Obama Administration Proffers a Comprehensive Derivatives Bill; Congress Begins Debate

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The authors review the provisions of the proposed financial reform bill affecting derivatives.

Authors' Note: Since this article was originally drafted, derivatives legislation has continued to progress in Congress. On December 11, 2009, the House of Representatives passed the "Wall Street Reform and Consumer Protection Act of 2009" (HR 4173), which approaches derivatives legislation in a manner similar to that of the Obama administration's proposed bill. Meanwhile, relevant committees in the Senate have continued to work on similar legislation. While the process has not concluded, readers should anticipate that some form of the regulatory reforms described herein will be enacted into law.

A new phase in the battle over derivatives regulation has opened with delivery of the Obama administration's proposed legislation to Congress and the markup of derivatives reform bills by key committees in the House of Representatives. The Over-the-Counter De-

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rivatives Markets Act of 2009 prepared by the Obama administration (the "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. The bill has been marked up by the House Financial Services Committee and the House Committee on Agriculture and should be on the House floor shortly. A comprehensive financial reform bill that will include new derivatives regulations is also expected to be considered by the Senate Banking Committee shortly.

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 securities swaps 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 major OTC 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, could be subject to substantial additional regulation by the CFTC and/or SEC with regard to their derivatives trading.

CENTRALIZED CLEARING REQUIREMENTS

As expected, the Administration's 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" 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.

By contrast, the mandatory clearing provisions of the bills reported out of committee in the House are not as stringent as the Administration's proposal. The House bills would only mandate centralized clearing if *both* parties to the swaps transaction were dealers or "major swaps participants."

Swap transactions that are not centrally cleared would have to be reported by the 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 aggregate positions would be made publicly available from information reported to central clearing facilities, swap repositories, and regulators.

EXCHANGE TRADING

The Administration's 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 would 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 would 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.

The House bills, however, significantly cut back on the Administration's proposed exchange trading requirement. Under the House bills, swaps that are required to be centrally cleared must either be traded on a registered exchange or swap execution facility or comply with end of the day reporting or confirmation requirements.

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. Under the Administration's proposal 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.

Definitions of "major swap participant" in the House bills do not rely on accounting standards, but exempt traders more generally if their derivatives positions are held for hedging or risk mitigation, so long as the positions do not "create substantial net counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets" (the House Committee on Agriculture bill) or "expose counterparties to significant credit losses that could have a material adverse effect on capital of the counterparties" (the House Financial Services Committee bill).

Under the Administration's proposal, the SEC and CFTC would jointly adopt standards applicable to swap dealers and major swap participants. 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.

OUTLOOK

Due to the extraordinary breadth of the proposal and the widespread use of OTC derivatives, the proposed legislation is engendering an active debate in Congress and will almost certainly continue to generate significant controversy. Key provisions of the legislation are likely to undergo significant change as it winds its way through the legislative process.

While the Administration and the relevant regulators press for the authority to impose higher capital and margin requirements on major market players and insist on greater centralized clearing and exchange trading, users of customized derivatives have expressed concern that these changes may inhibit their ability to access necessary risk management tools. In addition, heavy corporate users of derivatives that currently post little initial cash collateral are concerned about the additional costs that may result from central clearinghouses and exchanges, which often demand that market participants post hefty margin payments to secure their positions. Will Congress be able to navigate between those who insist that the OTC derivatives market needs substantial additional regulatory oversight and those who warn that additional regulation may deter businesses from using derivatives appropriately to manage their business risks? One can expect that Congress will ultimately give substantial additional authority to the regulators to enhance transparency and reduce systemic risks while leaving much of the details of who and how to regulate to the SEC, CFTC and bank regulators through future rulemaking.

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 comprehensive derivatives legislation become law.