participants and the effects on hedge funds of other significant provisions.

Special Entities

The Act creates new responsibilities for swap dealers and major swap participants that enter into swaps with special entities. Special entities include, among other entities, employee benefit plans, government plans and endowments and Federal and State agencies, states and municipalities. While it is unusual for a hedge fund to be trading with an employee benefit plan or a municipality, the hedge fund itself may be considered to be a plan for these purposes if a portion of its assets consists of employee benefit plan assets. Under this scenario, the hedge fund's counterparty would be the swap dealer or major swap participant facing the hedge fund special entity in the trade.

A swap dealer or major swap participant entering into a swap with a special entity will be obligated reasonably to believe that its special entity counterparty has an independent representative who, among other necessary qualifications, has sufficient knowledge to evaluate the transaction and its risks, is acting in the best interests of the special entity, makes appropriate disclosures and will provide written representations to the special entity regarding the pricing and appropriateness of the trade, and, in the case of a specified entity that is an employee benefit plan subject to the Employee Retirement Income Security Act of 1974, qualifies as a fiduciary. In addition, such swap dealer or major swap participant will have to comply with the standards and requirements set forth in regulations to be promulgated by the **Commodity Futures Trading Commission** and the **Securities and Exchange Commission**.

Position Limits

The CFTC is required to adopt regulations to provide position limits with respect to swaps, other than bona fide hedging swaps, that consist of contracts of sale for future delivery and options on the contracts or commodities subject to the rules of a designated contract market. Any swap execution facility that is a trading facility will have to adopt such position limits as are set by the CFTC. The derivatives provisions state that the law is intended to regulate swaps that perform or affect a "significant price discovery function with respect to regulated markets," taking into account concerns over excessive speculation, market manipulation and congestion and sufficient liquidity for bona fide hedgers.

In an attempt to prevent fraud and manipulation, the SEC is required to adopt regulations to establish limits on the size of positions in security-based swaps, also subject to a bona fide hedging exemption. The SEC also may issue regulations directing a self-regulatory organization to adopt position limits.

The Act provides that the position limits rules will not apply to positions acquired, but not increased, in good faith prior to the effective date of any rule, regulation or order that establishes the applicable position limit. Each of the Commissions may issue exemptions if it finds the exemption to be consistent with the stated intention and goals of the proposed law.

Recordkeeping Requirements

Swap dealers and major swap participants will be obligated: (1) to issue reports to the CFTC and/or the SEC, as applicable, regarding their swap positions and their financial condition pursuant to regulations to be issued by the CFTC and/or the SEC; (2) to keep books and records relating to their swap activities open for inspection by the CFTC and/or the SEC; and (3) to maintain daily trading and related records (for each

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counterparty and as identifiable for each swap transaction), recorded communications (including electronic mail and recordings of telephone conversations) and other information and for such time periods as may be required, by regulations to be issued by the CFTC and/or the SEC.

Consequences of the Spin-off Requirements

The Act may significantly disadvantage U.S. banks receiving Federal assistance by requiring that certain types of derivatives trading, notably equity derivatives, non-cleared credit default swaps and most commodity derivatives, be transacted only by newly spun-off derivatives trading affiliates that most likely will not be able to offer their counterparties credit enhancements in the form of a guaranty or other credit support from its parent or other banking affiliate. Such U.S. banks will still be able to enter into risk mitigating transactions intended to minimize the bank's own exposure, as well as interest rate, foreign exchange and cleared credit default transactions with their counterparties. Once this provision becomes effective, U.S. banks covered by this requirement will have up to 24 months to comply, which time period may be extended by the bank's appropriate Federal banking agency, after consultation with the CFTC and the SEC, for up to an additional one year period.

If a hedge fund trades a broad range of derivatives instruments, it may now be required to face two or more entities that have been spun-off from the same U.S. bank, each of which must be separately capitalized. The hedge fund counterparty will not be able to benefit from cross guarantees or cross affiliate netting. In this situation, the hedge fund's initial margin requirement likely will be greater than it would be if, instead, the hedge fund were facing a single counterparty. Further, should the bank or a spun-off bank affiliate become insolvent, the hedge fund's trades with each of its counterparties would be closed-out individually due to the absence of setoff and netting. The effect of this could be even more dramatic if the hedge fund's derivatives portfolio were to consist of both cleared and uncleared transactions with both the bank itself and its spun-off swap affiliate and, if the bank were to spin off more than one affiliate to take advantage of reduced regulatory capital charges in a non-U.S. jurisdiction, such other affiliates. As the collateral buckets multiply, the setoff and netting benefits decrease for the hedge fund counterparty.

Alternatively, the hedge fund could decide to trade with a highly rated non-U.S. bank, acting through a non-U.S. bank office that is permitted to face the hedge fund directly. In this case, the non-U.S. bank might be able to trade the full range of swap products required for the fund's strategy, resulting in reduced risk and more efficient margining for the hedge fund, but also a transfer of business to non-U.S. jurisdictions. U.S. banks, recognizing this possible loss of revenue, may choose to restrict their derivatives trading to those products they may continue to trade directly, which would result in fewer counterparty choices for hedge funds.

The Good News

The Act explicitly states that swaps and security-based swaps cannot be regulated as insurance under State law, which means that state insurance departments will not be able to rule that the seller of certain types of credit default swaps must be a licensed insurer. The Act also prohibits any state gaming or bucket shop law from invalidating any security-based swap, except as otherwise provided by the SEC.

Conclusion

Now that the Act has become law, hedge funds will have to assess the likelihood that they will end up being categorized as swap dealers or major swap participants. Because the Act is vague as to how broad a net will created by the Commissions to capture the derivatives market players they view as systemically important to the U.S. financial system, many hedge funds will not be able to determine their status—and what new requirements and restrictions apply to them—until after the applicable regulations are promulgated. Hedge funds that regularly engage in large-scale derivatives trading might be able to assume their categorization as swap dealers or major swap participants based solely on the language in the Act's derivatives provisions. Similarly, other hedge funds, based on the small size of their swap portfolio and the infrequency with which they enter into swaps, may be able to assume that they will not be so categorized, but they still will need to analyze the added costs of trading with counterparties that are classified as such. Many hedge funds, however, will fall into the middle ground of uncertainty and will need to consider whether, as both a practical and legal matter, they can and should await the promulgation of clarifying rules and regulations before attempting to determine in which bucket they fall. Should they pursue a "what if" plan and spend time and money preparing for responsibilities they may not have to assume, or await the clarifying regulations and risk coming up short against a demanding time frame for compliance?

In the long term, hedge funds that have to assume the administrative and financial burdens imposed by the Act may want to consider whether it makes sense for them to relocate outside the U.S. to avoid incurring the overall cost of compliance with the Act. Each of these determinations requires a facts-and-circumstances analysis that will be different for each hedge fund.

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

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