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LEGAL ALERT

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Senate Passes Financial Regulatory Bill – Dramatic Changes to Derivatives Regulation a Certainty

Months of tortuous debate have come to an end as the U.S. Senate passed its version of financial regulatory reform on May 20, 2010. The passage of this piece of legislation, the Restoring American Financial Stability Act of 2010 (Senate Bill), nearly ensures that the vast overhaul of regulation over the U.S. financial system that has been looming for much of the last year will finally be set in motion. The Senate Bill will now be sent to a conference of House members and Senators, where it will be reconciled with the Wall Street Reform and Consumer Protection Act of 2009 (House Bill) previously passed by the U.S. House of Representatives. A final bill could be ready for the President's signature by early July.

The Senate Bill is based primarily upon the legislation crafted by Sen. Chris Dodd (D-CT) in the Senate Banking Committee. The derivatives portion of the Senate Bill, however, incorporates the compromise language agreed to by Sen. Dodd and Sen. Blanche Lincoln (D-AR), based in large part on the work of the Senate Agriculture Committee. A summary of this compromise language can be found in our Legal Alert dated April 29, 2010. We have also created a chart detailing specific provisions impacting derivatives transactions, which is attached here. This chart includes section references to where specific provisions may be found in the Senate Bill, given that it is believed that the Senate Bill will be the basis for negotiations in conference.

The Senate Bill contains a number of amendments passed on the Senate floor that modify the original language submitted by Sen. Dodd, which are available here. Only two of these amendments, attached here, alter language in the derivatives section of the bill, one expanding the Commodity Futures Trading Commission's (CFTC) power to regulate manipulative activity in the swaps market, and the other preserving certain existing authority of the Federal Energy Regulatory Commission (not withstanding the CFTC's exclusive jurisdiction over swap transactions).

In addition to the derivatives issues highlighted in the chart attached to this alert, which include clearing, trading, margining and position limits, two hotly contested provisions affecting derivatives market participants were included in the final version of the Senate Bill. First, Section 619 of the Senate Bill incorporates the so-called "Volker Rule," which prohibits banks from engaging in certain proprietary trading of financial instruments, including derivatives transactions. Second, language proposed by Sen. Lincoln that would force banks to spin off their derivatives desks into separate entities has been included in Section 716 of the bill.

Finally, the Senate Bill maintains language highlighted in our Legal Alert dated May 12, 2010, that creates legal uncertainty for existing derivatives transactions. As detailed more fully in the previously mentioned alert, provisions in the Senate Bill could be interpreted to mandate margining of existing over-the-counter (OTC) transactions, to limit the rights of counterparties to OTC transactions to declare an Illegality termination event due to such unanticipated margin requirements, and to override certain prohibitions on transfer of OTC contracts.

Much debate exists regarding which provisions of the Senate Bill and the House Bill will be modified or deleted from the final regulatory reform legislation that is sent to the President for signature. What is no longer debated, however, is whether such legislation will be enacted. Passage of the Senate Bill virtually ensures that derivatives market participants will soon be forced to adjust to new regulations that may fundamentally alter the OTC derivatives markets. These regulations may be promulgated within six months based on the timing set forth in the Senate Bill.

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If you have any questions about this Legal Alert, please feel free to contact the attorneys listed below or the Sutherland attorney with whom you regularly work.

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