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OTC DERIVATIVES REGULATORY REFORM: WHAT THIS COULD MEAN TO HEDGE FUNDS

By Sherri Venokur, Esq., Matthew A. Magidson, Esq., and Christine S. Boyle, Esq.

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

Simultaneously, 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 Senator Christopher J. Dodd, entitled "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").

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 of the Anticipated Legislation

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

- Mandatory Clearing and Trading. Swaps between Swap Dealers and/or Major Swap Participants 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 Major Swap Participants 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.

Significant Provisions for Hedge Funds and Other End-Users

Generally speaking, because of the definition of Major Swap Participant 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 (the “SEC”) and the Commodity Futures Trading Commission (the “CFTC”) 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 the “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 a Major Swap Participant. These include:

- registering with the SEC and/or the CFTC;

- requirements for the clearing, trade execution and reporting of swaps;
- capital reserve 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 a Major Swap Participant 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) (emphasis added).

While the definition of the term Major Swap Participant 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 only to 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) (emphasis added); 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 a Major Swap Participant by clearing trades voluntarily.

We believe that, under the House Bill, only the largest and most leveraged hedge funds would be categorized as Major Swap Participants, 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, Major Swap Participants 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 Major Swap Participant 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.

Clearing and Trade 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 a Major Swap Participant; (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 a Major Swap Participant 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 (x) is not a Swap Dealer or Major Swap Participant and (y) 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, as well as the discussion draft submitted by Senator Dodd on behalf of the Senate Banking, Housing & Urban Affairs Committee. The issues raised in this Client Alert 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 United States.

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INVESTMENT MANAGEMENT

Please contact any of the attorneys below, or any other member of Lowenstein Sandler's Investment Management Group, for further information on the matters discussed herein.

Robert G. Minion

973 597 2424
rminion@lowenstein.com

Allen B. Levithan

973 597 2406
alevithan@lowenstein.com

Marie T. DeFalco

973 597 6180
mdefalco@lowenstein.com

Peter D. Greene

646 414 6908
pgreene@lowenstein.com

Sherri Venokur

212 204 8698
svenokur@lowenstein.com

Elaine M. Hughes

973 422 6502
ehughes@lowenstein.com

Scott H. Moss

973 597 2334
smoss@lowenstein.com

Andres Rueda

646 414 6869
arueda@lowenstein.com

Matthew A. Magidson

646 414 6952
mmagidson@lowenstein.com

Richard Bernstein

973 422 6714
rbernstein@lowenstein.com

Cole Beaubouef

973 597 2322
cbeaubouef@lowenstein.com

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www.lowenstein.com

New York

1251 Avenue of the Americas
New York, NY 10020
212 262 6700

Palo Alto

590 Forest Avenue
Palo Alto, CA 94301
650 433 5800

Roseland

65 Livingston Avenue
Roseland, NJ 07068
973 597 2500