Razor Alert

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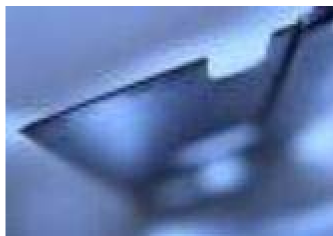

Proposals for US Regulatory Reform
Treatment of OTC Derivatives

There are several proposals to reform the regulation of the over the counter (OTC) derivatives market. The goal of this memorandum is to provide an overview of the alternatives different regulators and participants are considering, especially as new laws are being proposed as a result of the US Treasury White Paper on the subject.

This memorandum refers to the proposals as follows: US Treasury and CFTC proposals (the "Administration proposals") and the Congressional proposals introduced at various times by Harkin, Peterson, Markey, Levin, Collins and Stupak[i] [1] (the "Congressional proposals"). Also, the Federal Reserve, SEC, CFTC and NY Banking and New York Insurance Department have taken various actions as noted here. Several related court decisions regarding derivatives in the bankruptcy context and the disclosure of positions in derivatives in the acquisition context are also discussed here.

The goals of all of these proposals are as follows: promoting efficiency and transparency within the OTC markets; preventing activities within the OTC markets from posing risk to the financial system; preventing market manipulation, fraud and other market abuses; and ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

All the proposals seek to deal with systemic risk by eliminating or reducing counterparty risk. Therefore, the Congressional and Administration proposals require clearing of all standardized OTC derivatives through regulated central counterparties ("CCP") that impose robust margin requirements and other necessary risk controls. The NY Banking Department, the SEC, the CFTC and the Fed have issued approvals or temporary exemptions allowing certain CCPs to operate in the U.S. and allowing participants who use the clearing

operations to participate without certain registration requirements. The legal authority for some of these approvals or exemptions is not clear because some of the regulatory agencies arguably do not have authority over the products, the markets, or the customers involved. Indeed, some of the regulatory approvals appear to be less of a proper exercise of authority than a marking of territory. Still, the CCPs asked for regulatory approval or exemptions in order to enable them to solicit participants more easily. The SEC, CFTC and Fed have jointly issued an information-sharing agreement so that information each collects about the clearing house that it regulates may be shared with the other regulators.

Neither the Congressional proposals, nor the Administration proposals, mention whether there should be one or more CCPs. Obviously the owners/operators of each of the CCPs prefer that there be only one CCP and that theirs be the one. Also, the regulatory agencies do not mention the advantages or disadvantages of one CCP versus several. 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. Moreover, although all OTC derivatives are the concern of all the proposals and regulatory actions, all the proposals and actions focus primarily on credit default swaps as posing the greatest risks. Still counterparty risks are present in all such products (and even in more "traditional" products like performance bonds, monoline insurance, interest rate swaps etc.).

U.S. and European regulators dispute location of CCP. The EU believes that at least one CCP should be located in Europe, but there is no principled legal rationale given for this recommendation. 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 U.S. clearing house platform or a non U.S. platform that meets certain U.S. standards, although Harkin's proposal would bar all U.S. located traders from using non U.S. platforms.

Therefore, the Administration and Congress generally would not permit foreign boards of trade to operate in the U.S. unless they impose and enforce comparable position limits on these contracts and provide comparable trading data to the CFTC as is regularly provided by the U.S. exchanges. The goal is to prevent traders in the U.S. from avoiding U.S. position limits or reporting requirements by moving their trades onto a foreign exchange. Harkin's bill would prohibit U.S. entities from using foreign boards of trade while Peterson's bill would require foreign boards of trade to follow U.S. rules of order for U.S. located entities or transactions related to U.S. registered issuers.

Standardized contracts versus customized OTC derivatives. 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. 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. The better idea, and one that is gaining increasing support, is that regardless of whether an instrument is standardized or customized, or 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. Regulations should also ensure that customized derivatives are not used solely as a

means to avoid the 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 US Treasury has issued a white paper regarding various financial regulatory topics. This white paper's proposal to establish central counterparty clearing entities to trade standardized over the counter derivatives needs to be integrated with ("CCP") non-US efforts to do the same so that cross margining, netting, and settlement actions between clearing organizations are harmonized to avoid possible default and uncovered exposures.
The establishment of CCP's should be considered in the context of ensuring that where trades have a non-US component[ii], or are entirely outside the US, the intended goals are met. These goals include minimizing the impact of counterparty default, ensuring the ultimate trade settlement, and enabling regulators to address market manipulation arising from the incentives inherent in short positions.

The White Paper does not focus sufficiently on customized over the counter derivatives since not all transactions can be forced on to a CCP or an exchange.
Some form of netting, margin requirements, disclosure to regulators, and disclosure to the market should be imposed on participants in a transaction. There is no legal mechanism that could be fashioned to prohibit such customized derivatives, as some Congress members have proposed.

The CFTC has articulated the factors for whether a swap 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; (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 and (5) the extent to which any of the terms in the contract, including price, are disseminated to third parties.

H.R. 2448 proposes that the CFTC may (with SEC and Fed input) exempt customized transactions from the settlement and clearing requirements for certain OTC transactions. To provide such an exemption, the CFTC must find that: a contract is highly customized, is not frequently traded, does not serve a significant price discovery function, is entered by entities that can demonstrate high financial integrity (which may include certain net capital requirements) and must ensure public dissemination of information concerning cleared products, margin-setting methodologies, and other relevant information. Interestingly, certain forward and spot contracts are not subject to the settlement and clearing requirements.

H.R. 2448 (1) defines a CDS to mean a contract that "insures" a party to a contract against the risk that an entity may experience a loss of value as a result of an event specified in the contract, (2) excludes such CDS from the definition of a security excerpt with respect to the insider trading prohibitions, (3) prohibits anyone to enter into a CDS unless such person: (a) owns a credit instrument that is insured by the CDS; (b) would experience financial loss if an event specified in the CDS occurs with respect to the credit instrument and (c) meets the federal or state minimum capital adequacy standards.

The Administration and Congressional proposals would subject OTC derivatives dealers to regulation, including: conservative capital requirements, business conduct standards, reporting requirements, and initial margin requirements with respect to bilateral

credit exposures on both standardized and customized contracts. The CFTC would also subject all other firms who create large exposures to counterparties to some regulation. Similar "large trader" reporting requirements apply to certain traders in certain securities, treasury securities, commodities and futures.

In order for regulators to have comprehensive and timely information about the positions of each and every participant in all OTC derivatives markets, the proposals generally would require regulators to impose: recordkeeping and reporting requirements and requirements for all trades not cleared by CCPs to be reported to a regulated trade repository. CCPs and trade repositories must make available to the public aggregate data on open positions and trading volumes timely reports of trades and price data, and CCPs and trade repositories must make data on individual counterparties' trades and positions available to federal regulators. The CFTC supports the movement of standardized trades onto regulated exchanges and regulated transparent electronic trade execution systems. Regulators should have: authority to police fraud, market manipulation, and other market abuses, as well as authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to futures markets and market information from CCPs, trade repositories, and market participants.

Some of the proposals seek to ensure that OTC derivatives are not marketed inappropriately to unsophisticated parties. Current law seeks to protect unsophisticated parties from entering into inappropriate derivatives transactions by limiting the types of counterparties that could participate in those markets. The CFTC supports protection of the public from improper marketing practices by imposing business conduct standards applied to derivatives dealers regardless of the type of instrument involved, amending the limitations on participating in the OTC derivatives market in current law to tighten them or 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.

Some of the Congressional proposals seek to ban naked credit default swaps in several ways. The Administration proposals and the regulators generally do not support such bans. However, some of the Congressional proposals do. For example, to eliminate the swaps loophole, H.R. 2448 would require the CFTC to define what constitutes a *bona fide* hedging transaction consistent with the guidelines set in the bill. [2] [iii] To qualify as a *bona fide* hedging transaction, such transaction must: (a) be a substitute for a present or future physical transaction; (b) be economically appropriate to the reduction of business risks and (c) be related to values of a person's business assets, liabilities, or services. Alternatively, a hedging transaction must reduce the risks of a position entered under certain commodities law exemptions.

The concern that naked swaps are prone to abuse is not necessarily a reason to ban them. Not every party needs to hedge a transaction. A hedging party often buys protection from a non-hedged party (sometimes called a speculator). How a party hedges is subject to broad interpretations of risk management, including variations on the kind of institution, the counterparty, the instrument, the market, etc. The possibility of the notional value of swaps on a certain reference asset exceeding the notional value of the reference assets do not generally pose concerns about the ability to deliver the reference assets because there is generally cash settlement for credit default swap. The formation of a bubble resulting from the issuance of credit protection or a particular reference asset may be handled through reporting to repositories, clearing houses and regulators. Manipulation of the market for a security/reference

asset may be addressed by antifraud and anti-manipulation rules, like the rules dealing with the abuses which can arise from short sales and securities lending. Courts may deal with concerns about non-lending hedgers (sometimes called naked creditors) playing a role in bankruptcy in the same way as other creditors who have different interests.

On March 24, 2009, in the *Swaps CFTC Concept Release*, the CFTC raised questions on whether and how the CFTC should redefine the *bona fide* hedge exemption after it conducted the Swaps Call in the summer of 2008. The CFTC discussed whether to eliminate the *bona fide* hedge exemption for certain swap dealers and create a new limited risk management exemption from speculative position limits. The comment period is extended to June 16, 2009.

New York Insurance Department issued (and then retracted) a proposal to require that issuers of many credit default swaps should treat the swaps as insurance contracts. The reasons for the positions of the NYID are not clear. The NYID first proposed that insurance companies issued credit default swaps and had a position in the underlying reference entity should treat and report those positions as insurance contracts. The NYID proposal arose in the context of the AIG credit default swap portfolio which seems to have been issued and held in a non-regulated noninsurance company affiliate of the AIG insurance companies. The NYID then retracted the proposal as the CCP were being established in the US because apparently the CCPs would deal with the risk management concerns of the NYID. It is not clear why the NYID limited the original proposed treatment to hedged insurance companies. Later, the NYID, in an apparently unrelated action, asked All State Insurance, which has some NY regulated affiliates to provide details about its derivative portfolio to the NYID. It is not clear why the NYID did not have or ask for such positions sooner.

Generally, all the proposals seek to require more detailed recordkeeping, some reporting to regulators and some disclosure to the market/public. Generally, the Administration supports that all derivatives dealers also should be subject to recordkeeping and reporting requirements for all of their OTC derivatives positions and transactions. Regulated repositories complement central clearing by allowing the positions, transactions, and risks associated with those trades to be reported to regulators. Market transparency should be further enhanced by requiring that aggregated information on positions and trades be made available to the public.

All derivatives should be moved into central clearing and be required to be cleared through regulated central clearing houses and brought onto regulated exchanges or regulated transparent electronic trading systems. Standards for "back office" functions will help reduce risks by ensuring derivative dealers, their trading counterparties and regulators have complete, accurate and current knowledge of their outstanding risks. The CFTC believes that the agency which regulates an exchange or trade execution facility would also regulate the clearing houses for that market should continue to regulate the related OTC derivatives market.

Furthermore, a system for the timely reporting of trades and prompt dissemination of prices and other trade information to the public should be required. Both regulated exchanges and regulated transparent trading systems should allow market participants to see all of the bids and offers. The Administration wants position limits to be applied consistently across all markets and across all trading platforms and wants exemptions to them must be limited and well defined. The CFTC also should 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.

Generally, hedged creditors with credit default swap positions have not hampered bankruptcies or restructurings as a result of their having a different interest from other creditors. Bankruptcies can always be hampered by creditors with different interests. Some academics and journalists refer to creditors who have CDS protection on a reference entity to which they have made loans as "empty creditors." "Empty creditors" sounds like a judgment. This memorandum uses the term "hedged creditor." Generally, no bankruptcy petitioners have identified any cases where hedged creditors may take a view on the insolvency of the borrower/reference entity that has slowed or complicated to any great or practical extent any bankruptcy in a manner different from creditors with conflicting interests. First, any creditor may be hedged. Second, creditors may hedge with transactions other than credit default swaps or may have interests different from other creditors based on the diversity of creditors' business. Third, stopping speculation via credit default swaps (e.g., the current proposals to stop naked credit default swaps and even naked short selling) is not practical from a legal perspective. Often in a credit default swap the counterparty (for example, the credit protection seller) is "speculating" or does not have an underlying position in the reference security, although the protection seller may have hedged its risk in a different matter. Fourth, hedging can take place on the basis of an individual position or portfolio. Fifth, the U.S. and the UK securities regulators are struggling with whether certain credit default swap positions create an interest in a company that must be disclosed in the context of take-over laws. There is a U.S. court case and a UK proposal on contract for differences which demonstrate this struggle and the increasing trend to consider certain derivatives positions as requiring disclosure in certain acquisition/take over contexts.

Links

The White Paper, US Treasury - Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation

CFTC Concept Release on Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption from Speculative Position Limits

HR 2448 Prevent Unfair Manipulation of Prices (PUMP) Act of 2009

HR 2454 American Clean Energy and Security Act of 2009

S 961 Authorizing the Regulation of Swaps Act

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[i] On May 14, 2009, Congressman Bart Stupak (D-MI)1 introduced the "Prevent Unfair Manipulation of Prices (PUMP) Act of 2009" (H.R. 2448) to reform the existing regulatory scheme for the over-the-counter ("*OTC*") derivatives and energy commodities industry.

On May 21, 2009, the House Committee on Energy and Commerce adopted the "American Clean Energy and Security Act of 2009" (H.R. 2454). The measure, referred to as the "*Waxman-Markey Climate Bill*," seeks to combat global warming and promote clean energy by creating a cap and trade emissions program and by increasing renewable energy as a percentage of the U.S. power supply. Additionally, the Waxman-Markey bill incorporates substantially all of H.R. 2448 – PUMP Act.

H.R. 2448 (and the relevant provisions of the Waxman-Markey Climate Bill) (i) give the Commodity Futures Trading Commission ("*CFTC*") the authority to regulate all OTC derivatives transactions that are currently not regulated; (ii) regulate foreign boards of trade ("*FBOTs*") with energy transactions traded for delivery in the United States or on computer terminals located in the United States; (iii) close the "swaps loophole," no longer allowing energy transactions to be excluded from the exchange-trading requirements of the CEA; (iv) ban the "naked" credit default swaps ("*CDS*"); (v) set aggregate position limits for energy speculators across all markets – *i.e.*, including OTC derivatives markets; (vi) mandate clearing of all swaps through a designated clearing organization ("*DCOs*"); (vii) allow the CFTC to collect fees and create an independent funding system for oversight and enforcement of commodity

markets; (viii) clarify jurisdictional boundaries between the CFTC, the Federal Energy Regulatory Commission ("*FERC*"), and the Federal Trade Commission ("*FTC*") and amend certain provisions in the federal natural gas and power acts; and (ix) establish carbon and emissions as an included energy commodity subject to the FERC and CFTC regulation.

The Authorizing the Regulation of Swaps Act, introduced by Senator Carl Levin, D-Mich., and cosponsored by Senator Susan Collins, R-Maine, is intended to give federal financial regulators immediate authority over swap agreements. The bill contains the following provisions. The bill would repeal over a dozen provisions in existing law, including in the Commodity Futures Modernization Act of 2000, which prohibit federal financial regulators from regulating swap agreements. The bill would give authority to federal financial regulators, including bank, securities and commodities regulators, to oversee and regulate all types of swap agreements, including credit default, commodity, equity, interest rate, and foreign currency swaps. The bill uses the same definition of swap agreement that is used in current law to prohibit swaps regulation, and would authorize federal oversight and regulation of all exchange-traded and over-the-counter swaps. The bill does not require federal regulators to regulate swap agreements – it merely authorizes such regulation and removes barriers that have prevented this regulation since 2000. Nor does the bill provide any direction to federal financial regulators on how to regulate swaps other than to require them to consult, work, and cooperate with each other to promote consistency in the treatment of swap agreements.

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

[iii] Regulation of Certain Transactions in Derivatives Involving Energy Commodities, H.R. 2448, Sec. 3(g)(2)(A-B).