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Impact on OTC Derivatives End Users of US Proposals for Over-the-Counter Derivatives Legislation

The purpose of this note is to provide a summary of recent proposals by the United States to regulate over-the-counter ("OTC") derivatives and the implications of the proposals for commercial companies that use OTC derivatives for hedging purposes ("OTC End Users").

Administration and Congress' Proposals

US lawmakers are considering several legislative proposals that would substantially change the level of regulation of the OTC derivatives markets and market participants. The two principal committees of the US House of Representatives that have jurisdiction over derivatives markets have recently approved two separate proposals: the House Financial Services Committee on October 15, 2009 (the "Frank Proposal") and the House Agriculture Committee on October 21, 2009 (the "Peterson Proposal").[1] Both bills are broadly consistent with the OTC legislation proposed by the Obama Administration (the "Administration Proposal").[2]

The Frank Proposal and Peterson Proposal (together with the Administration Proposal, the "Proposals") differ in a number of respects. These differences will need to be resolved as the proposals progress through Congress. However, the common elements of the Proposals strongly suggest that any US legislation could result in a significant change in the OTC market generally and potentially have a significant impact on the derivatives activities of OTC End Users.

[1] The Frank Proposal and Peterson Proposal are discussed in more detail in our earlier publication (dated October 13, 2009) and available at http://www.shearman.com/congress-proposals-for-over-the-counter-derivatives-legislation-10-13-2009/

[2] 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.

Regulation of Major Swap Participants

Each of the Proposals provides for federal registration, supervision and regulation of not only "dealers" in swaps but also any non-dealer firm that takes a "substantial net position" in OTC derivatives ("Major Swap Participants"). "Substantial net position" is to be defined at a threshold that the regulators determine prudent for effective monitoring, management or oversight of the financial system.

Major Swap Participants would be subject to registration with the US Commodity Futures Trading Commission ("CFTC") and/or US Securities and Exchange Commission ("SEC") (depending on the underlying asset of their swaps), capital requirements, minimum initial and variation margin requirements, business conduct requirements (including standard of care and disclosure to customers), recordkeeping, reporting and regulatory disclosure requirements. How precisely these requirements would be applied to a non-dealer entity is not clear.

Exemptions for OTC End Users

A key question will be the extent to which the Major Swap Participant definition may apply to OTC End Users. The Proposals to various degrees attempt to exclude certain end-users from this definition through an exemption for hedging activities.

Under the Frank Proposal, positions held primarily for hedging (including balance sheet hedging) or risk management purposes are excluded. The Peterson Proposal excludes positions held primarily for hedging, reducing or otherwise mitigating commercial risk; at the same time, however, it separately includes as a Major Swap Participant anyone whose swaps create exposure that could have serious adverse effects on the financial stability of the banking system or financial markets. These carve-outs for hedging and risk management purposes are broader than the corresponding provision in the Administration Proposal, which only excludes an "effective hedge" under generally accepted accounting principles.

The impact of the Major Swap Participant requirement on OTC End User will thus depend in large part on the type of hedging exemption ultimately selected, as well as the relevant position size threshold.

Margin Requirements for End Users

Under the Frank Proposal and the Administration Proposal, Federal regulators may, but are not required to, impose margin requirements on swaps in which one of the counterparties is neither a swap dealer nor Major Swap Participant (i.e., swaps with an OTC End User). If regulators were given such authority and chose to enact a margin requirement on end-users, the result could have a significant impact on the economics of OTC derivatives for many market participants. Although some of the proposals have language intended to permit end-users to use non-cash margin for these purposes, the scope of such flexibility is unclear; and in any event it would not fundamentally alter the need to post margin.

Position Limits

Each of the Proposals gives the CFTC and SEC (depending on the product) the authority to impose position limits on any user of OTC derivatives with respect to certain derivative contracts. The effect of position limits would depend on the specific types of contracts covered, types of restrictions imposed (limits vs. accountability standards), aggregation rules and any available exceptions. These issues are not addressed by the Proposals, and would likely be left to implementing regulation by the SEC and CFTC.

Clearing and Exchange Trading Requirement

Each of the Proposals requires that certain types of swaps between "swap dealers" and/or "major swap participants" must be cleared by a regulated clearinghouse. In certain cases, transactions that are required to be cleared must also be traded through a regulated exchange or a regulated "alternative swap execution facility".

Exactly what swaps will be subject to the clearing and/or trading requirement, and who will make this determination, varies between the Proposals. The general intent is that more standardized swaps should be subject to the clearing and trading requirements. Most of the discussion has concerned credit and interest rate derivatives; it is not clear where commodity and other derivatives would fall in this analysis.

Even if end-users are not themselves required to use a trading facility or submit trades for clearing, these requirements may affect the availability and/or pricing of trades. For example, if dealers are required to do their own hedging in more standardized instruments, they may be less able, or less willing, to provide more customized hedges to end-users. Liquidity would tend to move to the more standard contracts, which may also affect the costs of hedging by an end-user.

Extraterritorial Scope of Proposals

Each of the Proposals could have significant extraterritorial effect. Notably, they do not specifically exclude non-US transactions or non-US parties from regulation, although the authority of US legislation would generally be limited to activities that use US jurisdictional means. The extent to which the Proposals could affect practices in non-US markets (or markets that are largely, but not completely, outside the US) is thus uncertain.

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 US financial regulation.

Chairman Frank sent a letter on November 3, 2009 to the SEC and CFTC discussing two of the most controversial issues in the proposals, namely the scope of the hedging exemption and the question whether the clearinghouse (under SEC/CFTC supervision) or the SEC/CFTC should have the authority to decide in the first instance if a transaction should be required to be cleared or not.

Chairman Frank stated that he would seek to clarify by way of an amendment the scope of the hedging exemption in more detail. He also stated that he will propose an amendment that gives the regulators and not the clearinghouses the authority to determine which transactions will be subject to mandatory clearing. While CFTC Chairman Gensler originally had indicated that making the clearing determination would be burdensome for the CFTC, he expressed on November 5, 2009 that he agrees with Frank's approach. We will continue to monitor and report on these and related proposals and counterproposals as the legislation evolves.

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