

Derivatives Alert

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Recent Bills to Amend Dodd-Frank Preview Coming Attractions in Post-Election Congress

Recently introduced legislation suggests that Republicans and Democrats in post-election Congress will be looking in very different directions on how to amend the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). On June 7, 2016, U.S. Rep. Jeb Hensarling, R-Texas, unveiled a discussion draft of the Financial CHOICE Act.¹ In a speech to The Economic Club of New York that same day, Rep. Hensarling said the bill “rests on the belief that bank capital is the most basic element in making a financial system healthy, resilient and reliable for economic growth.”² The Financial CHOICE Act would provide an “off-ramp” exempting financial institutions that meet certain criteria and make a “qualifying capital election” from the heightened Dodd-Frank supervisory regime and U.S. implementation of the Basel III capital and liquidity standards.³ In addition, the bill would repeal, among other Dodd-Frank provisions, Title II providing the Federal Deposit Insurance Corporation (FDIC) with orderly liquidation authority over certain insured financial institutions (potentially including clearinghouses), Title VIII providing the Financial Stability Oversight Council (FSOC) with authority to designate certain clearinghouses as financial market utilities (FMUs), and the Volcker Rule,⁴ which restricts covered financial institutions from making certain kinds of speculative investments.

Although the press conferences and releases unveiling the Financial CHOICE Act did not focus on the derivatives-related provisions in the bill, it would amend certain Commodity Exchange Act (CEA) provisions in a nearly identical manner as would the Commodity End-User Relief Act (CFTC Reauthorization Bill) passed by the House of Representatives last year.⁵ Among these amendments, the Financial CHOICE Act would: make the division heads of the Commodity Futures Trading Commission (CFTC) answerable to the entire commission, not just the chairman; enhance procedures governing the issuance of no-action relief, guidance and interpretive rules; introduce a technology plan and internal risk controls; limit the duration of an “omnibus order of investigation” under which the commission or staff may issue subpoenas; provide

¹ Financial CHOICE Act of 2016, H.R. Discussion Draft B., 114th Cong. (as discussed by H. Fin. Serv. Comm.) (Discussion Draft).

² Rep. Jeb Hensarling, remarks to The Economic Club of New York.

³ H. Fin. Serv. Comm., Executive Summary, “The Financial CHOICE Act: Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs,” at 1.

⁴ 12 U.S.C. § 851 (2012).

⁵ See Commodity End-User Relief Act, H.R. 2289, 114th Cong. §§ 201-213 (2015).

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for direct appellate review of rulemakings, including a special procedure for challenges to heightened cost-benefit analysis standards; and mandate that the CFTC issue a comprehensive cross-border compliance rule in accordance with formal notice and comment rulemaking procedures.⁶ In addition, the bill would require that the CFTC and Securities and Exchange Commission (SEC) harmonize all rules and interpretive guidance they have each issued pursuant to Title VII of Dodd-Frank.⁷

Coming from an entirely different perspective and citing a “glaring lack of federal oversight,” on June 29, 2016, Sen. Elizabeth Warren, D-Mass., Sen. Mark Warner, D-Va., and Rep. Elijah Cummings, D-Md., co-sponsored the Derivatives Oversight and Taxpayer Protection Act (Derivatives Oversight Bill). The Derivatives Oversight Bill would make numerous amendments to the CEA and federal banking laws to substantially increase regulation and oversight of derivatives.

CFTC Fees Imposed

The Derivatives Oversight Bill would require the CFTC to collect fees for a wide range of regulatory activities, such as swap dealer registration reviews and examinations, futures commission merchant examinations, derivatives clearing organization reviews, designated contract market rule reviews and swap execution facility designation reviews. The fees would be aimed to cover the CFTC’s annual appropriation from Congress.⁸ In setting fee rates, the CFTC would be required to consider whether the fees i) are reasonably related to the agency’s costs, ii) support access for smaller market participants, and iii) minimize negative impacts on markets. The CFTC would have to publish the fee rates and its methods of calculation.⁹

Penalties and Fines Increased

Civil monetary penalties for CEA violations would increase. Civil monetary penalties are currently set at the greater of \$1 million or triple the gain for violating provisions of the CEA prohibiting manipulation and \$140,000 or triple the gain for all other violations of the CEA or CFTC orders or regulations. The Derivatives Oversight Bill would raise these penalties for any violation of the CEA or CFTC orders and regulations to up to the greater of \$1 million for individuals or \$10 million for entities,

⁶ See Discussion Draft §§ 461-468.

⁷ See *id.* § 471.

⁸ See *Derivatives Oversight and Taxpayer Protection Act, S. 3118*, 114th Cong. § 11(a) (2016).

⁹ *Id.* § 11(b).

triple the violator’s gain, or triple the total losses incurred by any victims.¹⁰ Any of these penalties could be tripled again if the violator had been found within the previous five years to have recklessly or knowingly violated any orders, regulations or statutes administered by the CFTC, SEC or the Federal Energy Regulatory Commission.¹¹

Cross-Border Swaps Added

The Derivatives Oversight Bill would add to the CFTC’s regulatory oversight swaps entered into outside of the U.S. by an entity domiciled in the U.S., where that entity “bears swaps-related risks.” The CFTC would be required to allow a foreign jurisdiction to regulate these swaps instead of the CFTC, but only if the foreign rules were substantively equivalent to, and enforcement was no less stringent than as called for by, the U.S. rules.¹²

Oversight of FX Expanded

The Derivatives Oversight Bill would move the FX swaps and forwards markets¹³ (currently exempted from most CFTC regulation) under the full regulatory authority of the CFTC by eliminating the Treasury exemption set forth in CEA Section 1a(47).¹⁴

Data Oversight Enhanced

The Derivatives Oversight Bill would require the CFTC to make swap data repository (SDR) data available as soon as practical if requested by another financial regulator.¹⁵ It also would require the CFTC and the SEC — no later than two years after the bill’s enactment — to review data provided by swap dealers to SDRs to see if it is accurate and uses a consistent and standardized form that allows for aggregation and analysis by regulators. The bill would give the CFTC corollary power to revoke the license of any swap dealer that it and the SEC find to have provided unusable data.¹⁶

¹⁰ *Id.* § 102.

¹¹ *Id.*

¹² *Id.* § 103.

¹³ Federal Reserve Bank of New York, *Foreign Exchange Committee Semi-Annual Foreign Exchange Volume Survey* (October 2015).

¹⁴ S. 3118 §104. Currently, the secretary of the Treasury has the authority to exempt FX swaps and forwards from CFTC regulation. See CEA § 1a(47)(E), 7 U.S.C. 1a(47)(E) (2012).

¹⁵ S. 3118 § 105.

¹⁶ *Id.* § 106.

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Margin on Interaffiliate Swaps Required

No later than 180 days after the Derivatives Oversight Bill's enactment, entities would be required to collect margin on all uncleared interaffiliate swaps.¹⁷ This would modify the existing rule on uncleared margin requirements that the CFTC issued earlier this year, which did not require the collection of margin on interaffiliate swaps.¹⁸

Closeout Netting for Capital Purposes Banned

The Derivatives Oversight Bill would ban consideration of closeout netting in calculating minimum capital requirements, risk-based capital requirements and leverage limits, with limited exceptions for certain netting arrangements.¹⁹

¹⁷ *Id.* § 202.

¹⁸ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016) (to be codified at 17 C.F.R. pts. 23 & 140). In the final rule publication, Commissioner Bowen stated, "[T]his rule fails to meet statutory intent and it puts swap dealers we regulate at greater risk in times of financial stress because of its treatment of interaffiliate margin." *Id.* at 706.

¹⁹ S. 3118 § 203. There would be exceptions in some circumstances for netting arrangements that are documented under a formal master netting arrangement with a derivatives clearing organization that meets the financial standards approved by the Board of Governors of the Federal Reserve System and the FDIC, or with a counterparty. *Id.*

Regulators' Report on Clearinghouses Required

The CFTC, Office of the Comptroller of the Currency, FDIC and the Board of Governors of the Federal Reserve System would be required to jointly publish a report, within one year of the Derivatives Oversight Bill's enactment, with policy recommendations addressing a series of questions.²⁰ These questions cover the adequacy of prefunded default funds and prefunded liquidity sources at major clearinghouses and capital and liquidity resources at clearing members.²¹ The questions also cover the adequacy of capital levels at clearinghouses and the duties that clearinghouses owe to shareholders and the public interest.²²

²⁰ On July 5, 2016, Sens. Warren and Warner and Rep. Cummings sent both CME, Inc. and Ice Clear Credit LLC letters requesting that both entities provide information on their final recovery and resolution plans in the event of a systemic stress event. [Letter from Rep. Elijah E. Cummings, Sen. Elizabeth Warren, and Sen. Mark Warner to Phupinder Gill, CEO, CME Group Inc.](#) (July 5, 2016) (on file with the H. Comm. on Oversight & Gov't Reform).

²¹ S. 3118 § 204.

²² *Id.*

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