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The Wall Street Transparency and Accountability Act of 2010

Senate Committee on Agriculture, Nutrition, and Forestry, Chairman Blanche Lincoln

On April 21, 2010, the Senate Committee on Agriculture, Nutrition and Forestry approved the “Wall Street Transparency and Accountability Act of 2010” (referred to herein as the “Lincoln bill”). This bill, introduced by Committee Chairman Blanche Lincoln, is similar in many ways to the derivatives reform titles of the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173)¹ (referred to herein as the “House bill”) and the Restoring American Financial Stability Act (S.3217)² (referred to herein as the “Dodd bill”), but would impose additional requirements that could have profound effects on the structure and operation of the derivatives markets. It is expected that the Lincoln bill may replace (or be otherwise incorporated into) the derivatives title of the Dodd bill as it is considered on the Senate floor.

Overview

Like the House and Dodd bills, the Lincoln bill would make numerous changes to the regulation of derivatives, including mandatory clearing and exchange trading for certain transactions, registration and regulatory requirements for derivatives dealers and major market participants, capital and margin requirements for cleared

and uncleared transactions, segregation requirements for collateral, and position limits. Allocation of regulatory responsibility would be split between the CFTC and SEC, with the SEC generally having authority over security-based derivatives (other than some broad-based index contracts) and the CFTC generally having authority over other derivatives. The bill, through its definitions of “swaps” and “security-based swaps,” would cover the range of derivative products currently traded in the over-the-counter market.

The Lincoln bill would also go beyond the House and Dodd bills in certain significant respects. The bill would prohibit U.S. federal assistance (including Federal Reserve advances and access to the discount window as well as emergency liquidity or debt guarantee program assistance) to any dealer, major market participant, exchange or clearing organization in connection with derivatives activities or other activities.³ This provision could effectively require or encourage financial institutions to separate their derivatives businesses from their U.S. bank or U.S. branch office in order for the bank or branch to be eligible for these forms of federal assistance. The bill also adds broad new enforcement authorities that could apply to a range of derivatives market activities. Unlike the House bill, the bill would also cover foreign exchange forward and swap transactions absent a specific exemption.

¹ If you wish to review a summary of the House bill, you may refer to our December 22, 2009 client alert: [U.S. House of Representatives Passes Wall Street Reform Bill: A Preliminary Analysis](#). The House bill can be found at: http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/hr4173eh.pdf

² If you wish to review a summary of the Dodd bill, you may refer to our April 2, 2010 client alert: [U.S. Senate Banking Committee Approves a Sweeping Financial Regulatory Reform Bill](#). The Senate bill can be found at: http://banking.senate.gov/public/_files/TheRestoringAmericanFinancialStabilityActof2010AYO10732.xml0.pdf

³ The scope of “other activities” in this context is not clear from the bill.

Definition of Major Swap Participants

A key issue in the development of regulatory reform proposals has been the extent of their application to non-dealer market participants, referred to as “major swap participants.” In this respect, the Lincoln bill is generally similar to the House Bill. It includes as major swap participants non-swap dealers⁴ that maintain a substantial position in swaps, excluding positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan so long as the hedge is directly associated with the operation of the plan. Major swap participants would also include participants 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. The definition focuses on risk to the market generally, as opposed to individual counterparty credit risk, making it more akin to the House bill than the Dodd bill.⁵

The Lincoln bill also goes one step further to include as a major swap participant any financial entity (whether or not engaging in hedging activity), other than an entity predominantly engaged in providing customer financing for the purchase of an affiliate’s merchandise or manufactured goods, that is highly leveraged relative to the amount of capital it holds and maintains a substantial position in outstanding swaps in any major swap category. The bill leaves many aspects of this definition to be elaborated upon by CFTC and/or SEC regulation. It also contains broad rule-making authority to prevent evasion of this definition.

⁴ The term “swap dealer” means “any person who (i) holds itself out as a dealer in swaps, (ii) makes a market in swaps, (iii) regularly engages in the purchase of swaps in the ordinary course of business, or (iv) engages in activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.”

⁵ The second prong of the Dodd bill provision reads as follows: “whose failure to perform under the terms of its swaps would cause significant credit losses to its swap counterparties.”

Clearing and Exchange Trading Requirements and Exemptions

Much like the House and Dodd bills, the Lincoln bill requires clearing of a potentially broad class of swaps by a registered clearing organization. The CFTC or SEC, as applicable, will have rule-making authority to define the criteria for determining what swaps or classes of swaps are required to be cleared. If a swap fits within these criteria, and a clearing organization will clear it, then the swap is required to be cleared. In general, if a contract is required to be cleared, it must also be traded on a registered exchange or a registered swap execution facility (if one will accept the contract for trading). Swap execution facility is defined as “a trading facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the system.” This definition may exclude certain types of voice brokerage or single-dealer trading systems.

The Lincoln bill grants a narrow exemption from the clearing and trading requirements for “commercial end users.”⁶ The bill allows a commercial end user counterparty to elect not to clear a swap if it is using the swap to hedge commercial risk. (Alternatively, the commercial end user would have the right to require that the swap be cleared, in which case it could also choose where the swap would be cleared.) This hedge exemption resembles in some respects the broader language in the House bill, whereas, under the Dodd bill, the hedge must be an effective hedge under generally accepted accounting principles in order to qualify for the clearing exemption. Significantly, under the Lincoln bill, a commercial end user that is a public company must obtain the approval of

⁶ A “commercial end user” is defined as any person other than a financial entity who, as its primary business activity, owns, uses, produces, processes, manufactures, distributes, merchandises, or markets goods, services, or commodities (which shall include but not be limited to coal, natural gas, electricity, ethanol, crude oil, gasoline, propane, distillates, and other hydrocarbons) either individually or in a fiduciary capacity. “Financial entity” includes swap dealers, major swap participants, persons predominantly engaged in activities that are “financial in nature”, commodity pools and private funds.

its audit committee to enter into swaps exempted from the clearing and trading requirements. The Lincoln bill extends the commercial end user exemption to affiliates acting on behalf of the commercial end user parent (so long as the affiliate is not, and is not acting on behalf of, a financial entity).

Requirements for Swap Dealers and Major Swap Participants

The Lincoln bill follows the lead of the House and Dodd bills with respect to capital and margin requirements for swap dealers and major swap participants. The CFTC or SEC, as applicable, will set capital and margin requirements for non-bank swap dealers and major swap participants. Applicable bank regulators will set requirements for bank swap dealers and major swap participants that are banks. Similar to the Dodd bill, capital requirements would be required to be set higher for uncleared swaps as compared to cleared swaps. Where one party to the transaction is neither a swap dealer or major swap participant and is relying on the commercial end user clearing exception, the initial and variation margin requirements would not apply.

In terms of business conduct standards, the Lincoln bill provides that swap dealers transacting with municipalities and other government agencies and pension plans, endowments or retirement plans would have fiduciary obligations to those counterparties. This would mark a significant change from current market practice and expectations.

The bill also imposes margin segregation standards for both cleared and uncleared swaps, similar to those currently applicable to futures commission merchants under the Commodity Exchange Act.

Reporting Requirements

In terms of reporting and recordkeeping, all uncleared swaps must be reported to a regulated swap data repository or to the CFTC or SEC if a swap data repository

is unavailable. Counterparties must maintain books and records with respect to uncleared swaps for which there was no available repository. The Lincoln bill also contains a large swap trader reporting requirement comparable to that of the Dodd bill under which traders that enter into swaps that perform a “significant price discovery function” are required to file reports, as directed by the CFTC, if their positions are over a certain size limit (set by the CFTC).

Additional Provisions

The Lincoln bill contains broad prohibitions on “disruptive” market practices, including a prohibition on entering into a swap by a party that knows, or has reason to know, that its counterparty will or could use the swap to defraud a third party or the public or to violate any provision of law. This could impose significant additional risks, and related compliance burdens, on market participants. The bill also contains a section which requires the SEC and CFTC to recommend legislative changes to facilitate portfolio margining with respect to portfolios of securities, commodity futures and options, and swaps. The Lincoln bill empowers the CFTC and SEC to investigate and report on so-called “abusive swaps,” which are swaps or security-based swaps that are detrimental to the stability of the financial markets or their participants, although the consequences of such a determination are not certain. The bill also imposes additional approval requirements for contracts based on the occurrence or non-occurrence of an event, such as weather or political events.

Conclusion

The Lincoln bill calls for significant structural changes to the over-the-counter derivatives industry that would affect the business operations of many participants in the financial industry. Of course, many aspects of the Lincoln bill may still be modified as the Senate continues to work on a final comprehensive financial reform bill. We will continue to monitor and report as the legislative process

continues. As a final note, we emphasize that the proposed legislation is a complex and composite assortment of amendments to multiple parts of the federal commodities and securities laws. This publication

is not meant to be, and cannot be, a complete discussion of the proposal or its consequences.

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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