OBAMA ADMINISTRATION PROFFERS COMPREHENSIVE DERIVATIVES BILL—CFTC URGES TIGHTER RULES

A new phase in the battle over derivatives regulation has opened with delivery of the Obama administration's proposed legislation to Congress.[1] The Over-the-Counter Derivatives Markets Act of 2009 (Proposed Bill) is an ambitious proposal that would subject over-the-counter (OTC) derivatives and their users to comprehensive regulations, affecting banks, broker-dealers, hedge funds, industrial firms, international financial services providers, and many others. In an unexpected development that illustrates the scope of debate over the bill, US Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler urged tighter regulation than that proposed by the US Department of the Treasury in a letter submitted to the leadership of the US House of Representatives and US Senate.

I. Basics of the Proposed Legislation

The Proposed Bill covers virtually all types of OTC derivatives and defines them as "swaps." It defines security-based swaps as "securities," assigns jurisdiction over them to the Securities and Exchange Commission (SEC), and repeals the exemption from regulation that they once received under the Gramm-Leach-Bliley Act. Jurisdiction over other types of swaps would fall to the CFTC.

The Proposed Bill is intended to subject swaps to comprehensive regulation. Intermediaries, markets, clearing entities, and other derivative market participants would face substantial new registration and regulation requirements. In general, while such entities would be allowed to participate in both SEC- and CFTC-regulated markets, registration with both regulators would be required in order to do so. Even banking entities, which are already subject to comprehensive prudential regulation, would enjoy no exceptions from registration obligations.

II. Centralized Clearance Requirements

As expected, the Proposed Bill would require all standardized swaps to be cleared through registered central clearing organizations or clearing agencies and provides that any swap accepted for clearing will be presumed to be standardized. The SEC and CFTC would have to issue regulations to further define the term "standardized"

1 The proposed legislation can be found at http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf. Our prior advisory discussing Treasury's preliminary outline of a potential bill, "Major Regulation Proposed for Over-the-Counter Derivatives" can be found at http://www.arnoldporter.com/resources/documents/Advisory_MajorRegulationProposedForOverTheCounterDerivatives_060909.pdf.

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and would have the authority to designate any particular swap or class of swaps as "standardized." Central clearing would not be required if no registered clearing entity would accept the transaction for clearance, or if one of the counterparties was an entity other than a swap dealer or "major swap participant" (as discussed below), and did not meet the clearing organization's or agency's eligibility standards.

Transactions in swaps that are not accepted for clearing would have to be reported by both parties to the appropriate regulator or to a registered "swap repository," defined as an entity that collects and maintains the records of the terms and conditions of swaps entered into by third parties. Data on swap trading volumes and positions would be made publicly available from information reported to central clearing facilities, swap repositories, and regulators.

III. Exchange Trading

The proposed legislation goes beyond mandatory clearing for standardized swaps and requires swaps that are standardized be traded on an exchange. Specifically, swaps under the jurisdiction of the CFTC will have to be traded on a designated contract market or a new category of regulated exchange, called an "alternative swap execution facility." Likewise, security-based swaps will have to be effected on a registered national securities exchange or an alternative swap execution facility. However, an exception to the mandatory clearing and exchange trading requirement for standardized swaps would exist if no registered clearing organization would accept the transaction for clearance, or if one of the counterparties was an entity other than a swap dealer or major swap participant as defined by the Proposed Bill, and did not meet the relevant clearing organization's eligibility standards.

IV. Registration and Regulation of Swap Dealers and Major Swap Participants

Depending on the assets underlying the transactions, dealers in swaps and "major swap participants" would have to register with the SEC, the CFTC, or both. A "major swap participant" would be any non-dealer "who maintains a substantial net position" in outstanding swaps, "other than to create and maintain an effective hedge under generally accepted accounting principles" as defined by the SEC and CFTC. The proposed legislation treats swap dealers and major swap participants the same, leaving it up to the regulators to adopt rules that differentiate between them.

The SEC and CFTC would jointly adopt standards applicable to such entities. The agencies would have enforcement authority over the OTC derivatives market, and could establish position limits and reporting levels, business conduct standards, reporting and recordkeeping requirements, and capital requirements as they deem appropriate. Regulators would also establish margin requirements for swap transactions that are not centrally cleared. While banking entities are not excepted from the requirement to register, bank regulators would retain the authority to establish and enforce prudential standards, including capital standards and margin requirements, over the entities that they regulate. The legislation directs the SEC and CFTC to establish capital requirements for non-bank swap dealers and major swap participants, at least as strict as those established by the bank regulators, for swaps dealers and major swaps participants that are banks. The legislation also requires that the regulators set higher margin and capital standards for swaps that are not cleared by central counterparties.

V. Outlook

Due to the extraordinary breath of the proposal, we expect the coming Congressional hearings on the Proposed Bill to generate significant attention on Capitol Hill. At least one of the affected financial regulators, the CFTC, has already weighed in with comments. Shortly after the proposal was released, CFTC Chairman Gary Gensler wrote to Congress suggesting that the bill be strengthened by curtailing certain exceptions for foreign currency swaps and forward transactions. The CFTC also argues in its letter for bolstering the mandatory clearing requirement by eliminating the exception for transactions where one of the parties is not a swap dealer or major swap participant. The CFTC believes centralized clearing of all standardized trades will reduce systemic risk.

The Proposed Bill raises many other issues. For instance, it appears to provide that certain security-based swap transactions that do not involve the issuer or an underwriter would not be subject to registration under the Securities Act of 1933 (Securities Act). On the other hand, it would ban security-based swap transactions involving non-eligible contract participants unless such swaps are sold pursuant to an effective Securities Act registration statement. Users of customized derivative products may find their ability to trade affected by the exchange trading and mandatory clearing requirements. Likewise, position limits and new capital and margin requirements may impact the activities of heavy users of derivatives. However, the Proposed Bill leaves much of the work in defining the scope of the regulatory requirements to the regulators to be determined through future rulemaking.

For international transactions, the bill would have substantial implications. For example, where a non-US market allows US traders to have direct access to its electronic trading and order matching systems, it could be required to register with the CFTC. Also, foreign contracts that settle against the prices of contracts listed on US exchanges would be prohibited, unless the CFTC determined that the foreign market where the contracts are traded had implemented appropriate position limits, trade reporting standards, and information sharing arrangements, among other things. (Markets that already have received exemptions from the CFTC would be grandfathered).

Finally, the Proposed Bill's division of authority over the OTC derivatives market between the CFTC, SEC, and the bank regulators creates the potential for jurisdictional infighting, duplicative regulation, and legal uncertainty. Whether these jurisdictional issues can be effectively managed through joint rulemaking and inter-agency cooperation will be one of the many challenges faced by the regulators should the Proposed Bill pass the Congress in its current form.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney, or:

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