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U.S. Treasury Proposes Regulatory Framework for OTC Derivatives

On May 13, the U.S. Department of the Treasury (the "Treasury"), in a joint statement with the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC"), announced its intention to seek legislative changes that could significantly alter the regulatory framework for over-the-counter ("OTC") derivatives transactions and markets in the United States. According to the Treasury, these changes are designed to achieve four goals: (1) prevent activities in these markets from posing risks to the financial system; (2) promote the efficiency and transparency of these markets; (3) prevent market manipulation, fraud and other market abuses; and (4) ensure that OTC derivatives are not marketed inappropriately to unsophisticated parties. While the Treasury proposal has yet to be embodied in proposed legislation, the Treasury has identified the following five areas that would be the subject of any such legislation.

Mandatory Clearing of Standardized OTC Derivatives

The Treasury has stated that the Commodity Exchange Act (the "CEA") and the federal securities laws should be amended to require clearing of all standardized OTC derivatives through regulated clearinghouses. While the Treasury has not identified the criteria that would be used to determine whether an OTC derivative is "standardized," it has stated that the mere fact that an OTC derivative is accepted for clearing by a clearinghouse should create a presumption that the OTC derivative is a standardized contract and thus must be cleared through a regulated clearinghouse. We believe that for any proposal to require the mandatory clearing of OTC derivatives to be useful, it must set forth clear, objective criteria for determining whether an OTC derivative is standardized. Further, because many participants in the OTC derivatives markets are not direct members of clearinghouses, the Treasury's proposal would require them to establish clearing relationships with clearing members. Finally, the Treasury proposal would require clearinghouses to ensure that customized OTC derivatives are not used solely as a means of avoiding the mandatory clearing requirements described above. While the meaning of that statement is not entirely clear, it may imply that any implementing legislation should include anti-avoidance provisions that are designed to strengthen those mandatory clearing requirements.

Regulation of Large Derivatives Participants

The Treasury has stated that all OTC derivatives dealers and all other firms that create large exposures to counterparties should be subject to regulation that, among other things, would impose capital requirements and business conduct standards and set forth mandatory margin requirements in connection with OTC derivatives transactions. Currently, many of the largest OTC derivatives dealers are banks, which are already subject to a

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certain level of prudential supervision and regulation with respect to their OTC derivatives activities. However, the Treasury proposal would appear to take matters that have been subject to prudential supervision (such as margin requirements) and impose mandatory requirements with respect to these matters. More significantly, hedge funds and other firms that are active in the OTC derivatives markets could find themselves subject to a new regulatory regime with respect to these activities. In this regard, the Treasury's proposal does not specify any criteria for determining whether a firm has created a "large exposure" to one or more of its counterparties and would thus be subject to regulation under the Treasury's proposal.

New Transparency Initiatives

The Treasury proposal recommends that the CEA and the federal securities laws be amended to authorize the CFTC and the SEC to require that all transactions in standardized OTC derivatives be effected on regulated trading facilities and that these facilities be required to develop systems for promptly reporting these transactions. The Treasury has also stated that any such amendments should authorize the CFTC and SEC to impose recordkeeping and reporting requirements on participants in the OTC derivatives markets, and to require transactions that are not standardized (and thus not subject to mandatory clearing) to be reported to clearinghouses and regulated trade repositories, which would in turn make individualized transaction data available to regulators and aggregated transaction data available to the public. Certain of these requirements have already been imposed on clearinghouses that are clearing credit default swap transactions under exemptions from clearing agency registration granted by the SEC, and it appears that the Treasury desires to expand these requirements to all standardized OTC derivatives transactions. The Treasury's transparency proposal also would give the CFTC and the SEC the authority to mandate that standardized OTC derivatives be effected on regulated trading facilities, and would encourage regulated institutions to make greater use of exchange-traded derivatives.

Prevention of Market Manipulation, Fraud and Other Market Abuses

The Treasury proposal states that the CEA and the federal securities laws should be amended to ensure that the CFTC and the SEC have the clear and unimpeded authority to police market manipulation, fraud and other market abuses. In addition, the Treasury proposal advocates providing federal regulators with the authority to set position limits on OTC derivatives that perform a significant price discovery function.

Reexamination of Sophistication Criteria

Both the CEA and the federal securities laws exempt many OTC derivatives transactions effected between "eligible contract participants" from substantive regulation under these laws. In general, the test for determining whether a person is an eligible contract participant is based on the type or regulated status of a party or the total amount of assets held by that party (or a combination thereof), and does not take into account the party's experience or sophistication. The Treasury proposal encourages the CFTC and SEC to review this standard with a view toward making it more stringent and/or imposing a standard of care or additional disclosure requirements on market participants that engage in OTC derivatives transactions with less sophisticated counterparties.

The acting chairman of the CFTC and the chairman of the SEC have stated that they support the Treasury proposal, and the adoption of any legislation that implements the proposal will require close coordination among the Treasury, the CFTC and the SEC. We will continue to monitor the status of the Treasury proposal and any proposed legislation or regulations relating to the proposal.

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