

**PRESIDENT OBAMA'S PROPOSALS FOR REGULATION OF THE
OTC DERIVATIVES MARKET**

On June 17, 2009, the Obama administration released a white paper outlining its proposals, among other things, to reform significant aspects of the over-the-counter derivatives ("OTC Derivatives") market.¹ The policy aims of the proposals regarding OTC Derivatives, including credit default swaps specifically, are to: (i) prevent activities in those markets from posing risk to the financial system, (ii) promote the efficiency and transparency of those markets, (iii) prevent market manipulation, fraud, and other market abuses, and (iv) ensure that OTC Derivatives are not marketed inappropriately to unsophisticated parties.

Amending the Commodity Exchange Act ("CEA") and Other Securities Laws**Clearing of All Standardized OTC Derivatives**

The proposals provide that the Commodity Exchange Act ("CEA") and the securities laws should be amended to require clearing of all standardized OTC Derivatives through regulated central counterparties ("CCPs"). CCPs should be able to impose "robust margin requirements" and to take other measures to reduce risks. In addition, "customized" OTC Derivatives should not be used solely as a means to avoid using a CCP. While the distinction between "standardized" and "customized" is not spelled out, the proposals state that an OTC Derivative that is accepted for clearing by one or more CCPs should be presumed to be a standardized contract and thus required to be cleared. CCPs should also develop a system for timely reporting of trades and prompt dissemination of prices and other trade information.

The proposals also encourage fostering competition between regulated exchange-traded derivatives and regulated OTC Derivatives (such as those cleared with a CCP) to create market efficiencies and price transparency.

Recordkeeping and Reporting Requirements

In addition, the proposals provide that the CEA and securities laws should be amended to authorize the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") to impose recordkeeping and reporting requirements (including an audit trail) on all OTC Derivatives. This is one of many instances in the proposals where the authority

¹ *Financial Regulatory Reform: A New Foundation*, Department of the Treasury (June 17, 2009) ("Reform Proposal"), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. Our client memo on May 22, 2009 *Current Efforts to Regulate the OTC Derivatives Market*, briefly described the proposals that were being contemplated at that time by the Obama administration as well as other efforts at regulation that were underway.

between the CFTC and the SEC is directed to be shared “consistent with their respective missions,” although it is unclear how authority will be shared between the two agencies. Clearing OTC Derivatives would be deemed to satisfy certain requirements, as would reporting customized OTC Derivatives to a “regulated trade repository.” CCPs and regulated trade repositories would in turn be required to make aggregate data that they receive available to the public and individual trade data available on a confidential basis to the CFTC, the SEC, and the institution’s primary regulators. No specifics are given on who would qualify as a regulated trade repository.

Oversight and Enforcement

The CFTC and the SEC, pursuant to the proposals and consistent with their respective missions, should be given clear authority to “police and prevent fraud, market manipulation, and other market abuses involving all OTC Derivatives.” Position limits, according to the proposals, should also be set by the CFTC. The increased reporting requirements are intended to aid in discovering and remedying market abuses.

In addition, restrictions on the types of counterparties who can participate in the OTC Derivatives market, as well as disclosure standards, should be reviewed by the CFTC and the SEC to prevent unsophisticated parties (such as small municipalities) from entering into inappropriate derivatives transactions.

Regulatory Capital Requirements

According to the proposals, OTC Derivative dealers and other firms whose activities in the OTC Derivatives market create large exposures to counterparties should be subject to (i) capital requirements that are more conservative than existing bank regulatory capital requirements, (ii) business conduct standards, (iii) reporting requirements, and (iv) more stringent requirements relating to initial margins on counterparty credit exposures. The parameters of what would constitute a large exposure is not provided. OTC Derivatives that are not cleared with a CCP are singled out under the proposals for increased regulatory capital requirements.

Harmonization of Regulation of Futures and Securities

The proposals state that many differences in the regulation of futures and securities markets “are no longer justified” and that many of the instruments in these markets, in addition to OTC Derivatives, have common attributes. The proposals, therefore, seek to address “gaps and inconsistencies” in the regulation of all of these instruments by the CFTC and the SEC.

The CFTC and the SEC are requested to complete a report to Congress by September 30, 2009 “that identifies all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explains why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or makes recommendations for changes to statutes and regulations that would eliminate the differences.” If no report is received by September 30, 2009, then the newly formed Financial

Services Oversight Council² should address such differences and report its recommendations to Congress within six months of its formation.

Federal Reserve Oversight of Clearing and Settlement Systems

Under the proposals, the Federal Reserve would gain oversight authority over all systemically important payment, clearing and settlement systems. The Federal Reserve's authority would supplement that of existing regulators, such as the SEC and the CFTC.

The Federal Reserve would have the authority to assist in determining the scope of, and participate in, on-site examinations of payment, clearing and settlement systems by the primary regulators of those systems. The proposals would also grant the Federal Reserve the right to be consulted on all rule changes that affect such a system's risk management. Finally, the Federal Reserve would have the power to force a system that did not meet applicable standards to take corrective action. Although it would first recommend corrective action to the system's primary regulator, if the primary regulator did not comply, the Federal Reserve could force such action on an emergency basis, after consultation with the proposed Financial Services Oversight Council.

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² The Council would be formed to replace the President's Working Group on Financial Markets, and the membership of the Council would include (i) the Secretary of the Treasury, who shall serve as the Chairman; (ii) the Chairman of the Board of Governors of the Federal Reserve System; (iii) the Director of the National Bank Supervisor; (iv) the Director of the Consumer Financial Protection Agency; (v) the Chairman of the SEC; (vi) the Chairman of the CFTC; (vii) the Chairman of the FDIC; and (viii) the Director of the Federal Housing Finance Agency.