

Regulatory Developments Concerning Credit Derivatives

Update on Legislative Issues

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Overview of Legislative Status

- Administration proposal -- “Over-the-Counter Derivatives Markets Act of 2009” sent to Congress on August 11
- House Financial Services Committee Markup -- H.R. 3795
- House Agricultural Committee -- mark up of discussion draft scheduled for Oct 21
- Senate activity

Key Parts of House Financial Services Bill

- Registration and regulation of swap dealers and major swap participants including capital, margin and reporting
- Division of jurisdiction among CFTC, SEC and Prudential Regulators with broad exemptive powers for CFTC/SEC
- Requirements for clearing and exchange trading
- Registration and regulation of clearinghouses, swap repositories and swap execution facilities
- Definitions of swap, security-based swap and other key terms
- Potential extraterritorial reach subject to exemptions for comparable regulation in foreign countries

SwapDefinitions

- “Swap” is broadly defined and includes any transaction involving the exchange of payments based on the value of commodities, securities and other financial instruments and specifically includes credit default swaps
- “Security-based swap” is defined to include any transaction based on a narrow-based security index or on a single security or loan, and thus will also cover credit derivatives

With Whom Does One Register?

- CFTC will regulate swap dealers and major swap participants other than security-based swaps
- SEC will regulate security-based swap dealers and major security-based swap participants
- Registration to occur within one year of enactment
- Dual registration
 - If engage in both kinds of swap activities or in “mixed swaps”
- Goal of harmonized regulation

Who Must Register?

- Swap dealer -- “any person engaged in the business of buying and selling swaps for such person’s own account, through a broker or otherwise”
 - Exception if buy or sell swaps for one’s own account not as part of a regular business
- Major swap participants
 - Not a swap dealer but maintains “substantial net position in outstanding swaps” (excluding those positions held primarily for hedging commercial risk) or whose outstanding swaps expose counterparties to significant credit losses
- Bachus amendment provides CFTC/SEC with broad exemptive authority for the entire Act

What Are Consequences of Registration?

- CFTC/SEC reporting, recordkeeping, position limits and business conduct requirements
- CFTC/SEC prudential requirements (minimum capital and margin requirements)
 - May exempt swap dealer or major swap participant that is subject to comparable, comprehensive supervision and regulation on a consolidated basis by the CFTC/SEC, the Prudential Regulator or by government authorities in the home country
 - Prudential Regulator sets capital and margin requirements for banks
- Prohibition on “abusive swaps” replaced by a joint CFTC-SEC study

How Do These Requirements Apply to Banks?

- Prudential Regulator
 - FRB, OCC, FDIC
- Status of Banks
 - CFTC/SEC reporting, recordkeeping, position limits and business conduct rules apply to banks
 - CFTC/SEC capital and margin requirements do not apply
 - General exclusion of identified banking products subject to exceptions
- Applicability to Foreign Banks
 - U.S. branches and agencies of foreign banks
 - Non-U.S. offices of foreign banks
 - Authority of CFTC/SEC to provide exemptions

Clearing and Exchange-Trading of Derivatives

- Certain trades must be settled by clearinghouses and executed on exchanges
 - Swaps accepted by a registered clearing organization presumed to require clearing
 - CFTC/SEC to approve each swap or class of swaps before they are accepted for clearing
 - Does not apply to swaps involving end-users (i.e., one of the counterparties is not a swap dealer or major swap participant)
 - Swaps that must be cleared must also be traded on an exchange or swap execution facility

Regulation of Clearinghouses

- Clearinghouses, swap repositories and swap execution facilities must be registered
 - Clearing organization must be registered with CFTC (even if a bank or otherwise registered with the SEC)
 - CFTC/SEC may exempt clearinghouse that is subject to comparable, comprehensive supervision and regulation on a consolidated basis by the SEC/CFTC, a Prudential Regulator or the appropriate governmental authorities in the organization's home country
- Limits on ownership of clearing houses and swap execution facilities to minimize conflicts of interest

Role of Swap Repositories and Swap Execution Facilities

- All trades not cleared by a clearing organization must be reported to a swap repository or to the CFTC
 - Swap repository means an entity that collects and maintains records concerning the terms and conditions of swaps
- All trades requiring clearing must be executed on an exchange or a swap execution facility
 - Swap execution facility is defined as an entity that “facilitates the execution of swaps between two parties” and that is not a designated contract market.
 - Exception if no organization has approved trading of the swap

International Provisions

- U.S. regulators to consult and coordinate with foreign regulatory authorities on establishment of consistent international standards and may agree to information sharing
- CFTC/SEC may ban institutions from foreign countries whose regulation undermines the stability of the US financial system

When would the legislation be effective?

- The effective date of H.R. 3795 would be 180 days after enactment
- SEC/CFTC/Prudential Regulators to issue capital and margin rules within 180 days of enactment
- SEC/CFTC to issue various other regulations including defining key terms generally no later than 180 days after the effective date
 - If SEC/CFTC fail to act, Treasury to issue regulations

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