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FINANCIAL MARKETS ALERT

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Wall Street Transparency and Accountability Act of 2010

On July 15th, the U.S. Senate passed the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Financial Reform"), which was passed by the U.S. House of Representatives on June 30th and was signed by the President today. The legislation covers a wide variety of topics in an effort to address the causes of the recent turmoil in the financial markets. Title VII of the Financial Reform is titled the "Wall Street Transparency and Accountability Act of 2010" (the "Act"). The Act is the culmination of numerous Administration and legislative proposals for derivatives regulation that have been considered since the beginning of the 2008 financial crisis, including the collapse of Lehman Brothers and the meltdown of AIG, both of which thrust the $615 trillion over-the-counter (OTC) derivatives market[1] into the media and legislative spotlight. As expected, the Act makes sweeping changes to the regulation of OTC derivatives markets.

The primary goals of derivatives reform were clearly delineated from the beginning of the regulatory overhaul effort: increasing pricing transparency and reducing bilateral credit risk. The Act pursues these goals by encouraging and, in some cases, requiring derivatives to be traded on registered exchanges and cleared through registered central counterparties and by imposing margin and capital requirements on derivatives.

Regulated Entities and Regulated Transaction Types

Generally, the Act divides regulatory authority over derivatives between the Commodity Futures Trading Commission (CFTC), generally covering "swaps" (described below), and the Securities and Exchange Commission (SEC), generally covering "security-based swaps" (described below). However, a regulated entity's "prudential regulator"[2] is also relevant for certain purposes, including for establishing capital and margin requirements. The Act generally provides for the regulation of two types of transactions (swaps and security-based swaps) and four types of market participants (swap dealers, security-based swap dealers, major swap participants and major security-based swap participants).

Please click here to view the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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[1] Bank of International Settlements, Semiannual OTC derivatives statistics at end-December 2009 (December 2009). For a summary of this report, please click here.

[2] "Prudential regulator" means, *inter alia*, (i) the Board of Governors of the Federal Reserve System (the "Federal Reserve") (in the case of a regulated entity that this is a State-chartered bank that is a member of the Federal Reserve System, a State-charted branch or agency of a foreign bank, a foreign bank which does not operate an insured branch, a bank holding company or a savings and loan holding company); (ii) the Office of the Comptroller of the Currency (in the case of a regulated entity that is a national bank, a federally chartered branch or agency of a foreign bank or a federal savings association); (iii) the Federal Deposit Insurance Corporation (FDIC) (in the case of a regulated entity that is a State-chartered bank that is not a member of the Federal Reserve Bank or a State savings association); (iv) the Farm Credit Administration (in the case of a regulated entity that is an institution chartered under the Farm Credit Act of 1971, as amended); or (v) the Federal Housing Finance Agency (in the case of a regulated entity that is a regulated entity under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended).

"Swaps" are defined very broadly to include, *inter alia*, interest rate swaps, caps and floors, credit default swaps,[3] total return swaps, weather swaps, energy swaps, equity swaps, equity index swaps, agricultural swaps, commodity swaps and any "agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap".[4] Foreign exchange swaps and forwards (other than retail transactions) constitute swaps unless the Secretary of the Treasury makes a written determination that they should not be subject to regulation and they are not structured to evade the Act in violation of any CFTC rule.[5]

"Security-based swaps" are defined to include, *inter alia*, swaps based on either (i) 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.[6]

A "swap dealer" is defined as 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. (A "security-based swap dealer" is defined in substantially the same manner, but with respect to security-based swaps.) However, an insured depository institution will not be considered 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. To qualify as a swap dealer, a person must enter into swaps for such person's own account, either individually or in a fiduciary capacity, as part of a regular business.[7] A person may be designated as a swap dealer for one or more types or classes of swaps but not others.

A "major swap participant" is defined as any person who is not a swap dealer and (i) maintains a "substantial position" in swaps for any of the major swap categories (excluding positions held for hedging or mitigating commercial risk and positions maintained by any

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[3] Note that the Act explicitly provides that swaps are not to be considered insurance and are not to be regulated as insurance contracts under any State law. This provision is likely in response to proposals by certain State insurance regulators to regulate as insurance credit default swaps where the buyer of protection also owns the underlying obligation on which protection is written. *See* Client Alert.

[4] Note, however, that the definition of "swaps" excludes certain specified transactions, including (i) security-based swaps, (ii) contracts of sale of a commodity for future delivery (or an option on such a contact) and (iii) the sale of nonfinancial commodities or securities for deferred shipment or delivery, so long as such contracts are *intended* to be physically settled.

[5] Certain earlier legislative proposals suggested that foreign exchange swaps and forwards would not be regulated, as they are typically entered into by end-users for hedging purposes and had not been the root cause of any market turmoil. However, under the Act, such transactions are not given a full exemption but, rather, discretion is granted to the Secretary of the Treasury to determine whether they should be exempt from regulation.

In making such a determination, the Secretary of the Treasury is to consider (i) whether the required trading and clearing of foreign exchange swaps and forwards would create systemic risk, lower transparency, or threaten the financial stability of the U.S., (ii) whether such transactions are already subject to a regulatory scheme that is materially comparable to that established by the Act for other classes of swaps, (iii) the extent to which bank regulators of participants in the foreign exchange market provide adequate supervision (including capital and margin requirements), (iv) the extent of adequate payment and settlement systems for such transactions and (v) whether any exemption provided for such transactions potentially could be used to evade otherwise applicable regulatory requirements. Any such determination must be submitted to the appropriate committees of Congress and must explain the "qualitative difference" between foreign exchange swaps and forwards and other classes of swaps that would make them "ill-suited" for regulation as swaps and identify "objective differences" between foreign exchange swaps and forwards, on the one hand, and other swaps, on the other hand, that warrant an exempted status. Even if such a determination is made, foreign exchange swaps and forwards would remain subject to reporting requirements under the Act and to fraud and manipulation prohibitions.

[6] Note that "mixed swaps" are security-based swaps that are also based on the value of one or more interest or other rates, currencies, commodities, instruments of 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. They are to be regulated jointly by the CFTC and SEC, after consultation with the Board of Governors of the Federal Reserve.

[7] The CFTC is also required to establish factors for the exemption of entities that engage in a *de minimis* quantity of swap dealing in transactions with or on behalf of their customers.

employee benefit plan (or any contract held by such a plan) 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 U.S. banking system or financial markets or (iii) 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 maintains a substantial position in outstanding swaps in any major swap category.[8] (A "major security-based swap participant" is defined in substantially the same manner, but with respect to security-based swaps.) A person may be designated as a major swap participant for one or more categories of swaps without being classified as a major swap participant for all classes of swaps.[9]

The ultimate scope of the definition of major swap participant will be largely determined by the CFTC definition of "substantial position", which is to be set at the threshold that the CFTC 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 U.S.[10]

Each swap dealer (irrespective of whether it is registered as a depository institution or a security-based swap dealer) and major swap participant must register with the CFTC by filing a registration application and, by doing so, becomes subject to continuing reporting requirements pertaining to its business. Similarly, each security-based swap dealer (irrespective of whether it is registered as a swap dealer) and major security-based swap participant must register with the SEC by filing a registration application and, by doing so, becomes subject to continuing reporting requirements pertaining to its business.

Federal Assistance

The most controversial proposal under discussion during the reconciliation of the U.S. House of Representatives and U.S. Senate regulatory proposals that ultimately merged to become the Act came to be known as the "push-out" provision. This proposal was intended to prohibit future bailouts of banks using taxpayer funds. As drafted in the earlier U.S. Senate proposal, this provision would have effectively required commercial banks that are protected by federal deposit insurance or that have access to the Federal Reserve discount window (generally, financial institutions that are allowed to raise money at lower costs) to spin off into separate entities (and separately capitalize) their trading desks that provide derivatives products to customers in the regular course of banking relationships. The prohibition against certain entities receiving federal assistance remained in the Act, but it was tempered significantly.[11] Specifically, under the Act, beginning two years after the effectiveness of the Act, no "federal assistance"[12] may be provided to a "swaps entity" with respect to any swap, security-based swap or other activity of the swaps entity.

A "swaps entity" is defined to include any swap dealer or major swap participant, but, significantly, excludes major swap participants (but not swap dealers) that are insured depository institutions. Further, the financial assistance prohibition does not apply to insured depository institutions that limit their swap activities to: (i) hedging and other similar risk mitigating activities directly related to their own activities and (ii) swaps involving rates or reference assets that are permissible for investment by a national bank under specified law. This exception effectively permits banks to continue to act as counterparties in many common derivatives transactions, including interest rate swaps and foreign exchange transactions (which together comprise approximately 80% of the current OTC derivatives

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[8] Note that an exception exists for financing subsidiaries (i.e., entities whose primary business is providing financing and which use derivatives for purposes of hedging underlying commercial risks related to interest rate and foreign exchange exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company).

[9] Note that many of the provisions summarized in this Client Alert are relevant to both swaps, predominantly regulated by the CFTC, and security-based swaps, predominantly regulated by the SEC. Generally, the Act deals with such transactions in a parallel manner and, therefore, for purposes of simplicity, unless otherwise noted, only the provisions applicable to swaps are summarized herein.

[10] In drafting this definition, the Act instructs the CFTC to consider a person's relative position in uncleared, as opposed to cleared, swaps and provides that the CFTC may take into account the value and quality of collateral held against counterparty exposures.

[11] Nevertheless, the Act explicitly provides that "[t]axpayers shall bear no losses from the exercise of any authority under [the Act]".

[12] The Act defines "federal assistance" as the use of either (i) any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility or (ii) FDIC insurance or guarantees for the purpose of making any loan to any swaps entity or purchasing any stock, equity interest or debt obligation of any swaps entity; guaranteeing any loan or debt of any swaps entity; or entering into any assistance arrangement (including tax breaks), loss sharing or profit sharing with any swaps entity.

market), as well as bullion transactions. However, the Act also makes clear that credit default swaps (including such swaps referencing the credit risk of asset-backed securities) are not to be considered permissible activities of a bank unless they are centrally cleared.

The federal assistance provision provides for a transition period of up to 24 months (which may be extended for up to one additional year by the appropriate federal banking agency, after consultation with the CFTC and the SEC and upon taking into account several specified factors) for insured depository institutions that would qualify as swaps entities to divest themselves of the swaps or cease the activities that require them to register as swaps entities.

Special Entities

Legislators have struggled to find an appropriate balance between protecting "special" counterparties to derivatives, such as governmental entities, pension funds and endowments, and shutting them out of the market entirely.[13] In fact, the U.S. Senate bill prior to reconciliation with the U.S. House of Representatives bill proposed an approach that would have imposed fiduciary duties on dealers that propose or advise on, or serve as counterparties under, derivatives transactions with state and local governments or pension funds. This, of course, would have stood in marked contrast to existing general market practice that parties enter into derivatives transactions at "arms'-length" and that each party understands the risks of any transaction entered into, has not relied on the advice of the other party and has made its own investment decision, engaging such experts as it deems appropriate. The market feared that this approach would leave municipal entities largely unable to hedge interest rate risk related to floating rate debt issuances and leave pension funds unable to hedge risk and diversify portfolios through the use of derivatives transactions.

However, the Act takes a more balanced approach. In particular, the Act requires that each swap dealer or major swap participant that enters into or offers to enter into a swap with a "special entity" comply with the following requirements: (i) have a reasonable basis to believe that the special entity has an independent representative that has sufficient knowledge to evaluate each transaction and its risks, is not subject to a statutory disqualification, is independent of the swap dealer or major swap participant, undertakes a duty to act in the best interest of the special entity, provides written representations to the special entity regarding fair pricing and the appropriateness of each transaction and, in the case of an employee benefit plan subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA), is a fiduciary of the special entity and (ii) before the initiation of any transaction, disclose to the special entity in writing the capacity in which the swap dealer or major swap participant is acting. A "special entity" is defined to include federal agencies; States, State agencies, cities, counties, municipalities or other political subdivisions of a State; employee benefit plans under ERISA; governmental plans under ERISA; and endowments (including organizations described in section 501(c)(3) of the Internal Revenue Code of 1986, as amended).

A swap dealer that acts as an advisor to a special entity has a duty to act in the best interest of the entity and must make reasonable efforts to obtain such information as is necessary to make a reasonable determination that a swap it recommends is in the best interests of such entity, including information relating to the entity's financial status, tax status and investment (or financing) objectives. Moreover, a swap dealer or major swap participant advising a special entity on swaps may not employ schemes or engage in transactions that operate to defraud that entity or engage in any act that is fraudulent, deceptive or manipulative.

Business Conduct Standards

The Act requires the CFTC to adopt business conduct requirements that, inter alia, (i) establish a duty for swap dealers and major swap participants to verify that a counterparty meets the eligibility standards of an "eligible contract participant" and (ii) require swap dealers and major swap participants to (a) disclose information about the material risks and characteristics of a swap, any material incentives or conflicts of interest they have in connection with a swap and (b) provide counterparties with daily marks for swaps (which, for cleared transactions are to be made upon request and may derive from the appropriate derivatives clearing organization (DCO)). Swap dealers and major swap participants also must communicate in a fair and balanced manner based on principles of fair dealing and good faith.

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[13] The focus on these types of entities was, at least in part, likely in reaction to well-publicized recent situations where public entities, both in the U.S. and in Europe, incurred large losses on derivatives transactions (for related summaries, please see DMIR (May 2009) and DMIR (March 2010)).

Clearing

The Act makes it unlawful for any person to engage in a swap that the CFTC determines should be required to be cleared unless that person submits the swap for clearing to a registered or exempt DCO. The CFTC, on an ongoing basis, must review each type of swap to determine, following a 30-day public comment period, whether it should be required to be cleared. Moreover, DCOs are to submit for approval to the CFTC any type of swap they seek to accept for clearing and the CFTC is to take final action within 90 days of any such submission. The CFTC's determinations on what types of swaps should be required to be cleared are to be based on factors such as the existence of significant outstanding notional exposures, trading illiquidity and adequate pricing data, and the effect such clearing will have on systemic risk and competition. If the CFTC finds that certain swaps would otherwise be subject to mandatory clearing but no DCO accepts them for clearing, then the CFTC is to investigate and issue a public report on the matter; in this regard, the CFTC may take such actions as necessary and in the public interest, which may include applying margin and capital requirements to such swaps (although it appears that the CFTC may not mandate that a DCO accept a certain swap for clearing).

An important exemption to the clearing requirement of the Act (commonly referred to as the "commercial end-user exemption") exists if one counterparty to a swap (i) is not a financial entity,[14] (ii) is using the swap to hedge or mitigate "commercial risk" (as such term will be defined by the CFTC) and (iii) notifies the CFTC how it generally meets its financial obligations associated with uncleared swaps. Notwithstanding this exemption, such a party that satisfies these requirements and enters into a swap with a swap dealer or major swap participant may elect to require clearing of the swap and, in any such case, will have the sole right to select the DCO at which the swap will be cleared.

If one party to a swap that requires clearing is a swap dealer or major swap participant and the other party is not (including a party that is not using the swap to hedge or mitigate commercial risk), then the party that is not a swap dealer or major swap participant may select the DCO through which to clear that swap. DCOs are required to offset all swaps within the organization having the same terms and conditions and provide for the clearing of swaps executed either bilaterally or on an unaffiliated market on a non-discriminatory basis. Moreover, DCOs are subject to numerous core principles relating to financial resources, reporting and recordkeeping, risk management, settlement procedures, information sharing, governance fitness standards, conflicts of interest, and legal risks.

Swaps entered into before the date of enactment of the Act (or before the application of the clearing requirements under the Act) are exempt from the clearing requirements of the Act, so long as they are reported to a swap data repository[15] or the CFTC, as appropriate, within specified periods.

Exchange Trading

Generally, parties subject to the clearing requirement for a swap must execute that swap on a board of trade designated as a "contract market" or on a registered or exempt swap execution facility (SEF),[16] unless no board of trade or SEF makes the swap available for trading. It is important to note that swaps need not be executed on such a contract market or SEF if they are exempt from the clearing requirement under the commercial end-user exemption or otherwise. Each SEF must comply with numerous core principles, including that it (i) may permit trading only in swaps that are not readily susceptible to manipulation, (ii) must make public timely information on

[14] "Financial entity" is defined as (i) a swap dealer, (ii) a security-based swap dealer, (iii) a major swap participant, (iv) a major security-based swap participant, (v) a commodity pool, (vi) a private fund under the Investment Advisers Act of 1940, as amended, (vii) an employee benefit plan under ERISA, or (viii) a person predominantly engaged in activities that are in the business of banking or financial in nature under the Bank Holding Company Act of 1956, as amended. The Act permits the CFTC (or SEC, as the case may be) to consider whether to exempt from this definition small banks, savings associations, farm credit system institutions and credit unions, including depository institutions, farm credit system institutions or credit unions with total assets of $10 billion or less.

[15] A "swap data repository" is defined as a person that collects and maintains information or records with respect to transactions or positions in, or the terms and conditions of, swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility. Swap data repositories must be registered with, and are subject to inspection and examination by, the CFTC. A DCO may registered as a swap data repository.

[16] A "swap execution facility" is defined as a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that facilitates the execution of swaps between persons and is not a designated contract market.

price, trading volume and other swap trading data, as prescribed by the CFTC, (iii) must monitor trading in swaps to prevent manipulation, price distortion and settlement disruptions and (iv) must adopt for each contract position limitations or position accountability for speculators.

Capital and Margin Requirements

Registered swap dealers and major swap participants for which there is a prudential regulator must meet minimum capital and margin (both initial and variation) requirements prescribed by that regulator; swap dealers and major swap participants for which there is no prudential regulator must meet minimum capital and margin (both initial and variation) requirements prescribed by the CFTC. In setting capital requirements for a swap dealer or major swap participant for a single type (or class or category) of swaps, the prudential regulator or the CFTC, as applicable, is to take into account the risks associated with other types (or classes or categories) of swaps engaged in and other activities conducted by that person that are not otherwise subject to regulation by virtue of that person's status as a swap dealer or major swap participant. In prescribing margin requirements, the prudential regulator or the CFTC, as the case may be, is instructed to permit the use of non-cash collateral, as it determines to be consistent with preserving the financial integrity of markets trading swaps and preserving the stability of the U.S. financial system. The capital and margin requirements imposed in connection with uncleared swaps are to reflect the greater risk to the swap dealer or major swap participant and the financial system arising from such swaps.

A person who accepts any money, securities or property from or on behalf of a swap customer to margin, guarantee or secure a swap cleared by or through a DCO must register with the CFTC as a futures commission merchant (FCM).[17] An FCM must treat and deal with all monies, security and property of any such swaps customer as belonging to the swaps customer and such margin and collateral (with certain exceptions) must be segregated from the funds of the FCM and cannot be used to margin, secure or guarantee any trade or contract of any person other than such swaps customer. Money received as margin from a swaps customer may be invested in obligations of the United States, in general obligations of any State or any political subdivision of a State and in obligations fully guaranteed as to principal and interest by the United States, or in any other instrument that the CFTC may prescribe. A swap dealer or major swap participant must notify its counterparty at the beginning of any uncleared swap that the counterparty has the right to require segregation of the property used as initial margin (as opposed to variation margin) to margin, guarantee or secure its obligations. At the request of such counterparty, the swap dealer or major swap participant must (i) segregate such property for the benefit of the counterparty, and (ii) maintain such property in a segregated account at an independent third party custodian, separate from the assets of the swap dealer or major swap participant.

Reporting and Recordkeeping

Swaps entered into before the date of enactment of the Act must be reported to a swap data repository or the CFTC no later than 180 days after such enactment. Swaps entered into on or after enactment of the Act must be reported to a swap data repository or the CFTC not later than the later of 90 days after the date of enactment or such other time period after such swaps were entered into, as the CFTC may prescribe.

In addition, outstanding uncleared swaps entered into before the date of enactment of the Act must be reported to a swap data repository or the CFTC no later than 30 days after issuance of the interim final rule (to be promulgated by the CFTC within 90 days of the date of enactment of the Act) providing for the reporting of such swaps or such other period as the CFTC determines to be appropriate. Such swaps must be reported by the following counterparty: (i) for swaps where only one counterparty is a swap dealer or major swap participant, that counterparty, (ii) for swaps where one counterparty is a swap dealer and the other is a major swap participant, the swap dealer and (iii) for any other swaps, as selected by the counterparties.

Each swap dealer and major swap participant must make reports and maintain books and records, as required by the CFTC. Among other things, such entities must maintain daily trading records of their swaps and all related records and recorded communications (including electronic mail, instant messages and recordings of telephone conversations) and must maintain a complete audit trail for conducting comprehensive and accurate trade reconstructions.

[17] In connection with security-based swaps, such a person must be a registered broker, dealer or security-based swap dealer.

Real-Time Public Reporting

The CFTC must promulgate rules to subject swaps and pricing data to "real-time public reporting"[18] for purposes of enhancing price discovery. With respect to cleared swaps, the CFTC rules for real-time public reporting of swaps must contain provisions to (i) ensure that the information provided does not identify the participants, (ii) specify the criteria for determining what constitutes a large notional swap transaction (i.e., block trade) for particular markets and contracts, (iii) specify the appropriate time delay for reporting block trades to the public and (iv) take into account whether public disclosure will materially reduce market liquidity. With respect to uncleared swaps that are reported to a swap data repository, the CFTC is instructed to require reporting in a manner that does not disclose the business transactions and market positions of any person.

Large Swap Trader Reporting

Under the Act, it is unlawful for any person to enter into a swap that the CFTC determines performs a significant price discovery function with respect to registered entities if the person directly or indirectly enters into (or obtains a position in) the swap during any one day in an amount equal to or in excess of a threshold amount established periodically by the CFTC. However, this prohibition does not apply to persons who file with the CFTC appropriate reports regarding such transactions and positions and maintain books and records (open at all times for regulator inspection) of all such transactions and positions.

Abusive Swaps

The CFTC may by rule or order collect information as may be necessary concerning the markets for any type of swap and issue a report with respect to any type of swap that it determines to be detrimental to either the stability of a financial market or to participants in a financial market.

Exclusion of Certain Derivatives Contracts from Section 1256

As noted above, many derivatives transactions currently traded OTC will be required (or encouraged) to be traded on regulated exchanges. Under current law, section 1256 of the Internal Revenue Code of 1986, as amended (the "Tax Code"), requires that certain contracts traded on exchanges be marked to market annually for tax purposes and, for individuals, the gain or loss of such contracts is to be treated as 40% short-term capital gain or loss and 60% long-term capital gain or loss. As a result, individuals may benefit from a partial rate reduction. In contrast, marking to market transactions under section 475 of the Tax Code results in ordinary income treatment.

During the drafting of the Financial Reform, concerns were raised that swaps (as described in the Act) would constitute section 1256 contracts and, as a result, would be subject to the 40/60 characterization. In response to these concerns, Title XVI of the Financial Reform excludes the following derivatives transactions from section 1256: (i) any securities futures contract or option on such a contract, unless such contract or option is a dealer securities futures contract and (ii) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement. The legislative history states that the purpose of this exclusion was to address the re-characterization of income as a result of increased exchange-trading of derivatives contracts. Interestingly, Title XVI uses the term "swap," instead of "notional principal contract," which is the standard tax terminology used for derivatives transactions. Regulations will likely clarify that, in this context, swaps refer to notional principal contracts; however, the term "swap" would include more contracts than those included in the definition of notional principal contracts. Included within the mix of contracts excluded from section 1256 treatment are credit default swaps; this, together with the provision precluding the treatment of those contracts as insurance for state law purposes, suggests that credit default swaps will be characterized as notional principal contracts for U.S. federal income tax purposes. Finally, while mark-to-market treatment under section 1256 will not apply to excluded contracts, many taxpayers will remain subject to mark-to-market treatment under section 475, which is applicable to dealers and traders in securities, but under which gain and loss is subject to ordinary income treatment.

Title XVI of the Financial Reform is effective for tax years beginning after the date of enactment, which was July 21, 2010.

Effectiveness

The Act becomes effective upon the later of 360 days after its enactment or, to the extent a provision requires a rulemaking, not less than 60 days after publication of a final rule or regulation implementing such provision.

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[18] "Real-time public reporting" is defined to mean to report data relating to a swap, including price and volume, as soon as technologically practicable after the time at which the swap has been executed.