Over-the-Counter Derivatives Markets Act

Overview

- Over-the-counter derivatives legislation for the first time addresses an unregulated part of the financial markets that poses a potential risk to the broader economy. This risk was more than apparent last year when the failure of Lehman Brothers tied up the funds of thousands of investors worldwide that had entered into swap trades with the bank.

    - The federal government's decision to backstop the huge swap positions created by AIG in its business of insuring the assets on bank balance sheets was driven by the threat an insolvency of the insurance company would pose to the broader financial system.

- Swaps are financial contracts typically traded over-the-counter (OTC)—directly between two counterparties—that require an exchange of cash payments. The payments are based on the performance of an asset such as a security, the change in an interest rate index or the default of a company. This market has grown significantly over the past 15 years to a volume in the hundreds of trillions of dollars. That translates into millions of contracts between large banks.

- In setting out the first comprehensive system of regulation of the over-the-counter derivatives market, the legislation requires clearing and trading on exchanges or electronic platforms for all standardized transactions between dealers and other large market participants—called "major swap participants".

    - Over-the-counter derivatives include swaps, which are financial contracts that call for an exchange of cash flows between two counterparties based on an underlying rate, index, credit event or the performance of an asset.

- The legislation divides jurisdiction over swaps between the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). The SEC oversees activity in swaps that are based on securities like equity and credit-default swaps. The CFTC is responsible for all other swaps—including those based on interest rates and currencies.

Clearing

- The bill creates a mechanism to determine which swap transactions are sufficiently standardized that they must be submitted to a clearinghouse, or central counterparty (CCP) for clearing—a requirement when both counterparties are either dealers or major swap participants. Clearing organizations must seek approval from the appropriate regulator—either the CFTC or the SEC—before a swap or class of swaps can be accepted for clearing.

- Transactions in standardized swaps do not need to be cleared if one of the counterparties is not a swap dealer or major swap participant.

Mandatory Trading on Exchange or Swap Execution Facility

- A standardized and cleared swap transaction where both counterparties are either dealers or major swap participants must either be executed on a board of trade, a national securities exchange or a “swap execution facility”—as defined in the legislation. If none of these venues makes a clearable swap available for trading, the trading requirement would not apply. Counterparties would, however, have to comply with transaction reporting requirements established by the appropriate regulator. The legislation also directs the regulators to eliminate unnecessary obstacles to trading on a board of trade or a national securities exchange.

Registration and Regulation of Swap Dealers and Major Swap Participants

- Swap dealers and major swap participants must register with the appropriate Commission and dual registration is required in applicable cases. Capital requirements for swap dealers' and major swap participants' positions in cleared swaps must be set at greater than zero. Capital for non-cleared transaction must be set higher than for cleared transactions. The prudential regulators will set capital for banks, while the Commissions will set capital for non-banks at a level that is “as strict or stricter” than that set by the prudential regulators.

- The regulators are directed to set margin levels for counterparties in transactions that are not cleared. The regulators are not required to set margin in transaction where one of the counterparties is not a dealer or major swap participant. In cases where an end user is a counterparty to a transaction, any margin requirements must permit the use of non-cash collateral.