Morrison & Foerster News Bulletin

Volume 1, Issue 9 June 29, 2010

# Structured Thoughts

News for the financial services community.

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## The Impact of Financial Regulatory Reform on Structured Products

During the early morning hours of June 25, 2010, another hurdle in the financial regulatory reform process was cleared when a House-Senate Conference Committee concluded deliberations on the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"). The Act will now move to both chambers of Congress for approval, with the intent of having President Obama sign the Act into law by July 4.

The Act will impact the structured products industry largely in an indirect manner. Many provisions of the Act will adversely affect the ability of structured products issuers to hedge their exposures. In addition, new investor protection provisions and an enhanced definition of "accredited investor" may impact the offering process for structured products. The following is a general summary of the key provisions:[1]

[1] It should be noted that the ultimate scope of the Act's provisions will be unclear for quite some time, as it either directs or permits the Securities and Exchange Commission (the "SEC"), the Commodity Futures Trading Commission (the "CFTC"), and the Federal banking regulators to undertake hundreds of rulemakings.

## Implications for Hedging Activities[2]

### *Higher Hedging Costs*

The Act likely will lead to higher hedging costs for issuers of structured products. Under the Act, a swap[3] must be cleared to the extent that the CFTC or SEC, as applicable, has determined that the swap is required to be cleared and a clearinghouse has accepted the swap for clearing.[4] However, the Act provides an exception to the clearing requirement for certain commercial hedgers. Specifically, a swap is not subject to mandatory clearing if one of the counterparties to the swap is not a "financial entity,"[5] is using swaps to hedge or mitigate commercial risk, notifies the applicable regulator how it generally meets its financial obligations associated with entering into non-cleared swaps, and elects not to have the clearing requirement apply to the swap. To the extent that a swap must be cleared, it must also be executed on an exchange, unless no exchange makes the swap available for trading.

Taken together, these requirements likely will lead to higher hedging costs, due to the clearinghouse's margin requirements and transaction fees for the exchange. Issuers also should experience higher hedging costs for swaps that are not required to be cleared. Those swaps will be subject to new initial and variation margin requirements that the Act requires to be prescribed.

### *Limits to Amount of Hedging*

The Act contains certain provisions that could limit the amount of hedging that issuers of structured products may do. The CFTC is directed, and the SEC is authorized, to prescribe aggregate position limits for swaps and security-based swaps, respectively. The position limits contemplated by the Act are broader than existing or CFTC-proposed position limits because both exchange and OTC positions would be included.

The Act also broadens application of the quantitative limits in Section 23A of the Federal Reserve Act for bank affiliate transactions. This is accomplished by expanding the definition of "covered transaction" to include a "derivative transaction" with a bank's affiliate to the extent that it creates a credit exposure.[6] Thus, a bank issuer of a structured product will be prevented from entering into a swap with an affiliate if, taking into account that swap, the aggregate amount of covered transactions with that affiliate would exceed 10% of the bank's capital stock and surplus or the aggregate amount of covered transactions with all of the bank's affiliates would exceed 20% of the bank's capital stock and surplus. Note, however, that this would only be an issue in the context of swaps that are not cleared, because swaps subject to mandatory clearing would have to be executed on an exchange, barring an exemption.

### *Regulatory and Compliance Costs*

Issuers that qualify as "swap dealers"[7] or "major swap participants"[8] will be subject to a new regulatory regime those could have significant compliance costs. Among other things, swap dealers and major swap participants will be

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[2] We will publish a more detailed analysis of the derivatives provisions contained in Title VII in the near future.
[3] For convenience, the term "swap" includes both "swaps" and "security-based swaps," the term "swap dealer" includes both "swap dealers" and "security-based swap dealers," and the term "major swap participant" includes both "major swap participants" and "security-based participants."
[4] The regulator's determination may relate to an individual swap or any group, category, type, or class of swaps.
[5] A "financial entity" includes swap dealers, major swap participants, commodity pools, certain private funds, and pension plans but excludes certain finance company affiliates of manufacturers that hedge interest rate and foreign currency risk.
[6] Currently, credit derivatives are the only derivatives included in the "covered transaction" definition.
[7] A "swap dealer" is any person who (i) holds itself out as a dealer in swaps, (ii) makes a market in swaps, (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or (iv) engages in any activity causing the person to be commonly know in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer. The Act also requires the CFTC to prescribe an exemption from the definition for an entity that engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers. Note, however, that definition of "security-based swap dealer" does not contain the proviso relating to customer loan origination or the *de minimis* exception.
[8] A "major swap participant" is any person who is not a swap dealer and (i) maintains a substantial position (to be defined by the CFTC or SEC, as applicable) in swaps for any of the major swap categories as determined by the applicable regulator, excluding positions held for hedging or mitigating commercial risk and positions maintained by pension plans for the primary purpose of hedging or mitigating any risk directly associated with the

required to register with the CFTC or SEC, as applicable, and will be subject to new capital and margin requirements, reporting and recordkeeping requirements, and business conduct standards, which include certain disclosure obligations with respect to the material risks and characteristics of a swap and any material incentives or conflicts of interest.

## Implications for the Offering of Structured Products

### *Investor Protection*

The Act contains a number of provisions aimed at increasing investor protection. It establishes within the SEC the Investor Advisory Committee and the Office of the Investor Advocate. Among other things, the Investor Advisory Committee will advise and consult with the SEC on the effectiveness of disclosure and initiatives to protect investor interest and the Office of the Investor Advocate will identify problems that investors have with financial service providers and investment products.

The Act grants the SEC rulemaking authority to require broker-dealers to provide retail investors with specific documents or information prior to the purchase of an investment product or service. It also (i) requires the SEC to conduct a study to evaluate the effectiveness of existing legal or regulatory standards of care for broker-dealers and investment advisers providing personalized investment advice and recommendations about securities to retail customers and (ii) provides the SEC with rulemaking authority to require broker-dealers and investment advisors to act in the best interest of retail customers when providing personalized investment advice about securities to those customers. Other studies required by the Act include studies regarding financial literacy among investors and conflicts of interest.

### *Accredited Investor*

Lastly, the Act requires the SEC to increase the net worth standard for a natural person in the definition of "accredited investor." Specifically, the net worth of the person (or joint net worth with that person's spouse) must exceed 1,000,000, excluding the value of the person's primary residence. Although the SEC is granted the authority to periodically adjust the dollar threshold, the $1,000,000 threshold must remain for the next four years.

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operation of the plan, (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets, or (iii) is a financial entity that is highly leverage relative to the amount of capital it holds, that is not subject to capital requirements set by a Federal banking agency, and maintains a substantial position in outstanding swaps in any major swap category. Certain finance company affiliates of manufacturers that hedge interest rate and foreign currency risk are excluded from the definition of "major swap participant" but not from the definition of "major security-based swap participant." The latter definition also does not contain the reference to pension plans.

# Clearing the Way for Reform: European Commission Public Consultation on Derivatives and Market Infrastructures

On the 22 September 2009, it was agreed by leaders of the G-20 countries that all standardised over the counter ("OTC") derivatives should be traded on exchanges or electronic trading platforms and cleared through central clearing counterparties ("CCPs") by the end of 2012. At this time, the EU Commission (the "Commission") had already completed a public consultation on the clearing and settlement of OTC derivatives, which was discussed at a high-level conference in Brussels on 25 September 2009.

The EU Commission subsequently published a communication entitled "Ensuring efficient, safe and sound derivatives markets: Future policy actions" on 20 October 2009 (the "Communication").[9] This communication confirmed that the Commission was seeking to achieve a paradigm shift away from what it considered was the traditional view that derivatives are for professional use, for which light-handed regulation is sufficient.

In the Communication, the Commission set out four key areas in which it proposed to take action in connection with OTC regulation being:

- reducing counterparty credit risk, in particular by strengthening the requirements for clearing derivatives;
- reducing operational risk, in particular by further standardising the contracts and electronic processing of transactions;
- increasing transparency, in particular by the use of trade repositories and enhanced transaction reporting; and
- improving market integrity and oversight including extending the Market Abuse Directive to OTC derivatives and imposing position limits.

On 14 June 2010, the Commission published a public consultation (the "Consultation")[10] noting that it is in the process of finalising its draft legislative proposals arising from the consultation process to date but that it considers finalising its views necessary in respect of four specific issues: 1) clearing and risk mitigation of OTC derivatives, 2) the requirements for central clearing counterparties, 3) interoperability between CCPs, and 4) the reporting obligations and requirements for Trade Repositories. The Consultation also gives consideration to the role that the European Securities and Markets Authority[11] ("ESMA") may play in this regard. The Commission notes that it will consider the responses to the Consultation in finalising its legislative proposals for regulation of OTC Derivatives, which it currently proposes to adopt in September 2010.

## Clearing and Risk Mitigation of OTC Derivatives

The Commission proposes that financial counterparties will be required to clear all those OTC derivative contracts which it has determined are subject to an obligation to be cleared (a so-called "clearing obligation"),[12] in a relevant CCP. Accordingly, it needs to determine which contracts should be subject to such a clearing obligation. In this regard, the Commission has devised two possible approaches.

The first of these is referred to as a bottom-up approach. Here the CCP proposes to clear certain contracts and then submit a proposal for approval to the relevant Competent Authority. Once this is received, the Competent Authority will inform ESMA of its decision to approve the CCP's clearing of those contracts. ESMA will then

[9] The European Commission, "Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank": http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20091020_563_en.pdf.

determine whether a clearing obligation should apply to those contracts.[13] In this way, classes of existing cleared contracts will be separated between those that are obligated to be cleared and those that are not.

However, the bottom-up approach fails to encompass any contracts which should also be subject to a clearing obligation, but for which a clearing facility does not yet exist in practice. The second, top-down approach deals with this through ESMA, together with the European Systematic Risk Board ("ESRB"),[14] making a determination as to which (presently non-cleared) contracts should be subject to the clearing obligation. The Commission believes that both approaches are necessary on the basis that "meeting the G-20 commitment cannot be left entirely to the initiative of the clearing industry."

To the extent that derivative contracts are put in place which are not subject to the clearing obligation, the Commission states in the Consultation that it would still expect counterparties to put appropriate procedures and arrangements in place to "measure, monitor and mitigate operational and credit risk." These might, among other things, include the use of electronic means to provide effective and comprehensive trading confirmations, as well as robust and resilient processes to monitor the value of outstanding contracts on a mark-to-market basis.

## Non-Financial Undertakings

The extent to which the new regulatory regime for OTC derivatives will impact upon non-financial corporate entities which use derivatives for hedging or investment purposes has been and is likely to continue to be one of the most controversial aspects of the proposals for greater regulation of OTC derivatives. In its Communication, the Commission stated that it believed non-financial firms had become part of the web of mutual dependence created by derivatives contracts and that some of the cost of strengthening the market infrastructure for OTC derivatives be borne by such entities.

In the Consultation, the Commission proposes a two-fold threshold test. Once the positions taken by the non-financial entity exceed an "information threshold" (the amount of which is yet to be determined), the entity will not be subject to a clearing obligation, but will be required to notify the Competent Authority that its positions have exceeded the specified threshold. Where such a counterparty's positions exceed a higher "clearing" threshold (again yet to be determined), a clearing obligation will apply.

The Commission states that it will calibrate the relevant threshold levels at a later date, taking into account the systemic relevance of the sum of net positions by counterparty per class of derivative. The previous proposals in relation to non-financial companies have been controversial and are likely to prompt considerable feedback in relation to the Consultation. More than 160 companies signed a letter objecting to the proposals in the Communication. The European Association of Corporate Treasurers has stated, in particular, that the proposals will increase the cost of derivatives for companies, which may discourage them from hedging and therefore actually expose them to greater risks. Requiring too many types of derivatives to be centrally cleared will also limit the scope for companies to enter into specifically tailored contracts, which may make it difficult for them to precisely hedge their exposure. The extent to which the proposals set out in the Consultation will affect non-financial entities will depend significantly upon where the threshold levels are set.

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[10] The European Commission, "Public Consultation on Derivatives and Market Infrastructures": http://ec.europa.eu/internal_market/consultations/docs/2010/derivatives/100614_derivatives.pdf.

[11] ESMA is a new European supervisory authority, governing individual financial institutions (taking a micro-prudential perspective) and replacing the Committee of European Securities Regulators (CESR).

[12] For this purpose, financial counterparties will need to either participate in a CCP (thereby becoming a "clearing member"), or enter into a contractual relationship with a clearing member, allowing the financial counterparty to clear its transactions through a CCP.

[13] It is suggested by the Commission that ESMA will publish its decision in a register. Such register will contain a list of all eligible classes of derivatives and the CCPs authorised to clear them.

[14] A new European body set to take a macro-prudential view of the financial system as a whole, issue early risk warnings and provide recommendations for action.

## Requirements for CCPs

The forthcoming legislation on OTC derivatives clearing will include rules relating to the governance arrangements in respect of the CCPs themselves. In terms of general requirements, the Commission highlights (among other things) the need for a clear organisational structure, adequate policies/procedures and effective information technology systems and personnel. However, in certain areas the Consultation is more specific, seeking opinion in respect of the following objectives:

- Each CCP should have an internal risk committee in place. Such committee would remain independent of the management of the CCP. The risk committee's duties might include advising the CCP on risk management issues such as changes to its risk model, default procedures and the clearing of new classes of instruments;
- Each CCP should maintain a clear set of principles to govern conflicts of interest between itself and its clearing members or their clients;
- CCPs should retain control of their functions, such that outsourcing to third parties is likely to be restricted or prohibited;
- CCPs should establish and maintain categories of admissible clearing members and "non-discriminatory, transparent and objective" admissions criteria. Compliance with these provisions should be reviewed annually, with procedures in place for the removal of clearing members who fail to meet the relevant criteria;
- In order to improve transparency, there should be public disclosure of all prices and fees associated with the services provided by each CCP. Other information that the Commission believes should be disclosed includes details of the risks associated with central clearing and key information on the CCPs risk management model;
- CCPs will be obligated to maintain accounts and records that allow for the segregation (from itself and other clearing members) of the assets and positions of any individual clearing member. Further, clearing members will need to distinguish and segregate in accounts with the CCP the assets and positions of each of its clients; and
- CCPs will be subject to a number of harmonised prudential requirements in order to improve financial stability. These include, among other things, the obligation to: a) maintain a certain amount (as yet undetermined) of permanent and available capital; b) measure and assess exposures to clearing members and other CCPs; c) impose, call and collect margins to reduce the credit exposure to its clearing members; d) maintain a "default fund" to cover losses arising from the default of one or more of its clearing members (funded by contributions by the clearing members themselves); e) maintain the resources necessary to cover losses that exceed margin requirements and the default fund (e.g., guarantees or loss-sharing arrangements etc.); and f) have procedures in place to take prompt action to contain losses resulting from the default of its clearing members.

In view of the key role that CCPs will play in the new regulatory structure for OTC derivatives and the volume of trades to be cleared through them, the organisational requirements and risk management obligations to be imposed on CCPs will be a vital part of the new regulatory framework. The systemic consequences of a failure of a CCP could be very significant and the requirements will therefore be closely scrutinised. The Commission has asked, in particular, for comments on the role and function of the risk committee of each CCP, whether they are sufficient to prevent and manage potential conflicts of interest and whether there should be specific rules relating to the ownership of CCPs.

## CCPs in Third Countries

Having regard to the global nature of the derivatives market and no doubt the possibility of being open to charges of protectionism, the Commission has suggested that CCPs established in third countries could be allowed to provide clearing services to entities established in the EU, subject to certain conditions. The Commission states that the criteria could include the need for a third country CCP to be authorised and subject to appropriate supervisions and regulation in such third country. This is likely to require the Commission to reach a decision on equivalence regarding the legal and supervisory authority of each relevant third country.

## Interoperability

The Commission has also sought views in respect of "interoperability," acknowledging that this was not discussed in the October 2009 Communication. This is where two or more CCPs enter into an arrangement with each other in order to facilitate a coordinated execution of transactions. The Commission recommends in the Consultation that such arrangements should only be entered into in circumstances where each CCP has full, non-discriminatory access to the data of its partner CCP. If there are restrictions, these should only arise for the purpose of controlling risk. A number of conditions have also been suggested, which would need to be met in order for an interoperability agreement to be reached. These include the requirement to put policies in place which identify, monitor and manage any additional risks created by the terms of the relevant arrangement. The Commission further states that regulatory approval may also be required to give effect to an interoperability agreement.

## Reporting Obligations

The Commission restates its views in the Communication that the reporting and assembling of data collected by Trade Repositories is of the utmost importance. It states that any future legislation will therefore make clear that relevant authorities in the EU should be provided with unfettered access to such information. In this regard, the Consultation requests views on precisely what information should be reported and to whom. Consideration has been given to the option of only requiring financial counterparties to report details of their derivatives trades (with non-financial counterparties or any other entity) to a financial repository or competent authority. Alternatively, the Commission has considered the possibility that every EU derivative contract (regardless of who the counterparty is) should be reported.

Different options have also been presented regarding the need to ensure that European authorities can access the information they require from the Trade Repositories, particularly from those based in third countries. One suggested option might be to require that third country Trade Repositories establish an EU subsidiary as a condition to registration. Alternatively, third country Trade Repositories may be required to meet conditions of equivalence in respect of regulation and supervision (in the same way as may be applied to CCPs, as described above). Finally, the Commission has also suggested a third option, whereby only public utilities will be allowed to perform the role of Trade Repository. It is presently unclear from the Consultation precisely what "public" means in this context.

## Responses

In an early response statement, the International Swaps and Derivatives Association (ISDA) has stated that it supports proposals that will require the use of, and reporting to, Trade Repositories for OTC derivatives. In fact, ISDA is further committed to "delivering robust, efficient and accessible central clearing to the OTC derivatives market." In this regard, ISDA stated in September 2009 that it was committed to clearing 95% of new eligible CDS trades and 90% of interest rate swaps. The Commission's proposals as set out in the Consultation go some way to achieving these objectives; however, we expect that that there will be a number of skeptical comments from the derivatives industry in respect of the methods that the Commission is proposing to employ. In particular, it remains to be seen whether the suggested delegation of power to ESMA—a body which is still in its infancy, is not yet operational, and arguably has limited experience in determining which contracts must and should be cleared through CCPs—will go unquestioned. The Consultation will remain open for responses until 10 July 2010.

In addition to considering feedback on its Consultation, the Commission and industry participants are also likely to be keeping a very close eye on events on the west side of the Atlantic Ocean. The issue of OTC regulation is, of course, currently the subject of heated debate and discussion in the US, with the Restoring Financial Stability Act of 2010 ("RFSA") passed by the US Senate on 20 May 2010. This also contains radical changes to the regulation of derivatives in the US. The Act remains subject to a reconciliation process in the US. The US legislation covers similar ground to the Commission proposals, including seeking to require the majority of OTC derivative transactions to be cleared through CCPs. As in the EU, a key element of the debate in the US has been the extent to which non-financial entities which utilise derivatives will be subject to the requirements. Under the current RFSA provisions, non-financial entities can opt out of the clearing requirements only if they are hedging their own commercial risks or those of a parent or affiliate. RFSA also contains detailed requirements for reporting derivatives data to swap data repositories and also greater public reporting of transaction data. If the end results in the EU and US differ significantly, it could give rise to the possibility of participants seeking to move derivative operations to the system they regard as more favourable.

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