

Client Alert

Financial Markets Developments

The Obama Administration has now taken a major concrete step toward outlining its framework for regulatory reform of the financial markets in the United States. On May 13, 2009, Treasury Secretary Timothy Geithner provided Congress with details on the establishment of a comprehensive regulatory framework for over-the-counter (“OTC”) derivatives. In a related press release, the Treasury Department referenced the critical gaps and weaknesses in the financial regulatory system that the economic crisis of the past 20 months has exposed. The press release noted that, as risk built up in the OTC derivatives market (and in the market for credit default swaps in particular), market participants’ internal risk management systems, rating agencies and regulators did not adequately understand or address the behavior of market participants until it was too late.

After consultation with the Commodity Futures Trading Commission (the “CFTC”), the Securities and Exchange Commission (the “SEC”) and other regulators regarding the design of the framework, the Secretary of the Treasury now seeks the statutory tools for a new system of regulation of the previously unregulated OTC derivatives market. In furtherance of its objectives, the Treasury Department has indicated that it will work with foreign authorities to promote a level regulatory playing field to ensure that this program will not be undermined by weaker standards abroad.

The proposed regulatory reform looks to achieve four main objectives:

- containing systemic risk by seeking to prevent activities in these markets that pose risk to the entire financial system;
- addressing market efficiency and price transparency in the derivatives market;
- ensuring market integrity by preventing manipulation, fraud and other market abuses; and
- protecting certain derivatives users by ensuring that OTC derivatives are not sold inappropriately to unsophisticated participants.

To achieve these goals it is suggested that like products and activities must be subject to similar regulation and oversight, regardless of the type of charter or system of regulation to which a market participant may already be subject under federal or state law.

Systemic Risk

It is proposed that the Commodity Exchange Act (the “CEA”) and the securities laws should be amended to require central clearing of all standardized OTC derivatives through regulated central counterparties (“CCPs”), such as the Chicago Mercantile Exchange or the Intercontinental Exchange. Robust margin requirements and risk controls will be proposed for CCPs to ensure that the centralized



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clearing requirement is not circumvented solely by customizing an OTC derivatives transaction. Large dealers and market participants with large exposures to counterparties would be subject to robust and appropriate prudential supervision through a regulatory regime. The regime proposed by Treasury will impose conservative capital requirements, business conduct standards, reporting requirements and conservative requirements relating to initial margins on counterparty credit exposures. Risks associated with customized bilateral OTC derivative transactions that are not cleared through a CCP would be subject to this conservative regime imposed upon derivatives dealers.

Market Efficiency and Price Transparency

It has also been proposed that the CEA and the securities laws authorizing both the CFTC and the SEC be amended, in a manner consistent with their respective missions, to impose record-keeping and reporting requirements on all OTC derivatives. Trades not cleared through a CCP (i.e., those involving non-standardized contracts) would have to be reported to a regulated trade repository. By virtue of the clearing of standardized contracts through a CCP or the reporting of customized transactions to a regulated trade repository, certain of the new record keeping and reporting requirements would be deemed satisfied.

CCP's and trade repositories would then be required to make open positions and trading volumes on an aggregated basis available to the public, and trades and positions of any individual market participant available on a confidential basis to appropriate federal regulators. By requiring the movement of standardized transactions in the OTC markets onto regulated exchanges and regulated transparent electronic trade execution systems as proposed, market efficiency and price transparency should be improved. Further, the development of a system for timely reporting and prompt dissemination and the encouragement of the greater use of regulated exchange-traded derivatives by regulated financial institutions would all be the focus of any proposed legislation.

Market Integrity

To ensure market integrity and confidence in the market process, federal regulators would obtain unimpeded authority to police fraud, market manipulation and other market abuses involving all forms of OTC derivatives by amending the CEA and the securities laws. Additionally, the establishment of the authority to set position limits on OTC derivatives that serve a significant price discovery function has been proposed.

Protection of Unsophisticated Parties

Under the proposed changes, the current principle-based approach to regulating OTC derivatives—prohibiting the participation by counterparties in these markets if they are deemed to not have the sophistication and ability to knowledgeably execute these transactions—would be maintained. However, because the Secretary of the Treasury has suggested that these limits are not sufficiently stringent, the bar to participation in the transactions would be raised. Currently, the CFTC and the SEC are reviewing participation limits with a view to providing recommendations on how to modify the applicable legislation to tighten the limits, or to impose additional disclosure requirements or standards of care in the marketing of OTC derivatives to less sophisticated counterparties. Small municipalities presumably would be included within the category of less sophisticated counterparties, and transactions with these counterparties would be subject to the tightened limits and to the additional disclosure requirements or increased standard of care.

The Treasury Department will now work with Congress to implement the measures outlined in Secretary Geithner's proposals in order to shape US legislation and regulation of the OTC derivatives market. Secretary Geithner also suggests that working closely with foreign regulatory authorities is necessary to achieve these objectives and to promote consistent legislation across jurisdictions, and that failing to do so would possibly undermine efforts in the United States because derivatives activity would simply migrate to markets with inadequate regulatory oversight.

The Details Are for Tomorrow

The proposals outlined in the May 13 letter are largely consistent with the pronouncements of the Treasury Department on March 26, 2009 on the overall goals and structure of US regulatory reform. The proposal is more in the nature of a concept release and does, however, leave a number of items and questions to be detailed and answered in the legislative process. Threshold questions as well as more pointed issues still need to be addressed. We have outlined a few of these below.

It is not certain how “derivatives” will be defined under the new regulatory regime. What types of OTC derivatives are intended to be covered by the new regulations? Further, proper consideration should be given to whether all types of trades may be centrally cleared.

The standardized/customized divide itself is unclear. Inadequate drafting of the legislation in this respect may affect product innovation, inadvertently limit market liquidity and raise legal concerns and uncertainty in some product categories.

Which market participants will be subject to central clearing? Is it the intention that regulated centralized counterparties cover all standardized derivatives (i.e. not only those in the inter-dealer market but also trades between dealers and end-users)?

Jurisdictional issues abound as well. Which federal regulatory authority will be tasked with oversight of swap dealers or of central clearing counterparties? Much of the new proposal adopts a products and activities approach to regulatory reform. This raises many interesting questions, as banks have traditionally been supervised at the level of the institution as opposed to being subject to product-specific regulation. If a bank is a derivatives dealer, would its federal bank supervisors be responsible for ensuring compliance with this new regulatory regime? Also, will this new proposed federal legislation preempt state legislative efforts pursuant to which “covered” credit default swaps might be regulated as a form of insurance?

Will dealers use existing firms to operate the regulated central counterparty and the regulated trade repository or will new entities be formed? Is there a possibility that all OTC derivatives, even those that are not security-based swap agreements, might now be treated as securities for some or all purposes under the federal securities laws?

How will margining be approached and regulated for customized transactions? How much information on transactions will be disclosed? Who, other than a financial institution’s regulator, will be given access to this information? How will privacy be insured? What will be the cost of accessing that information?

All are interesting questions. We trust they will be addressed in the weeks and months ahead.

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