

Clients & Friends Memo

Obama Proposal for Regulatory Reform as It Relates to OTC Derivatives Markets

June 22, 2009

On June 17, 2009, the Obama Administration released its recommendations for reform of our financial regulatory system (the "**Proposal**")¹, and the Firm sent its clients and friends a memorandum summarizing the proposals. This memorandum explains the regulatory reform aspects of the proposal related to over-the-counter ("**OTC**") derivatives markets.

The Proposal, authored by the U.S. Department of the Treasury ("**Treasury**"), largely repeats many of the specific proposals introduced in the May 13, 2009 Geithner letter to Congress (the "**Geithner Letter**")² regarding comprehensive regulatory reform for *all* OTC derivatives markets.

The Proposal emphasizes two additional broad themes relevant to the OTC derivatives market. First, fragmentation of the federal regulatory system (SEC, CFTC and banking regulators) has created gaps and weakness in the nation's oversight of financial firms, including oversight of OTC derivative transactions. As a result, all large, interconnected firms that pose systemic risk issues should be subject to regulation by the Federal Reserve Board, with the assistance of a new "Financial Services Oversight Council" (the "**Council**"). The proposed new Council, which would be chaired by Treasury and include the heads of the principal federal financial regulators, would "help fill gaps in supervision", "facilitate information sharing and coordination among the principal federal financial regulatory agencies" and "provide a forum for resolving jurisdictional disputes between regulators". Second, the growth of the OTC derivatives markets and the introduction of new derivatives instruments requires harmonization in the regulation of economically similar derivatives products by the CFTC and SEC. As a result all OTC derivatives markets must have a coherent and coordinated regulatory framework.

¹ To view the Obama Administration's white paper, see, http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

² See <http://www.ustreas.gov/press/releases/tg129.htm>

Specific Proposals

The Proposal suggests that innovation in the OTC derivatives markets over recent years was too rapid for many financial institutions' risk management systems, market infrastructure and the nation's regulatory regime. As a result, the financial crisis exposed concentrated risk and opacity in the OTC derivatives markets. The proposals in the Proposal cover not just CDS markets but *all* OTC derivatives markets, and reserve maximum flexibility to develop a new regulatory framework that:

- prevents activities in the OTC derivatives markets from posing risk to the entire financial system;
- promotes efficiency and transparency in the OTC derivatives markets;
- prevents market manipulation, fraud and other market abuses;
- ensures that OTC derivatives are not marketed inappropriately to unsophisticated parties;
- harmonizes futures and securities regulation; and
- enhances the Federal Reserve's authority over market infrastructure.

Preventing Risk to the Financial System

The Proposal proposes that the Commodities Exchange Act ("**CEA**") and securities laws should be amended to require all "standardized" OTC derivatives to be cleared through one or more regulated central counterparties ("**CCP**") which impose "robust margin requirements as well as other necessary risk controls." The assumption here is that derivatives exposures potentially creating systemic risk are most effectively managed when derivatives are cleared through regulated CCPs. Therefore, to the extent that OTC derivatives are approved for clearance by a CCP, such OTC derivatives would be presumed "standardized" and ineligible for OTC trading. Although "customized" OTC derivatives need not be cleared through a CCP, customization of OTC derivatives solely as a method to avoid central clearing would be prohibited.

In addition, the Proposal states that OTC derivatives dealers and "all other firms whose activities in those markets create large exposures to counterparties" should be subject to "a robust regime of prudential supervision and regulation." This clearly expands the scope of OTC derivatives regulation beyond financial institutions that are currently regulated on the federal level to encompass corporates like AIG Financial Products, as well as some hedge funds and issuers of other structured products. These regulations would impose "conservative" capital requirements, business conduct standards, reporting requirements and initial margin requirements. Regulatory capital requirements on OTC derivatives that are not centrally cleared also would be set at levels greater than those for standardized derivatives to protect against the (presumed) greater degree of risk and create additional incentives for standardization.

Promoting Efficiency and Transparency

In order to improve efficiency and transparency in the OTC markets, the Proposal proposes that market regulators (*e.g.*, the CFTC and SEC) have the authority to impose record keeping and reporting requirements (including an audit trail) on all OTC derivatives, some of which should be deemed satisfied if centrally cleared through a CCP, or, for customized transactions, reported to a regulated trade data repository. Such record keeping and reporting requirements might extend to structured products with embedded customized contracts. The establishment of regulated trade data repositories for customized contracts is perhaps the most significant measure proposed in this regard. These regulated repositories (as well as CCPs for standardized OTC derivatives) would accumulate and publish open positions and trading volumes to the public. They would also, on a confidential basis, provide federal regulators with data on the positions of individual participants.

In addition, to encourage pricing transparency, regulators would move “standardized” OTC derivatives onto regulated exchanges and electronic trading systems. Corresponding regulations covering trade reporting as well as price and information dissemination would also apply. The Proposal recommends encouraging regulated financial institutions to make greater use of regulated exchange-traded derivatives and suggests that the increased competition between OTC derivatives markets and regulated exchanges resulting from this and from moving standardized OTC derivatives onto exchanges would increase efficiency and benefit end-users.

Preventing Market Manipulation, Fraud and Abuse

The proposal calls for “clear, unimpeded authority” for the CFTC and the SEC “to police and prevent fraud, market manipulation, and other market abuses.” This would include CFTC authority to set position limits on OTC derivatives that “perform or affect a significant price discovery function with respect to regulated markets.”

Protecting Unsophisticated Parties

The Proposal indicates that existing laws designed to protect unsophisticated parties from entering into inappropriate derivatives transaction “are not sufficiently stringent.” The CFTC and SEC are reviewing existing law to determine how limits can be tightened, additional disclosure requirements can be imposed or standards of care in connection with the marketing of derivatives can be increased. In addition, the Proposal proposes the creation of the “Consumer Financial Protection Agency” in furtherance of the goal of protecting consumers of financial products and services.

Harmonization of Futures and Securities Regulation

Acknowledging that “the broad public policy objectives of futures regulation and securities regulation are the same” and in an effort to reduce legal uncertainty and forestall turf battles that consume agency resources, the Proposal proposes amending applicable statutes and regulations to address gaps and inconsistencies in the regulation of futures and securities markets. Such amendments would be based on CFTC and SEC recommendations to Congress. The paper suggests that harmonizing the regulatory regimes would “permit a broader range of instruments to trade on any regulated exchange” and again suggests that the resulting increased competition among exchanges would make markets more efficient and benefit end users. The paper recommends that CFTC and the SEC prepare a report to Congress by September 30, 2009 identifying “all existing conflicts in statutes and regulations with respect to similar types of financial instruments” and either justifying the difference or providing a proposal to eliminate the difference. If the two agencies are unable to reach agreement by September 30, 2009, then the Council would have a mandate to resolve the differences within six months of its creation.

Federal Reserve Authority Over Market Infrastructure

Acknowledging the critical role of clearing systems in the mitigation or exacerbation of systemic risk, the Proposal states that “a key determinant of the risk posed by the interconnectedness of financial institutions is the strength or weakness of arrangements for settling payment obligations and financial transactions between banks and other financial institutions”. If these entities fail or do not perform their function properly, they can be a source of contagion. The Proposal proposes granting authority to the Federal Reserve to oversee payment, clearing and settlement systems that are deemed systemically important and payment, clearing, and settlement activities of financial firms that are deemed systematically important, and, in consultation with the Council, to set risk management standards for their operation. It proposes defining a covered system as “a payment, clearing, or settlement system the failure or disruption of which could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threatening the stability of the financial system.” If such system is subject to comprehensive federal regulation by another regulator, that regulator would remain its primary regulator, and any information requests from the Federal Reserve would be made first to the primary regulator.

Further, the paper indicates that the Federal Reserve should have the authority to open Reserve Bank accounts, financial services and the discount window to systemically important payment, clearing and settlement systems. Many of these systems depend on commercial banks to perform critical payment and financial services and to provide them with the liquidity they need to complete settlement. Access to Reserve Bank accounts, financial services and to the discount window mitigates the risk that a payment, clearing or settlement system would be unable to timely settle transactions where the bank it relies on is unable/unwilling to perform.

Where Have We Seen Certain of These Concepts Before?

Most of the proposals regarding regulatory reform for the OTC derivatives markets were set forth in the Geithner Letter. Specifically, the Geithner letter called for (i) clearing of all standardized derivative contracts through CCPs and the movement of such contracts onto regulated exchanges and electronic trading systems, (ii) expansion of the scope of derivatives regulation beyond financial institutions to include all firms with large exposures to counterparties, (iii) required record keeping and reporting for all derivatives transactions, including collection of information in regulated trade repositories for customized contracts, (iv) clear authority for regulators to police fraud, market manipulation and other market abuses, and (v) revisions to existing laws to strengthen protections for unsophisticated parties.

These objectives and proposals in turn have been presented by various entities in releases extending back several years. For instance, Secretary Geithner's March 2009 Congressional testimony and the Framework for Regulatory Reform covered the same material. A 2008 report by the Counterparty Risk Management Policy Group ("**CRMPG III Report**") prepared for then Treasury Secretary Paulson cited central counterparty clearing as a way to mitigate systemic risk.³ A 1999 report published by the President's Working Group on Financial Markets recommended (i) improved transparency, (ii) coordination with non-U.S. financial centers in establishing international standards and (iii) potentially, direct regulation of hedge funds.⁴

The call for prudential regulation and the harmonization of regulations as presented in the Proposal would be one step in the direction proposed in Paulson's "Blueprint"⁵, released in March 2008, which recommended the merger of the CFTC and the SEC and the harmonization of securities and futures regulation, as well as the appointment of the Federal Reserve as a single consolidated regulator with broad oversight and authority. The CRMPG III report expressed support for the initiative of the Treasury in setting forth its Blueprint and recognized the importance and urgency of the issue of the role of the Federal Reserve in prudential supervision and financial market oversight. A 2005 report by the Counterparty Risk Management Policy Group⁶ raised concerns over a trend towards a rules based approach and suggested that prudential regulation can have the benefit of limiting opportunities for regulatory arbitrage.

³ "Containing Systemic Risk: The Road to Reform, The Report of the CRMPG III"
(<http://www.crmpolicygroup.org/docs/CRMPG-III.pdf>)

⁴ "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management"
(<http://www.treas.gov/press/releases/reports/hedgfund.pdf>)

⁵ See Treasury's "Blueprint for a Modernized Financial Regulatory Structure" published in March 2008
(<http://www.treas.gov/press/releases/reports/Blueprint.pdf>)

⁶ See <http://www.crmpolicygroup.org/crm2/docs/CRMPG-II.pdf>

Observations and Further Issues

The program should be expected to evolve as the Administration works with Congress and the regulators to craft concrete legislation and/or regulation. It is clear that some aspects of the proposed reforms are aspirational statements that raise more questions than answers. In particular, the proposals directed at managing risk and promoting market “efficiency” raise many complicated issues while deferring difficult choices to a later time, including:

- **Regulatory agency consolidation:** Certainly the idea of a single consolidated supervisor for all large, interconnected firms, combined with the creation of the Council to improve interagency cooperation, is desirable. However, Congress will need to clearly define the jurisdictional authority of market regulators, including the CFTC, the SEC and the Federal Reserve, as well as give the Council power to implement its “umpire” role. While the Proposal instructs that the Council improve interagency cooperation, it appears that OTC derivatives would still remain subject to regulation by the SEC, CFTC and bank regulators.
- **Consolidation of OTC derivatives regulatory regimes:** Giving all OTC derivatives markets a coherent and coordinated regulatory framework is vital to promoting transparency and efficiency of markets. But it is important to recognize that years of market practice and vested interests in the financial community, combined with a history of turf battles between regulatory agencies, will make the job of the Fed and the Council a tall order. In addition, the task will require Congress to clear out decades of legal underbrush.
- **Definitional issues:** The term “OTC derivative” is not defined. This definition could be expansive and include a host of “high risk complex financial instruments.” There is no clarity yet as to how to distinguish a “standardized” OTC derivative contract from a “customized” one.⁷ Note that the presumption that a derivative contract is standardized if it is merely “accepted” for clearing through a CCP rests a significant amount of power in each CCP to unilaterally decide whether a contract is standard or custom. The stakes for these definitional issues are high. If the regulators exert too heavy a hand in centralizing derivatives trading, the value of derivatives as a tool to customize risk could be seriously impaired. On the other hand, too broad a definition of customized contracts could leave too many contracts outside of the centrally cleared market for it to be an effective systemic risk mitigant.
- **International arbitrage issues:** In addition to potential arbitrages between the various U.S. regulatory regimes, enhanced US regulation increases the incentive to migrate transactions to foreign OTC derivatives markets, thereby potentially garnering more favorable margin or reporting results. While the Treasury devotes an entire section of the Proposal to its

⁷ For example, would the desire of the relevant parties to customize such things as adjustments to extra-ordinary events, settlement mechanics, or dispute rights be sufficient to permit OTC trading, or would such trading only be permitted when basic economic terms are not available in a standardized product?

current and proposed efforts to reach international consensus on important issues such as capital requirements, oversight and supervision on an international level and crisis prevention and management, adding multiple foreign regulators only increases the duration and difficulty of the task.

- **Prudential regulation:** The Proposal calls for robust new prudential regulation, representing the first time securities laws would shift in the direction of a principles based regime and away from its over 70 year history as a rules based regime. The paper suggests only in broad strokes what this might look like. Improving risk regulation would be difficult enough purely as a technical matter, without having to deal with multiple regimes administered by different regulators. In the existing environment, the debate over any proposed regulation will implicate issues of competition and regulatory arbitrage. The Council is intended to be a strong first step in promoting interagency cooperation and identifying which agencies are best equipped to regulate particular risks.
- **CFMA and state law issues:** The Proposal does not discuss the ongoing status of the Commodity Futures Modernization Act of 2000 (the “**CFMA**”) in the context of its regulatory scheme. In particular, we note that the CFMA provided preemption from state anti-gambling and bucket shop laws for certain kinds of derivatives. If the CFMA were no longer to apply, such derivatives would again be subject to such regulation at the state level.
- **State insurance regulation:** Several states have moved forward with plans to regulate CDS as insurance under state insurance regulations. While the Proposal proposes the creation of an Office of National Insurance within Treasury to promote national coordination in the insurance sector, it is unclear what effect state efforts to regulate derivatives as insurance will have.

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