Obama Administration Supports More Regulation and Restructuring of OTC Derivatives Markets

On June 17 the Obama Administration issued its white paper proposing a comprehensive overhaul of the U.S. financial regulatory system with the goal of restoring stability in the U.S. and global financial markets. (click here) The Administration called the proposed reforms “essential” to restoring confidence in the markets and stated that it stopped short of trying to include every change that might be “desirable” under less urgent circumstances. Additional regulation of over-the-counter (OTC) derivatives and reformation of OTC markets was a significant element of the proposed reforms.

President Obama’s proposal touches almost every corner of the financial markets and is intended to address five key objectives: (1) promote robust supervision and regulation of financial firms; (2) establish comprehensive regulation of financial markets; (3) protect consumers and investors from financial abuse; (4) provide the government with the tools it needs to manage financial crises; and (5) raise international regulatory standards and improve international cooperation.

Establish Comprehensive Supervision and Regulation of Financial Markets

As part of the second stated objective of establishing comprehensive regulation of the financial markets, the white paper states that the growth of OTC derivatives and the introduction of new financial instruments have highlighted the need for regulating these products. The Administration proposes to enhance the Federal Reserve’s authority over the core infrastructure of the financial markets in order to reduce the potential for contagion among financial firms and markets in a crisis. Specifically, the proposal includes the following directives that, if implemented, would have a significant impact on OTC markets:

1. **Comprehensive Regulation of OTC Derivatives.** As we have seen in various recent proposals, including Treasury Secretary Tim Geithner’s letter to Congress (click here) and Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler’s testimony to Congress (click here), the Administration would: (i) impose recordkeeping and reporting requirements on all OTC derivatives transactions; (ii) impose a comprehensive regulatory structure on all OTC derivatives market participants; and (iii) require standardized OTC derivatives to be centrally cleared through regulated clearinghouses and executed on regulated exchanges. In addition, the CFTC and the Securities and Exchange Commission (SEC) would have clear authority to police and prevent fraud, market manipulation and other market abuses involving all OTC derivatives, including CFTC authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.

2. **Enhanced Supervision and Regulation of Securitization Markets.** The white paper proposes a number of reforms to address the “breakdown in market discipline” in the securitization markets. The proposal requires: (i) originators or sponsors of structured products to retain a 5 percent economic interest in the credit risk of securitized assets; (ii) the elimination of the immediate recognition of gain on sale by originators under generally accepted accounting principles (GAAP), requiring instead that originators recognize income over time; (iii) securitizations to be consolidated on the originators’ balance sheets; and (iv) ongoing reporting by issuers of asset-backed securities, along with improved and standardized disclosure practices.
3. **Conservative Capital Requirements for Banks in General and OTC Dealers in Particular; Initial Margin Requirements on All Non-Cleared OTC Derivatives.** This directive will be accomplished through the formation of a working group of regulators and outside experts that will conduct a fundamental reassessment of the design and structure of capital requirements and will issue recommendations by December 31, 2009.

4. **Expanded Authority of the Federal Reserve** over all "systemically important financial firms" designated by the Federal Reserve (so-called Tier 1 Financial Holding Companies, or FHCs), which could include large hedge funds and other financial institutions that are not banks or bank holding companies, as well as foreign institutions that have either a presence in the United States or an impact on its markets. The capital, liquidity and risk management standards for Tier 1 FHCs will be stricter than for other financial firms and will be applied to the entire organization, including all foreign and domestic subsidiaries and affiliates. The proposal also includes a new regime to dissolve nonbank financial institutions whose failure could have serious systemic effects, and improves accountability for the Federal Reserve's emergency lending authority.

5. **Harmonization of CFTC and SEC Regulations.** Oversight of the financial markets by two separate regulatory authorities has led to jurisdictional disputes in some areas and gaps in regulation in others. The proposal requires eliminating jurisdictional uncertainties and ensuring that economically equivalent instruments are regulated in the same manner, regardless of which agency has jurisdiction. This harmonization is expected to improve product innovation, increase competition between markets and exchanges and permit a broader range of instruments to trade on a regulated exchange. The white paper recommends that the two agencies converge on principles of regulation that are sufficiently precise such that market practices that are in violation of those principles can be readily identified and subjected to enforcement, but also sufficiently flexible to allow for innovation. The CFTC and the SEC will be required to deliver a joint report to Congress by September 30, 2009, outlining the conflicts in their rules and recommending changes.

6. **Federal Reserve Authority to Oversee All Systemically Important Payment, Clearing and Settlement Systems.** The CFTC and the SEC will remain as the primary regulators of clearinghouses currently under their supervision, but the Federal Reserve will have a role in assessing risk management at these clearinghouses and will allow these payment, clearing and settlement systems to access its discount window.

In addition, the white paper proposes that hedge fund advisers be required to register with the SEC under the Investment Advisers Act of 1940 and be subject to regular reporting on assets and risk exposures and periodic examinations. These requirements will extend to all advisers of private pools of capital whose assets under management exceed a "modest threshold." The proposal contemplates a minimum level of reporting to regulators to cover the amount of assets under management, borrowings, off-balance-sheet exposures and any other information necessary to assess whether a fund or family of funds is so large, interconnected to other financial market participants or highly leveraged that it poses a threat to financial stability. The SEC would also be granted authority to conduct periodic examinations of these identified funds to monitor compliance with the proposed requirements and to allow the Federal Reserve to determine whether the fund poses a threat to financial stability. The Federal Reserve would have the authority to supervise and regulate any such fund in the same manner as other institutions that are found to present systemic risk.
Implications for the Derivatives Market

Additional regulation of, and limits on, OTC derivatives transactions and the requirement that derivatives transactions be cleared or traded on exchanges may impose additional strains on liquidity due to margin or collateral requirements and may limit the ability of market participants to meet business, tax and accounting requirements (e.g., for hedge treatment). Requiring certain products to be centrally cleared may also preclude the netting of exposure between transactions that are cleared and those that are not cleared. Moreover, the requirement for initial margin on all non-cleared OTC transactions would represent a major change in market practice and may be motivated by the Administration’s desire to reduce the incentive for trades to be customized and thereby exempt from central clearing.

The proposals set out in the white paper add up to more regulation and higher costs for all participants in the OTC derivatives market. For dealers this will translate into lower profits and for end-users this will likely mean that trading in the OTC derivatives markets will be curtailed and in some cases unavailable to meet ongoing risk management and investment needs. To date, there has been little, if any, discussion of how the new rules could impact existing trades and documentation, but these matters will require careful attention as the new OTC environment takes shape over the coming weeks and months.

The Administration’s white paper makes sweeping proposals, but it is the various committees of the House and Senate that will craft the changes in the law that will be necessary to put the plan into effect. Although some of the proposed changes—such as the reports on capital requirements and CFTC-SEC harmonization—can be implemented by the Administration through regulatory action, most of the important proposals must be approved by Congress. Treasury officials have said that their goal is to implement these reforms by the end of 2009. We will continue to monitor legislative and regulatory developments and keep you abreast of all relevant changes.

If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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