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Administration Proposes Regulation of Over-The-Counter Derivatives

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Client Advisory
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In a May 13 press release and letter from Secretary Geithner to Congressional leaders the Administration outlined a four part legislative approach to regulate over-the-counter derivatives, also known as swaps. (http://www.ustreas.gov/press/releases/tg129.htm).

The first part is to prevent activities within the over-the-counter market that pose risk to the financial system. Included within this are requirements that standardized over-the-counter derivatives be cleared through a regulated central counterparty. These regulated central counterparties would have to impose margin requirements and other risk controls to ensure that customized derivatives are not used solely to avoid using a central counterparty. It would posit that if a derivative is accepted for clearing by one central counterparty it is a standardized over-the counter derivative. Derivatives dealers and others who create large exposures to counterparties would be subject to a regime of prudential supervision and regulation. This would include: conservative capital requirements; business conduct standards; reporting requirements; and initial margin requirements.

The second part is to promote efficiency and transparency in the derivatives market. This would include imposing record-keeping and reporting requirements. All trades not cleared through a central counterparty would have to be reported to a regulated trade repository. The central counterparties and regulated trade repositories would have to make aggregate data on open positions and trading volume publicly available, and data on individual counterparties available to federal regulators. It also calls for the development of a system for timely reporting trades and prompt dissemination of prices and other trade information.

The third part is to prevent market manipulation, fraud and other market abuses. Clear and unimpeded authority would be given market regulators to police fraud, market manipulation and other market abuses. The Commodities Futures Trading Commission would have authority to set position limits on over-the-counter derivatives that perform or affect a significant price discovery function with respect to the futures market. The central counterparties, trade repositories and market participants would have to provide market regulators with market information.

The fourth part is to ensure that over-the-counter derivatives are not marketed inappropriately to unsophisticated parties. It would amend the Commodity Exchange Act and the federal securities laws to tighten the limits or to impose additional disclosure requirements or standards of care with respect to the marketing of derivatives to less sophisticated counterparties, such as small municipalities.

The Chair of the Securities and Exchange Commission and the CFTC as well as the International Swaps and Derivatives Association expressed support for these proposals.

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