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LEGAL ALERT

January 7, 2010

Derivatives Legislation Update: House Passes Bill; Senate Bill a Work in Progress

With the arrival of the new year, derivatives market participants around the globe are taking stock of a tumultuous 2009 and asking what new regulatory changes could occur in this year to address the perceived deficiencies that led to the collapse of financial markets in 2008. Participants in the over-the-counter (OTC) derivatives markets are hopeful that with the adoption of new legislation, some of the regulatory uncertainty in this market will be clarified and that the market will become less opaque. At the same time, there is much concern and apprehension that proposed legislation might unduly restrict the use of OTC derivatives products that have proven to be a cost-effective means of managing risk on both Wall Street and Main Street.

Through much of 2009, the U.S. Congress debated legislative proposals aimed at reforming the financial system that could dramatically change the way the OTC derivatives industry operates. These proposals may take final form in 2010 and, if enacted, will initiate a new regulatory regime to govern previously lightly regulated OTC transactions. To understand the impact of these changes and to anticipate their ramifications to existing risk management practices, participants in the OTC derivatives market should familiarize themselves with the current legislative landscape.

As we enter a new legislative session in 2010, most of the financial reform proposals put forward in 2009 have fallen by the wayside, with three proposals currently being the most relevant and including provisions that are likely to become parts of a new law enacted in the coming year. Those proposals are: (1) last summer's Obama Administration proposal put forth under the auspices of the U.S. Treasury Department (the Administration Proposal); (2) the Wall Street Reform and Consumer Protection Act of 2009, passed by the U.S. House of Representatives on December 11, 2009 (H.R. 4173, or the Joint House Bill); and (3) the Restoring American Financial Stability Act of 2009, proposed by Senator Chris Dodd, Chairman of the Senate Banking Committee (the Dodd Bill). In addition to these three proposals, it is expected that Senator Blanche Lincoln, Chairman of the Senate Agriculture Committee, will submit a draft bill addressing derivatives regulation in the near future. The prospect of a new bill proposed by Senator Lincoln, coupled with the announced negotiation of a revised Dodd Bill by Senate Banking Committee Democrats and Republicans, provide ample opportunity for changes to be made to the Senate version of a derivatives regulatory bill. As a result, meaningful input in the legislative drafting process is still possible. However, this window of opportunity is quickly closing, with Senator Dodd and others announcing that a new Senate bill could be introduced before the end of January.

Each of the aforementioned proposals would bring far-reaching oversight and regulation to the previously lightly regulated OTC derivatives industry. They will affect industry participants in unique ways based on a number of new regulatory categories and classifications. Though generally similar in structure, the current proposals differ in separate ways that may be significant to individual market participants. To understand the impact of these changes, and to anticipate their ramifications for existing risk management practices, participants in the OTC derivatives market should familiarize themselves with the current legislative proposals.

We have linked to this Legal Alert a chart highlighting the similarities and differences among the Administration Proposal, the Joint House Bill, and the Dodd Bill for certain of the proposed provisions that could significantly alter the way OTC markets work:

- Required Clearing and Trading
- New Requirements Imposed on Dealers
- Regulation of Major Swap Participants
- Position Limits on Commodity and Other Contracts

The discussion below provides an overview of the major regulatory changes summarized in the chart.

Clearing and Trading Requirements

One of the most dramatic of the proposed changes to the regulation of OTC derivatives is the forced clearing and trading of many transactions that heretofore have been largely bilaterally executed in the OTC markets. Although the legislative proposals differ slightly in their terminology and definitional framework, each will require the clearing of all OTC trades that are accepted for clearing by a board of trade designated as a clearing organization. In each case, however, this expansive requirement comes with an exception for typical corporate end-user participants. These exceptions generally exclude from mandatory clearing those transactions where one of the counterparties is not a dealer, or a "Major Swap Participant" or "Major Security-Based Swap Participant" (together referred to herein as an MSP). The Administration Proposal, the Joint House Bill and the Dodd Bill each vary this end-user exception with additional requirements and/or specifications (see linked chart).

For those transactions that must be cleared, each of the proposals would also require that such transactions be traded on an exchange unless the specific transaction at issue is not available for trading on an exchange. Moreover, even if a transaction is not forced onto a clearinghouse or traded on an exchange, it will still be subject to new regulatory oversight. In particular, each of the current proposals contains new reporting requirements for those transactions that continue to be executed in the OTC market.

Even though end-users are not subject to these clearing and trading requirements, increased dealer costs associated with these new trading arrangements—primarily driven by funding costs required to meet clearinghouse and exchange margin requirements—will likely be passed on to end-users via bilateral collateral requirements or wider dealer spreads.

Foreign exchanges or clearinghouses accessible by U.S. market participants might also become subject to these and other new U.S. regulatory requirements under the proposed laws. Both the Administration Proposal and the Dodd Bill provide the U.S. Commodity Futures Trading Commission (CFTC) with the authority to adopt rules requiring the registration of foreign boards of trade that offer direct access to participants located in the United States. Additionally, all three current proposals would force foreign boards of trade offering contracts that are linked to the closing prices of U.S.-based contracts to comply with CFTC information, recordkeeping, position limit, and oversight requirements.

Interestingly, in the United Kingdom (UK), while agreeing generally with the objectives of U.S. regulators and legislators, the recent White Paper on "Reforming OTC Derivatives Markets" (UK White Paper)—issued by the British Treasury office and the UK's principal financial regulator, the Financial Services Authority (FSA)—questions a number of the U.S. proposals regarding clearing and exchange trading and concludes that such proposals "could have potentially damaging impacts on financial markets." According to the UK White Paper, 43% of the global OTC market is located in the UK. Thus, this White Paper represents a significant regulatory rift that could affect the U.S. legislation and will certainly affect implementation of any legislation that is ultimately adopted in the United States. In particular, the UK White Paper questions whether it is prudent to require all "standardized" trades to be centrally cleared, pointing out that "standardization" is but one of several factors (e.g., regular availability of prices, sufficient market liquidity, and whether the product contains inherent risks that cannot be mitigated) to be considered in determining whether a product can be effectively risk managed by a central clearing entity. The UK White Paper also expresses concern about aggregating risk in central counterparties that could themselves be rendered insolvent on account of the default of several of their members.

New Requirements Imposed on Dealers

Each of the three legislative proposals also imposes new requirements upon "dealers," a category that includes any person who, as part of a regular line of business, engages in buying and selling swaps. The most significant of these requirements, if adopted as expected, will impose new or additional capital and margin requirements on dealers. While the Joint House Bill addresses these requirements with a broad brush, the Administration Proposal and the Dodd Bill both specify that capital requirements for those dealers who are already regulated will be increased so that capital held for cleared swaps must be greater than zero and capital held for non-cleared swaps must be sufficient to offset the greater risk to the dealer and the financial system arising from use of swaps. Dealers who are not already subject to bank regulation will be required to have capital requirements put in place that are as strict or more strict than those of dealers who are subject to bank regulation. Minimum initial and variation margin requirements may also be imposed on dealers, with certain exceptions carved out for non-cleared swaps with a counterparty who is not a swap dealer, or where the counterparty is using the swap as part of an "effective hedge" or predominantly engaged in activities that are not financial in nature. If requested by a counterparty, dealers may also be required to deposit collateral or margin in a segregated account with a third-party custodian.

As previously noted regarding mandatory clearing (with margining), these requirements—particularly those requiring increased capital and limited rehypothecation (use) by dealers of collateral and margin posted to them—will almost certainly increase the cost of these transactions for dealers. Again, such costs are likely to be passed on by dealers to end-users (e.g., through bilateral collateral requirements or wider spreads) to compensate for margin funding costs, even if the end-users themselves are not directly subject to the new regulatory requirements.

Additionally, dealers will be required to register with the CFTC and/or the U.S. Securities and Exchange Commission (SEC)—depending on the type of swaps they buy and sell (i.e., commodity swaps or security-based swaps, respectively)—and be subjected to reporting and recordkeeping requirements, as well as business conduct standards, to make certain that there is an established standard of care to ensure that their customers are eligible to enter into swap transactions and that appropriate disclosure is made of any material risks, the source and amount of any fees, material incentives, or any conflicts of interest.

The proposals also address documentation requirements as well as "back office" standards, which impose responsibilities on dealers to monitor trading and to establish and enforce internal systems and procedures.

Regulation of Major Swap Participants

In addition to the requirements imposed upon dealers, the proposed legislation provides for substantial dealer-like requirements to be imposed upon certain large end-users of OTC derivatives products. The proposals all refer to these large end-users as MSPs, but each of the proposals defines an MSP differently. A derivatives market participant that becomes classified as an MSP will face potentially significant capital, margining and other operational, reporting and recordkeeping burdens that it would not otherwise confront as a mere end-user of derivatives.

With each new legislative proposal, the defining characteristics of an MSP have significantly evolved. The Administration Proposal originally defined an MSP as a person other than a dealer who maintains a substantial net position in outstanding swaps. Also, under the Administration Proposal, swaps that were entered into to create and maintain an effective hedge under Generally Accepted Accounting Principles (GAAP) were excluded from the net position of the end-user for purposes of determining whether it maintained a "substantial net position."

MSP was similarly defined under the Joint House Bill as a non-dealer who maintains a substantial net position in outstanding swaps. However, the exclusion proposed by the Joint House Bill is much broader than the GAAP effective hedge exclusion in the Administration Proposal. Under the Joint House Bill, derivatives positions held primarily for hedging, reducing or otherwise mitigating a person's commercial risk are not considered for purposes of determining whether the non-dealer end-user has a substantial net position in outstanding swaps. In one respect, however, the definition of MSP in the Joint House Bill is broader than in the Administration Proposal. Unlike the Administration Proposal, the Joint House Bill also defined an MSP to include a non-dealer end-user whose outstanding swaps create substantial net counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial services markets.

In the third main legislative proposal, the Dodd Bill, the hedging exception is totally excluded from the definition of an MSP. Instead, in defining MSP the Dodd Bill relies exclusively on the "substantial net counterparty exposure" concept from the Joint House Bill. Under the Dodd Bill, a non-dealer is an MSP if other market participants have net counterparty swap transaction exposure to the non-dealer that would expose the other market participants to significant credit losses if the non-dealer defaulted on the swap transactions.

None of the proposals elaborates on, or provides guidelines for, interpreting phrases—such as "substantial net position," "substantial net counterparty exposure which could have serious adverse effects" or "significant credit losses" —that are used in the various definitions of an MSP and could be subject to a range of disparate views. For example, whether collateral or margin held by one counterparty would diminish the "net counterparty exposure" is not addressed. The Joint House Bill and the Dodd Bill do, however, call for the CFTC and/or the SEC, as applicable based on the types of swaps being regulated, to adopt additional rules elaborating on the definitions of an MSP. The Joint House Bill calls for the applicable regulators to define by rule or regulation the term "substantial net position" at a numerical threshold, prudent for the effective monitoring, management and oversight of entities that can significantly impact the financial system. The Dodd Bill more generally requires regulators to adopt rules further defining MSP within 180 days of the bill's effective date.

The differences among the definitions of an MSP in each of the three proposals, although seemingly slight, are materially important. Depending on how these concepts are interpreted by regulators, they could greatly expand or restrict the number of non-dealer participants in the derivatives markets that become classified as MSPs.

Position Limits on Commodity Contracts

Each of the three relevant proposals would significantly expand the authority of the CFTC to impose position limits on both exchange-traded commodities and OTC swaps that "perform or affect a significant price discovery function" in order to prevent—as expressed in the Joint House Bill—"excessive speculation," "market manipulation," and "squeezes and corners," "to ensure sufficient market liquidity for bona fide hedgers," and to "avoid disruption of market price discovery function." Of course, this is a balancing act because some amount of speculation is in fact necessary to facilitate the price discovery function performed by the futures markets. There is also an effort to take cognizance of international trading by, among other things, providing the CFTC authority to address contracts traded on a foreign board of trade that settle against a price listed on a domestic contract.

With respect to security-based swaps, both the Joint House Bill and the Dodd Bill would amend the Securities Exchange Act of 1934 to allow the SEC to establish position limits with respect to security-based swaps to prevent fraud and manipulation.

The most recent of the key proposals, the Joint House Bill, breaks new ground with respect to position limits by incorporating the idea that OTC trades that are "economically equivalent" to futures contracts and options on futures contracts should also be subject to identical requirements. Other differences between the Joint House Bill and the other two proposals are that the Joint House Bill seeks to provide additional guidance to the CFTC with respect to identifying transactions or positions that should qualify for the "bona fide hedging" exception, and also provides for ongoing formalized Congressional oversight of whatever position limits are adopted by the CFTC. Although the concept of a bona fide hedging exception is incorporated into the provisions authorizing the SEC to establish positions, for securities-based swaps, no guidance is provided as to what this might mean.

Interestingly, the UK White Paper previously noted takes strong exception to the proposed position limit regulatory regime contemplated by the regulatory proposals in the United States. The UK authorities directly question some of the assumptions underlying the position limit provisions of the U.S. proposals, namely whether there is any basis for treating commercial hedgers differently from financial participants (e.g., speculators) in terms of preventing market manipulation and whether there is any sound factual basis for associating large commodity price movements with the growing interest in commodities investments by the investing public. The UK White Paper raises particular questions regarding the feasibility of imposing position limits on OTC markets because of the complex, disparate and international nature of those markets.

There are no indications that the reservations concerning position limits expressed in the UK White Paper are shared by U.S. regulators or the legislators supporting the current regulatory proposals. As such, participants in the derivatives markets may be forced to adjust to new position limit standards that could require them to re-think conventional hedging strategies.

Conclusion

The regulatory changes highlighted above will affect both the operational and the financial terms of OTC transactions in significant ways. Whether a dealer or MSP facing new capital, disclosure, reporting, and clearing requirements or an end-user transacting with a dealer or MSP counterparty, the broad scope of the current regulatory proposals will touch almost all transactions currently executed in the OTC market. Market participants may be forced to re-think their hedging strategies, counterparty relationships and transaction terms to account for the new regulatory landscape. Those businesses that proactively plan for how to address regulatory changes will be in the best position to succeed in this new world of OTC regulation.

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