

August 17, 2009

Treasury OTC Derivatives Legislative Proposal

Treasury Department Releases Over-the-Counter Derivatives Markets Act of 2009, Bringing OTC Derivatives Under Comprehensive Regulatory Supervision.

SUMMARY

On August 11, the Treasury Department released the Over-the-Counter Derivatives Markets Act of 2009 (“OCDMA”), its legislative proposal to regulate the over-the-counter (OTC) derivatives industry. The proposed legislation provides an approach to comprehensively regulating OTC derivative transactions and the entities that enter into OTC derivatives transactions. Through its proposal, the Treasury Department is recommending the repeal of many provisions of the Commodity Futures Modernization Act (“CFMA”), which was adopted in 2000.

BACKGROUND

On August 11, the Treasury Department released the Over-the-Counter Derivatives Markets Act of 2009 (“OCDMA”), its legislative proposal to regulate the over-the-counter (“OTC”) derivatives industry.¹ The proposed legislation closely follows the proposals offered by Treasury Secretary Timothy Geithner² and Commodity Futures Trading Commission (“CFTC”) Chairman Gary Gensler³ earlier this year. Treasury’s proposed legislation shares similar themes with the joint principles⁴ offered by House Agriculture Committee Chairman Colin Peterson and House Financial Services Committee Chairman Barney Frank, whose Committees have jurisdiction over the federal banking regulators, the Securities and Exchange Commission (“SEC”) and the CFTC. Given the full legislative agenda of the Senate in the fall, it is expected that the House of Representatives will move first on drafting OTC derivatives legislation, likely using the Administration legislative proposal as a template for its own legislation. It remains unclear if Congress will pass OTC derivatives legislation in the remaining Congressional legislative session.

However, should the climate change/energy legislation and healthcare reform efforts stall, lawmakers will turn their attention to financial reform, including regulation of OTC derivatives.

FRAMEWORK OF LEGISLATION

The OCDMA effectively divides regulatory authority over OTC derivatives between the CFTC and the SEC, reflecting the current division of jurisdiction between the agencies in the futures markets. Specifically, under the OCDMA, security-based swaps and credit derivatives based on a single security or issuer, or a narrow based group of securities, will be regulated by the SEC and swaps and credit derivatives based on broad-based indices will be regulated by the CFTC. The same division will also apply to swaps based on corporate debt and event-based contracts. All other OTC products, including interest rate, currency and commodity swaps, will fall under the control of the CFTC. However, federal banking regulators will maintain their jurisdiction over identified banking products (as defined by the Commodity Futures Modernization Act of 2000), unless the appropriate federal banking agency, in consultation with the CFTC and/or SEC, determines that the banking product has been structured in such a way that it performs the same function as a swap or was structured in a way to avoid regulation. If the regulators make that determination, the banking product will be regulated by the CFTC or the SEC.

The bill sets an aggressive timeline – 6 months to 1 year, for the agencies to implement the required rule-makings. Swap transactions entered into before the enactment of OCDMA must be reported to a regulated repository within 6 months of the effective date of the regulation.

Treatment of Standardized and Customized OTC Contracts

OCDMA requires all standardized OTC contracts to be executed either on an exchange or an “alternative swap execution facility” (“ASEF”, a newly created term), and to be cleared through a central clearing party (“CCP”) that is regulated as a derivatives clearing organization by the CFTC or a securities clearing agency regulated by the SEC. Any OTC derivative that is accepted by any CCP for clearing is presumed to be standardized. In addition, OCDMA identifies several criteria to determine if an OTC contract is standardized, including the extent to which the terms of the contract, including price, are disseminated to third parties or referenced in other agreements, contracts, or transactions; the volume of transactions for the particular contract; and the extent to which the terms are similar or different to other contracts that are cleared. However, if one of the counterparties is not a swap dealer or major swap participant (“MSP”) and is unable to meet the eligibility requirements of the CCP, there is no execution or clearing requirement. Of course, this raises the concern that CCPs will expand their eligibility criteria to capture this business.

Contracts that are not standardized must be centrally cleared or reported to a regulated trade repository. However, a customized contract will not be required to be cleared and will still be permitted to be traded over-the-counter, if all of the following conditions are satisfied -- (1) one counterparty is not a swap dealer or MSP; (2) that party is predominantly engaged in nonfinancial activities; and (3) it uses the swap to hedge under generally accepted accounting principles (“GAAP”). Through the CCP and trade repository,

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regulators will have access to information about OTC derivative transactions and related open positions of individual market participants; the public will have access to aggregated data on open positions and trading volumes.

The proposed legislation provides legal certainty for any hybrid instrument sold to any investor or any swap agreement, contract, or transaction between eligible contract participants or persons reasonably believed to be eligible contract participants despite the failure of either transaction to meet the definition of a swap or to be cleared pursuant to OCDMA. However, this safe harbor does not extend to security-based swaps.

As currently written, OCDMA could limit or prohibit end-user access to customized swaps. First, unless the swap is used precisely to hedge market or credit risks under GAAP, any customized swap transaction will be subject to super margin and capital requirements, creating a significant cash flow issue for commercial entities. Furthermore, as derivatives clearing organizations (“DCO”) expand their criteria as to which contracts can be cleared, this will substantially limit the universe of contracts that are not standardized, given that once an OTC derivative contract is cleared by any DCO, unless it meets the criteria above, including compliance with GAAP, it will be considered a standardized contract and must be executed and cleared. As a result, many corporate entities will no longer have access to the customized OTC derivative transactions they use to hedge market price risks.

Regulation of OTC Dealers

The proposed legislation would create new categories of market participants under the Commodity Exchange Act and directs the CFTC and the SEC to adopt joint interpretations of the defined terms, which includes “swap,” “swap dealer,” “swap repository,” and “major swap participant.” Under OCDMA, the definition of a swap subject to the statute will not include: any sale of a nonfinancial commodity for deferred shipment or delivery, so long as such transaction is physically settled; equity securities, or foreign exchange swaps or forwards. However, a currency swap will be considered a commodity swap under the proposed legislation, as are credit spreads, credit default swaps, and credit swaps. A major swap participant (“MSP”) is defined as an entity that is not a swap dealer, but that maintains significant positions in outstanding swaps that are not for hedging purposes.

The proposed legislation requires federal banking regulators, the CFTC, and the SEC to impose strict capital and margin requirements on all OTC derivative dealers and MSPs. Federal banking regulators will have authority over banks that act as swap dealers and the CFTC and the SEC will have jurisdiction over non-bank swap dealers. Swap dealers and MSPs will be required to maintain prescribed levels of capital, daily trading records and records of their communications with counterparties, and will be required to comply with business conduct standards set by the CFTC: to disclose material risks of swap transactions; the source and amount of fees or remuneration that swap dealer/MSP would receive; and other material incentives/conflicts. The CFTC and SEC will be required to “harmonize” their regulatory regimes for swap

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dealers and MSPs. The proposed legislation raises the significant concern that the definition of swap dealer or major swap participant could reach commercial entities whose working capital constraints will not allow them to meet these new capital or margin requirements.

For customized, bilateral contracts, the end-user will be required to post margin to the swap dealer and the relevant regulatory authority will perform audits of the dealer to ensure that proper margin is posted. In turn, this may require additional legislative and/or regulatory changes to protect the margin posted by the end-user. Again, the narrow carve-out for non-financial entities using OTC derivative contracts to hedge price risk may limit or make customized OTC transactions inaccessible for non-financial entities that do not qualify for the limited exemption.

Additional clarification will be needed from Congress and/or the CFTC and SEC to determine whether entities such as hedge funds will be deemed MSPs; and what will happen to commodity forwards that do not result in physical settlement, even if their terms call for physical delivery. The lack of clarity with regard to the exemption of forward settled contracts could create substantial legal uncertainty, which had largely been eliminated by the Commodity Futures Modernization Act, as parties might not know if their forward contract will be treated as such or as a swap subject to regulations until maturity.

Position Limits

The proposed legislation gives the CFTC and the SEC authority to set aggregate position limits and large trader reporting requirements for OTC derivatives that perform a significant price discovery function and to aggregate positions across futures markets, OTC markets and foreign boards of trade. The CFTC will also have the authority to grant hedge exemptions from the aggregate position limits.

During the end of July and the first week of August, the CFTC concluded several hearings on whether the CFTC should take certain actions to address concerns over “excessive speculation” in the energy futures markets, including the direct imposition by the CFTC of federal speculative positions on energy commodities. The CFTC also sought additional comments on whether it should eliminate hedge exemptions for swap dealers with respect to their positions in futures contracts that offset their exposure to their noncommercial counterparties.⁵ While the CFTC did not announce or propose any specific steps with regard to position limits or hedge exemptions at the hearings, several Commissioners noted that the CFTC did not have the authority it needed to set aggregate position limits on OTC contacts.⁶ It is very likely that the CFTC will move directly to set federal speculative (hard) position limits later this fall and given the authority to, will set aggregate position limits across different markets. It is also likely that the CFTC will move forward, in some form, on limiting hedge exemptions for swap dealers and/or noncommercial market participants.

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Regulation of Securities-Based Swaps

In a repeal of the provisions of the Gramm-Leach-Bliley Act and the CFMA, OCDMA defines “securities-based swap” as “securities” under the Securities Act of 1933, so that if an issuer offers a swap, for the purposes of the Securities Act the issuer is deemed to have offered the underlying security. There is also a registration requirement for a securities-based swap, if offered to a non-eligible contract participant, as the proposed legislation broadens the definition of Section 13(d) to include securities-based swaps for the purposes of determining beneficial ownership. However, securities-based swap transactions can still be done as private placements without registration under the Securities Act or the Exchange Act of 1934.

Additional clarification from Congress and the CFTC and/or SEC will be needed for the definition of a swap, since, as currently drafted, it excludes options on securities and securities indices, which effectively exempts them from the mandatory exchange trading and clearing requirements of OCDMA. However, equity swaps and equity variance swaps are not exempt.

In addition, the expansion of Rule 13d beneficial ownership to security-based swaps creates serious implications under Section 16(a) reporting requirements and Section 16(b) short-swing profit rule.

Exemption of Foreign Exchange Contracts

The exclusion of foreign exchange swaps and forwards from the definition of swaps effectively excludes these contracts from additional regulation under OCDMA. The Administration noted that these transactions are not considered OTC derivative transactions under “generally prevailing market conventions,” have significant economic differences from derivatives, including short time-frames, high turnover ratios and involve physical exchanges of principal, and bank regulators currently have access to information and authority over these markets. However, OCDMA does cover currency-related swaps and options. The distinction between foreign exchange and currency swaps is unclear.

Additional Provisions

The proposed legislation gives the CFTC authority to prohibit access to foreign boards of trade (“FBOT”) that provide direct access to contracts linked to U.S.-listed contracts, unless the FBOT implements certain regulatory standards that are “comparable” to the requirements applied by the U.S. exchange.

The proposed legislation also directs the CFTC to require futures commission merchants and brokers to implement appropriate informational barriers between the trading activity of a firm and the research unit that may cover some of the products being traded. This issue was raised by several CFTC Commissioners during the recent CFTC hearings on excessive speculation in the energy markets.

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ENDNOTES

- ¹ The Over-the-Counter Derivatives Markets Act of 2009 is available at:
<http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf>
- ² The Treasury Proposal is available at: http://www.financialstability.gov/latest/tg_05132009.html
- ³ The CFTC's Proposal is available at:
<http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opagensler-3.pdf>
- ⁴ The Frank-Peterson Principles are available at:
http://www.house.gov/apps/list/press/financialsvcs_dem/otc_principles_final_7-30.pdf
- ⁵ This spring, the CFTC released a Concept Release on whether or not to eliminate bona fide hedge exemptions for swap dealers, and to replace them with limited risk management exemptions.

The Concept Release is available at:
<http://www.cftc.gov/stellent/groups/public/@lfederalregister/documents/file/e9-6187a.pdf>.

For additional information on the Concept Release, see our Memorandum, CFTC Issues Concept Release Seeking Comment on Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Exemption from Speculative Position Limits, dated March 24, 2009.
- ⁶ For additional information on the CFTC Hearings, see our Memorandums, CFTC Hearings on Energy Markets, dated August 11, 2009 and CFTC Considers Direct Imposition of Speculative Position Limits on Energy and Other Commodities, dated July 9, 2009.

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