



## The House of Representatives Passes OTC Derivatives Legislation

### A Legislative Update from the Schiff Hardin LLP Securities and Futures Regulation Group

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On December 11, 2009, the House of Representatives passed the Derivative Markets Transparency and Accountability Act ("Act") by a 223-202 vote.<sup>1</sup> The Act shares many characteristics with a similar bill that the Treasury Department transmitted to Congress for consideration in August 2009 ("Treasury Bill")<sup>2</sup> and a bill – introduced by the Chairman of the Senate Banking Committee in November 2009 – that is currently pending in the Senate.

In keeping with the Obama Administration's commitment to overhaul the regulation of financial markets in the United States, the Act would change how the markets for over-the-counter ("OTC") derivatives, and the participants in those markets, are regulated in the United States. The legislation contains provisions addressing (a) which agencies should regulate OTC derivatives, (b) how the OTC derivatives markets should be regulated, (c) how participants in the OTC derivatives markets should be regulated and (d) how smaller users of derivatives should be protected.

#### A. Jurisdiction and Regulatory Oversight

Although some observers have advocated merging the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") into a single agency, the Act does not take that approach. The Act does require the CFTC, the SEC, and the Secretary of the Treasury jointly to "conduct a study of the desirability and feasibility of establishing, by January 1, 2012, a single regulator for all transactions involving financial derivatives." The Act allocates regulatory oversight of the OTC derivatives markets between the CFTC and SEC (each an "Agency" and, collectively, the "Agencies") based on the nature of the instrument or commodity underlying the derivative.<sup>3</sup>

<sup>1</sup> The text of the Act is contained in Title III of "The Wall Street Reform and Consumer Protection Act of 2009," available at <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.4173>.

<sup>2</sup> For a summary of the recommendations contained in the Treasury Bill, see the Schiff Hardin LLP Securities and Futures Regulation Group Legislative Update, "Obama Administration's Proposed OTC Derivatives Legislation," available at [http://www.schiffhardin.com/publications/secfut\\_0909/secfut\\_0909.pdf](http://www.schiffhardin.com/publications/secfut_0909/secfut_0909.pdf)

<sup>3</sup> The Act separately authorizes the CFTC and the Federal Energy Regulatory Commission ("FERC") to negotiate two memoranda of understanding to establish procedures for coordinating their respective regulatory efforts to minimize overlap and conflicts and to share information in connection with their respective enforcement authority. The Act provides that it does not limit or affect FERC's statutory authority over agreements, contracts and transactions (i) that are not executed, traded, or cleared on a registered entity or trading facility and (ii) that are entered into pursuant to a tariff or rate schedule approved by FERC. But the Act does not resolve the potentially conflicting jurisdictions of the

The Act generally grants authority to the SEC to regulate the markets and participants in "security-based swaps" and grants authority to the CFTC to regulate the markets and participants in all other "swaps." The term "security-based swap" is defined to mean a swap that is based on (i) a narrow-based security index, (ii) a single security or loan or (iii) an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index that directly affects the financial condition of the issuer. The Act defines the term "swap" very broadly to encompass virtually any type of derivatives contract or transaction except for regulated futures contracts subject to CFTC jurisdiction, physically-settled sales of commodities for deferred delivery, securities options and other securities subject to SEC regulation, and security-based swaps.<sup>4</sup> The Act gives the CFTC (with concurrence by the Secretary of the Treasury) discretion to determine whether foreign exchange (currency) swaps and forwards should be regulated as swaps.<sup>5</sup>

Accordingly, under the Act, equity swaps and credit default swaps that are based on single issuers or narrow-based indices would fall under SEC jurisdiction, while the CFTC would have jurisdiction over equity swaps and credit default swaps based on a broad-based index, as well as over all OTC derivatives based on physical commodities, interest rates, currencies and other intangibles such as carbon emission allowances and the weather. This allocation of jurisdiction between the CFTC and SEC with respect to OTC derivatives is consistent with how jurisdiction between them is allocated under existing laws with respect to exchange-traded derivatives.

In addition to allocating jurisdiction, the Act would expand the regulatory authority of the CFTC and SEC by repealing a number of provisions that had been enacted as part of the Commodity Futures Modernization Act of 2000

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CFTC and FERC with respect to OTC derivatives transactions based on natural gas or electric power.

<sup>4</sup> The CFTC and SEC jointly are tasked with refining the definitions of "swap" and "security-based swap." If the Agencies are unable to adopt the requisite rules within the specified 270-day statutory deadline, the Act authorizes either Agency to escalate the unresolved matter to a newly-created Financial Services Oversight Council ("FSOC") for resolution of the matter. The voting members of the FSOC would consist of the Treasury Secretary, the Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairman of the SEC, the Chairman of the CFTC, the Chairperson of the Federal Deposit Insurance Corporation, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration and the head of the Consumer Financial Protection Agency.

<sup>5</sup> This provision represents a change from the Treasury Bill. Under the Treasury Bill, foreign exchange swaps and forwards were simply excluded from the definition of "swap."

("CFMA"). One of the objectives of the CFMA was to provide legal certainty for OTC derivatives. The CFMA provided legal certainty by adding a number of sections to the Commodity Exchange Act ("CEA") that expressly excluded swaps and other OTC derivatives meeting certain criteria from the provisions of the CEA and the CFTC's jurisdiction. The Act would repeal those sections. The CFMA also added sections to the CEA authorizing the creation of markets, known as derivatives transaction execution facilities and exempt boards of trade, that were to be regulated less stringently than fully-regulated exchanges. Those sections also would be repealed by the Act. In addition, the CFMA amended the Securities Act of 1933 and the Securities Exchange Act of 1934 by, among other things, providing that the definition of "security" in those statutes does not include any security-based swap agreement. The Act would reverse that action.

Not only would the Act remove provisions from existing laws that restrict the jurisdiction of the CFTC and SEC over OTC derivatives, but it also would grant significant new powers to the Agencies to regulate the OTC derivatives markets and the participants in those markets.<sup>6</sup> The expanded regulatory authority of the Agencies is discussed in the following sections.

## B. Regulation of OTC Derivatives Markets

The Act would expand the regulatory authority of the CFTC and the SEC over OTC derivatives markets, including exchanges, clearing organizations, and two new categories of regulated entities – "swap execution facilities" (described below) and "swap repositories" (described below). The Act would require the CFTC and SEC, acting independently or jointly, to adopt various rules for regulating OTC derivatives markets within 270 days after the Act is enacted.<sup>7</sup> Additionally, the CFTC and SEC would be authorized to prescribe rules necessary to prevent parties from evading the requirements that would otherwise apply to swap transactions and to collect information sufficient to identify types of swaps that are detrimental to the stability of the financial markets or their participants.

One of the most controversial elements of this legislation is the requirement that certain OTC derivatives would be required to be cleared through a regulated central counterparty. With central clearing, persons holding

positions in swaps would be required to deposit initial margin in the form of specified liquid assets and to make variation margin payments in cash as their positions are marked to the market on a daily basis. A number of commercial users of swaps argued to Congress that the margin requirements associated with clearing would increase substantially the cost of using swaps and would thus discourage corporations from using swaps to hedge their commercial risks.

The Treasury Bill addressed this issue by providing an exception to the clearing requirement for swap transactions where one of the counterparties is a party that uses swaps to create and maintain an effective hedge under generally accepted accounting principles ("GAAP"). However, certain commercial users felt that this exception did not go far enough, because it did not cover legitimate hedging strategies that do not fit within the strict rules to qualify for hedge treatment under GAAP. The Act would provide an exception to the clearing requirement if (a) no clearing organization accepts the swap for clearing or (b) one of the counterparties to the swap is neither a "swap dealer" nor a "major swap participant,"<sup>8</sup> and such counterparty is using swaps to hedge or mitigate commercial risk, including operating or balance sheet risk. This exception is much broader than the one under the Treasury Bill because it is not limited to uses of swaps that qualify for hedge treatment under GAAP.

Swaps that are cleared would be required to be traded either on a registered exchange or on a facility called a swap execution facility ("SEF").<sup>9</sup> The Act would require exchanges and SEFs where swaps are traded to register with either the CFTC or the SEC, or both, depending on the types of swaps being traded. Either Agency would be authorized to exempt SEFs from registration if it finds that the SEF is subject to comparable regulation on a consolidated basis by the other Agency, a "Prudential Regulator,"<sup>10</sup> or the appropriate governmental authority in the SEF's home country. Once registered, exchanges and SEFs would be subject to regulatory scrutiny and to various recordkeeping and reporting requirements. Exchanges

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<sup>8</sup> The new terms "swap dealer" and "major swap participant" are discussed below in Part C of this paper.

<sup>9</sup> Like an exchange, a SEF would provide a trading facility for swaps. It differs from an exchange in that a SEF would not perform self-regulatory functions. A voice brokerage facility would qualify as a SEF.

<sup>10</sup> A "Prudential Regulator" means the Board of Governors of the Federal Reserve System for certain state-chartered banks or state-chartered branches of foreign banks, the Office of the Comptroller of the Currency for national banks and federally-chartered branches of foreign banks, or the Federal Deposit Insurance Corporation for state-chartered banks that are not members of the Federal Reserve System.

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<sup>6</sup> Subtitle A of the Act authorizes the CFTC to regulate the markets for swaps (other than security-based swaps), and Subtitle B of the Act authorizes the SEC to regulate the markets for security-based swaps. In most instances, the provisions in both Subtitles are comparable.

<sup>7</sup> If one Agency believed that the other Agency had adopted a rule that infringed on the first Agency's jurisdiction, that Agency would be authorized to obtain judicial review of the dispute by filing a petition for review in the U.S. Court of Appeals for the District of Columbia Circuit.

and SEFs also would need to have rules in place to deter trading abuses and to establish (where necessary and appropriate) speculative position limits, and the financial resources to enforce those rules. Exchanges and SEFs would be required to provide market participants with the information necessary to identify and evaluate the risks and costs associated with trading OTC derivatives. Additionally, they would be required to disclose publicly their operating procedures, margin requirements, capital resources and fees, and aggregate settlement information, including prices, volume, and open interest for all contracts. Finally, exchanges and SEFs would be required to establish emergency policies and procedures, including the authority to limit or suspend trading, in order to protect the derivatives markets against manipulation and fraud.

The Act would require all derivatives clearing organizations that centrally clear swaps to register with either the CFTC or the SEC, or both, depending on the types of swaps being cleared.<sup>11</sup> Once registered, derivatives clearing organizations would be subject to regulation by the CFTC or the SEC, or both, including standards for financial resources, settlement procedures, rule enforcement, system safeguards, reporting and recordkeeping, disclosure, and mitigation of conflicts of interest. Derivatives clearing organizations would be required to measure their credit exposure on a daily basis and would be encouraged to limit their exposure to potential losses from defaults by members and participants through margin requirements and other risk control measures designed to guard against any disruption in operations. Both Agencies would be authorized to exempt, conditionally or unconditionally, certain derivatives clearing organizations from registration if the Agency determines that the organization is subject to comparable, comprehensive regulation by the other Agency, a Prudential Regulator or a comparable regulator in the organization's home country.

Under the Act, any person who enters into a swap that is not cleared would be required either to have the data regarding the swap accepted by a "swap repository" or to report comparable data about the swap in accordance with rules to be prescribed by the CFTC or SEC as applicable to that type of swap. The Act defines the term "swap repository" to mean an entity that collects and maintains records of the terms and conditions of swaps entered into by third parties. Swap repositories would be required to register with either the CFTC or the SEC, or both. Once registered, all swap repositories would be required to maintain and disclose certain information on swaps,

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<sup>11</sup> An exemption to this registration requirement is provided for (i) banks and (ii) clearing organizations that are already registered with either the CFTC or SEC, to the extent that they were engaged in clearing swaps or security-based swaps, as the case may be, before enactment of the Act.

including counterparty information, to the appropriate Agency. Additionally, all swap repositories would be subject to inspection and examination and would be required to provide the Agencies with confidential information on OTC derivative transactions, open positions, and individual market participants. In turn, the CFTC and SEC would be required to make aggregate trading data (including price and volume data) publicly available on a timely basis, but in a manner in which the identity of the counterparties is protected. Both the CFTC and the SEC would be authorized to exempt swap repositories from registration if the Agency determines that the repository is subject to comparable, comprehensive supervision or regulation by the other Agency, a Prudential Regulator or a comparable regulator in the repository's home country.

The Act would prohibit a foreign board of trade from providing direct access to its electronic trading system to members and participants in the United States with respect to any contract that is settled based on settlement prices of a comparable contract that is traded on a U.S.-registered exchange or SEF, unless certain requirements are met (e.g., the foreign board of trade makes its trading information public; adopts position limits comparable to those imposed by the U.S. exchange; has the authority to impose limits on market participants to prevent or reduce the threat of price manipulation, excess speculation, price distortion, and disruption of delivery or cash settlement; and agrees to provide information to the CFTC regarding large trader positions and other relevant regulatory data).<sup>12</sup> The Act would limit its regulatory scope to swap activities conducted inside the United States unless activities outside the United States have a direct and significant connection with activities in, or effect on, United States commerce or violate applicable rules of the CFTC. Further, the Act would require the CFTC, the SEC, and the Prudential Regulators to work with foreign regulatory authorities to establish international standards for the regulation of swaps.

### C. Regulation of Market Participants

The Act would create a regulatory structure for certain OTC derivatives market participants that would subject them to extensive registration, reporting, and recordkeeping requirements. The Act would require "swap dealers" and "major swap participants" to register with the CFTC, and "security-based swap dealers" and "major security-based swap participants" to register with the SEC.<sup>13</sup> The Act

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<sup>12</sup> With respect to foreign boards of trade that provide direct access to participants in the U.S. before the date of enactment of the Act, the effective date for this prohibition would be 180 days after the enactment date.

<sup>13</sup> Participants in both types of swaps would be required to register with both Agencies unless one or both Agencies provide an exemption.

defines a “swap dealer” as a person who “(i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly engages in the purchase of swaps and their resale to customers in the ordinary course of a business; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.” It defines a “major swap participant” as any person who falls outside the definition of “swap dealer,” but who maintains a “substantial net position” (to be defined in rule-making by each Agency) in outstanding swaps, excluding positions held primarily for hedging its commercial risk, or who holds outstanding swaps that create substantial net counterparty exposure that could have serious adverse effects on the financial system.

Once registered, all swap dealers and major swap participants would be required to comply with various reporting and recordkeeping requirements enumerated in the Act. Likewise, they would be subject to various business conduct rules (addressing fraud, market manipulation, disclosure of material risks and characteristics of swaps, and failure to supervise), documentation obligations (including retention of trading records, customer records, audit trails, and recorded communications), and back office requirements (relating to position limits, fee disclosures, and conflicts of interest between a firm’s research and trading departments).

The Act would impose new capital and margin requirements on swap dealers and major swap participants, as established by the Prudential Regulators (for banks), by the CFTC (for non-bank participants in the swap market), or by the SEC (for non-bank participants in the market for security-based swaps).<sup>14</sup> The capital and margin requirements are to be set at levels that would help ensure the safety and soundness of the swap dealer or major swap participant and, in the case of non-cleared swaps, would be appropriate for the risk associated with holding swaps that are not centrally cleared.

When a swap counterparty provides funds or other assets to a swap dealer as initial margin or collateral to secure the obligations of the counterparty under a swap with the dealer that is not submitted for clearing, the Act would provide that, if the counterparty so requests, the swap dealer would be required to hold such funds or assets in an account that is carried by an independent custodian and designated as a segregated account for the counterparty in

accordance with rules prescribed by the CFTC, SEC or a Prudential Regulator. This type of segregation requirement exists today in the exchange-traded futures market, but not in the OTC derivatives market. In the current OTC derivatives market, the amount of collateral that a dealer collects from a swap counterparty and how such collateral is held are subject to individual negotiation between the parties, based in large part on their respective credit standing and other factors related to the particular transaction. Since holding the counterparty’s collateral in a segregated account at an independent custodian would increase the dealer’s transaction costs, the dealer presumably would pass on those higher costs to any counterparty that requests segregation of its collateral.

In addition, the CFTC would be authorized to impose aggregate position limits (with related hedge exemption provisions) on instruments that are based on the same underlying commodity, including contracts listed by designated contract markets, contracts traded by foreign boards of trade, and swap contracts that perform or affect a significant price discovery function with respect to registered entities.<sup>15</sup> Likewise, the SEC would be authorized to impose aggregate position limits (and related hedge exemption provisions) across listed securities and security-based swaps. Either Agency would have the ability to exempt, conditionally or unconditionally, any person, transaction or swap from the newly-created position limits

The Act also would authorize the CFTC (and the SEC) to impose heightened large trader reporting and recordkeeping requirements on any person who enters into or obtains a position in swaps (or security-based swaps) that exceeds the position limits established by the Agencies. Large traders would be required to file reports regarding the transactions or positions that caused the trader to exceed the position limits. Additionally, large traders would be required to maintain books and records that show complete details concerning all relevant transactions and positions.

#### D. Protection of Smaller Users of Derivatives

The Act would restrict the ability of smaller entities to use OTC derivatives by making it unlawful for any person who is not an “eligible contract participant” (“ECP”) <sup>16</sup> to enter into a swap unless the swap is traded on a registered

<sup>14</sup> Under the Act, the Prudential Regulators would be required jointly to adopt rules (within one year after the Act is enacted) for banks to determine the requisite minimum capital requirements and minimum initial and variation margin requirements for swaps. The CFTC and SEC would be required to do the same for non-bank participants under their respective jurisdictions. The Prudential Regulators, CFTC and SEC would be expected to consult with one another in adopting these rules.

<sup>15</sup> The Act would direct the CFTC to conduct a study on whether the imposition of position limits causes trading to move from U.S. exchanges to trading venues outside the United States.

<sup>16</sup> As discussed below, the term “eligible contract participant” is defined in the CEA to include persons and entities who meet specified financial standards.

exchange. Moreover, the Act would eliminate the CFTC's authority to grant exemptions from the swap-related provisions of the Act, except as expressly authorized under the Act.<sup>17</sup>

The Act also would amend the definition of "eligible contract participant" in two respects. In clause (vii) (relating to government entities such as municipalities), the amount of assets that a government entity would be required to own and invest on a discretionary basis would be increased from \$25 million to \$50 million. In clause (xi) (relating to individuals), the wording would be changed. Presently, an individual qualifies as an eligible contract participant so long as he has total assets in an amount in excess of (i) \$10 million or (ii) \$5 million if the derivatives transaction is for hedging purposes. The Act would not change those dollar amounts, but it would change the standard from one based on total assets to one based on "amounts invested on a discretionary basis." Both of these changes would reduce the number of persons eligible to participate in derivatives not traded on an exchange.

These restrictions on the ability of smaller entities to participate in OTC derivatives may have unintended consequences. For example, a small municipality may need to issue bonds in order to finance a construction project. The bond market typically will offer better pricing for floating-rate bonds than for fixed-rate bonds. The municipality thus would prefer to issue floating-rate bonds and to hedge its interest rate exposure by entering into an interest rate swap. In order to obtain favorable tax and accounting treatment, the terms of the swap would need to be customized to match the dollar amount and maturity of the bonds, meaning that the swap would not be sufficiently standardized to be traded on an exchange. However, if the municipality does not qualify as an ECP, it would be prohibited from entering into an OTC swap.<sup>18</sup> This prohibition would compel the municipality either (i) to incur the higher costs of issuing fixed-rate bonds or (ii) to issue floating-rate bonds without hedging its interest rate risk – both alternatives being substantially less attractive to the

municipality than its preferred course that involves using an interest rate swap

In addition, the Act would impose more regulation on retail commodity transactions. Specifically, it would require all commodity transactions that are financed by the offer or offered on a leveraged or margined basis to a person who is not an ECP to be traded on an exchange subject to CFTC jurisdiction. This requirement would not apply to transactions in securities or identified banking products, nor would it apply to transactions that result in actual delivery with 28 days or that create an enforceable delivery obligation between parties that have the ability to deliver and accept delivery, respectively, in connection with their line of business.

### Conclusion

Although the Derivative Markets Transparency and Accountability Act was approved by the House in December 2009, the Senate has not yet adopted any bill regarding the regulation of OTC derivatives. Assuming that the Senate passes such a bill, Schiff Hardin LLP will continue to track the legislative process and to see what legislation, if any, ultimately becomes law.

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<sup>17</sup> In contrast, under the current CEA, the CFTC has the authority to grant exemptions from the requirements of the CEA to certain classes of persons or types of transactions in order "to promote responsible economic or financial innovation and fair competition," even if the criteria in the statutory exclusions are not met.

<sup>18</sup> The CFTC issued a Policy Statement Concerning Swap Transactions in 1989 that provides a swap harbor for OTC swaps that have individually negotiated terms, that are not marketed to the general public and that are undertaken for commercial purposes as part of the parties' lines of business. Under CFTC precedent, this safe harbor applies even when one of the parties to the swap does not qualify as an ECP. However, it appears that enactment of the Act would overturn that precedent and eliminate the flexibility offered by the safe harbor.

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