# CURRENT EFFORTS TO REGULATE THE OTC DERIVATIVES MARKET

In recent months, branches of the federal government, the states and the private sector have initiated multiple efforts to regulate over-the-counter derivatives ("OTC Derivatives"). While much of the attention has been focused on credit derivatives (which are one type of OTC Derivative) the proposed regulation could affect other types of OTC Derivatives, including equity derivatives, interest rate swaps and total return swaps. This memorandum will describe briefly the actions that have been taken by the Obama Administration, Congress, states, private sector groups and regulatory agencies to respond to concerns about OTC Derivatives. The results of this activity are still very unclear, and it appears that will remain the case for some months, but it is instructive to understand what might be expected in terms of regulation in the future.

## I. Key Federal Initiatives.

### A. Obama Administration Initiatives.

#### 1. Memorandum of Understanding Among The Federal Reserve, SEC and CFTC.

On November 14, 2008, the Federal Reserve Board (the "Federal Reserve"), the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC") entered into a Memorandum of Understanding (the "MOU") regarding the establishment of a central counterparty for credit derivatives. The MOU does not create legally binding obligations, but instead formalizes the intent of the parties to establish a framework for consultation and information-sharing on issues related to a clearinghouse for credit derivatives, to facilitate the regulatory approval process and to encourage more consistent regulatory oversight. The MOU was executed as part of an initiative of the President's Working Group on Financial Markets, which is continuing to work to encourage improvements in the OTC Derivatives market. The Treasury Secretary serves as chair of the group, which includes the Chairs of the Federal Reserve, the SEC and the CFTC.

#### 2. Treasury Announcement.

The Obama Administration, under the leadership of Treasury Secretary Timothy Geithner, as part of its comprehensive financial system reform initiative, has also focused on the regulation of OTC Derivatives. On May 13, 2009, Secretary Geithner announced an Administration proposal for a comprehensive regulatory framework for all OTC Derivatives. Geithner indicated that the Administration intends to work with Congress to bring greater transparency and regulation to OTC Derivatives. Some stated objectives of the Administration strategy are as follows:

(i) The Commodity Exchange Act ("CEA") and the securities laws should be amended to require clearing of all standardized OTC Derivatives through regulated central counterparties (*i.e.*, a clearinghouse) ("CCPs"). These CCPs should impose margin requirements and other "necessary risk controls."

(ii) The CEA and securities laws should be amended to authorize the CFTC and the SEC to impose recordkeeping and reporting requirements for all derivatives, whether or not standardized and cleared with a CCP, and to make this information available to the public on a timely basis.

(iii) The CFTC and the SEC should have clear authority "to police fraud, market manipulation, and other market abuses" and to set position limits.

(iv) The CFTC and the SEC should also seek ways "to protect unsophisticated parties from entering into inappropriate derivatives transactions. . . ."

Given the historic jurisdictional divisions in Congress regarding regulation of derivatives, the congressional reaction to Secretary Geithner's proposal was, not surprisingly, non-committal. House Agriculture Committee Chairman Rep. Peterson (D-MN) and House Financial Services Committee Chairman Rep. Frank (D-MA) issued a joint statement applauding Secretary Geithner, agreeing that "there must be strong comprehensive and consistent regulation of OTC derivatives," and promising to "work closely together to achieve that goal." Senator Tom Harkin (D-IA), Chairman of the Senate Agriculture, Nutrition and Forestry Committee, also commended Secretary Geithner, called the proposal "a step in the right direction," and indicated that he "looked forward to working with the Administration and my colleagues in Congress as we move forward on this critical issue."

Following the recent confirmation on May 19th of Gary Gensler as the new Chairman of the CFTC, the House Agriculture Committee, which has legislative jurisdiction and oversight authority over the CFTC, indicated that it now expects to move forward with legislation regarding OTC Derivatives this summer.

B. Congressional Initiatives.

1. The Derivatives Trading Integrity Act of 2009.

On January 15, 2009, Senate Agriculture Committee Chairman Tom Harkin (D-IA) introduced S.3714, the Derivatives Trading Integrity Act of 2009 (the "Trading Integrity Act"). The Trading Integrity Act was introduced in a prior session of Congress but was not voted on. The Trading Integrity Act would amend the CEA to: (i) repeal the exemption or exclusion from regulation by the CFTC of specified derivative transactions, swap transactions, and related electronic trading facilities; (ii) restrict futures trading to contract markets or derivatives transaction execution facilities; and (iii) abolish exempt boards of trade. The result would be that the CFTC would have regulatory authority over OTC Derivatives.

2. Derivatives Markets Transparency and Accountability Act of 2009.

The House Agriculture Committee, which has legislative jurisdiction and oversight authority over the CFTC, on February 12, 2009, approved H.R. 977, the Derivatives Markets Transparency and Accountability Act of 2009 (the "Derivatives Act"). The Derivatives Act has not been brought before the full House of Representatives for a vote, pending resolution of fundamental questions about the exclusivity of CFTC jurisdiction over OTC Derivatives, and further consideration of the Obama Administration's May 13, 2009 regulatory framework proposal.

The Derivatives Act would

- grant the CFTC, as opposed to the SEC or the Federal Reserve, primary authority to regulate OTC Derivatives. It would require the clearing of almost all OTC Derivatives, including preexisting trades, with very limited exceptions;

- impose very broad reporting requirements and require that the CFTC make public much of the reported information in order to prevent price manipulation, market disruptions and excessive speculation;

- direct the CFTC to assess "whether agreements, contracts, or transactions entered into in reliance [on certain exemptions under the CEA] or any other exemption issued by the CFTC . . . that are fungible . . . with agreements, contracts, or transactions traded on or subject to the rules of any board of trade or electronic trading facility . . . have the potential to (A) disrupt the liquidity or price discovery function on a registered entity; (B) cause a severe market disturbance in the underlying cash or futures market; or (C) prevent or otherwise impair the price of a contract listed for trading on a registered entity from reflecting the forces of supply and demand in any market." The CFTC may then use its discretion to impose position limits and "take corrective actions to enforce the limits" even on derivatives that would otherwise be exempt from the clearing requirements. The CFTC would also have the right to suspend trading on any derivative trades.

A prior draft of the Derivatives Act had contained a ban on naked credit derivatives (credit derivatives in which the purchaser of protection does not own the underlying reference obligation); however, this provision was removed from the draft that was introduced in February.

3. Authorizing the Regulation of Swaps Act.

On May 4, 2009, Senators Carl Levin (D-MI) and Susan Collins (R-ME) introduced S. 961, the "Authorizing the Regulation of Swaps Act" (the "Swaps Act"). The Swaps Act has not yet been acted on by the Senate Banking, Housing and Urban Affairs Committee or by the full Senate.

In introducing the bill, Senators Levin and Collins stated that the statutory and regulatory exemptions granted to derivatives have proven to be a mistake. To address this mistake, the Swaps Act would essentially remove all current exemptions provided to OTC Derivatives under federal securities and commodities laws. The stated intent of the Swaps Act is to provide immediate transparency, accountability, and stability to the financial markets in advance of more comprehensive legislation of the entire financial industry. All OTC Derivatives and any derivatives that are traded on an exchange would be subject to broader, but unspecified, federal regulation.

Among other things, the Swaps Act would eliminate the exemptions currently applicable to OTC Derivatives under the Securities Act of 1933 and the Securities Exchange Act of 1934 that were passed as part of the Gramm-Leach-Bliley Act, as well as the exemptions provided by the Commodity Futures Modernization Act of 2000 under the CEA.

As noted, the Swaps Act does not specify how derivatives should be regulated or which federal agencies should have primary oversight. The Swaps Act rather confers authority on the CFTC, the Federal Deposit Insurance Corporation, the Federal Reserve, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the SEC, and "any other Federal agency that is authorized under any provision of Federal law to regulate any financial institution or type or class of financial instrument or offering thereof." The Swaps Act states that they should each regulate derivatives within their regulatory jurisdiction and should "consult, work, and cooperate with each other to promote consistency in the treatment of swap agreements."

4. The American Clean Energy Act.

On May 15th, 2009 Chairman Henry A. Waxman (D-CA), House Committee on Energy and Commerce, and Subcommittee Chairman Edward J. Markey, Subcommittee on Energy and the Environment, introduced "The American Clean Energy Act" (H.R. 2454) (the "Energy Act"), which included various provisions regarding energy derivatives. Although the Energy Act is currently being considered by the House Energy and Commerce Committee, as discussed above, the CFTC and the SEC are currently also seeking to regulate OTC Derivatives.

The Energy Act, among other things, would seek to modify the way energy swaps are currently treated under the CEA. In general, it would eliminate certain exemptions for energy swaps under the CEA and limit the CFTC's authority to provide exemptions from the CEA for energy swaps. In addition, the Energy Act would require the CFTC to set position limits for energy swaps and would require the mandatory settlement and clearing of energy swaps. It would also seek to make explicit that nothing in the CEA should be read to conflict with the powers and authority of the Federal Energy Regulatory Commission. With respect to credit derivatives, unlike the Derivatives Act, the Energy Act would seek to ban "naked" credit derivatives and require minimum capital adequacy standards for purchasers of "covered" credit derivatives.

C. SEC Enforcement Actions.

On May 5, 2009, it was reported that the SEC brought the first insider trading case relating to credit default swaps against a hedge fund manager. The SEC alleges in the case that a bond salesman tipped off a hedge fund manager when the salesman learned of the restructuring of a bond offering that was expected to increase the price of credit default swaps covering those bonds.[1] Using this inside information, the hedge fund manager then allegedly purchased credit default swaps covering the bonds and later closed out the swap positions at a gain. This appears to be one of the investigations mentioned recently by SEC Chairman Mary Schapiro when she said the SEC is pursuing about 150 investigations involving hedge funds and up to 50 involving credit default swaps and other derivatives.[2]

What is noteworthy about the case and the statement by Chairman Schapiro is that the SEC appears intent on initiating enforcement investigations in far more diverse areas of the securities markets than has been the case in recent years. Articulating an aggressive theme on this topic, a senior official with the SEC's New York Regional Office was recently reported as saying, "We need to be policing even the most complex markets to ensure that all investors, regardless of their supposed sophistication, have a fair shake. We have to be every bit as sophisticated."

Hedge fund and other private fund managers, as well as others in the securities markets who are involved with derivative instruments, should prepare for increased scrutiny by the SEC and its staff.

II. State Initiatives.

The New York State Insurance Department[3] has actively participated in the efforts of the National Conference of Insurance Legislators' ("NCOIL") to regulate certain credit derivatives as insurance at the state level. While the model bill is currently in its preliminary drafting stage, NCOIL plans to move forward with drafting the bill unless preempted by any federal action to regulate credit derivatives. The model bill is supported by legislators representing several states including, among others, Connecticut, Georgia and Indiana. New York State Assemblyman Joseph Morelle (D), with the assistance of the New York State Insurance Department, has led the discussion and the bill-drafting efforts.

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1 *SEC Files First Credit Default Swap Insider Trading Case*, SEC Litigation Release No. 21023 (May 5, 2009).

2 Chairman Mary L. Schapiro, *Speech by SEC Chairman: Address to the Society of American Business Editors and Writers* (April 27, 2009).

3 Note that on September 22, 2008 New York Governor David A. Paterson announced in a press release that in January 2009 New York State would begin regulating certain credit derivatives as it does insurance. Such credit derivatives would have been permitted to be issued only by licensed financial guaranty insurance companies under New York's previous financial guaranty insurance statutes. On November 20, 2008, the New York State Insurance Department announced that it would "delay indefinitely its application of New York Insurance Law" to credit derivatives pending action at the federal level.

The model bill currently contemplates that only a "credit default insurance corporation" would be permitted to issue "credit default insurance" and provides that the transaction would be regulated by the applicable state departments of insurance. Any model law promulgated by NCOIL would need to be adopted on a state-by-state basis.

## III. Private Sector Initiatives

### A. International Swap and Derivatives Association ("ISDA")

ISDA, through its members, has undertaken various initiatives to address public concerns regarding the terms of credit derivatives that are entered into using ISDA standard documentation.

On April 8, 2009, ISDA's 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol (the "Big Bang Protocol") went into effect for pre-existing credit derivatives. Among other things, the Big Bang Protocol is intended to provide a binding and uniform method of determining (i) whether credit events under credit derivatives have occurred and (ii) the settlement value of such trades through an auction procedure. The determinations will be made by a preselected determination committee (made up of dealers and end-users) and there will be opportunity to dispute and comment on the findings of the determination committee. A significant number of ISDA members signed onto, and agreed to comply with, the terms of the Big Bang Protocol.

In conjunction with the Big Bang Protocol, ISDA published the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 ISDA Credit Derivatives Definitions for the purpose of applying the principles of the Big Bang Protocol to future credit derivative transactions.

### B. Central Counterparties for Clearing OTC Derivatives.

A common theme of many proposals is that all credit derivatives (and in some cases all OTC Derivatives) should be traded on an exchange and cleared through CCPs.

Currently, parties to credit derivatives are exposed to each other's creditworthiness. A CCP would interpose itself between counterparties to credit derivatives, and potentially other OTC Derivatives, becoming the buyer to every seller and the seller to every buyer.[4] It is believed that a CCP (capitalized by its members and with the authority to impose daily margin calls) would be more financially secure and would also provide one place for regulators to view traders' positions and prices. Whether the SEC or the CFTC should regulate the CCP for OTC Derivatives has not yet been decided.

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[4] Trades effected on U.S. futures exchanges are currently cleared through a CCP.

On December 24, 2008, the SEC published two orders ("Orders") establishing conditional exemptions from provisions of the Securities Exchange Act of 1934 (the "Exchange Act") to facilitate exchange trading and CCP activities with respect to the market for certain credit derivatives.[5] The SEC has also approved interim final temporary rules providing related exemptions under the Securities Act of 1933 and the Exchange Act.[6] The SEC's action is intended to help stabilize financial markets by reducing counterparty risk and promoting efficiency in the market for credit derivatives.[7] The SEC sought comments on the exemptions, which expire on September 25, 2009.[8]

The SEC is providing a temporary exemption from the requirement to register as a national securities exchange to any exchange that effects or reports transactions in non-excluded credit derivatives. The SEC appears to take the position (i) that security-based swaps (that are exchange-traded or centrally cleared and novated to a CCP) are "non-excluded CDS" and (ii) that such non-excluded CDS neither fall within the Gramm-Leach-Bliley Act's limitation of the SEC's authority over the OTC Derivatives market for credit derivatives nor the general exclusion of swap agreements in Section 3A of the Exchange Act. With respect to these "excluded swaps," the SEC's authority is generally confined to certain antifraud and insider trading provisions in the Exchange Act.

Both LIFFE Administration and Management ("LIFFE A&M") and LCH.Clearnet Ltd. ("LCH.Clearnet") were granted exemptions from provisions of the Exchange Act with respect to their activities in clearing and settling Cleared Index CDS.[9] LCH.Clearnet acts as the CCP for

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5 The SEC issued the following orders pursuant to Exchange Act Section 36:

- "Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions from Sections 5 and 6 of the Exchange Act for Broker-Dealers and Exchanges Effecting Transactions in Credit Default Swaps" ("Exchange and Broker-Dealer Exemption"); and
- "Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection with Request of LIFFE Administration and Management and LCH.Clearnet Ltd. Related to Central Clearing of Credit Default Swaps, and Request for Comments" ("CCP Exemption").

SEC Release No. 34-59165 (Dec. 24, 2008) and SEC Release No. 34-59164 (Dec. 24, 2008).

6 *See* Release Nos. 33-8999; 34-59246; 39-2549 (Temporary Exemptions For Eligible Credit Default Swaps To Facilitate Operation Of Central Counterparties To Clear And Settle Credit Default Swaps).

7 *See* SEC Press Release 2008-303 (Dec. 23, 2008) ("SEC Press Release").

8 Comments were due by March 23, 2009.

9 The CCP Exemption is limited to "Cleared Index CDS," which are non excluded CDS that are (i) submitted (or offered, purchased or sold on terms providing for submission) to LCH.Clearnet, and (ii) offered only to, purchased only by, and sold only to Eligible Contract Participants ("ECPs"), and in which the reference index is an index in which 80 percent or more of the index's weighting is comprised of the entities or securities described in the Order. The Order provides no definition of "index." An ECP is defined in Section 1a(12) of the CEA as, among others, a financial institution (as defined in Section 1a(15) of the CEA), an investment company registered under the Investment Company Act of 1940, a U.S.-registered broker-dealer, or a wealthy individual, in each case acting for its, his or her own account.

all transactions processed through LIFFE A&M's OTC Derivatives processing service, called Bclear. LCH.Clearnet is a "recognized clearing house" in the United Kingdom (the "U.K."), and LIFFE A&M is a "recognized investment exchange" in the U.K. The U.K. Financial Services Authority ("FSA") is the main regulator of LCH.Clearnet and the Bank of England oversees its payment system. The SEC is temporarily exempting LCH.Clearnet from the requirement to register as a clearing agency under Section 17A of the Exchange Act to perform the function of a clearing agency (*i.e.*, CCP) for Cleared Index CDS transactions for U.S. market participants.[10]

To encourage use of CCPs, the SEC will apply substantially the same jurisdictional framework that applies to transactions in excluded swaps[11] to LCH.Clearnet, LIFFE A&M and eligible contract participants. The SEC will do this, however, solely with respect to transactions in Cleared Index CDS, and the SEC will also retain its enforcement authority under Exchange Act provisions.[12] The exemption, however, is not available to certain specified entities.

The SEC has also recently granted exemptions to (i) ICE US Trust, LLC[13] (the "Ice Trust"), the recently established clearinghouse subsidiary of Intercontinental Exchange Inc., and (ii) the CME Group Inc. and its associated joint venture, CMDX,[14] to begin clearing credit derivatives. The approval exempted these entities from certain exchange registration requirements and exempted brokers and dealers that effect credit derivative transactions on such exchanges from the prohibition on trading on unregistered exchanges. Each entity has begun acting as a CCP for credit derivatives.

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10 The exemption is not limited to transactions in Cleared Index CDS that occur on exchanges. However, the exemption appears to contemplate that the index-based CDS that will be cleared by LCH.Clearnet will have standardized specifications and therefore will be non-excluded swaps. See Release 34-59164, Section II.A.1.

11 As discussed above, the SEC has limited jurisdiction over excluded swaps. This exemption, in effect, states that the SEC will not exert jurisdiction beyond what it can exercise with respect to excluded swaps. The SEC may be modeling this exemption on an earlier interpretive statement about clearing agency activity. *See* "Confirmation and Affirmation of Securities Trades; Matching," SEC Release No. 34-39829 (Apr. 6, 1998). *See also* SEC Release No. 34-44188 (Apr. 17, 2001) (granting conditional exemption from clearing agency registration to Global Joint Venture Matching Services - US, LLC (n/k/a Omgeo)). Additionally, the SEC is adopting a form of "unilateral recognition" of the FSA regulatory scheme for LCH.Clearnet and LIFFE A&M.

12 This exemption does not extend to government securities provisions or Sections 5, 6, 12, 13, 14, 15, 16 or 17A of the Exchange Act. However, the SEC notes that these provisions are addressed in separate exemptions and the final rules.

13 In early March 2009, Intercontinental Exchange Inc. received approval from the SEC to acquire The Clearing Corp., which was a clearinghouse owned by eight large dealers in the credit derivatives market. Intercontinental Exchange, Inc. and The Clearing Corporation, on behalf of ICE Trust, requested that the SEC grant exemptions from certain requirements under the Exchange Act with respect to the proposed activities of ICE Trust in clearing and settling certain credit derivatives. *See* SEC Release No. 34-59527 (March 6, 2009)

14 CME Group Inc., a Delaware stock corporation, is the holding company for The Chicago Mercantile Exchange Inc., as well as Board of Trade of the City Of Chicago, Inc., New York Mercantile Exchange, Inc., Commodity Exchange, Inc. and their subsidiaries. *See* SEC Release No. 34-59578 (March 13, 2009).

The exemptions were issued on a temporary basis so that the SEC could evaluate the situation and determine whether amendments were necessary. In developing the exemptions, the SEC consulted with the Federal Reserve Board and the CFTC pursuant to the MOU.[15]

As discussed above, pending Federal legislation would require the clearing of all credit derivatives and possibly other types of OTC Derivatives. In an effort perhaps to avoid the need for regulation, many dealers have voluntarily started clearing, on the ICE Trust, their credit derivatives that face other dealers.

**Conclusion.**

While regulation of OTC Derivatives in some form seems inevitable, it is unclear which federal agency will end up with primary regulatory authority, whether individual states will still insist upon imposing their own regulations and whether voluntary efforts by dealers and other users of OTC Derivatives will affect the final regulatory structure. We will continue to provide updates as developments occur.

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15 *See* SEC Press Releases 34-59164 n.7 and 59165 n.7.

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