

## @ Regulatory

### In this issue:

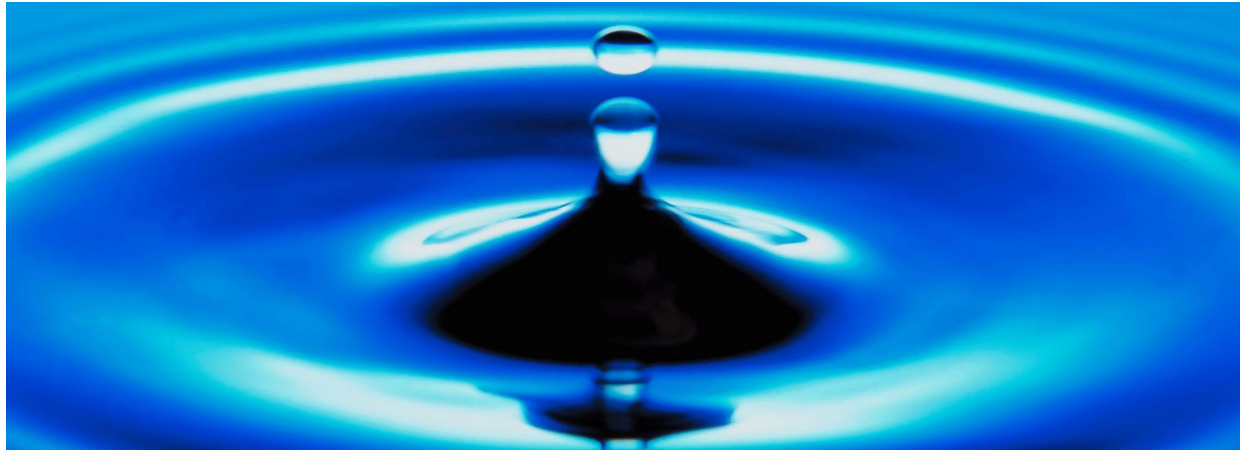
#### News Bulletins

1 Banking

#### Feature Articles

3 Securities

10 Investment Management



## News Bulletins: Banking

### FDIC Releases New Policy Statement on Prudent Commercial Real Estate Loan Workouts

On October 30th, 2009, the Federal Deposit Insurance Corporation (FDIC), in coordination with the agencies of the Federal Financial Institutions Examination Council<sup>1</sup> (FFIEC), adopted a policy statement which supports prudent commercial real estate (CRE) loan workouts. Its intent is to help identify risks related to loan workout plans and to help ensure the appropriate regulatory reporting and accounting treatment is used when engaging in these efforts. "The financial regulators recognize that prudent commercial real estate (CRE) loan workouts are often in the best interest of the financial institutions and creditworthy CRE borrowers."<sup>2</sup> This policy statement, *Policy Statement on Prudent Commercial Real Estate Loan Workouts*,<sup>3</sup> stresses that performing loans, including those that have been renewed or restructured on reasonable modified terms, made to creditworthy borrowers will not be subject to adverse classification solely because the value of the underlying collateral declined.

The new guidance, which replaces the 1991 *Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans*, focuses primarily on assisting examiners in evalu-

ating institutions' efforts to renew or restructure loans to creditworthy commercial real estate (CRE) loan borrowers. This newly released guidance contains important information listed in the 1991 policy while also addressing expectations around loan workout arrangements, classification of loans, and regulatory reporting and accounting considerations.

The *Loan Workout Arrangements* section, a key addition to the new guidance, discusses the different types of loan workouts along with key areas for consideration before arranging a loan workout with a borrower. Examples of loan workouts include an extension of loan terms, extension of additional credit, and the restructuring of a current loan. Also listed are certain expectations to ensure that an institution is not criticized for entering into loan workout arrangements with borrowers. For example, it is expected that an institution would have a practical workout policy, a personalized and sensible workout plan for each borrower, analysis of the borrower's total current financial obligations, an internal loan grading system, and a detailed allowance for loan and lease losses methodology.

Another addition to the new guidance is *Regulatory Reporting and Accounting Considerations*. This section addresses how the decision to get involved in loan workout plans with borrowers may affect an institution's regulatory reporting regarding items such as interest accruals, troubled debt restructuring treatment, and credit loss estimates. The responsibility of manage-

ment to ensure the loan workout staff regularly communicates with the accounting and regulatory reporting staff regarding the institution's loan restructurings is stressed. Constant communication between these two groups will help to ensure reporting consequences of restructurings are accurately presented in regulatory reports. Implications for interest accrual, restructured loans, and allowance for loan and lease losses are also discussed in more detail within the *Regulatory Reporting and Accounting Considerations* subsections.

The new guidance provides a number of scenario analyses in the examples of loan workouts along with reference materials provided in the appendices of the document.

### Federal Reserve Board Issues Proposed Guidance on Sound Incentive Compensation Policies

The Federal Reserve Board (the "Board", the "Fed") has recently issued (October 22, 2009) a proposal designed to "ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of their organizations."<sup>4</sup>

Two supervisory initiatives are included within the proposal. The first initiative applies to large, complex banking organizations (LCBOs). The policies and procedures of each of these firms are to be reviewed "to determine their consistency with the principles for risk-appropriate incentive compensation set forth in the proposal."<sup>5</sup> The organization-specific policies will be assessed by supervisors in a special coordinated "horizontal review," and the "policies and implementing practices adopted by these firms in response to the final supervisory principles will become a part of the supervisory expectations for each firm and will be monitored for compliance."<sup>6</sup>

The second supervisory initiative will include a review of compensation practices at regional, community, and other banking organizations not classified as large and complex. These reviews will be tailored to take account of the size, complexity, and other characteristics of the banking organization.

The guidance is designed to apply to the compensation of: (1) senior executives and others responsible for oversight of an organization's firm-wide activities or material business lines; (2) individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk;

and (3) groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk.

"Compensation practices at some banking organizations have led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability," Federal Reserve Chairman Ben S. Bernanke said. "The Federal Reserve is working to ensure that compensation packages appropriately tie rewards to longer-term performance and do not create undue risk for the firm or the financial system."

Along with the proposed guidance, the Board released six "Questions and Answers." The topics addressed were:

- *What is a guidance, what does it do, how is it enforced?* – Supervisory guidance focuses attention on risk issues and articulates supervisory expectation to the organizations that the Federal Reserve supervises.
- *What happens next?* – In addition to receiving comments the Board expects banking organizations to review the current incentive compensation arrangements to "ensure that they do not encourage excessive risk-taking" and to implement corrective programs where needed.
- *Why is the Federal Reserve not suggesting a pay cap or outlawing particular practices?* – The Board recognizes that one size, whether for firms or employees, doesn't fit all. Best practices for balancing risk and rewards in incentive compensation programs are likely to continue to develop and evolve.
- *Why is the Fed doing this; what authority does the Fed have to oversee compensation?* – As noted in the Fed's response, "recent events have highlighted that inappropriate compensation practices can contribute to safety and soundness problems at banking organizations and to financial instability."<sup>8</sup> The Board has clear authority to act in this area as Section 8 of the Federal Deposit Insurance Act authorizes the Federal Reserve to take action against a banking organization if the organization is engaged, or is about to engage in, any unsafe or unsound practice.
- *Who will be subject to the compensation guidance?* – The guidance will apply to all banking organizations supervised by the Federal Reserve, including U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency,

or commercial lending company subsidiary in the United States.

- *How is this guidance related to recent work by international bodies like the Group of Twenty or the Financial Stability Board? – It is consistent with the Financial Stability Board’s (FSB) Principles for Sound Compensation Practices issued in April 2009 and with the FSB’s recent Implementation Standards.*

Comments were accepted on the proposed guidance through November 27.

## Feature Articles: Securities

### Momentum Increasing for Over-the Counter-Derivatives Reform

The historic disruptions in the financial marketplace over the past few years have prompted the Obama administration to reform financial market regulation. This proposed reform includes additional regulations over consumer financial products, bond rating agencies and the creation of a regime for regulating systematic risk across all types of financial service firms. The complex over-the-counter (OTC) derivatives market which, according to the Bank of International Settlements was valued at approximately \$591 trillion at year end 2008, has drawn considerable attention from the U.S. Congress due to its role in the financial crisis.<sup>9</sup>

The reform of the OTC derivatives market is directed primarily at the counterparty credit risk in the financial system and the lack of transparency of the individual transaction information to the market and to regulators. The current structure of the OTC derivatives market can be traced back to the passing of the Commodities Futures Modernization Act in 2000. This bill, co-sponsored by then Senate Banking Committee chairman Phil Gramm (R-TX), exempted many OTC derivatives from regulation,<sup>10</sup> resulting in a lack of publicized data, mutual dependency between counterparties (forming an intricate web of bilateral contracts), and limited contractual provisions with minimal requirements for posting margin or capital. The systematic risks that the OTC derivatives market pose, and the lack of transparency has led to the U.S. Department of the Treasury, U.S. Congress, the International Swaps and Derivatives Association, European regulators and others to make regulatory reform of the OTC derivatives market a top priority.

### Time line for reform of OTC derivatives

On August 11th, 2009, the Obama administration presented the initial draft of the “Over-the-Counter Derivatives Market Act of 2009”<sup>11</sup> to provide sweeping legislation toward the regulation of the OTC derivatives market. This bill proposes, among other things, joint jurisdiction by both the U.S. Commodity Futures Trading Commission (CFTC) and the U.S. Securities and Exchange Commission (SEC) over swaps and security-based swaps; requirements that standardized swaps must be cleared by a derivatives clearing organization and then traded on a regulated exchange; and the introduction of specific capital and margin requirements.<sup>12</sup>

Following this original proposal, two different committees of the U.S. House of Representatives proposed bills largely based on the administration’s proposal. The House Financial Services Committee, led by its Chairman, Barney Frank (D-MA), approved its “Over-the-Counter Derivatives Market Act of 2009” on October 16, 2009. On October 21, 2009, the U.S. House Agricultural Committee, led by Committee Chairman Colin Peterson (D-MN), voted to move its “Derivatives Markets Transparency and Accountability Act of 2009”<sup>13</sup> forward. House leadership is now working to reconcile the bills and is moving towards a unified bill to send to the House for a vote.<sup>14</sup>

Additionally, on November 10, 2009, Senate Banking Committee, Chairman Christopher Dodd (D-CT) unveiled a sweeping 1,136-page regulatory reform bill that proposes to consolidate financial regulators, impose higher capital requirements on financial institutions, create a single new commission for consumer protection, and revamp the derivatives industry.<sup>15</sup> Senator Dodd’s proposed regulatory changes to the OTC derivatives market are largely in line with Congressman Frank’s, however differences remain. Senator Dodd’s proposal is a discussion draft that has not yet been vetted by the Senate Banking Committee that Senator Dodd chairs, but is expected to be cleared by the committee in December.

The three drafts raise issues and concerns that require further examination. The following matrix lists some of the key provisions and primary differences.



Discussion Points	House Banking Committee's Over-the Counter Derivatives Market Act of 2009 <sup>i</sup>	Senate Banking Committee's Over-the Counter Derivatives Market Act of 2009 <sup>ii</sup>	House Agriculture Committee's Derivatives Markets Transparency and Accountability Act of 2009 <sup>iii</sup>
<b>Rulemaking</b>	<ul style="list-style-type: none"> <li>Joint rulemaking between CFTC and SEC for almost all rules concerning swap/security-based swap-related provisions ( Section 111 (c)(1) pg. 20)</li> <li>In the event that neither the SEC nor CFTC can jointly adopt a uniform rule within 180 days the "Secretary of the Treasury" will prescribe rule (Section 111 (c)(2) pg. 20)</li> </ul>	<ul style="list-style-type: none"> <li>Joint rulemaking between CFTC and SEC for almost all rules concerning swap/security-based swap-related provisions (Section 711, pg. 385)</li> <li>In the event that neither the SEC nor CFTC can jointly adopt a uniform rule within 180 days the "Agency for Federal Stability" will prescribe rule (Section 711 (b) pg. 385)</li> </ul>	<ul style="list-style-type: none"> <li>CFTC consults with SEC and prudential regulators before commencing any rulemaking regarding swap-related provisions (Section 3 (a) pg. 3)</li> <li>SEC consults with CFTC and prudential regulators before commencing any rulemaking regarding security-based swap provisions ( Section 3 (a) pg. 3-4)</li> <li>In the event of a conflict of interest each has the option to file a petition with the DC Court of Appeals (Section 3 (c) pg. 6)</li> </ul>
<b>Definition of swap dealer</b>	<ul style="list-style-type: none"> <li>Person engaged in business of buying and selling swaps/security-based swaps for own account, through a broker or otherwise</li> <li>Exception: not as a part of regular business (Section 111 (a)(39) and (44) pg. 12)</li> </ul>	<ul style="list-style-type: none"> <li>Person engaged in business of buying and selling swaps/security-based swaps for own account, through a broker or otherwise</li> <li>Exception: not as a part of regular business (Section 711 (a)(39) pg. 381-382)</li> </ul>	<ul style="list-style-type: none"> <li>Person for whom significant part of business is holding itself out as dealer of swaps/security-based swaps, making markets, buying and selling to customers as ordinary course of business (Section 101 (c) (39) pg. 17)</li> </ul>
<b>Definition of major swap participant</b>	<ul style="list-style-type: none"> <li>Non-swap dealer/non-security-based swap dealer who: <ul style="list-style-type: none"> <li>Maintains a substantial net position of swaps/security-based swaps, excluding those primarily held for hedging, reducing or mitigating commercial risk, whose outstanding swaps create substantial net counterparty exposure (current and potential future) that would expose counterparties to significant credit losses that could have a material adverse effect on capital of the counterparties (Amendment #3, pg.1)</li> </ul> </li> <li>The SEC and CFTC jointly define substantial net position for effective monitoring of financial system ( Section 111 (a)(39) and (40) pg. 12-13)</li> </ul>	<ul style="list-style-type: none"> <li>Non-swap dealer/non-security-based swap dealer whose outstanding swaps create new counterparty credit exposure (current or potential future exposures) to other market participants that would expose those other market participants to significant credit losses in the event of the person's default (Section 711 (a)(40) pg. 382)</li> </ul>	<ul style="list-style-type: none"> <li>Non-swap dealer/non-security-based swap dealer who maintains a substantial net position in non-cleared swaps/security-based swaps (Section 101 (c) (40)(A) pg. 17-18)</li> <li>Require the CFTC and SEC to independently define substantial net position at a threshold that effectively monitors the oversight of entities which are systemically important or can significantly impact the financial system (Section 101 (c) (40)(B) pg. 18)</li> </ul>

Discussion Points	House Banking Committee's Over-the Counter Derivatives Market Act of 2009 <sup>i</sup>	Senate Banking Committee's Over-the Counter Derivatives Market Act of 2009 <sup>ii</sup>	House Agriculture Committee's Derivatives Markets Transparency and Accountability Act of 2009 <sup>iii</sup>
<b>Clearing requirement determination</b>	<ul style="list-style-type: none"> <li>The CFTC will monitor all swap activity and determine which will be cleared, consistent with public interest, after considering, among other things, the availability of swap clearing-houses in which to clear the swaps (Section 113 (j)(1) pg. 24-25)</li> </ul>	<ul style="list-style-type: none"> <li>The CFTC and SEC must adopt rules that determine which swaps must be cleared. The rules must consider certain enumerated factors, including whether a Derivatives Clearing Organization (DCO) is prepared to accept the swap for clearance (Section 713 (j) (4) pg. 394-396)</li> </ul>	<ul style="list-style-type: none"> <li>Only swaps/security-based swaps that will be accepted by a DCO/clearing agency are required to be cleared (Section 103 (j)(1) pg. 24)</li> </ul>
<b>Clearing exceptions</b>	<ul style="list-style-type: none"> <li>DCO/clearing agency won't take swap/security-based swap</li> <li>One of counterparties is not a swap dealer/security-based swap dealer or major swap/security-based swap participant (Section 113 (j)(8) pg. 29)</li> </ul>	<ul style="list-style-type: none"> <li>DCO/clearing agency won't take swap/security-based swap</li> <li>One of counterparties is not a swap dealer/security-based swap dealer or major swap/security-based swap participant or does not meet the eligibility requirements of any DCO ( Section 713 (j)(9)(A) pg.398-399)</li> </ul>	<ul style="list-style-type: none"> <li>One of the counterparties: <ul style="list-style-type: none"> <li>Is not a swap dealer/security-based swap dealer or major swap/security-based swap participant, and</li> <li>Can demonstrate appropriate business/risk management practices for non-cleared swaps/security-based swaps</li> </ul> </li> <li>None of the counterparties are a Tier 1 financial holding company (Section 103 (j)(8) pg. 31-32)</li> </ul>
<b>Trading requirement</b>	<ul style="list-style-type: none"> <li>Swaps/security-based swaps where both counterparties are either swap dealers/major swap participants, and are subject to clearing requirements, must execute the transaction on either a board of trade or swap execution facility (Section 113(j)(6) p. 27)</li> </ul>	<ul style="list-style-type: none"> <li>Swaps/security-based swaps where both counterparties are either swap dealers/major swap participants, and are subject to clearing requirements, must execute the transaction on either a board of trade or swap execution facility (Section 713 (j)(8)(A) pg. 398)</li> </ul>	<ul style="list-style-type: none"> <li>Swaps/security-based swaps determined to be cleared must also be traded on regulated exchange or alternative swap execution facility (Section 103 (k)(1) pg. 32)</li> </ul>
<b>Trading exceptions</b>	<ul style="list-style-type: none"> <li>Trading not required if no board of trade or alternative swap execution facility makes the swap available for trade (Section 113 (j)(8) pg. 29)</li> </ul>	<ul style="list-style-type: none"> <li>Trading not required if no board of trade or alternative swap execution facility makes the swap available for trade (Section 713 (j)(8)(B) pg. 398)</li> </ul>	<ul style="list-style-type: none"> <li>Trading not required if no regulated exchange or alternative swap execution facility will list the swap (Section 103 (k) (2) pg. 32)</li> </ul>

Discussion Points	House Banking Committee's Over-the Counter Derivatives Market Act of 2009 <sup>i</sup>	Senate Banking Committee's Over-the Counter Derivatives Market Act of 2009 <sup>ii</sup>	House Agriculture Committee's Derivatives Markets Transparency and Accountability Act of 2009 <sup>iii</sup>
<b>Capital requirements for BANK swaps dealers, major swap participants and holding companies</b>	<ul style="list-style-type: none"> <li>Prudential regulators shall impose the following: <ul style="list-style-type: none"> <li>Greater than 0 for cleared swaps</li> <li>Substantially higher than 0 for any non-cleared swap (Section 4s (e)(2)pg. 59-60)</li> </ul> </li> <li>The Federal Reserve Board will set capital requirements for bank holding companies as strict as or stricter than those set by prudential regulators (Section 4s (e)(3) pg. 60-61)</li> </ul>	<ul style="list-style-type: none"> <li>The Financial Institutions Regulatory Authority (FIRA) shall impose the following capital requirements: <ul style="list-style-type: none"> <li>Greater than 0 for cleared swaps</li> <li>Substantially higher than 0 for any non-cleared swap (Section 717 (d)(3)(A) pg. 435)</li> </ul> </li> <li>The Federal Reserve Board will set capital requirements for bank holding companies as strict as or stricter than those set by prudential regulators (Section 717 (d)(3)(C) pg. 436)</li> </ul>	<ul style="list-style-type: none"> <li>Prudential regulators impose initial/variation <b>capital AND margin requirements</b> that: <ul style="list-style-type: none"> <li>Help ensure the safety and soundness of the swap dealer/ major swap participant</li> <li>Are appropriate for the risk associated with non-cleared swaps held by swap dealers/ major swap participants (Section 4s (d)(1)(A) pg. 59-60)</li> </ul> </li> </ul>
<b>Capital requirements for NON-BANK swap dealers and major swap participants</b>	<ul style="list-style-type: none"> <li>The SEC and CFTC shall impose capital requirements for non-banks that are as strict as or stricter than those set by prudential regulators (Section 4s (e)(3) pg. 60)</li> </ul>	<ul style="list-style-type: none"> <li>The SEC and CFTC shall impose capital requirements for non-banks that are as strict as or stricter than those set by FIRA (Section 717 (d)(3)(B) pg. 436)</li> </ul>	<ul style="list-style-type: none"> <li>The SEC and CFTC shall impose initial/variation capital AND margin requirements that: <ul style="list-style-type: none"> <li>Help ensure the safety and soundness of the swap dealer/major swap participant</li> <li>Are appropriate for the risk associated with non-cleared swaps held by swap dealers/major swap participants (Section 4s (d) (1)(B) pg. 60)</li> </ul> </li> </ul>
<b>Margin requirements for BANK swaps dealers, major swap participants and holding companies</b>	<ul style="list-style-type: none"> <li>Prudential regulators will impose both initial and variation margin requirements for all swaps under their jurisdictions that are not cleared by a registered DCO (Section 4s (e)(4) pg. 61)</li> <li>Prudential regulators may exempt requirements for swaps/security-based swaps where one of the counterparties is not a swap dealer/ security-based swap dealer or major swap/security-based swap participant (Section 4s(e) (4) pg. 61)</li> </ul>	<ul style="list-style-type: none"> <li>FIRA will impose both initial and variation margin requirements for all swaps under its jurisdiction that are not cleared by a registered DCO (Section 717 (d)(4)(A)(i) pg. 437, 438)</li> <li>FIRA may provide exemptions if one of the counterparties is: <ul style="list-style-type: none"> <li>Is neither a dealer or major swap participant</li> <li>Using the swap as an effective hedge under GAAP</li> </ul> </li> <li>Predominately engaged in activities that are not financial in nature (Section 717 (d)(4)(A) (ii) pg. 438-439)</li> </ul>	<ul style="list-style-type: none"> <li>Refer to capital requirements</li> </ul>

Discussion Points	House Banking Committee's Over-the Counter Derivatives Market Act of 2009 <sup>i</sup>	Senate Banking Committee's Over-the Counter Derivatives Market Act of 2009 <sup>ii</sup>	House Agriculture Committee's Derivatives Markets Transparency and Accountability Act of 2009 <sup>iii</sup>
<p><b>Margin requirements for non-cleared swaps held by dealer or major swap participant who is NOT a bank</b></p>	<ul style="list-style-type: none"> <li>The SEC and CFTC shall impose margin requirements for non-banks that are as strict as or stricter than those set by prudential regulators (Section 4s (e)(4) pg. 62)</li> </ul>	<ul style="list-style-type: none"> <li>The SEC and CFTC shall impose margin requirements for non-banks that are as strict as or stricter than those set by FIRA</li> <li>Exemptions by SEC/CFTC are as follows: <ul style="list-style-type: none"> <li>If one of the counterparties is neither a dealer or major swap participant</li> <li>If the counterparty is using the swap as an effective hedge under GAAP</li> <li>If the counterparty is predominately engaged in activities that are not financial in nature (Section 717 (d)(4)(B) pg. 441-442)</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Refer to capital requirements</li> </ul>
<p><b>Supplemental margin and segregation of margin collateral</b></p>	<ul style="list-style-type: none"> <li>Margin requirements set by the SEC/CFTC for any non-swap dealer or major swap participant shall provide for the use of non-cash assets as collateral (Section 4s(e)(4) pg. 61)</li> <li>Cleared swaps: collateral shall be segregated, maintained, and used for the benefit of the counterparty and treated as customer property (Section 4t(a) pg. 70)</li> <li>Non-cleared swaps: collateral should be maintained in an account carried by an independent third-party custodian and designated as a segregated account (Section 4t(b) pg. 71)</li> </ul>	<ul style="list-style-type: none"> <li>FIRA and the SEC/CFTC may permit the use of non-cash collateral for bank/non-banks if consistent with preserving the financial integrity of markets trading swaps AND preventing systematic risk (Section 717 (d)(5) pg. 444)</li> <li>Any party to a swap that is exempt from margin requirements and is a BANK may request that the counterparty provide additional margin (Section 717 (d)(6) pg. 444)</li> <li>Cleared swaps: collateral shall be segregated, maintained, and used for the benefit of the counterparty and treated as customer property (Section 718 (a) pg. 454)</li> <li>Non-cleared swaps: collateral should be maintained in an account carried by an independent third-party custodian and designated as a segregated account (Section 718 (b) pg. 455)</li> </ul>	<ul style="list-style-type: none"> <li>A person can NOT be registered as a swap dealer unless the person, at all times, adheres to the <b>set-aside-requirements</b> for those swaps not-cleared, an amount equal to the minimum margin requirements plus: <ul style="list-style-type: none"> <li>Any additional set-aside funds that the person and counterparty agree upon</li> <li>Any additional amount actually received from counterparty</li> <li>Any accrued but unpaid losses in connection with the swap less any accrued but unpaid gains (mark-to-market margin) ( Section 4s (d)(3) pg. 61-63)</li> </ul> </li> <li>Cleared swaps: collateral shall be segregated, maintained, and used for the benefit of the counterparty and treated as customer property (Section 3D (a) pg. 157)</li> <li>Non-cleared swaps: collateral should be maintained in an account carried by an independent third-party custodian and designated as a segregated account (Section 3D (b) pg. 158)</li> </ul>

## Discussion of key provisions and primary differences

**Registration and rulemaking:** Although all three versions of the bills call for the CFTC and SEC to have some jurisdiction over the swap market, the bills differ in how that jurisdiction would be divided up.

- All three bills require all swap dealers and major swap participants to register with the CFTC regardless if those organizations are registered with the SEC. All three bills also require all security-based swap dealers and major security-based swap participants to register with the SEC.
- Congressman Frank and Senator Dodd have both proposed that the CFTC and SEC will have joint rule making authority over the OTC derivatives market. This is unusual in that the SEC would have rulemaking authority over organizations that are not required to register with it, but this process should promote harmonization between the CFTC and SEC and enable the creation of similar rules for comparable products.
- To address the concern related to delay, in the event that neither commission can agree upon a uniform rule within 180 days both Congressman Frank and Senator Dodd have transferred the rulemaking process to a higher authority. In Congressman Frank's bill, this power is given to the Fed. However, under Senator Dodd's proposal, that authority has been granted to a new agency called the Agency for Financial Stability. The role of this agency would be to identify and respond to systematic risks prevalent within the financial system.<sup>16</sup>
- Congressman Peterson intends to split the rulemaking between the two agencies and give them both the option of consulting prudential regulators and one another, if necessary. This governing structure would create separate rules and policies but should streamline the entire rulemaking process.

**Definition of dealer:** The Securities Exchange Act of 1934 currently defines a securities dealer as "any person engaged in the business of buying and selling securities for his own account."<sup>17</sup>

- Both Congressman Frank and Senator Dodd currently define "swap dealer" and security-

based "swap dealer" by adding those terms to the "dealer" definition in the Exchange Act. This definition would have the advantage of using an existing term around which a body of law has been established. Use of this definition would likely require smaller less systemically important firms to register.

- Congressman Peterson varies from the Securities Exchange Act definition by limiting the classification of a swap and securities-based swap dealer to those firms that as a *significant* part of their business hold themselves out as a dealer or make markets in swaps. The term "significant" is not defined in the legislation, so presumably the CFTC and SEC would be left to determine how to apply it.

**Definition of major swap participant:** The definition of a major swap participant has been a subject of concern because it distinguishes parties that may actively speculate using swaps from those that use them to reduce the risk from their commercial activities ("end users"). Those parties that are deemed to be major swap participants will be required to register and be subject to regulation much in the same way swap dealers are.

- All three drafts exempt any firm that hedges (including balance sheet hedging) and/or holds swaps for the purpose of "risk management". The challenge for the legislature and the regulators that must interpret the legislation would be how to distinguish between firms that are using derivatives to hedge business risk from those that are taking a more speculative position. The drafts use terms like "substantial net position" as a means to making that distinction, but how the CFTC and SEC would interpret that term is unclear at this time.
- All three of the drafts look to the impact caused by a default of the counterparty as a means of distinguishing between end users and major swap participants. Both the Senator Dodd and Congressman Frank versions look to the impact of a default on other counterparties, while under the Congressman Peterson bill, the determination is based upon whether or not the default of the counterparty could significantly impact the stability of the financial system. Some commentators take the view that Congressman Peterson's approach will capture a smaller universe of end users.<sup>18</sup>



**Clearing/trading:** Clearing and trading requirements have been a point of focus by policymakers, regulators and the industry. While central clearance mitigates counterparty credit risk and exchange trading promotes price transparency, both reduce the ability of the market to provide customized swaps that fit the particular needs of commercial end-users. The price transparency afforded by exchange trading also may lower the profit margins of the dealer community.

- Each draft allows central clearing agencies, such as the Chicago Mercantile Exchange and Intercontinental Exchange, to determine if a swap should be cleared. This allowance essentially recognizes that if systemic counterparty credit risk is going to be centralized at particular clearing organizations, those organizations must have the ability to determine which swaps meet their risk management criteria.
- End-users of swaps will remain exempt from any clearing requirements.<sup>19</sup> Forcing an end-user to execute their swaps through a clearing agency would increase transaction costs and diminish their ability to obtain a customized product specific toward their operational needs.
- All swaps/security-based swaps that are cleared must trade on a regulated exchange or alternative swap execution facility.
- All three drafts currently state that any standardized (clearable) swap where both counterparties are either dealers or major swap participants (not end-users) but where a board of trade, national securities exchange, or swap execution is available, may be exempt from trading requirements.<sup>20</sup>

**Capital and margin collateral requirements:** All three versions of the bill include capital margin collateral and segregation requirements. These requirements are important because they mitigate credit risk in the system, but they also significantly increase the transaction cost.

- Any counterparty to a non-cleared swap/security-based swap, including end-users, must post margin collateral to secure their performance obligation. This requirement directly increases their transaction cost but mitigates counterparty credit risk in the system.

- Both Congressman Frank and Congressman Peterson give the CFTC and SEC authority to impose margin and capital requirements that are at least as stringent as those set by the prudential regulators, i.e., senior banking supervisors. The Senator Dodd version takes the same approach, but replaces the prudential regulators with one bank regulatory agency – the Financial Institutions Regulatory Authority.
- The practice today in the securities and commodity futures industry is to allow firms and customers to post securities as margin collateral to secure margin obligations. Congressman Frank's bill limits the use of non-cash margin collateral to end-users and non-cleared swaps wherein one party is not a swap dealer or major swap participant to post non-cash collateral as margin. Senator Dodd's bill permits the use of non-cash collateral for all banks/non-banks if consistent with preserving the financial integrity of markets trading swaps and preventing systematic risk. Senator Dodd's bill is more consistent with the current practice where non-cash collateral is allowed with regulatory approval. Congressman Frank's bill would result in higher financing cost for those that trade swaps, as they would not only have to now provide margin collateral, but they would have to raise cash to do it.
- All three bills call for the segregation of margin collateral. For cleared transactions this is consistent with current industry practice in the listed derivatives industry. SEC and CFTC rules call for segregation for margin collateral received for options and futures transactions, but allow for an offset when that collateral is transmitted to a central clearing organization to cover a margin obligation required of the broker/dealer of FCM related to that same position. Practices vary in the current over-the-counter market, where many participants are not subject to regulation.

### Overseas regulatory developments

In addition to recent developments regarding OTC derivatives regulation in the United States, there also have been significant developments overseas. The International Swaps and Derivatives Association (ISDA) has successfully implemented a two-prong

reform policy called the Big-Bang and Small-Bang protocol.<sup>21</sup> The function of these supplements is to provide transparency in the physical settlement of CDS contracts and validation of credit/succession events, which will be enforced by newly created "Determination Committees."<sup>22</sup>

The European Commission has also adopted a *Communication* to help ensure financial stability in the OTC derivatives markets on a global scale. The four specific tools that the *Communication* outlines in order to increase transparency and combat regulatory arbitrage are 1) contract standardization, 2) central data repositories, 3) central counter-party clearing, and 4) trade execution on public trading venues – along the lines of the three drafts currently in discussion within the United States.<sup>23</sup>

## Conclusion

The proposed legislation has the potential for transforming what is now the OTC derivatives market into a marketplace that looks more like the current listed market for derivatives. If that transformation occurs, the current OTC derivatives market will bear the benefits of the cleared exchange-traded market, e.g. less counterparty credit risk in the financial system, but also its shortcomings, e.g. less access to customized products. While it may present higher transactional costs in the way of margin and capital requirements, those requirements would also lessen systemic risk because they make it more likely that participants in the market will honor their obligations. Although the transactional costs may increase, the legislative changes would in fact lower the barrier to entry for these products. Currently, because of the lack of central clearance, entrance to the market is limited to large firms that have the credit standing to be accepted by other counterparties. If much of the market becomes centrally cleared, smaller firms could participate, as long as they can meet regulatory capital and margin requirements.

For additional information on this topic contact Michael P. Jamroz, partner, Deloitte & Touche LLP, [mjamroz@deloitte.com](mailto:mjamroz@deloitte.com), + 1 202 879 5310, or Marjorie Forestal, senior manager, Deloitte & Touche LLP, [mforestal@deloitte.com](mailto:mforestal@deloitte.com), +1 212 436 6632.

# Feature Articles: Investment Management

## Strengthening the Regulatory Framework of Money Market Funds

On June 24, 2009, the Securities and Exchange Commission (SEC) released proposed amendments to Rule 2a-7 and certain other rules (the "Money Market Release") under the Investment Company Act of 1940 ("Investment Company Act").<sup>24</sup> In his speech before the SEC's June 24, 2009 open meeting, Commissioner Luis Aguilar commented that the proposed amendments to Rule 2a-7 are designed to increase the resilience of money market funds to market disruptions, protect the stable Net Asset Value (NAV), and improve money market funds' ability to satisfy significant demand for redemptions.<sup>25</sup> An additional proposed amendment to Rule 2a-7 would include enhancing the SEC's oversight of money market funds by requiring funds to report holdings to the SEC on a monthly basis. On September 18, 2009, interim final temporary rule 30b1-6T was adopted by the SEC under the Investment Company Act as a temporary measure to establish reporting requirements immediately.<sup>26</sup> The proposed key amendments to Rule 2a-7 are discussed below, including those that are being temporarily addressed by Rule 30b1-6T.

## Portfolio quality

Proposed amendments would limit exposure to credit risk by requiring money market funds to only invest in "First Tier" securities. The SEC indicated in the Money Market Release that the proposed amendments are designed to improve portfolio quality by:<sup>27</sup>

- Limiting the fund to invest in "eligible securities"<sup>28</sup> only, which would eliminate the fund's ability to invest in second tier securities
- Requiring the fund's board of directors to promptly reassess securities to confirm that credit risk remains minimal, if subsequent to investment in the fund:



1. A security ceases to be a First Tier security; or
  2. A fund adviser becomes aware of an unrated security receiving a rating from any Nationally Recognized Statistical Rating Organization (NRSRO) below the highest short-term rating category
- Permitting funds to invest in long-term unrated securities provided the security has received long-term ratings in the highest two NRSRO rating categories

On September 17, 2009 the SEC re-opened the comment period on previously proposed amendments aimed at removing references to NRSROs in regards to the determination of eligible securities.

### Diversification

The SEC is requesting comments regarding potential restrictions to the diversification limits of Rule 2a-7, in terms of issuer diversification, and guarantor and demand diversification including:

- Limiting investments in repurchase agreements to those collateralized by cash items or U.S. Government securities
- Requiring money market fund board of directors to evaluate the creditworthiness of the counterparty, regardless of whether the repurchase agreement is fully collateralized

### Portfolio maturity

To limit the exposure of the money market fund to interest rate risk, the proposed amendment would shorten the average maturity limits of securities held by the funds. Among other things, the proposed amendments would:

- Limit the dollar-weighted average portfolio maturity to 60 days from the current limit of 90 days
- Impose a new maturity test that would limit the weighted average life maturity to 120 days (the weighted average life would be measured without regard to interest reset dates)
- Limit purchases of government securities, for funds utilizing the "Penny-Rounding Pricing Method", to those securities with a remaining maturity of 762 calendar days or less

### Portfolio liquidity

Currently, liquidity requirements do not exist under Rule 2a-7, but money market funds are subject to Section 22(e) of the Investment Company Act, which requires registered investment companies to satisfy redemption requests in no more than seven days. The proposed amendment addresses liquidity risks by adding new risk-limiting conditions designed to improve money market funds' ability to meet significant redemption demands.

The proposed amendment would prohibit money market funds from investing in illiquid securities and would impose daily and weekly liquidity requirements for retail and institutional funds.<sup>30</sup> The proposed rule would also require the fund's board of directors to make a determination, no less frequently than once per calendar year, as to whether the fund is a retail or institutional fund by taking criteria such as historical cash flows and minimum initial investment requirements into consideration.

### Stress testing

The proposed amendments would also require the fund's board of directors of funds using the amortized cost method to conduct periodic stress testing<sup>33</sup> to assess the fund's ability to maintain a stable NAV based upon hypothetical events (i.e., short-term interest rates, downgrade of a portfolio security). The proposed amendment does not specify how frequently stress testing must be performed; instead it tasks the fund's board of directors with the responsibility to determine at what interval stress testing is appropriate and reasonable in consideration of the current market environment. The proposed rule would require the fund to maintain records of the stress testing for six years including dates on which the testing was performed and hypothetical events considered.<sup>34</sup>

The SEC is proposing a new rule, which would permit all money market funds to suspend redemptions, following notification to the SEC, upon breaking the buck, to provide for orderly fund liquidation with the appropriate board approval.<sup>35</sup> Additionally, the "know your investor"<sup>36</sup> provisions within the proposed rule would require the fund's board of directors to determine, at least annually, that the fund (or its transfer agent) has the capacity to meet its redemption needs.

## Enhanced disclosure of portfolio information

Finally, the SEC proposes reporting disclosure requirements including:

- Requiring money market funds to disclose portfolio holdings within two business days by the end of each month on their websites, specifically including the fund's schedule of investments, the issuer, principal amount and amortized cost
- Requiring money market funds to provide the SEC with a monthly electronic filing of more detailed portfolio holding information, which the SEC intends to make publicly available two weeks after the filing

The SEC comment period ended September 8, 2009. Comments submitted to the SEC by industry groups, including the Investment Company Institute and the Securities Industry and Financial Markets Association, generally voiced opposition to the proposed rule by asserting, among other things, that eliminating the credit quality requirements may weaken the strength of the existing money market regulations.

For further information on this topic, please contact Michael Chung, director, Deloitte & Touche, LLP, [michung@deloitte.com](mailto:michung@deloitte.com), +1 312 486 5382, Jay Regan, senior manager, Deloitte & Touche, LLP, [jregan@deloitte.com](mailto:jregan@deloitte.com), +1 617 437 2014 or Lynne Robertson, manager, Deloitte & Touche, LLP, [lrobertson@deloitte.com](mailto:lrobertson@deloitte.com), +1 617 437 3762.

## Contributors

**The Editors would like to thank the following contributors from Deloitte & Touche LLP to the News Bulletins:**

Anna Blythe (Banking), Jeanne-marie Smith (Banking)

**Additional Contributors to the Securities Feature Article:** Jonathan Almay and Richard Rosenthal (*Momentum Increasing for Over-the Counter-Derivatives Reform*)

## About This Publication

@Regulatory is a regular publication in which we apprise readers of some of the latest developments across the banking, securities, investment management and insurance industries. For distribution inquiries please visit our registration page at <http://deloitte.12hna.com/preferences>. Choose your area of interest (your choice of financial services industry sector(s)) and then tick the box for "Regulatory Update" and you'll receive these e-mails in the future.

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte, its affiliates, and related entities shall not be responsible for any loss sustained by any person who relies on this publication.



# End Notes—I

- <sup>1</sup> The Federal Financial Institutions Examination Council is comprised of the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).
- <sup>2</sup> *Ibid.*
- <sup>3</sup> <http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf>
- <sup>4</sup> <http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf>
- <sup>5</sup> <http://www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm>
- <sup>6</sup> *Ibid.*
- <sup>7</sup> *Ibid.*
- <sup>8</sup> *Ibid.* p.3.
- <sup>9</sup> *BIS Quarterly Review*. December 2009. p.A103. <http://www.bis.org/statistics/otcder/dt1920a.pdf>
- <sup>10</sup> <http://www.cftc.gov/opa/press00/opa4481-00.htm>
- <sup>11</sup> <http://www.hedgefundlawblog.com/wp-content/uploads/2009/08/over-the-counter-derivatives-markets-act-of-2009.pdf>
- <sup>12</sup> *Ibid.* p.15.
- <sup>13</sup> [http://agriculture.house.gov/inside/Legislation/111/hr3795\\_Reported.pdf](http://agriculture.house.gov/inside/Legislation/111/hr3795_Reported.pdf)
- <sup>14</sup> <http://www.emii.com/Articles/2321677/Derivatives/Derivatives-Articles/Financial-Services-Committee-Passes-OTC-Bill.aspx>
- <sup>15</sup> [http://banking.senate.gov/public/\\_files/AYO09D44\\_xml.pdf](http://banking.senate.gov/public/_files/AYO09D44_xml.pdf)
- <sup>16</sup> [http://banking.senate.gov/public/\\_files/AYO09D44\\_xml.pdf](http://banking.senate.gov/public/_files/AYO09D44_xml.pdf), pg.26
- <sup>17</sup> <http://www.sec.gov/divisions/marketreg/bankdealerguide.htm>
- <sup>18</sup> [http://www.davispolk.com/files/Publication/adcb3a76-3d1b-4ad7-94af-009c91c97e43/Presentation/PublicationAttachment/2cf2d467-bbe7-44a2-af02-01181bd76049/102909\\_FrankPeterson\\_Bills.pdf](http://www.davispolk.com/files/Publication/adcb3a76-3d1b-4ad7-94af-009c91c97e43/Presentation/PublicationAttachment/2cf2d467-bbe7-44a2-af02-01181bd76049/102909_FrankPeterson_Bills.pdf), pg. 2
- <sup>19</sup> [http://www.house.gov/apps/list/press/financialsvcs\\_dem/pressder\\_101509.shtml](http://www.house.gov/apps/list/press/financialsvcs_dem/pressder_101509.shtml)
- <sup>20</sup> *Ibid.*
- <sup>21</sup> <http://www.isda.org/press/press040809.html>
- <sup>22</sup> [http://www.dechert.com/library/FS\\_Issue\\_9\\_04-09-ISDA\\_Auction\\_Hardwiring.pdf](http://www.dechert.com/library/FS_Issue_9_04-09-ISDA_Auction_Hardwiring.pdf)
- <sup>23</sup> <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1083&format=HTML&aged=0&language=EN&guiLanguage=en>
- <sup>24</sup> Money Market Fund Reform; Proposed Rule; Release No. IC-28807; File No. S7-11-09; June 24, 2009, p.1. <http://www.sec.gov/rules/proposed/2009/ic-28807.pdf>.
- <sup>25</sup> Luis A. Aguilar, Commissioner, U.S. Securities and Exchange Commission, Speech: Strengthening the Money Market Framework with Investors in Mind. June 24, 2009. <http://www.sec.gov/news/speech/2009/spch062409laa.htm>
- <sup>26</sup> Interim Final Temporary Rule; 30b1-6T under the Investment Company Act of 1940 was adopted September 18, 2009 and is effective through September 17, 2010. The interim final temporary rule requires money market funds, under certain circumstances, to report portfolio holdings and valuation information to the SEC. The interim final temporary rule is intended to replace substantially similar information requirements established by the Temporary Guarantee Program for Money Market Funds that the Department of the Treasury implemented on April 1, 2009. The Temporary Guarantee Program for Money Market Funds expired on September 18, 2009.
- <sup>27</sup> Money Market Fund Reform Proposed Rule, p. 25-41.
- <sup>28</sup> Eligible Securities would be redefined to only include securities, at the time of purchase, with the highest short-term debt ratings, instead of the two highest two short-term debt ratings from the requisite NRSRO, and if unrated, has been determined by the fund's board of directors to be of comparable quality.
- <sup>29</sup> SEC Rule 2a-7 [17 CFR 270.2a-7] under the Investment Company Act.
- <sup>30</sup> SEC proposed rules 2a-7(c)(5)(iii) and 2a-7(c)(5)(iv) under the Investment Company Act.

<sup>31</sup> SEC proposed rule 2a-7(a)(24) under the Investment Company Act. A “retail fund” is defined as any fund not determined to be an institutional fund.

<sup>32</sup> SEC proposed rule 2a-7(a)(18) (defining “Institutional Fund”).

<sup>33</sup> Money Market Fund Reform Proposed Rule, p. 112.

<sup>34</sup> SEC proposed rule 2a-7(c)(8)(ii)(D)(2), (3) under the Investment Company Act.

<sup>35</sup> SEC proposed rule 22e-3 under the Investment Company Act.

<sup>36</sup> SEC proposed rule Proposed rule 2a-7(c)(1) under the Investment Company Act.

## End Notes—II

<sup>i</sup> Frank Discussion Draft (Oct. 2):

[http://financialservices.house.gov/Key\\_Issues/Financial\\_Regulatory\\_Reform/FinancialRegulatoryReform/Discussion\\_Drafts/OTC\\_Draft.pdf](http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/Discussion_Drafts/OTC_Draft.pdf)

Frank Amendments (Oct. 15):

[http://www.house.gov/apps/list/speech/financialsvcs\\_dem/markup\\_100809.shtml](http://www.house.gov/apps/list/speech/financialsvcs_dem/markup_100809.shtml)

<sup>ii</sup> Senator Dodd’s Discussion Draft

[http://banking.senate.gov/public/\\_files/AYO09D44\\_xml.pdf](http://banking.senate.gov/public/_files/AYO09D44_xml.pdf)

<sup>iii</sup> Peterson Discussion Draft (Oct. 20)

[http://agriculture.house.gov/inside/Legislation/111/JDG\\_372\\_xml.pdf](http://agriculture.house.gov/inside/Legislation/111/JDG_372_xml.pdf)

**Managing Editor:**

John Graetz  
Principal  
Deloitte & Touche LLP  
[jgraetz@deloitte.com](mailto:jgraetz@deloitte.com)  
+1 415 783 4242

**Sector Editors:**

Jeanne-marie Smith  
Manager  
Deloitte & Touche LLP  
[jeasmith@deloitte.com](mailto:jeasmith@deloitte.com)  
+1 202 879 5611

Karen Vaughn  
Senior Manager  
Deloitte & Touche LLP  
[kvaughn@deloitte.com](mailto:kvaughn@deloitte.com)  
+1 703 251 1388

Nicholas Denton-Clark  
Senior Manager  
Deloitte & Touche LLP  
[Ndenton-clark@deloitte.com](mailto:Ndenton-clark@deloitte.com)  
+1 212 436 4090

Moshe Sinensky  
Senior Manager  
Deloitte & Touche LLP  
[msinensky@deloitte.com](mailto:msinensky@deloitte.com)  
+1 212 436 5421

**Editorial Manager:**

Jeanne-marie Smith  
Manager  
Deloitte & Touche LLP  
[jeasmith@deloitte.com](mailto:jeasmith@deloitte.com)  
+1 202 879 5611

**Financial Services:**

Henry Ristuccia  
Partner  
Deloitte & Touche LLP  
[hristuccia@deloitte.com](mailto:hristuccia@deloitte.com)  
+1 212 436 4244

Rhoda Woo  
Director,  
Deloitte & Touche LLP  
[rwoo@deloitte.com](mailto:rwoo@deloitte.com)  
+1 212 436 3388

**About Deloitte**

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see [www.deloitte.com/about](http://www.deloitte.com/about) for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

Copyright ©2009 Deloitte Development LLC. All rights reserved.

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte, its affiliates, and related entities shall not be responsible for any loss sustained by any person who relies on this publication.