

Clients & Friends Memo

Draft U.S. Law Seeks to Regulate Credit Default Swaps

February 2, 2009

On January 28, 2009, Rep. Collin Peterson (D-Minn.), chairman of the U.S. House of Representatives Committee on Agriculture (the "Committee"), distributed an updated draft bill that would, among other things, prohibit credit default swap transactions unless the buyer of protection owns or otherwise has financial exposure to the reference asset specified in the swap. The bill would also require all over-the-counter derivatives transactions to be settled and cleared through a central clearinghouse registered with the U.S. Commodity Futures Trading Commission (the "CFTC") or through certain other regulated clearing organizations, with the potential for exemption by the CFTC of transactions that satisfy certain criteria, including that they are highly customized and infrequently traded. The Committee has legislative jurisdiction and oversight authority over the CFTC.

Under the draft "Derivatives Markets Transparency and Accountability Act of 2009," "It shall be unlawful for any person to enter into a credit default swap unless the person would experience financial loss if an event that is the subject of the credit default swap occurs." The bill defines a "credit default swap" as "a contract which insures a party to the contract against the risk that an entity may experience a loss of value as a result of an event specified in the contract, such as a default or credit downgrade."

Numerous press reports appearing since the circulation of the updated draft have noted that only a relatively small percentage of the current credit default swap market involves protection buyers that own or otherwise have financial exposure to the underlying reference asset. As such, the bill would have a dramatic effect on the market in its present form. Many of these same reports note that while central clearinghouses that are funded by their member institutions may add stability to financial markets, certain costs may be incurred in requiring derivatives contracts that are currently over-the-counter to be settled through a clearinghouse, to the extent the required standardization of contracts drives trading to overseas markets that do not require such settlement.

The International Swaps and Derivatives Association ("ISDA") issued a comment in response to the draft legislation. "This bill would increase the cost and reduce the availability of essential risk management tools while failing to address the true causes of the credit crisis," said ISDA Chairman

Eraj Shirvani. "Throughout the crisis, credit default swaps have remained available and liquid. They have been the only means of hedging credit exposures or expressing a view at a critical time for the industry. Impairing their use would be counterproductive to efforts to return the credit markets to a healthy, functioning state."

The draft legislation comes on the heels of two bills covering over-the-counter derivatives that were introduced in the U.S. Senate in November 2008. The "Derivatives Trading Integrity Act of 2008," proposed by Sen. Tom Harkin (D-Iowa), would require, among other things, most swaps and other derivatives contracts to be traded on a CFTC-regulated exchange. A provision of the "Financial Regulation Reform Act of 2008" proposed by Sen. Susan Collins (R-Maine) would require the Securities and Exchange Commission (the "SEC"), in consultation with the CFTC and the Board of Governors of the Federal Reserve System, to issue rules to designate clearinghouses for credit default swaps. In addition, in September 2008 the State of New York announced plans (later suspended in light of regulatory initiatives announced by U.S. federal authorities) to apply state insurance regulation to credit default swaps in which the buyer of protection owns the underlying reference asset. At the same time, New York authorities called for new federal regulation that would cover credit default swaps in which the buyer of protection did not own the underlying reference asset. The Chairman of the SEC, in turn, asked Congress to give the SEC the authority to regulate credit default swaps, including that portion of the marketplace involving so-called "naked credit default swaps." The needs to improve transparency and to prevent systemic risk to the financial markets are frequently cited as reasons for increased oversight and regulation of over-the-counter derivatives.

The chances of the draft bill's introduction and passage are unclear. At a minimum, this most recently circulated draft illustrates the likelihood of significant changes in the way the credit default swap market functions and the virtual certainty of increased regulation of the marketplace itself.

Hearings on the bill are expected to be held on February 3 and 4, 2009, after which the Committee may make changes to its language before voting on whether it should be considered by the full House of Representatives. We will continue to monitor these legislative developments and any other action taken to regulate credit default swaps or other over-the-counter derivatives.

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