



Obama Administration's Proposed OTC Derivatives Legislation

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

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On August 11, 2009, the U.S. Treasury Department transmitted to Congress proposed legislation that would adopt sweeping changes to how the markets for over-the-counter (“OTC”) derivatives, and the participants in those markets, would be regulated in this country.¹ The proposal contains legislative language to implement the recommendations relating to OTC derivatives that were contained in the Obama Administration’s “White Paper” on financial regulatory reform that was issued on June 17, 2009.² The draft legislation contains the Obama Administration’s proposals for (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.

Jurisdiction and Regulatory Oversight

Although some observers had advocated merging the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) into a single agency, the Obama Administration did not go in that direction. Instead, the Administration’s proposal would allocate regulatory oversight of the OTC derivatives markets between the CFTC and SEC based on the nature of the instrument underlying the derivative product. The draft bill 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 OTC derivatives. The term “security-based swap” is defined to mean a swap that is based on (i) a narrow-based security index,³ (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 draft bill 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, securities options and other securities subject to SEC regulation, and foreign exchange (currency) swaps and forwards.⁴

Accordingly, under the draft bill, 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 OTC derivatives based on physical commodities, interest rates, currencies and other intangibles such as carbon emission allowances and the weather. The draft bill also contemplates the possibility of a “mixed swap,” the value of which derives in part from a security and in part from something else. The bill appears to provide for joint regulation by the CFTC and SEC over mixed swaps.⁵ 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 draft bill 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 (“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 Administration’s draft bill 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 draft bill. In addition, the CFMA had amended the Securities Act of 1933 (“1933 Act”) and the Securities Exchange Act of 1934 (“1934 Act”) by, among other things, providing that the definition of “security” in those statutes does not include any security-based swap agreement. The draft bill would reverse that action by

¹ The text of the 115-page draft bill is available at <http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf>.

² The White Paper is entitled *Financial Regulatory Reform – the New Foundation: Rebuilding Financial Supervision and Regulation*. For a summary of the recommendations contained in the White Paper, see the Schiff Hardin LLP Securities and Futures Regulation and Financial Institutions Alert dated June 24, 2009.

³ The term “narrow-based security index” means an index that satisfies any one of the following criteria:

1. The index has nine or fewer component securities;
2. One security comprises more than 30% of the index’s weighting;
3. The five highest weighted component securities in the aggregate comprise more than 60% of the index’s weighting; or
4. The bottom quartile of the component securities has combined average daily trading volume of less than \$50 million, or \$30 million if the index includes at least fifteen securities.

⁴ In a letter to the Chairmen and Ranking Members of the relevant Congressional committees dated August 17, 2009 (the “Gensler Letter”), Gary Gensler, the recently-confirmed Chairman of the CFTC, suggests that the exclusion for foreign exchange swaps should be deleted from the draft bill and the exclusion for foreign exchange forwards should be narrowed.

⁵ The Gensler Letter suggests that mixed swaps should be regulated either by the SEC (if their value is based primarily on a security) or by the CFTC (if their value is based primarily on something else), but not by both agencies.

adding security-based swaps to the definitions of “security” in both the 1933 Act and the 1934 Act.⁶

Not only would the draft bill remove provisions from existing laws that restrict the jurisdiction of the CFTC and SEC (each individually, an “Agency” and, collectively, the “Agencies”) over OTC derivatives, but it also affirmatively grants significant new powers to the Agencies to regulate the OTC derivatives markets and the participants in those markets.⁷ The expanded regulatory authority of the Agencies is discussed in the following sections.

Regulation of OTC Derivatives Markets

The draft bill expands the regulatory authority of the CFTC and the SEC over OTC derivatives markets – including exchanges, clearing organizations, alternative swap execution facilities (described below) and swap repositories (described below). Of special importance, the draft bill sets forth trading and clearing requirements for “standardized” swaps.

The term “standardized” is not defined in the draft bill. However, the bill contains a presumption that a swap is standardized if it is accepted for clearing by a derivatives clearing organization registered with either the CFTC or the SEC. The bill requires the CFTC and SEC jointly to adopt rules within 180 days after the proposed legislation is enacted⁸ to define the term “standardized,” taking into consideration such factors as the extent to which the terms of a swap (including price) are disseminated to third parties; the volume of transactions in a swap; the extent to which the terms of a swap are similar to the terms of other agreements, contracts, and transactions that are centrally cleared; whether any discrepancies between a swap and similar transactions are of economic significance; and any other factors the Agencies determine to be appropriate. The CFTC and SEC also will be authorized to prescribe rules necessary to prevent parties from evading the requirements that apply to “standardized” swaps.

In general, standardized swaps are required to be traded either on a registered exchange or on a facility called an

alternative swap execution facility (“ASEF”).⁹ Standardized swaps also are required to be cleared by a registered clearing organization. The bill provides exceptions to these requirements if (a) no clearing organization will accept the swap for clearing or (b) one of the counterparties to the swap is neither a “swap dealer” nor a “major swap participant,”¹⁰ and such counterparty does not meet the eligibility requirements of any clearing organization that clears the swap.

Under the draft bill, exchanges and ASEFs where swaps are traded will be required to register with either the CFTC or the SEC, or both, depending on the types of swaps being traded. Once registered, exchanges and ASEFs will be subject to regulatory scrutiny and to various recordkeeping and reporting requirements, including mandatory disclosure of position limits, trading procedures, and mitigation of conflicts of interest. Exchanges and ASEFs also will need to have rules in place to deter trading abuses, along with the financial resources to enforce those rules. Exchanges and ASEFs will 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 will 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 ASEFs will 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 draft bill requires 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. Once registered, derivatives clearing organizations will 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 will be required to measure their credit exposure on a daily basis and will 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

⁶ However, the draft bill does not repeal the language in Section 2A of the 1933 Act or in Section 3A of the 1934 Act providing that the definition of “security” in each of those statutes does not include any security-based swap agreement. This appears to be a drafting oversight.

⁷ Subtitle A of the draft bill authorizes the CFTC to regulate the markets for swaps (other than security-based swaps), and Subtitle B of the bill authorizes the SEC to regulate the markets for security-based swaps. In most instances, the provisions in both subtitles are comparable.

⁸ If the CFTC and SEC are unable to adopt the requisite joint rules within the specified 180 day statutory deadline, the draft bill requires the Secretary of the Treasury to step in and promulgate the rules instead.

⁹ Like an exchange, an ASEF provides a trading facility for swaps. It differs from an exchange in that an ASEF does not perform self-regulatory functions.

¹⁰ The new terms “swap dealer” and “major swap participant” are discussed below in Part C of this paper.

are 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 or – if the organization is a bank or bank branch – by a “Prudential Regulator” (*e.g.*, the Board of Governors of the Federal Reserve System for 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).

All swaps, even if they are not cleared, are subject to specified reporting and recordkeeping requirements. The draft bill 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 will be required to register with either the CFTC or the SEC or both. Once registered, all swap repositories will be required to maintain and disclose certain information on swaps, including counterparty information, to the appropriate Agency. Additionally, all swap repositories will be subject to inspection and examination and will 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 will 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 are authorized to exempt swap repositories from registration if the Agency determines that the repository is subject to comparable, comprehensive supervision or regulation by another regulator.

The draft bill further authorizes the CFTC to adopt regulations that will require the registration of foreign boards of trade that provide members and other market participants located in the United States with direct access to the foreign board of trade’s electronic trading system. A foreign board of trade will be prohibited from providing direct access 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 ASEF, 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).

Regulation of Market Participants

The draft bill would create a regulatory structure for derivatives market participants that would subject them to extensive registration, reporting, and recordkeeping requirements, all of which are to be implemented pursuant to rules jointly promulgated by the Agencies within one year of the bill’s enactment. The bill 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.¹¹

The draft bill defines a “swap dealer” as “any person engaged in the business of buying and selling swaps for such person’s own account, through a broker or otherwise,” so long as such trading activity is a part of the dealer’s regular business, either as an individual or in a fiduciary capacity. It defines a “major swap participant” as any person who falls outside the definition of “swap dealer” but who nevertheless “maintains a substantial net position in outstanding swaps, other than to create and maintain an effective hedge under generally accepted accounting principles.”

Once registered, all swap dealers and major swap participants will be required to comply with various reporting and recordkeeping requirements enumerated in the draft bill. Likewise, they will be subject to various business conduct rules (addressing fraud, market manipulation, 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 draft bill will impose new capital and margin requirements on derivatives market participants. Swap dealers and major swap participants will be subject to capital and margin requirements, including standards for minimum financial resources, as established by either the Prudential Regulators (for banks) or jointly by the CFTC and SEC (for non-bank market participants).¹² The draft bill

¹¹ Participants in both types of swaps will be required to register with both Agencies. However, either the CFTC or the SEC may exempt a market participant from registration if the participant will be subject to comparable regulation by the other Agency.

¹² Under the draft bill, the Prudential Regulators shall jointly adopt rules (within 180 days after the bill is enacted) for banks to determine the requisite minimum capital requirements and minimum initial and variation margin requirements for both standardized and non-standardized swaps. The CFTC and SEC, acting jointly, shall do the same for non-bank participants. The Prudential Regulators, CFTC and SEC are expected to consult with one another.

requires that the capital requirements be higher for non-cleared swaps than for cleared swaps, in order to offset the greater risk to the swap dealer or major swap participant and to the financial system itself arising from the use of non-standardized swaps that are not centrally cleared.¹³

In addition, the CFTC will 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. Likewise, the SEC will be authorized to impose aggregate position limits (and related hedge exemption provisions) across listed securities and security-based swaps. Either Agency may exempt, conditionally or unconditionally, any person, transaction or swap from the newly-created position limits.

The draft bill also authorizes 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 will be required to file reports regarding the transactions or positions that caused the trader to exceed the position limits. Additionally, large traders will be required to maintain books and records that show complete details concerning all relevant transactions and positions.

Protection of Smaller Users of Derivatives

The draft bill 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”)¹⁴ to enter into a swap unless the swap is traded on a registered exchange. That restriction is consistent with the criteria used in those sections of the CEA in which specified transactions in OTC derivatives are excluded from CFTC jurisdiction. However, 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. The draft bill would eliminate the CFTC’s authority to grant exemptions from the swap-related provisions of the bill, except as expressly authorized under the bill.

¹³ The higher capital requirements for non-cleared swaps will provide a financial incentive to market participants to encourage clearing for swaps whenever it is feasible to do so.

¹⁴ As discussed below, the term “eligible contract participant” is defined in the CEA to include persons and entities who meet specified financial standards.

The draft bill also would amend the definition of “eligible contract participant” in two respects. In clause (vii) of the definition (relating to government entities such as municipalities), the amount of assets that a government entity must own and invest on a discretionary basis would be increased from \$25 million to \$50 million. In clause (xi) of the definition (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 draft bill does 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 OTC derivatives.

If enacted into law, 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 will typically 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.¹⁵ 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 draft bill would impose more regulation on retail commodity transactions. Specifically, it would require all commodity transactions that are financed by the offeror 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

¹⁵ 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 draft bill would overturn that precedent and eliminate the flexibility offered by the safe harbor.

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 lines of business.

Conclusion

Even before the Obama Administration's draft bill was submitted, members of Congress had introduced a number of different bills dealing with the regulation of OTC derivatives. There are several committees in the House and Senate that have jurisdiction over certain aspects of this subject, and there are conflicting views as to what should be done. It will be very interesting to follow the legislative process and to see what legislation, if any, is ultimately enacted.

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