financial reform matters

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ROPES & GRAY

Preparing for Financial Reform: Derivatives

The Senate has proposed strict federal regulation of over-the-counter (OTC) derivatives transactions in the *Wall Street Transparency and Accountability Act of 2010,* Title VII of the Senate financial overhaul bill, the *Restoring American Financial Stability Act of 2010* which passed on May 20, 2010. The Senate bill takes a firmer hand to regulating the derivatives market than either the Obama administration or the House of Representatives recommended (the August 2009 U.S. Treasury proposal and December 2009 House bill to oversee OTC derivatives were discussed in earlier Ropes & Gray Alerts—U.S. Treasury Proposes Bill for Increased Federal Regulation of OTC Derivatives (August 14, 2009), and Potential Effects on Funds and Investment Advisers of The Wall Street Reform and Consumer Protection Act of 2009 (January 11, 2010), respectively).

The Senate bill:

- pushes banks to drop their derivatives trading units into separately capitalized affiliates or exit the OTC derivatives market
- includes fewer exemptions from both entity registration and clearing and trading requirements
- imposes a fiduciary duty on dealers that enter into swaps with a pension plan, endowment, retirement plan, or government entity
- demands the CFTC and SEC write regulations to implement the bill within six months after the President signs it into law

Will these and other stricter rules adopted by the Senate survive the reconciliation process to be led by Senator Dodd (D-CT) and Representative Frank (D-MA)? Here are six key questions Sen. Dodd and Rep. Frank will consider:

1. Should banks be required to spin-off derivatives trading desks?

The Senate bill includes a proposal by Sen. Blanche Lincoln (D-AR) that would eliminate a bank's access to loans or guarantees from the Federal Reserve or FDIC unless the bank's derivatives trading units are housed in a non-guaranteed affiliate separate from the deposit-taking bank or are divested altogether. In addition, the Senate bill includes a modified version of the "Volcker Rule" that would ban certain "proprietary trading" in federally insured banks, another potential limit on future OTC derivatives activities that are not "on behalf of a customer, as part of market-making activities or, otherwise in connection with or in facilitation of customer relationships."

Although opposed by the Obama administration, if the Lincoln proposal survives the Dodd-Frank conference, bank counterparties would either need to capitalize a non-bank subsidiary to house their derivatives business units or exit the OTC derivatives market. Trading activity could slow for an extended period as the banks sort through their options, including shifting operations to foreign jurisdictions, then execute restructuring plans. Parties to long-term derivatives transactions may wish to review the restrictions on transfer in their documentation to determine if their counterparty can transfer their transactions to a derivatives trading affiliate without their consent. In addition, European and Asian banks could step forward

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to meet demand and new non-bank counterparties also could emerge, meaning buy-side users of derivatives could face increased risk from cross-border bankruptcies as well as less creditworthy counterparties, and may also bear increased costs for OTC derivatives transactions as dealers seek to recover their increased capital and other costs.

2. Who must register with the CFTC and/or SEC?

The Senate bill identifies four types of non-bank entities that must register with (and will be regulated by) the CFTC and/or SEC:

(i) entities that maintain a substantial position in any major swap category (excluding swaps hedging commercial risks or positions maintained by a benefit plan)
(ii) entities whose swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets
(iii) financial entities (including hedge funds) that are highly leveraged and maintain a substantial position in any major swap category
(iv) swap dealers

The term "substantial position" is to be defined by the CFTC and SEC at a threshold prudent for oversight of entities that are systemically important or that can significantly impact the U.S. financial system.

The Senate bill seems to cast a wider net, requiring more entities to register than the House bill, which, for example, did not require highly leveraged financial entities to register. The scope of the registration requirement remains uncertain, however, until regulations clarify what is an ambiguous registration threshold under both the Senate and House versions. Beyond dealers, the target of the registration requirement originally seemed to be entities like AIG. This group now could include certain funds if the CFTC and SEC determine that the size of their swaps trading in any category is "systemically important." On its face, the registration threshold appears to be set at a high enough level to exclude the derivatives investment activities of most hedge funds and mutual funds, although certain funds could be required to register when the threshold definition is clarified by the CFTC and SEC.

3. What OTC trades must be cleared and traded on an exchange?

The Senate bill requires that every swap be cleared unless no registered clearinghouse or agency will accept the swap for clearing, or the CFTC or SEC determines that the swap is not required to be cleared. The Senate bill further mandates that all cleared swaps be traded on an exchange or similar facility.

The Senate bill grants a clearing/trading exemption to commercial or non-financial end-users that may elect not to clear a swap subject to the clearing requirement if the swap is hedging a commercial risk.

The breadth of the clearing/trading exemption is important to buy-side and end-user counterparties not only because of potentially stricter collateral requirements and higher costs of a clearinghouse but also because of the potential lost opportunity to use non-standardized derivatives tailored to a particular hedge or investment strategy. In addition, uncertainty regarding collateral segregation requirements, portability of trades, and treatment of customer funds in bankruptcies involving clearing facilities are looming concerns for buy-side and end-user counterparties forced to transact derivatives through a clearinghouse.

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4. Will FX derivatives be regulated?

The Senate bill states that foreign exchange swaps and foreign exchange forwards will be regulated by the CFTC, unless the Secretary of the Treasury makes a written determination that these OTC derivatives should not be so regulated.

The final bill could reverse this assumption and adopt the approach taken in the House bill that exempts foreign exchange swaps and forwards from CFTC regulation unless the CFTC seeks and obtains the concurrence of the Secretary of the Treasury to regulate these OTC derivatives. In any event, both the Senate and House bills require information regarding foreign exchange swaps and forwards be reported to a swap repository or the CFTC.

5. Will the CFTC and SEC work together?

Unlike the House bill, the Senate bill does not require joint rulemaking between the CFTC and SEC, only dictating that the agencies consult in certain circumstances and giving each commission the ability to challenge the other's regulations in court.

If the CFTC and SEC are not required to work together on regulations, buy-side and end-user counterparties may be caught between inter-agency turf battles as well as face different rules for economically similar transactions.

6. How quickly will the new rules be in place?

The Senate bill, in general, gives the CFTC and SEC six months after enactment of the bill to write implementing regulations. By contrast, the House bill provides a more lenient one-year period for implementation. Both bills leave many interpretative and implementation decisions to the CFTC and SEC, and the agencies may have to scramble to write regulations or issue guidance piecemeal. Both the House bill and the Senate bill exempt OTC derivatives transactions that are outstanding on the date of enactment from many of the new clearing requirements, although such transactions will be required to be reported.

The Senate-House reconciliation conference could complete its work by the end of June and the final bill could be signed by President Obama in July. We will update you on the final version of the bill in another alert after it is enacted. If you have any questions about the Senate bill or the House bill, please contact the Ropes & Gray attorney who normally advises you.

We are monitoring the progress of financial reform legislation, especially those changes that may affect the investment management, banking, hedge and private investment fund, and derivatives businesses. If you have questions concerning **Financial Reform Matters**, please contact any of the attorneys listed below or the Ropes &Gray attorneys with whom you regularly work.

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