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Treasury Proposes New Regulatory Framework for Over-the-Counter Derivatives

Overview

On May 13, 2009, U.S. Treasury Secretary Timothy Geithner announced a legislative proposal to establish a comprehensive regulatory framework for over-the-counter (“OTC”) derivatives. Although the proposal, contained in a two-page letter sent to Congressional leaders (the “Treasury Letter”),¹ is short on specifics, if enacted it could fundamentally change the way OTC derivatives are traded and regulated. Among other matters, the proposal would:

- Require clearing of all “standardized” OTC derivatives through regulated central counterparties, and impose additional requirements on parties to non-standardized derivatives
- Require reporting and recordkeeping for all OTC derivatives
- Require or encourage trading of standardized contracts on futures exchanges or other regulated transparent electronic markets
- Authorize position limits for OTC derivatives
- Impose additional counterparty requirements for participation in the OTC derivatives market
- Strengthen U.S. Securities and Exchange Commission (“SEC”) and Commodity Futures Trading Commission (“CFTC”) enforcement authority

¹ Letter from Timothy F. Geithner to the Honorable Harry Reid, United States Senate (May 13, 2009) *available at* <http://www.financialstability.gov/docs/OTCletter.pdf>.

The proposal would significantly alter the framework for the regulation (or non-regulation) of OTC derivatives under the Commodity Futures Modernization Act of 2000 (the “CFMA”), which exempted large categories of derivatives from substantive regulation by the SEC and CFTC. Significantly, the Treasury Letter states that the proposed legislation should not call into question the enforceability of OTC derivatives, which was a major objective of the CFMA.

Secretary Geithner announced the proposal together with Acting CFTC Chairman Michael Dunn and SEC Chairman Mary Schapiro. The proposal reflects views previously expressed by Secretary Geithner in Congressional testimony as well as elements from other proposed legislation.² House Agriculture Committee Chairman Collin Peterson and House Financial Services Committee Chairman Barney Frank (whose committees have oversight over the CFTC and SEC, respectively) have “applauded” the proposal and announced a plan to work together to achieve the goals of “strong, comprehensive and consistent regulation of OTC derivatives.”³

² Testimony of Timothy F. Geithner, Secretary of the Treasury, United States Department of the Treasury, before the United States House of Representatives Committee on Financial Services (Mar. 26, 2009) *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/geithner032609.pdf. *See, e.g.*, Derivatives Markets Transparency and Accountability Act, H.R. 977, 111th Cong. (2009).

³ Statement of Chairman Collin Peterson and Chairman Barney Frank, House Agriculture Committee and House Financial Services Committee, United States House of Representatives, 111th Cong., (May 13, 2009) *available at* http://www.house.gov/apps/list/press/financialsvcs_dem/pr051409.shtml.

Proposed Regulatory Reforms

Clearing, Enhanced Financial Requirements and Market Structure

The proposal would require significant structural changes in the OTC derivatives markets, particularly by imposing a requirement that many OTC derivatives be cleared.

These changes would include:

- Amendment of the Commodity Exchange Act (the “CEA”) and the securities laws to require clearing of all standardized OTC derivatives through regulated central counterparties (“CCP”)
- CCPs would be required to impose robust margin requirements and other necessary risk controls
- Non-standardized derivatives would not be required to be cleared, **but**
 - Customized OTC derivatives could not be used solely as a means to avoid using a CCP
 - If an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared
 - Non-cleared trades would have to be reported to a regulated trade repository
- All OTC derivatives dealers and all other firms who create large exposures to counterparties should be subject to a robust regime of prudential supervision and regulation, which would include:
 - Conservative capital requirements
 - Business conduct standards
 - Reporting requirements
 - Initial margin requirements with respect to bilateral credit exposures on both standardized and customized contracts
- The movement of standardized trades onto regulated exchanges and regulated transparent electronic trade execution systems

- The encouragement of regulated institutions to make greater use of regulated exchange-traded derivatives

The proposed requirement for clearing raises a number of questions for market participants, including how a non-standardized transaction would be defined. The time frame for imposing any clearing requirement would also be important, as the focus of efforts to date in clearing OTC derivatives has been the credit default swap (“CDS”) market, which are probably most amenable to clearing in the short run. Clearing of other types of derivatives may present operational challenges. There may also be questions as to what it means for a trade to be “cleared,” particularly in the context of a transaction by a party that is not itself a member of a clearinghouse. The enhanced financial standards for firms that create large exposures could apply to parties, like hedge funds, that have not traditionally had capital requirements or otherwise been subject to substantive regulation of this type.

Forcing, or encouraging, the movement of transactions onto regulated exchanges or other regulated trading facilities would also significantly alter the way many OTC derivatives are negotiated and executed. The Treasury Letter does not specify how regulated financial institutions would be encouraged to use regulated exchange-traded derivatives.

Reporting and Recordkeeping

Under current law, market participants in the OTC derivatives market are not generally required to report or disclose the volume and nature of OTC derivatives positions to regulators or the market. To provide regulators comprehensive and timely information about the positions of participants in OTC derivatives markets, the Treasury Letter requests that legislation include:

- Amendment of the CEA and securities laws to authorize the CFTC and the SEC to impose:
 - Recordkeeping and reporting requirements (including audit trails) for all OTC derivatives

- CCPs and trade repositories must make aggregate data on open positions and trading volumes available to the public
- CCPs and trade repositories must make data on an individual counterparty's trades and positions available to federal regulators
- The development of a system for the timely reporting of trades and prompt dissemination of prices and other trade information

Although there have recently been steps, particularly in the CDS market, toward increased reporting of aggregate positions to the market and regulators, rules of this type would be a significant change from current practice. The proposal would appear to apply to all market participants, not merely brokers or dealers.

Preventing Market Manipulation, Fraud, and other Abuses

The Treasury Letter requests that the CEA and securities laws be amended to ensure that the CFTC and the SEC have:

- Clear and unimpeded authority for market regulators to police fraud, market manipulation, and other market abuses
- In the case of the CFTC, authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets

The Treasury Letter does not specify the particular additional authorities to be given to the regulators in this area, although changes could include the extension of existing anti-fraud and anti-manipulation authorities to transactions that are currently excluded from the CEA (such as under Section 2(d) or 2(g) thereof) or that are excluded from the securities laws as non-securities-based swap agreements. The potential imposition of position limits would be a marked change from the current OTC markets. The impact would depend, among other factors, on the types of contracts covered, the types of limits

imposed (limits vs. accountability standards), aggregation rules and any available exceptions.

Limits on Access to OTC Derivatives Markets

The Treasury Letter suggests that current limits on participation in OTC derivatives markets that are intended to protect unsophisticated parties from entering into inappropriate derivatives transactions are not sufficiently stringent. Presumably, changes in this area could involve limitations on the definitions of "eligible contract participant" or "eligible commercial participant" under the CEA, which are the basis for various exemptions from regulation under the CEA and securities laws. Other alternatives mentioned in the Treasury Letter include disclosure requirements or standards of care for marketing derivatives. The Treasury Letter also suggests a particular concern with municipal counterparties.

Which agency will serve as the Primary Regulator?

The Treasury Letter notably does not call for a single agency to have responsibility for regulation of OTC derivatives. In particular, the allocation of responsibilities between the SEC and CFTC, historically the source of significant controversy, is not addressed, other than through references to their "respective missions." The letter also does not address the role of banking regulators, which have played a significant role in some OTC derivatives markets such as CDS. The approach is consistent with recent statements by legislators that they do not necessarily foresee a change in the structure of the existing financial regulators but that perhaps a strengthening of such regulators could be appropriate.⁴ This sentiment is underscored by the Treasury Letter's call to strengthen SEC and CFTC enforcement authority.

⁴ Kara Scannell, *Frank Backs Regulator for Systemic Risk*, The Wall Street Journal, February 4, 2009, available at <http://online.wsj.com/article/SB123370729697045667.html>.

Conclusion

The Treasury Letter provides the outline of a comprehensive approach to the regulation of the entire OTC derivatives market. While many details would need to be worked out in the legislative process, the statements of the Treasury, SEC and CFTC, as well as key legislators, in support of the approach suggests that reform along the lines suggested is increasingly likely. We will provide further alerts as proposed legislation is developed.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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