Proposed Reform of the OTC Derivatives Market: *Turning "Weapons" into Plowshares?*

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Populist politicians and press, anxious to identify villains to blame for the global economic meltdown, have enthusiastically endorsed Warren Buffett's derisive 2003 "financial weapons of mass destruction" label for derivative products. Buffett's concerns, which now ring prescient to many ears, centered on the fact that, before a derivative contract is settled, the parties to that contract record profits and losses based on mark-to-market estimates without any money having changed hands and notwithstanding the fact that some derivatives do not have a sufficient market on which to base the marks. Further, derivatives can exacerbate the problems a company may face that otherwise would have been under control. This is because of the use of requirements for collateral to be posted in the event of a ratings downgrade. First Enron and now AIG are the poster children for this conundrum: collateral triggers designed to limit counterparty credit risk can create troublesome consequences. As a rating is downgraded collateral calls are made and, as the company faces the need to put up additional cash, its spiraling illiquidity leads to further ratings downgrades, additional collateral triggers and still greater pressure on liquidity.

Former Federal Reserve Board Chairman Alan Greenspan has in the past been a champion of OTC derivatives as instruments that have permitted the unbundling and dispersion of risk and thereby a reduction of systemic risk. Most observers, in fact, still tout these instruments for their efficient re-allocation of a variety of risks. For example, OTC derivatives are key building blocks in structured finance insofar as they are the primary means to hedge or transfer related commodity, credit, currency, and interest rate risks inherent in transactions that underlie structured finance. Of course, in any use of these products the management of counterparty credit risk is of utmost importance since real risk transfer fails if the parties to whom risk is transferred cannot perform their contractual obligations. Debate continues as to whether there is sufficient transparency and counterparty credit risk mitigation in the OTC derivatives market. Regardless of the outcome of the academic arguments, most acknowledge that a certain amount of legislative and regulatory attention is inevitable.

The OTC derivatives market is increasingly the policy focus of lawmakers in the United States, in Europe and elsewhere. The objective and details of reaching stated policy goals of transparency and regulatory reform continue to prove elusive, however, and the various legislative efforts to date leave many questions unanswered and conceivably conflict with one another. It will be important that the political need to provide a timely response to concerns about transparency and counterparty credit risk be balanced against the need to face head-on the complications that will necessarily be involved in the responsible redesign of a complex and global OTC derivatives market. This article examines proposed legislative and regulatory developments as well as OTC derivatives industry efforts that are likewise afoot.

The activities in the United States have been frequent and myriad and thus comprise a large portion of this discussion, but that is not to give the impression that other foreign officials are not similarly focused on these issues. Note that European regulators compelled industry participants to commit to CDS clearing in the EU a full year before it turned to rule proposals. Meanwhile, in the United States, legislative proposals have been intertwined among industry commitments with respect to a variety of OTC derivatives reform goalposts. While none of these developments are the final word on what can be expected in the future, they represent key steps toward an imminent broad financial system overhaul, potentially on a multi-jurisdictional basis.

U.S. CONGRESSIONAL ACTIVITIES

On January 15, the Derivatives Trading Integrity Act of 2009 (DTIA), sponsored by Senator Tom Harkin (D-IA), was introduced to the Senate Committee on Agriculture, Nutrition and Forestry. On February 11, the Derivatives Markets Transparency and Accountability Act of 2009 (DMTA), sponsored by Representative Collin Peterson (D-MN), was introduced to the House Committee on Agriculture. The bill was considered and passed by the Committee by voice vote on February 12. On May 4, the Authorizing the Regulation of Swaps Act (ARSA), sponsored by Senator Carl Levin (D-MI) and Senator Susan Collins (R-ME), was introduced to the Senate Committee on Banking, Housing, and Urban Affairs. Next, on May 13, Treasury Secretary Timothy Geithner outlined the Obama Administration's goals for the regulatory framework for OTC derivatives. More recently, on June 17, the U.S. Department of the Treasury published its proposed regulatory overhaul for the U.S. financial system in a document entitled "Financial Regulatory Reform: A New Foundation." Finally, on June 26, the House of Representatives narrowly passed the American Clean Energy and Security Act of 2009 (ACES), which, though focused on clean energy reforms, incorporates important regulatory limitations on derivatives. This flurry of bills and pronouncements has done little to add substance to the Treasury framework, but ACES may be an indication of what is becoming abundantly clear: OTC derivatives will be subject to new legislation in the United States in the near term.

Congressional Bills and the Obama Administration's Directives

The DTIA proposed to amend the Commodity Exchange Act (CEA) by repealing the exemptions or exclusions from regulation currently afforded to specified derivatives, requiring all futures contracts (including virtually all OTC derivatives) to trade on a designated contract market or a derivatives transaction execution facility, and abolishing exempt boards of trade.

The DMTA would subject OTC derivatives to reporting and recordkeeping requirements as determined by the Commodity Futures Trading Commission (CFTC). The bill would also require the CFTC to determine whether fungible OTC agreements have the potential to disrupt market liquidity and price discovery and, if so, to impose and enforce position limits for speculators trading the agreements. Finally, the DMTA aimed to subject prospective OTC transactions either to settlement and clearing on a CFTC- or Securities and Exchange Commission (SEC)-regulated derivative clearing organization or to reporting to the CFTC. Because of the heightened concerns regarding credit default swaps (CDS), the DMTA also would grant the CFTC the authority to suspend CDS trading with the concurrence of the President and would establish that CDS traded or cleared by registered entities will not be considered exempt for purposes of enforcing insider trading prohibitions.

ARSA, the most recent legislative proposal, would repeal current exemptions and exclusions afforded to derivatives products and grant federal regulators authority to regulate all types of OTC and exchange-traded derivatives, without exception, immediately. The sponsors of this bill offered it as an interim step, making the way for anticipated comprehensive financial reform later in the year.

On May 13, the Obama Administration, through the Treasury Department, outlined the framework on which it expects Congress to build a new regulatory regime for OTC derivatives. Treasury Secretary Timothy Geithner laid out several principles. First, he instructed that the CEA should be amended "to require clearing of all standardized OTC derivatives through regulated central counterparties." Second, he recommended that all OTC derivatives dealers and others who create large exposures to counterparties be subject to "a robust regime of prudential supervision and regulation." Next, Secretary Geithner proposed that the CEA and securities laws be amended to allow for a variety of recordkeeping and reporting rules and to ensure that the CFTC and SEC have "clear and unimpeded authority" with respect to policing market abuses and the authority to set position limits. Finally, he noted that the CFTC and SEC are reviewing the limitations on participants in OTC derivatives markets to recommend amendments to the CEA and securities laws to tighten those limits or impose additional disclosure.

Then, in June, the Treasury Department published its proposed regulatory overhaul for the U.S. financial system in a document entitled "Financial Regulatory Reform: A New Foundation." In particular, four public policy objectives were outlined: 1) preventing activities in OTC derivatives markets from posing risk to the financial system; 2) promoting the efficiency and transparency of those markets; 3) preventing market manipulation, fraud, and other market abuses; and 4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

Finally, ACES, though still before the U.S. Senate, may reflect greater Congressional consensus around OTC derivatives legislation than the introduced bills discussed above. First, as a clean energy bill, ACES addresses climate change and renewable energy issues, including with respect to the regulation of trading the related emissions allowance and renewable credit derivatives. ACES also would eliminate current exemptions for OTC derivatives involving energy commodities, amend the CEA to place eligibility limitations on entering into a CDS, and eliminate the CEA's preemption of state gaming and "bucket shop" laws. Eliminating such preemption would have the effect of prohibiting naked CDS (CDS in which the buyer of protection does not own the obligation that is the subject of the trade). These provisions, embedded in the shroud of climate change, are an end-run around seemingly slower-paced, direct discussions about OTC derivatives reform.

WHAT DOES ALL THIS MEAN?

Central Clearing—What's "Standard" Anyway?

There are many themes—some overlapping and some contradictory—in the bills that have been introduced and in Secretary Geithner's statements. The common thread among all of them is transparency. Clearing seems to be the oft-quoted solution to the transparency problem. ARSA would not specifically require clearing but instead would give broad authority to regulators to work with one another on the consistent treatment of derivatives. Secretary Geithner stated that all standardized OTC derivatives should be cleared through regulated central counterparties (CCPs) and that the acceptance of an OTC derivative by one or more CCPs should create a presumption that it is a standardized contract. He elaborated that the standardized part of the OTC market should be moved onto regulated exchanges and regulated transparent electronic trade execution systems. In prepared testimony before the House Financial Services and Agriculture Committees on July 10, Secretary Geithner stated that "a high volume of transactions in a contract and the absence of economically important differences between the terms of the contract and the terms of other contracts that are centrally cleared" would be indicators that it is standardized.

What is not clear is what other parameters would establish whether a product is "standardized" and, once that is determined, which contracts should be cleared via CCPs, traded on an electronic trading platform, or quoted on a regulated exchange. None of the current bills nor Secretary Geithner has identified who—market consensus, individual participants or a regulator—would determine whether a derivative is standardized. Secretary Geithner's latest comments suggest that there would not be a product-based approach for making this determination. Since, according to the Treasury's framework, some contracts would be presumed to be standardized because of their acceptance by a CCP, it would appear that there might be a voluntary component in the initial decision to submit a trade to a CCP.

Further, Secretary Geithner suggested that regulated institutions be encouraged to make greater use of regulated exchange-traded derivatives. Which derivatives would be required (versus elected) to be traded in a certain manner is an issue that has not been settled. Of course, all these questions arise without getting to the question of whether certain OTC derivatives are suitable for any of these trading options in the first instance. As noted below, the OTC derivatives industry has already indicated that substantial portions of the OTC derivatives market are only made "electronically eligible" with difficulty and perhaps for some products it may not be possible as a practical matter. The current bills and the Treasury proposal have lumped all OTC derivatives together and suggested the same (or substantially similar) treatment.

Are My Margin Requirements the Same as Yours?

As part of the overall Treasury proposal, the Federal Reserve Board would be given supervisory and regulatory oversight of any firm whose failure could pose a threat to financial stability due to its combination of size, leverage, and interconnectedness (referred to in the proposal as a "Tier 1 FHC"), regardless of whether such firm owns an insured depository institution. Through its expanded powers, the Federal Reserve Board would be able to impose these new capital and regulatory requirements on all Tier 1 FHCs engaged in derivatives activities.

Since standardized trades were not defined, it is unclear what transactions would be deemed to be customized. This distinction could have very important practical implications for the economics of a particular transaction. For example, since trades that are considered customized need not be cleared, they would not be subject to mandatory margin rules. Secretary Geithner stated that CCPs would be expected to impose robust margin requirements and that there would be an effort to ensure that customized OTC derivatives not become a means of avoiding the use of CCPs. Certainly, any difference between cleared and customized OTC derivatives would create an arbitrage opportunity that legislators likely would seek to avoid. On the other hand, imposing margin requirements eliminates an important facet of having a so-called customized trade. In Secretary Geithner's comments on July 10, he stated that derivative contracts that are not centrally cleared must have margin requirements "substantially above" those that are centrally cleared. Again, it remains to be seen whether variations in margin standards would be permitted based upon the particular derivative product category or the sophistication of the parties to the trade.

It is also unclear at this juncture the extent to which margin requirements and capital requirements will overlap. It seems that perceived derivatives risk exposure will be addressed in the case of Tier I FHCs and other regulated financial institutions through more conservative regulatory capital requirements, but not necessarily to the exclusion of margin rules. Will perceived derivatives risk exposure be addressed in the case of regulated financial institutions primarily through the proposed more stringent capital requirements? In contrast, will participants that are not Tier 1 FHCs and are not otherwise regulated financial institutions be subjected to stricter margin requirements given that they may not otherwise be required to set aside capital for their derivatives trading activities? This assumes of course that non-regulated entities would be allowed to continue to directly enter into derivatives transactions. As a practical matter, if the capital or margin requirements that are required are more than the economic capital that the related derivatives positions should have, the related trades will simply move to a jurisdiction or to a forum where the "excessive" capital or margin requirements do not apply.

Are Derivatives Too Dangerous for Your Own Good?

The Treasury Secretary did not suggest that derivatives markets be limited solely to regulated financial institutions. He did, however, note that all OTC derivatives dealers and other firms whose activities in those markets create large exposures to counterparties should be subject to an appropriate and "robust" regime of prudential supervision and regulation. Specifically, Treasury recommended more conservative regulatory capital requirements on OTC derivatives (which would be more stringent than existing bank regulatory capital requirements for OTC derivatives), business conduct standards, reporting requirements, and conservative initial margin requirements. Presumably, players would not need to be regulated financial institutions to trade in derivatives as long as they are subject to appropriate reporting, margin, and business conduct standards.

Reporting and Recordkeeping

A secondary theme to the Treasury framework and the bills that have been introduced in Congressional committees is recordkeeping/reporting. Secretary Geithner's proposal was that the CFTC and SEC should have the authority to impose recordkeeping and reporting requirements on all OTC derivatives. He included the caveat that clearing standardized transactions through a CCP or reporting customized transactions to a regulated trade repository could obviate the need to meet certain of these requirements. The trade repository would then have to make aggregate data on open positions and trading volumes available to the public and any particular counterparty's trade data available on a confidential basis to the CFTC, the SEC and the counterparty's primary regulator. Mr. Geithner also noted the importance of market efficiency and price transparency. Part of what appears to be intended in connection with any future reporting requirements is a system to assure dissemination of prices and other trade information to the market. We will need to see the extent to which players will be allowed to compete in derivatives markets in the future on the basis of price and whether the same level of price transparency will be required for customized trades.

Manipulation Issues

Another issue that has been mentioned in Congressional bills and in Mr. Geithner's remarks is with regard to preventing market manipulation, fraud, and other market abuses. Secretary Geithner's proposals on this point were not specific; instead, a reference to giving the CFTC and SEC broad and apparently unfettered authority to police fraud, market manipulation, and other market abuses involving OTC derivatives laid the foundation for such measures.

In addition, Secretary Geithner proposed that the CFTC should have authority to set position limits on OTC derivatives that have a price discovery function relating to regulated markets. It is not clear how those derivatives would be identified and correlated with the regulated markets to which they are purportedly related. The assumed means to the goal of preventing market abuses is that information provided to regulators (whether on a voluntary or mandatory basis) by the combination of CCPs, trade repositories, and market participants will create the picture needed to establish such correlations. The gap, of course, is how the various products might be categorized and what would distinguish trades that are voluntarily reported versus those that are reported by mandate. The Secretary stopped short of suggesting that U.S. securities and commodities laws be amended to redefine derivatives as either securities or regulated commodities. Doing so would give the SEC and CFTC the most explicit means of regulating derivatives transactions.

Other Developments

As derivatives practitioners well know, current law limits the types of parties that may participate in unregulated derivatives. Treasury's view is that the limits are not sufficiently stringent. In this regard, the CFTC and SEC are reviewing the current eligibility limits to recommend how to amend existing laws to tighten those limits or to impose additional disclosure requirements or standards of care with respect to marketing derivatives to less sophisticated counterparties such as small municipalities. Little detail has been provided as to additional indicia, beyond current requirements, of sophistication for this market.

Another issue that remains unresolved is regulatory jurisdiction. As many participants in the derivatives markets are painfully aware, the present U.S. regulatory regime with respect to derivatives is mind-numbingly complex. Part of this complexity is due to the sometimes overlapping authority of the SEC and CFTC. Therefore, one of the stated goals in the Treasury framework is the elimination of these jurisdictional uncertainties and the assurance that economically equivalent instruments be regulated in the same manner regardless of whether it is the SEC or CFTC that has jurisdiction over the relevant instrument or market. Treasury has asked that the CFTC and the SEC complete a report to Congress identifying all existing conflicts in statutes and regulations regarding similar types of financial instruments. This report, due by the end of September, would need to explain why the current differences are necessary for investor protection, market integrity, and price transparency, or make suggested changes to eliminate the differences. Moreover, if the two agencies cannot agree on the explanations and recommendations by the deadline, Treasury has proposed that unresolved issues be referred to a new Financial Services Oversight Council, which would then be required to resolve the disagreements and provide Congress with its recommendations within six months of that council's formation.

Following the issuance of Treasury's June proposal, the heads of the SEC and CFTC affirmed their willingness to work together to better delineate the respective responsibilities of each agency over the vast derivatives market. They commented that the SEC should continue to have responsibility with respect to derivatives linked to stocks, bonds and securities and that the CFTC should oversee all other derivatives. The new directive that the two agencies identify and resolve conflicts is at least an important recognition of the need to harmonize these conflicts, once and for all.

One major open issue relates specifically to CDS. Since last fall, state insurance regulators have been scrutinizing covered CDS (that is, CDS in which the buyer of protection owns the obligation that is the subject of the trade) as potentially appropriate to subject to state insurance laws. On September 22, 2008, the New York State Insurance Department issued Circular Letter No. 19, announcing that on January 1, 2009 the Department would start treating covered CDS as insurance contracts under the New York Insurance Law. That effort was tabled when OTC derivatives began to take a place on the federal financial reform agenda. In June of this year amendments drafted by the Department were introduced in the New York legislature. Those amendments would exempt CDS from insurance regulation, provided that the New York Insurance Department determines that CDS are otherwise being "effectively and comprehensively regulated," including by requiring CDS writers to maintain adequate capital and post sufficient trading margins to minimize counterparty risk.

The Division of Insurance of the State of Missouri (whose state slogan is "I'm from Missouri, and you've got to show me") has taken an even more activist role than the New York Insurance Department. On November 19, 2008, the Division issued Bulletin No. 08-12, providing that covered CDS are insurance contracts and that issuing covered CDS in Missouri constitutes an insurance business that requires a certificate of authority from the Division. The Division has so far refused to suspend its effort to regulate covered CDS, citing as its reason the fact that no comprehensive federal regulatory scheme has yet been put in place.

Meanwhile, the Task Force on Credit Default Swaps of the National Conference of Insurance Legislators (NCOIL) has drafted model legislation that would classify covered CDS as "credit default insurance" and regulate the issuers of covered CDS as "credit default insurance corporations" along the lines of financial guaranty insurance corporations (often called "monolines"). Among other things, the NCOIL Task Force's draft proposal would require credit default insurance corporations to maintain contingency reserves against their CDS exposures. The NCOIL Task Force's draft proposal has been sharply criticized by industry participants, but it was presented to the NCOIL Financial Services & Investment Products Committee on July 9. After two hours of testimony and debate, the draft was tabled until NCOIL's annual meeting in November. Even if the proposal is eventually adopted as model law by NCOIL, it is unclear whether it would be enacted into law by state legislatures. In short, it remains uncertain whether federal legislative action with respect to OTC derivatives in general and CDS in particular could alter or obviate the perceived need for action by state insurance regulators and legislators.

Finally, all of these efforts leave unresolved a critical problem—that is, the regulatory arbitrage that will be created by a U.S. regulatory regime that is different from that continuing or established in other jurisdictions. A more harsh atmosphere in the United States on any number of points could send OTC derivatives abroad. For example, the requirements for reporting and recordkeeping could place such a heavy burden on participants in the United States that engaging in derivatives trading here would no longer be justifiable or financially worthwhile. None of the proposals address the fact that much of the derivatives market is truly global and fungible. Indeed, even differences in clearinghouse rules may introduce a similar kind of regional arbitrage.

ACROSS THE POND

Derivatives have received no less scrutiny in Britain and Europe than in the United States. In 2008, major derivatives dealers signed a commitment concerning the establishment of a central clearing counterparty for CDS in Europe. The central clearing platform is to be established, regulated and supervised in Europe by July 31 of this year. While central clearing is technically voluntary, the pressure from regulators to increase transparency and mitigate counterparty credit risk, which led to this commitment, was brought home through explicit mention of regulatory intervention as an alternative. This pressure has only increased with growing scrutiny of the credit crisis and the market that is believed to be one of its major causes. In a report published in February of this year, Jacques de Larosière, a former French Treasury official, recommended the simplification and standardization of most OTC derivatives and the introduction and use of at least one well-capitalized central clearinghouse for CDS in the EU. In March of this year, Lord Turner, chairman of the U.K.'s Financial Services Authority, reviewed events leading to the current financial crisis and recommended reforms intended to address steps that the international community could take to enhance regulatory and supervisory standards and international coordination. One area of focus for the Turner Review was the complexity and opacity of structured credit and other derivatives, with an emphasis on the exaggerated effect that CDS can exert upon boom and bust cycles. The Turner Review was accompanied by Discussion Paper 09/2 (DP 09/2), which outlined detailed policy proposals, including consideration of revised capital requirements, regulated collateral calls, and additional product-specific regulation.

Regulators in Europe have not issued proposed rules to date, but the relatively early date by which market participants committed to central clearing for CDS reveals the serious tone that has been taken there. On the heels of the de Larosière report, in March of this year the European Parliament and European Council initiated a report that was designed to identify regulatory gaps with respect to derivatives. That report was announced on July 3, and the European Commission is expected to make rule proposals on the basis of that report as a matter of priority. The outline recommended a greater use of standardized contracts, central data repositories, public exchanges, and clearinghouses through which market participants can post and have the benefit of collateral. A consultation period will continue until August 31, followed by a European Commission hearing expected on September 25 and preparation of legislation by year-end.

Previously, European regulators had considered a voluntary code of conduct for the derivatives market. This would have required equity exchanges and clearinghouses to offer pricing transparency and a greater choice of services. It is now believed that a mandatory code is on the table. It is important to note that, from the time the voluntary, though pressured, commitment to CDS clearing was made, the European Commission has escalated its attention to, and willingness to act on, perceived weaknesses in the derivatives market. It is clear that, while the commitments from industry have been welcomed, the book being written on the regulation of derivatives is far from complete.

CLEANING HOUSE

CDS Auctions

Though it seems certain that the regulatory landscape for derivatives in general and CDS in particular will change in both the United States and in Europe, it will not have been because of a lack of industry-driven efforts to establish and maintain good order. The industry has taken significant steps to increase the transparency and fungibility of these products over many years but with greater resolve as the credit crisis deepened.

One of the major areas of recent focus for the derivatives industry, both of its own volition and due to regulatory attention, has been CDS. Regardless of whether it's warranted, AIG's large exposures to CDS have been blamed in part for this level of attention. Moreover, the Federal Reserve Bank of New York has for some years raised concerns about settlement risk in the CDS market. The exponential growth in volume of CDS transactions resulted in the notional amount of CDS written on heavily traded underlying credits becoming many multiples of the outstanding principal amount of debt available for purchase. Since the buyer of protection in these mostly physically traded transactions would need to deliver debt of an underlying reference entity in order to settle "Credit Events" (defined below), there were concerns that the unavailability of sufficient debt could result in an inability to settle a large number of transactions. These concerns came to a head in the fall of 2005, when the trading price of Delphi bonds far exceeded the bond price that would be merited for a bankrupt auto parts manufacturer in standard distressed trading conditions. The spike in trading price had been caused by credit protection buyers chasing after a limited amount of Delphi debt to deliver under their physically settled CDS contracts. Once the settlement period had passed, debt trading prices fell back to expected levels. Credit protection buyers and sellers had traditionally shunned cash settlement, lacking confidence that the mechanism contained in the 2003 ISDA Credit Derivatives Definitions (Credit Derivatives Definitions) would produce a fair result. Now credit protection buyers had suffered under physical settlement, and a solution was required (not least because the explosion in outstanding credit derivatives contracts, versus outstanding debt, made the outcome for Delphi likely to be the future norm).

As if the solution needed a greater sense of urgency, a period that had seen very few credit events gave way to the beginning of what became a very troubled credit cycle. Beginning with the bankruptcy filing of Collins & Aikman Products Co. in May of 2005, the International Swaps and Derivatives Association, Inc. (ISDA) began publishing protocols that facilitated multilateral amendments to remove physical settlement and replace it with an auction process to generate a cash settlement amount for trades subjected to each protocol. Once there was consensus that a Credit Event had occurred with respect to heavily traded underlying credits, ISDA typically published a protocol to allow parties wishing to participate in the protocol to amend their trades from physical settlement to an auction procedure, and, pursuant to an agreement with Markit Group Limited (Markit), Markit subsequently conducted an auction to determine the price that would be used to calculate cash settlement amounts. The first several of these protocols covered only index CDS due to the high volume of those trades and standardized terms governing them, and thus only derivatives dealers participated. Over time, credit events began to occur with respect to single name CDS with higher trading volumes, and pressure mounted to include a wider range of the market. As the pace of credit events began to quicken, ISDA began facilitating meetings among major dealers and large hedge funds to develop an auction mechanism that could, in the future, be embedded in the standard credit default swap.

That mechanism was eventually hardwired into credit default contracts through the ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement (Auction Supplement), which was published in April of this year. Under the Auction Supplement, newly established ISDA Credit Derivatives Determinations Committees (Determinations Committees or DCs), at the request of market participants, may make determinations as to whether payment defaults or bankruptcies (Credit Events) have occurred with respect to an issuer of debt obligations (a Reference Entity), whether an auction will be held, and whether an obligation is deliverable in settlement of credit default swaps covering that Reference Entity. Determinations Committees also determine whether certain recapitalizations, mergers, spin-offs, or similar events (Succession Events) with respect to Reference Entities have occurred.

Determinations Committees have been established on a regional basis. Each DC is comprised of both dealer and buy-side representatives. To increase transparency, after each meeting the applicable DC publishes on the ISDA website all of its decisions as to whether or not a Credit Event or Succession Event has occurred with respect to a designated Reference Entity. The Auction Supplement "hardwires" the auction procedures as well as the Determinations Committees rules by amending the Credit Derivatives Definitions. Thus, parties are able to incorporate these terms into their future transactions by incorporating the Credit Derivatives Definitions (unless they otherwise specify) into their trades. The North American Determinations Committee most recently determined that a Credit Event had occurred with respect to General Motors Corporation and authorized an auction for the settlement of CDS transactions subject either to the Auction Supplement or to the so-called "Big Bang Protocol" discussed below.

In addition to the introduction of Determinations Committees and hardwiring auction settlement as the method of settlement, the Auction Supplement also provided for a standard look-back period for Credit Events and Succession Events. That is, to be effective, a Credit Event must not have occurred more than 60 days prior to the date that notice of the potential Credit Event was first provided to the applicable DC. In the case of Succession Events, the event must not have occurred more than 90 days prior to the date that notice of the potential Succession Event was first provided to the relevant DC. These look-back rules allow Credit Events or Succession Events that occur prior to the trade date for a trade nevertheless to be covered by the trade so long as the Credit Event or Succession Event occurred within 60 days or 90 days, as the case may be, of the trade date.

As with other ISDA protocols, upon adherence, the Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol (the so-called "Big Bang" Protocol) amended the terms of covered CDS transactions between one adhering party and each other adhering party, on a multilateral basis. In the case of the Big Bang Protocol, the impact of adherence was the implementation of the substance of the Auction Supplement (including incorporating resolutions of the Determinations Committee, applying auction settlement as the settlement method, and adding backstop dates for credit and succession events in existing and future trades between adhering parties).

As has been the case in previous ISDA CDS protocols, certain transactions, including loan-only transactions, U.S. municipal transactions, and CDS on asset-backed securities, are specifically excluded from the Big Bang Protocol. Transactions are split among those transactions that are subject to all the provisions of the Big Bang Protocol and those that are excluded from the auction provisions of the protocol (Covered Non-Auction Transactions). Covered Non-Auction

Transactions include fixed recovery, reference obligation only, preferred CDS, and party-specified Non-Auction transactions. For these trades, the remaining provisions of the Big Bang Protocol, including Determinations Committee determinations, still apply. For example, parties will be bound by a decision of a Determinations Committee that a Credit Event occurred, but they will not have to settle their trades pursuant to the subsequent auction settlement that is held.

Going forward, adherents can bilaterally exclude specific transactions from the Big Bang Protocol by specifying so in their trade documentation or a side letter for such a transaction. Most major market participants adhered to the Big Bang Protocol. ISDA does not expect to publish ad-hoc protocols for future Credit Events (excluding "Restructuring" as described below); therefore, parties that did not adhere or that face non-adhering counterparties will need to settle their trades in a bilateral manner going forward.

If a Determinations Committee decides not to make a ruling on whether there has been a Credit Event with respect to a particular Reference Entity, then parties having CDS covering that Reference Entity may independently determine whether a Credit Event has occurred in accordance with the terms of their documentation. If a DC does makes a ruling, its decision (whether positive or negative) is binding on all parties that adhered to the Big Bang Protocol. All of these changes have operated in a robust and efficient manner to date, tested through a number of recent Credit Events. The General Motors auction had been the most anticipated test, as that company's default was in years past the "big one" that market watchers had feared would bring down the CDS market if physical settlement remained the only option.

Other Developments for Standard CDS Contracts

One of the ISDA initiatives to standardize CDS contracts in recent years was the development of a matrix that, if incorporated by reference, sets forth certain key common terms for standard single name CDS depending on region-based transaction types. Simultaneous with the publication of the Auction Supplement and the launch of the Big Bang Protocol, a few changes were made to the standard North American CDS in an effort to increase trade liquidity and fungibility. First, pricing for standard single-name CDS covering the most heavily traded North American corporate and high-yield reference entities moved from running premiums to a fixed coupon plus an upfront fee. Under the new convention, protection buyers pay a fixed rate of either 100 (initially for North American corporate entities) or 500 basis points (initially for North American high-yield entities), and pay an up-front fee equal to the present value of the risk represented by the underlying bonds less the fixed coupon. This structure intentionally mirrors the convention for trades based on CDS indices.

Next, after a long saga, "Restructuring" was removed as a Credit Event for the standard North American CDS contract. This change was part of an effort to have CDS trade in a fashion similar to that of bonds and indices. Trades that already included Restructuring at the time of the change retained it, and parties may still include Restructuring as a Credit Event if they specifically build it into their documentation, but new standard North American trades only include Credit Events relating to a payment failure or insolvency of a Reference Entity. The North American DC will have the authority to determine whether a Restructuring Credit Event has occurred, but that decision will not bind participants to any auction held. Rather, it is envisioned that Restructuring will be dealt with on an ad-hoc basis, with voluntary adherence on any auction that is decided to be held. In mid-June of this year, ISDA circulated a draft term sheet outlining auction mechanics designed for Restructuring Credit Events. The key settlement mechanic of what is being called the "Small Bang" protocol is that when a Restructuring triggers CDS contracts, they will be settled based on buckets depending on the maturity of their underlying reference obligations. As with the decision that a Restructuring Credit Event has taken place, a Determinations Committee decision would determine whether an auction is to take place with respect to CDS assigned to each bucket. The formal protocol is expected to open for adherence around July 13, with implementation of its terms expected on July 27.

As the single name CDS market moved toward these new standard terms, ISDA made available the CDS Standard Model, a tool for increased CDS pricing transparency. The model uses an underlying code (based on J.P. Morgan's CDS Analytical Engine) that is widely used to price CDS contracts, and is now available to the entire industry through an open source license. Standard inputs to the model, including recovery value and yield curve, will also be made available.

More recently, in line with the push for increased standardization, transparency, and liquidity as well as the desire to facilitate the compression of offsetting trades and central clearing of CDS, additional market practice changes to the trading convention for CDS took effect on June 22. Among the changes is the application of fixed coupons to trades of the standard European transaction type. Also, trades of the Latin America and Emerging European CDS transaction types will move from monthly to quarterly contract roll dates.

Clearing Hurdles

As mentioned earlier, clearing has been the preferred solution for both achieving greater transparency and alleviating concerns around counterparty credit risk. U.S. and European regulators have been pushing for some time for CDS, which, at their peak, had an outstanding notional amount in excess of $50 trillion, or more than three times the U.S. Gross Domestic Product and bigger than all the U.S. credit markets put together, to be traded through clearinghouses. As noted above, Treasury Secretary Geithner's proposals and various U.S. legislative initiatives seek to require some level of central counterparty clearing for OTC derivatives. The industry has acceded to the calls for voluntary commitments to clearing, lest more stringent regulatory requirements be expedited.

The use of central counterparty clearinghouses is expected to address operational and risk management needs of the credit derivatives market. Since each participant, whether buying or selling, would be facing the clearinghouse as its counterparty, both ease of trading and the reduction of counterparty risk will be served. The first clearinghouse to receive all necessary regulatory approvals and to start trading was ICE Trust (a subsidiary of Intercontinental Exchange Inc.). It is overseen by the Federal Reserve Board and members may include banks or other institutions that fulfill the membership requirements, which include net worth of at least $5 billion as well as a credit rating of A or better. Buy-side participants, such as hedge funds, meeting ICE Trust's membership eligibility requirements can also apply for membership although not many buy-side participants are likely to carry credit ratings. To date, more than $600 billion in U.S. credit products have been cleared by ICE Trust.

CDS that are cleared by ICE Trust are deemed to be novated such that ICE Trust becomes a counterparty to each of the buyer and seller under separate CDS. Among other things, ICE Trust is able to net positions between it and each member and, accordingly, receives payments from and makes payments to each member on a net basis. Markit has agreed to provide the daily prices that will be used for mark-to-market pricing, margining, and clearing by ICE Trust. Among other things, this will provide greater market transparency as to closing settlement prices and trading volume for covered trades. CME Group also has regulatory approvals for clearing CDS but, for the moment, it lacks the dealer backing that ICE Trust has accumulated.

One of the concerns raised by regulatory bodies is the concentration of CDS trading in only a few dealer institutions in recent years. (Note that the top 10 global banks are involved in 70% of all credit derivatives transactions.) Over time, the use of clearinghouses such as ICE Trust is expected to reduce the volume of settlement payments among members of the clearinghouse and, in theory, reduce counterparty credit risks that arise under CDS. However, trading CDS through clearinghouses may not effectively address concentration risk given that, at least initially, the clearinghouse members will be the major dealers currently involved in most trades. In order to address counterparty risk, members must provide collateral to ICE Trust to cover their obligations under cleared CDS. Members must also make initial and ongoing contributions to a guaranty fund that can be used by ICE Trust in the event of a member default.

Members of ICE Trust can continue to trade CDS with non-members under their existing documents. Going forward, members will be obligated under ICE Trust's rules to offer non-members the option of segregating initial margin for back-to-back CDS trades that are cleared through ICE Trust.

"Security-based swap agreements" are presently not regulated as securities under U.S. securities laws, other than with respect to anti-fraud, anti-manipulation, and anti-insider trading provisions. In order to qualify as a security-based swap agreement a swap must be subject to individual negotiation. Due to concern that cleared CDS with standardized terms would not satisfy this requirement, ICE Trust applied and received from the SEC an exemption on behalf of itself and its members from any broker-dealer registration and regulatory requirements that might have otherwise applied if CDS cleared by ICE Trust were deemed to be securities.

Taking the Bull by Its Horns

On June 2, ISDA through the ISDA Board Oversight Committee, the Managed Funds Association, the Operations Management Group (OMG), and the Asset Management Group of the Securities Industry and Financial Markets Association submitted to the President of the Federal Reserve Bank of New York a letter outlining the commitments of market participants to significantly reduce systemic risk and increase transparency. The letter notes the industry's goal of fairly balancing interests of dealers and customers and is in line with the goals expressed by Secretary Geithner earlier in the year. With respect to credit derivatives, the letter commits participants to continue to strengthen settlement and recounts the milestones met in relation to auction hardwiring and CDS clearing. As for equity products, participants set deadlines for implementation of centralized reporting of July 31, 2010 and for T+4 matching of 95% of electronically eligible transactions between OMG members of September 30 of this year. The industry will seek to expand the number of interest rate products eligible to be centrally cleared and implement a centralized reporting infrastructure for standardized products by year-end. Finally, market participants will identify and pursue additional advances in collateral management and complete a market-wide proposal for margin dispute resolution by September of this year. While meaningful measures in their own right, these commitments also demonstrate the considerable inherent technical issues and complexities of making various OTC derivative products "electronic eligible" so as to facilitate the desired netting/settlement and reporting benefits.

CONCLUDING REMARKS

Headlines have played perhaps too large a role in the ongoing debate about whether and how OTC derivatives posed a systemic risk that triggered the current credit crisis. Mesmerized by Buffett's oft-quoted phrase, "financial weapons of mass destruction," many have stopped short of reading the entirety of the annual report in which that phrase appeared and have ignored that company's apparent recognition of the value of derivatives as a risk management tool. Citing the AIG debacle, some observers at times have demonized CDS and OTC derivatives in general without an understanding of what was unique (though dysfunctional) about AIG's situation and contracts. For example, the use of rating triggers is only one of many tools available to OTC derivatives market participants for managing counterparty credit risk, and indeed many commentators argue that such rating triggers are (citing Lehman's decent rating) too late and after the fact to effectively manage such risk. While it is hard to argue about the "value" of transparency and the need to have effective tools for "systemic" risk, the current proposed bills in the United States appear to go substantially further and significantly increase the risk of unintended consequences. If any enacted legislation overreaches, the affected transactions will almost surely flow to a forum or an alternative form that does not impose undue burdens. Worse, banks and insurance companies may be limited in their ability or unable to effectively manage their portfolio risk.

Any potential damage to the OTC derivatives market is not a threat that would be limited to the financial services industry. Commercial enterprises utilize OTC derivatives to protect their operations from a variety of market risks, including currency, interest rate, and other market fluctuations. If they cannot use these instruments or if the costs of doing so are not justifiable, the risks they manage will be passed on to consumers of their products through higher prices. Striking a balance between the desire to have a greater level of transparency to effectively curb systemic risk on one hand and the temptation to succumb to the headlines of the day on the other hand will be difficult. Nonetheless, participants in this process ought to face the complexity involved head-on, much like responsible users of OTC derivatives have done to date.