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OTC Reform And What It Could Mean For Hedge Funds

On December 11, 2009 the U.S. House of Representatives passed sweeping legislation entitled The Wall Street Reform and Consumer Protection Act of 2009. Title III of the bill, the Derivative Markets Transparency and Accountability Act (the House Bill), covers over-the-counter derivatives transactions in response to the widespread perception that OTC derivatives, and particularly credit default swaps, substantially contributed to the financial crisis.

The Senate Committee on Banking, Housing & Urban Affairs is considering a companion bill currently in the form of a discussion draft submitted on November 16, 2009 by Committee Chairman Chris Dodd, entitled The Restoring American Financial Stability Act of 2009, which includes as Title VII, the Over-the-Counter Derivatives Markets Act of 2009 (the Senate Bill and, together with the House Bill, the Proposed Legislation). Dodd subsequently directed two committee members, Senators Judd Gregg and Jack Reed, to draft new language for the Senate Bill with a focus on OTC derivatives.

In whatever form the Proposed Legislation ultimately is enacted, it will subject, for the first time, OTC derivatives, as well as those entities that play a significant role in these markets, to comprehensive federal regulation. This will be accomplished by amending various provisions of the Commodity Exchange Act and the Securities Exchange Act of 1934.

Key Features

In all likelihood, the legislation will include the following general requirements:

- **Mandatory Clearing and Trading:** Swaps between Swap Dealers and/or so-called Major Swap Participants (MSP or MSPs) that would be accepted for clearing are required to be cleared. Swaps that are required to be cleared may be traded only on a regulated exchange or swap execution facility, except if no such exchange or facility is available for such trading.
- **Transaction Reporting:** Swaps that are not accepted for clearing, including swaps entered into prior to the legislation's enactment, must be reported.
- **Capital and Margin:** Swap Dealers and MSPs are required to reserve capital, and to collect margin from their swap counterparties, in amounts specified by the appropriate rulemaking agencies.
- **Segregation of Collateral:** A Swap Dealer, if requested by

its customer, must segregate collateral posted to the Swap Dealer to secure the customer's obligations to the dealer under an OTC swap.

Provisions Significant To Funds

Generally speaking, because of the definition of MSP and the various exemptions to the clearing and trading requirements in the House Bill, it likely would have a less severe impact on the hedge fund industry when compared with parallel provisions in the Senate Bill. The question whether such exemptions remain broad ultimately will be determined by the rules promulgated by the rulemaking agencies.

Under the House Bill, such rulemaking would be undertaken by the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission individually, after consultation with each other and the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and/or the Federal Deposit Insurance Corporation, as appropriate (called Prudential Regulators). The Senate Bill contemplates joint rulemaking by the SEC and CFTC.

Major Swap Participant. Under the Proposed Legislation, most of the requirements applicable to a Swap Dealer also apply to an entity that is categorized as an MSP. These include:

- registering with the SEC and/or the CFTC;
- requirements for the clearing, trade execution and reporting of swaps;
- capital reserving and margin requirements as specified by the appropriate rulemaking agency;
- documentation, back-office and recordkeeping requirements as prescribed by the SEC and/or the CFTC; and
- compliance with business conduct standards as adopted by the SEC and/or the CFTC.

Under the House Bill, an entity that is not a Swap Dealer is considered an MSP if that entity:

- (i) maintains a substantial net position in outstanding swaps, excluding positions held primarily for hedging, reducing or otherwise mitigating its commercial risk, including operating and balance sheet risk; or
- (ii) whose outstanding swaps create substantial net counterparty exposure among the aggregate of its counterparties that could expose those counterparties to significant credit losses. (House Bill § 3101(a)(39)(A); see also § 3202(a)(66).)

While the definition of an MSP in the Senate Bill appears to be substantially similar to the House Bill definition, the House Bill directs the SEC or CFTC, as applicable, to refine the terms “substantial net position,” “substantial net counterparty exposure” and “significant credit losses” (the Threshold Factors), and includes guidelines for the agencies to establish such thresholds.

Importantly, the House Bill provides that the Threshold Factors should be defined with reference to only uncleared trades and set at levels that enable “the effective monitoring, management and oversight of entities which are systemically important or can significantly impact the financial system through counterparty credit risk.” (House Bill §§ 3101(a)(39)(B), see also §3202(a)(67)(B).)

Thus, while not explicit in the text, the provision implies that the term Major Swap Participant will not include an entity if such entity’s failure to pay its obligations under swaps would not significantly impact the financial system. In addition, because cleared trades are to be excluded from the definition of the Threshold Factors, a hedge fund might be able to avoid classification as an MSP by clearing trades voluntarily.

We believe that, under the House Bill, only the largest and most leveraged hedge funds would be categorized as MSPs, whereas the Senate Bill would capture funds whose default or insolvency would have no material impact on the financial system as a whole. Neither version of the Proposed Legislation takes into consideration the mitigating effect of collateral on counterparty credit risk.

Capital and Margin Requirements

Underlying the Proposed Legislation is the conclusion that at least some hedge funds should be treated the same as banks, even though hedge funds are capitalized solely by sophisticated private investors and banks utilize funds deposited by the general public. Thus, MSPs are made subject to most of the same requirements as are Swap Dealers.

While the House Bill at least narrows the scope of those entities that could fall within the definition of MSP by including systemic impact as a factor to be considered by the relevant regulator, the Senate Bill seems to ignore this factor entirely. If banks and other financial institutions are subject to meaningful capital reserve requirements and are required to collect adequate collateral from their hedge fund counterparties, then a hedge fund’s failure to pay its obligations to a bank under a swap would not materially impact the bank, much less the financial system as a whole. The Senate Bill, if enacted, could result in the imposition of capital reserve requirements upon entities that otherwise would—and should—be able to set parameters for and manage their own risk without regulatory oversight.

Execution Requirements

The House Bill provides that a swap will not require clearing if one of the parties meets three criteria:

- (a) it is neither a Swap Dealer nor an MSP;
- (b) it has entered into the swap in order to hedge or mitigate commercial risk; and
- (c) it has notified the relevant agency as to how it will meet its financial obligations with respect to uncleared trades.

This means that, under the House Bill, a hedge fund that is not classified as an MSP may still need to clear those trades that are not entered into in order to hedge a commercial risk. The parallel provision in the Senate Bill permits the SEC or CFTC, as applicable, to exempt a swap from the clearing and trade execution requirements if one of the parties is not a Swap Dealer or MSP and also does not meet the eligibility requirements for any clearinghouse that would clear the swap. With respect to the clearing and trade execution requirements, then, it appears that the Senate Bill would offer greater flexibility to hedge funds than would the House Bill.

Position Limits

Although both versions of the Proposed Legislation would permit the CFTC and SEC to impose position limits on swaps and security-based swaps that perform or affect a “significant price discovery function,” the House Bill would authorize the SEC to impose position limits on security-based swaps whether or not they significantly facilitate price discovery. In addition, the Senate Bill, but not the House Bill, would permit the SEC to establish position limits for listed securities. Because the provisions in the Proposed Legislation would cover cash-settled transactions which, because of the depth of the market, are not susceptible to manipulation, we believe these limitations are overly broad and would hinder the steps being taken to revitalize the financial system. Given the strong adverse responses to these proposals based on the fact that the provisions are overly broad, it is uncertain what the legislation, when enacted, will provide on this subject.

At this time, the Senate will be evaluating the House Bill, and the Senate Bill is being revised by the Senate Banking, Housing & Urban Affairs Committee. The issues raised in this article may be among the most contentious topics debated in the context of the OTC derivatives portion of the Proposed Legislation. Whichever way Congress sways, the OTC derivatives legislation, when enacted, will result in a sea change in the way OTC derivatives are traded in the U.S.

This week’s Learning Curve was written by Sherri Venokur, member of the firm and chair, and Matthew Magidson, counsel, in Lowenstein Sandler’s derivatives practice group, and by Christine Boyle, associate in the corporate group.