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Client Update
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OTC Derivatives—In the Crosshairs of US Legislative and Regulatory Change Part III: An Update

Summary

We have previously written about legislative and regulatory developments facing the over-the-counter (OTC) derivatives market.[1] These development include a number of bills introduced in Congress as well as the framework outlined by the Department of the Treasury in the June white paper, "Financial Regulatory Reform: A New Foundation," for a new regulatory regime for OTC derivatives to be implemented by legislation.

On August 11, 2009, the Treasury Department sent to Congress its (115 double-spaced pages) legislative proposal, the Over-the-Counter Derivatives Markets Act of 2009 (OTC Act).[2] The far-reaching legislation is the Obama Administration's attempt to establish a comprehensive regulatory scheme for the OTC derivatives market and all major participants in that market. Consistent with the framework set out in the white paper, the OTC Act would provide for: (i) regulation and transparency for all OTC derivative transactions, (ii) prudential and business conduct regulation of all OTC derivatives dealers and other major market participants, and (iii) expanded regulatory and enforcement tools to prevent manipulation, fraud and other abuses in that market. If enacted, the OTC Act will represent a sea change in the operation of the OTC derivatives market.

Full Update

The OTC Act would implement the four main objectives set forth in the Treasury Department's framework. *First,* the legislation seeks to guard against activities seen as posing excessive risk to the financial system. *Second*, the legislation aims at increasing transparency and efficiency. *Third*, the legislation is designed to prevent market manipulation, fraud, insider trading and other market abuses. *Finally*, the legislation's stated goal is to block OTC derivatives from being marketed inappropriately to unsophisticated parties.

A NEW DAY FOR THE OTC DERIVATIVES MARKETPLACE

Multiple Regulatory Authorities

The essential foundation of the OTC Act is regulatory reform. The current US regulatory regime with respect to derivatives is quite complex, though it was clarified with respect to most OTC products by the Commodity Futures Modernization Act of 2000 (CFMA). The OTC Act directs the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) jointly to prescribe "uniform" rules and regulations. The SEC would regulate security-based swaps and credit derivatives referencing a single security or loan or issuer or a narrow group of securities, while the CFTC would regulate credit derivatives referencing broad-based indices as well as all other OTC derivative products.

The OTC Act would repeal many of the CFMA provisions that currently exempt many (if not most) swaps and other OTC derivatives from regulation, and would remove existing limitations on both the CFTC's and the SEC's jurisdiction with respect to certain derivatives, including with respect to swaps between eligible contract participants. The proposed legislation also amends the Securities Act of 1933 (1933 Act) to include security-based swaps within the definition of "security." Further, the OTC Act would amend the Securities Exchange Act of 1934 (1934 Act) by eliminating the current federal preemption of state law, including

state gaming and "bucket shop" laws, in relation to security-based swaps that do not occur between eligible contract participants or are not effected on a national, registered securities exchange, thereby rendering such security-based swaps subject to such state laws.

In addition to product-level regulatory supervision, OTC derivative market participants would also be subject to potentially (even likely) overlapping registration, regulatory and supervision requirements. Banks that are swap dealers or major swap participants will continue to be regulated by their current applicable federal bank regulatory agencies (defined by the legislation as "Prudential Regulators"). The CFTC and the SEC are prevented from prescribing rules imposing prudential requirements on entities for which there is a Prudential Regulator, but that limitation would not limit the authority of the CFTC or the SEC to prescribe appropriate business conduct, reporting and record-keeping requirements where required to protect investors. In addition, federal banking agencies generally would retain exclusive regulatory authority in relation to identified banking products (presumably as such term is defined in section 206 of the Gramm-Leach-Bliley Act of 1999 although the OTC Act does not include this definition for purposes of these provisions) unless an appropriate federal banking agency determines, in consultation with the CFTC and the SEC, that a product is a swap or security-based swap, or has been structured as an identified banking product in order to evade provisions of the Commodity Exchange Act, the 1933 Act or the 1934 Act.

The OTC Act would require swap dealers or major swap participants to register with the CFTC irrespective of whether that party is also either a bank or is registered with the SEC as a security-based swap dealer or a major security-based swap participant. A "swap dealer" is defined as an entity engaged in the business of buying and selling swaps for its own account, but excludes a person that does not engage in that activity as part of a regular business. A "major swap participant" is defined as any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, but excludes a person who engages in such activity to maintain an effective hedge under generally accepted accounting principles, a narrow and unclear criterion for the wide range of parties that hedge for risk management and cost containment purposes. Parallel definitions apply to "security-based swap dealer" and "major security-based swap participants."

In addition to possible dual registration, registered swap dealers, major swap participants, security-based swap dealers and major security-based swap participants would be required to meet prudential requirements consisting of minimum levels of capital and margin. US banks (including US branches and agencies of foreign banks) would need to meet the requirements set jointly by the Prudential Regulators, while nonbanks would need to meet those set jointly by the CFTC and the SEC. The relevant Prudential Regulator would impose capital requirements for cleared swaps and security-based swaps, as well as initial and variation margin requirements for all swaps and security-based swaps that are not cleared by a registered derivatives clearing organization or registered clearing agency.

The Prudential Regulators may, but are not required, to impose margin requirements with respect to swaps where one counterparty: (i) is not a swap dealer or major swap participant; (ii) is predominantly engaged in non-financial activities; and (iii) is using the swap as part of an effective hedge under generally accepted accounting principles, again a narrow and unclear category. As discussed below, the capital requirements for swaps and security-based swaps that are not cleared are required to be higher than those set for cleared products. The CFTC and the SEC are directed to impose capital and margin requirements as strict as, or stricter than, those set for banks by the Prudential Regulators. The legislation also provides that the Federal Reserve Board should set capital requirements for OTC derivatives of bank holding companies and Tier 1 financial holding companies on a consolidated basis that would be as strict as, or stricter than, the capital requirements set by the Prudential Regulators.

The CFTC and the SEC are to jointly adopt uniform rules governing persons registered as swap dealers or major swap participants and persons that are registered as security-based swap dealers or major security-based swap participants, with The Treasury Department as the "default" rulemaking body if they fail to do so. Registrants would be required under any such rules to meet the minimum capital and margin requirements noted above. In addition, the CFTC

and the SEC would issue rules establishing various reporting and recordkeeping requirements, certain business conduct requirements as well as documentation and back office requirements, notably including valuation of swaps or security-based swaps. These rules could also apply to banks.

Notwithstanding earlier signals that oversight of the OTC derivatives market might rest with a central regulatory body or, more recently, that multiple and overlapping registrations and requirements might not be imposed, the OTC Act appears to catapult the OTC derivatives market into new and untested waters that could result in worse conditions than might have been expected by OTC derivatives market participants. *First*, registration with one regulatory body would not obviate the need for registration with, or regulation and supervision by, the others. *Second*, product level requirements would divide a large market participant's activities into categories that may be subject to differing rules depending on the particular regulatory body having oversight.

While the OTC Act directs the CFTC and the SEC to jointly prescribe uniform rules for registrants and for products, that process is unlikely to yield true uniformity since the rules would be based in different statutory structures and, over time, would be interpreted and enforced by regulatory bodies with a history of antagonistic co-existence.

Clearing (the Problems Away)

All discussions about OTC derivatives regulatory reform have pointed to the benefits of clearing. And, indeed, the OTC Act requires all "standardized" OTC derivatives to be centrally cleared, with a goal of reducing risks to financial stability that arise from "the web of bilateral connections among major financial institutions." The proposed legislation would require standardized swaps to be centrally cleared by a derivatives clearing organization registered with the CFTC or, in the case of standardized security-based swaps, by a securities clearing agency registered with the SEC. In order to promote transparency, standardized swaps also would have to be traded on a CFTC- or SEC-regulated exchange or, for eligible participants, on a CFTC- or SEC-regulated alternative swap execution facility, unless such trades were entered into between eligible contract participants.

The clearing requirements would not apply if no registered derivatives clearing organization will accept the swap for clearing, or if one of the counterparties to the swap is not a swap dealer or major swap participant and does not meet the eligibility requirements of any derivatives clearing organization that clears the swap. Market participants have already questioned whether and, if so, how clearing eligibility standards might be affected as a result of these requirements. There would be similar treatment of security-based swaps if no registered clearing agency will accept it for clearing, or if one party is not a security-based swap dealer or major security-based swap participant and does not meet eligibility requirements of any registered clearing agency that clears the transaction.

"Standardized" versus "Customized": Definition Please?

Although market watchers had hoped for clarification of what is "standardized" versus "customized," the legislation proposes a broad definition of standardized OTC derivatives that is reportedly designed to evolve with the markets. As has been stated by the Treasury Department previously, a swap that is accepted for clearing by any regulated central clearinghouse will be presumed to be standardized. However, the CFTC and the SEC are to jointly define the term "standardized" as broadly as possible after taking into account the following factors: (i) the extent to which any of the terms of the swap, including price, are disseminated to third parties or are referenced in other agreements, contracts or transactions; (ii) the volume of transactions in the swap; (iii) the extent to which the terms of the swap are similar to the terms of other agreements, contracts or transactions that are centrally cleared; (iv) whether any differences in the terms of the swap, compared to other agreements, contracts or transactions that are centrally cleared, are of economic significance; and (v) any other factors the CFTC and the SEC determine to be appropriate.

Both parties who enter into swaps that are not accepted for clearing would need to report such transactions to a registered swap repository, the CFTC or the SEC. In addition, the CFTC and the SEC would be given authority to prevent attempts by market participants to use "spurious" customization to avoid

central clearing and exchange trading. As noted above, higher margin requirements and higher capital requirements will apply to customized swaps in order to encourage greater use of standardized swaps and substantial migration of OTC derivatives onto central clearinghouses and exchanges.

The Treasury Department has repeatedly stated that "customized" OTC derivatives should not be employed in order to avoid using a central clearinghouse, but it has also consistently declined to specifically define "standardized" versus "customized." The OTC Act now provides a rationale for that gap (e.g., market evolution) and more time to provide further details (e.g., joint or at least "uniform" definitions by the CFTC and SEC).

While it is still unclear what parameters would establish whether a product is standardized, it appears that the CFTC and/or the SEC could determine whether and how to classify a derivative as standardized, since they will be the arbiters of whether "spurious" customization is taking place. One developing conundrum concerns expressions by clearinghouses that they cannot clear products before understanding whether the products are standard. The proposed legislation appears to leave any clarification to market evolution and to joint CFTC-SEC resolution. A somewhat daunting concern is that the legitimate business need of market participants for a few bespoke terms in a trade might make the trade inappropriate for clearing and might, therefore, be singled out by regulators as an attempt to avoid otherwise required clearing.

Another question is how trades will be grouped. If some interest rate swaps are deemed to be standardized, will all follow suit? Will parties need to obtain regulatory guidance to identify in advance the likely classification of each trade and its status as standardized or customized? What costs to innovation might be imposed by this legislation?

Informational Transparency

In addition to clearing, greater access to information has been viewed as a driver of market transparency for OTC derivatives. The Obama Administration's proposed legislation requires swap repositories (and security-based swap repositories) to provide regulatory agencies with access on a confidential basis to OTC derivative transactions and related open positions of individual participants and grant to the public access to aggregate data on open positions and trading volume. The described duties of a swap repository (or a security-based swap repository) are to accept, maintain and make available swap data as prescribed by the CFTC (or the SEC), and such bodies would be subject to inspection and examination. The CFTC and the SEC are to jointly adopt uniform rules governing entities that register as swap repositories or security-based swap repositories. In addition, the CFTC and the SEC are each permitted to exempt from registration any swap repository subject to comparable, comprehensive supervision or regulation by another domestic or foreign regulator.

One Big Happy Family

The OTC Act seeks to ensure the supervision of all OTC derivatives dealers and other major market participants. Under the legislation, bank participants would be regulated by the federal banking agencies, while nonbank participants would be regulated by the CFTC or the SEC. All OTC derivative dealers and major market participants would be subject to strict capital and margin requirements as imposed by their respective regulators. The CFTC and the SEC would be required to issue and enforce strong business conduct, reporting and recordkeeping rules with respect to these entities.

While banks have already been subject to prudential regulation and supervision, including with respect to their use of OTC derivatives, their nonbank counterparts that take large positions in this market would join the family of regulated OTC derivative market participants. All would face the newly minted requirements for capital and margin, business conduct and recordkeeping. In light of continued financial stress and the more deliberative pace of similar discussions abroad, one wonders whether the cost of engaging in OTC derivatives and related businesses in the United States could become too high, with the result that OTC derivatives market participants will seek more accommodative jurisdictions.

Keeping the Bad Guys at Bay

Consistent with the Treasury Department's previously announced framework for OTC derivatives reform, the proposed legislation would give the CFTC and the

SEC "clear, unimpeded authority" to police market abuses. In the current environment, speculators are viewed as causing harm to financial markets; therefore, their activities would be limited by the OTC Act through imposition of applicable position limits.

The OTC Act would give both the CFTC and the SEC authority to set aggregate position limits and large trader reporting requirements for OTC derivatives that "perform or affect a significant price discovery function with respect to regulated markets." How such products will be identified and correlated with the regulated markets to which they are purportedly related presumably will be determined by the relevant regulatory body. The position limits that may be set by the CFTC and the SEC are unclear because they are stated as applying across a variety of enumerated contracts and persons, rather than across positions held by a particular person. This raises the question of how broad the groupings of persons or contracts will be under this regime. Will position limits across contracts or multiple persons choke the flow of legitimate trading by unrelated parties? Will position limits inhibit or constrain legitimate hedging?

Although current law effectively limits the types of parties that may participate in OTC derivatives to eligible contract participants, the view of the Treasury Department under the Obama Administration is that the eligibility limits are not sufficiently stringent. Thus, the CFTC and the SEC have been reviewing the current participation limits to recommend how to amend existing laws to tighten those limits or to impose additional disclosure requirements or standards of care with respect to marketing derivatives to less sophisticated counterparties. In line with this effort, the OTC Act would narrow the definition of who may engage in OTC derivatives in an effort to protect individuals and small municipalities. In particular, if a governmental entity or political subdivision, instrumentality, agency or department of such an entity, seeks to qualify as an eligible contract participant on the basis of the investments it owns and invests on a discretionary basis, the threshold amount would be raised from $25 million to $50 million. Individuals would no longer be judged on the basis of total assets but on the basis of amounts invested on a discretionary basis.

Long Arms of Jurisdiction

While the OTC Act seems likely to add impetus for OTC derivatives market participants to seek more accommodative jurisdictions, if they, their counterparties or the products in which they transact touch the United States, there are questions raised about whether the proposed legislation can be left behind.

On a general level, the OTC Act is not explicit about extraterritorial jurisdiction or application outside the United States. The Prudential Regulators would have exclusive authority to enforce prudential requirements of the OTC Act with respect to banks and US branches or agencies of foreign banks that are swap dealers, security-based swap dealers, major swap participants or major security-based swap participants. In addition, the CFTC is authorized to adopt rules and regulations requiring the registration of foreign boards of trade that provide US-based members and market participants with direct access to that board's electronic trading and order matching system. Foreign boards of trade would be prohibited from providing US-based members or other market participants with direct access to the electronic trading and order matching systems of the foreign board of trade with respect to a contract that settles against the price of a contract listed for trading on a CFTC-registered entity unless the CFTC determines that the foreign board of trade meets certain standards that are comparable to the requirements applicable to US boards of trade.

Because the underlying statutes reach entities that use US jurisdictional means to do business with US persons, in the absence of exemptions, non-US entities that do business with persons in the United States, such as the non-US offices of foreign banks, could be required to register with the SEC or the CFTC if they otherwise meet the definitions of swap dealer/security-based swap dealer or major swap participant/major security-based swap participant. Moreover , the SEC's and the CFTC's prudential, market practices and antifraud requirements might then apply to the registered entity on a global basis, not just to transactions involving US persons. Non-US banking entities also appear to be ineligible for an exemption as an entity regulated by a Prudential Regulator because they are regulated by their home country authorities, not by US banking regulators (except to the extent of their US branches and agencies). The legislation should be modified to

limit these extraterritorial effects and ideally it would recognize as Prudential Regulators those regulators from jurisdictions that implement comparable or stricter limits on OTC derivatives activities.

Moreover, while the US branches and agencies of foreign banks would have Prudential Regulators, nothing in the OTC Act indicates that the non-US offices of such foreign banks would be exempt from other requirements of the OTC Act, even with respect to their non-US business. Any final legislation should also be clarified to limit any extraterritorial impact on a foreign bank resulting from the registration of its US branches or agencies with the CFTC or the SEC.

Is the Train Approaching the Station?

Notwithstanding the largely uninterrupted and efficient operation of OTC derivative markets during the recent financial distress, the momentum for greater regulation of derivatives, and OTC products in particular, appears to be building. The language of the OTC Act may not be the final word in achieving the goal of appropriate and clear legislative action and regulatory supervision, but its distribution to Congress will now add to the pressure on the House and the Senate to work on legislation when the Congressional session resumes after Labor Day.

It is notable that an alternate plan proposed by Representatives Barney Frank, chairman of the House Committee on Financial Services, and Collin Peterson, chairman of the House Committee on Agriculture, would not create such heavy burdens as those imposed by the Obama Administration's legislative language, particularly in forcing all "standardized" OTC derivatives onto regulated exchanges. As the chairmen of the key House committees with responsibility for the CFTC and the SEC, their views will be important in shaping the final version of the House bill. In addition, the New Democrat Coalition (New Dems), a group of moderate Democratic members of Congress, have proposed legislation that would create a new agency within the Treasury Department for the oversight of OTC derivatives, the Derivatives Trading Accountability and Disclosure Act of 2009. The New Dems' proposal would increase regulation and reporting requirements placed on the derivatives market, while still allowing for customized and OTC derivatives trading. They state as their goals greater protection, while maintaining an active derivatives market that encourages investment, economic growth and job creation.

It is unlikely that the Senate will act as quickly as the House, and probably will not consider these issues until after the House has acted because of other priorities in the Senate. As in the House, oversight of the CFTC and the SEC is divided between the Committee on Banking, Housing and Urban Affairs (Banking Committee) and the Committee on Agriculture Nutrition and Forestry (the Agriculture Committee). Although Senator Thomas Harkin, chairman of the Agriculture Committee, has been somewhat active on the issue, Senator Christopher Dodd, chairman of the Banking Committee, has been preoccupied with health care reform legislation.

Any adverse impact on the OTC derivatives market resulting from final legislation would not be limited to the financial services industry. Also affected would be commercial enterprises that utilize OTC derivatives to protect their operations from a variety of market risks, including currency, interest rate, commodity and other market fluctuations. Even if these businesses were not "major swap participants" subject to the new regulatory scheme, they could be adversely affected if they are unable to access the tailored products necessary to manage their risks. If they cannot use these instruments, or if the costs of doing so are excessive, the risks they manage will be passed on to consumers of their products through higher prices.

Now that the Administration's themes have been translated into legislative language, the debate will begin in earnest. We hope to learn soon whether a balance will be struck with appropriate legislation that will preserve the breadth, depth and innovative flexibility of the OTC derivatives market in the United States and facilitate its future growth and evolution to meet the needs of its participants.

Endnotes

1. See our June 18, 2009, and May 19, 2009, Client Updates on this topic, available respectively at http://www.mayer-brown.com/publications/article.asp?id=7027&nid=6, and http://www.mayerbrown.com/publications/article.asp?id=6753.

2. The proposed legislation is available at http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf.

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