

August 14, 2009

Obama Administration Proposes OTC Derivatives Bill

Following closely upon its June 17, 2009, white paper proposing comprehensive reform of the U.S. financial regulatory system (more information regarding the white paper may be found in our previous legal alert, available [here](#)), the Obama Administration has released its proposed bill for the regulation of over-the-counter (OTC) derivatives transactions, entitled “Over-the-Counter Derivatives Markets Act of 2009” (the Act) (the Treasury Department’s overview of the Act, which contains a link to the full text of the Act, is available [here](#)).

The Act combines a number of recent proposals for regulation of OTC markets, including many of the principles described by Rep. Collin Peterson (D-MN) and Rep. Barney Frank (D-MA) in their concept paper, Description of Principles for OTC Derivatives Legislation, released on July 30, 2009 (available [here](#)). The Act is divided into two sections, one focused on the regulation of swap markets generally, and the other specifically dealing with security-based swaps. Key provisions of the Act include the following:

Regulation of Swap Markets

- Grants the Commodity Futures Trading Commission (CFTC) jurisdiction over certain previously exempted OTC swap transactions, including those between “eligible contract participants,” as defined in the Commodity Exchange Act¹;
- Requires clearing of all “standardized swaps” by a registered derivatives clearing organization and trading of all standardized swaps on a regulated designated contract market or, for eligible contract participants, a registered alternative swap execution facility;
- Directs the CFTC and the Securities and Exchange Commission (SEC) to jointly adopt rules defining “standardized” swaps, but creates a presumption of standardization for swaps that are accepted for clearing by a derivatives clearing organization;
- Requires parties entering into non-standardized swaps to report these transactions to the CFTC or to a swap depository;
- Requires derivatives clearing organizations that clear swaps to register (or obtain an exemption from registration) with the CFTC;
- Requires swap dealers and major swap participants² to register with the CFTC and (1) meet minimum capital and margin requirements; (2) meet reporting and recordkeeping requirements; (3) act in accordance with business conduct standards; (4) conform to documentation and back-office standards; and (5) comply with requirements relating to documentation, position limits, disclosure, conflicts of interest, and antitrust considerations;
- Authorizes the bank regulators, the CFTC and the SEC, as applicable, to set capital and minimum initial margin levels and variation margin requirements for trading on or through registered entities;

¹ The Act defines the term “swap” which would include OTC swap transactions. The Act also requires the CFTC and SEC to jointly redefine “eligible contract participant.”

² The term “major swap participant” is not specifically defined in the Act, which leaves the determination of qualifying participants to the CFTC and the SEC. The Act defines “major swap participant” as 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, as the Commodity Futures Trading Commission and the Securities and Exchange Commission may further jointly define by rule or regulation.

- Authorizes the CFTC to establish aggregate position limits across commodity contracts, including those traded on foreign boards of trade and OTC swap contracts that perform or affect a significant price discovery function with respect to regulated markets;
- Provides the CFTC with jurisdiction over foreign boards of trade that provide members or other participants in the United States access to the electronic trading and order matching systems;
- Prohibits foreign boards of trade from giving participants in the United States access to electronic trading and order matching systems with respect to contracts that settle against the price of a contract on a CFTC-registered entity unless such foreign boards of trade have comparable standards as U.S. boards of trade;
- Requires market participants to record large swap positions that perform or affect a significant price discovery function with respect to regulated markets and report such positions to the CFTC;
- Grants primary enforcement authority for non-security-based swap markets to the CFTC; and
- Directs the CFTC to make available to the public, in a manner that does not disclose market positions of any individual entity, aggregate data on swap trading volumes and positions.

Regulation of Security-Based Swaps

- Adds security-based swaps to the definition of “security” under the Securities Exchange Act of 1934, as amended (the 1934 Act);
- Grants the SEC authority to regulate security-based swaps as redefined under the Act;
- Requires the clearing of all “standardized” security-based swaps by a registered clearing agency and trading of all standardized security-based swaps on a registered national securities exchange, or for eligible contract participants, on a registered alternative swap execution facility.
- Requires the reporting of all non-standardized security-based swap transactions to the SEC or to a security-based swap repository;
- Directs the CFTC and the SEC to jointly adopt rules defining “standardized” securities-based swaps, but creates a presumption of standardization for security-based swaps that are accepted for clearing by any clearing organization;
- Prohibits parties that are not eligible contract participants from entering into security-based swaps off of a registered national securities exchange;
- Requires security-based swap dealers and major security-based swap participants to register with the SEC and (1) meet minimum capital and margin requirements; (2) meet reporting and recordkeeping requirements; (3) act in accordance with business conduct standards; (4) conform to documentation and back-office standards; and (5) comply with requirements relating to documentation, position limits, disclosure, conflicts of interest, and antitrust considerations;
- Authorizes the SEC to establish aggregate position limits across securities listed on exchanges or security-based swaps that perform or affect a significant price discovery function with respect to regulated markets (the SEC may exempt from such limits any person, class of persons, transaction or class of transactions);
- Directs self-regulatory organizations to also establish position limits related to security-based swaps;
- Requires market participants to record large security-based swap positions that perform or affect a significant price discovery function with respect to regulated markets and report such positions to the SEC;
- Prohibits the sale or purchase of security-based swaps by persons who are not eligible contract participants, unless such security-based swaps are sold pursuant to an effective registration statement under the Securities Act of 1933, as amended; and

- Directs the SEC to make available to the public, in a manner that does not disclose market positions of any individual entity, aggregate data on security-based swap trading volumes and positions.

It is impossible to predict with any degree of certainty how enactment of the Treasury proposal would impact the OTC market, but it can confidently be said that the OTC market would change dramatically. One reason why it is difficult to forecast the impact is that the Treasury proposal leaves critical determinations to the future decisions of the various regulators, including not only the CFTC and the SEC but also the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (and in cases where the SEC and the CFTC fail to jointly act in a timely manner, the Treasury Department). For example, the regulators, acting either individually or jointly, must determine:

1. Who will qualify as a “Major Swap Participant” and “Major Security-Based Swap Participants,” answering the question of what constitutes a “substantial net position in outstanding swaps”;
2. What swaps will be determined to be “standardized” and thus required to be cleared and traded on an exchange or a new “registered alternative swap execution facility”;
3. What capital requirements will be imposed on swap dealers and major swap participants; and
4. What minimum initial margin and variation margin requirements will be imposed on swap dealers and major swap participants with respect to non-standardized swaps.

Each of the above determinations could have a material impact on the future of the OTC markets and those determinations will likely not be made until many months following enactment of the proposed legislation.

Notably, although credit default swaps have been the focus of much of the recently proposed legislation, the Act does not impose any specific additional restrictions on credit default swaps. We are concerned, however, that the Act specifically states that it does not divest authority from any federal or state agencies derived from other applicable law. As such, swap transactions (including credit default swaps) may in the future become subject to additional regulation from federal or state regulatory agencies, such as state insurance regulators. Additionally, the broadening of the definition of securities under the 1934 Act may have unforeseen and unintended consequences; for example, with respect to transaction disclosure and reporting obligations. We will continue to monitor developments related to the regulation of OTC derivatives and keep abreast of all significant legislation affecting these markets.



If you have any questions regarding this Legal Alert, please feel free to contact the attorneys listed below or the Sutherland attorneys with whom you regularly work.

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