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FINANCIAL REFORM: A ROUGH VIEW

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Introduction: After confining most derivatives trading to regulated exchanges and regulated clearing organizations for generations, the Congress decided in year 2000 that some users – large and/or sophisticated financial and commercial players[2] – could safely conduct transactions of this nature among themselves without regulation and without posing a threat to the general economy. The events of 2008-2009 encouraged a review of that decision and new legislation now is pending in both the House of Representatives and the United States Senate to restore some level of federal oversight of this activity. What lessons have been drawn from the 2008-2009 experience are that we relaxed our credit requirements too much for these "high-end"

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[2] In many cases, of course, these institutions were simply aggregations of savings or small investments by members of the general public for whom regulatory oversight would almost surely have been provided absent aggregation. The losses suffered by pension plans, endowment funds and the like attest to that fact.

transactions and that we lost sight of the growth and role of unregulated derivatives in our society.[3]

Meanwhile, the segment of the derivatives world that had remained under federal supervision survived intact, without requiring a cent of TARP money or other forms of public bail-out. Not surprisingly, the Congress is now proposing to overlay some of those regulatory safeguards on the remainder of the derivatives markets.

We are observing a moving phenomenon. What – if anything – emerges from the Congress may differ significantly from this snapshot.

Jurisdictional assignment: The Commodity Futures Trading Commission ("CFTC") receives the lion's share of regulatory jurisdiction under these proposals, taking authority over all forms of presently-unregulated derivatives except those involving a security; the latter will be regulated by the Securities and Exchange Commission ("SEC").[4]
In a number of areas, the legislation contemplates that the two agencies will develop joint regulations – a process that has been slow of implementation in the case of their only other collaboration – security futures contracts, but separate actions are also allowed on a number of subjects.

Instruments affected: Swaps and other derivatives that are not currently regulated but could exclude foreign currencies or transactions in non-financial assets resulting in

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3 *This memorandum focuses solely on the derivatives to be regulated by the Commodity Futures Trading Commission and does not address the provisions for "security-based swaps" to be regulated by the Securities and Exchange Commission.*

4 The SEC's jurisdiction could include credit default swaps triggered by a failure to pay on a debt security even though it is an option with payment unrelated to the value of the underlying security.

physical delivery. The term "swap" is used to include *any* type of transaction including various forms of options and event-triggered payments.[5]

Registration duties: For activity within the CFTC's jurisdiction, there are *at least* four new types of entities that must apply for registration and satisfy the related requirements. These include:

- *Swap dealers* that make it their business to offer or arrange derivatives transactions, including capital requirements related to non-cleared exposures;
- *Major swap participants* that may have other business operations but tend to maintain a substantial net position in derivatives not associated with their commercial risk management ("hedging") activity, including capital requirements related to non-cleared exposures;
- *Swap execution facilities* that offer mechanisms for others to execute derivative transactions but do not choose to qualify as designated contract markets (the CFTC's current full-service market category), including core principles similar to those required of a designated contract market;[6] and

[5] Structurally, a traditional swap is virtually indistinguishable from a futures contract. Both track the value of something in a symmetrical way, have a limited life, and are generally settled by cash payments. The CFTC exempted them from being regulated as futures contracts only because – in the early years – their use was confined to quite large or affluent participants ("eligible swap participants") through private negotiation. See 17 C.F.R. §35.1 *et seq.* Swaps with asymmetrical payments are virtually indistinguishable from options, also under CFTC jurisdiction except when securities are involved. While Congress might decide simply to eliminate the "swap" category of instrument and to fold it into the futures and/or option regimes, proposals to date have not taken that approach.

[6] The existence of comparable "core principles" for swap execution facilities and for designated contract markets ("DCOs") may encourage new entrants to seek full DCO status.

- *Swap data repositories* that collect and disseminate trade date related to derivatives activity not conducted on a CFTC-regulated market or through a CFTC-regulated clearing organization, including core principles.

In addition, at least one of the bills authorizes - but does not require – the CFTC to impose standards on a foreign board of trade that allows direct access from the United States to its electronic trading and order-matching systems and settles based on the price of a U.S. market.

The definitions of "futures commission merchant," "introducing broker," "associated person," "floor broker" and "floor trader" would be amended to include persons dealing with derivatives ("swaps") other than futures contracts and commodity options.

Two categories of market that are now recognized in the Commodity Exchange Act – derivatives transaction execution facilities ("DTEFs") and exempt boards of trade ("EBOTs")– would be eliminated.

Trading on CFTC-registered facilities and through clearinghouses: The principal objective of most legislation is to require that derivatives transactions must occur on a transparent trading platform – a designated contract market or a swap execution facility – where the market is visible to all, and be made subject to the additional credit protections offered by a CFTC-regulated clearing organization.

Some bills prohibit derivatives trading except on a CFTC-designated contract market unless the parties are "eligible contract participants" as defined and modified in the legislation.

Transactions conducted between swap dealers, or between swap dealers and major swap participants, are generally required to be conducted on a trading facility and subject to clearing unless the facility or clearer refuses to do so. The latter could occur if the derivatives transaction deviates in its terms from the more standardized instruments routinely traded and cleared; the difference in terms could impede liquidation of customized transactions in the event of default.

Special rules for hedging end-users: The one group of derivatives participants that may continue – at its election - to conduct derivatives transactions away from a CFTC-regulated trading facility or a CFTC-regulated clearing organization are "eligible contract participants" as defined that are engaged in a line of commerce that is other than swaps trading ("end-users") and that employ derivatives to manage ("hedge") price risks arising from their commercial activities. These OTC transactions may be between end users, with a swap dealer, or with a major swap participant – an exception from the trading/clearing requirement for the latter two categories that would normally apply.

Financial requirements: In addition to the capital requirements imposed on registered swap dealers and major swap participants, the prudential regulator (CFTC, SEC or bank regulator) would establish initial and variation margin requirements for all non-cleared derivatives transactions that may include non-cash collateral if approved. Swaps to which a commercial hedger is a party may be exempt from the margin requirements under certain versions of the legislation.[7] Initial margin is to be segregated with an independent custodian for uncleared trades if the counterparty requests.

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[7] A proposal to "grandfather" existing swaps so as to require collateral only for swaps created after enactment, promoted by Berkshire Hathaway, was recently defeated in the Senate. It was not immediately evident whether the rejection applies only to swap dealers or (in Berkshire's case) major swap participants.

No federal assistance ("bail-out") is permitted to a derivatives clearing organization or swap entity.[8]

Trading restrictions: The CFTC or SEC may set position limits for derivatives that perform a significant price discovery function (e.g., price linkage, arbitrage, material price reference, etc.).[9]

Control of clearing organizations: The bills either restrict, or allow the agencies to restrict, the size of ownership interest in a clearing organization that swap dealers and major swap participants may hold (e.g., 20%).

Foreign access: Agencies may prohibit use of domestic derivatives by entities in a foreign country where regulation undermines U.S. financial stability.

Miscellaneous: A new provision for protecting and rewarding whistleblowers may be added, as may a prohibition against trading on the basis of nonpublic information gained from federal employment or from a federal worker. Some bills also create a "Consumer Financial Protection Bureau" that is largely unrelated to the regulation of OTC derivatives.

8 The term "swap entity" is defined to include swap dealers, major swap participants, swap execution facilities, designated contract markets or clearing house. It is a widely-held view that the inability of a swap entity to participate in the Federal Deposit Insurance Corporation's program or to borrow from the Federal Reserve's discount window will cause dual purpose banks/dealers to separate into different entities.

9 To the extent that trading occurs on a designated contract market or swap execution facility, that entity would presumably impose its own position limits.