Derivatives | August 14, 2009

Obama Administration Submits Final Legislation to U.S. Congress Regarding Over-the-Counter Derivatives

On August 11, 2009, the Obama Administration pushed forward its financial services reform proposals by submitting to the U.S. Congress its final piece of draft reform legislation, the "Over-the-Counter Derivatives Markets Acts of 2009" ("Proposed Legislation"). The Proposed Legislation is intended to provide comprehensive regulation of all over-the-counter ("OTC") derivatives markets, including for credit default swaps ("CDS"), and market participants. If enacted, the Proposed Legislation would result in fundamental changes to the way OTC derivative markets operate. The Proposed Legislation is generally consistent with the reforms suggested in the Administration's White Paper on financial market reform issued on June 17, 2009.[1]

The highlights of the Proposed Legislation

- Require "standardized" OTC trades to be (i) cleared through a regulated clearinghouse *and* (ii) traded either on a regulated exchange or a regulated "alternative swap execution facility";
- 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 "significant" net positions in OTC derivatives for non-hedging purposes ("major swap participants");
- Split the regulatory authority over the OTC markets between the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC");
- Delegate some regulatory authority to federal banking agencies for swap dealers and major market participants that are banks; and
- Tighten the definition of eligible parties that are able to engage in OTC derivative transactions.

New Clearing and Trading Requirements

The Proposed Legislation would result in fundamental changes in the way derivatives markets are structured, particularly by requiring that all "standardized" OTC trades be

- Cleared through a clearing organization regulated by the CFTC or a securities clearing agency regulated by the SEC, depending on the product; and

[1] The Proposed Legislation is available at http://ustreas.gov/press/releases/tg261.htm. The White Paper is discussed in our earlier client publication (dated June 22, 2009) available at http://www.shearman.com/us-financial-regulatory-reform-implications-for-derivatives/.

- Traded either on a regulated exchange or a regulated "alternative swap execution facility".
  - A swap that is accepted for clearing by any registered derivatives clearing organization will be presumed to be standardized.
  - In addition, the SEC and CFTC must, within 180 days of the enactment of the Proposed Legislation, by rule jointly define the term "standardized" *as broadly as possible* taking various factors into account, such as volume, similarity to other contracts that are cleared, and extent of dissemination of the terms to third parties.

The proposed requirement for clearing raises a number of questions for market participants, including the time frame, as the focus in clearing OTC derivatives has been the CDS market, which is probably most amenable to clearing in the short run. Clearing of other types of derivatives may present various operational and other challenges. 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.[2]

The Proposed Legislation contains an exemption from the clearing and trading requirement which will permit a bilaterally negotiated OTC market for certain transactions to continue to exist. Pursuant to this exemption, the clearing and trading requirements do not apply if

- No clearing organization will accept the swap for clearing, or
- One of the counterparties is not a "swap dealer" or "major swap participant" and does not meet eligibility requirements of any clearing organization that accepts the swap for clearing.

The scope of this exemption will also have to be clarified through SEC and CFTC rulemaking. One significant question will concern the meaning of "eligibility requirements" of a clearing organization for this purpose, including in the context of indirect clearing.

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

The Proposed Legislation requires 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.[3] The Proposed Legislation establishes 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 as any non-dealer that maintains a substantial net position in swaps, other than for an effective hedge under generally accepted accounting principles, to be further jointly defined by the CFTC and SEC.

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.

Swap dealers and major swap participants will be subject to substantial regulation including the following:

- Registration with SEC and/or CFTC;

[2] The rules of the clearinghouse must "prescribe that all swaps with the same terms are fungible and may be offset with each other". It is not clear whether this language is intended to require that clearinghouses allow for offset of positions carried through different clearinghouses. There is also some uncertainty as to whether a foreign clearinghouse might be able to clear swaps with U.S. persons for this purpose.

[3] By contrast, non-dealer participants in securities or futures markets are not typically subject to direct regulation in their activities as such, with certain exceptions.

- Capital requirements for all swaps (including cleared trades)[4] which will be higher for *non-cleared* trades to encourage the migration of derivatives onto central clearinghouses and exchanges;
- Minimum initial and variation margin requirements for *non-cleared* swaps. These will be set for market participants that are banks by federal banking agencies and for others by the SEC and CFTC;
- 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 defined 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 within 365 days after enactment of the Proposed Legislation 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.

Significantly, the Proposed Legislation does not seem to necessarily impose these registration and other requirements on non-dealer, non-major swap participant, non-financial end-users engaging in hedging activity although the scope of the hedging exception is unclear.

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. For non-cleared, bilateral transactions, a requirement to collect initial margin would also reflect a change in market practice, particularly in the interdealer market, and questions may arise as to the permitted methodology for margin requirements, permitted forms of margin and timing, thresholds and any exceptions. It is also not clear how any such requirement would apply to non-U.S. firms. With limited exceptions, derivatives transactions have not been subject to comprehensive business conduct standards, including affirmative disclosure requirements. 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

To prevent fraud and manipulation, the SEC and CFTC may impose position limits on swaps within their 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 SEC and CFTC shall 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 SEC/CFTC rulemaking.

Position limits may be imposed on *any* market participant, including any group or classes of persons. However, the SEC and CFTC 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 potential imposition of position limits would be a marked change from the current OTC markets. Its impact would depend, among other factors, on the types

[4] Significantly, the legislation does not appear to contemplate "zero" risk weighting for transactions with a clearinghouse.

of contracts covered, types of restrictions imposed (limits vs. accountability standards), aggregation rules and any available exceptions.

No Ban of CDS or other Particular Product

Significantly, the proposed new regulatory framework would not ban any particular product or class of product (e.g., CDS) or treat CDS as insurance, as proposed by some legislators and commentators.

Allocation of Jurisdiction over OTC Derivatives Markets

Instead of establishing one single agency as regulator for derivatives, the Proposed Legislation divides the jurisdiction among the CFTC, the SEC, and federal banking agencies, while seeking to assure substantially similar requirements for functionally or economically similar products.

- The regulatory authority over the OTC market is split between the SEC and CFTC:
  - The SEC has jurisdiction over security-based swaps (including CDS), on individual securities and narrow-based indexes; and
  - The CFTC will regulate all other OTC derivatives, including swaps (including CDS) involving broad-based indices.
- For swap dealers and major swap participants that are banks, the regulatory authority for (i) prudential requirements (including activity restrictions), (ii) minimum capital requirements, (iii) minimum margin requirements, (iv) recordkeeping requirements for activities related to the business as a swap dealer or major swap participant, (v) certain disclosure requirements to regulators, and (vi) the related enforcement authority is delegated to the competent federal banking agencies.

This effectively requires dual registration and regulation by the SEC and CFTC of major market dealers, market participants, exchanges and clearing organizations and thus may complicate the regulatory landscape. For example, trading index CDS would be subject to CFTC jurisdiction, but single name CDS would be subject to SEC jurisdiction.

Joint Rulemaking by SEC and CFTC

The SEC and CFTC are required to jointly implement many of the rules. This is intended to ensure substantially similar rules for functionally or economically similar products and permit products to trade on a broader range of exchanges and markets. In addition, it may limit duplicative or inconsistent regulation to the extent major dealers are required to register with, and be regulated by, both the SEC and CFTC.

Notably, in the event that the CFTC and SEC fail to jointly prescribe uniform rules and regulations under any of the provisions of the Proposed Legislation, the Secretary of the Treasury ("Treasury"), in consultation with the CFTC and SEC, can prescribe rules and regulations under such provisions.

This fall-back jurisdiction of Treasury may pressure the CFTC and SEC to resolve longstanding disputes as to the scope of their respective authorities over financial products and differences in approaches to regulation of products and intermediaries. However, the joint rulemaking may still raise practical implementation difficulties. The experience of the two agencies with single stock futures after the enactment of the Commodity Futures Modernization Act of 2000 ("CFMA") may be instructive.

Regulatory Status of OTC Derivatives

The Proposed Legislation eliminates CFMA exemptions for OTC derivatives and provides a new, more limited swap exemption from the Commodity Exchange Act ("CEA"). Importantly,

- Swaps will be subject to anti-fraud, anti-manipulation, reporting and other CFTC authority; and
- The limitations on the SEC's authority over securities-based swaps under the CFMA would be eliminated. Security-based swaps in many respects could be treated as securities under the securities laws.

Limits on Access to OTC Derivatives Markets

In order to further protect unsophisticated parties from entering into inappropriate derivatives transactions, the Proposed Legislation seeks to tighten the definition of eligible participants in these markets. In particular, the CFTC and SEC will review the criteria for participation in the OTC markets and, among other matters, define the term "eligible contract participant" under the CEA within 180 days after enactment of the legislation.

The proposal indicates particular concern with marketing of swaps to municipal counterparties. In line with this concern, the Proposed Legislation requires that a government entity or political subdivision of a government entity, among other criteria, invests on a discretionary basis in $50 million or more of investments in order to qualify as an "eligible contract participant" under the CEA.[5]

Trade Repository

Both counterparties to a non-cleared swap must report the swap either to a swap repository or, if there is no repository that would accept the swap, to the CFTC or SEC. Such reporting must occur for swaps entered into before enactment of the Proposed Legislation within 180 days and for any new swaps within 90 days or such other time prescribed by the CFTC or SEC by rule or regulation.

Noteworthy in this context, The Depository Trust & Clearing Corp. ("DTCC") plans to transform its CDS warehouse into a limited purpose trust company as it seeks an expanded role in post-trade processing of over-the-counter derivatives.[6] DTCC is thus expected to act as a trade repository for CDS.

Beneficial Ownership

The Proposed Legislation would give the SEC the authority to define certain security-based swaps as conferring beneficial ownership of the underlying securities for reporting purposes under section 13(d) and (g) of the Securities Exchange Act of 1934.

Moving Forward

If enacted, the Proposed Legislation would result in significant structural changes in the OTC derivatives markets. Of course, many aspects of the Proposed Legislation may be modified as lobbyists, industry officials, and lawmakers engage in a debate on Capitol Hill over the Administration's plan and, more generally, the future of U.S. financial regulation. We will continue to monitor and report on these and related proposals and counterproposals as the legislation evolves.

[5] Currently under the CEA, the threshold for government entities and their subdivisions to be "eligible contract participants" is $25 million in investments on a discretionary basis.

[6] DTCC has filed applications for membership in the U.S. Federal Reserve System and with the New York State Banking Department. The new company would be called the Warehouse Trust Company LLC.

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.

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