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Representative Frank Releases Discussion Draft for Over-the-Counter Derivatives Reform

A discussion draft of legislation to regulate the over-the-counter ("OTC") derivatives markets (the "Draft Bill") was released on October 2, 2009 by House Financial Services Committee Chairman Barney Frank. The Draft Bill builds on the Obama Administration's "Over-the-Counter Derivatives Markets Act of 2009" (the "Obama Proposal") that was released on August 11.[1] It adds regulation in some areas and softens a number of key provisions, most importantly the clearing and exchange trading requirements and exclusions for end users. Among other things, the Draft Bill would:

- give the CFTC and the SEC sole responsibility for determining whether a swap or security-based swap, respectively, must be cleared;
- impose requirements as to how trades must be executed, but not mandate exchange trading except for non-eligible contract participants;
- require collateral for cleared swaps to be segregated and treated as customer property and, at the request of a counterparty to a swap not submitted for clearing, require collateral to be held as customer property in a third-party custodial account;
- exclude end users more broadly from the terms "major swap participant" and "major security-based swap participant";
- allow the use of non-cash assets as collateral to comply with margin requirements;
- provide more flexibility for international financial institutions to engage in swaps and security-based swaps with US persons;
- allow the SEC and the CFTC, acting jointly, to prohibit transactions in any swap or security-based swap that they consider detrimental to the financial market or any participants in the financial market;
- authorize the Secretary of the Treasury to ban an entity that is domiciled in a foreign country that regulates swaps or security-based swaps in a manner that the Secretary of the Treasury finds undermines the stability of a financial market from participating in financial activities in the United States;
- authorize the SEC to set position limits for security-based swaps and security-based swap agreements, while not extending such authority to listed securities; and
- require clearing agencies to register with the SEC prior to clearing security-based swaps and extend certain other Obama Proposal requirements for derivatives clearing organizations to clearing agencies, including compliance with core principles such as risk management guidelines, settlement procedures, financial resource adequacy and participant and product eligibility standards.

The House Financial Services Committee will hold a hearing on Wednesday, October 7, to discuss the Draft Bill and the Obama Proposal. In many respects, the Draft Bill hews closely to the Obama Proposal, although it revises certain key provisions in a way that responds to some but not all of the criticisms and suggestions voiced by the derivatives industry and end users.

This memorandum compares the Draft Bill with the Obama Proposal and discusses the main differences between the two proposals.

[1] For a brief summary and analysis of the Obama Proposal, *see* Davis Polk Newsflash, "Obama Administration Proposes Sweeping Legislation to Regulate Over-The-Counter Derivatives" (August 17, 2009).

Classification of OTC Derivatives and Allocation of Jurisdiction

The Draft Bill is identical to the Obama Proposal in terms of the derivatives that it would regulate and the allocation of regulatory jurisdiction between the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC"). The terms "swap," "security-based swap" and "mixed swap" are defined to include the same instruments and products as under the Obama Proposal. Both the Draft Bill and the Obama Proposal provide that swaps would be regulated by the CFTC, security-based swaps by the SEC and mixed swaps jointly by the SEC and CFTC. The prudential regulators, namely, the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, and the SEC and the CFTC would have authority to set and enforce prudential requirements, such as capital and margin requirements, for the entities that they regulate.

This preservation of the Obama Proposal's OTC derivative classification framework means that many definitional questions around these terms would persist, including, for example, whether certain credit default swaps and credit-linked notes would fall under the definition of security-based swap and therefore be regulated by the SEC. As under the Obama Proposal, the Draft Bill would provide the SEC and the CFTC with power to designate certain products as swaps but explicitly deprive the agencies of discretionary exemptive authority, thereby limiting counterparty certainty of how particular structured transactions might be treated.

Unlike the Obama Proposal, the Draft Bill would not redefine "security" under the Securities Exchange Act of 1934 to include security-based swaps. The Draft Bill would, however, redefine "security" under the Securities Act of 1933 (the "Securities Act") to include security-based swaps.

No Mandatory Exchange Trading Requirement

In stark contrast to the Obama Proposal, the Draft Bill would not require exchange trading for any contract in which both parties are eligible contract participants. A contract that is required to be cleared under the Draft Bill and is entered into between counterparties that are either swap dealers or major swap participants, or security-based swap dealers or major security-based swap participants, may be executed on a range of venues, including over-the-counter. Specifically, the counterparties may choose to execute their transaction:

- on a board of trade designated as a contract market or registered national securities exchange (for a swap and security-based swap, respectively);
- on a swap execution facility registered with the CFTC or an alternative swap execution facility registered with the SEC;
- on a foreign swap execution facility subject to regulation under the home country's law; or
- over-the-counter, in which case the counterparties to the contract must comply with recordkeeping and end-of-day transaction reporting as prescribed by the SEC or the CFTC.

There are also specific provisions for transactions that involve a foreign counterparty or are executed outside the United States. These provisions are discussed below under "International Derivatives Markets – Related Provisions."

Required Clearing and Use of Swap and Security-Based Swap Repositories

The Draft Bill would require the SEC and the CFTC to determine, on the basis of certain enumerated factors, which security-based swaps and swaps must be cleared. Unlike the Obama Proposal, the Draft Bill does not contain a presumption that any contract accepted for clearing would be "standardized" and therefore subject to mandatory clearing. Under the Draft Bill, the factors to be considered by the SEC and the CFTC in requiring clearing include:

- the existence of significant outstanding notional exposures, trading liquidity and adequate pricing data;

- the availability of one or more swap clearinghouses with the rule framework, capacity, operational expertise and resources and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded;
- the impact on the mitigation of systemic risk, taking into account the size of the market for such a contract and the resources of the swap clearinghouses available to clear the contract;
- the impact on competition; and
- the existence of reasonable legal certainty in the event of the insolvency of the relevant swap clearinghouse or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds and property.

This approach to required clearing is based on the capabilities of clearinghouses and the purposes of the clearing function, namely, to provide transparency and mitigate risk. Giving the SEC and the CFTC, rather than clearinghouses, the authority to determine what is sufficiently standardized to warrant mandatory clearing also addresses any potential conflicts raised by the status of clearinghouses as both regulated and profit-making entities.

The Draft Bill leaves open many of the details about the nature of clearing arrangements, delegating to the SEC and the CFTC the work of defining the scope of the clearing functions that are necessary to satisfy the clearing requirement. Prior to adopting any rules on clearing, the SEC and the CFTC would be required to consult with the appropriate federal banking agencies and each other. Presumably, the SEC and the CFTC would adopt rules articulating eligibility criteria for clearing that clearinghouses and market participants could follow, rather than engage in a product-by-product determination.

The Draft Bill also broadens the exception to clearing requirements, as well as trade execution requirements, by excepting any swap or security-based swap transaction in which one of the counterparties to the swap is not a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant, and removing the Obama Proposal's further requirement that such counterparty not meet the eligibility requirements of a clearinghouse that clears the swap.

The Draft Bill clarifies which counterparty would be responsible for reporting swaps and security-based swaps that are not accepted for clearing. If one counterparty is a swap dealer or security-based swap dealer, such counterparty would be required to report the transaction; otherwise, the counterparties could agree which one would report the transaction.

A significant feature of the Draft Bill that does not appear in the Obama Proposal would require the rules of registered derivatives clearing organizations and clearing agencies to provide for the acceptance of a standardized swap or security-based swap, respectively, regardless of the system on which the transaction was executed. This provision seems to be aimed at fostering fungibility and competition and may be seen as controversial by commentators who support vertical integration of clearing and trading platforms.

Identification and Regulation of Derivatives Dealers and Major Market Participants

- ***Identification of Derivatives Dealers and Major Market Participants***

Like the Obama Proposal, the Draft Bill would subject "swap dealers" and "security-based swap dealers" (which we sometimes refer to collectively as "derivatives dealers") and "major swap participants" and "major security-based swap participants" (which we sometimes refer to collectively as "major market participants") to certain regulatory and registration requirements.

The term "major swap participant" still would be defined under the Draft Bill as "any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps," or, in the case of security-based swaps, "any person who is not a security-based swap dealer and who maintains a substantial net position in outstanding security-based swaps." As in the Obama Proposal, the term "substantial net position" would be jointly defined by the SEC and the CFTC. The Draft Bill, however,

provides general guidance by requiring that the agencies determine a threshold that is "prudent for the effective monitoring, management and oversight of the financial system." Importantly, the Draft Bill would avoid the possibility of a protracted stalemate between the SEC and the CFTC in defining this term by giving the agencies 60 days to set a threshold and, if they are unable to do so, providing for the Secretary of the Treasury to determine the threshold.

The Draft Bill contains broader exclusions from the category of major market participants by excluding persons whose positions are held "primarily for hedging (including balance sheet hedging) or risk management purposes." By contrast, the Obama Proposal limits its exclusion to persons who maintain substantial net positions for the purpose of creating and maintaining an "effective hedge" under generally accepted accounting principles ("GAAP"). By eschewing the narrow, technical GAAP definition of effective hedge, the Draft Bill would exclude a larger number of end users.

The Draft Bill further specifies that a person can be designated as a major swap participant for each type of swap or security-based swap that the person holds. This indicates that substantial net positions would be determined not only on the basis of aggregate swap or security-based swap positions but also on the basis of positions held in a given type of swap or security-based swap.

Interestingly, as in the Obama Proposal, the definitions of "swap dealer" and "security-based swap dealer" are broadly defined in the Draft Bill to include "any person engaged in the business of buying and selling swaps for such person's own account through a broker or otherwise . . . [except that it] does not include a person that buys or sells swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." This definition might well capture many hedge funds and other end users that are outside of the Draft Bill's definitions of major market participants.

- ***Prudential Supervision of Derivatives Dealers and Major Market Participants***

The Draft Bill would leave intact the role of prudential regulators, the SEC and the CFTC in setting capital and margin requirements for derivatives dealers and major market participants subject to their respective jurisdictions. It would also preserve most of the guidelines for setting such requirements; however, the margin provisions applicable to non-derivatives dealers and non-major market participants would be revised.

For instance, in an apparent concession to end users who have complained that cash margin requirements make hedging transactions so expensive as to be impractical, the SEC and the CFTC would be required to allow the use of non-cash assets as collateral for margin. Presumably, as is current practice, dealers could set their own haircuts and exercise reasonable discretion in valuing such assets.

- ***Position Limits and Large Trader Reporting***

The Draft Bill removes the provisions of the Obama Proposal that would allow the SEC to adopt, and to direct a self-regulatory organization ("SRO") to adopt, position limits for securities on which a security-based swap is based. Rather, the Draft Bill provides, subject to the expanded aggregation rules described below, that the SEC and SROs may only set position limits for security-based swaps, and not the underlying securities. The SEC, however, would also have authority to set position limits for "security-based swap agreements," which the Draft Bill defines as swaps on broad-based security indices and swaps on government securities. Furthermore, by removing the Obama Proposal's requirement that swap execution facilities and alternative swap execution facilities adopt position limits for each of their contracts, the SEC, on its own and through SROs, and the CFTC, would be solely responsible for imposing such limits.

While the position limits, position accountability and large trader reporting requirements are substantially altered in the Draft Bill for security-based swaps, the provisions relating to swaps are left intact. The Draft Bill expands the authority of the SEC by allowing position limits to be set for each security-based swap or

security-based swap agreement, rather than limit such authority to the aggregate amount of positions held by a person.

The SEC and SROs would have the further authority to require any person to aggregate positions in a greater number of products and instruments than would the Obama Proposal. Whereas the Obama Proposal would limit such authority to "(1) securities listed on a national securities exchange; and (2) security-based swaps that perform or affect a significant price discovery function with respect to regulated markets," the Draft Bill would extend the authority to any security-based swap and any security, group of securities, loan or index thereof, on which or to which such security-based swap is based upon or related, as well as any security-based swap agreement and certain securities upon which the security-based swap is based.

The Draft Bill simplifies and expands the large trader reporting requirements by giving the SEC the authority to require any person that effects transactions in security-based swaps, security-based swap agreements and certain securities and loans, and any index thereof, on which or to which security-based swaps and security-based swap agreements may be based or related, to report their positions to the SEC.

The Draft Bill would preserve the recordkeeping and reporting requirements of the Obama Proposal for derivatives dealers and major market participants, and it would add an additional requirement that they keep their books and records relating to transactions in swaps based on one or more securities open to inspection and examination by the SEC.

Segregation of Assets

In a provision absent from the Obama Proposal, the Draft Bill would impose requirements to segregate margin and collateral. For cleared swaps, the derivatives dealer, futures commission merchant, derivatives clearing organization or clearing agency that holds funds or property as margin or collateral would be required to "segregate, maintain, and use the funds or other property for the benefit of the counterparty." For non-cleared swaps, a derivatives dealer that holds collateral or margin for a swap or security-based counterparty would be required, at the request of such counterparty, to segregate the funds or property for the benefit of the counterparty and to maintain the funds or other property in a third-party custodial account that is designated as a segregated account for the counterparty. The SEC, CFTC or prudential regulator, as applicable, would determine the rules and regulations governing segregation of assets both for cleared swaps and over-the-counter swaps.

Although the segregation requirement for cleared swaps is in line with what is required for futures contracts under the current commodity laws, these provisions differ from the rules currently applicable to OTC derivatives transactions and to dealers under the securities laws that require segregation of funds and securities only under limited circumstances. Currently, margin funds and securities are used to finance lending to the customer, and without legal authority to rehypothecate such collateral, under the Draft Bill, the broker-dealer could have to find additional sources of financing, thereby limiting the amount of credit that it could extend. The provisions relating to third-party custodial arrangements seem to reflect the concerns of many end users growing out of the Lehman insolvency about the status of posted collateral in an insolvency of a dealer counterparty.

International Derivatives Markets – Related Provisions

The Draft Bill provides substantial carve-outs from its requirements, including clearing and exchange trading, for certain foreign transactions and foreign counterparties, thereby limiting its extraterritorial reach.

First, perhaps as a "carrot" to international regulatory authorities, it would require the SEC and the CFTC, in consultation with the Secretary of the Treasury and prudential regulators, to adopt rules exempting a foreign financial institution from registration and any other requirements of the Draft Bill based on their

finding that the institution is subject to comparable regulation in its home country. This requirement could therefore apply to registration requirements for clearing agencies, derivatives dealers and major market participants.

Even without this exemption, other foreign entities and persons might not be subject to clearing and exchange trading requirements. The SEC and the CFTC are given flexibility in setting the clearing requirements that would allow the SEC and CFTC to not require US clearing if a transaction is subject to foreign clearing requirements. The Draft Bill also would not impose any trading-related requirements on swaps and security-based swaps entered into by a foreign swap dealer or foreign swap market participant or entered into by a US swap or security-based swap dealer or US major swap or security-based swap dealer where such transaction takes place outside the United States or with a foreign counterparty, except that such transactions would be required to comply with any recordkeeping and reporting requirements that may be prescribed by the relevant foreign regulator.

As a "stick" to the above "carrot," the Draft Bill contains a striking provision that would give the Secretary of the Treasury the authority to prohibit any entity that is domiciled in a foreign country that regulates swaps or security-based swaps from participating in financial activities in the United States if the Secretary of the Treasury finds that such regulations undermine the stability of a financial market.

In light of these provisions, the Draft Bill would require the SEC, the CFTC and prudential regulators, as well as the financial stability regulator and the Office of Derivatives Supervision, to consult and coordinate with foreign regulatory authorities in an effort to establish consistent international standards for regulating swaps and allow for information-sharing arrangements as necessary or appropriate in the public interest.

Selected Provisions

The Draft Bill would largely preserve many of the ancillary provisions of the Obama Proposal, including:

- requiring the SEC and CFTC to adopt rules jointly, at times in consultation with prudential regulators, and providing for the Secretary of the Treasury to adopt rules in the event that the SEC and CFTC are unable to do so;
- explicitly limiting the SEC's and CFTC's exemptive authority over swaps and security-based swaps to those areas in which the agencies are specifically granted exemptive authority;
- requiring that swaps and security-based swaps that are not cleared be reported to a swap repository or security-based swap repository;
- imposing recordkeeping and reporting requirements on derivatives dealers, major market participants, derivatives clearing organizations, clearing agencies, swap repositories, security-based swap repositories, swap execution facilities and alternative swap execution facilities;
- giving the SEC and CFTC rulemaking and enforcement authority to prevent market manipulation, fraud and other market abuses and imposing "statutory disqualification" limitations on persons associated with newly regulated entities;
- providing the prudential regulators with exclusive authority to enforce the prudential requirements that they set for entities under their jurisdiction that are derivatives dealers or major market participants;
- providing the SEC authority to extend the beneficial ownership requirements of Section 13 (and thereby indirectly the short-swing profit rule of Section 16) to include positions underlying security-based swaps equity securities underlying security-based swaps and other derivatives;
- narrowing the definition of "eligible contract participant" for certain government entities and persons;
- granting the CFTC authority to register and partially regulate foreign boards of trade that permit direct access to US participants;

- requiring swaps with non-eligible contract participants to be entered into on, or subject to, the rules of a board of trade designated as a contract market under section 5 of the Commodity Exchange Act of 1936;
- requiring security-based swaps that are offered or sold to any person that is not an eligible contract participant to be registered under Section 10 of the Securities Act and effected on a registered national securities exchange; and
- preempting state wagering, gaming, bucket shop and similar laws for security-based swaps between eligible contract participants or effected on a national securities exchange, and preempting most state securities laws.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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