Regulating OTC Derivatives: How Hard Would It Be To Undo the CFMA?

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I. Introduction

On May 13, in a press release jointly attended by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"), the U.S. Department of Treasury ("Treasury") announced its intention to pursue legislation to overhaul the regulatory structure of over-the-counter ("OTC") derivatives (the "Proposal").[1] Today OTC derivatives remain largely excluded from regulatory oversight due to the Commodity Futures Modernization Act of 2000 ("CFMA"), legislation enacted in the waning days of the Clinton Administration. In an effort to address certain gaps in our financial regulatory system that are widely blamed for the recent market upheaval, the Proposal seeks a sharp departure from the deregulatory policy agenda embodied by the CFMA. Though bold in its ambition to impose a brand new regulatory scheme for derivatives, the Proposal as of today raises many more questions than it answers.

Below, we first describe the key elements of the Proposal, explore jurisdictional questions and then set forth potential implications for various market participants.

II. Treasury's Proposal: Overhauling the Regulation of OTC Derivatives

The Proposal sets forth suggested regulatory reforms appropriate to address specific goals, including the following:

A. Controlling Potential Risk to the Financial System

The proposal would mandate clearing of all *standardized* OTC derivatives transactions through regulated central counterparties ("CCPs"). To improve the effectiveness of this requirement, Treasury calls for a robust regime of supervision and regulation over firms that create significant exposures to counterparties, as well as robust risk controls to be implemented by CCPs, including margin requirements. Additionally, CCPs would be required to maintain protocols to monitor instances where market participants attempt to circumvent such controls by customizing OTC derivatives for the sole purpose of avoiding regulation. Furthermore, the Proposal creates a presumption of standardized status if the OTC derivative is accepted for clearing by one or more regulated CCPs.

B. Promoting Transparency and Efficiency

Certain aspects of the market upheaval over the last twenty months have been tied to a perceived lack of transparency in trading activity of OTC derivatives. The Proposal seeks to increase market transparency in all OTC derivatives markets (that is, whether or not the contracts are standardized) by implementing trade reporting obligations and public dissemination of trade information. Additionally, the Proposal includes an explicit encouragement for "greater use" of regulated exchange-traded derivatives.

C. Market Integrity and Investor Sophistication

The Proposal seeks broad regulatory reforms necessary to authorize the CFTC and SEC to effectively prevent and detect fraudulent market activity for all OTC derivatives. In addition, these agencies would be authorized to set certain position limits on OTC derivatives to address market integrity concerns related to excessive exposure. Finally, in an effort to provide enhanced investor protection, the Proposal contemplates that the SEC and the CFTC may seek additional authority to implement disclosure or sales practice rules in connection with the marketing of derivatives to less sophisticated investors.

III. Jurisdictional Uncertainty Looms: Securities or Commodity Regulation

Prior to passage of the CFMA, there was uncertainty regarding the application of the Commodity Exchange Act ("CEA") and the federal securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934 (collectively referred to herein as "Securities Laws") to OTC derivatives. The CFMA granted broad regulatory exclusions for most OTC derivatives, including security-based swap agreements. As a result, there is no meaningful regulatory oversight today for most derivatives transactions effected in the OTC market among "eligible contract participants." While the Proposal is vague on many levels, the Treasury clearly intends to scale back the regulatory relief afforded under the CFMA. This leaves questions regarding how exactly the CEA and Securities Laws should be amended in the future to govern these products, dealers and their counterparties. Set forth below are some of the basic jurisdictional issues that would need to be addressed in the regulatory reform process.

A. Modified Definition of a Security

The Proposal seeks amendments to the CEA and the Securities Laws in order to provide the CFTC and SEC with jurisdiction over various derivatives-related market activities. Will regulatory reform efforts proceed on the basis that standardized OTC derivatives are securities or commodities? What about customized OTC derivatives? Will a new quasi-security category be created for purposes of maintaining SEC jurisdiction over certain OTC derivatives, such as security-based swap agreements?

B. Registration Implications

Under the relevant provisions of the CFMA, no broker-dealer registration is needed to engage in the offer and sale of security-based swap agreements as a market intermediary. If these OTC derivatives are deemed to be securities, what are the potential registration implications for market participants? Will OTC derivative dealers maintain their status as a special class of broker-dealers?

C. Harmonization of Regulatory Efforts

Under the Securities Laws, centralized trading platforms are regulated either as exchanges or alternative trading systems, while the CEA imposes different regulatory requirements between derivatives transaction execution facilities and designated contract markets. Will regulatory reform efforts recognize the costs associated with duplicative and uncoordinated regulatory requirements? With discussions of possible regulatory consolidation efforts between the SEC and CFTC, is there a need to harmonize the CEA and Securities Laws more broadly?

IV. Potential Implications for Market Participants

The Proposal also includes elements that likely would impact existing market participants including dealers, buy-side firms and providers of electronic trading platforms. Below are potential implications for each participant based on the limited information available.

A. Dealers

- Increased regulatory burden associated with the need to comply with more stringent capital requirements and business conduct standards, including a potential disclosure regime for less sophisticated investors;
- Costs associated with systems necessary to maintain records and report transactions and positions;
- An obligation to establish and codify clearing relationships with market participants; and
- Increased competition as a result of on the regulatory pressures for market participants to effect transactions through regulated exchanges and trading platforms.

B. Buy-Side Firms

- Regulatory pressure to make greater use of standardized contract and regulated trading facilities;
- Position limits and greater restrictions on eligibility criteria with respect to certain derivatives transactions; and
- Risk of regulatory scrutiny over individual trades and positions in customized derivatives.

C. Electronic Trading Platform Providers

- Increased demand for electronic trading systems for purposes of prompt dissemination of trade and position reporting; and
- Increased demand for electronic recordkeeping systems.

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[1] See http://www.ustreas.gov/press/releases/tg129.htm;
http://www.financialstability.gov/docs/OTCletter.pdf.