U.S. Treasury Proposes Bill for Increased Federal Regulation of OTC Derivatives

Overview

- The U.S. Treasury sent a draft bill to Congress on August 11 that seeks greater federal regulation of OTC derivatives.
- The draft legislation requires "major swap participants" (generally, entities which take large positions in OTC derivatives that do not qualify as GAAP hedges) to register with the CFTC, SEC or an applicable banking regulator, treating these entities like OTC derivatives dealers.
- Treasury proposes that "standardized" derivatives be: (1) centrally cleared by an entity regulated by the CFTC or SEC; and (2) traded on an exchange or electronic trading facility regulated by the CFTC or SEC.
- The Treasury language seeks to curtail non-standardized derivatives by imposing higher capital and margin requirements on derivatives dealers and major swap participants using non-standardized derivatives.
- The Treasury bill gives the CFTC new rights to establish aggregate position limits with respect to swaps and certain other derivatives.
- Treasury's proposed bill seeks to enhance disclosure of derivatives to regulators as well as provide aggregated data on swap trading volumes and positions to the public.
- Under the proposed bill, implementing regulations must be adopted within 180 days of the bill's enactment.
- The U.S. Congress is expected to enact legislation regulating OTC derivatives by the end of 2009.

The proposed legislation raises important issues for many of our buy-side clients, in particular because certain hedge funds and mutual funds may be required to register with the CFTC and/or the SEC as "major swap participants" if the legislation is enacted in its current form. We expect to provide more detailed analysis and commentary with respect to the proposed legislation as things develop.

Background

As promised in a May 2009 policy release, and as part of its financial reform package, the U.S. Treasury sent Congress a draft bill entitled the "Over-the-Counter Derivatives Markets Act of 2009" on August 11, 2009. The draft bill seeks greater federal regulation and transparency of over-the-counter (OTC) derivatives transactions.

Greater regulation

The U.S. Treasury draft bill requires "major swap participants" to register with a federal regulator, putting this group of entities in the same category as OTC derivatives dealers. Generally, the term "major swap participant" means any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, other than to create and maintain an effective hedge under generally accepted accounting principles (GAAP). The Commodity Futures Trading Commission (CFTC) and

the Securities and Exchange Commission (SEC) are authorized jointly to define this term further. The draft bill also requires "major security-based swap participants" (generally, major swap participants who use security-based swaps) to register with the SEC, potentially resulting in a dual registration requirement.

Under the Treasury proposal, the Federal Reserve Board, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation will monitor banks that are dealers in swaps or security-based swaps, major swap participants, and major security-based swap participants while non-bank dealers in swaps or security-based swaps, major swap participants and major security-based swap participants will fall under the watch of the CFTC and/or SEC. The Treasury bill directs the applicable federal regulators to develop business conduct, registration, reporting, and recordkeeping rules as well as capital and margin requirements for all dealers in swaps or security-based swaps and major swap participants and major security-based swap participants. As the bill is drafted, the regulated dealers and major participants will be required to maintain daily trading records and a complete audit trail of trades as well as develop back office operating standards as prescribed by the federal regulators.

In addition, the proposed bill requires that all "standardized" derivatives be cleared through a central counterparty that is registered with either the CFTC or the SEC. The central clearinghouse must prescribe that all swaps with the same terms and conditions are fungible and may be offset with each other.

It is notable that since foreign exchange swaps and foreign exchange forwards are excluded from the definitions of the terms "swap" and "derivative" under the draft bill, parties that engage in these transactions exclusively would not be subject to the draft bill's requirements.

The draft legislation directs the CFTC and SEC to define the term "standardized" within 180 days of the bill's enactment, indicating that a swap that is accepted for clearing by any registered derivatives clearing organization is presumed to be standardized and that the CFTC and SEC should jointly define the term as broadly as possible. The draft bill also permits these regulators to prescribe rules to prevent parties from evading this definition.

The proposed legislation seeks to constrain the use of non-standardized derivatives by imposing higher capital and margin requirements on such derivatives when used by regulated dealers and major participants.

As part of its proposal to make all OTC derivatives subject to greater federal regulation, Treasury's draft proposal repeals the provisions of the Commodity Exchange Act (CEA) that exclude certain OTC derivative contracts involving energy and metal commodities from regulation, popularly known as the "Enron loophole."

Greater transparency

To improve the availability of information about OTC derivatives, the proposed legislation requires standardized derivatives to be traded on a CFTC- or SEC-regulated exchange or a CFTC- or SEC-regulated alternative swap execution facility. Entities using customized, non-cleared OTC derivatives must report such transactions either to a central data repository or to the CFTC or SEC, depending on whether security-based swaps are involved. Institutional investment managers would also be required to report security-based swap agreements on SEC Form 13F. In addition, the draft bill requires the CFTC and the SEC to provide public access to aggregated data on open positions and trading volumes.

The Treasury bill gives the CFTC the right to establish aggregate position limits for contracts listed by designated contract markets, contracts traded on foreign boards of trades, and swap contracts that perform or affect a significant price discovery function with respect to regulated markets, while permitting exemptions for hedging positions. Similarly, the draft bill authorizes the SEC to establish both position limits for securities listed on a national securities exchange and security-based swaps that perform or affect a significant price discovery function with respect to regulated markets as well as large trader reporting requirements for security-based swaps that perform or affect a significant price discovery function with respect to regulated markets.

Under the proposed legislation, swap execution facilities will have the emergency authority to liquidate or transfer open swap or security-based swap positions or to suspend or limit trading in such contracts in order to deter abuses, in consultation and cooperation with the CFTC or the SEC, as applicable. The proposed legislation also takes steps to create uniform OTC derivatives regulation globally by prohibiting foreign boards of trade from offering access to contracts linked to U.S.-listed contracts to persons located in the United States unless the foreign board of trade meets certain regulatory standards that are "comparable" to the requirements applied by the U.S. exchange that lists the linked contract.

Open questions

The Treasury draft bill leaves open many important questions, including the definitions of a standardized derivative and a major swap participant as well as the levels of capital and margin that federal regulators can impose. The Treasury also leaves open questions about how clearinghouses will operate, for example, in regard to membership requirements and portability of collateral.

Another outstanding issue is whether information about derivatives made available to various regulators will lead these regulators to discuss the information more freely with each other. The proposal tries to head off inter-agency turf battles, instructing the CFTC and SEC to work jointly to develop rules and standards for regulating swaps and security-based swaps. With history as its guide, however, Treasury has reserved for itself the role of arbiter if the CFTC and SEC fail to cooperate.

Finally, the proposed legislation may create an incentive to fit into the GAAP definition of hedging, to avoid regulatory oversight. The experience of companies required to restate earnings by the SEC because of their failure to comply with the GAAP hedging standards suggests, however, this effort may be easier said than done.

Looking ahead

Several bills to regulate the OTC derivatives market have been introduced in Congress, including ones by Sen. Harkin (D-Iowa) and by Agriculture Committee Chairman Rep. Peterson (D-Minn.). Rep. Petersen and Rep. Frank (D- Mass.), Chairman of the House Financial Services Committee, recently issued a joint statement calling for derivatives regulatory reform. Some federal legislators have called for more severe regulations, such as a ban on "naked" credit default swaps, in which an entity purchasing protection against a borrower's default does not own a loan or debt security of the borrower. Congress is expected to focus on OTC derivatives regulation when it reconvenes in the fall, and legislation may be enacted by the end of the year.

For more information on the U.S. Treasury's proposed bill to increase federal regulation of OTC derivatives, please contact your Ropes & Gray attorney or any of the attorneys in Ropes & Gray's Hedge Fund or Investment Management practice groups.

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