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Administration Unveils Over-The-Counter Derivatives Reform

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The Treasury Department introduced earlier this month the details for its reform of the over-the-counter (OTC) derivatives market that was first outlined in their white paper for financial regulatory reform. The Over-The-Counter Derivatives Markets Act of 2009 (the OTC Act), a summary of which, together with legislative language, can be found here, would bring the currently unregulated markets for OTC derivatives, including credit default swaps (CDS), under the supervision of the SEC, CFTC and federal bank regulators. Among other things, the proposed legislation would effect the following changes:

- **Require Central Clearing and Trading of OTC Derivatives:** All standardized OTC derivatives (Swaps) would be required to be centrally cleared by a "derivatives clearing organization" regulated by the CFTC or "clearing agency" regulated by the SEC and traded on a regulated exchange, board of trade, or "alternative swap execution facility." To encourage development of this market, regulators would be directed to broadly define "standardized" Swaps and would be required to impose higher capital and margin requirements on customized Swaps. The clearing and trading requirements would not apply to a Swap where (1) no central derivatives clearing organization or central clearing agency will accept the Swap or (2) one of the counterparties to the Swap (a) is not a Dealer or Major Swap Participant and (b) does not meet the eligibility criteria for any derivatives clearing organization or clearing agency.
- **Regulate Traders and Large Market Participants:** All traders in Swaps (Dealers) and purchasers that maintain a substantial net position in outstanding Swaps, other than to create and maintain an effective hedge under GAAP (Major Swap Participants), would be required to register with the CFTC and/or SEC. Because the application of GAAP to Swaps can be uncertain, various non-financial players with significant hedging positions might be classified as Major Swap Participants if they enter into hedges that are later found to be ineffective under GAAP. Dealers and Major Swap Participants would be subject to a system of supervision for recordkeeping and would be subject to capital and margin requirements. Companies that might become subject to regulation as Major Swap Participants will likely monitor these proposals and modify their hedging policies accordingly.
- **Require Enhanced Disclosure and Public Reporting Regarding Swaps:** All Swaps that are not centrally cleared would be required to be reported to a registered "swap repository" or to the CFTC or SEC. The derivatives clearing organizations, clearing agencies and swap repositories would report information about trades to the CFTC and SEC, and the regulators would then share information about trades with the appropriate federal regulators. In addition, the CFTC and SEC would publicly disclose aggregate data on Swap trading volumes and positions in a manner that would not disclose the business transactions and market positions of any person. Depending upon timing and level of detail in the reports, the public availability of such information might affect the confidentiality of Swaps and settlements by market participants with large positions.
- **Set Aggregate Position Limits:** The CFTC and SEC would be empowered to set limits on the aggregate number or amount of positions in contracts based on the same underlying commodity or security that may be held by any person for each month across (1) contracts or securities listed on a designated contract market or exchange and (2) Swaps that perform or affect a significant price discovery function with respect to regulated markets. These rules have the potential effect of regulating the volume and availability of Swaps listed on exchanges.

Although the Administration's proposal provided substantial detail, key questions remain, including how the regulators would interpret the scope of the bill, if enacted. Although the legislative calendar is packed with significant policy proposals, the two key players in the House of Representatives, Barney Frank, chairman of the committee with jurisdiction over the SEC, and Collin Peterson, chairman of the committee with jurisdiction over the CFTC, introduced a statement of joint principles on July 30, 2009, that was similar to the details of the original Administration proposal. As the process unfolds, key issues to follow include:

- **Harmonizing or Consolidating Regulatory Oversight:** Financial regulatory reform as a whole attempts to close off gaps in regulations, including the largely unregulated markets for CDS and other OTC derivatives that regulators hold responsible for damaging financial institutions and the economy as a whole. In addition, financial regulatory reform seeks

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to consolidate the federal financial infrastructure to create uniform standards and regulators. This proposal seeks uniformity by requiring joint rulemaking by the CFTC and the SEC and by seeking to harmonize their respective regulations. In fact, the CFTC and SEC have called public meetings to discuss the harmonization of existing regulations. Nevertheless, the legislation preserves both agencies and their separate authority, leading to the possibility of dual exchanges and dual registration requirements for Dealers, while also preserving the authority of bank regulators to regulate Dealers that are subject to their jurisdiction. The proposal attempts to limit jurisdictional delays by giving the Treasury, the author of the OTC Act, the authority to issue rules if the CFTC and SEC fail to do so within 180 days of the failure by the SEC and CFTC to adopt rules required under the law.

- **Evolving of Central Markets:** The Administration proposal depends on the existence of central agencies, many of which do not yet exist, including alternative swap execution facilities and swap repositories. The Administration believes that the legislation will create these markets, and the success of the proposal depends upon the creation and development of active central markets.
- **Regulation of Banking Products:** The proposal does not apply to any "identified banking product," which would include deposit accounts, certificate of deposits, letters of credit, debit accounts and loan participations unless federal banking regulators, in consultation with the CFTC and SEC, determine that the product is a Swap and has become known to the trade as a Swap. The intent of this provision appears to preserve the traditional authority of bank regulators over these products, but commentators have raised questions as to this potentially significant gap in the proposed law.
- **Transparency and Oversight versus Restrictions:** This proposal's main focus, central clearing and trading, coupled with capital and margin requirements, is consistent with goals established in the Administration's financial regulatory reform proposal of regulating through transparency and oversight, rather than setting compensation and restricting investments. The potential to set position limits, however, goes farther and has raised eyebrows among market participants. In addition, Congress has indicated an interest in restricting specified financial instruments. For example, Representatives Frank and Peterson have proposed outright prohibitions on a "naked" CDS (*i.e.*, a CDS where the purchaser does not own the underlying security). As this proposal is taken up in the House of Representatives, position limits, limits on speculation and other trading restrictions will likely gain traction.
- **Confidentiality of Trading Strategies:** Consistent with the Administration's proposal to regulate hedge funds (and other private investment funds), the OTC Act would require confidential disclosure of trading information for the purpose of evaluating risks to the financial system as a whole. Public disclosure will only be made as to aggregate positions. Regulators face a similar issue in determining whether hedge funds should be required to disclose their beneficial owners, a very sensitive topic to hedge fund managers and investors. The Administration has not publicly taken a position, although their proposals in this area have been more limited than the bills introduced in Congress. Protections for proprietary and/or sensitive information will be the subject of vigorous debate.

Congress has shown significant interest in reforming the OTC markets, but it is difficult to predict the likelihood of passage of the OTC Act at this time. The introduction of such a detailed package nonetheless evidences the priority of this issue to the Administration.

In response to the current economic downturn and the evolving governmental approach to abate its effects, Andrews Kurth formed its Economic Recovery and Government Opportunities Task Force (ERGO). ERGO is a cross-disciplinary effort designed to assist our clients in three broad areas related to economic recovery:

- The Financial Stability Plan, including Government initiatives such as TALF and PPIP that are intended to re-establish viable markets and create opportunities for the business and investment community,
- Recovery Act/Stimulus Appropriations, including the 2009 American Recovery and Reinvestment Act, and
- Financial Regulatory matters, including prospective changes to the regulatory framework of financial institutions and financial intermediaries, and the reallocation of enforcement authority among federal and/or state authorities.

Andrews Kurth remains committed to keeping our clients and the business community informed about these developments and potential opportunities. Should you have any questions about these matters, please contact G. Michael O'Leary, Jeff C. Dodd, Melinda Brunger, Peter Bogdanow or your Andrews Kurth contact.