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## Derivatives Regulation Update

The lingering financial uncertainty of 2008 may be compounded by a year of regulatory uncertainty for the derivatives industry in 2009. Frequently mentioned as culpable for the deterioration of the financial markets, derivatives are now facing the ire of regulators who are desperately seeking solutions to the current economic downturn. The current portfolio of proposed solutions involves both state and federal authorities and has the potential to vastly expand the regulatory scrutiny placed upon over-the-counter transactions.

### House Agriculture Committee

Concurrently with the announcement of the House Agriculture Committee's membership for the 111<sup>th</sup> Congress, Chairman Collin Peterson (D-MN) circulated a draft version of his [Derivatives Markets Transparency and Accountability Act of 2009](#) (the Act), which aims to dramatically alter the regulation of over-the-counter contracts. The Act introduces regulation on a vast array of market issues, from imposing reporting and recordkeeping requirements on over-the-counter transactions to expanding the powers and staff of the Commodity Futures Trading Commission (CFTC).

In addition to the foregoing, the Act contains two substantial changes that would result in a complete reorganization of the derivatives industry. First, the Act would force *all* over-the-counter transactions to be settled and cleared through a CFTC-regulated, designated clearing organization. Although attempts to develop clearinghouses for credit default swaps have been in the works for months (for more information, view Sutherland's [Legal Alert](#) from January 16, 2009), shifting the entire over-the-counter contract market onto an exchange would fundamentally alter the way derivatives transactions are traded and settled.

Second, the Act would make it a violation of the Commodity Exchange Act to merely enter into an "uncovered" credit default swap. An uncovered credit default swap occurs when a party buys a credit default swap on a given reference entity but is not directly exposed to financial losses with respect to such entity, e.g. through ownership of the financial obligations of such entity. By removing the ability of market participants to speculate on credit defaults by purchasing or selling uncovered credit default swaps, the Act would immediately eliminate a large portion of the \$31 trillion credit default swap market.

Chairman Peterson held hearings for the House Agriculture Committee on February 3-4, 2009, to further discuss the regulation of derivatives. More than 20 representatives from the derivatives and financial industry, as well as state regulators and advocates for end-users, testified both in favor of and against additional regulation of the derivatives market. Copies of the testimony of various witnesses can be obtained [here](#).

### Missouri Department of Insurance

At the same time the Act seeks to outlaw uncovered credit default swaps on a federal level, it now appears that covered credit default swaps may face new regulation from certain state insurance departments. In the second half of 2008, the state insurance departments of both New York and Missouri issued bulletins indicating that they would begin regulating covered credit default swaps as insurance under state law. This type of regulation is premised on the theory that covered credit default swaps are analogous to insurance contracts because they transfer the risk of financial loss in a given transaction to a third party. If the transfer of risk in this manner is viewed as an insurance transaction, then issuers of

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covered credit default swaps would be forced to register with applicable state insurance departments in order to avoid an enforcement action for illegally issuing insurance products.

New York State Insurance Department Superintendent Eric Dinallo tabled his plans to regulate covered credit default swaps on November 20, 2008, in response to federal efforts to comprehensively regulate the derivatives market (for more information, view Sutherland's [Legal Alert](#) from November 21, 2008). The state of Missouri, however, pressed forward with its plans to regulate covered credit default swaps as insurance beginning January 1, 2009 (for more information, click [here](#)). Although Missouri's actions do not have a broad effect on the national market in covered credit default swaps, the state's willingness to regulate these contracts even as the federal government discusses a more comprehensive solution creates a bold precedent for other state insurance departments to consider.

### Studies on Regulatory Reform

Recent measures taken by federal legislators and state insurance departments are not the isolated actions of regulatory hawks, but rather the natural outflow of aggressive calls for regulatory reform supported by a number of recent studies on the issue. Three major studies on reforming the financial system were released in January 2009. Each of these reports calls for a system-wide overhaul of financial regulation in the United States.

The U.S. Government Accountability Office report entitled, "[Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System](#)," highlights the need for new regulation with a comprehensive, systemwide focus. The Congressional Oversight Panel (established pursuant to the Emergency Economic Stabilization Act of 2008) issued its "[Special Report on Regulatory Reform](#)," encouraging the adoption of far-reaching reforms to effectively manage systemic risk and increase transparency in the financial markets. This report specifically addresses credit default swaps and other over-the-counter contracts, which it regards as part of the "Shadow Financial System" that must be brought under further regulation. Finally, the Group of Thirty released a report entitled, "[Financial Reform: A Framework for Financial Stability](#)," that reiterates the call for increased federal oversight of the financial markets including significant regulation of the over-the-counter derivatives market.

The derivatives market—in particular, credit default swaps—enters 2009 under a cloud of regulatory uncertainty. What is clear, however, is that calls for increased oversight echoing around the federal and state regulatory apparatus will result in a flurry of new issues that participants in over-the-counter markets must consider. We will continue to monitor this changing landscape and update you on important developments.



*If you have any questions regarding this Legal Alert, or the services we provide, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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