Comprehensive Regulatory Framework for OTC Derivatives Proposed as a Prelude to Reform of the U.S. Financial System

In the Obama Administration’s first major step in overhauling the financial regulatory system, the U.S. Treasury proposed to Congressional leaders an outline of a framework for the regulation of over-the-counter (“OTC”) derivatives on May 13, 2009. Momentum for comprehensive reform of OTC derivatives regulation has increased in recent months, as the Administration and Congress have engaged in a wholesale reconsideration of a number of core issues, including the appropriate regulator for OTC derivatives, the types of derivative products that should be regulated and the appropriate form of the regulations for those products. The proposal, which would bring OTC derivatives under a comprehensive regulatory regime for the very first time, was contained in a letter sent by Treasury Secretary Timothy Geithner to Senate Majority Leader Harry Reid (D-NV) and House Speaker Nancy Pelosi (D-CA), as well as other leaders in the Senate and the House. The May 13th proposal not only signals that the Obama Administration and Congressional leaders may be close to reaching a consensus on the general features of the regulatory structure, but that reform efforts are likely to proceed at a fast pace.

Although details of the new regulatory structure are not yet available, it is clear that major operational and legal changes to the OTC derivative markets will result. This Alert describes the context of the Administration’s announcement, provides an overview of the Administration’s proposal and discusses the likely impact on the OTC derivatives market.

Overview of Proposed Framework

The Administration’s proposal seeks to advance four main principles:

1. Contain systemic risks to the financial system posed by OTC derivatives by:
   a. Amending the Commodity Exchange Act (“CEA”) and the securities laws to require clearing of all standardized OTC derivatives through regulated central counterparties (“CCPs”); and
   b. Subjecting all OTC derivatives dealers and other firms that create large exposures to counterparties, such as hedge funds, to prudential supervision and regulation, including capital, business conduct, reporting and margin requirements.

2. Promote the efficiency and transparency of markets in OTC derivatives by amending the CEA and securities laws to authorize the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) to:
   a. Impose recordkeeping and reporting requirements, including those for trades that are not cleared by CCPs;
b. Require that standardized trades be moved to regulated exchanges and electronic trade execution systems; and

c. Develop a system for timely dissemination of trade information and reporting of trades.

3. Prevent market abuses such as manipulation and fraud by amending the CEA and securities laws to provide the CFTC and SEC with the authority to:

a. Police market abuses and fraud;

b. Access market information related to CCPs, trade repositories, and, on a confidential basis, trades and positions of individual market participants (the latter information would also be available to the participant’s primary regulator, such as the Board of Governors of the Federal Reserve System or the Comptroller of the Currency); and

c. In the case of the CFTC, set position limits on OTC derivatives that affect price discovery on futures markets.

4. Ensure that OTC derivatives are not marketed to unsophisticated parties inappropriately by imposing suitability standards or requiring additional disclosure and otherwise limit participation in certain derivative transactions.

Issues Related to the New Comprehensive Regulatory Framework

The OTC derivatives regulatory proposal recommends amendments to federal law that are intended to bring about a robust regulatory regime governing dealers and other firms whose activities in OTC derivatives markets create large exposures to counterparties. These proposed changes are in response to the massive recent growth of the $680 trillion OTC derivatives market, highly publicized issues surrounding the use of credit derivatives and crises involving major derivative counterparties such as Bear Stearns, Lehman Brothers and AIG (or their respective affiliates) that resulted in systemic risk to global financial markets.

The proposals would also make another significant change by requiring that all standardized OTC derivatives be cleared by CCPs. Broadly mandated central clearing of OTC derivatives transactions would raise many of the same issues that have appeared in connection with recent initiatives for the central clearing of credit default swaps, including tensions between the competing interests of dealers and end-users, as well as differences between the conventions of OTC markets on one hand and exchange-traded markets on the other. While complex transactions would be exempt from the central clearing requirement, they would have to be truly customized to avoid mandatory central clearing because Treasury is proposing a presumption that a derivative contract is standardized and thus required to be centrally cleared if it has been accepted for clearing by one CCP.

As the details of the proposed regulatory framework are developed for enactment and implementation, two contentious issues are likely to arise, the outcome of which will determine whether – and to what extent – the U.S. OTC derivatives market survives. One of these concerns the demarcation line between “standardized” contracts that would be required to be cleared through a CCP and “customized” contracts that would be exempt from central clearing. Several observers have expressed concern that an exclusion for customized products opens the way for circumvention of the regulatory scheme, and Senator Harkin, Chairman of the Senate Committee on Agriculture, Nutrition and Forestry, has introduced a bill to require that all OTC derivatives be traded on regulated exchanges.

The second issue likely to arise concerns the model of central clearing that will emerge as the dominant one for CCPs, and whether it will be a direct access model or rely on swap dealers as intermediaries. Officials within leading central clearing houses continue to envision a market in which OTC derivative transactions co-exist with trading on exchanges by members of regional derivatives exchanges throughout the world.

Treasury’s recommended changes go right to the heart of the manner in which these instruments are traded and the less transparent markets in which they presently trade. A critical part of the new regime sought by Treasury involves the development of an electronic system for the timely reporting of trades and prompt dissemination of
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prices and other trade information, much like the Trade Reporting and Compliance Engine™ (“TRACE”) for eligible fixed income OTC transactions. Treasury’s current initiative seeks to bring large volumes of OTC derivatives onto an electronic platform like TRACE to increase transparency for market participants and enhance the monitoring capabilities of Federal regulators. The current OTC derivative market operates in many respects like the bond trading market prior to TRACE; Treasury thereby intends to restore confidence in the OTC derivatives market by means of more widespread electronic processing of trade activity. The May 13, 2009 letter from Treasury does not specifically indicate the degree to which an individual counterparty’s trades and positions would be available on a confidential basis to the CFTC, the SEC or other regulators and to what extent this information would be disseminated to the market.

To address market integrity concerns, Treasury proposes clear, unimpeded authority to police fraud and market manipulation. These changes would likely entail the dismantling of the extensive framework of regulatory exemptions for swaps that has been in place at least since passage of the Gramm-Leach-Bliley Act of 1999 and the Commodity Futures Modernization Act of 2000. The tightening of suitability requirements and enhanced disclosure requirements in the marketing and sales of OTC derivatives appears to be a response to recent enforcement actions and other publicized cases in which municipalities entered into derivatives contracts and incurred large losses; the municipalities in these cases later claimed that they did not understand the terms of these contracts.

Past as Prologue: The Legislative Context of the Proposal

The context in which the May 13th proposal arose may provide important signals about its likelihood of being implemented. The contents and timing of the proposal were driven, at least in part, by Congressional demands that the Obama Administration reinforce its commitment to a comprehensive regulatory framework for OTC derivatives. On March 23, 2009, Senator Bernard Sanders (I-VT) placed a procedural hold on the confirmation of Gary Gensler, President Obama’s nominee for Chairman of the CFTC. Senator Sanders, joined by Senator Maria Cantwell (D-WA), objected to Mr. Gensler’s confirmation on the ground that he previously sought to exempt OTC derivatives from regulation as a Treasury Department official in the Clinton Administration. Although the Senate Committee on Agriculture, Nutrition and Forestry approved the nomination by a vote of 19-0, Senate rules allow a Senator to prevent a confirmation vote once a procedural hold is entered.

The Obama Administration’s commitment to an OTC derivatives regulatory framework now paves the way for the Senate to consider Mr. Gensler’s confirmation. On May 14, 2009, the day after Secretary Geithner’s announcement on OTC regulation, Senators Sanders and Cantwell announced that they no longer object to Mr. Gensler’s nomination (see Senator Sanders’ statement; Senator Cantwell’s statement).

The Administration’s proposal has also met with support from House Financial Services Committee Chairman Barney Frank (D-MA) and House Agriculture Committee Chairman Colin Peterson (D-MN), who share jurisdiction over OTC derivatives issues. The House Agriculture Committee oversees the CFTC and the House Financial Services Committee has jurisdiction over the SEC. In a joint statement, the two Chairmen lauded the Administration’s proposal (see statement). The joint statement of support is significant because the Chairmen have disagreed in the past about the appropriate regulator for OTC derivatives. Chairman Frank has indicated support for OTC derivatives regulation by a single regulator resulting from a merger of the CFTC with the SEC. Chairman Peterson has adamantly opposed such a merger because it would likely result in the Agriculture Committee losing jurisdiction over the derivatives market–jurisdiction that was notably asserted in H.R. 977, a bill entitled “The Derivatives Markets Transparency and Accountability Act of 2009.” We have previously written about this bill and the jurisdictional issues involved in our Alert “Opening Salvo Fired in Financial Market Reform Effort, But Many Battles Lie Ahead.”
Conclusion

The May 13th OTC derivatives proposal contains recommendations that will have a significant impact on the OTC derivatives market in the United States. Support that key Congressional leaders have shown for Treasury’s recent proposal indicates that a consensus is emerging on a comprehensive framework for the regulation of OTC derivatives. This growing consensus also indicates that widespread reform of OTC derivatives not only has significant momentum, but this reform may move on a fast track to target other areas of the U.S. financial system that have come under fire.