Derivatives

Selling over-the-counter derivatives is among the most lucrative businesses for the largest financial companies. U.S. commercial banks held derivatives with a notional value of $216.5 trillion at the end of the 1st quarter of this year, according to the Office of the Comptroller of the Currency. JPMorgan Chase & Co., Citigroup Inc., Bank of America Corp., Goldman Sachs Group Inc. and Morgan Stanley hold 97 percent of that total. All this trading was done on an unregulated market. It was the ultimate financial free-for-all, with no rules, no limits and no one minding the store. When reality caught up with the housing market, these unregulated derivatives helped bring down companies including Lehman Brothers and forced the bailout of systemically dangerous financial institutions like AIG.

Clearing

Clearing requirements will ensure that trades are processed through third-party clearinghouses that guarantee payment in case of default and require parties to have cash to back their bets.

- **We won**: Despite tremendous pressure from special interest groups claiming they should be exempt from clearing requirements, it is estimated that the conference report will require around 90% of standard derivatives to clear. This means that once the bill is passed large banks, insurance companies, hedge funds and other financial institutions will be required to submit standardized swaps to clearinghouses and post margin to back their bets. The only exemptions from the clearing requirements are for commercial companies like airlines and home heating oil distributors and other small players in the derivatives market who are legitimately hedging risk.

Trading

Currently, over-the-counter ('OTC') derivatives are considered private contracts. There is no way for regulators to analyze all the derivatives activity going on in the system and determine whether there is risk to the system. There is also no way for derivatives users to determine whether they are getting a fair price.

- **We won:**
    - Derivatives will be traded on an open, regulated exchange or "swap executive facility" much like the New York Stock Exchange.
    - Regulators will have the information they need to oversee risky activities and prevent fraud.
    - Market participants will also be able to access a constant feed of real-time pricing data for standard derivatives that will allow them to shop around for the best deals on derivatives so they can manage price fluctuations in products they use in their day-to-day operations.

Enforcement:

- **We won**: Regulators have authority to take action if a clearing house refuses to accept a transaction that regulators have determined must clear.

- **We compromised**: The only limit on regulators' authority is that they cannot force a clearinghouse to accept a swap for clearing if it would undermine the financial integrity of the clearinghouse or create systemic risk.

Foreign Exchange Swaps

- **We won**: Foreign exchange swaps are required to clear and trade unless the Secretary of Treasury makes a determination that they should not. This determination must be based on a variety of factors including whether comparable regulation is in place and whether regulating these trades could result in systemic risk. In addition, if the Secretary of Treasury determines that clearing and trading are not required, he must report to Congress. All federal financial regulators will also be required to write rules to protect retail investors in this market.

Cap on banks' clearinghouse ownership

- **We compromised**: The SEC and CFTC have authority to set a hard cap on clearinghouse ownership so big banks can't use their ownership interests to force standard swaps to be done in the unregulated markets that are more profitable for the biggest banks.
- **We lost**: Reformers wanted a set standard – big banks couldn't control more than 20 percent of voting interests in a clearinghouse, period.
- **We won**: Regulators will have the authority to put rules in place that can prevent the conflict of interest that exists when the same people who profit from unregulated trades participate in the decision whether trades should be conducted in the less profitable regulated markets. This may include hard caps on banks' ownership interest in a clearinghouse.

Fiduciary duty for swaps dealers

- **We lost**: The Senate bill gave swaps dealers a fiduciary duty to pension funds and municipalities. The conference report weakens this duty, creating a loophole that says the fiduciary duty exists when the broker is acting as an adviser, but in comparable provisions under existing law that apply to securities broker-dealers, a broker-dealer is almost never deemed to be acting as an adviser.
- **We won**: The bill provides business conduct standards and disclosure requirements for swaps dealers when they do business with pension funds and municipalities.

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Swaps desk spin-off

- **We won**: The Senate-passed bill required taxpayer-backed institutions to spin off their swaps desks so no taxpayer money could be at risk, ever. That provision was weakened in conference to apply to only between 3 and 20 percent of swaps activity and to force the desks into a separately capitalized subsidiary. It does, however, include the riskiest activities including some of those most associated with the crisis – such as a credit-default swaps in which companies like AIG sold insurance on their bets to companies like Goldman Sachs without having to prove they had the money to pay if the bets went bad.

- **We lost**: The conference report provides that banks may continue to deal in swaps if they pertain to “permissible assets”, as defined in current banking law. Swaps based on permitted assets include swaps based on interest rates, currency, gold and silver. Insured institutions will also be permitted to trade cleared, investment grade CDS. That could leave 80 percent or more of the activity on swaps desks still under the auspices of taxpayer-backed institutions.