

OTC DERIVATIVES RULES IN HOUSE FINANCIAL REFORM BILL (H.R. 4173)

This client update outlines the OTC derivatives provisions in the House financial reform bill (H.R. 4173) summarized in our January 8, 2010 client update. We summarized the Treasury Department's proposal for OTC derivatives reform in our September 9, 2009 client alert.

Key Takeaways

1. The House bill follows the Treasury proposal requiring swaps to be cleared and traded on a regulated facility.
2. The clearing requirement is not applicable for swaps involving a party (i) that is not a swap dealer, (ii) that uses the swap to hedge a commercial risk, (iii) whose outstanding swaps do not contain a net counterparty exposure that could have "serious adverse effects on the financial stability of the United States banking system or financial markets" and (iv) who notifies the CFTC or the SEC as to how it meets its obligations under non-cleared swaps.

House Bill Follows Treasury Proposal to Require Clearing and Exchange Trading for Specified Transactions But Adds Exemption for Commercial Hedgers

Both the Treasury proposal and the House bill would require that swaps be cleared and traded on a regulated facility unless the specific transaction is exempt from that requirement. The House bill would add an exception for any transaction in which one of the parties is using the swap to hedge commercial risk (defined to include operating or balance sheet risk), so long as that hedging party is not a swap dealer or major swap participant and notifies the CFTC (or the SEC for security-based swaps) how it generally meets its financial obligations under non-cleared swaps (or security-based swaps). There is a separate exception for transactions that are not accepted for clearing or execution by any regulated facility or, in the case of clearing, for which the CFTC has not determined such swap is required to be cleared.

As in Treasury's proposed legislation, the term "swap" is used throughout the House bill to cover all types of OTC derivatives, not solely those normally labeled swap. The CFTC is given jurisdiction over swaps (and swap dealers and major swap participants) while the SEC is given jurisdiction over security-based swaps (and security-based swaps and major security-based swap participants). For simplicity, we will refer to swaps, swap dealers, major swap participants and the CFTC. Those references apply equally to the SEC and security-based swap transactions, their dealers, and their major participants. The SEC would make determinations, receive reports, and perform for the security-based swaps market all the functions of the CFTC described below for the swaps market.

Exemption Available to Commercial Hedgers Only if Their Derivatives Positions Do Not Threaten the Banking System or Financial Markets

Because the House bill provides a complete exception from clearing and execution requirements for commercial hedgers so long as they are not swap dealers or major swap participants, the definitions of those terms are crucial in determining whether a swap needs to be cleared or executed on a regulated facility. The House bill's definition of a swap dealer is not controversial in covering any party that meets common sense definitions of a dealer for swaps or for a specific type of swap. Somewhat controversial is that a party's swap dealer status might only apply to a specific type of swap so that the "dealer" could enter into other swaps without meeting clearing and execution requirements (*i.e.*, as a hedger, if it were not otherwise a major swap participant).

The definition of major swap participant was controversial and was ultimately established in the House bill through an amendment. That amendment defined a major swap participant as a non-dealer that either (1) maintains substantial net positions in swaps not used for hedging or mitigating its commercial risk or (2) has outstanding net counterparty swap exposures that could have serious adverse effects on the stability of the US banking system or financial markets. The amendment eliminated a narrower definition that would have treated a hedger as a major swap participant if its counterparty exposures could cause significant counterparty losses, not necessarily serious effects for the overall market or banking system. The House debate made clear the difference was intended. The change was opposed by Barney Frank and Colin Peterson, the Chairs of the two House committees (Financial Services and Agriculture) involved with the legislation.

The CFTC would determine whether the swap exposures of a party would create a systemic risk so as to require it to be treated as a major swap participant. When LTCM nearly collapsed in 1998 many observers cited the "systemic risk" created by LTCM's derivatives exposures. A hedge fund engaging in trading like LTCM could be designated a major swap participant (MSP). Few commercial firms would seem likely to receive such designation.

Because the exception for commercial hedgers should cover most non-dealers that are not large enough swap market forces to be considered MSPs, the House bill in practice would largely establish clearing and execution requirements for swap dealers and MSPs. Even those swaps would not need to be cleared and executed through regulated facilities if the swap were not of the type required to be cleared and executed, as described below.

Only Certain Swaps Required to Clear and Trade on Regulated Facilities

The House bill, like the Treasury proposal, would require dealers and major swap participants to clear a swap with each other (or with a party not hedging or mitigating commercial risk) if (1) a derivatives clearing organization (DCO) will accept the swap for clearing and (2) the CFTC determines such clearing should be required. It is unclear whether the CFTC determination would be a meaningful requirement. The Treasury proposal would have created a presumption that any swap accepted for clearance by a DCO should be subject to mandatory clearance. The House bill does not have that presumption.

If a swap between swap dealers and MSPs (or non-hedgers) is required to be cleared it must also be executed on an exchange or swap execution facility (SEF) if any exchange or SEF will list that contract. If no exchange or SEF will list that contract, parties required to clear the swap (*i.e.*, dealers, MSPs, and non-commercial hedgers) would be required to comply with transaction reporting and recordkeeping requirements to be established by the CFTC.

Swaps With Commercial Hedgers Would Still Be Subject to Reporting and Financial Safety Regulation

Even though swap transactions with commercial hedgers would not be subject to clearing and exchange trading requirements, they would be subject to new regulation.

First, the hedging party would need to notify the CFTC how it generally meets its financial obligations under non-cleared swaps. Depending upon what the CFTC requires to meet this notice requirement, this could be a substantial barrier for some companies, especially those wishing to enter into one-off transactions. For example, special purpose vehicles, such as issuers of asset-backed securities, that would seek to hedge mismatches between fixed rate assets and floating rate liabilities or different currencies might be hampered if the CFTC requirements are onerous or require lengthy waiting periods. If the CFTC were not satisfied, the House bill would require the party to clear and execute swaps in the same manner as a non-hedger.

Second, regulators of swap dealers and MSPs (with the CFTC serving that role for an MSP without another regulator) would need to impose margin and capital requirements on non-cleared swaps entered into by those parties. This requirement would likely raise the pricing offered by swap dealers and MSP's to their counterparties under non-cleared swaps and therefore could effectively force counterparties to either clear or not enter into a trade.

Third, all non-exchange traded swaps would need to be reported to a swap repository or the CFTC.

Revisions to Definition of Eligible Contract Participant Would Require More Parties to Execute Swaps on Exchanges

The existing legal basis for not executing OTC derivatives on regulated exchanges is the Commodity Futures Modernization Act, which codified practice in the OTC derivatives market by excluding from the Commodity Exchange Act's exchange trading requirement swaps entered into by "eligible contract participants." That term was intended to cover "sophisticated parties." It included municipal government entities that own and invest, on a discretionary basis, \$25 million or more of assets and individuals with at least \$10 million in assets (or \$5 million if the transaction is intended as a hedge). Municipal entities are also eligible contract participants in any transaction in which their counterparty is a bank, broker-dealer, insurance company, or other regulated entity listed in the CFMA. The House bill would double the municipal threshold to \$50 million in assets under management for transactions using that qualification for eligible contract participant. The dollar thresholds for individuals would stay the same, but the test would not be based on total assets, but instead would be based on total investment assets. A party that cannot meet the eligible contract participant definition is required to use exchange traded futures, not OTC derivatives.

Additional Requirements for Swap Dealers and MSPs

Along with registration requirements for swap dealers and MSPs, the House bill would impose on those parties disclosure requirements for their customers (except for dealers or MSPs), some of which have long been sought by critics of the OTC derivatives market. These would include material risk and conflicts disclosures and (if requested) daily marks of collateral positions. Dealers would be required to segregate collateral if requested. Dealers and MSPs would be required to maintain specified daily trading records, with back-up and audit trails.

If you would like to discuss any of the issues addressed in this Client Update or would simply like to find out more about Chapman, please contact Ken Marin at kmarin@chapman.com or Bob Lockner at lockner@chapman.com.

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