

Proposals to Reform the OTC Derivatives Market Differ in Certain Key Respects

Contributed by: Robert Claassen and Peiyi Zhao, Paul Hastings

In response to last year's financial crisis, three pieces of legislation have been introduced to tighten regulation of the over-the-counter (OTC) derivatives market. On August 11, 2009, the Obama Administration released its proposal entitled, "OTC Derivatives Markets Act of 2009" (Administration Proposal). On November 11, 2009, the Senate Banking Committee, led by Senator Christopher Dodd, introduced a proposal called, "Restoring American Financial Stability Act of 2009" (Dodd Proposal) to overhaul the financial system, including the OTC derivatives market. On December 11, 2009, the House passed a package of bills named, "Wall Street Reform and Consumer Protection Act" (House Bill), one of which covers the reform of the OTC derivatives market.¹

The three proposals would establish a regulatory regime where OTC derivatives transactions would either be subject to mandatory clearing, or be reported to a trade repository. Derivatives dealers and "major swap participants" would be required to register with the Commodity Futures Trading Commission (CFTC) or the Securities and Exchange Commission (SEC), and meet capital and margin requirements. Position limits on derivatives would be aggregated to avoid market manipulation. While all three proposals aim to bring transparency and accountability to the \$600 trillion global derivatives market, they differ in certain respects as to who the rulemaking regulators are, how "major swap participant" is defined, and how clearing and exchange trading, capital and margin requirements, and position limits are determined.²

Rulemaking Regulator

Under the Administration and Dodd Proposals, rulemaking authority would be held jointly by the CFTC and SEC. The CFTC would have jurisdiction over swaps, swap dealers, and major swap participants, and the SEC would have jurisdiction over security-based swaps, security-based swap dealers, and major security-based swap participants (collectively, swaps, swap dealers, and major swap participants). If the CFTC and SEC fail to act jointly, the Secretary of the Treasury would issue final rules under the Administration Proposal, while a newly created Agency for Financial Stability would issue final rules under the Dodd Proposal.

The House Bill would not follow a joint rulemaking approach. Instead, the CFTC and SEC would independently make rules within their jurisdictions after consulting with each other and prudential regulators. If conflicting rules arise, either agency would be able to petition the U.S. Court of Appeals for the D.C. Circuit to resolve discrepancies. The CFTC and SEC, however, would jointly adopt rules to define the terms "security-based swap agreement" and "swap." If they are unable to jointly

prescribe these rules, a newly created Financial Services Oversight Council would resolve the impasse.

Definition of "Major Swap Participant"

The definition of "major swap participant" is one of the hotly debated issues in the proposals. Once classified as a "major swap participant," the OTC derivatives market participant would be subject to comprehensive federal regulation and supervision. A major swap participant would be required to register with the CFTC or SEC, clear and trade certain swaps held, satisfy minimum capital and margin requirements, as well as comply with business conduct, reporting, and disclosure rules.

The Administration Proposal would define "major swap participant" as "any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps." What would constitute a "substantial net position" is undefined. The House Bill would add into the definition any person whose outstanding swaps "create substantial net counterparty exposure that would have serious adverse effects on the financial stability of the United States banking system or financial markets." The terms "substantial net position" and "substantial net counterparty exposure" would be left for the CFTC and SEC to define. Under the Dodd Proposal, "major swap participant" is defined as any person "who is not a swap dealer, and whose outstanding swaps create net counterparty credit exposure to other market participants that would expose them to significant credit losses in the event of the person's default." The term "significant credit losses" is undefined.

The Administration Proposal would exempt from the definition of "major swap participant" any person to the extent his use of swaps is for hedging purposes under generally accepted accounting principles (GAAP). In addition to hedging, the House Bill would exempt any person who maintains substantial net positions in outstanding swaps, if he holds swaps primarily for hedging, reducing, or mitigating commercial risk. This exemption, however, would not be available to a person whose outstanding swaps create "substantial net counterparty exposure," as determined by the CFTC or SEC. The Dodd Proposal does not contain any exemption from the classification.

Mandatory Clearing and Exchange Trading

The Administration Proposal would require all "standardized" swaps to go through centralized clearing. Swaps would be presumed to be standardized if they are accepted for clearing by a regulated clearinghouse. The CFTC and SEC would jointly define what constitutes standardized swaps. Under the House Bill and Dodd Proposal, swaps would be submitted for clearing if a regulated clearinghouse accepts the swaps for clearing, and the CFTC/SEC has determined that the swaps are required to be cleared. After making such determination, the counterparties of the swaps or the CFTC/SEC could request a stay of the clearing requirement until the CFTC/SEC completes a review of the terms of the swaps.

Under the Administration and Dodd Proposals, clearing would not be required if no regulated clearinghouse accepts the swaps for clearing, or one of the counterparties is an end-user—a person who is neither a swap dealer nor a major swap participant.

The clearing exemption under the House Bill would be slightly different. Clearing would be exempted if one of the counterparties to the swaps is an end-user, is using swaps to hedge or mitigate commercial risk, including operating or balance sheet risk, and notifies the CFTC or SEC how it generally would meet the financial obligations associated with entering into non-cleared swaps.

All three proposals would require cleared swaps to be traded on a board of trade, a regulated securities exchange, or an alternative swap execution facility. Under the Administration and Dodd Proposals, trading would not be required if no regulated clearinghouse accepts the swaps for clearing. Under the House Bill, trading would not be required if no board of trade, regulated securities exchange, or alternative swap execution facility would make the swaps available for trading.

Capital and Margin Requirements

In an effort to protect counterparties against default, each of the three proposals would impose capital and margin requirements on swap dealers and major swap participants. Prudential regulators, under the Administration Proposal and the House Bill, and a newly established Financial Institutions Regulatory Administration (FIRA), under the Dodd Proposal, would impose a greater than zero capital requirement for cleared swaps from bank swap dealers and major swap participants, and a higher capital requirement for non-cleared swaps. Under all three proposals, the CFTC and SEC would impose capital requirements for non-bank swaps as strict as or stricter than those set by prudential regulators or the FIRA.

Under the Administration Proposal and House Bill, prudential regulators would impose initial and variation margin requirements on non-cleared swaps held by bank swap dealers and major swap participants. The House Bill would exempt such margin requirements, if one of the counterparties is an end-user. The Administration Proposal would further require such end-user to show he uses the swaps as part of an effective hedging strategy, and engages in activities that are not predominantly financial in nature. The Dodd Proposal is similar to the Administration Proposal, except that the FIRA, instead of prudential regulators, would set margin requirements. Also, before granting an exemption, the FIRA would consult with the Agency for Financial Stability, CFTC and SEC. If the Agency for Financial Stability rejects the exemption, the FIRA would not be allowed to grant such exemption. For non-cleared swaps held by non-bank swap dealers and major swap participants, under all three proposals, the CFTC and SEC would impose margin requirements as strict as or stricter than those set by prudential regulators.

Position Limits

All three proposals would authorize the CFTC to establish aggregate position limits for swap contracts listed by designated contract markets, contracts traded on foreign boards of trade, and swap contracts that would perform or affect a significant price discovery function. The CFTC would consider price linkage, arbitrage, material price reference, material liquidity, and other relevant factors in determining whether a swap contract would perform a significant price discovery function. The House Bill

would also authorize the CFTC to set position limits, other than bona fide hedge positions, on physically deliverable commodities.

For security-based swaps, the Administration and Dodd Proposals would require the SEC to adopt rules establishing aggregate position limits for securities listed on a national securities exchange, and security-based swaps that perform a significant price discovery function. The House Bill would allow the SEC to aggregate security-based swaps, and any security, loan, or index of securities or loans on which such security-based swaps are based.

Conclusion

The major differences among the three proposals are who would be classified as "major swap participants" and to what extent end-users would be exempted from regulation. The Dodd Proposal would define "major swap participant" in a way that captures swap participants whose outstanding swaps would create counterparty credit exposure and significant credit loss, even if swaps were used for hedging or commercial risk mitigation purposes. The definition under the Administration Proposal, on the other hand, would only cover swap participants who maintain a substantial net position in swaps. End-users would be exempted from mandatory clearing, except that the House Bill would also require end-users to show they use swaps to hedge or mitigate commercial risk and meet their financial obligations. As for margin requirements, under the House Bill, swap dealers and major swap participants would be exempted if one of the counterparties is an end-user. However, under the Administration and Dodd Proposals, the end-user would be further required to show he uses the swaps for hedging and engages in non-financial activities. Lawmakers are challenged to reconcile all the differences in these proposals before a final bill can be crafted and passed into law.

OTC Derivatives Regulation Comparison Chart

	Administration Proposal	House Bill	Dodd Proposal
Rulemaking Regulator	CFTC and SEC would jointly make rules. If conflicting rules arise, the Secretary of the Treasury would make final rules.	CFTC/SEC would make rules independently. If conflicting rules arise, each commission would petition the D.C. Circuit Court for resolution.	CFTC and SEC would jointly make rules. If conflicting rules arise, the Agency for Financial Stability would make final rules.
Definition of "major swap participant" (MSP)	A non-dealer who maintains a substantial net position in outstanding swaps. <u>Exemption:</u> Hedging under GAAP.	A non-dealer who maintains a substantial net position in swaps, or if his swaps create counterparty exposure that could have serious adverse effects on the stability of the U.S.	A non-dealer whose outstanding swaps would create net counterparty credit exposure to other market participants that would expose them to significant

		banking system or financial market. <u>Exemption:</u> hedging, reducing or mitigating commercial risk by a person who maintains a substantial net position in swaps.	credit losses in the event of the person's default. <u>No Exemptions</u>
Mandatory Clearing	"Standardized" swaps would be cleared. CFTC and SEC would jointly define the term "standardized." <u>Exemption:</u> One party is an end-user, or no regulated clearinghouse would accept the swaps.	Swaps would be submitted for clearing if a regulated clearinghouse accepts the swaps for clearing, and the CFTC/SEC has determined the swaps are required to be cleared. CFTC/SEC could stay clearing pending review. <u>Exemption:</u> One party is an end-user, is using swaps to hedge or mitigate commercial risk, including operating or balance sheet risk, and shows ability to meet financial obligation.	Swaps would be presumed to be cleared if a regulated clearinghouse accepts the swaps. Need CFTC/SEC's prior approval. CFTC/SEC could stay clearing pending review. <u>Exemption:</u> One party is an end-user, or no regulated clearinghouse would accept the swaps.
Mandatory Exchange Trading	Standardized swaps would be traded on a board of trade, an exchange or an alternative swap execution facility (ASEF). <u>Exemption:</u> No regulated clearinghouse would accept the swaps for clearing, or one party is an end-user.	Swaps subject to clearing would be traded on a board of trade, an exchange or an ASEF. <u>Exemption:</u> No board of trade, exchange or ASEF would list the swaps for trading.	Same as the Administration Proposal.
Capital requirements for bank dealers and MSPs	Prudential Regulators (PRs) would set capital requirements greater than zero for cleared swaps, and higher capital requirements for non-cleared swaps.	Same as the Administration Proposal.	The Financial Institutions Regulatory Administration (FIRA) would set capital requirements greater than zero for cleared swaps, and

			higher capital requirements for non-cleared swaps.
Capital requirements for non-bank dealers and MSPs	CFTC and SEC would set capital requirements as strict as or stricter than capital requirements set by PRs.	Same as the Administration Proposal.	Same as the Administration Proposal.
Margin requirements for bank dealers and MSPs	PRs would set both initial and variation margin requirements for non-cleared swaps. PRs could, but not required to, set margin requirements if one of the counterparties is an end-user, uses the swaps for hedging under GAAP, and engages in non-financial activities.	PRs would set both initial and variation margin requirements for non-cleared swaps. PRs could, but not required to, set margin requirements if one of the counterparties is an end-user. Non cash collaterals would be used to satisfy such margin requirements.	Same as the Administration Proposal, except that FIRA would set both initial and variation margin requirements. Before granting an exemption, FIRA would consult with the Agency for Financial Stability, CFTC and SEC. If the Agency for Financial Stability rejects the exemption, FIRA could not issue such exemption.
Margin requirements for non-bank dealers and MSPs	CFTC and SEC would set margin requirements as strict as or stricter than margin requirements set by PRs.	Same as the Administration Proposal.	Same as the Administration Proposal.
Position limits	CFTC would set aggregate position limits for swaps listed by designated contract market, swaps traded on foreign board of trade, and swaps that perform a significant price discovery function. SEC would set aggregate position limits for securities listed on a national exchange, and	CFTC would aggregate position limits for swaps listed by designated contract market, swaps traded on foreign boards of trade, and swaps that perform a significant price discovery function. CFTC also would set position limits, other than bona fide hedge positions, on physically deliverable commodities. SEC would aggregate position limits for	Same as the Administration Proposal.

	security-based swaps that perform a significant price discovery function.	security-based swaps, and any security, loan, or index of securities or loans on which such security-based swap is based.	
--	---	---	--

Rob Claassen is chair of Paul Hastings' derivatives and structured products group. He is based in the firm's Palo Alto office. Peiyi Zhao is an associate in the corporate department of Paul Hastings and is based in the firm's Palo Alto office.

¹ Relevant amendments to the House Bill are available at:
http://www.rules.house.gov/111/SpecialRules/hr4173/3_peterson_hr4173.pdf;
http://www.rules.house.gov/111/SpecialRules/hr4173/6_murphy_hr4173.pdf.

² A chart that compares the major differences of the three proposals is appended to this article.