MAJOR REGULATION PROPOSED FOR OVER-THE-COUNTER DERIVATIVES

In a major effort to reform and expand financial regulation, the Department of the Treasury (Treasury) has proposed a comprehensive system that would supervise the purchase and sale of derivatives. Similar to current requirements for US banks that issue loans, Treasury wants to impose, among other things, capital requirements on financial entities that sell derivatives to help insure stability in the case of default. The basic details of Treasury's proposal on derivatives, as announced so far, are discussed in the following advisory.

PREVENTING ACTIVITIES WITHIN THE OTC MARKETS FROM POSING RISK TO THE FINANCIAL SYSTEM

Treasury's proposal recommends that the Commodity Futures Trading Commission (CFTC) or the Securities and Exchange Commission (SEC) have substantial and broad authority to ensure that those who engage in the sale of derivatives do not partake in practices that put the overall financial system at risk. Treasury suggests that the Commodity Exchange Act (CEA) and the securities laws be amended to require clearing of all standardized over-the-counter (OTC) derivatives through regulated central counterparties (CCP). Specifically, Treasury's proposal states that CCPs must impose substantial margin requirements and other necessary risk controls. The proposal does not attempt to define when a OTC derivative is "standardized," however it does state that if a contract is accepted for clearing by one or more fully regulated CCP, it should create a presumption that it is "standardized" and therefore be required to be cleared. In addition, Treasury's plan suggests that all OTC derivatives dealers and other firms that create large exposures to counterparties should be subject to a robust system of prudential supervision and regulation. It is suggested this system include: conservative capital requirements, business conduct standards, reporting requirements. as well as initial margin requirements with respect to bilateral credit exposures on both standardized and customized contracts.

PROMOTING EFFICIENCY AND TRANSPARENCY WITHIN THE OTC MARKETS

In an effort to help make certain that federal regulators have complete information about the OTC derivatives markets, Treasury's plan suggests that the CEA and relevant securities laws be amended to impose a variety of stringent requirements on market participants. These new requirements include: new recordkeeping and reporting requirements (including audit trails); requirements for all trades not cleared by CCPs

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Market Volatility and the Changing Regulatory Landscape

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to be reported to a regulated trade repository; movement of standardized trades onto regulated exchanges; implementation of regulated transparent electronic trade execution systems; development of a system for the timely reporting of trades; prompt dissemination of prices and other trade information; and the encouragement of regulated institutions to make greater use of exchange-traded derivatives. Accordingly, participants in the OTC derivatives markets should be aware of the potential implementation of such new standards and anticipate the need to employ appropriate procedures and systems to ensure compliance.

PREVENTION OF MARKET MANIPULATION, FRAUD, AND OTHER MARKET ABUSES

Treasury's proposal also seeks to expand the CFTC and SEC's ability to prevent manipulation and fraud in the derivatives market. Specifically, the proposal states that the CEA and securities laws should be amended to ensure that the CFTC and SEC have the authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to futures markets. In addition, the CFTC and SEC should have full access to market information from CCPs, trade repositories, and market participants to provide to market regulators.

CFTC CHAIRMAN'S REMARKS ON THE MAJOR EXPANSION IN REGULATION OF DERIVATIVE PRODUCTS

In his June 4, 2009 testimony before the Senate Committee on Agriculture, new CFTC Chairman Gary Gensler gave more details about the proposed regulation of the derivatives markets. Gensler stated that any regulatory framework should apply to all dealers and all derivatives. Specifically, he believes that it should include interest rate swaps, currency swaps, commodity swaps, credit default swaps, and equity swaps. Further, in an attempt to prevent future abuses, Chairman Gensler also stated that regulation should apply to dealers and derivatives regardless of the type of swaps or derivatives that are invented in the future. Treasury's proposal as well as Chairman Gensler's Senate testimony further illustrate the need for OTC derivatives market participants to prepare themselves for new oversight and regulation, and implement the necessary procedures to ensure compliance.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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