

The Intended Consequences Of Derivatives Legislation

Law360, New York (July 08, 2010) -- For nearly a year, commercial businesses from airlines to public utilities have petitioned Congress to listen to their concerns about the derivatives title of the financial reform legislation. The list of the problematic provisions has been long.

Some provisions would have required commercial end users to transact primarily, or for some end users exclusively, on U.S. Commodity Futures Trading Commission-regulated exchanges. Other provisions would have required end users either to clear or to margin (or both) all of their derivatives transactions.

Still other provisions were duplicative of existing regulatory regimes — requiring real time reporting to the CFTC of transactions that utilities were already reporting to the Federal Energy Regulatory Commission, and giving the CFTC enforcement authority that is duplicative of the authority given by Congress to FERC.

These provisions would have created significant unnecessary costs and administrative burdens for American companies who have worked with their derivatives counterparties for years on an unsecured, over-the-counter basis. These Main Street businesses, and their OTC derivatives transactions, played no role in the financial institutions crisis of 2008-2009.

Drafters of the derivatives title produced bills and amendments that contained the same problematic provisions. When one of these provisions was removed, others appeared.

Lawyers and businesses explained how each of the existing, diverse and important commodity and derivatives markets work, and how such laws and regulations would negatively affect American businesses. They asked policymakers to understand the differences between markets and derivatives products, and how such products are used to hedge commercial risks. They asked policymakers to draft carefully.

Legislators, staffers and regulators acknowledged the problems that certain provisions would or could create for certain end users. But those provisions remained. The end user opposition to the derivatives title grew stronger, more vocal and more unified in response.

In the last draft of the Conference Committee Report on June 25, 2010 — at the end of a marathon 20-hour Conference Committee session — a key provision protecting end users disappeared from the derivatives title. End users and Conference Committee members called the question — "WHAT HAPPENED TO THE END USER PROTECTION FROM MARGINING AND MARGINING COSTS?"

At a reconvened Conference Committee meeting on June 29, there was a discussion of the provision, and of the consequences to end users of not reinserting the provision into the derivatives title. Conference Committee

Chairmen Barney Frank, D-Mass., and Christopher Dodd, D-Conn., acknowledged that deleting the provision was likely a mistake — and a substantive, not a technical, flaw in the legislation.

By one estimate, this drafting mistake could require American businesses to sideline \$1 trillion in margin accounts rather than invest that money in their businesses. In addition to this potential for direct regulatory margin costs to end users, the flaw will also significantly increase indirect costs and administrative burdens on American businesses.

The deleted provision (which was in the Senate version of the derivatives title, and in the Conference Committee's "base text") exempted from regulatory margining both parties to a swap to which an end user is a party, whether an existing swap or one entered into in the future — and for good reason. Even if the regulators "only" impose margin requirements on a swap dealer or a major swap participant for a swap to which an end-user is a party, the dealer will be required to post its regulatory margin to the end user counterparty.

In a bilateral, non-cleared swap transaction, if one contract party posts margin, the other party must hold and administer that margin. There isn't an exchange or a clearing house or a financial intermediary to hold and administer that margin. And, since many OTC derivatives transactions to which end users are parties today are not margined at all, end users don't have the personnel and systems to hold or administer daily margin.

If swap dealers and major swap participants are required to post margin, end users will have to either build or buy such back office systems, rather than building infrastructure or buying inventory or equipment. Moreover, if the swap dealer or major swap participant is required to post regulatory margin for an uncleared swap, it is realistic to assume that such market professional will contractually require the end user counterparty to post reciprocal contract margin.

And, if that market professional is required or chooses to post its regulatory margin in cash, such market professional will require its end user counterparty to post cash as contract margin. Or, the market professional will charge an additional credit-related fee or value any non-cash collateral it allows the end user to post at a discount to the face or fair market value of that non-cash asset.

These are indirect regulatory costs which the legislation will impose on commercial end users. The choice that Congress has given American businesses is clear: Either continue to do business as you do today and pay the additional direct and indirect costs imposed by the financial reform legislation, or choose not to hedge your commercial risk using derivatives.

After discussion, the Conference Committee voted not to correct its mistake. Instead, the chairmen of the two responsible Senate Committees (Sens. Dodd and Blanche Lincoln, D-Ark.) wrote a letter on June 30, 2010, to the chairmen of the two responsible House Committees (Reps. Frank and Collin Petersen, D-Minn.).

The June 30 Senate to House letter is an important document — and should be widely distributed. The letter does much more than just acknowledge the end user margining flaw in the legislation. The Senate/House letter is a catalog of several of the other problematic provisions in the derivatives title that the end-user community has been petitioning Congress to address for almost a year. The letter acknowledges that Congress has known for months of appropriate legislative fixes to these problems.

After the Conference Committee vote and after the Senate/House letter was sent, the House passed the flawed legislation. If the Senate passes the legislation, the regulators will begin a year-long rule-making process to implement the legislation. Dozens, perhaps hundreds, of rule-makings will be necessary, and time will be of the essence so that regulatory certainty can allow the financial markets to operate, and American businesses to finance their operations and manage their short and long-term commercial risks.

But the Senate/House letter asks the public to ignore what the legislation says. The letter acknowledges that the derivatives title does not address this catalog of legitimate end user concerns and issues. The Senate/House letter asks the regulators, who are on the cusp of massive rule-making proceedings, either to wait until Congress fixes its mistakes, or to begin a year of complex financial markets rule-making without Congress having established the scope of the regulators' authority. The letter asks the American people and regulators not to read the law, but instead to read the letter.

The Senate will take up the legislation when it returns from the congressional July 4th recess. If passed, the legislation will create regulatory uncertainty, raise the cost of financing American business, eliminate cost-effective, long-term risk management options, and divert capital needed to build infrastructure and buy inventory and equipment. It will deter American companies from utilizing financial derivatives to manage their commercial risks.

The Senate/House letter indicates that Congress understands these consequences. The regulatory uncertainty, the direct and indirect costs, and the regulatory burdens on American businesses are intentional.

--By Patricia Dondanville, Schiff Hardin LLP

Patricia Dondanville is a partner with Schiff Hardin in the firm's Chicago office.

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