U.S. Financial Regulatory Reform – Implications for Derivatives

Overview

On June 17, 2009, the Department of the Treasury published a legislative proposal on Financial Regulatory Reform (“Plan”). This client alert summarizes the key components of the Plan regarding the regulation of all over-the-counter (“OTC”) derivatives, the harmonization of futures and securities regulation and the oversight of systemically important payment, clearing, and settlement systems.

The Plan is intended to create comprehensive regulation of all OTC derivatives markets. Such regulation would address four broad objectives:

- preventing activities in those markets from posing risk to the financial system;
- promoting the efficiency and transparency of those markets;
- preventing market manipulation, fraud, and other market abuses; and
- ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

Significantly, the Plan would not ban any particular product or class of product (e.g., credit default swaps) or require exchange trading for all derivatives, as has been proposed by some legislators and commentators. The Plan also would not establish any single agency as the regulator for derivatives, instead strengthening the role of both the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”).

Proposed Regulatory Reforms

Clearing, Enhanced Financial Requirements and Market Structure

The Plan would result in significant structural changes in the OTC derivatives markets, particularly by imposing a requirement that many OTC derivatives be cleared. These changes would include the following:

- All “standardized” OTC derivatives would have to be cleared through regulated central counterparties (“CCPs”). CCPs would be required to impose “robust” margin requirements and other risk controls
- Non-standardized or customized 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 regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared
- All OTC derivatives dealers and all other firms who create large exposures to counterparties would be
subject to a robust regime of prudential supervision, including capital requirements (intended to be more conservative than the existing bank regulatory capital requirements for OTC derivatives), business conduct standards, reporting requirements and requirements for taking initial margin on counterparty credit exposure, including for non-cleared transactions

- Trading in the standardized parts of the OTC derivatives markets would be moved to regulated exchanges and regulated transparent electronic trading platforms and regulated financial institutions would be encouraged to make greater use of exchange-traded derivatives

These changes would be enacted through amendments to the Commodity Exchange Act (“CEA”) and the securities laws. The proposed requirement for clearing raises a number of questions for market participants, including how a 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 is probably most amenable to clearing in the short run. Clearing of other types of derivatives may present various operational and other 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 prudential regulation. For non-cleared, bilateral transactions, a requirement to collect initial margin would also reflect a change in market practice, particularly in the interdealer market, and questions remain as to the permitted methodology for determining margin requirements, permitted forms of margin and timing, thresholds and any exceptions, among other considerations. It is also not clear how any such requirements would apply to non-U.S. firms.

Forcing, or encouraging, the movement of transactions onto regulated exchanges or other regulated transparent trading facilities would also significantly alter the way many OTC derivatives are negotiated and executed. The Plan does not specify how this movement would be accomplished (e.g., whether by mandates, different capital requirements or other means). Furthermore, the Plan does not specify how regulated financial institutions would be encouraged to use regulated exchange-traded derivatives.

**Reporting and Recordkeeping Requirements**

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, except for certain limited securities law filings. To provide regulators comprehensive and timely information about the positions of participants in OTC derivatives markets, the Plan recommends that legislation:

- Authorize the CFTC and the SEC to impose:
  - Recordkeeping and reporting requirements for all OTC derivatives. Certain of these requirements could be satisfied if the transaction is cleared through a CCP or submitted to a regulated trade repository
  - CCPs and trade repositories would be required to 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 on a confidential basis 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 Plan appears to apply to all market participants, not only dealers. It is unclear whether the requirements would include reporting of derivative transaction prices as now occurs for various securities transactions.

Preventing Market Manipulation, Fraud, and other Abuses

The Plan recommends that the CEA and securities laws be amended to ensure that the CFTC and the SEC have clear and unimpeded authority to police fraud, manipulation and other market abuses involving all OTC derivatives. In addition, the CFTC would have authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.

The Plan does not specify the particular additional market abuse 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 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 of position limits would depend, among other factors, on the types of contracts covered, the types of restrictions imposed (limits vs. accountability standards), aggregation rules and any available exceptions. Together with the enhanced reporting requirements discussed above, these additional authorities are intended to better enable regulators to monitor and combat market abuse.

Limits on Access to OTC Derivatives Markets

The Plan states that current limits on participation in OTC derivatives markets, which are intended to protect unsophisticated parties from entering into inappropriate derivatives transactions, are not sufficiently stringent. It further states that the SEC and CFTC are reviewing those limits and will recommend amending the CEA and the securities laws to tighten the limits regarding the types of counterparties that can participate and/or to impose additional disclosure requirements or standards of care with respect to marketing of derivatives to less sophisticated counterparties. The Plan indicates a particular concern with marketing to municipal counterparties.

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. Imposition of a standard of care for marketing derivatives would be a more significant change in current OTC practice, under which counterparties are presumed to be able to make their own determinations to enter into transactions without reliance on advice of the counterparty.

Harmonization of Futures and Securities Regulation

The Plan also sets a goal of trying to resolve longstanding disputes between the SEC and the CFTC as to the scope of their respective authorities over financial products and differences in approaches to regulation of products and intermediaries by these agencies. The Plan notes that the broad public policy objectives of futures regulation and securities regulation are the same, namely protecting investors, ensuring market integrity, and promoting price transparency. According to the Plan, many differences in regulation of the securities and futures markets are no longer justified.

Thus, the Plan calls for greater harmonization and coordination between the SEC and the CFTC. In particular, the two agencies should seek to harmonize futures and securities laws for economically equivalent instruments to permit products to trade on a broader range of exchanges and markets. Notably, the Plan does not call for the merger of the SEC and CFTC. It also does not appear to be intended to affect the CFTC’s existing authority over agricultural, energy and physical commodity transactions.
The Plan recommends that the SEC and the CFTC complete a report to Congress by September 30, 2009 that identifies all conflicts in statutes and regulations with respect to similar types of financial instruments and that recommends changes to eliminate those differences. If they cannot reach agreement by September 30, 2009, the new Financial Services Oversight Council that the Plan proposes to establish will be required to report its recommendations to Congress.

Systemically Important Payment, Clearing and Settlement Systems and Related Activities

The Plan would give the Federal Reserve enhanced oversight authority over systemically important payment, clearing and settlement systems. This authority would be supplemental rather than replace the existing authority of primary regulators, such as the SEC and CFTC. For example, the Federal Reserve would seek to obtain reports and collect information first through the primary regulator(s) and would have back-up examination and enforcement authority with respect to risk management standards. Legislation will be proposed that broadly defines the characteristics of systemically important payment, clearing, settlement systems and settlement activities of financial firms and that sets objectives and principles for their oversight and conduct. The Plan does not detail any specific standards or provisions to be imposed by the Federal Reserve.

The Plan would also give systemically important payment, clearing and settlement services direct access to Federal Reserve accounts and services, including access to the discount window for emergency liquidity.

Conclusion

The Department of the Treasury’s Plan provides the outline of a more comprehensive approach to OTC derivatives regulation. Some proposals would make a significant change from current practices, while others would be more incremental. Notably, the reforms seem designed to fit within the existing securities and commodities law framework, rather than establishing a completely new framework. Many significant details will need to be worked out in the legislative process. We will provide further alerts as legislation develops.

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.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Azam H. Aziz  
New York  
+1.212.848.8154  
aaziz@shearman.com

Geoffrey B. Goldman  
New York  
+1.212.848.4867  
geoffrey.goldman@shearman.com

Donna M. Parisi  
New York  
+1.212.848.7367  
dparisi@shearman.com

M. Holland West  
New York  
+1.212.848.4579  
hwest@shearman.com

Bradley K. Sabel  
New York  
+1.212.848.8410  
bsabel@shearman.com

Geoffrey B. Goldman  
New York  
+1.212.848.4867  
geoffrey.goldman@shearman.com

Donna M. Parisi  
New York  
+1.212.848.7367  
dparisi@shearman.com

M. Holland West  
New York  
+1.212.848.4579  
hwest@shearman.com

Bettina Turck-Avery  
New York  
+1.212.848.4773  
bettina.turck@shearman.com

Kalin S. Velev  
New York  
+1.212.848.4180  
vvelev@shearman.com

Christian R. Sabella  
New York  
+1.212.848.4588  
csabella@shearman.com