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Regulators and Market Participants Target Future Regulation of Credit Default Swaps

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Over the past several weeks, U.S. and U.K. regulators and various market participants have made several potentially significant statements regarding the possible future regulation of credit default swaps ("CDS").[1] The Securities and Exchange Commission ("SEC"), the Commodities Futures Trading Commission ("CFTC"), the Board of Governors of the Federal Reserve (the "Federal Reserve"), the President's Working Group on Financial Markets ("PWG"),[2] and the New York Insurance Department ("NYID") in the U.S., the U.K. Financial Services Authority ("FSA") in the U.K., as well as a group of eight major CDS dealers (the "Dealers"),[3] have all expressed concerns about CDS, their regulation and the availability of information about the CDS market.

Four events are particularly noteworthy. First, the Dealers informed the European Commission of their support for the establishment of a central counterparty for CDS ("CDS CCP") based in Europe. Second, the PWG announced various measures that its members have taken, or will take, designed to strengthen the CDS market. Third, the House of Representatives Committee on Agriculture held hearings regarding the regulation of CDS at which officials from the SEC, the CFTC, the Federal Reserve and the NYID spoke. Fourth, the FSA announced that it may bring insider-trading charges against investors who use credit default swaps to create false impressions regarding the underlying securities. While the future of the regulation of CDS is far from clear, these statements are important indicators of measures that may be taken in the near future.

1 CDS contracts are derivative instruments by which financial institutions and other businesses manage their exposure to credit risk. In a CDS contract, a credit protection buyer transfers certain specified credit event risks to a credit protection seller. The risks specified in the CDS are taken by the protection seller in exchange for periodic payments from the buyer. If a designated "credit event" occurs, the CDS seller becomes obligated to make payments to the buyer. CDS contracts frequently include provisions under which the protection seller must post collateral upon the occurrence of specified events.

2 The President's Working Group on Financial Markets is chaired by the Secretary of the Treasury and includes the Chairs of the Federal Reserve Board, the SEC, and the CFTC.

3 The Dealers, with all signatories to a letter to the European Commission, are Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan Chase, Morgan Stanley, and UBS.

The Dealers' Announcement

On December 16, 2008, the Dealers sent a letter to Charlie McCreevy, European Commissioner for Internal Market and Services, responding to a request for information regarding the Dealers' support for a CDS CCP. The Dealers confirmed their support for "clearing, where practicable, CCP-eligible Credit Default Swaps on European reference entities and indices based on these entities, through one or more central counterparties, including backloading of existing outstanding contracts." The Dealers noted their commitment to establishing a CDS CCP in the European Union by the end of the second quarter 2009.

In general terms, CDS CCP would function as an intermediary between the buyer and the seller of credit protection. The CDS CCP would not be a party to the CDS but would bear the credit risk of each of the counterparties. The CDS CCP would only make itself available to counterparties that met the CDS CCP's financial and other requirements. The CDS CCP would have (as CDS counterparties typically have) the ability to demand collateral. In addition, like a commodities futures exchange, the CCP would have its own capital to perform a CDS contract if a party defaulted. A CDS CCP would theoretically reduce systemic risk by ensuring the payment of the CDS in the event of a default by a counterparty.

The Dealers noted several steps they would take to help establish a European CDS CCP. In particular, the Dealers agreed to resolve by the end of the first quarter of 2009—to the extent that the Dealers could do so alone—the "outstanding technical, regulatory, legal and practical issues that could limit CCP clearing for the above-mentioned contracts." The Dealers identified a number of these outstanding issues, ranging from identifying a "regulatory framework that allows clearing and regulatory oversight of cleared global CDS contracts" to addressing what kinds of transactions should be CDS CCP-eligible. The Dealers stated that they would make available the technical specifications identified by the Dealers to all providers of CDS CCP services.

The Dealers' statement indicates a commitment by the Dealers to establish a CDS CCP based on European indices and references obligations in 2009. However, many of the particular outstanding technical issues—such as the implementation of a regulatory framework—are outside of the Dealers' control. It is also unclear the extent to which trade groups and other market participants will participate in the Dealers' efforts.

The PWG's Release

On November 14, 2008, the PWG issued a press release (the "PWG Release") announcing that, in conjunction with the Comptroller of the Currency and the Federal Reserve Bank of New York, the PWG and its member organizations had been considering a series of improvements in the OTC derivatives markets, most of which focused on CDS. The PWG announced as its "top near-term OTC derivatives priority" the implementation of a central counterparty service for CDS. The PWG Release noted that several potential central counterparties for CDS had submitted proposals and that regulatory authorities were assessing these proposals. The PWG Release stated that the PWG anticipated that one or more CDS central counterparties would commence operations before the end of 2008. InterncontinentalExchange ("ICE") and the Chicago Mercantile Exchange ("CME") have submitted to the SEC, CFTC, Federal Reserve and other regulators' proposals to be CDS clearinghouses subject to US regulation.

The PWG Release also discusses a Memorandum of Understanding ("MOU") reached among the Federal Reserve, the CFTC, and the SEC in which the three regulators agreed to cooperate and share information in carrying out their respective responsibilities with regard to CDS CCPs. The Memorandum of Understanding notes that a CDS CCP may be "one or more" of a state-chartered bank (which would be subject to regulation by the Federal Reserve), a Derivatives Clearing Organization (which would be subject to regulation by the CFTC), or a clearing agency as defined in the Securities Exchange Act of 1934 (“Exchange Act”), (which would be subject to regulation by the SEC). Therefore, it remains unclear which of these regulators would have overall responsibility to regulate a CDS CCP in the U.S. or whether the responsibility would be fragmented based on the nature of the CDS CCP.

The PWG Release also lists four policy objectives for the OTC derivatives markets: (i) market transparency, (ii) enhanced risk management, (iii) strengthened infrastructure, and (iv) continued cooperation among regulatory authorities.

Congressional Hearings

On November 20, 2008, the U.S. House of Representatives Committee on Agriculture (the “Committee”) held hearings on credit default swaps. The panel included Ananda Radhakrishnan of the CFTC, Patrick Parkinson of the Federal Reserve, Erik Sirri of the SEC, and Eric Dinallo, the New York Superintendent of Insurance.

The CFTC Testimony:

Mr. Radhakrishnan described the MOU among the CFTC, the Federal Reserve and the SEC and noted that the CFTC would cooperate with the other agencies in developing a clearing solution for CDS products and had been cooperating in reviewing the CDS CCP proposals submitted by ICE and the CME. He also stated that the act of clearing through a CDS CCP would not change the legal status of an OTC derivative and render the OTC derivative subject to any additional legal requirements.

The SEC Testimony:

Mr. Sirri noted that CDS pose risks “systemically to financial stability” and also pose a “risk of manipulation”. He stated that “[t]he SEC has a great interest in the CDS market because of its potential impact on the securities markets and the Commission's responsibility to maintain fair, orderly, and efficient securities markets.” He added that while most CDS comply with the Commodity Futures Modernization Act’s (“CFMA”) swap exclusion from the Securities Act of 1933 (the Securities Act) and the Exchange Act, the SEC does retain “limited authority” to enforce anti-fraud prohibitions under the federal securities law, including insider trading provisions, for CDS that are “security-based swap agreements.”[4]

Mr. Sirri also noted that the SEC was working with the prospective CDS CCPs to craft relief exempting the CDS CCPs from some or all of the requirements of the Securities Act and Exchange Act that the SEC believes would apply to CDS if CDS could no longer use the “swap exclusion,” an exclusion under the CFMA that currently applies to most CDS.

Mr. Sirri also discussed the PWG’s desire to oversee the implementation of CDS CCPs, noting that a CDS CCP could be “an important step” in reducing counterparty risks and could thereby “help mitigate potential systemic impacts.” According to Mr. Sirri, a CDS CCP could be beneficial because a CDS CCP could

[4] The CFMA amended Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1)(A), (B), and (C) of the Exchange Act to apply to security-based swap agreements. In addition, under Section 20(d) of the Exchange Act, if communicating, purchasing or selling a security while in possession of material nonpublic information would violate the Exchange Act, then the same conduct in connection with the purchase or sale of a security-based swap agreement would result in comparable liability. The CFMA modified Section 9(a) of the Exchange Act to prohibit various forms of manipulation in transactions involving security-based swaps, including manipulation of the price of the underlying securities through such transactions. Finally, the CFMA also amended Sections 16(a) and (b) of the Exchange Act to require reporting and disgorgement of short-swing profits by insiders in connection with transactions in security-based swap agreements.

contain the failure of a market participant, and could reduce risk by uniform margining and other risk controls over its exposure to a single participant. Furthermore, a CDS CCP could ensure that trades were cleared and settled in a timely manner.

The Federal Reserve Testimony:

Mr. Parkinson reiterated many of the comments made by Mr. Sirri and Mr. Radhakrishnan, noting in particular the PWG and the various regulators were working to establish CDS CCPs as quickly as possible. Mr. Parkinson stated that the primary federal regulators for the two U.S. CDS CCPs would be the CFTC and the Federal Reserve; news reports suggest that the Federal Reserve would be the primary regulator for the ICE CCP and the CFTC would be the primary regulator for the CME CCP. In addition, Mr. Parkinson noted the need for enhanced risk management policies and procedures among market participants and stated that the Federal Reserve and bank supervisors from other countries were cooperating to implement various enhancements.

The NYID Testimony:

At the hearing Mr. Dinallo announced that the NYID would delay its plans to regulate a subset of CDS under the New York Insurance Law.[5] Mr. Dinallo explained that “New York had been prepared to step in” to regulate CDS because of the “serious problems resulting from the total lack of regulation” of CDS in the past. Mr. Dinallo stated that because comprehensive solutions were being developed by the federal government, the NYID would “delay indefinitely” regulating the CDS market.

The NYID’s announcement is a significant reversal of its controversial proposal to regulate CDS. It appears, for the time being, to eliminate the possibility that certain types of CDS contracts will be treated as insurance. Furthermore, assuming other states follow New York’s lead, the NYID announcement signals that any new regulation of CDS will be done on a uniform federal basis rather than on both the federal and state levels.

The FSA Release

In November 2008, the FSA’s Markets Division issued a newsletter addressing, among other issues, whether CDS are covered by the U.K. market abuse regulatory regime. The newsletter noted that “although CDS[s] are not admitted to trading on a prescribed market, we consider that most CDS[s] are likely to be caught by the U.K. market abuse regime.” In particular, the FSA newsletter noted that a CDS will be subject to insider dealing and disclosure of insider information provisions where the CDS is a “related investment,” which is defined as an investment whose price or value depends on the price or value of a qualifying investment such as an underlying bond. The FSA also noted that a CDS would be subject to certain “misuse of information” provisions where the relevant behavior occurs in relation to a CDS whose subject matter is a qualifying investment. In addition, the use of CDS could be subject to market manipulation, misleading behavior and market distortion regulations. The FSA emphasized that effecting transactions in CDS which “give, or are likely to give, a false or misleading impression as to the price of one or more qualifying investments (*e.g.*, shares or bonds), other than for legitimate reasons” would be one form of abusive market behavior.

[5] Such plans were discussed in Circular Letter No. 19, which was issued by the NYID on September 22, 2008. Circular Letter 19 expressed the NYID’s intent that, effective January 1, 2009, the NYID would treat certain CDS (so called “covered swaps,” where the purchaser of protection holds a material interest in the underlying security and is seeking to hedge its exposure) as insurance.

The FSA announcement makes clear the FSA's belief that transactions in CDS are subject to the FSA's oversight and could potentially give rise to civil or criminal liability under U.K. law.

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