

Clients & Friends Memo

Regulatory Reform of OTC Derivatives Markets

May 15, 2009 To address “critical gaps” in the regulation of derivatives, the Obama Administration outlined comprehensive regulatory reform for all over-the-counter (“**OTC**”) derivatives markets. The May 13, 2009 release by the U.S. Department of the Treasury¹ summarizes the statements sent by U.S. Treasury Secretary Geithner to Senator Harry Reid and other members of Congress.²

The reforms largely echo the Framework for Regulatory Reform³ described by Secretary Geithner in his congressional testimony last March. In addition, they are consistent with recommendations by groups such as the President’s Working Group on Financial Markets, the Counterparty Risk Management Policy Group and others to enhance stability and transparency in the financial markets by, among other reforms, mandating centralized clearing of standardized credit default swap (“**CDS**”) contracts.

However, the release broadens the scope of proposed reform to cover not just CDS but *all* OTC derivatives markets. In doing so, the release reserves maximum flexibility for legislators 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; and
- ensures that OTC derivatives are not marketed inappropriately to unsophisticated parties.

Preventing Risk to the Financial System

The release proposes that all “standardized” OTC derivatives be cleared by one or more regulated central counterparties which impose “robust margin requirements and other necessary risk controls.” The assumption here is that reforms reducing systemic risk are most effective when more

¹ See <http://www.ustreas.gov/press/releases/tg129.htm>

² See <http://www.financialstability.gov/docs/OTCletter.pdf>

³ See <http://www.treasury.gov/press/releases/tg72.htm>

OTC derivatives are cleared through regulated central counterparties. Therefore, to the extent that OTC derivatives are approved for clearance by a central counterparty, such OTC derivatives would be presumed “standardized”. Although “customized” OTC derivatives need not be cleared through a central counterparty, customization of OTC derivatives solely as a method to avoid central clearing would be prohibited.

In addition, the release states that OTC derivatives dealers and “all other firms who 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 regulated financial institutions to encompass corporates like AIG Financial Products, as well as some hedge funds. These regulations would impose “conservative” capital requirements, business conduct standards, reporting requirements and initial margin requirements for both customized and standardized OTC derivatives.

Promoting Efficiency and Transparency

In order to improve efficiency and transparency in the OTC markets, the release recommends that market regulators (e.g., the CFTC and SEC) have access to “comprehensive and timely information” regarding the trading positions of “each and every” participant in all OTC derivatives markets. Perhaps the most significant measure proposed in this regard would be the establishment of regulated trade repositories for customized contracts. These regulated repositories (as well as central counterparties 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 and price and information dissemination would also apply.

Preventing Market Manipulation, Fraud and Abuse

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

Protecting Unsophisticated Parties

The release 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.

Where Have We Seen These Concepts Before?

The objectives and proposals set forth in the release are not new. In addition to being covered by Secretary Geithner's March 2009 Congressional testimony and the Framework for Regulatory Reform, many of these concepts have been addressed in reports extending back several years. For instance, a 2008 report by the Counterparty Risk Management Policy Group prepared for then Treasury Secretary Paulson cited central counterparty clearing as a way to mitigate systemic risk.⁴ 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.⁵ However, unlike past attempts to identify and fill perceived regulatory gaps that have ended without action, there can be no question today that substantial regulatory change is on its way.

Industry Reaction

ISDA welcomed the proposal as "an important step toward much-needed reform of financial industry regulation." ISDA further supported industry measures designed to protect the "smooth functioning of privately negotiated derivatives" and said that it looks forward to working with policymakers to ensure that such reforms help to "preserve the widespread availability of swaps and other important risk management tools."⁶

Observations and Further Issues

Like previous statements, the new Treasury release is more aspirational policy statement than concrete blueprint. As such, the program should be expected to evolve as the regulators work with Congress to craft concrete legislation and/or regulation. Indeed, it may be the case that the new release was intended primarily to head-off alternative Congressional efforts rather than as the definitive statement of the Administration's plans.

⁴ "Containing Systemic Risk: The Road to Reform, The Report of the CRMPG III"
(<http://www.crmpolicygroup.org/docs/CRMPG-III.pdf>)

⁵ "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management"
(<http://www.treas.gov/press/releases/reports/hedgfund.pdf>)

⁶ <http://www.isda.org>

That said, it is clear that some aspects of the proposed reforms raise more questions than others. 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:

- **Definitional issues:** Specifically an “OTC derivative” is not defined. This definition could be expanded to a host of “high risk complex financial instruments.” In addition, how to tell a “standardized” OTC derivative contract from a “customized” one is unknown.⁷ 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.
- **Jurisdictional issues:** Congress will need to clearly define the jurisdictional authority of market regulators, including the CFTC and the SEC.⁸ The current system of derivatives regulation is a patchwork of CFTC and SEC regulations based on the characterization of the product, many of which share similar economic characteristics. Resituating derivatives within the various regulatory frameworks administered by the SEC, CFTC and bank regulators will require clearing out a lot of legal underbrush as well as resolving turf battles.
- **Prudential regulation:** The Treasury statement calls for robust new prudential regulation, without suggesting what it 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.
- **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 release notes that the Administration is working with foreign regulators, adding multiple foreign regulators only increases the duration and difficulty of the task.

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?

⁸ Also note that the Treasury’s “Blueprint for a Modernized Financial Regulatory Structure” published in March 2008 prescribed movement towards a single consolidated regulatory authority. (See <http://www.treas.gov/press/releases/reports/Blueprint.pdf>) Developments in this regard remain fluid.

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