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Clients&FriendsMemo

Some Concerns with the Derivatives Legislation

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Ordinarily, in writing with regard to a proposed law, the expected role of the law firm lawyer is to provide a description rather than commentary. In the case of the proposed Derivatives Legislation,[1] the law firm lawyer attempting a non-committal description must confront the following problems: (i) the Derivative Legislation's substance is inconsistent with its stated purposes; (ii) the Derivatives Legislation would give a degree of discretionary power to the U.S. government that is far out of the ordinary; (iii) the legislation is loosely drafted in even its key provisions; (iv) it could make for radical changes in the financial system that seem not to have been considered; (v) it would likely motivate institutions to move jobs to Europe, damaging the U.S. economy and particularly the Northeastern financial center economy; (vi) it would discourage banks' capital market and real estate lending in the United States by increasing their risks; and (vii) it would hurt banks' profitability at a time when they are struggling.[2]

The above list of problems with the Derivatives Legislation has, itself, an inherent problem: it seems over-agitated. How can it be credible to suggest that proposed legislation that has passed each House of Congress, in varying forms, and has been the focus of so much favorable press commentary, could be quite so harmful?

To answer this question, it is necessary to describe the actual words in the Derivatives Legislation, and to talk about what they mean, what their likely effects would be and what questions these words leave unanswered.

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1 There have been a goodly number of versions of the "Derivatives Legislation." For the purpose of this memorandum, we refer to Senate Amendment No. 3739 to Senate Bill 3217, proposed April 29, 2010, (pp. 501-893): http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s3217as.txt.pdf The criticisms that are expressed herein as to this version of the Derivatives Legislation would apply, with minor modifications, to all of the versions.

2 For a prior memorandum expressing the concern that the "reform" of financial regulation is moving in the wrong direction, *see* Cadwalader Clients & Friends Memo: "The Future of Financial Regulation: Meet the New Regulators, Better Than the Old Regulators?" (Jan. 27, 2009), available at http://www.cadwalader.com/assets/client_friend/012209_Future_of_Financial_Regulation.pdf

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Substance of the Derivatives Legislation.

The "Derivatives Legislation" is now more formally titled the "Wall Street Transparency and Accountability Act of 2010." The title of the legislation, the use of the word "Accountability," is telling: a good part of the justification for the legislation, and certainly much of the associated "discussion," is about finding a villain. And while the Derivatives Legislation purports to be about derivatives regulation, in fact, much of the body of the bill seems less about regulating derivatives than it does about which regulator is to be divvied up the authority for that regulation.

As the financial crisis has unfolded, various federal government regulators have come under criticism for supposed miscues. It has been rumored that the Office of Thrift Supervision would be eliminated; that the CFTC would be merged into the SEC; that the SEC would be reduced in stature; that the FDIC would be merged into the Federal Reserve Board; that the Federal Reserve Board would be stripped of its power; that all of the federal regulators would lose power over credit default swaps to state insurance regulators.

Against that background of regulatory attacks and counterattacks, a very significant focus of the Derivatives Legislation is on the shifting balance of power between the banking regulators, the SEC and the CFTC. To illustrate this point, it is useful to compare how Congress handles two legal questions that are raised by the Derivatives Legislation: (i) how to split up power between the CFTC and the SEC, on the one hand; and (ii) how to determine which "Wall Street" entities should be regulated as major swap participants, on the other.

i. *Procedures Relating to the CFTC/SEC Jurisdictional War.* Ever since the CFTC's authority was expanded to include financial products in 1974, the CFTC and the SEC have been at odds over their jurisdictions. While this kind of jurisdictional turf fighting is not unusual in Washington (the CFTC also fights with the Federal Energy Regulatory Commission and the SEC also fights with the banking regulators), there is no other jurisdictional battle in which the lulls are so infrequent. The Derivatives Legislation should be seen as the latest round of that battle.

It is this inter-agency battle between the CFTC and the SEC that takes up a disproportionate share of the actual words of the "Derivatives" Legislation. Of the first 24 pages of the bill, 20 pages set out how the CFTC and the SEC will "work together," including very detailed procedures as to how long the arguments between the agencies may continue, the procedures for judicial review, and what happens during the period between the time in which the SEC and the CFTC go to court and a final court decision. Beyond the first 24 pages of the bill, the Derivatives Legislation includes extensive details as to the manner in which the SEC, the CFTC and the various banking regulators must consult with each other, or not, and which can take action on their own, and which can second guess the others.

ii. *Procedures Relating to Regulated Entities.* The Derivatives Legislation by its terms requires each of the CFTC and the SEC to determine those entities—referred to as "major swap participants"[3] ("MSPs")—(i) whose activities "could have serious adverse effects on the financial stability of the United States banking system or financial markets" or (ii) that enter into swaps and are "highly leveraged" or (iii) that "maintain a substantial position . . . in any major swaps category." The matter of determining which entities are MSPs should be of great importance inasmuch as these are the entities whose failures could have "serious adverse effects" on U.S. financial stability.

As to MSPs, one should expect at a minimum that the Derivatives Legislation would set out **at least the following fundamental procedures:** (i) the procedure by which the SEC or the CFTC makes a determination as to which entities fit into the definition by virtue of their potential adverse effects on the economy or high leverage; (ii) a procedure for an entity to contest the determination by the SEC or the CFTC that it is an MSP; (iii) if an entity becomes subject to regulation as an MSP, a process and timeframe during which it might come into compliance with any regulations to which it might be subject; and (iv) a procedure by which an MSP might show that it has altered its conduct so that it is no longer subject to regulation.

On these fundamental procedural requirements, seemingly essential to the operation of the new regulatory scheme, the Derivatives Legislation is **silent.** This comparison demonstrates the true topic of the Derivatives Legislation: (i) on the topic of administering disputes between the SEC and the CFTC, **20 pages**; (ii) on the topic of procedures for determining which entities' failure would create financial instability in the United States, **0 pages**.

Turning from procedure to substantive questions: (i) what do the words in the Derivatives Legislation defining the term "major swap participant" mean? (ii) how in practice would the regulators determine which entities fit within the words? and (iii) how would the regulators make "fair" judgments as to whom to regulate?

Words like "substantial position" and "highly leveraged" **have no meaning in law;** and they have **no economic meaning** without context. Whether an entity is "highly leveraged" will depend on numerous factors, such as the liquidity and volatility of its positions, the concentration of those positions, the term of its debt and so on. The Derivatives Legislation establishes no procedure by which the CFTC or the SEC may determine whether an entity is "highly leveraged." Will every entity that is in the United States or that does business in the United States (and that enters into

[3] Section 721: Definitions (Major swap participant) (pp. 539-41); Section 761: Definitions Under the Securities Exchange Act of 1934 (major security based swap participant) (pp. 764-67).

derivatives) have to furnish its balance sheets to the CFTC and to the SEC? Would entities have to furnish their balance sheets daily, monthly, yearly? How will the regulators compute leverage; *e.g,* would this be specific as to each entity or would there be any distinctions made on the basis of the type of entity or the business that the entity was in? Would it matter if the entity was leveraged through overnight repurchase agreements or 30-year term debt?

Similarly, it is unclear how the CFTC and the SEC would determine that an entity's failure could have a substantial impact on the U.S. economy. How will the regulators analyze the transactions (not limited to swaps) into which a firm has entered, and then analyze the financial position of its material counterparties, let alone the financial position of the second level counterparties?

Where the words in a statute have no legal meaning, and where there is no procedure by which the words could be implemented in practice, the regulators will of necessity make judgment calls. There is neither a procedure in the Derivatives Legislation to challenge those judgment calls; nor, if there were such a procedure, would there be a basis on which to make a challenge of a regulator's judgment. In the absence of words that have legal meaning, there is no basis for regulated persons to appeal to an arbitrator or the court.

What will be the Effect of the Law? The adoption of a law should be based on a vision of how the law might impact the world. The proponents of the Derivatives Legislation seem not to have considered the way in which the Derivatives Legislation might change, arguably damage, the financial markets and the U.S. economy.

Termination of Contracts. For example, a derivative contract typically contains a provision that either party can terminate the contract if there is a change in law (such as the adoption of the Derivatives Legislation) that would either (i) make the continuation of the contract illegal or (ii) impose added costs on a party. This type of provision is not unique to derivatives; it's legal boilerplate in many different types of contracts. Adoption of the Derivatives Legislation would constitute a "change in law" that could either make many existing derivatives illegal or that could increase the costs to the parties. Thus, it **should follow** that many derivatives will be terminated either because they must be (they have become illegal) or because they are no longer economically rational in light of the increased costs.

However, the Derivatives Legislation contains a provision that provides that no party to a derivatives contract can terminate the contract on the grounds that the Derivatives Legislation has made the contract illegal.[4] In other words, (i) the Derivatives Legislation will make it illegal to be party to certain contracts; **and** (ii) the Derivatives Legislation will also make it illegal to terminate those contracts.

[4] Section 739: Legal Certainty For Swaps (pp. 706-7).

Use of Swaps Subsidiaries. It appears that one of the ways in which Congress expects firms to cope with the new requirements is to transfer swaps positions from an existing company (the "parent") into a newly established swaps affiliate (the "subsidiary") that will be limited to a swaps business. The concept appears to be that by isolating swaps in the subsidiary, this will reduce the risk caused to the parent by the swaps. While this concept of isolating risk has surface appeal, economically the benefits are questionable and there are some clear disadvantages.

The parent will be required to establish a new swaps subsidiary, which will potentially be a drain of human resources, and to capitalize it, which will be a burden on the parent's assets. Since the new swaps subsidiary will be weaker than the parent, counterparties will likely ask for a parent guarantee (putting the parent back where it started) or else will settle for doing business with the smaller subsidiary, which is likely at greater risk of failing than the larger parent. Assuming that the parent corporation wanted the economic benefits of the swaps transactions, the subsidiary must transfer those economics back into the parent (again putting the parent back where it started).

The regulators may believe that if the swaps entity fails, the parent will be able to survive. This is unlikely. The lesson to be learned from the Lehman Brothers insolvency is that if any company in a financial holding company structure fails, there will inevitably be a run on all the other companies in the holding structure, likely bringing them all down. Further, the parent company will almost certainly be subject to cross-default provisions, so that a failure of the swaps entity will result in the parent company defaulting on its own obligations.

Congress is thus drawing the wrong lesson from the failure of Lehman Brothers and from that of AIG. The lesson is not to regulate swaps. The lesson is that it is ineffective to regulate the capital of a subsidiary (whether a bank, a broker-dealer or an insurance company) if the capital of the holding company is not regulated: the financial failure of an unregulated holding company will likely result in a run on, and the ultimate failure of, the regulated subsidiary. Thus, moving risk from a parent to a weaker swaps subsidiary is counterproductive.

Price Controls. One of the goals that the Derivatives Legislation is intended to accomplish is to impose indirect price controls on energy and agricultural commodities. The way that these price controls are intended to work is that the CFTC will establish "position limits" (that is, limit the amount of a particular asset that can be purchased) by any "group or class of trader."[5] The CFTC's power would not be limited to controlling the actions of a single entity or of a group of entities acting together—the CFTC could regulate individuals, even though acting wholly independently of

[5] Section 737: Position Limits (for commodity-based swaps) (pp. 694-698); see also Section 763(h) (position limits for security-based swaps) (pp. 831-34).

each other, that the CFTC deems to be in the "same class" (a term that is crucial to understanding the Derivatives Legislation—but nowhere defined).[6]

For example, suppose that the price of oil rises to $300 a barrel and the CFTC determines the price of oil should be $200 a barrel. Suppose that there are 100 public commodity pools of varying size that have, over varying periods of time, purchased oil futures. To reduce the price of a barrel of oil to the "right" price of $200, the CFTC would establish a "position limit" on these 100 commodity pools (and all other public commodity pools) so as to reduce demand for oil and force the price of oil down to $200. But can the CFTC (i) not only "know" the right price of oil, or at least know it better than the collective wisdom of the market; and (ii) arrive at that right price by forcing buyers out of the market?[7]

How will, or can, this be implemented? The Commodity Exchange Act has long had provisions that limit the positions that any one person, or group of persons acting together, can purchase. However, the CEA does not have any provision that provides that (i) if I purchase an asset, (ii) you will be limited in your purchases, even though you have no relationship with me, because we are of the same "class." The Derivatives Legislation does not explain how this could work. For example, if I purchased oil first, does that mean that you would be prevented from buying any oil? If you wanted to purchase oil, would I have to sell?

Banks Out of the Swaps Market. The Derivatives Legislation would effectively force U.S. banks out of the swaps market.[8] The effect of the prohibition seems not to have been truly considered by Congress[9] and so it seems worthwhile to raise some of the likely consequences of such a prohibition.

As a starting matter, the banks will have to fire people involved in the swaps business and sell assets related to the swaps business. Who will hire the people? Who will buy the assets?

Banks use derivatives for a variety of risk management purposes. For example, when a bank makes a loan to a corporation, it may also enter into a credit default swap that hedges the risk of the loan.

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6 The existing position limits of the CFTC are not intended to act as a means of price control, but to prevent any person, or group of persons, from engaging in manipulative behavior.

7 *But* see a 2002 speech by Ben Bernanke, now the Chairman of the Federal Reserve Board, then a mere governor, arguing that it is not practicable for the government, or at least the Federal Reserve Board, to identify and pop asset bubbles. *"Asset Price Bubbles and Monetary Policy."* http://www.federalreserve.gov/boarddocs/speeches/2002/20021015/default.htm

8 Section 716: Prohibition Against Federal Government Bailouts of Swaps Entities (pp. 513-515).

9 One proof of this is that much of the Derivatives Legislation is largely concerned with the regulation of swaps activity by banks. If banks are prohibited from doing swaps, why do we have to regulate their swaps activity?

If banks can not enter into credit default swaps, then they would likely make fewer loans and face greater risk on those loans they did make.[10]

There may be some who believe that, if the United States adopts a law prohibiting U.S. banks from entering into swaps, the Europeans will follow suit. By driving U.S. banks out of the swaps business, the United States will be clearing the market for the European banks, disabling U.S. competition. Why would non-U.S. governments not see this as a great opportunity for their regulated banks?

Questions for Legislators and Regulators.

The Derivatives Legislation will make for major changes in our economy and our economic system. This memorandum proposes the following partial list of questions that should be answered before these changes are adopted:

- The Derivatives Legislation may effectively prohibit banks from entering into swaps such as interest rate swaps or credit default swaps. What will be the effect of those prohibitions on the risks that banks must assume in connection with lending activities either in real estate or in the corporate financial markets? What will be the effect of the prohibitions on corporate entities that want to transform their interest payments; *e.g.*, from fixed to floating rate? What will be the effect on mortgage lenders that are seeking to hedge interest rate changes as in real estate loans?

- If the swaps business is profitable, and yet banks have lost a substantial amount of money over the last few years, won't taking swaps out of banks make it even more likely that banks will fail by reducing their profitability? To the extent that banks use swaps for hedging, won't taking swaps out of banks increase the risk that banks take, making them more likely to fail?

- The Derivatives Legislation will result in a "substantial" increase in the number of entities that the CFTC and the SEC must regulate, the types of transactions that they regulate, and the number of rules that they must enforce. Can the CFTC and the SEC adopt all the necessary rules in the six months required by the Legislation? What is the estimated cost to the agencies of regulating so many additional new entities: dealers, major swap participants, new types of exchanges, trading repositories? Will the agencies require

[10] *See* Speech by Federal Reserve Board Chairman Ben Bernanke, June 12, 2006, Modern Risk Management and Banking Supervision ("To an important degree, banks can be more active in their management of credit risks and other portfolio risks because of the increased availability of financial instruments and activities such as. . . credit derivatives . . . ") http://www.federalreserve.gov/newsevents/speech/Bernanke20060612a.htm

additional staffing? How much and at what skill levels? Will the agencies be able to continue their continue tasks while taking on these new requirements?

- How will the CFTC and the SEC determine whether an entity poses a risk to the U.S. financial system? How will the CFTC and the SEC determine whether an entity is highly leveraged?

- How will the CFTC and the SEC determine whether the price of an asset is too high or too low? Assuming that the regulators do not currently have expertise to determine "true" prices, how will the regulators develop and maintain such expertise?

- The Derivatives Legislation prohibits swaps from being terminated even if the swaps have now become illegal. Assuming that this provision is dropped from the final bill, what is the value of the swaps that will be terminated on the basis of the legislation; and how will the termination of the swaps affect the U.S. markets?

- The Derivatives Legislation prohibits the federal government from providing any assistance to a failing clearing corporation. Since the Derivatives Legislation requires the centralization of credit risk in the clearing corporations, and there will be very few clearing corporations, won't the clearing corporations be the ultimate "too big to fail"?[11]

- If the Derivatives Legislation is adopted, will other countries follow suit and prohibit their banks from entering into swaps? If the answer is no, what will be the effect on the competitive position of U.S. financial institutions?

- Recently the SEC has conducted a number of investigations as to the use of credit default swaps in connection with insider trading. What is the logic for giving the CFTC, rather than the SEC, jurisdiction over many credit default swaps? Won't splitting jurisdiction over trading in such instruments impede the efforts to catch insider trading?

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[11] One of the "concepts" that has been marketed in connection with the Derivatives Legislation is that the use of a clearing corporation somehow "disappears" risk. This can not be true; otherwise, it would be possible to transfer an infinite number of transactions to a clearing house without risk. In fact, the more "open" the clearing house is, in terms of the types of transactions that it will accept and the parties that it will take as members, the more risk that there will be in the clearing house. *See, e.g*, John W. McPartland, *Federal Reserve Bank of Chicago*, (Oct. 1, 2009) Reproduced from Chicago Fed Letter Number 267. The same author has published a series of Chicago Fed Letters on clearing and settlement; these are available on the Chicago Fed website. *See, e.g. Fed Letter Number 210 (January 2005)* ("Another one of the issues that arises is the continued consolidation among CCPs [central clearing parties] concentrates the aggregate risk . . .To understand how clearing and settlement systems operate, specifically how the CCPs support today's modern securities and derivatives markets, we need to consider the intricate inter-relationship that exist between the CCPs and payments systems, exchanges, trade intermediaries, settlement banks, market participants and other CCPs. **One should not take this financial "plumbing" for granted just because it is often out of view."**)

What Could Be Done to Improve this Legislation?[12]

The following general concepts in the legislation could be made workable (although actual language should be cleaned up and it would be better to consider their ramifications with more care, particularly as they materially effect the energy and agriculture markets):

- Require the registration of swaps dealers (subject to the CFTC) and securities swaps dealers (subject to the SEC); banks should remain solely subject to the banking regulators.[13]

- Authorize the regulators to establish capital regulations, margin requirements, and asset protection requirements that would apply to regulated dealers, including banks.[14] Allow commercial users to enter into swaps without being subject to margin requirements, provided that the dealers take an appropriate capital charge.

- Authorize the CFTC, the SEC and the banking regulators to devise a system by which swap transaction information could be reported to the regulators, collected and aggregated.[15] Estimate the expense of such a system. Make a recommendation as to whether such a system should be adopted and whether it should apply to all swaps. (Assuming that it should be implemented, this would provide the information necessary to determine whether further regulation is desirable and what such regulation should look like.)

- Clarify or improve the bankruptcy treatment of cleared swaps, both on CFTC regulated swaps and SEC regulated swaps.[16]

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[12] This memorandum has tried to point some illustrative problems with the Derivatives Legislation. To demonstrate that the problems in this memorandum are not a complete list, we will point out two other major inconsistencies: (a) the Derivatives Legislation would require that anyone entering a swap with a pension plan be a "fiduciary" to that pension plan; however, existing law makes it illegal for a "plan" to enter into a swap with someone who is a fiduciary to the plan; (b) the Derivatives Legislation requires swaps to be effected through clearing corporations, but the most recent amendments proposed today to the Derivatives Legislation would provide that swaps can no longer terminate on a party's bankruptcy—making them as a practical matter impossible to clear.

[13] *See* Sec. 731: Registration and Regulation of Swap Dealers and Major Swap Participants (p. 642); Sec. 764: Registration and Regulation of Security-Based Swap Dealers and Major Security-Based Swap Participants (p. 848).

[14] *See id.*

[15] *See* Sec. 727: Public Reporting of Swap Transaction Data (pp. 623-27); Sec. 761(i) (Public Reporting and Repositories for Security-Based Swaps) (pp. 834-39).

[16] *See* Sec. 724: Swaps; Segregation and Bankruptcy Treatment (pp. 586-593); Sec. 763(d) (Segregation of Assets Held as Collateral in Security-Based Swap Transactions) (pp. 824-828).

- Provide that credit default swaps are not an insurance product.[17] Give regulatory authority over credit default swaps to the SEC, which is the logical agency to monitor their use in connection with insider trading.

- Provide that (i) security-based swaps are "securities" for purposes of the Advisers Act and the Investment Company Act and (ii) advice with respect to swaps on commodities may subject an entity to registration as a commodity trading advisor under the CEA.[18] Require the CFTC and the SEC to conform the regulatory requirements that apply to advisers who must register with both agencies.

- Authorize a study of portfolio margining, which will facilitate the integration of CFTC swaps and of derivatives subject to the securities laws.[19]

- Conduct studies of the financial markets led by persons without political allegiances or academic hobbyhorses.

- Give the CFTC authority to set swaps positions limits as to any "person," to the same extent that the CFTC now has authority with respect to futures, *i.e.,* to prevent price manipulation.[20]

- Improve recordkeeping requirements around (i) swaps, (ii) collateral arrangements, (iii) inter-affiliate transactions and (iv) valuations.[21]

- As a general rule, "swaps" should be regulated in a manner that is consistent with the way in which securities are regulated.[22]

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If you have any questions about the foregoing, please contact Steven Lofchie at steve.lofchie@cwt.com or at (212) 504-6700.

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[17] *See* Sec. 721 (defining "Swap") (pp. 545-55).

[18] *See* Sec. 721 (defining "Swap") (pp. 545-55); Sec. 761 (defining "Security-Based Swap) (pp. 767-70).

[19] *See* Sec. 713: Recommendations for Changes to Portfolio Margining Laws (p. 512).

[20] *See* Sec. 737: Position Limits (for commodity-based swaps) (pp. 694-698).

[21] *See* Sec. 729: Reporting and Recordkeeping (pp. 636-639); Sec. 766: Reporting and Recordkeeping (pp. 881-887).

[22] Although I am seldom fully in agreement with the SEC on any conceptual point, I generally agree with a statement made in a letter by SEC Chairman Schapiro to Senator Lincoln: "swaps often are just economic substitutes for the asset or event underlying a contract."