

# Chapter 16

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## The Over-the-Counter Derivatives Market and the Credit Crisis

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\* The author wishes to acknowledge the input of J. Paul Forrester, Edmund Parker, Lawrence R. Hamilton, and David R. Sahr, partners at Mayer Brown LLP; Joel S. Telpner, a former partner at Mayer Brown LLP; and Xiaoyi Guo, an associate at Mayer Brown LLP.

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Populist politicians and press, anxious to identify villains to blame for the global credit crisis, have enthusiastically endorsed Warren Buffett's derisive 2003 "financial weapons of mass destruction"<sup>1</sup> label for derivative products. Buffett's concerns, which now ring prescient to many ears, centered on the fact that, before a derivative contract is settled, the parties to that contract record profits and losses based on mark-to-market estimates without any money having changed hands and notwithstanding the fact that some derivatives do not have a sufficient market on which to base the marks. Further, derivatives can exacerbate the problems a company may face that otherwise would have been under control. This is because of the use of requirements for collateral to be posted in the event of a ratings downgrade. First Enron and now AIG are the poster children for this conundrum: collateral triggers designed to limit counterparty credit risk can create troublesome consequences. As a rating is downgraded collateral calls are made and, as the company faces the need to post additional cash, its spiraling illiquidity leads to further ratings downgrades, additional collateral triggers, and still greater pressure on liquidity.

Alan Greenspan, former Chairman of the U.S. Federal Reserve Board of Governors ("Federal Reserve Board"), has in the past been a champion of over-the-counter (OTC) derivatives as instruments that have permitted the unbundling and dispersion of risk and thereby a reduction of systemic risk. Most observers, in fact, still tout these instruments for their efficient re-allocation of a variety of risks. For example, OTC derivatives are key building blocks in structured finance transactions insofar as they are the primary means to hedge or transfer the commodity, credit, currency, or interest rate risks inherent in those transactions. Of course, in any use of these products, the management of counterparty credit risk is

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1. Buffet Warns on Investment "Time Bomb" (Mar. 4, 2003), <http://news.bbc.co.uk/2/hi/business/2817995.stm>.

of utmost importance since true risk transfer fails if the parties to whom risk is transferred cannot perform their contractual obligations. Debate continues as to whether or not there is sufficient transparency and counterparty credit risk mitigation in the OTC derivatives market. Regardless of the outcome of the academic arguments, most acknowledge that a certain amount of legislative and regulatory attention is inevitable.

The OTC derivatives market is increasingly the policy focus of lawmakers in the United States, Europe, and elsewhere. The details of accomplishing stated policy goals of transparency and regulatory reform continue to prove elusive, however, and the various legislative proposals to date leave many questions unanswered. It will be important that the political need to provide a timely response to concerns about transparency and counterparty credit risk be balanced against the need to address the complications that will necessarily be involved in redesigning a complex and global OTC derivatives market in a responsible manner. This chapter will examine proposed legislative and regulatory developments involving OTC derivatives as well as industry efforts that are likewise afoot.

The developments in the United States have been frequent and myriad and thus comprise a large portion of this discussion, but that is not to give the impression that foreign officials are not similarly focused on these issues. Note, for example, that European regulators compelled industry participants to commit to CDS clearing in the European Union a full year before it turned to rule proposals. Meanwhile, in the United States, legislative proposals have been intertwined with industry commitments with respect to a variety of OTC derivatives reform goalposts. While none of these developments is the final word on what can be expected in the future, each signifies the march toward an imminent broad financial system overhaul, potentially on a multi-jurisdictional basis.

### **§ 16:2 U.S. Congressional Activities and the Obama Administration's Directives**

In the period from the beginning of this year until mid-August, when this chapter was written, three Congressional bills were introduced with the aim of increasing regulatory limitations on the OTC derivatives market, and a fourth was passed by the U.S. House of Representatives. On January 15, the Derivatives Trading Integrity Act of 2009 (DTIA), sponsored by Senator Tom Harkin (D-IA), was introduced to the 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.

On May 13, U.S. Treasury Secretary Timothy Geithner outlined the Obama Administration's goals for the regulatory framework for OTC derivatives. Then, on June 17, the Treasury Department published its proposed regulatory overhaul for the U.S. financial system in a document entitled, "Financial Regulatory Reform: A New Foundation."<sup>2</sup> Finally, on June 26, the House of Representatives narrowly passed the American Clean Energy and Security Act of 2009 (ACES), which, though focused on clean energy reforms, incorporates important regulatory limitations on derivatives.

### **§ 16:2.1 Over-the-Counter Derivatives Markets Act of 2009 ("OTC Act")**

On August 11, 2009, the Treasury Department sent to Congress its legislative language, the Over-the-Counter Derivatives Markets Act of 2009 ("OTC Act"), for the regulation of the OTC derivatives market. The OTC Act, contained in 115 double-spaced pages, is far-reaching and intended by the Obama Administration to establish a comprehensive regulatory scheme for the OTC derivatives market and major participants in that market. Consistent with the Treasury Department's policy framework, the OTC Act would provide for regulation and transparency for all OTC derivative transactions, prudential and business conduct regulation of all OTC derivative dealers and other major market participants, and expanded regulatory and enforcement tools intended to prevent manipulation, fraud and other abuses in that market. Furthermore, if its key provisions are enacted, the proposed legislation will represent a sea change in the way that the OTC derivatives market will operate going forward. ACES and the OTC Act may be the best indications, among all the summer's activities and statements, of what is becoming abundantly clear: OTC derivatives will be subject to new legislation in the United States in the near term.

### **§ 16:2.2 DTIA**

The DTIA proposed to amend the Commodity Exchange Act (CEA) by repealing the exemptions or exclusions from regulation currently afforded to specified derivatives, requiring all futures con-

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2. Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation (2009), available at [www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

tracts (including virtually all OTC derivatives) to trade on a designated contract market or a derivatives transaction execution facility, and abolishing exempt boards of trade.

### **§ 16:2.3 DMTA**

The DMTA would subject OTC derivatives to reporting and recordkeeping requirements as determined by the Commodity Futures Trading Commission (CFTC). The bill's proposals 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 aimed to subject prospective OTC transactions either to settlement and clearing on a CFTC- or Securities and Exchange Commission (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.

### **§ 16:2.4 ARSA**

ARSA, the most recent legislative proposal from a Congressional committee, would repeal current exemptions and exclusions afforded to derivative products and grant federal regulators authority to regulate all types of OTC and exchange-traded derivatives, without exception, immediately. The sponsors of this bill offered it as an interim step, paving the way for anticipated comprehensive financial reform later in the year.

### **§ 16:2.5 U.S. Treasury Department Proposals**

On May 13, the Obama 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."<sup>3</sup> Second, he recommended that all OTC derivatives dealers

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3. Letter from Timothy Geithner, U.S. Treasury Secretary to Harry Reid, U.S. Senate (May 13, 2009) (on file with author), *available at* [www.financialstability.gov/docs/OTCletter.pdf](http://www.financialstability.gov/docs/OTCletter.pdf).

and others who create large exposures to counterparties be subject to “a robust regime of prudential supervision and regulation.”<sup>4</sup> Next, Secretary Geithner proposed 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.<sup>5</sup> Finally, he noted 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.

Then, in June, the Treasury Department published its proposed regulatory overhaul for the U.S. financial system in a document entitled, “Financial Regulatory Reform: A New Foundation.” Outlining the view that OTC derivatives markets, including credit default swaps, ought to be subject to comprehensive regulation, the proposal fell in line with piecemeal elements that have been discussed since the Obama Administration first announced its ambitions for financial regulatory reform. 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 proposal shared many similarities with Secretary Geithner’s May 13 outline of regulatory principles for OTC derivatives but also contained important new developments.

### **§ 16:2.6 ACES, The OTC Act, and Key Parts of the Legislative Agenda**

ACES, although the U.S. Senate is not expected to consider complementary legislation until the fall, may reflect greater Congressional consensus around OTC derivatives legislation than the introduced bills discussed above. First, ACES is presented as a clean energy bill and most of its 1,400-plus pages relate to climate change and renewable energy issues, including with respect to the regulation of trading the related emissions allowance and renewable credit derivatives; however, it also would amend the CEA to place eligibility limitations on entering into a CDS. In particular, if ACES became law, one would not be permitted to enter into a CDS unless one owned a credit instrument insured by the CDS, had exposure to financial loss if an event referenced by the CDS occurred with respect

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4. Letter from Timothy Geithner, *supra* note 3.

5. *Id.*

to it, and met minimum capital adequacy standards that could be established by the CFTC in consultation with the Federal Reserve Board. ACES also would eliminate the CEA's preemption of state gaming and "bucket shop" laws that would have the effect of prohibiting naked CDS (CDS in which the buyer of protection does not own the obligation that is the subject of the trade). In sum, these provisions are an end run around direct discussions about OTC derivatives reform, embedded in the shroud of climate change.

As its title might suggest, ACES does address emissions allowance and renewable credit derivatives as well. If enacted, the provisions addressing these products would direct an interagency working group to submit a written report to the President and Congress with recommendations to the CFTC for proposed regulations for the oversight of markets for regulated allowance derivatives. There are also provisions to eliminate current exemptions for OTC derivatives involving energy commodities, which are defined as coal, oil, gas, electricity, natural gas, and other substances used as sources of energy as determined by the CFTC.

The OTC Act would implement the four main objectives set forth in the Treasury Department's framework for OTC derivatives regulatory reform. First, the legislation seeks to guard against activities seen as posing excessive risk to the financial system. Next, the legislation aims at increasing transparency and efficiency. Third, the legislation is designed to prevent market manipulation, fraud, insider trading, and other market abuses. The final stated goal is to block OTC derivatives from being marketed inappropriately to unsophisticated parties.

Starting with regulatory authority, the essential foundation of the OTC Act, there are several potential issues. The current U.S. regulatory regime with respect to derivatives is quite complex, though it was clarified with respect to most OTC products by the Commodity Futures Modernization Act of 2000 (CFMA). The proposed legislation directs the CFTC and the SEC jointly to prescribe "uniform" rules and regulations. The SEC would regulate security-based swaps and credit derivatives referencing a single security or issuer or a narrow group of securities, while the CFTC would regulate credit derivatives referencing broad-based indices as well as all other OTC derivative products.

The OTC Act would repeal many provisions of the CFMA, which currently exempt (many, if not most) swaps from regulation, and remove existing limitations on both the CFTC's and the SEC's jurisdiction with respect to certain derivatives, including with respect to swaps between eligible contract participants. The proposed legislation would also amend the Securities Act of 1933 ("1933 Act") to include security-based swaps within the definition of "secu-

rity.” Further, the OTC Act would amend the Securities Exchange Act of 1934 (“1934 Act”) by eliminating the current preemption of state law, including state gaming and “bucket shop” laws, in relation to security-based swaps that are not between eligible contract participants or effected on a national, registered securities exchange, thereby rendering such security-based swaps subject to such state laws.

### **[A] Prudential Regulators**

In addition to product-level regulatory supervision, participants would also be subject to potentially (and even likely) overlapping registration, regulatory, and supervision requirements. Swap dealers and major swap participants that are banks will continue to be regulated by their current federal bank regulatory agencies (defined as “Prudential Regulators” by the legislation). The CFTC and the SEC are prevented from prescribing rules imposing prudential requirements on entities for which there is a Prudential Regulator, but that limitation would not limit the authority of the CFTC and the SEC to prescribe appropriate business conduct, reporting, and record-keeping requirements where required to protect investors. In addition, federal banking agencies generally would retain exclusive regulatory authority in relation to identified banking products (presumably as such term is defined in section 206 of the Gramm-Leach-Bliley Act of 1999) unless an appropriate federal banking agency determines, in consultation with the CFTC and the SEC, that a product is a swap or security-based swap, or has been structured as an identified banking product in order to evade provisions of the Commodity Exchange Act, the 1933 Act or the 1934 Act.

The OTC Act would require swap dealers or major swap participants to register with the CFTC irrespective of whether the person is also a bank or is registered with the SEC as a security-based swap dealer or a major security-based swap participant. A “swap dealer” is defined as a person engaged in the business of buying and selling swaps for its own account, but excludes a person that does not engage in that activity as part of a regular business. A “major swap participant” is defined as any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, but excludes a person who engages in such activity to maintain an effective hedge under generally accepted accounting principles, a narrow and unclear criterion for the wide range of parties that hedge for risk management and cost containment purposes. Parallel definitions apply to “security-based swap dealer” and “major security-based swap participant.”

In addition to possible dual registration, registered swap dealers, major swap participants, security-based swap dealers, and major se-

curity-based swap participants would be required to meet prudential requirements consisting of minimum levels of capital and margin. U.S. banks (including U.S. branches and agencies of foreign banks) would need to meet the requirements set jointly by the Prudential Regulators, and non-banks would need to meet those set jointly by the CFTC and the SEC. The relevant Prudential Regulator would impose capital requirements for cleared swaps and security-based swaps, as well as initial and variation margin requirements for all swaps and security-based swaps that are not cleared by a registered derivatives clearing organization or registered clearing agency. The Prudential Regulators may, but are not required to, impose margin requirements with respect to swaps where: (i) one counterparty is not a swap dealer or major swap participant; (ii) that party is predominantly engaged in non-financial activities; and (iii) it is using the swap as part of an effective hedge under generally accepted accounting principles, again a narrow and unclear category. As discussed below, the capital requirements for swaps and security-based swaps that are not cleared are required to be higher than those set for cleared products. The CFTC and the SEC are directed to impose capital and margin requirements as strict as, or stricter than, those set for banks by the Prudential Regulators. The legislation also provides that the Federal Reserve Board should set capital requirements for OTC derivatives of bank holding companies and Tier 1 financial holding companies on a consolidated basis that would be as strict as, or stricter than, the capital requirements set by the Prudential Regulators.

### **[B] CFTC and SEC**

Under the OTC Act, the CFTC and the SEC are to jointly adopt uniform rules governing persons registered as swap dealers or major swap participants and persons that are registered as security-based swap dealers or major security-based swap participants, with the Treasury Department as the “default” rulemaking body if they fail to do so. Registrants would be required under any such rules to meet the minimum capital and margin requirements noted above. In addition, they would issue rules establishing various reporting and recordkeeping requirements, certain business conduct requirements as well as documentation and back-office requirements, notably including valuation of swaps or security-based swaps. As noted, these rules could also apply to banks.

Regulatory jurisdiction has always been and continues to be a central theme of discussions regarding derivatives. 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 overlap-

ping authority of the SEC and CFTC. As noted in the Treasury's framework:

[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.<sup>6</sup>

Therefore, one of the stated goals of the Treasury 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 relevant instrument or market. In line with that goal, the Treasury Department asked 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 must 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, 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.

Market participants have regarded this as an important new development because historically it has been uncertain whether the political appetite existed to address directly the jurisdictional tug-of-war 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 widespread speculation in this regard. 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 financial system reform, 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

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6. Financial Regulatory Reform, *supra* note 2.

products loomed large, only to be complicated as products such as carbon emissions derivatives are introduced into the U.S. market. In May, 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.

Following the issuance of Treasury's June proposal, the heads of the SEC and CFTC affirmed their willingness to work together to better delineate the respective responsibilities of each agency over the vast derivatives market. They commented that the SEC should continue to have responsibility with respect to derivatives linked to stocks, bonds, and securities and that the CFTC should oversee all other derivatives. Of course, this simply set the stage for the difficult task to follow in addressing all of the overlapping and conflicting laws and regulations to which many derivatives are subject. The new directive that the two agencies identify and resolve conflicts is at least an important recognition of the need to harmonize these conflicts, once and for all.

Notwithstanding earlier signals that oversight of the OTC derivatives market might rest with a central regulatory body or, more recently, that multiple and overlapping registrations and requirements might not be imposed, the OTC Act appears to catapult the OTC derivatives market into new and untested waters that potentially will result in worse conditions than expected. First, registration with one regulatory body would not obviate the need for registration with, or regulation and supervision by, the others. Second, product-level requirements would divide a large market participant's activities into categories that may be subject to differing rules depending on the particular regulatory body having oversight. While the OTC Act directs the CFTC and the SEC to jointly prescribe uniform rules for registrants and for products, that process is likely to yield something much less than true uniformity since the rules would be based in different statutory structures and, over time, interpreted and enforced by separate regulatory bodies, who have a long history of antagonistic coexistence.

### **[C] Clearing**

The first key product-level proposal relating to OTC derivatives is required clearing. During the current credit crisis, OTC derivatives have been viewed as operating in the shadows of legitimate financial markets. Clearing is the oft-quoted solution to this perceived lack of transparency. ARSA did not specifically require clearing but instead gave broad authority to regulators to work with one another on the consistent treatment of derivatives. The Trea-

sury framework recommended that all standardized OTC derivatives be cleared through regulated central counterparties (CCPs) and that the acceptance of an OTC derivative by one or more CCPs should create a presumption that it is a standardized contract. It elaborated that the standardized part of the OTC market should be moved onto regulated exchanges and regulated transparent electronic trade execution systems. In prepared testimony before the House Financial Services and Agriculture Committees on July 10, Secretary Geithner stated that “a high volume of transactions in a contract and the absence of economically important differences between the terms of the contract and the terms of other contracts that are centrally cleared” would be one indicator that it is standardized.<sup>7</sup>

What has not been clear is what other parameters would establish whether a product is “standardized” and, once that is determined, which contracts should be cleared by CCPs, traded on an electronic trading platform, or quoted on a regulated exchange. None of the Congressional committee bills nor the Treasury framework identified who—market consensus, individual participants or a regulator—would determine whether a derivative is standardized. Secretary Geithner’s comments prior to delivering the OTC Act suggested that there would not be a product- or participant-based approach for making this determination.

Secretary Geithner also suggested that regulated institutions be encouraged to make greater use of regulated exchange-traded derivatives. Which derivatives would be required (versus elected) to be traded in a certain manner was an important unresolved issue. Of course, all these questions arose without getting to the question of whether certain OTC derivatives are suitable for any of these trading options in the first instance. The OTC derivatives industry has already indicated that substantial portions of the OTC derivatives market are only made “electronically eligible” with difficulty and perhaps for some products it may not be possible as a practical matter. The Congressional committee bills, the Treasury proposals, and the OTC Act have lumped all OTC derivatives together and suggested the same (or substantially similar) treatment.

The OTC Act delivers on the Treasury Department’s stated policy goals by requiring all “standardized” OTC derivatives to be centrally cleared toward the goal of reducing risks to financial stability that are currently said to arise from “the web of bilateral connec-

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7. Press Release, Secretary Timothy F. Geithner before the House Financial Services and Agriculture Committees Joint Hearing on Regulation of OTC Derivatives (July 10, 2009), *available at* [www.treas.gov/press/release/tg204.htm](http://www.treas.gov/press/release/tg204.htm).

tions among major financial institutions.”<sup>8</sup> The proposed legislation would require standardized swaps to be centrally cleared by a derivatives clearing organization registered with the CFTC or, in the case of standardized security-based swaps, by a securities clearing agency registered with the SEC. In order to promote transparency, standardized swaps also would have to be traded on a CFTC- or SEC-regulated exchange or, for eligible participants, on a CFTC- or SEC-regulated alternative swap execution facility, unless such trades were entered into between eligible contract participants. The clearing requirements would not apply if no registered derivatives clearing organization will accept the swap for clearing or one of the counterparties to the swap is not a swap dealer or major swap participant and does not meet the eligibility requirements of any derivatives clearing organization that clears the swap. There would be similar treatment of security-based swaps if no registered clearing agency will accept it for clearing or one party is not a security-based swap dealer or major security-based swap participant and does not meet eligibility requirements of any registered clearing agency that clears the transaction. Market participants have already questioned whether and, if so, how clearing eligibility standards might be affected as a result of these requirements.

#### **[D] Standardized Versus Customized**

Though market watchers had hoped for clarity around what is “standardized” versus “customized,” the OTC Act proposes a broad definition of standardized OTC derivatives that is reportedly designed to evolve with the markets. As has been stated by the Treasury Department previously, a swap that is accepted for clearing by any regulated central clearinghouse will be presumed to be standardized. However, the CFTC and the SEC are to jointly define the term “standardized” as broadly as possible after taking into account the following factors: (i) the extent to which any of the terms of the swap, including price, are disseminated to third parties or are referenced in other agreements, contracts, or transactions; (ii) the volume of transactions in the swap; (iii) the extent to which the terms of the swap are similar to the terms of other agreements, contracts, or transactions that are centrally cleared; (iv) whether any differences in the terms of the swap, compared to other agreements, contracts, or transactions that are centrally cleared, are of economic significance; and (v) any other factors the CFTC and the SEC determine to be appropriate.

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8. *Id.*

Both parties who enter into swaps that are not accepted for clearing would need to report such transactions to a registered swap repository, the CFTC, or the SEC. In addition, the CFTC and the SEC would be given authority to prevent attempts by market participants to use “spurious” customization to avoid central clearing and exchange trading. Higher margin requirements and higher capital requirements will apply to customized swaps in order to encourage greater use of standardized swaps and substantial migration of OTC derivatives onto central clearinghouses and exchanges.

The Treasury Department has repeatedly stated that “customized” OTC derivatives should not be used to avoid using a central clearinghouse, but also consistently declined to specifically define “standardized” versus “customized.” The OTC Act now provides a rationale for that gap (for example, market evolution) and more time to provide further details (for example, joint or at least “uniform” definitions by the CFTC and SEC). While it is still unclear what parameters would establish whether a product is standardized, it appears that the CFTC and/or the SEC could determine whether and how to classify a derivative as standardized, since they will be the arbiters of whether “spurious” customization is taking place. One confounding conundrum that seems to be developing is the concern that clearinghouses have expressed that they cannot properly manage the risk of products forced into clearing before understanding whether they are standard. The proposed legislation would appear to leave that to market evolution and joint CFTC-SEC resolution. A somewhat daunting concern is market participants’ need for a few bespoke terms in a trade for legitimate business reasons might make it inappropriate for clearing, and therefore be singled out by regulators as an attempt to avoid otherwise required clearing. Another question raised is how trades will be grouped. If some interest rate swaps are deemed to be standardized, will all follow suit? Will parties need to obtain regulatory guidance to identify in advance the likely classification of each trade and its status as standardized or customized? What costs to innovation might be imposed by this legislation?

### **[E] Informational Transparency**

In addition to clearing, greater access to information has been viewed as a driver of market transparency for OTC derivatives. Thus, a secondary theme to the Treasury framework and the OTC derivatives reform bills that have been introduced in Congressional committees is recordkeeping/reporting. Secretary Geithner’s proposal was that the CFTC and SEC should have the authority to impose recordkeeping and reporting requirements on all OTC derivatives in order to make trading in the products more transparent and efficient.

He has in the past included 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. 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.

The Obama Administration's proposed legislation would require swap repositories (and security-based swap repositories) to provide regulatory agencies with access on a confidential basis to OTC derivative transactions and related open positions of individual participants and grant to the public access to aggregate data on open positions and trading volume. The described duties of a swap repository (or a security-based swap repository) are to accept, maintain, and make available swap data as prescribed by the CFTC or the SEC, and such bodies would be subject to inspection and examination. The CFTC and the SEC are to jointly adopt uniform rules governing entities that register as swap repositories or security-based swap repositories. In addition, each of the CFTC and SEC is permitted to exempt from registration any swap repository subject to comparable, comprehensive supervision or regulation by another domestic or foreign regulator.

### **[F] Capital and Margin**

As discussed, it remains unclear how standardized trades will be distinguished from those that are customized. One of the practical implications of this distinction is what margin will be imposed. 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, suggested that the conservative margin requirements proposed could be imposed on customized OTC derivatives in this regulatory regime on a comparable basis to the margin rules for 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. In Secretary Geithner's comments on July 10, he stated that derivative contracts that are not centrally cleared must have margin requirements "substantially above" those that are centrally cleared.<sup>9</sup>

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9. *Id.*

The OTC Act seeks to ensure the supervision of all OTC derivatives dealers and other major market participants. Under the legislation, bank participants would be regulated by the federal banking agencies, while non-banks would be regulated by the CFTC or the SEC. All OTC derivative dealers and major market participants would be subject to strict capital and margin requirements imposed by their respective regulators. The CFTC and SEC would be required to issue and enforce strong business conduct, reporting and recordkeeping rules with respect to these entities. While banks have already been subject to prudential regulation and supervision, including with respect to their use of OTC derivatives, their non-bank counterparts that take large positions in this market would join the family of regulated OTC derivative market participants. All would face the newly minted capital and margin, business conduct, and recordkeeping requirements. As a practical matter, particularly in light of the more deliberative pace of similar discussions abroad, if the capital or margin requirements that are required represent more than the economic capital that the related derivatives positions should have, the related trades will simply move to a jurisdiction or to a forum where the “excessive” capital or margin requirements do not apply.

### **[G] Policing Market Abuse**

Another issue that has been mentioned in Congressional reform bills and in Mr. Geithner’s remarks is the prevention of market manipulation, fraud, and other market abuses. In its May 13 letter, as well as in the OTC derivatives proposals in the financial system reform outline, the Treasury Department recommended that Congress 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. The Treasury Department’s proposals on this point were not detailed; instead, a reference to giving the CFTC and SEC broad and apparently unfettered authority to police fraud, market manipulation, and other market abuses involving OTC derivatives laid the foundation for such measures.

In the current environment, speculators are viewed as causing harm to financial markets. Thus, Secretary Geithner proposed that the CFTC should have authority to set position limits on OTC derivatives that have a price discovery function relating to regulated markets in order to constrain the activities of speculators. It is not clear how derivatives with a price discovery function would be identified and correlated with the regulated markets to which they are purportedly related. It is assumed that information provided to regulators (whether on a voluntary or mandatory basis) by the combi-

nation 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 might be categorized and what would distinguish trades that are voluntarily reported versus those that are reported by mandate.

The OTC Act would indeed give both the CFTC and the SEC authority to set such aggregate position limits and large trader reporting requirements for OTC derivatives within their purview. The position limits that may be set by the CFTC and the SEC are unclear because they are stated as applying across a variety of enumerated contracts and persons, rather than across positions held by a particular person. This raises the question of how broad the groupings of persons or contracts will be under this regime. Will position limits across contracts or multiple persons choke the flow of hedging and legitimate trading by unrelated parties?

As derivatives practitioners well know, current law limits the types of parties that may participate in unregulated derivatives. The Treasury Department under the Obama Administration holds the view that the limits are not sufficiently stringent. Thus, the CFTC and SEC have been 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. In line with this effort, the OTC Act would narrow the definition of who may engage in OTC derivatives in an effort to protect individuals and small municipalities. In particular, if a governmental entity or political subdivision of a governmental entity, or an instrumentality, agency, or department of such an entity, seeks to qualify as an eligible contract participant on the basis of the investments it owns and invests on a discretionary basis, the threshold amount would be raised from \$25 million to \$50 million. Individuals would no longer be judged on the basis of total assets but on the basis of amounts invested on a discretionary basis.

### **[H] Long Arms of Jurisdiction**

While the OTC Act seems likely to add impetus for OTC derivatives market participants to seek more welcome shores, if they, their counterparties, or the products in which they transact touch the United States, there are questions raised about whether the proposed legislation can be left behind. On a general level, the OTC Act is not explicit about extraterritorial jurisdiction or application outside the United States. The Prudential Regulators would have exclusive authority to enforce prudential requirements of the OTC Act with respect to banks and U.S. branches or agencies of foreign banks that are swap dealers, security-based swap dealers, major

swap participants, or major security-based swap participants. In addition, the CFTC is authorized to adopt rules and regulations requiring the registration of foreign boards of trade that provide members and market participants located in the United States with direct access to its electronic trading and order matching system. Foreign boards of trade would be prohibited from providing members or other market participants located in the United States with direct access to the electronic trading and order matching systems of the foreign board of trade with respect to a contract that settles against the price of a contract listed for trading on a CFTC-registered entity unless the CFTC determines that the foreign board of trade meets certain standards that are comparable to the requirements applicable to U.S. boards of trade.

Because the underlying statutes reach entities that use U.S. jurisdictional means to do business with U.S. persons, in the absence of exemptions, non-U.S. entities, such as the non-U.S. offices of foreign banks, that do business with persons in the United States could be required to register with the SEC or the CFTC if they meet the definition of either swap dealer or major swap participant. Moreover, the SEC's and the CFTC's prudential, market practices and antifraud requirements could then apply to the registered entity on a global basis, not just to transactions involving U.S. persons. Non-U.S. banking entities would also not appear to be eligible for an exemption as an entity regulated by a Prudential Regulator because they are regulated by their home country authorities, not by U.S. banking regulators (except to the extent of their U.S. branches and agencies). The legislation should be modified at the minimum to limit extraterritorial effects and ideally it would recognize as Prudential Regulators those regulators from jurisdictions that implement comparable or stricter limits on derivatives activities.

Moreover, while the U.S. branches and agencies of foreign banks would have Prudential Regulators, nothing in the OTC Act indicates that the non-U.S. offices of such foreign banks would be exempt from other requirements of the OTC Act, even with respect to their non-U.S. business. Any final legislation should also be clarified to limit any extraterritorial impact on a foreign bank resulting from the registration of its U.S. branches or agencies with the CFTC or the SEC.

## **[I] Next Steps in the Legislative Process**

Notwithstanding the largely uninterrupted and efficient operation of OTC derivative markets during the recent financial distress, the momentum for greater regulation of derivatives and OTC products in particular appears to be building. The language of the OTC Act may not be the final word in achieving the goal of appropriate

and clear legislative action and regulatory supervision, but its distribution to Congress will now add to the pressure on the House and the Senate to work on legislation. As with other reform initiatives, it is likely that the Senate will not act as quickly as the House and probably will not consider these issues until after the House has acted because of other priorities in the Senate.

It is notable that the plan that had been proposed by Representatives Barney Frank, chairman of the House Committee on Financial Services, and Collin Peterson, chairman of the House Committee on Agriculture, would not create such heavy burdens as those imposed by the Obama Administration's legislative language, particularly in attempting to drive all "standardized" OTC derivatives onto regulated exchanges. As the chairmen of the key House committees with responsibility for the CFTC and the SEC, their views will be important in shaping the final version of the House bill. In addition, the New Democrat Coalition ("New Dems"), a group of moderate Democratic members of Congress, has proposed a new agency within the Treasury Department for the oversight of OTC derivatives, under the Derivatives Trading Accountability and Disclosure Act of 2009. The New Dems' proposal would increase regulation and reporting requirements placed on the derivatives market, while still allowing for customized and OTC derivatives trading. They state as their goals greater protection, while maintaining an active derivatives market that encourages investment, economic growth, and job creation.

Now that the Administration's themes have been translated into legislative language, the debate has begun in earnest. We hope to learn soon whether a balance will be struck with appropriate legislation that will preserve the breadth, depth, and innovative flexibility of the OTC derivatives market in the United States and facilitate its future growth and evolution to meet the needs of U.S. participants.

### **§ 16:3 Return of CDS Versus Insurance Debates**

One major open issue involving OTC derivatives relates specifically to 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. On September 22, 2008, the New York State Insurance Department issued Circular Letter No. 19, announcing that on January 1, 2009 the Department would start treating covered CDS as insurance contracts under the New York Insurance Law. That effort was tabled when OTC derivatives began to take a place on the federal financial reform agenda. In June of this year amendments drafted by the Department were introduced in the New York legislature. Those

amendments would exempt CDS from insurance regulation, provided that the New York Insurance Department determines that CDS are otherwise being “effectively and comprehensively regulated,” including by requiring CDS writers to maintain adequate capital and post sufficient trading margins to minimize counterparty risk.

The Division of Insurance of the State of Missouri (whose state slogan is “I’m from Missouri, and you’ve got to show me”) has taken an even more activist role than the New York Insurance Department. On November 19, 2008, the Division issued Bulletin No. 08-12, providing that covered CDS are insurance contracts and that issuing covered CDS in Missouri constitutes an insurance business that requires a certificate of authority from the Division. The Division has so far refused to suspend its effort to regulate covered CDS, citing as its reason the fact that no comprehensive federal regulatory scheme has yet been put in place.

Meanwhile, the Task Force on Credit Default Swaps of the National Conference of Insurance Legislators (NCOIL) has been drafting model legislation that would classify covered CDS as “credit default insurance” and regulate the issuers of covered CDS as “credit default insurance corporations” along the lines of financial guaranty insurance corporations (often called “monolines”). Among other things, the NCOIL Task Force’s draft proposal would require credit default insurance corporations to maintain contingency reserves against their CDS exposures. The Task Force presented its proposed model legislation to the NCOIL Financial Services and Investment Products Committee on July 9. After two hours of testimony and debate, the NCOIL Task Force’s draft proposal, which has been sharply criticized by industry participants, was tabled until NCOIL’s annual meeting in November. Even if the proposal is eventually adopted as model law by NCOIL, it is unclear whether it would be enacted into law by state legislatures. Further, with states like New York and Missouri acting separately to address whether CDS transactions have a place in insurance regulation, an unfortunate patchwork of insurance laws relating to CDS could emerge. On the other hand, the ACES bill approved by the U.S. House of Representatives is an example of federal legislative action with respect to OTC derivatives in general and CDS in particular that could alter or obviate the perceived need for action by state insurance regulators and legislators.

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 would no longer be justifiable or financially worthwhile. None of the proposals address the 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.

#### **§ 16:4 Across the Pond**

Derivatives have received no less scrutiny in Great Britain and Europe than in the United States. In 2008, major derivatives dealers signed a commitment concerning the establishment of a central clearing counterparty for CDS in Europe. The central clearing platform is to be established, regulated, and supervised in Europe by July 31 of this year. While central clearing is technically voluntary, the pressure from regulators to increase transparency and mitigate counterparty credit risk, which led to this commitment, was brought home through explicit mention of regulatory intervention as an alternative. This pressure has only intensified and become more widespread with growing scrutiny of the credit crisis and the market that is believed to be one of its major causes. At a meeting of the European Commission's Derivatives Working Group in early July, two clearinghouses, Eurex and ICE, stated that they would be ready to clear index and single name CDS by the July 31 deadline. While the European Commission was pleased to hear that report, it stressed the importance of the industry's ability to meet the deadline.

In March of this year, Britain's Financial Services Authority (FSA) published the Turner Review, in which Lord Turner, Chairman of the FSA, reviewed events leading to the current financial crisis and recommended reforms intended to address steps that the international community could take to enhance regulatory and supervisory standards and international coordination. One area of focus for the Turner Review was the complexity and opacity of structured credit and other derivatives, with an emphasis on the exaggerated effect that CDS can exert upon boom and bust cycles. The Turner Review was accompanied by Discussion Paper 09/2 (DP 09/2), which outlined detailed policy proposals, including consideration of revised capital requirements, regulated collateral calls, and additional product-specific regulation.

Regulators in Europe had not yet issued proposed rules by the publication of the Turner Review and DP 09/2, but the relatively early date by which market participants committed to central clearing for CDS reveals the serious tone that has been taken there for some time. In a report published in February of this year, Jacques de Larosière, a former French Treasury official, recommended the sim-

plification and standardization of most OTC derivatives and the introduction and use of at least one well-capitalized central clearinghouse for CDS in the EU. On the heels of that report, in March of this year the European Parliament and European Council initiated a report that was designed to identify regulatory gaps with respect to derivatives. That report was announced on July 3, and the European Commission is expected to make rule proposals on the basis of that report as a matter of priority. The outline recommended a greater use of standardized contracts, central data repositories, public exchanges, and clearinghouses through which market participants can post and have the benefit of collateral. While welcoming the industry efforts toward the central clearing of CDS, the European Commission pointed out its consideration of stronger incentives to use CCPs either by changing regulatory capital rules or by introducing European legislation. A consultation period was followed by a European Commission hearing on September 25, and legislation is expected in 2010. It is noteworthy that this report strikes similar notes as those sounded by the U.S. Treasury and Congress.

Previously, European regulators had considered a voluntary code of conduct for the derivatives market. This would have required equity exchanges and clearing houses to offer pricing transparency and a greater choice of services. It is now believed that a mandatory code is on the table. It is important to note that, from the time the voluntary, though pressured, commitment to CDS clearing was made, the European Commission has escalated its attention to, and willingness to act on, perceived weaknesses in the derivatives market. It is clear that, while the commitments from industry have been welcomed, the book being written on the regulation of derivatives is far from complete.

### **§ 16:5 Cleaning House**

Though it seems certain that the regulatory landscape for OTC derivatives will change in both the United States and in Europe, it will not have been because of a lack of industry-driven efforts to establish and maintain good order. The industry has taken significant steps to increase transparency and fungibility for these products over many years but with greater resolve as the credit crisis deepened.

One of the major areas of recent focus for the derivatives industry, both of its own volition and due to regulatory attention, has been CDS. Whether warranted or not, AIG's large exposures to CDS are in part to blame for this level of attention. Moreover, the Federal Reserve Bank of New York ("New York Fed") has for some years raised concerns about settlement risk in the CDS market. The exponential growth in volume of CDS transactions resulted in the notional amount of CDS written on heavily traded underlying cred-

its becoming many multiples of the outstanding principal amount of debt available for purchase. Since the buyer of protection in these mostly physically traded transactions would need to deliver debt of an underlying reference entity in order to settle "Credit Events" (defined below), there were concerns that the unavailability of sufficient debt could result in an inability to settle a large number of transactions. These concerns came to a head in the fall of 2005, when the trading price of Delphi bonds far exceeded the bond price that would be merited for a bankrupt auto parts manufacturer in standard distressed trading conditions. The spike in trading price had been caused by credit protection buyers chasing after a limited amount of Delphi debt to deliver under their physically settled CDS contracts. Once the settlement period had passed, debt trading prices fell back to expected levels. Credit protection buyers and sellers had traditionally shunned cash settlement, lacking confidence that the mechanism contained in the 2003 International Swaps and Derivatives Association, Inc. (ISDA) Credit Derivatives Definitions ("Credit Derivatives Definitions") would produce a fair result. Now, credit protection buyers had suffered under physical settlement, and a solution was required (not least because the explosion in outstanding credit derivatives contracts versus outstanding debt made the outcome for Delphi likely to be the future norm).

As if the solution needed a greater sense of urgency, a period that had seen very few credit events gave way to the beginning of what became a very troubled credit cycle. Beginning with the bankruptcy filing of Collins & Aikman Products Co. in May of 2005, ISDA began publishing protocols that facilitated multilateral amendments to remove physical settlement and replace it with an auction process to generate a cash settlement amount for trades subjected to each protocol. Once there was consensus that a Credit Event had occurred with respect to heavily traded underlying credits, ISDA typically published a protocol to allow parties wishing to participate in the protocol to amend their trades from physical settlement to an auction procedure, and, pursuant to an agreement with Markit Group Limited (Markit), Markit subsequently conducted an auction to determine the price that would be used to calculate cash settlement amounts. The first several of these protocols only covered index CDS due to the high volume of those trades and standardized terms governing them, and thus only derivatives dealers participated. Over time, Credit Events began to occur with respect to single name CDS with higher trading volumes, and pressure mounted to include a wider range of the market. As the pace of Credit Events began to quicken, ISDA began facilitating meetings among major dealers and large hedge funds to develop an auction mechanism that could, in the future, be embedded in the standard CDS.

**§ 16:5.1 Auction Supplement**

The mechanism established in the ISDA CDS protocols was eventually hardwired into credit default contracts through the ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement (“Auction Supplement”), which was published in April of this year. Under the Auction Supplement, newly established ISDA Credit Derivatives Determinations Committees (“Determinations Committees”), at the request of market participants, may make determinations as to whether payment defaults or bankruptcies (“Credit Events”) have occurred with respect to an issuer of debt obligations (a “Reference Entity”), whether an auction will be held, and whether an obligation is deliverable in settlement of credit default swaps covering that Reference Entity. Determinations Committees also determine whether certain recapitalization, mergers, spin-offs, or similar events (“Succession Events”) with respect to Reference Entities have occurred.

Determinations Committees have been established on a regional basis. Each Determinations Committees is comprised of both dealer and buy-side representatives. To increase transparency, after each meeting the applicable Determinations Committees publishes on the ISDA website all of its decisions as to whether or not a Credit Event or Succession Event has occurred with respect to a designated Reference Entity. The Auction Supplement “hardwires” the auction procedures as well as the Determinations Committees rules by amending the Credit Derivatives Definitions. Thus, parties are able to incorporate these terms into their future transactions by incorporating the Credit Derivatives Definitions (unless they otherwise specify) into their trades.

In addition to the introduction of Determinations Committees and hardwiring auction settlement as the method of settlement, the Auction Supplement also provided for a standard look-back period for Credit Events and Succession Events. Accordingly, to be effective, a Credit Event must not have occurred more than sixty days prior to the date that notice of the potential Credit Event was first provided to the applicable Determinations Committees. In the case of Succession Events, the event must not have occurred more than ninety days prior to the date that notice of the potential Succession Event was first provided to the relevant Determinations Committees. These look-back rules allow Credit Events or Succession Events that occur prior to the trade date for a trade nevertheless to be covered by the trade so long as the Credit Event or Succession Event occurred within sixty days or ninety days, as the case may be, of the trade date.

**§ 16:5.2 Big Bang Protocol**

As with other ISDA protocols, upon adherence, the Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol (the so-called “Big Bang Protocol”) amended the terms of covered CDS transactions between one adhering party and each other adhering party, on a multilateral basis. In the case of the Big Bang Protocol, the impact of adherence was the implementation of the substance of the Auction Supplement (including incorporating resolutions of the Determinations Committee, applying auction settlement as the settlement method, and adding backstop dates for Credit and Succession Events in existing and future trades between adhering parties).

As has been the case in previous ISDA CDS protocols, certain transactions, including loan-only transactions, U.S. municipal transactions, and CDS on asset-backed securities, are specifically excluded from the Big Bang Protocol. Transactions are split among those transactions that are subject to all the provisions of the Big Bang Protocol, and those that are excluded from the auction provisions of the protocol (“Covered Non-auction Transactions”). Covered Non-auction Transactions include fixed recovery, reference obligation only, preferred CDS, and party-specified non-auction transactions. For these trades, the remaining provisions of the Big Bang Protocol, including Determinations Committee determinations, still apply. For example, parties will be bound by a decision of a Determinations Committee that a Credit Event occurred, but they will not have to settle their trades pursuant to the subsequent auction settlement that is held.

Going forward, adherents can bilaterally exclude specific transactions from the Big Bang Protocol by specifying so in their trade documentation or a side letter for such a transaction. Most major market participants adhered to the Big Bang Protocol. ISDA does not expect to publish ad-hoc protocols for future Credit Events (excluding “Restructuring” as described below); therefore, parties that did not adhere or that face non-adhering counterparties will need to settle their trades in a bilateral manner going forward.

If a Determinations Committee decides not to make a ruling on whether there has been a Credit Event with respect to a particular Reference Entity, then parties having CDS covering that Reference Entity may independently determine whether a Credit Event has occurred in accordance with the terms of their documentation. If a Determinations Committee does make a ruling, its decision (whether positive or negative) is binding on all parties that adhered to the Big Bang Protocol. All of these changes have operated in a robust and efficient manner to date, tested through a number of Credit Events, including the bankruptcy of General Motors, which in

years past was the “big one” that market watchers had previously feared would bring down the CDS market if physical settlement remained the only option.

One of the ISDA initiatives to standardize CDS contracts in recent years was the development of a matrix that, if incorporated by reference, sets forth certain key common terms for standard single name CDS depending on region-based transaction types. Simultaneous with the publication of the Auction Supplement and the launch of the Big Bang Protocol, a few changes were made to the standard North American CDS in an effort to increase trade liquidity and fungibility. First, pricing for standard single-name CDS covering the most heavily traded North American corporate and high-yield reference entities moved from running premiums to a fixed coupon plus an upfront fee. Under the new convention, protection buyers pay a fixed rate of either 100 (initially for North American corporate entities) or 500 basis points (initially for North American high-yield entities), and pay an upfront fee equal to the present value of the risk represented by the underlying bonds less the fixed coupon. This structure intentionally mirrors the convention for trades based on CDS indices.

### **§ 16:5.3    *Restructuring Supplement and Small Bang Protocol***

Next, after a long saga, the standard CDS on North American corporate names generally ceased to trade with the Restructuring Credit Event as a trigger for settlement. This change was part of an effort to have CDS trade in a fashion similar to that of bonds and indices. Trades that already included Restructuring at that time retained it, and parties may still include Restructuring if they specifically build it into their documentation; however, new standard North American trades only include settlement triggers relating to a payment failure or insolvency of a Reference Entity. Because the standard North American CDS did not include the event, the Auction Supplement and Big Bang Protocol did not provide mechanics for Restructuring, and there was a recognition that trades with Restructuring should not settle identically across the board for a particular Reference Entity. The Restructuring Supplement (defined below) extended the Auction Supplement mechanics to Restructuring, replicating the maturity limitation requirements for Deliverable Obligations set forth in the Credit Derivatives Definitions. Adherence to the Small Bang Protocol (defined below) allowed parties to amend their legacy CDS to incorporate the Restructuring Supplement on a multilateral basis and also deemed adherence to the Big Bang Protocol, offering market participants a final opportunity to participate in the latter.

The 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement to the Definitions (the “Restructuring Supplement”) was published on July 14, and the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring CDS Protocol (the “Small Bang Protocol”), which is designed for Restructuring Credit Events, was implemented on July 27. The key settlement mechanic of these documents is that when a Restructuring triggers CDS contracts subject to their terms, they will be settled based on buckets appropriate on the maturity dates of their proposed deliverable obligations. The Auction Supplement provides for a single list of obligations that are deliverable in settlement of a particular Reference Entity. For trades that incorporate Restructuring with maturity limitations, obligations are only deliverable depending on that obligation’s final maturity. For this reason, the Restructuring Supplement provides for up to eight different maturity buckets and multiple auctions based on maturity buckets for a single Restructuring event. Obligations would need to have a final maturity date that is on or prior to a particular maturity bucket’s end date to be deliverable in settlement for that auction.

The appropriate regional Determinations Committee has the authority to determine whether a Restructuring Credit Event has occurred, though parties retain the ability to trigger their CDS contracts for settlement. A Determinations Committee decision would determine whether an auction is to take place with respect to CDS contracts assigned to each maturity bucket. If no auction is to take place with respect to a particular maturity bucket, buyers of protection would have the option to subject their trades to an auction for a shorter maturity bucket than that otherwise appropriate to their trades. Sellers of protection may move trades to the longest dated maturity bucket. As noted earlier, adherence to the Small Bang Protocol automatically deems adherence to the Big Bang Protocol for any parties that did not directly adhere to the latter.

The Restructuring Supplement and Small Bang Protocol are important because they provide for Restructuring Credit Events to settle pursuant to the auction methodology of the Auction Supplement and Big Bang Protocol, but taking into account the maturity limitations set forth in the Credit Derivatives Definitions. This has been of interest to regulators, who have seen the CDS auction methodology as a major step forward in reducing settlement risk. Further, in the context of the push for CDS clearing, they note the requirement of clearinghouses that trades covering Restructuring with maturity limitations be subject to the Restructuring Supplement directly or through adherence to the Small Bang Protocol in order to be accepted for clearing. To bring these points home, British and U.S. financial regulators joined industry conference calls to voice their

encouragement for market participants to adhere to the protocol. This kind of regulatory attention has not been lost on the OTC derivatives market, which has taken significant steps to increase transparency and efficiency for these products over many years but now with even greater focus.

#### **§ 16:5.4 Other Industry Efforts**

On June 2 of this year, the 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 New York Fed a letter outlining the commitments of market participants to significantly reduce systemic risk and increase transparency. The letter notes the industry's goal of fairly balancing interests of dealers and customers and that it is in line with the goals expressed by Secretary Geithner earlier in the year. With respect to credit derivatives, the letter commits participants to continue to strengthen settlement and recounts 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% of electronically eligible transactions between OMG members of September 30 of this year. The industry will 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 have been identifying and pursuing additional advances in collateral management and completed a market-wide proposal for margin dispute resolution, which was submitted to regulators on September 30 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.

#### **§ 16:6 Clearing Hurdles**

As mentioned above, clearing has been the preferred solution both for achieving greater transparency and for alleviating concerns around counterparty credit risk. U.S. and European regulators have been pushing for some time for CDS, which, at their peak, had an outstanding notional amount in excess of \$50 trillion, or more than three times the U.S. Gross Domestic Product and bigger than all the U.S. credit markets put together, to be traded through clearinghouses. As noted above, Treasury Secretary Geithner's proposals

and various U.S. legislative initiatives seek to require some level of central counterparty clearing for OTC derivatives. The industry has acceded to the calls for voluntary commitments to clearing, lest more stringent regulatory requirements be expedited.

The use of central counterparty clearinghouses is expected to address operational and risk management needs of the credit derivatives market. Since each participant, whether buying or selling, would be facing the clearinghouse as its counterparty, both ease of trading and the reduction of counterparty risk will be served. The first clearinghouse to receive all necessary regulatory approvals and to start trading in the United States (in early March 2009) was ICE Trust, which is a subsidiary of Intercontinental Exchange Inc. It is overseen by the Federal Reserve Board and members may include banks or other institutions that fulfill the membership requirements, which include net worth of at least \$5 billion as well as a credit rating of A or better. Buy-side participants, such as hedge funds, meeting ICE Trust's membership eligibility requirements can also apply for membership, although many buy-side participants are not likely to carry credit ratings. To date, more than \$600 billion in U.S. credit products have been cleared by ICE Trust.

CDS that are cleared by ICE Trust are deemed to be novated such that ICE Trust becomes a counterparty to each of the buyer and seller under separate CDS. Among other things, ICE Trust is able to net positions between it and each member and, accordingly, receives payments from and makes payments to each member on a net basis. Markit has agreed to provide the daily prices that will be used for mark-to-market pricing, margining, and clearing by ICE Trust. Among other things, this will provide greater market transparency as to closing settlement prices and trading volume for covered trades.

One of the concerns raised by regulatory bodies is the concentration of CDS trading in only a few dealer institutions in recent years. (Note that the top ten global banks are involved in 70% of all credit derivatives transactions.) Over time, the use of clearinghouses is expected to reduce the volume of settlement payments among members of the clearinghouse and, in theory, reduce counterparty credit risks that arise under CDS. However, trading CDS through clearinghouses may not effectively address concentration risk given that, at least initially, the clearinghouse members will be the major dealers currently involved in most trades. In order to address counterparty risk, members must provide collateral to ICE Trust to cover their obligations under cleared CDS. Members must also make initial and ongoing contributions to a guaranty fund that can be used by ICE Trust in the event of a member default.

Members of ICE Trust can continue to trade CDS with non-members under their existing documents. Going forward, members

will be obligated under ICE Trust's rules to offer non-members the option of segregating initial margin for back-to-back CDS trades that are cleared through ICE Trust.

CME Group, in partnership with Citadel Investment Group, also has the regulatory approvals for clearing CDS; however, for the moment it lacks the dealer backing that ICE Trust has accumulated. In Europe, NYSE Euronext Liffe's Bclear OTC wholesale platform has processed equity derivatives since 2005 and, with its central counterparty operator LCH.Clearnet, launched CDS index contract clearing in December of last year. That launch made Liffe's the first exchange to offer clearing of CDS index trading in Europe. In July of this year, Eurex Clearing informed the market of its planned mid-July launch of Eurex Credit Clear, which started production on July 27.

### **§ 16:7 Conclusion**

Headlines have played perhaps too large a role in the ongoing debate about whether and how OTC derivatives posed a systemic risk that triggered or contributed to the current credit crisis. Mesmerized by Buffett's oft-quoted phrase, many have stopped short of reading the entirety of the annual report in which that phrase appeared and have ignored that company's apparent recognition of the value of derivatives as a risk management tool. Citing the AIG debacle, some observers at times have demonized CDS and OTC derivatives in general without an understanding of what was unique (though dysfunctional) about AIG's situation and contracts. For example, the use of rating triggers is only one of many tools available to OTC derivatives market participants for managing counterparty credit risk and indeed many commentators argue that such rating triggers are (citing Lehman's decent rating) too late to effectively manage such risk. While it is hard to argue against the value of "transparency" and the need to have effective tools for "systemic risk," the current proposed bills in the United States appear to go substantially further and significantly increase the risk of unintended consequences. If any enacted legislation overreaches, the affected transactions will almost surely flow to a forum or an alternative form that does not impose undue burdens. Worse, banks and insurance companies may be limited in their ability to effectively manage their portfolio risk.

Any potential damage to the OTC derivatives market is not a threat that would be limited to the financial services industry. Commercial enterprises utilize OTC derivatives to protect their operations from a variety of market risks, including currency, interest rate, and other market fluctuations. If they cannot use these instruments or if the costs of doing so are not justifiable, the risks they

manage will be passed on to consumers of their products through higher prices. The challenge ahead will be to strike a balance between the desire to have a greater level of transparency and to effectively curb systemic risk on the one hand, and the temptation to succumb to the headlines of the day on the other.

