New York State and the SEC call for Urgent Regulation of Credit Default Swaps

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The Securities and Exchange Commission ("SEC") and New York State have both called this week for urgent regulation of the approximately $60 trillion credit default swap ("CDS") market, which is being blamed by some for significantly contributing to the ongoing financial crisis. On Monday, New York Governor Paterson announced that New York will begin to regulate one part of the CDS market starting on January 1, 2009. He urged the federal government quickly to adopt regulations covering the remainder of this market. In testimony before the Senate Committee on Banking, Housing, and Urban Affairs on September 23, 2008, SEC Chairman Cox echoed Governor Paterson's concerns, noting that regulation of the CDS market, which has ballooned to double what it was in 2006 with a current notional value of $58 trillion, is critical "to enhance investor protection and ensure the operation of fair and orderly markets."

CDS, which have in recent years become the most dominant product of the credit derivatives market, are private contracts in which parties transfer credit or default risk from one counterparty to the other. CDS can be a useful instrument for bond owners to hedge against the risk of the bond issuer's inability to pay interest or principal by reducing the risk of volatility in the value of the underlying obligation. In contrast, some market participants also buy or sell CDS in which investors do not own the underlying debt instruments and are buying or selling the CDS based on their view regarding the potential for a decline in the issuer's ability to pay. Because of turmoil in the credit markets in 2007 and 2008, an increasing number of obligations referenced in CDS are facing actual or potential defaults.

New regulation of the CDS market will have major implications for market participants, not the least of which will involve complex jurisdictional and applicable law questions.

Chairman Cox stated that, while neither the SEC nor any other regulator currently has direct authority over the CDS market, the SEC's Division of Enforcement is committed to using its anti-fraud authority to combat the potential for market manipulation in the CDS market. In that regard, the anti-fraud provisions of the Securities Exchange Act of 1934 ("Exchange Act") apply specifically to security-based swap agreements even though swap agreements are excluded from the definition of "security" in the Exchange Act.

Although the New York State Insurance Law had previously treated CDS as "contracts," not insurance, New York State is now taking the view that CDS contracts in which the buyer of the swap is the owner of the underlying bonds are insurance and are subject to regulation by the state's Insurance Department ("Department"). Under this view, CDS bought or sold without ownership of the underlying securities would not be insurance and thus would not be regulated by the Department.

The Department issued Circular Letter No. 19 (2008) on Monday to provide guidance for financial guarantee insurers ("FGIs") on this issue, as well as on other issues relating to regulation of collateralized debt obligations ("CDOs"), among other things.[1] The Circular sets forth a series of "best practices" to which the Department expects FGIs under its jurisdiction to adhere as of January 1, 2009, pending their formalization as regulations. The new guidelines will not affect any existing CDS.

The new Best Practices cover:

- **Credit protection for CDS.** To ensure that FGIs are able to manage the risks associated with CDS "prudently and equitably," FGIs are expected to confine their participation in the CDS market to transactions in which the insurer's risk is roughly comparable to that assumed when directly insuring bonds. Thus, the Department expects FGIs to limit their issuance of policies on CDS to transactions where:
  - The FGI guarantees only failures to pay obligations when due or payable when the failure is the result of financial default or insolvency;
  - The CDS does *not* define a credit, termination, or default event to include a change in the credit quality, rehabilitation, liquidation or insolvency of the FGI providing credit support for one of the counterparties; *and*
  - Neither the CDS agreement nor the contract under which the FGI provides its guaranty requires the insurer to post collateral.
- **Insurance for CDOs of ABS (collateralized debt obligations of asset-backed securities).** Essentially, FGI's should not issue any policy that backs CDOs collateralized by successive pools of ABS in multiple tranches (known as "CDO-squared") unless certain protections are in place:
  - Restrictions on concentrations of risk to reduce exposure;
  - Monitoring of non-investment grade credit risk and extension of the 95% investment grade standard to an FGI's entire business;
  - Restatement and continued maintenance of appropriate underwriting and risk

management standards;

- Increased capital and surplus requirements, which have not changed since 1989;
- Increased capital for insurance that includes operating leverage; and
- Additional regulatory and reporting requirements.

In asserting that certain CDS are "insurance" and that the writer thereof is an insurance company, the Department could have the federal banking regulators and the SEC, as well as plaintiffs' lawyers seeking to assert private rights of action under the federal securities laws, as potential adversaries. Following disputes between the banking and insurance industries during the 1980s and 1990s over who had authority to regulate the insurance activities of banks and of specific banking products, the Gramm-Leach-Bliley Act ("GLB") provided that the insurance activities of any person, including a national bank, shall be functionally regulated by the states, which have exclusive jurisdiction over the regulation of insurance as a result of the "reverse preemption" provisions in the McCarran-Ferguson Act. Under GLB, a national bank may not provide insurance as a principal unless the insurance is an authorized product. The Office of the Comptroller of the Currency has authorized national banks to engage in CDS transactions, so it would appear that banks engaging in CDS transactions could also be subject to regulation as "insurance companies" by the Department. Disputes over whether such insurance activities are authorized and/or should be regulated by the state insurance commissioners or by federal banking agencies are to be resolved by the U.S. Court of Appeals for the District of Columbia Circuit, with an expedited review and appeal to the U.S. Supreme Court.

The fast-paced developments of the past few weeks make it more likely that CDS will be brought within the oversight authority of either or both federal and state regulators.

[1] State of New York Insurance Department Circular Letter No. 19 (2008), Sep. 22, 2008.

Authors

Yoon-Young Lee

SENIOR COUNSEL

yoon-young.lee@wilmerhale.com

+1 202 663 6720

Jeannette K. Boot

PARTNER

jeannette.boot@wilmerhale.com

+1 212 295 6507