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Securitization Update
May 19, 2009

OTC Derivatives — In the Crosshairs of U.S. Regulatory Change

Summary

Perhaps not surprisingly, the over-the-counter (OTC) derivatives market is increasingly the focus of the U.S. legislative agenda. On January 15, the Derivatives Trading Integrity Act of 2009 (DTIA), sponsored by Senator Tom Harkin (D-IA), was introduced to the U.S. 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. Most recently, on May 13, Treasury Secretary Timothy Geithner outlined the Obama Administration's goals for the regulatory framework for OTC derivatives.

The flurry of bills and pronouncements have done little to add substance to that framework but have made one thing abundantly clear: OTC derivatives will be subject to a new regulatory landscape.

Full Update

CONGRESSIONAL COMMITTEE BILLS AND THE ADMINISTRATION'S DIRECTIVES

The DTIA proposes to amend the Commodity Exchange Act (CEA) by repealing the exemptions or exclusions from regulation currently afforded to specified derivatives, by requiring all futures contracts (including virtually all OTC derivatives) to trade on a designated contract market or a derivatives transaction execution facility, and by 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 proposes to subject prospective OTC transactions either to settlement and clearing on a CFTC- or 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 the products and grant federal regulators authority to regulate all types of OTC and exchange-traded derivatives, without exception, immediately. The sponsors of this bill see it as an interim step, making the way for anticipated comprehensive financial reform later in the year.

On May 13, the 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 recommends that all OTC derivatives dealers and others who create large exposures to counterparties be subject to "a robust regime of prudential supervision and regulation." Third, Secretary Geithner proposes 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 notes 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.

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 is transparency; however, the road to achieving that is rife with blind corners. Clearing seems to be the oft-quoted solution to the transparency problem. ARSA does not specifically require clearing but instead gives broad authority to regulators to work with one another on the consistent treatment of derivatives. Secretary Geithner states that all standardized OTC derivatives should be cleared through regulated central counterparties and that the acceptance of an OTC derivative by one or more regulated central counterparties (CCPs) should create a presumption that it is a standardized contract. He goes on to say that the standardized part of the OTC market should be moved onto regulated exchanges and regulated transparent electronic trade execution systems.

What is not clear is what parameters would establish whether a product is standardized or, once that is determined, which contracts are to be cleared via CCPs, traded on an electronic trading platform or quoted on a regulated exchange. There is no mention of who—market consensus, individual participants or a regulator—will determine whether a derivative is standardized. It is also unclear whether there will be a product-based approach for making this determination or whether the determination may vary based upon counterparty participant.

Since, according to Secretary Geithner's framework, some contracts would be presumed to be standardized because of their acceptance by a CCP, it would appear that there is a voluntary component in the initial decision to submit a trade to a CCP. Further, Secretary Geithner suggests that regulated institutions be encouraged to make greater use of regulated exchange-traded derivatives. Which derivatives will be required (versus elected) to be traded in a certain manner is an issue that has been left open. Of course, all these questions arise without getting to the question of whether certain OTC derivatives are unsuitable for any of these trading options in the first place. Currently the bills and the Treasury proposal lump all OTC derivatives together.

Are My Margin Requirements the Same as Yours?

Because standardized trades are 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. Secretary Geithner states that CCPs would be expected to impose robust margin requirements and to ensure that customized OTC derivatives do not become a means of avoiding the use of CCPs. This certainly suggests that comparable margin requirements will be imposed on customized OTC derivatives in this regulatory regime on a comparable basis to the margin rules of CCPs. Certainly, any difference will 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. 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.

Also unclear at this juncture is the extent to which margin requirements and capital requirements will overlap. Will perceived derivatives risk exposure be addressed in the case of regulated financial institutions primarily through more stringent capital requirements, possibly beyond those suggested by Basel II? In contrast, will non-regulated players in the derivatives markets 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 will be allowed to continue to directly enter into derivatives transactions.

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 be subject to an appropriate regime of prudential supervision and regulation. It is too soon to know what this might entail, although the Secretary suggests that key elements of a robust regulatory regime must include capital requirements, business conduct standards, reporting requirements and conservative initial margin requirements. Presumably, players will 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 is that the CFTC and the SEC should have the authority to impose recordkeeping and reporting requirements on all OTC derivatives. He includes 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.

Secretary 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

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

In addition, it is 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 will 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 will be categorized and what will 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 commodities. Doing so would give the SEC and the CFTC the most explicit means of regulating derivatives transactions.

Other Open Issues

For some time, there have been discussions of merging the CFTC and the SEC. The Congressional bills and Secretary Geithner call for an increasingly intertwined role for both those regulatory bodies in virtually every function recommended. However, conspicuously absent from Secretary Geithner's proposal is any suggestion that the two regulatory bodies be combined. It is possible that the need for action on OTC derivatives, though still very preliminary, outpaced the considerations of whether the two agencies should be merged or replaced by a single regulator. It will be interesting to follow the untangling that will be necessary to determine which regulator will perform the specific functions that may be detailed later, particularly as this will reopen old debates about which products fall under which agency's purvue. The question will likely become further complicated as new products, such as carbon emissions derivatives, are introduced into the U.S. market.

The second major open issue relates to credit default swaps (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. State insurance regulators had at one point tabled those efforts in order to learn what federal legislation might allay their concerns that covered CDS were inappropriately operating outside the insurance regulatory regime. Most recently, the National Conference of Insurance Legislators' Task Force on Credit Default Swaps Regulation revised proposed model legislation that it has developed. It is uncertain whether federal legislative action with respect to OTC derivatives in general and CDS in particular will alter or obviate the need for action by the insurance regulators.

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 is no longer justifiable or financially worthwhile. None of the proposals address that 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.

Not many remain who debate the need for greater transparency in the OTC derivatives market or the possibility that a certain amount of regulatory attention is warranted. The details of reaching those goals continue to prove elusive, however, and much like the responsible use of the products involved, the complexity ought to be faced head-on.

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