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News Bulletin

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Credit Derivatives: Recent Regulatory Developments

The financial crisis that has buffeted the global financial markets since the summer of 2007 may well lead to one of the most dramatic reworkings of the regulatory framework that governs financial markets and their participants since the 1930s. In all likelihood, a key element of any reform will address how to contain systemic risk and ensure the stability of the financial system. While this will require action on many different fronts, it is almost certain that derivatives—and in particular, credit derivatives—will be a major focus of that effort.

So far, 2009 has been a busy year. On March 26, Secretary Geithner introduced the Administration's framework for comprehensive regulatory reform of the financial regulatory system (the "Treasury Framework"). Prior to that, multiple bills were introduced in the U.S. Senate and House of Representatives that impact, in varying degrees, credit derivatives and, in some cases, all OTC derivatives. In addition, final regulatory hurdles were overcome for two central counterparties ("CCPs"), and clearing of certain standardized credit derivatives began in the United States for the first time.

This Client Alert addresses those and other recent developments concerning credit derivatives in the United States.

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").[1] 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.

[1] 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. Require all hedge fund advisers with assets under management above a moderate threshold to register with the U.S. Securities and Exchange Commission (the "SEC").

4. Establish a comprehensive framework of oversight, protections and disclosure for the OTC derivatives markets, 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 markets (the "Derivatives Framework").

1. The U.S. government will regulate the markets for credit default swaps and OTC derivatives for the first time.

2. 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.

3. All *standardize*d 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.

4. 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.

5. 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.

6. 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 Derivatives Framework with a short discussion of the perceived shortcomings and failures of the credit derivatives market, the scope of the Derivatives 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 Derivatives Framework calls for the clearing of all standardized OTC derivatives. 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 Derivatives Framework will survive remains to be seen.

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."[2] Prior to the announcement of the Treasury Framework, three separate bills were introduced in 2009 that impact credit derivatives and, in some cases, all OTC derivatives in varying degrees. Although it is now unlikely that the bills will move forward, they may contain elements that will ultimately make their way into the larger legislative effort that addresses the Treasury 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 (the "DTIA")[3] is fairly straightforward: roll back most of the exemptions in the Commodity Exchange Act (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 (the "DMTAA")[4] on February 11, 2009. Broader in scope than the DTIA, the DMTAA 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 Commodity Futures Trading Commission (the "CFTC"), for registered futures commission merchants, introducing brokers, floor brokers and floor traders. The DMTAA 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 DMTAA 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 DMTAA amends the exemptions for exempt and excluded OTC derivatives to require that those transactions be settled and cleared through a CFTC-registered

[2] A copy of the letter is available at www.house.gov/apps/list/press/financialsvcs_dem/033009_doddfranktoobama.pdf.
[3] 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.
[4] 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.

clearing entity. For OTC derivative transactions relating to an excluded commodity (*i.e.*, financials), the DMTAA also allows those transactions to be settled and cleared through a 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 transactions and their own financial integrity, including a net capital requirement that is comparable to a net capital requirement that would be associated with the transactions if they were cleared.

- *Authority of CFTC to Suspend Trading in Credit Default Swaps.* Section 16 is the only part of the DMTAA 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.[5]

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

Representative Castle introduced the Financial System Stabilization and Reform Act of 2009 (the "FSSRA") on March 26, 2009.[6] 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 FSSRA includes a definition of "credit default swap"[7] 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 FSSRA 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.

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 ("ICE Trust") application become a

[5] Section 16 of the DMTAA 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...."
[6] 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.
[7] Section 118 of the FSSRA 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."

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 certain 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.

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"),[8] which is similar to the New York Insurance Department's Circular Letter No. 19.[9] 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 comprehensive 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 would likely 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 have 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.[10] The model legislation will establish strong solvency and disclosure requirements for credit default swaps,

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[8] A copy of the Insurance Bulletin is available at www.insurance.mo.gov/Contribute%20Documents/InsuranceBulletin08-12.pdf.
[9] For our discussion of Circular Letter No. 19 and subsequent developments relating to it, please see our Client Alerts entitled "Credit Default Swaps as Insurance: One Regulator of Many?" at www.mofo.com/news/updates/files/081006CreditDefault.pdf and "From TARP to ARRP: Is 2009 the Year We Get Out from Under the TARP?" at www.mofo.com/news/updates/files/090116TARP.pdf.
[10] A copy of NCOIL's press release is available at www.ncoil.org/HomePage/2009/0492009CDSCallPressRelease.pdf.

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.

Contacts

David H. Kaufman
(212) 468-8237
dkaufman@mofo.com

David A. Trapani
(212) 336-4469
dtrapani@mofo.com

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