

Derivatives | October 13, 2009

## Congress' Proposals for Over-the-Counter Derivatives Legislation

On October 2, 2009, House Financial Services Committee Chairman Barney Frank circulated a discussion draft of the “Over-the-Counter Derivatives Markets Acts of 2009” (“Frank Proposal”).<sup>1</sup> The Frank Proposal is broadly consistent with the legislative proposal by the Obama Administration (“Administration Proposal”)<sup>2</sup> for regulation of the over-the-counter (“OTC”) derivatives markets and market participants. However, it adds regulation in some new areas and may provide more flexibility in others, particularly with respect to the clearing and exchange trading requirements and exemptions for end users, and several regulators and commentators have suggested that some of the changes deviate too much from the Administration Proposal. On October 9, 2009, House Agriculture Committee Chairman Collin C. Peterson released his own proposed OTC legislation (the “Peterson Proposal”)<sup>3</sup>, which is in some areas closer to the original Administration Proposal. Nonetheless, like the Administration Proposal, the Frank Proposal and the Peterson Proposal would result in fundamental changes to the way OTC derivatives markets operate.

### Main Differences from Administration Proposal

- The Frank Proposal gives the Commodity Futures Exchange Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) the responsibility to determine which swaps must be

cleared through a regulated clearinghouse, backing away from the Administration Proposal’s requirement to clear all “standardized” OTC derivatives. The Peterson Proposal leaves such determination to the clearinghouse, subject to SEC and CFTC approval (depending on the product).

- In contrast to the Administration Proposal and the Peterson Proposal, the Frank Proposal does not require exchange trading of all cleared contracts on a regulated trading facility.
- The Frank Proposal and the Peterson Proposal impose requirements on swap dealers to segregate margin and collateral, including for non-cleared swaps.

<sup>1</sup> The Frank Proposal is available at [http://www.house.gov/apps/list/press/financialsvcs\\_dem/discussion\\_draft\\_otc.pdf](http://www.house.gov/apps/list/press/financialsvcs_dem/discussion_draft_otc.pdf). We understand that Congressman Frank is expected to propose further changes to his bill.

<sup>2</sup> The Obama Proposal is discussed in our earlier publication (dated August 14, 2009) and available at <http://www.shearman.com/obama-administration-submits-final-legislation-to-us-congress-regarding-over-the-counter-derivatives-08-14-2009>. The Obama Proposal is available at <http://ustreas.gov/press/releases/tg261.htm>.

<sup>3</sup> The Peterson Proposal is available at [http://agriculture.house.gov/inside/Legislation/111/JDG\\_372\\_xml.pdf](http://agriculture.house.gov/inside/Legislation/111/JDG_372_xml.pdf)

- The Frank Proposal and Peterson Proposal generally provide more flexibility as compared to the Administration Proposal for international financial institutions to engage in swaps with U.S. persons without registration in the U.S., acknowledging a significant concern with the Administration Proposal.
- At the same time, however, the Frank Proposal (but not the Peterson Proposal) gives the Secretary of the Treasury (“Treasury”) the authority to ban an entity domiciled outside the U.S. from participating in financial activities in the United States if the country of domicile regulates swaps in a manner that the Treasury finds undermines the stability of a financial market.
- Under new general authority, the SEC and CFTC, acting jointly, may under the Frank Proposal (but not the Peterson Proposal) prohibit transactions in any swap or security-based swap that they find would be detrimental to the stability of a financial market or participants in that market.

### Key Provisions Largely Preserved from Administration Proposal

- The Frank Proposal and Peterson Proposal require federal registration, supervision and regulation of not only any firm that deals in OTC derivatives (“swap dealers”) but also any non-dealer firm that takes “substantial net positions” in OTC derivatives (“major swap participants”). The Frank Proposal contains an exception from the major swap participant definition for hedging and risk management, intended to exclude corporations and other end users from the registration requirement. This exception is substantially broader in the Frank Proposal than the exemption of the Administration Proposal. The Peterson Proposal does not contain such an exception.
- The Frank Proposal and Peterson Proposal each split the regulatory authority over the OTC markets between the SEC and the CFTC and delegate some

regulatory authority to federal banking agencies for swap dealers and major market participants that are banks.

- The Frank Proposal and Peterson Proposal tighten the definition of eligible parties that are able to engage in OTC derivative transactions.

### New Clearing and Execution Requirements

The Frank Proposal requires that the CFTC and/or the SEC (depending on the product) determine the swaps that must be cleared through a clearing organization regulated by the CFTC or a securities clearing agency regulated by the SEC, depending on the product.<sup>4</sup> The clearing requirement, however, would not be imposed on all “standardized” OTC derivatives – as under the Administration Proposal – but only to those designated by the CFTC or SEC, based on factors such as

- The existence of significant outstanding notional exposure, trading liquidity and adequate pricing data;
- The availability of one or more clearinghouses with an appropriate rule framework;
- The impact on the mitigation of systemic risk and competition; and
- The existence of reasonable legal certainty in the event of the insolvency of the relevant clearinghouse or one of its members with respect to the treatment of customer positions and property.

Further, a contract that is required to be cleared under the Frank Proposal and entered into between counterparties that are either swap dealers or major swap participants, or security-based swap dealers or security-based swap participants, must be executed

- On a board of trade designated as a contract market or registered national securities exchange;

<sup>4</sup> The Peterson Proposal, by contrast, leaves it to the clearinghouse to determine, subject to CFTC and SEC approval (depending on the product), which swaps and security-based swaps need to be cleared.

- On a swap execution facility registered with the CFTC or SEC;
- On a foreign swap execution facility subject to regulation under the home country's law; or
- Over-the-counter, provided that the counterparties must comply with recordkeeping and end-of-day transaction reporting requirement as may be prescribed by the CFTC, SEC or, in certain cases, foreign regulators.

The Frank Proposal defines the exception to the clearing and trade execution requirement more broadly than the Administration Proposal and the Peterson Proposal by excluding any swap or security-based swap in which one of the counterparties is *not* a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant. In addition, the Frank Proposal allows for execution of cleared trades outside of a trading facility. This effectively leaves more room for a bilaterally negotiated OTC market.

As with the Administration Proposal, these proposed requirements for clearing leave open a number of questions for market participants, including the time frame for implementation. There may also be questions as to what it means for a trade to be "cleared", particularly in the context of a transaction by a party that is not itself a member of a clearinghouse.<sup>5</sup> Any such details about the nature and scope of the required clearing arrangement will have to be defined by CFTC and SEC regulation.

### Regulation and Registration of "Swap Dealers" and "Major Swap Participants"

Like the Administration Proposal, the Frank Proposal and Peterson Proposal require any firm that deals in OTC derivatives and any other firm that takes large positions in OTC derivatives to register with the SEC and/or CFTC and be subject to federal supervision and substantive regulation. As applied to non-dealer market participants,

this will mark a significant expansion in the scope of regulation.<sup>6</sup> The Frank Proposal and Peterson Proposal establish new categories of "swap dealers" and "major swap participants" to be subject to these requirements.

- "Swap dealer" is defined analogously to "dealers" for purposes of the securities laws (but without exceptions for banks).
- "Major swap participant" is defined in the Frank Proposal as any non-dealer that maintains a substantial net position in swaps, excluding positions held primarily for hedging (including balance sheet hedging) or risk management purposes. The CFTC and SEC are to define jointly the term "substantial net position" at "a threshold that the regulators determine prudent for the effective monitoring, management or oversight of the financial system."

The impact of these new requirements will of course depend on the scope of the "major swap participant" definition. It appears to be intended to cover entities like American International Group, Inc., but may also cover investment funds and other entities with significant derivatives activities.

The carve-out for hedging and risk management in the Frank Proposal is significantly broader than the Administration Proposal, which required the narrower "effective hedge" under generally accepted accounting principles. Several commentators have criticized the "risk management" exception as ambiguous and potentially too broad, and the Peterson Proposal contains neither the hedging nor the "risk management" carve-out.

As under the Administration Proposal, swap dealers and major swap participants will be subject under the Frank Proposal and Peterson Proposal to substantial regulation including the following:

- Registration with SEC and/or CFTC;

<sup>5</sup> The rules of the clearinghouse must provide for acceptance of a standardized swap or security-based swap "regardless of the system on which the transaction was executed". This provision arguably aims at fostering fungibility and competition but may raise practical issues.

<sup>6</sup> By contrast, non-dealer participants in securities or futures markets are typically *not* subject to direct regulation in their activities as such, with certain exceptions.

- Capital requirements for all swaps (including cleared trades)<sup>7</sup>, which under the Frank Proposal will be higher for *non-cleared* trades to encourage the migration of derivatives onto central clearinghouses and exchanges; the Peterson Proposal provides that the capital requirements must help ensure the safety and soundness of the swap dealer or major swap participant and be appropriate for the risk associated with *non-cleared* swaps held;
- Minimum initial and variation margin requirements for *non-cleared* swaps for swap dealer and major market participants. These will be set for market participants that are banks by federal banking agencies and for others by the SEC and CFTC. Margin requirements may, but are not required to, be imposed with respect to swaps in which one of the counterparties is not a swap dealer or major swap participant;
- If collateral requirements are imposed on transactions with end users, the use of non-cash assets as collateral must be permitted;<sup>8</sup>
- Business conduct requirements, including
  - Standards of care to verify that any counterparty meets the eligibility standard for an “eligible contract participant”, a term that is to be jointly redefined by the SEC and CFTC; and
  - Disclosure requirements that differ from current practice by including information about material risks and characteristics of the swap, fees and remuneration and other incentives or conflicts of interests;
- Recordkeeping and reporting requirements including daily trading records;

- Back-office requirements to be defined by the CFTC or SEC in consultation with federal banking agencies; and
- Disclosure to regulators of information concerning terms and conditions of swaps, swap trading operations and financial integrity protections relating to swaps.

Taken together, these enhanced requirements, including capital standards, may apply to parties, like certain hedge funds, that have not traditionally been subject to prudential regulation. Depending on how these requirements are implemented by the SEC and CFTC, they have the potential to significantly alter the way business in these markets has traditionally been conducted.

### Position Limits

As under the Administration Proposal, the CFTC may impose position limits under the Frank Proposal to prevent fraud and manipulation on swaps within its jurisdiction that “perform or affect a significant price discovery function” with respect to regulated markets. To determine whether a swap performs or affects a significant price discovery function, the CFTC must consider, as appropriate, (i) the linkage of the swap price to the price of contracts traded on a regulated market, (ii) the extent to which transactions in other contracts on a regulated market reference the swap price, (iii) the volume of swaps being traded, and (iv) such other factors specified by CFTC rulemaking.

The Frank Proposal provides that the SEC (or a self-regulatory organization (“SRO”) under SEC direction) may impose position limits only for security-based swaps, and not the underlying securities as allowed under the Administration Proposal. The SEC may, however, also set position limits on “security-based swap agreements” defined to include swaps on broad-based security indices and swaps on government securities. In addition under the Frank Proposal, the SEC and SROs may require any person to aggregate positions

<sup>7</sup> Significantly, the Frank Proposal does not appear to contemplate “zero” risk weighting for transactions with a clearinghouse.

<sup>8</sup> This provision is in response to concerns raised by end users that collateral requirements could make hedging transactions so expensive as to be impractical.

across a greater number of products and instruments than would the Administration Proposal.<sup>9</sup>

Position limits may be imposed on *any* market participant including any group or classes of persons. However, the CFTC or SEC may, by rule, regulation, or order, exempt, conditionally or unconditionally, any person or class of persons, any swap or class of swaps, or any transaction or class of transaction, from any such position limits.

The position limits of the Peterson Proposal are generally similar. As with the Administration Proposal, the potential imposition of position limits would depend, among other factors, on the types of contracts covered, types of restrictions imposed (limits vs. accountability standards), aggregation rules and any available exceptions.

### Segregation of Assets

The Frank Proposal introduces a new requirement for swap dealers, futures commission merchants, derivatives clearing organizations or clearing agencies that hold funds or property as margin or collateral in connection with cleared trades to “segregate, maintain, and use the funds or other property for the benefit of the counterparty.” For non-cleared swaps, the counterparty will be entitled to request that the derivatives dealer segregate the funds or property for the benefit of the counterparty and maintain the funds or other property in a third-party custodial account that is designated as a segregated account for the counterparty. The Peterson Proposal contains substantially similar segregation requirements but limited to security-based swap dealers and clearing agencies.

The requirement would impose for the first time a segregation regime for OTC derivatives transactions and dealers. The new provision seems to reflect concerns many end users and regulators have raised after the Lehman insolvency with respect to the treatment of collateral held by an insolvent dealer counterparty. As

dealers in swaps may not be able to rehypothecate segregated customer margin for funding purposes, this change could have significant effects on the economics of OTC derivatives.

### Flexibility for International OTC Derivatives Market

In order to promote effective and consistent global regulation of swaps, the SEC, CFTC and prudential regulatory and other U.S. agencies are required under the Frank Proposal and the Peterson Proposal to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation of swaps, and may agree to appropriate information-sharing arrangements. In addition, under both proposals, the SEC and CFTC are required, in consultation with other regulators, to adopt rules exempting a non-U.S. financial institution from registration and any other requirements based on their finding that the institution is subject to comparable regulation in its home country. This exemption could apply, for example, to clearing organizations, derivatives dealers and major market participants.

However, the Frank Proposal (but not the Peterson Proposal) reserves at the same time the Treasury’s right to prohibit any entity domiciled in a foreign country that regulates swaps in a manner which the Treasury “finds undermines the stability of a financial market” from participating in financial activities in the United States.

### Moving Forward

If enacted, the Frank Proposal and the Peterson Proposal would result in significant structural changes in the OTC derivatives markets. Of course, many aspects of the Frank Proposal and Peterson Proposal may be modified as lobbyists, industry officials, and lawmakers engage in a debate on Capitol Hill over the legislation and, more generally, the future of U.S. financial regulation. Main concerns with respect to the Frank Proposal that have been raised during a hearing on October 7, 2009 before the House Committee on Financial Services include the following:

<sup>9</sup> Particularly, the Frank Proposal extends the authority to require aggregation of any security-based swap and any security, group of securities, loan or index thereof, on which or to which security-based swaps and security-based swap agreements may be based or relate.

- The Chairman of the CFTC suggested that – like the Peterson Proposal – the clearinghouse managing the risk would be best positioned to determine, under the supervision of the regulators, for which products clearing should be required. The CFTC Chairman further argues that “standardized” end user products should also be cleared, and that all cleared swaps must be exchange traded.
- The Director of the SEC Division of Risk, Strategy, and Financial Innovation suggested that to avoid regulatory arbitrage all securities-related OTC derivatives should be regulated more like securities and other non-security related OTC derivatives should be regulated more like futures. He also suggested that the bill be revised to strengthen the SEC’s existing anti-fraud and anti-manipulation authority over securities-related OTC derivatives, to further clarify the split of jurisdiction between the

SEC and CFTC over OTC derivatives<sup>10</sup>, and to consider revising the qualification standards for “eligible contract participants” that are permitted to engage in OTC derivatives.

- End users suggested, and the Peterson Proposal provides, that capital requirements should clearly recognize the internal risk management processes utilized by dealers. Others emphasized that customized and all intra-group OTC derivatives should not be subject to a clearing requirement and that a prohibition of “naked” OTC derivatives transaction would be inappropriate.

We will continue to monitor and report on these and related proposals and counterproposals as the legislation evolves.

<sup>10</sup> Notably, the Peterson Proposal provides that the CFTC shall “consult” with the SEC and prudential regulator for rulemaking regarding swap-related provisions and that the SEC shall “consult” with the CFTC and prudential regulator for rulemaking regarding security-based swap provisions. It also allows the CFTC and SEC to initiate expedited challenges in the U.S. Court of Appeals of Washington D.C. of the other agency’s rules that encroach on the challenging agency’s jurisdiction.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

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