A Matter of Trust

Trustees Should Expect Changes to Derivatives Markets Under Dodd-Frank Act

In response to perceived market conditions leading to the recent economic downturn in the United States, Congress passed, and the President signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. This sweeping legislation provides the framework for federal regulation in several areas relevant to the activities of trustees, including derivatives transactions.

Derivatives, or swaps, are often used in transactions involving special purpose entities, particularly in securitization transactions, to hedge against interest rate and currency risks. These special purpose entities are often trusts formed in the State of Delaware with a local bank acting as trustee.

Prior to Dodd-Frank’s enactment, derivatives transactions were largely unregulated. Through Dodd-Frank, Congress intended to tame the free-wheeling swaps market in order to prevent some of the excesses that it believed contributed to our recent economic turmoil.

The Act empowers regulators to oversee certain dealers and participants engaged in the derivatives market. In addition, many swaps will now be subject to mandatory clearing by a derivatives clearing organization. Swap users can expect increased regulatory responsibilities in the areas of reporting, capital, compliance staffing and record-keeping. The Act, therefore, is expected to substantially increase the regulatory cost of entering into derivatives transactions.

Trustees engaged in transactions using derivatives may see changes to such transactions in response to the Act, but industry experts have argued that the new law should not target the trustees in their individual capacities solely by virtue of the trust or the trustee entering into a swap for a particular financing transaction. Dodd-Frank’s derivatives protections are designed to monitor entities holding large swap portfolios to ensure that potentially market damaging risk taking by such participants does not proceed unchecked. Most trustee relationships, however, are established at the individual deal level and, especially where derivatives are used, may involve special purpose vehicles designed as distinct, stand-alone legal entities. (Whether a special purpose entity’s swaps would be aggregated with its sponsoring group’s remains subject to comment during the current rule-making period, but even if so aggregated, should not subject the trustee to additional regulation.) It is not expected that trustees engaged as swap counterparties across multiple, distinct transactions would be considered, by aggregation of those transactions, major participants subject to regulation.

It is worth noting that some major institutions that act as trustees may qualify separately for regulation under Dodd-Frank based on the size of their own portfolio of swaps.

The true effects of the Act are only now coming into focus through the rules-making process, but be assured changes are on the way...