

Credit Derivatives: Recent Regulatory Developments in the United States

BY DAVID H. KAUFMAN AND DAVID A. TRAPANI¹

Derivatives, and in a particular credit derivatives (otherwise known as credit default swaps), are routinely cited as a major cause of the current global financial crisis. Critics assert that credit default swaps were responsible for the near-demise of AIG and various monoline financial guarantee insurers, created dangerous levels of systemic counterparty risk throughout the financial markets and were subject to manipulative trading practices (akin to naked shorting in the equity markets) that hastened the downfalls of the likes of Bear Stearns and Lehman Brothers. While a causal link appears to exist between certain credit default swap activities and the troubles of AIG and the monoline insurers, it can be argued that compelling evidence supporting the other asserted ill-effects of credit default swaps has yet to be presented. This should not be a surprise. The failures of significant financial institutions are less than a year old, and deducing the true causes of those failures, including the breakdown in credit markets that preceded them, will no doubt require substantial time and effort by economic historians and others. The debate over what truly caused this financial crisis is likely to rage on for many years.

It appears, however, that the regulatory response to the “problem of derivatives” will be implemented well before this debate

is resolved. Reform and regulation (or, in some respects, re-regulation) of the derivatives markets is being presented as essential to containing systemic risk and ensuring the stability of the financial system. Over-the-counter (“OTC”) derivatives (a category that encompasses credit default swaps) are a particular target of the plethora of reform and regulatory initiatives currently under discussion. This article will endeavor to provide an overview of these initiatives, focusing in particular on recent developments through May 2009 that could affect credit default swap trading in the United States.

So far, 2009 has been a busy year. On March 26, Secretary Geithner introduced the Administration’s broad framework for comprehensive regulatory reform of the financial regulatory system (the “Treasury Framework”). As a follow-up, on May 13 Secretary Geithner provided additional details regarding the Administration’s comprehensive regulatory framework for OTC derivatives (the “OTC Derivatives

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Framework”). In Congress, multiple bills have been introduced in the U.S. Senate and House of Representatives that would impact, in varying degrees, credit default swaps and, in some cases, all OTC derivatives. Two central counterparties (“CCPs”) obtained final regulatory approvals for clearing credit derivatives, and clearing of certain standardized credit derivatives began in the United States for the first time. On the enforcement front, the U.S. Securities and Exchange Commission (the “SEC”) filed its first ever case alleging insider trading involving credit default swaps. Finally, and not to be forgotten (at least, not yet), there were additional efforts to regulate credit default swaps as insurance on a state-by-state basis.

Federal Developments

The Treasury Framework

In his March 26, 2009 testimony before the House Financial Services Committee, Secretary Geithner stated that the Administration’s proposed comprehensive framework for regulatory reform will cover four broad areas: systemic risk; consumer and investor protection; eliminating gaps in the U.S. regulatory structure; and international coordination (the “Core Principles”).² After noting that detailed frameworks for each of those areas will be forthcoming in the coming weeks, he proceeded to discuss in greater detail the systemic risk element of the Treasury Framework.

The Treasury Framework contains six key elements that are designed to address systemic risk:

1. Establish a single independent regulator with responsibility over systemically important firms and critical payment and settlement systems, including payment and settlement systems for OTC derivatives.
2. Establish and enforce higher standards on capital and risk management for systemically important firms, including requiring that those firms be able to aggregate counterparty risk exposures on an enterprise-wide basis within a matter of hours.
3. Require all hedge fund advisers with assets under management above a moderate threshold to register with the SEC.
4. Establish a comprehensive framework of oversight, protections and disclosure for the OTC derivatives market, including moving the standardized parts of those markets to CCPs and encouraging further use of exchange-traded instruments.
5. Establish new requirements for money market funds to reduce the risk of rapid withdrawals.
6. Establish a stronger resolution mechanism that gives the government tools to protect the financial system and the broader economy from the potential failure of large, complex financial institutions.

Secretary Geithner preceded his discussion of the fourth key element by stating that certain insurance companies’ excessive risk-taking and poor counterparty credit risk management by many banks trading credit default swaps on asset-backed securities amplified the current financial crisis. He also asserted that the lack of transparency in the credit derivatives market contributed, in part, to the failure by regulators to appreciate credit default swaps’ potential to threaten the entire financial system or bring down a company of the size and scope of AIG. In no uncertain terms, Secretary Geithner made it clear that “the days when a major insurance company could bet the house on credit default swaps with no one watching and no credible backing to protect the company or taxpayers from losses must end.” Against this backdrop, Secretary Geithner introduced the main components of the Administration’s comprehensive framework of oversight, protections and disclosure for the OTC derivatives market.

- The U.S. government will regulate the markets for credit default swaps and OTC derivatives for the first time.
- All dealers in OTC derivative markets and any other firms whose activities in those markets pose a systemic threat will be subject to

a “strong” regulatory and supervisory regime as systemically important firms.

- All *standardized* OTC derivatives will be required to be cleared through appropriately designed CCPs, and greater use of exchange-traded instruments will be encouraged. CCPs will be subject to comprehensive settlement systems supervision and oversight, consistent with the authority envisioned in the first key element.
- All *non-standardized* OTC derivatives will be required to be reported to trade repositories and will be subject to robust standards for documentation and confirmation of trades, netting, collateral and margin practices, and close-out practices.
- In order to increase transparency in the OTC derivatives markets, CCPs and trade repositories will be required to make aggregate data on trading volumes and positions available to the public and to make individual counterparty trade and position data available on a confidential basis to federal regulators, including those with responsibilities for market integrity.
- Participant eligibility requirements will be strengthened and, where appropriate, disclosure or suitability requirements will be introduced. In addition, all market participants will be required to meet recordkeeping and reporting requirements.

It is particularly interesting (but not surprising) that although Secretary Geithner introduced the Administration’s framework for regulating OTC derivatives with a short discussion of the perceived shortcomings and failures of the credit derivatives market, the scope of that framework extends to *all* OTC derivatives. For example, as discussed below, there has been a tremendous effort to establish CCPs for credit derivatives. However, the framework introduced by Secretary Geithner calls for the clearing of all standardized OTC derivatives.

The OTC Derivatives Framework³

In a May 13, 2009 letter to Senator Reid, Secretary Geithner provided further details regarding the Administration’s proposal for the establishment of a comprehensive regulatory framework for OTC derivatives.⁴

The OTC Derivatives Framework contains four objectives:

1. Preventing OTC derivatives activities from posing risk to the financial system;
2. Promoting the efficiency and transparency of OTC derivatives markets;
3. Preventing market manipulation, fraud, and other market abuses; and
4. Ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

Secretary Geithner noted that a critical element in achieving these four objectives is that similar products and activities must be subject to similar regulations and oversight. Guided by this principle, the OTC Derivatives Framework would amend the Commodity Exchange Act (the “CEA”), the securities laws, and any related regulatory measures to accomplish the four objectives specifically as follows:

Systemic Risk

- Require all *standardized* OTC derivatives to be cleared through regulated CCPs. This requirement is intended to improve market efficiency and price transparency.
- Ensure that CCPs impose robust margin requirements and other necessary risk controls.
- Ensure that *customized* OTC derivatives are not used solely as a means to avoid clearing OTC derivatives through a CCP. For purposes of distinguishing between “standardized” and “customized” OTC derivatives, an OTC derivative will be presumed to be a standardized contract if it is accepted for clearing by one or more fully regulated CCPs.

- Subject (i) all OTC derivatives dealers and (ii) all other firms whose activities in OTC derivatives markets “create large exposures to counterparties”⁵ to a “robust and appropriate” regime of prudential supervision and regulation. Key elements of such a regime must include:
 - Conservative capital requirements;
 - Business conduct standards;
 - Reporting requirements; and
 - Conservative requirements relating to initial margins on counterparty credit exposures.

Market Efficiency and Price Transparency

- Authorize the Commodity Futures Trading Commission (“CFTC”) and the SEC, consistent with their respective missions, to impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. Clearing standardized OTC derivatives through a CCP or reporting customized OTC derivatives to a regulated trade repository could be deemed to satisfy certain of these recordkeeping and reporting requirements.
- Require development of a system for timely reporting of trades and prompt dissemination of prices and other trade information. In this regard, CCPs and trade repositories would be required to make available to the public aggregate data on open positions and trading volumes and make available on a confidential basis to the CFTC, the SEC, and an individual counterparty’s primary regulators data on the entity’s trades and positions.
- Move the standardized portion of OTC derivatives markets onto regulated exchanges and regulated transparent electronic trade execution systems. This language was not in the Treasury Framework and represents a substantial change if the Administration is actually proposing that all standardized OTC derivatives must be *traded* and *cleared* on regulated platforms.

- Encourage regulated financial institutions to make greater use of regulated exchange-traded derivatives.

Preventing Market Abuses

- Ensure that the CFTC and the SEC, consistent with their respective missions, have clear, unimpeded authority to “police” fraud, market manipulation, and other market abuses involving all OTC derivatives.
- Authorize the CFTC to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.⁶

Eligibility and Disclosure Requirements

- Tighten the eligibility limits or impose additional disclosure requirements or standards of care when marketing derivatives to less sophisticated counterparties such as small municipalities.
- Secretary Geithner noted that the CFTC and the SEC are reviewing the current requirements in order to recommend how the CEA and the securities laws should be amended in this regard.

As Washington begins the enormously challenging process of creating a new financial regulatory framework, a process which will be daunting both in terms of its potential breadth and number of interested parties, the extent to which the broad scope of the OTC Derivatives Framework will survive remains to be seen. In what appears to be an effort to blunt some concern about the sweeping changes that the OTC Derivatives Framework would impose, Secretary Geithner recognized in his letter that the enforceability of OTC derivatives should not be called into question in connection with the implementation of the OTC Derivatives Framework.

Congressional Efforts

In a March 30, 2009 letter to President Obama, the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, Senator Dodd, and the Chairman of the House Committee on

Financial Services, Representative Frank, jointly expressed their agreement with the Core Principals and their commitment to work with the Administration “to enact legislation by the end of the year to create a new, more robust regulatory framework to enhance financial stability and protect investors and consumers in the 21st Century.”⁷ Prior to the announcement of the OTC Derivatives Framework, four separate bills were introduced in 2009 that impact credit derivatives and, in some cases, all OTC derivatives in varying degrees. Although it is unlikely that those bills and a derivatives-related bill that was introduced on the day after the OTC Derivatives Framework was announced will all move forward, they may contain elements that ultimately will make their way into the larger legislative effort that addresses the Treasury Framework and the OTC Derivatives Framework.

Derivatives Trading Integrity Act of 2009 (S. 272)

Introduced by Senator Harkin on January 15, 2009, the point of the Derivatives Trading Integrity Act of 2009 (“DTIA”)⁸ is fairly straightforward: roll back most of the exemptions in the CEA for OTC derivatives and certain derivatives traded on exempt markets that were created by the Commodity Futures Modernization Act of 2000 and thus force those transactions to be traded on registered exchanges. The amendments, among other things, remove from the CEA the exemptions for exempt and excluded OTC derivatives, including credit derivatives.

Derivatives Markets Transparency and Accountability Act of 2009 (H.R. 977)

Representative Peterson introduced the Derivatives Markets Transparency and Accountability Act of 2009 (“DMTAA”)⁹ on February 11, 2009. Broader in scope than DTIA, the bill contains a number of provisions that impact the credit derivatives market.

- *Transparency and Recordkeeping.* Section 5 of the bill subjects exempt and excluded OTC derivative transactions to reporting and recordkeeping requirements, as determined by

the CFTC, for registered futures commission merchants, introducing brokers, floor brokers and floor traders. The bill also includes exempt and excluded OTC derivative transactions as part of the CFTC’s large trader reporting requirements and, more importantly, provides the CFTC with special call authority over “any person” to obtain data on that person’s exempt or excluded OTC derivative transactions and positions, but only to the extent that the CFTC determines it appropriate to deter and prevent price manipulation or any other disruption to market integrity or to diminish, eliminate, or prevent excessive speculation.

- *Over-the-Counter Authority.* Section 11 of the bill directs the CFTC to determine whether exempt or excluded OTC derivatives that are fungible with certain listed contracts have the potential to disrupt the liquidity or price discovery function on registered exchanges, cause a severe market disturbance in the underlying cash or futures markets, or prevent or otherwise impair the price of a listed contract from reflecting the forces of supply and demand in any market. If the CFTC makes such a determination, it is authorized to impose and enforce position limits on the relevant OTC derivative transactions.
- *Clearing of OTC Derivatives.* Section 13 of the bill amends the exemptions for exempt and excluded OTC derivatives to require that those transactions be settled and cleared through a CFTC-registered clearing entity. For OTC derivative transactions relating to an excluded commodity (*i.e.*, financials), the bill also allows those transactions to be settled and cleared through an SEC-regulated clearing entity. As an alternative to clearing, parties may elect to report their OTC derivative transactions to the CFTC, so long as the parties demonstrate the financial integrity of the transaction and their own financial integrity, including a net capital requirement that is comparable to a net capital requirement that would be associated with the transaction were it cleared.

- *Authority of CFTC to Suspend Trading in Credit Default Swaps.* Section 16 is the only part of the bill that expressly refers to credit default swaps. It grants the CFTC authority to summarily suspend trading in *any* credit default swap and summarily suspend *all* trading on any CFTC-regulated exchange or facility, or otherwise, in credit default swaps if, in the opinion of the CFTC, the public interest and the protection of investors so require. However, before the CFTC may act, it must notify the President of its decision and the President must notify the CFTC that the President does not disapprove of the decision. Section 16 contains its own definition of “credit default swap,” which also excludes credit default swaps that are traded on or cleared by a registered entity from the definition of “security” under the CEA, the Securities Act of 1933, and the Securities Exchange Act of 1934 (the “Exchange Act”), except for purposes of enforcing the prohibitions against insider trading.¹⁰

Financial System Stabilization and Reform Act of 2009 (S. 664 and H.R. 1754)

Senator Collins introduced the Financial System Stabilization and Reform Act of 2009 on March 23, 2009,¹¹ and Representative Castel introduced the U.S. House of Representatives version of the bill (H.R. 1754) on March 26, 2009.¹² Although the bill is focused primarily on establishing a systemic risk monitor for the United States financial system, it also contains two sections that expressly relate to credit derivatives.

- *Reporting and Recordkeeping for Positions Involving Credit Default Swaps.* Section 118 of the bill includes a definition of “credit-default swap”¹³ and creates a new term, “credit-default swap trading clearinghouse.” Curiously, under section 118 a credit-default swap trading clearinghouse is an approved centralized clearinghouse for credit-default swap trading that is designated by the SEC, in consultation with the CFTC and the Chairman of the Board of Governors of the Federal

Reserve System (the “Fed”), but is subject to regulation by the CFTC. Credit-default swap trading clearinghouses must be adequately capitalized by its participants, may assess its participants for amounts necessary to maintain a default fund, and may impose trading limits.

In addition, section 118 directs the CFTC to require, by rule, recordkeeping requirements of at least five years for any person holding, maintaining, or controlling any position in any credit-default swap that is executed through a credit-default swap trading clearinghouse. Moreover, the CFTC must prescribe rules requiring regular or continuous reporting of positions in those contracts in accordance with requirements regarding size limits.

- *Clearing of Credit Derivatives.* Section 120 of the bill effectively forces all credit-default swaps to be cleared by requiring any person that engages in a credit-default swap to utilize a clearinghouse that has been designated by the SEC for that purpose. Note that unlike the Treasury Framework and DMTAA, section 120 only requires the clearing of credit default swaps. Section 120 also directs the SEC to issue, in consultation with the CFTC and the Fed, rules to designate clearinghouses for credit-default swaps and to prohibit fraudulent, deceptive, or manipulative acts or practices in connection with credit-default swaps.

Authorizing the Regulation of Swaps Act (S. 961)

Senators Levin and Collins introduced the Authorizing the Regulation of Swaps Act (“ARSA”)¹⁴ on May 4, 2009. The bill is designed as an interim measure to provide “federal financial regulators”¹⁵ with the authority to regulate “swap agreements”¹⁶ pending the enactment of more specific statutory provisions in any forthcoming financial reform legislation. In other words, the bill would permit federal financial regulators to design their own regulatory framework for OTC

derivatives prior to the federal legislation that ultimately may replace that framework. Although the bill is intended to restore confidence in the financial markets, it is hard to imagine how it would result in anything other than a disabling degree of legal uncertainty for the OTC derivatives markets pending any action by federal financial regulators.

- *Repeal of Prohibitions on Regulating Swap Agreements.* Section 2 of the bill repeals various provisions contained in the CEA, the securities laws, and the banking laws that prohibit federal financial regulators from regulating swap agreements.¹⁷
- *Authority of Federal Financial Regulators to Regulate Swap Agreements.* Section 3(a) of the bill authorizes (but does not direct) each federal financial regulator to “exercise oversight over” any swap agreement that is subject to the federal financial regulator’s jurisdiction or is entered into, purchased, or sold by any entity that is subject to the federal regulator’s jurisdiction. In addition, each federal financial regulator may (but is not required to) promulgate, interpret, and enforce regulations, issue orders of general applicability, and impose disclosure, reporting, or recordkeeping requirements, procedures, or standards relating to any such swap agreements.¹⁸ However, prior to taking any such action, the applicable federal financial regulator “must consult, work, and cooperate” with other federal financial regulators to promote consistency in the treatment of swap agreements.
- *Exclusive Jurisdiction among Federal Financial Regulators.*¹⁹ Section 3(b) of the bill provides the SEC with exclusive jurisdiction among federal financial regulators with respect to oversight and regulatory activities relating to exchanges and clearing agencies over which the SEC has jurisdiction and any swap agreements that are traded on or cleared through those exchanges and clearing agencies. Similarly, section 3(b) provides the CFTC with exclusive jurisdiction among

federal financial regulators with respect to oversight and regulatory activities relating to trading facilities and registered entities over which the CFTC has jurisdiction and any swap agreements that are executed on, traded on, or cleared through those trading facilities and registered entities.

Prevent Unfair Manipulation of Prices Act (H.R. 2448)

Representative Stupak introduced the Prevent Unfair Manipulation of Prices Act²⁰ on May 14, 2009. Although the bill focuses primarily on energy derivatives, certain provisions directly or indirectly affect credit derivatives.

- *Clearing of OTC Derivatives.* Much of the language in section 6 of the bill is identical to language in section 13 of the DMTAA. Like the DMTAA, section 6 amends the exemptions for exempt and excluded OTC derivatives to require that those transactions be settled and cleared through a CFTC-registered clearing entity. Section 6 also allows OTC derivative transactions relating to an excluded commodity (*i.e.*, financials) to be settled and cleared through an SEC-regulated clearing entity.

However, section 6 is more restrictive than the DMTAA regarding the availability of an alternative to the clearing requirement. Under the DMTAA, parties may elect to report their OTC derivatives transactions to the CFTC as an alternative to clearing, so long as the parties demonstrate the financial integrity of the transaction and their own financial integrity. In contrast, section 6 provides the CFTC with the authority to exempt transactions (or any class thereof) from the clearing requirement, provided that it determines that the transactions are “highly customized” as to their material terms and conditions, are transacted infrequently, do not serve a significant price-discovery function in the marketplace, and the parties and the transactions meet a financial integrity test that is similar to the one in the DMTAA.²¹ Any transaction so exempted must be reported to the CFTC in a

manner designated by the CFTC or to such other entity that the CFTC deems appropriate. Section 6 requires the CFTC to consult with the SEC and the Federal Reserve regarding any exemptions that relate to excluded commodities or entities for which the SEC or the Federal Reserve serve as the primary regulator.

- *Ban on Naked Credit Default Swaps (with a Twist)*. Section 7(a) of the bill makes it unlawful for any person to enter into a credit default swap²² unless the person (i) owns a credit instrument that is insured by the credit default swap, (ii) would experience “financial loss” if an event that is the subject of the credit default swap occurs with respect to the credit instrument, and (iii) meets certain minimum capital adequacy standards. The minimum capital adequacy standards that must be met are any established by the CFTC, in consultation with the Federal Reserve, or, if *more stringent*, any minimum capital adequacy standards established by any State in which the swap is originated or entered into, or in which possession of the contract involved takes place. In a further nod to the States, section 7(b) of the bill eliminates the CEA preemption of State and local gaming and bucket shop laws, but only with respect to “credit default swaps in which the purchaser of the swap would not experience financial loss if an event that is the subject of the swap occurred.”

Central Counterparties

Further progress was made with respect to CCPs operating in the United States. On March 4, 2009, the Board of Governors of the Federal Reserve System approved ICE US Trust LLC’s application become a member of the Federal Reserve System, and on March 6, 2009, the SEC granted temporary exemptions from certain requirements under the Exchange Act, such as the requirement to register as a clearing agency under section 17A, with respect to the proposed activities of ICE Trust in clearing and settling certain credit default swaps, as well as the proposed activities of cer-

tain other persons in connection with ICE Trust’s clearing and settlement activities.

The SEC granted similar temporary exemptions to The Chicago Mercantile Exchange Inc. (“CME”) and Citadel Investment Group, L.L.C. (“Citadel”), including to certain other persons in connection with the CME’s and Citadel’s proposed activities in clearing and settling certain credit default swaps, on March 13, 2009. Both SEC orders granting the temporary exemptions were similar to the temporary exemptions that the SEC granted with respect to LCH.Clearnet’s CCP proposal on December 23, 2008. As with the LCH.Clearnet order, the SEC granted the exemptions on a temporary basis in order to assist with the prompt development of CCPs for the credit default swaps market. The temporary exemptions for ICE Trust will expire on December 7, 2009, and the temporary exemptions for CME/Citadel will expire on December 14, 2009.

Shortly after obtaining its final regulatory approval, ICE Trust began clearing credit default swaps on North American Markit CDX indices on March 9, 2009, thus becoming the first CCP to do so in the United States.

SEC Enforcement

The SEC brought its first enforcement action involving the alleged insider trading of credit default swaps on May 5, 2009.²³ In its complaint, the SEC alleged that Jon-Paul Rorech (“Rorech”), a bond and credit default swap salesman at a registered broker-dealer, obtained confidential information concerning the restructuring of an upcoming bond issuance for VNU N.V., a Dutch media conglomerate (“VNU”), for which Rorech’s employer was serving as the lead underwriter. As originally announced, the bond issuance was to include bonds issued by two of VNU’s subsidiaries. However, at the time of that announcement, the only VNU-related credit default swaps that were available in the market referenced the holding company, VNU, rather than either of the two subsidiaries. In order to address the perceived market demand for VNU obligations that would be deliverable into credit default swaps referencing VNU, the bond issuance was restructured to include a tranche of VNU debt.

The SEC alleged that Rorech provided this confidential information about the restructured bond offering to Renato Negrin (“Negrin”), a portfolio manager at a hedge fund adviser (the “Manager”), who then purchased credit default swaps referencing VNU on behalf of one of the hedge fund advised by the Manager. The price of those credit default swaps significantly increased after the restructured bond issuance was announced, and Negrin unwound the hedge fund’s position in them for a profit of approximately \$1.2 million.

The SEC alleged that Rorech and Negrin violated section 10(b) of the Exchange Act and Rule 10b-5 thereunder.²⁴ It sought a final judgment to permanently enjoin Rorech and Negrin from future violations of the federal securities laws, to disgorge all unlawful trading profits, together with prejudgment interest, and to pay civil penalties. Given the heightened scrutiny of credit derivatives that the financial crisis has generated, this case may represent the leading edge of a wave of upcoming enforcement actions involving credit derivatives.

State Developments

Missouri Insurance Bulletin

On November 19, 2008, the Missouri Department of Insurance, Financial Institutions and Professional Regulation (the “Department”) issued Insurance Bulletin 08-12 (the “Insurance Bulletin”),²⁵ which is similar to the New York Insurance Department’s Circular Letter No. 19.²⁶ The Insurance Bulletin concludes that engaging in the business of issuing covered credit default swaps in Missouri (*i.e.*, where the protection buyer has a “present legal interest in the reference entity or reference obligation”) constitutes an insurance business that requires protection sellers to obtain a certificate of authority.

The Insurance Bulletin states that January 1, 2009 is the date on which regulatory enforcement is to begin; however, it also notes that the director will exercise discretion in enforcing the insurance laws as they relate to covered credit default swaps. This is to allow an opportunity for the enactment of comprehensive federal legislation regarding credit default swaps. If compre-

hensive federal regulation of credit default swaps is adopted prior to January 1, 2009 or appears significantly likely to be adopted soon thereafter, the Insurance Bulletin states that the director may defer or suspend any or all Department enforcement actions.

As of February 4, 2009, a Department staff member confirmed that the Insurance Bulletin has not been deferred or suspended and will not be deferred or suspended in the absence of comprehensive federal regulation. However, the Department likely would defer, suspend, or withdraw the Insurance Bulletin once such federal regulation is adopted. Until such time, however, the Department staff member reaffirmed that the Department is prepared to take enforcement actions, although there has not yet been any.

NCOIL

On April 8, 2009, the National Conference of Insurance Legislators (“NCOIL”) announced that its Task Force on Credit Default Swap Regulation will draft model legislation that will allow the states to regulate credit default swaps.²⁷ The model legislation will establish strong solvency and disclosure requirements for credit default swaps, and will rely on, among other things, New York’s financial guaranty insurance statute and requirements proposed in New York Insurance Department’s Circular Letter No. 19.

In the announcement, NCOIL President Senator James Seward (NY) was quoted as follows: “While we welcome an opportunity to discuss CDS with the new Administration and with our Congressional colleagues, we believe that it is the states that must develop the regulatory framework. As we draft legislation, we would think that Congress would encourage, not override, this desperately needed reform.” Given the global nature of credit derivatives, coupled with the ongoing federal effort to adopt comprehensive regulatory reform, it is hard to imagine Congress not overriding any attempted regulation of credit default swaps on a state-by-state basis.

Conclusion

Considering the overlapping—and in some cases ill-defined—regulatory and laws and reform initiatives now being promoted, it is difficult to predict with any accuracy the final form of any new laws and regulations that ultimately may be adopted in response to the perceived problems of credit default swaps, in particular, and OTC derivatives, in general. Perhaps the most confident statement one can make is that substantial new regulations affecting credit default swaps and other OTC derivatives are likely to be enacted, though whether this will happen before year end is less certain. Still, given the unresolved debate over how credit default swaps and other OTC derivatives contributed to today's financial crisis, we face a lingering concern that such new laws and regulations might fail to address the actual underlying causes, while themselves having unintended negative effects on the financial markets. For example, do any of the proposed regulations represent a sensible response to the credit default swap-related problems experienced by AIG and the monoline insurers? Some have argued that these problems were attributable to an antiquated insurance regulatory system that was ill-equipped to regulate the complex holding company structure of an entity such as AIG. This regulatory gap which generally allowed credit default swap activities to proceed with little or no required reserves, combined with management's overconfident reliance on its triple A rating, deficiencies in internal risk controls and the impact of mark-to-market accounting, may well (when the final history is written) represent an accurate accounting of why the AIG/monoline debacle occurred. Whether any of the proposed initiatives we discuss would address these problems is open to debate. Aside from the credit default swap activities of AIG and monolines, and despite all assertions in the media to the contrary, a good case can be made that the bulk of the credit default swap market and all other segments of the OTC derivative markets functioned well during the market upheaval of 2008. Although an unprecedented number of major credit events occurred in 2008 and during the first half of 2009, indus-

try-sponsored auctions and bilateral negotiations and settlements facilitated resolution of a massive volume of outstanding credit default swaps without systemic consequences. Yet, several of the initiatives we discuss would impose dramatically heightened margin requirements on credit default swaps and many other segments of the OTC derivatives market, which could (even though not the intent) drain liquidity from a financial system already suffering from severe credit constraints. So, as the next wave of laws and regulations begin to take shape in coming months, we are left to wonder: Can the strong impulse for dramatic regulatory action be tempered by a well-informed understanding of the actual underlying causes and a concern for avoiding counterproductive effects on the financial markets? Time will tell.

A final note: As this article goes to press, we and others throughout the financial industry are busily digesting the White Paper, which provides further details on the Administration's regulatory initiatives for OTC derivatives as well as many other aspects of the financial system. It is noteworthy that earlier in June, before the White Paper's issuance, the dealer and buy-side community submitted a letter to the Federal Reserve, the OCC and numerous other regulatory authorities reporting on the progress achieved to date and planned for the near future on a host of industry-initiated programs aimed at addressing systemic risk issues in the OTC derivatives markets. Whether these initiatives, already aggressively being pursued by the financial community, will impact the drive for regulatory reform evidenced by the White Paper represents one more intriguing aspect of the legislative process that will unfold over the balance of this year.

NOTES

1. This article is based on a News Bulletin from Morrison & Foerster LLP that is available at www.mofo.com/news/updates/files/090420CreditDerivatives.pdf and is republished with permission. David H. Kaufman is a Partner and David A. Trapani is Of Counsel in the Capital Markets practice of the New York office of Morrison & Foerster LLP.
2. Treasury Secretary Geithner's written testimony is available at www.ustreas.gov/press/releases/

- [tg71.htm](#). A description of the four components of the Treasury Framework and a more detailed outline of the systemic risk component are available at www.ustreas.gov/press/releases/tg72.htm.
3. On June 17, 2009, the Treasury Department released its much anticipated white paper, titled "Financial Regulatory Reform: A New Foundation" (the "White Paper"). The White Paper's proposals regarding regulation of the OTC derivatives markets are, for the most part, identical to those proposed in the OTC Derivatives Framework. The text of the White Paper is available at www.financialstability.gov/docs/regs/FinalReport_web.pdf. For a discussion of the White Paper, please see the Morrison & Foerster LLP News Bulletin "Newton's Third Law and the White Paper" at www.mofo.com/news/updates/files/090618WhitePaper.pdf.
 4. Secretary Geithner's letter is available at <http://www.financialstability.gov/docs/OTCletter.pdf>. An outline of the OTC Derivatives Framework is available at www.ustreas.gov/press/releases/tg129.htm.
 5. Note that this is a lower qualifying standard than the one proposed in the Treasury Framework, which covered firms whose activities in OTC derivatives markets "pose a systemic threat."
 6. Note that position limits were not expressly included in the Treasury Framework.
 7. A copy of the letter is available at www.house.gov/apps/list/press/financialsvcs_dem/033009_doddfranktoobama.pdf.
 8. The text of the bill is available at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s272is.txt.pdf.
 9. The text of the bill is available at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h977ih.txt.pdf.
 10. Section 16 poorly defines the term "credit default swap" to mean "a contract which insures a party to the contract against the risk that an entity may experience a loss of value as a result of an event specified in the contract, such as a default or credit downgrade...."
 11. The text of the bill is available at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s664is.txt.pdf.
 12. The text of the bill is available at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1754ih.txt.pdf.
 13. Section 118 defines "credit-default swap" as "a bilateral derivative contract that transfers, in exchange for 1 or more lump-sum or other payments, from 1 party to another, the risk that an entity, regardless of whether owned by the buyer of the protection, may experience a loss of value from a credit event such as a default, credit downgrade, or other contractually agreed-upon adverse event."
 14. The text of the bill is available at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s961is.txt.pdf.
 15. Section 4 of the bill broadly defines "federal financial regulator" to mean the CFTC, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the SEC, and "any other Federal agency that is authorized under any provision of Federal law to regulate any financial institution or type or class of financial instrument or offering thereof."
 16. Note that the definition of "swap agreement" largely follows the same definition that is contained in the Commodity Futures Modernization Act of 2000 (the "CFMA") and retains the requirement that the swap agreement be between eligible contract participants.
 17. Most of those provisions were enacted under the CFMA.
 18. Given this broad authority, it is unclear what additional authority, if any, is intended for each federal financial regulator to "exercise oversight over" such swap agreements.
 19. In an apparent drafting error, section 3(b) uses the term "shall" instead of "may" when referring to the SEC and CFTC carrying out their respective regulatory and oversight activities that are authorized under section 3(a).
 20. The text of the bill is available at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h2448ih.txt.pdf.
 21. Note, however, that unlike the DMTAA, which requires that the financial integrity standards "shall" include a net capital requirement that is "comparable" to the net capital requirement that would be associated with the transaction

were it cleared, section 6 provides that such standards “may” include, with respect to a federally regulated financial entity for which net capital requirements are imposed, a net capital requirement that is “higher” than the net capital requirement that would be associated with the transaction were it cleared.

22. The definition of “credit default swap” in section 7(a) of the bill is substantively identical to the definition of credit default swap in section 16 of the DMTAA.
23. *SEC v. Jon-Paul Rorech, et al.*, No. 09-CV-4329 (S.D.N.Y. filed May 5, 2009). A copy of the complaint is available at www.sec.gov/litigation/complaints/2009/comp21023.pdf.
24. The SEC alleged that the credit default swaps at issue qualified as security-based swap agreements under the Gramm-Leach-Bliley Act of 2002 and were therefore subject to the antifraud provisions of section 10(b) of the Exchange Act and Rule 10b-5 thereunder.
25. A copy of the Insurance Bulletin is available at www.insurance.mo.gov/Contribute%20Documents/InsuranceBulletin08-12.pdf.
26. For a discussion of Circular Letter No. 19 and subsequent developments relating to it, please see the Morrison & Foerster LLP News Bulletin “Credit Default Swaps as Insurance: One Regulator of Many?” at www.mofo.com/news/updates/files/081006CreditDefault.pdf and the Morrison & Foerster LLP Client Alert “From TARP to ARRP: Is 2009 the Year We Get Out from Under the TARP?” at www.mofo.com/news/updates/files/090116TARP.pdf.
27. A copy of NCOIL’s press release is available at www.ncoil.org/HomePage/2009/0492009CDSCalIPressRelease.pdf.