OTC DERIVATIVES REFORM

BACKGROUND

Over the past two years, the derivatives market has been subject to increased scrutiny as policy makers have attempted to understand the underpinnings of the current bout of violent market fluctuations.

Starting last summer, when oil prices rose above $140 a barrel, legislators began to look at ways of limiting what was thought to be excessive speculation.

Over the course of the summer, oil prices plummeted. By the end of the year, it came to light that credit default swaps (CDS) played a key role in the significant deterioration of a number of important financial institutions, such as AIG.

At the beginning of the 111th Congress, House Agriculture Committee Chairman Colin Peterson (D-MN) introduced HR 977, the "Derivatives Markets Transparency & Accountability Act". The bill was marked up and reported out of the Agriculture Committee on February 12, 2009. AFP provided comments on the bill as introduced.

The bill would have extended the Commodity Futures Trading Commission's (CFTC) authority to financial instruments, including interest rate and foreign exchange swaps. The bill would have required these products be subject to position limits, clearing, and initial capital & margin requirements.

As the year progressed, the Administration released a more moderate proposal. The other committee of jurisdiction, House Financial Services, held its own hearings on the matter, as well as a joint hearing with the Agriculture Committee.

On October 15, 2009, the House Financial Services Committee passed a bill that would require increased exchange trading, increased clearing, and increased capital and margin requirements. The bill exempts foreign exchange swaps and exempts **most** end-users from these requirements. Banks as well as companies considered to be major swap participants will be subject to this additional regulation. The following week, the House Agriculture Committee passed similar legislation. A comparison of the two bills is included in this section.

The House Financial Services and Agriculture bills will need to be reconciled. It is unknown when a vote before the full House will take place, but it is rumored that this bill will be wrapped in with other financial markets regulatory overhaul proposals, which are still being considered.

On the Senate side, the Banking Committee has yet to consider a derivatives bill, but it is rumored that they will work with the bill passed by the House. In the Senate Agriculture Committee, Chairman Tom Harkin (D-IA) introduced language to eliminate OTC derivatives. In September, Senator Harkin became the Chairman of the Health, Education, Labor, and Pensions (HELP) Committee. His successor on the

Agriculture Committee, Senator Blanche Lincoln (D-AR), is much more moderate, although her position on derivatives is unknown.

The Administration submitted the proposal that served as the basis for the House Financial Services bill. Among the regulators, CFTC Chairman Gary Gensler has been a vocal advocate for increased exchange trading, clearing, and initial capital & margin requirements for all derivative trades. During his tenure in the Clinton Administration, he was an advocate for deregulation. His previous positions led to delays in his confirmation this year, which may explain his present intractability on this issue.

AFP ACTIONS

As the year progressed, AFP worked to educate regulators & legislators on the use of OTC derivative products by corporate end-users to mitigate risk. AFP submitted letters to a number of Committees reviewing the matter, including House Financial Services, Banking, House & Senate Agriculture, and Senate Homeland Security & Government Oversight. In addition to the letters, AFP submitted suggested language during the mark-up process to exempt end-users from additional regulation. The bills approved by the House Financial Services and Agriculture Committees reflect the success these efforts have had on bringing attention to the prudent hedging practices AFP members utilize to mitigate risk for their organizations.

In September, AFP Vice Chairman and GRC Member, Michael Connolly testified before an historic joint-hearing held by the Securities and Exchange Commission (SEC) and CFTC. At the hearing, Mr. Connolly explained how his company, Tiffany & Co, uses derivatives to hedge risk and how regulations should be structured in order to continue the practice.

STATUS

The two versions of H.R. 3795 approved by the House Financial Services and Agriculture Committees will need to be reconciled before they can be brought before the full House for a vote. The bill is mostly finalized, but important amendments to prevent conflicts of interests on behalf of clearing houses and exchanges could still be introduced. Although we have made a good deal of progress excluding end-users from the onerous requirements imposed on dealers, AFP has maintained that derivatives transactions for the purpose of risk mitigation are inherently not systemically risky and should not be regulated as such.

It is unclear how this issue will be handled in the Senate. New leadership in the Senate Agriculture Committee is likely to produce significantly more moderate legislation. The Senate Banking Committee has largely been silent on derivatives legislation and is rumored to be disposed to marking up legislation passed by the House. It is unclear how Banking Committee Chairman Christopher Dodd’s opposition to the Systemic Risk proposal favored by the Administration and House Financial Services could play into this.

NEXT STEPS

We have scheduled a meeting with the CFTC Chairman Gary Gensler to explain the potential cost of the additional regulations he is advocating. This will also be a tremendous opportunity to learn how he intends to exercise the powers that may soon be granted to his Commission.

Additionally, we will be meeting with the staff of key legislators in the Senate to help shape the debate before it gains wide attention.

In the House, debate has largely been closed. It is unlikely that the nature of the exemption for end-users will become more or less inclusive, but we will continue to reach out to leadership to attempt to sway the final bill to ensure all hedging transactions are clear from onerous regulations.