Hunton & Williams

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OTC Transactions Subject to Scrutiny: Legislative and Regulatory Developments

As the 111th Congress begins, over-the-counter (OTC) derivatives and commodity transactions are once again in the spotlight. With tremendous effort to right the economy at all levels of government, the trading markets will be significantly affected by both new legislation and new regulation. Some recent developments are discussed below.

Congressional Action

Rep. Collin Peterson (D-MN), chairman of the House Agriculture Committee, introduced draft legislation in January titled, "Derivatives Markets Transparency and Accountability Act of 2009" (the "Bill"). The Bill seeks to bring greater transparency to futures markets and order to the OTC market for swaps and other credit derivatives.

Chairman Peterson's proposed legislation is similar to a bill addressing the OTC market that the House passed last year (H.R. 6604) and legislation proposed last December by the Senate Agriculture Committee chairman, Sen. Tom Harkin (D-IA). The Bill takes a less severe approach than Sen. Harkin's proposed legislation, which sought to eliminate all OTC trading for derivatives and contracts for future delivery. The Bill is also broader than the Harkin Bill, addressing issues regarding credit default swaps and the trading of carbon and emission credits.

The Bill provides that:

- The U.S. Commodity Futures Trading Commission (CFTC) has jurisdiction over all OTC transactions, regardless of the nature of the underlying exposure.
- CFTC will set position limits for all commodities (other than bona fide hedges), including OTC transactions that may have significant market impact. Advisory groups will be established to recommend such position limits.
- CFTC has call authority to obtain information about any OTC market transaction.
- CFTC will establish reporting and recordkeeping requirements for all OTC trading.
- CFTC will disaggregate and publicly report the number and value of trades by index funds and certain other passive investors.
- CFTC will classify market participants as speculators or physical hedgers and publicly report information about their positions.
- All OTC trades must be settled and cleared through a CFTC-regulated clearing organization. Excluded

commodities (e.g., interest rate, currency), however, can clear through a clearing organization regulated by the Securities and Exchange Commission or the Federal Reserve. CFTC can exempt from the mandatory clearing requirement certain transactions that are highly customized, transacted infrequently and do not have a significant price discovery function.

- CFTC will regulate all trading of carbon and emission credits.
- "Naked" credit default swaps (where the party is not hedging an exposure) are prohibited.
- The "off-shore loophole" is partially closed by requiring foreign exchanges, for their U.S. participants, to maintain position limits and reporting requirements similar to U.S. exchanges.

The House Agriculture Committee held hearings the week of February 2 to solicit reactions to and comments on the Bill. In general, wide support was expressed for bringing transparency into the marketplace. The panelists, however, provided spirited discussion on several provisions in the Bill.

Several panelists favored position limits as a method of preventing speculators from causing too much volatility in the commodities market — volatility that purportedly has recently hurt farmers. This position appeared to resonate with several members of the House Agriculture Committee. In contrast, several panelists expressed concern that position limits would thwart the necessary and positive role of speculators in price discovery.

The proposal for mandatory clearing of OTC swaps was criticized by several panelists. Many of the panelists expressed concern with the chilling effect such a requirement might have in the financial and commodities markets. Many transactions are done on a bilateral basis since they are highly customized and do not trade widely. Panelists representing clearinghouses stated that such contracts are not suitable for centralized clearing. Proponents of mandatory clearing argued that such concerns were abated with the CFTC's authority in the Bill to exempt certain transactions. However, some panelists argued that, despite such authority to exempt transactions, a presumption that a transaction must be centrally cleared, together with the hurdle to obtain an exemption, would substantially inhibit the development of new products. For example, one panelist tied this concern to the budding market for carbon and emissions credits.

As an alternative to requiring central clearing for all OTC transactions, the hearings contained some discussion of the CFTC mandating capital and margin requirements applicable to all OTC trades. The panelists appeared mixed in their views regarding the effectiveness of such requirements. Some of the panelists, however, recommended formulating incentives for the major dealers to move to centralized clearing, such as capital relief for such trades.

The debate over banning naked credit default swaps was intense. Certain panelists argued that the ban would destroy a valuable risk management tool, and would damage liquidity and price discovery in the broader credit market. In addition, the ban would make index trading very difficult. Other panelists argued that the ban was needed, pointing to the alleged role of credit default swaps in the current financial crisis, particularly for AIG, and the related burden borne by the American taxpayers.

Several members of the House Agriculture Committee sought industry participation in finding a compromise on regulating credit default swaps (CDSs), such as granting CFTC the authority to periodically ban naked CDS positions if and when the SEC might temporarily ban short selling. In particular, Rep. Jim Marshall (D-GA) challenged the dealer community to begin offering potential solutions, labeling the dealer community's objections to date, in the absence of any proposals, as simply "stonewalling" the legislative process.

Joseph D. Morelle, chair of the New York State Assembly Standing Committee on Insurance, appeared on behalf of the National Conference of Insurance Legislators (NCOIL). He argued that credit default swaps are a specie of insurance, particularly when an economic interest is hedged. Morelle also raised an argument that the regulation of such credit default swaps should be left to the states as a matter of insurance law.

Chairman Peterson restated his position that the CFTC should become the regulator of credit default swaps and possibly most, if not all, derivatives. At one point, he stated that he is "flatly opposed" to giving the authority to regulate credit default swaps to the Federal Reserve or the SEC because of his concerns that such agencies are too close to the dealer community. Nevertheless, he recognized that it was unlikely that the CFTC would have exclusive jurisdiction.

Many panelists agreed with Chairman Peterson that the CFTC is competent to oversee trading of carbon and emission credits. However, none fully agreed with his position that the CFTC is better equipped to handle such trading than the Federal Energy Regulatory Commission "(FERC)". Chairman Peterson stated at one point that he was staking out a position in the Bill about which federal agency should be the regulator for carbon and emissions trading, and that he anticipates intense discussions with the House Energy and Commerce Committee, which is expected to support FERC as the appropriate regulator.

Several panelists mentioned the possibility that one or more of the proposals might push the futures and derivative markets overseas. Certain members of the House Agriculture Committee, including Chairman Peterson, did not agree. They referenced their conversations with foreign regulators, who purportedly thought the bankruptcy laws in such foreign states are not as robust as U.S. insolvency law to support trading. In several instances, members of the committee suggested that the U.S. should be a leader in regulating derivatives markets, a view that was tempered by several panelists who recommended that the U.S. not act unilaterally in this area, given the reality that the commodities and derivatives market is a global one.

The House Agriculture Committee will now begin marking up the Bill. Chairman Peterson announced he expected to have additional hearings on the Bill in the next four months.

State Action

State representatives of the National Conference of Insurance Legislators (NCOIL) met in late January to discuss regulation of credit default swaps. No action resulted from the January meeting. However, the general sentiment appears to be that states should regulate credit default swaps. Thus, it is foreseeable that NCOIL may draft model legislation to be adopted by the states.

SEC Action

To promote the operation of central clearing of credit default swaps, the SEC issued temporary rules to make technical adjustments to the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act") and the Trust Indenture Act of 1939. The commission, however, did not alter the definition of "swap agreement" for purposes of the exclusion of swaps from constituting "securities" as provided by Section 2A of the Securities Act and Section 3A of the Exchange Act.

How We Can Help

The statutory and regulatory framework for financial and commodities transactions is rapidly changing. Hunton & Williams has been monitoring these developments. We are working with our clients to fashion effective solutions to address those changes affecting their businesses. Our combination of substantive experience in energy, commodities and derivatives and of extensive work in federal and state government matters offers our clients strategic insight about the legal developments in the derivatives and commodities markets. When called upon, we also represent clients in the legislative and regulatory processes. Please let us know if we can help your company in this area.