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Securitization Update
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OTC Derivatives — In the Crosshairs of Regulatory Change, Part II

Summary

Over-the-counter (OTC) derivatives have drawn a heavy dose of politicians' ire during the current financial downturn. In a previous update discussing regulatory developments facing the OTC derivatives market, we described a number of Congressional Committee bills and a framework outlined by the Secretary of the U.S. Department of the Treasury, upon which the Obama Administration expects Congress to build a new regulatory regime for OTC derivatives.[1]

On June 17, 2009, the Treasury Department published its proposed regulatory overhaul for the U.S. financial system in a document entitled, "Financial Regulatory Reform: A New Foundation." The new proposal falls in line with piecemeal elements that have been discussed since the Obama Administration first announced its desire to overhaul the current financial regulatory structure. In particular, the proposed reforms relating to OTC derivatives are consistent with the previously announced Treasury recommendations. From this point, Congress will debate the details of how OTC derivatives reform will take place in conjunction with discussions about broader financial regulatory reform. This update will describe the Obama Administration's goals for new legislation that would impose a more rigid regulatory framework around OTC derivatives.

Full Update

DIRECTIVES FROM THE OBAMA ADMINISTRATION

There are some policymakers who are convinced that the OTC derivatives market operates in the shadows of "legitimate" financial markets. Others suggest that the regulators that already have oversight of derivatives dealers might have been better informed if the products themselves were subject to more direct regulation. In either case, the outcome of these views is very likely to be a higher level of regulation.

In its June 17 proposal, "Financial Regulatory Reform: A New Foundation," the U.S. Treasury Department outlined the view that OTC derivatives markets, including credit default swaps, ought to be subject to comprehensive regulation. In particular, four public policy objectives were outlined: (i) preventing activities in OTC derivatives markets from posing risk to the financial system; (ii) promoting the efficiency and transparency of those markets; (iii) preventing market manipulation, fraud, and other market abuses; and (iv) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties. The June 17 proposal has many similarities with Treasury Secretary Timothy Geithner's May 13 outline of regulatory principles for OTC derivatives but also contains important new developments.

TRANSLATING PUBLIC POLICY INTO ACTION POINTS

Clearing and Defining What's Standard

Addressing a theme that recurs in all the discussions about OTC derivatives regulation, the Treasury framework recommends the amendment of the Commodities Exchange Act (CEA) and the securities laws so that all "standardized" OTC derivatives are required to be cleared through regulated central counterparties (CCPs). Furthermore, the CCPs should be required to impose "robust margin requirements as well as other necessary risk controls."

Treasury has reiterated that "customized" OTC derivatives should not be used to avoid using a CCP, with the creation of a presumption that a contract is standardized if an OTC derivative is accepted for clearing by a CCP. In addition, Treasury recommends moving "the standardized part of these markets" onto regulated exchanges and regulated transparent electronic trade execution systems for OTC derivatives and requiring a system for the reporting of trade details. Further, Treasury continues to suggest that regulated financial institutions be encouraged to make greater use of regulated exchange-traded derivatives. These recommendations are presented as a means to contain systemic risk and to improve market efficiency and price transparency.

It is still unclear what parameters would establish whether a product is standardized and, once that is determined, which contracts are to be cleared via CCPs, traded on an electronic trading platform or quoted on a regulated exchange. Who will determine whether and how to classify a derivative as standardized has not been identified. As we have noted before, since 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. Which derivatives will be required (versus elected) to be traded in a certain manner is still an open question and no distinctions are being made among various OTC derivatives, some of which may be ill-suited to any of these trading options.

Robust Regulatory Regime

The next theme that the proposal addresses concerns the supervision of all OTC derivatives dealers and others whose activities in those markets create large exposures to counterparties. It is recommended that these entities be subject to "a 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 rules for initial margin against counterparty credit exposure. As we noted in our prior update on this topic, it does not appear that parties will need to be regulated financial institutions to trade in derivatives as long as they are subject to the reporting, margin and business conduct standards to be put in place.

As part of the overall Treasury proposal, the U.S. Federal Reserve Board (the Fed) 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 Fed would be able to impose these new capital and regulatory requirements on all Tier 1 FHCs engaged in derivatives activities.

As mentioned above, it remains unclear how standardized trades will be distinguished from those that are customized. The practical implications of this distinction include whether a trade is subject to mandatory margin. The recommendation that CCPs be expected to impose robust margin requirements, and the effort to ensure that customized OTC derivatives not become a means of avoiding the use of CCPs, suggests that the conservative margin requirements being proposed will be imposed on customized OTC derivatives in this regulatory regime on a comparable basis to the margin rules of CCPs. Certainly, any difference 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. Again, it remains to be seen whether variations in margin standards would be permitted and under what circumstances.

At this juncture, the extent to which margin requirements and capital requirements will overlap has not been specified. 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. The question lingers whether OTC derivatives participants that do not fall into the category of Tier 1 FHCs and are not otherwise regulated financial institutions, assuming they will still be allowed to directly enter into derivatives transactions, will be subjected to stricter margin requirements given that they may not otherwise be required to set aside capital for their derivatives trading activities.

Reporting and Recordkeeping

Again consistent with Secretary Geithner's May 13 letter, the financial system reform framework reiterates the recommendation that the CEA and the securities laws be amended to authorize the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to impose record-keeping and reporting requirements on all OTC derivatives. It is the view of the Treasury Department that such requirements will make OTC derivative markets more transparent and efficient. Some such requirements would be deemed to be satisfied either by clearing on a CCP or reporting transactions to a regulated trade repository. Then, the CCPs and trade repositories would be required to make aggregate data on open positions and trading volumes available to the public and make party-specific data available on a confidential basis to the CFTC, SEC, and the institution's primary regulators. It seems that Treasury is committed to a system to ensure dissemination of prices and other trade information to the market. The extent to which parties 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 are still open questions.

Manipulation Issues

Finally, as in Secretary Geithner's May 13 letter, the OTC derivatives proposals in the financial system overhaul outline recommend that legislators amend the CEA and securities laws in any way necessary to ensure that the CFTC and the SEC have "clear, unimpeded authority" with respect to policing market abuses involving OTC derivatives and that the CFTC has authority to set position limits on OTC derivatives that "perform or affect a significant price discovery function with respect to regulated markets." This point still does not contain specifics; instead, legislators may make this authority broad and apparently unfettered. It is no clearer now than it was in May how derivatives that "perform or affect a significant price discovery function with respect to regulated markets" 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 was that information provided to regulators (whether on a voluntary or mandatory basis) by the combination of CCPs, trade repositories and market participants would create the picture needed to establish such correlations. The gap in how the various products will be categorized and what will distinguish trades that are voluntarily reported versus those that are reported by mandate remains.

New Developments in the Regulatory Environment

As noted above, there are some added details in the latest Treasury pronouncement that were not a part of the May framework. First, 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 participation 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. This objective is interesting because, while the press has focused somewhat on smaller OTC derivatives market participants, neither Mr. Geithner's prior statement nor any of the current Congressional bills have honed in on issues relating to "unsophisticated" market participants. Little detail has been provided as to additional indicia, beyond current requirements, of sophistication for this market.

Another issue that remains unresolved is regulatory turf. 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 confusing and overlapping authority of the SEC and CFTC. As noted in the proposal:

> [o]ne result of this jurisdictional overlap has been that economically equivalent instruments may be regulated by two agencies operating under different and sometimes conflicting regulatory philosophies and statutes .... In many instances the result of these overlapping yet different regulatory authorities has been numerous and protracted legal disputes about whether particular products should be regulated as futures or securities.

Therefore, one of the stated goals in the proposal 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 instrument or market.

Treasury is recommending 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 would be due by the end of September and 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.

This is an important new development because, until now, it was uncertain whether the political appetite existed to address head-on the turf battles that have existed for years between the CFTC and the SEC. For some time, there had been discussions of merging the CFTC and the SEC, and early in the year there was much speculation in this regard. The Congressional bills that have been introduced thus far and Secretary Geithner's May letter recommended an increasingly intertwined role for both those regulatory bodies in virtually every function described. Conspicuously absent from Mr. Geithner's original proposal was any suggestion that the two regulatory bodies be combined.

When news spread that the Obama Administration had abandoned the merger idea in apparent recognition that such an effort would significantly delay work on the substance of reforms aimed at the financial system, derivatives market participants were left with the old problem of trying to determine which regulatory body would regulate any particular derivative and whether or not certain derivatives are commodities, securities, both or neither. The prospect of old power struggles among Congressional leaders with committee oversight of various financial products loomed large, only to be complicated as products such as carbon emissions derivatives are introduced into the U.S. market. In the May outline, the Treasury 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 have given the SEC and CFTC the most explicit means of regulating derivatives transactions. With this in mind, the new directive that the two agencies identify and resolve conflicts is a very important recognition of the need to harmonize, once and for all, conflicting and overlapping regulations.

Action Points of the OTC Derivatives Market

Notwithstanding the harmonization of CFTC and SEC authority, a critical problem remains — 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 recognition of the fact that much of the derivatives market is truly global and fungible seems to be lacking from the policymaking agenda. Because of this, the market's own efforts to reach the public policy goals that have been outlined by the Treasury Department and the various Congressional bills may stand the greatest chance of achieving desired reforms while preserving OTC derivative markets in the United States.

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 (the New York Fed) a letter outlining the commitments of market participants to significantly reduce systemic risk and increase transparency. The letter noted 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 committed participants to continuing to strengthen settlement and recounted 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 percent of electronically eligible transactions between OMG members by September 30, 2009. The industry indicated that it would 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 stated that they would 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.

The regulation of OTC derivatives is imminent notwithstanding the fact that, unlike other parts of the financial system, OTC derivatives markets have operated smoothly and to a large degree uninterrupted during this time of great financial stress. Further, unlike markets for other financial instruments, derivatives market participants, largely through ISDA, have for some time cooperated closely with the New York Fed and engaged in myriad self-policing activities. Time will tell whether this existing framework combined with the redoubled self-policing efforts of market participants will cause policymakers to seek appropriate legislation that will not threaten the preservation of the OTC derivatives market in the United States.

Endnotes

1 "OTC Derivatives — In the Crosshairs of U.S. Regulatory Change," available at http://www.mayerbrown.com/publications/article.asp?id=6753.

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