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Status of Proposals to Address US Derivatives Regulatory Framework

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This article focuses on the weaknesses of US regulation of financial derivatives. Section A reviews the history of the U.S. regulatory framework for financial derivatives. Section B discusses the weaknesses or gaps in such framework and the proposals for dealing with the weaknesses identified in Section B.

The challenges are primarily in the supervisory area, although the financial derivatives markets and the containment of financial institution risk would benefit immensely from reforms to the legal framework that would allow for the regulation of financial derivatives. The proposals for legal reform described would generally require that standardized financial derivatives contracts as much as possible be traded on exchanges and/or cleared through central counter-party clearing houses ("CCPs").

Forcing standardized financial derivatives onto exchanges and CCPs should lead to the imposition of collateral, capital, and other risk management requirements on financial institutions, and thereby to a reduction in risk. However, such requirements would not change the fact that the supervisors must understand the exposures of each financial institution and engage in more rigorous prudential supervision over the participants/intermediaries in the markets, regardless of whether such products and exposures are regulated or forced onto exchanges or CCPs. Currently, because the financial derivatives markets are opaque and the instruments are not traded on exchanges or centrally cleared, the US supervisors do not have easy access to the tools to help gauge exposures and values, although certain tools (i.e., the legal mechanisms for requiring participants to measure and restrict their risk), are available.

The issues raised by customized financial derivatives are more difficult. Truly customized products may be difficult to trade on exchanges or clear through CCPs, as may be required for standardized derivatives. From a legal perspective, banning customized derivatives does not appear easily feasible or advisable, because they can be disguised by being integrated into more complex documents, hidden in offshore transactions, etc. Moreover, they serve a legitimate hedging purpose. One possible way for dealing with customized derivatives is requiring that they be reported to a central trade repository. This is not as good as an exchange (where the transaction occurs and data is recorded) or a CCP (where risk is shared among members), but still makes information more accessible to supervisors. In any case, supervisors will need to be diligent about assessing the risks of institutions, possibly using the trade repository information.

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HISTORY OF US REGULATION OF DERIVATIVES

This section discusses the key features, actors, and status of the history of US derivatives regulation.

Key historical features of the U.S. regulation of derivatives. The current structure of US regulation of derivatives reflects the historical inception and development of derivatives markets and reflects the following key features: similar products are regulated in different ways, regulation for similar products does not exist, and regulation is sometimes institution focused and not activity oriented. There is a vast array of underlying instruments including indices, interest rates, foreign exchange, securities, and commodities. Transactions which are exchange traded vs. over the counter ("OTC") traded are differentiated, the nature of the counter-parties, and whether transactions are individually negotiated (customized) may change their treatment. Institutional and individual participants vary greatly in sophistication and the purpose for the transactions (speculation, hedging, insurance arbitrage, and regulatory arbitrage) may determine the regulatory coverage. Another historical feature is that several regulators appear to or claim to have overlapping authority over products, entities, or markets while also sometimes refusing to exercise such authority or exempting classes of transactions. In such cases, the regulators may also make clear that the derivatives are legal and enforceable.

Regulation of market participants. Brokers, advisors, pool operators, traders, and end users in regulated futures products are regulated or not depending on their chartering regulator, their counter-party, their purpose, their activity, and their volume. All of these regulators do however have the power to regulate the market participants for supervisory, prudential, and safety and soundness purposes, even if the product is unregulated. The regulators could therefore impose prudential and safety and soundness standards on many participants that would approximate the kind of regulation that many reformists believe is now ideal. *Why such regulation did not occur prior to the financial crisis has never been answered adequately.*

Key regulatory actors shaping the U.S. regulation of derivatives. The U.S. laws on derivatives are an amalgam of regulatory action (primarily the Commodities Futures Trading Commission (the "CFTC"), the Federal Reserve System (the "Fed"), the Securities and Exchange Commission (the "SEC"), the Federal Deposit Insurance Corporation (the "FDIC"), self regulatory organizations (e.g., the National Futures Association, the Chicago Mercantile Exchange, and the Financial Industry Regulatory Authority), exchanges, 50 state insurance regulators, other bank regulators and legislative action, court decisions, and congressional committees with jurisdiction over areas such as agriculture and finance, market practices and contracts developed by participants, or industry groups (such as the International Securities and Derivatives Association ("ISDA"), clearing entities, and risk measurement and management software and data companies).

The most prominent recent example of an industry actor and the regulators working towards some regulation of a product is the treatment of credit default swaps ("CDS"). Federal law largely exempts CDS from SEC and CFTC regulation and NY State Insurance Department, for example, has not treated CDS as insurance products. To reduce counter-party and other risks, market participants have established clearing houses (approved or exempted by the regulators) and ISDA has instituted an auction protocol. These initiatives increase standardization, compress CDS performance, and facilitate clearing trades with the goal of reducing systemic risk. The NY Insurance Department has temporarily, in reaction to these efforts, suspended efforts to treat CDS issued by insurance companies as insurance products.

There have also been recent efforts to standardize CDS documentation terms including a protocol published by ISDA to effect major changes to the way CDS are settled. ISDA has created an auction protocol, governing future and certain past CDS transactions, that establishes auction settlement as the default method for settling CDS following a credit event with respect to any reference entity.

Substance of US derivatives regulation derives from two historical features. Most of the exemptions -- whether statutory or regulatory -- result from a desire not to regulate financial products (derivative transactions on a commodity like currency, interest, credit, equity or other measure of economic or commercial risk, securities, and certain other financial instruments) so long as such transactions have two historically important features: (1) they are able to be traded on an exchange and (2) the counter-parties are sophisticated.

Only standardized derivatives can easily be traded on an exchange where the trade may be matched and data may be stored. This facilitates regulation.

Many transactions between sophisticated persons, regardless of the nature of the financial derivative product are exempt from U.S. regulation because such persons are viewed as requiring less protection. Currently, commodity related individually negotiated financial instruments that fall within the exclusive jurisdiction of the CFTC no longer must be traded on a registered commodities contract market or exchange absent some exemption. So there is now a significant public over the counter ("OTC") market for commodities related instruments that neither the CFTC nor the SEC regulates.

Most OTC derivatives and swap transactions are virtually unregulated except to the limited extent that some of the underlying instruments are securities. Still, even if the reference asset is regulated, the regulations do not address the formulas and contractual relationships that create the risks. Generally, OTC derivatives are not subject to SEC regulation because they involve contracts between the creator and the investor where the gains of one are the losses of the other – not involving a common enterprise. Although now securities based swap agreements are excluded from the definition of securities, they are subject to the securities law antifraud provisions. Swaps are therefore not securities nor do they have to be exchange traded. However, options on securities are securities derivatives which are traded on an exchange and which are treated as securities.

Attempts at risk reduction. Certain financial derivatives are subject to anti-fraud provisions, the anti-manipulation provisions, and anti-insider-trading provisions of the securities or commodities laws even if not otherwise regulated. The SEC and CFTC may also generally not impose reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider-trading with respect to non-regulated derivatives, although this lack of authority does not mean that the SEC, CFTC, and other regulators could not restrict excessive risk taking by the entities they regulate.

For the SEC or CFTC to claim regulatory authority over derivatives may require new laws or different interpretations by the regulators. Another more immediately effective approach may be for supervisors to use, in a more robust fashion, existing supervisory powers. Since customers individually negotiated derivatives cannot be forced onto exchanges or cleared easily, the most effective way to regulate the consequences may be to regulate the counter-parties. Of course, some counter-parties may fall outside of the regulatory jurisdiction of regulators (e.g. certain hedge funds). However, industry practices and supervisory guidance in other areas has been adopted to regulate counter-parties (like prime brokers) to such hedge funds for unrelated transactions.

WEAKNESS IN THE US FINANCIAL DERIVATIVES REGULATORY FRAMEWORK AND RECENT REGULATORY PROPOSALS.

Several weaknesses exist in the US regulatory treatment of the OTC derivatives market. (This article uses the term "weaknesses" to mean factors which may make the framework less effective than a more rationalized system reflecting risks and developments in the market.) Some of these weaknesses arise because of divisions among regulators, markets, products, and financial institutions. To address these weaknesses, there are several proposals to reform the regulation of the OTC derivatives market. If the US structure of derivatives regulation were left unchanged, many weaknesses which have lead to high risk taking by systemically important institutions, could still be addressed by supervisory mechanisms over market participants. The article focuses on weaknesses in regulatory requirements regarding: (1) information disclosure; (2) restricting or sharing risk; (3) regulatory jurisdiction; (4) international coordination of regulation of derivatives; (5) the regulation of marketing to unsophisticated customers; and (6) the prevention of market abuse. These weaknesses may exist in other countries.

General overview of proposals. To address the weaknesses discussed above, there are several proposals to reform the regulation of the OTC derivatives market. One overarching critique of the current proposals is that they do not adequately focus on derivatives other than credit default swaps. Although all kinds of OTC derivatives raise similar issues, most proposals and recent regulatory actions focus primarily on credit default swaps as posing the greatest risks. Still counter-party risks are present in all such products (and even in more "traditional" products like performance bonds, mono-line insurance, interest rate swaps, etc.).

The goal of the various proposals is to regulate: (1) all standardized contracts and (2) tailored or customized swaps that are not able to be cleared or traded on an exchange.

Most proposals do not address the issues raised by customized OTC swaps. Some of the Congressional proposals would ban customized swaps by: (1) requiring all swaps to be standardized or (2) requiring all swaps to be cleared through a CCP, which in effect would require all swaps to be standardized. There is no realistically legal mechanism that could be fashioned to prohibit customized derivatives, as some Congress members have proposed. Another idea that is gaining increasing support is that regardless of whether an instrument is standardized, customized, traded on an exchange, or on a transparent electronic trade execution system, the regulators should have clear, unimpeded authority to impose recordkeeping and reporting requirements, impose margin requirements, and prevent and punish fraud, manipulation, and other market abuses. Recent proposals also would require that customized derivatives are not used solely as a means to avoid the proposed clearing requirement. The goal is to prevent dealers and traders from changing just a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and electronic filing systems.

The U.S. Administration wants regulatory limits to be applied consistently across positions, all markets, and across all trading platforms and wants exemptions to them to be limited and well defined. The CFTC also proposes to have authority to impose recordkeeping and reporting requirements and to police the operations of all exchanges and electronic trading systems to prevent fraud, manipulation, and other abuses.[2] Although all kinds of OTC derivatives raise similar issues, most proposals and recent regulatory actions focus primarily on credit default swaps as posing the greatest risks. Still counter-party risks are present in all such products (and even in more "traditional" products like performance bonds, mono-line insurance, interest rate swaps, etc.).

1. Information Disclosure

The US legal framework does not require information about derivatives size or position risk to be disclosed adequately to counter-parties, other market participants, the public, and the regulators. OTC derivatives positions are generally not required to be centralized completely at a data warehouse, exchange, or CCP. Although there is a system for large trader position reporting, this system is apparently not adequate in providing the information regulators say they need. Consequently, during the crisis, some regulators did not know the exposure of their regulated financial institutions to either particular positions or to the counter-parties who might fail. Industry participants have created their own data warehouses to deal partly with these problems. The SEC, CFTC, and Fed have jointly issued an information-sharing agreement so that information each collects about the CCP that it regulates may be shared with the other regulators.

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[2] The CFTC believes that the agency which regulates an exchange or trade execution facility would also regulate the clearing houses for that market and should continue to regulate the related OTC derivatives market.

Moreover, the US legal framework generally does not encourage or require OTC derivatives to be exchange traded. The benefit of exchange traded products is that it is easy to store information like trade count, size of trades, and counter-parties. The CFMA allowed for OTC derivatives (where the underlying commodity is financial and theoretically unlimited in supply) to trade away from regulated exchanges, on the grounds that standardized exchange traded derivatives would limit the ability of market participants to hedge precisely and not work given current accounting guidelines.

Also, the crisis revealed the necessity to gather information on derivatives from a systemic perspective.

Proposals

The proposals generally would require regulators to require that: (1) recordkeeping and reporting requirements for all trades not cleared by CCPs be reported to a regulated trade repository; (2) CCPs and trade repositories make available to the public aggregate data on open positions and trading volumes, timely reports of trades, and price data; (3) CCPs and trade repositories make data on individual counter-parties' trades and positions available to federal regulators; (4) all derivatives dealers also be subject to recordkeeping and reporting requirements for all of their OTC derivatives positions and transactions; (5) aggregated information on positions and trades be made available to the public; and (6) both regulated exchanges and regulated transparent trading systems should allow market participants to see all of the bids and offers. The senate proposal would require data collection and publication through clearing houses or swap repositories to improve market transparency and provide regulators important tools for monitoring and responding to risks. Using the enhanced information from CCPs, trade repositories, and market participants, regulators are considering: authority to police fraud, market manipulation, and other market abuses and authority to set position limits on OTC derivatives that perform or affect a significant price discovery function.

2. Weaknesses in the ability to restrict or share risk

The current US legal framework fails to address systemic risk because it does not require the sharing of counter-party risk. To address the risk of a default of a derivatives counter-party, there exists no legally required mechanism to share the risk among financial institutions. Prior to the crisis, despite the absence of certain legal tools, regulators could have imposed safety and soundness requirements on the market participants they regulated, which would have effectively forced transactions on to CCP which would in turn impose capital and collateral requirements and (depending on the form of the CCP and the rules of the jurisdiction) share risk among clearing house members.

Assuming that trades are cleared through a CCP, the current US legal framework fails to address issues including the segregation of accounts, access to collateral, portability of margin held in segregated accounts, and cash netting of trades, in the case of a failure of a clearing member ("CM"), where the non-defaulting counter-party would want to assess its collateral position risk and its counter-party risk and net its positions, move collateral to another CM, and hedge exposures as needed. Legal reform may be needed in this area.

US laws do not address the risks posed by customized OTC derivatives, but the laws do allow the regulators to obtain information about all types of exposures of derivatives market participants and therefore to restrict the growth of the exposure of individual institution. In order to ensure that as many standardized derivatives as possible are centrally cleared so that their risk can be shared throughout the market, the US must have a mechanism for determining whether a swap should be considered standardized and therefore whether it may be centrally cleared. The US framework also does not subject OTC derivatives dealers to regulatory limits including: conservative capital requirements, business conduct standards, reporting requirements, or initial margin requirements for credit exposures on both standardized and customized contracts, although the framework does subject many financial institutions (and indirectly their counter-parties) to many of these standards and requirements.

Proposals

The industry has developed CCPs to enable such risk sharing. Risk sharing through a CCP requires standardization of OTC derivatives. The proposals advocate that all st*andardized* derivatives should be moved into CCPs and brought onto regulated exchanges or regulated transparent electronic trading systems. The National Conference of Insurance Legislators ("NCOIL") has drafted model legislation (the "Model Bill") that would subject CDSs to a state regulatory regime closely modeled on that regulating financial guaranty insurance in New York. The NCOIL Model Bill would: (1) broadly require all CDS protection sellers to register with state insurance departments as providers of "credit default insurance;" (2) make "naked" CDS illegal by requiring CDS protection buyers to have a "material interest" in the reference security; (3) subject providers of credit default insurance to capital adequacy requirements identical to those applicable under New York financial guaranty insurance law; (4) subject providers of credit default insurance to concentration restrictions; (5) require providers of credit default insurance to file "policy forms" with state insurance regulators; and (6) require all credit default insurance to operate on a "pay-as-you-go" basis under which the credit default insurer would "step into the shoes" of the defaulting obligor and continue scheduled payments for the duration of the obligation of the reference security.[3] The Standards for "back office" functions will help reduce risks by ensuring derivative dealers, their trading counter-parties, and regulators have complete, accurate, and current knowledge of their outstanding risks. There is no proposal for risk sharing in customized derivatives transactions.

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[3] In a 2000 opinion, the New York Insurance Department Office of General Counsel took the position that CDS are not financial guaranty insurance, for which an insurance license is required, where "the seller will make payment to the buyer upon the happening of a negative credit event and such payment is not dependent upon the buyer having suffered a loss." Under this opinion, so long as the CDS contract does not require the protection buyer to suffer an actual loss (regardless of whether the protection buyer actually holds or intends to hold a reference security), the CDA would not be insurance. "Naked CDS," those in which the protection buyer does not hold the reference security, are not financial guaranty insurance under such an interpretation and are not regulated by the New York Insurance Department. On September 22, 2008, the New York Insurance Department released Circular Letter No. 19, proposing to classify CDS as insurance if the protection buyer "*holds, or reasonably expects to hold*, a material interest in the referenced obligation." On November 20, 2008, however, the New York Insurance Department announced in its First Supplement to Circular Letter No. 19 that "[i]n light of [the] progress made toward comprehensive federal regulation of CDS, New York will delay indefinitely its application of New York Insurance Law to CDS as described [in] Circular Letter No. 19."

To subject as many OTC derivatives as possible to CCP risk sharing or trade exchanges and repositories for pricing and addressing asset bubbles, the proposals contain factors to consider for whether a derivative should be considered standardized, including: (1) the acceptance of an instrument for clearing by a fully regulated clearing house; (2) the volume of transactions in the instrument and the frequency of trades; (3) the similarity of the terms in the contract to terms in standardized contracts; (4) economic significance of differences in terms from a standardized contract; (5) the extent to which any of the terms in the contract, including price, are disseminated to third parties; and (6) the price discovery utility of the derivatives.

The proposals and industry initiatives to establish CCPs involve a complex determination of which clearing structure should be used for standardized CDSs, and for any particular CM, or for its customer. Therefore, the proposals require considering a variety of concepts including the possible adoption of new laws.[4]

There is concern that one CCP could create a moral hazard and a single point of failure, however, there is also concern that having multiple CCPs could result in a race to the bottom as each CCP tries to relax its standards in order to attract participants and a more fractured regulation.

The proposals would also in different ways require certain swaps participants to: (1) register and impose capital, collateral, business conduct, and position reporting requirements on registered swaps participants; (2) require higher capital for swaps participants who are dealing in non-cleared or non-exchange traded swaps; (3) require certain swaps to be approved for (or exempted from) clearing and exchange trading; (4) require registration of CCPs and exchanges; and (5) require collateral segregation. The senate proposal would require central clearing and exchange trading for derivatives that can be cleared and provides a role for both regulators and clearing houses to determine which contracts should be cleared, requires the SEC and the CFTC to pre-approve contracts before clearing houses can clear them, and require traders post margin and capital on un-cleared trades in order to offset the greater risk they pose to the financial system and encourage more trading to take place in transparent, regulated markets.

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[4] The following factors should be considered: (1) rules reducing the extent to which CDS clearing customers of CMs will have to share in any shortfall in custodial property including rules: (a) relating to the manner of segregation of custodial property; (b) enabling or enhancing the ability of CMs to rehypothecate customer margin to CCPs without customers losing their proprietary interest in that margin on the CM's insolvency; and (c) protecting customers against the risk of a CM's failure to segregate money and assets; (2) rules enhancing the ability of CCPs to transfer or novate a CM's customer positions with the CCP and related customer margin posted by that CM to the CCP on that CM's default or insolvency and, where necessary, to effect the transfer or novation of the customer's underlying positions with that CM and related customer margin held by that CM to successor CMs; (3) rules related to the timely access by customers to their margin after the insolvency of a CM; (4) rules concerning the efficacy of trust (statutory or otherwise) over assets posted by customers in jurisdictions that do normally recognize the efficacy of trusts; (5) rules designating that the default rules and proceedings of a clearing house take precedence over general insolvency proceedings of the insolvent CM, whether or not such clearing house is in the same jurisdiction as the insolvent CM; and (6) legislation empowering regulators to develop relevant rules relating to any or all of the above matters.

3. Overlap and gaps in regulatory authority

In the US, regulatory authority over derivatives is shared over various regulators and is further fractured by different, uncoordinated, and inconsistent regulation over different kinds of traders, product markets, counter-parties, clearing entities, exchanges, and information repositories.[5] The senate proposal would provide the SEC and CFTC with authority to regulate over-the-counter derivatives so that irresponsible practices and excessive risk-taking can no longer escape regulatory oversight and use the Administration's outline for a joint rulemaking process with the Agency for Financial Stability stepping in if the two agencies cannot agree. In the US, the NY Insurance Department and other state insurance regulators have not generally regulated either: (1) credit default swaps and other derivatives that have certain features of insurance contracts or (2) insurance companies and their affiliates engaging in such derivatives transactions.

4. Weaknesses in the international coordination of regulation of derivatives (both OTC and exchange traded)

Derivatives trade and position information are not generally coordinated on an international basis. There are however many MOUs between the US and other countries to share information for specific institution-specific, supervisory, or enforcement reasons. Currently, foreign boards of trade may operate in the US, even though they do not impose and enforce comparable position limits on derivatives and do not provide comparable trading data to the CFTC or other US regulators in the same way as is regularly provided by the US exchanges.

Proposals

To prevent traders in the US from avoiding US position limits or reporting requirements by moving their trades onto a foreign exchange, one proposal would prohibit US entities from using foreign boards of trade while another proposal would require foreign boards of trade to follow US rules of order for US located entities or transactions related to US registered issuers.

The establishment of CCPs should be considered in the context of ensuring that where trades have a non-US component[6], or are entirely outside the US, the intended goals are met. These goals include minimizing the impact of counter-party default, ensuring the ultimate trade settlement, and enabling regulators to address market manipulation arising from the incentives inherent in short positions.

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[5] An example and acknowledgement of the division among regulators is that the NY Banking Department, the SEC, the CFTC, and the Federal Reserve have issued approvals or temporary exemptions allowing certain CCPS to operate in the US and allowing participants who use the clearing operations to participate without fulfilling certain registration requirements. Moreover, the insurance regulators in various states have wavered on whether certain products or participants are within their jurisdiction.

[6] Non-US parties, reference assets, derivatives, and clearing organizations.

The US and European regulators do not agree on the location of CCPs – an issue which is important for liquidity of markets and access to regulators, protection of counter-parties in a country, and determination of rules regarding collateral, portability, as in case of the bankruptcy of a derivatives counter-party or CM. The EU believes that at least one CCP should be located in Europe, but there is no principled legal rationale given for this recommendation. (Similarly, there is no principal legal reason for a CCP located in the US.) It is more important that there is certainty about the applicability of a particular legal framework because financial institutions would benefit when confronted with challenges related to bankruptcy, access to collateral, segregation of accounts, and netting and close-out of trades.[7]

5. Weaknesses in the regulation of marketing derivatives to unsophisticated parties

Some commentators have expressed concern that OTC derivatives were marketed inappropriately to unsophisticated parties. For example, some commentators point to small municipalities that bought derivatives they apparently did not understand or appreciate the risk. Also, derivatives have been embedded in asset securitization vehicles and investors did not understand the structure or risks.

Proposals

Some proposals would limit the types of counter-parties that could participate in those markets, to impose business conduct standards applied to derivatives dealers regardless of the type of instrument involved, and to impose additional disclosure requirements and requiring standards of care (e.g., suitability or know your customer requirements) with respect to marketing of derivatives to institutions that infrequently trade in derivatives, such as small municipalities.

[7] The EU proposes that a European CCP must be used when the reference asset is a European security, but it is not clear how "European security" should be defined. For example, the European security could be defined by where the security is registered, listed, marketed, or where the issuer is incorporated, or has most of its assets, business, or revenue. Most of the Congressional proposals indirectly seek to force transactions into a US clearing house platform or a non-US platform that meets certain US standards, although Harkin's proposal would bar all US located traders from using non-US platforms.

6. Weaknesses in the regulation of derivatives related market abuses

Some commentators say that the US legal framework encouraged market abuse, especially in: (1) the manipulation of the stock of financial institutions where there are credit default swap holders or short sellers who were hoping to benefit from credit default swaps and short sale positions and (2) in the bankruptcy of commercial companies where certain creditors have taken naked credit default swaps and short sales positions which may have given them a greater incentive to be paid on their CDS positions rather than on the loans they made. Commentators have also expressed concern that reference assets may be unavailable and that credit default swaps may contribute to asset bubbles. Many of these commentators ignore the fact that existing U.S. law contains mechanisms for regulators and courts to punish and/or restrict fraud market manipulation of insider trading and excessive risk taking by certain financial institutions. There are also accepted industry practices like cash settlement closeout netting which can deal with any concern regarding the inventory of available assets.

Proposals

The US regulators are struggling with whether certain credit default swap's positions create an interest in a company that must be disclosed in the context of take-over laws. There is a US court case which demonstrates this struggle and the increasing trend to consider certain derivatives positions as requiring disclosure in certain acquisition/take-over contexts. The CFTC has also discussed whether to exempt certain swap dealers if hedges are in good faith and whether to create a new limited risk management exemption from speculative position limits.