

Preparing for Inconsistency: Why the US and European Legislators May Differ in their Approaches to OTC Derivatives Reform

By Eric L. Foster

Introduction

Many compliance professionals I speak with are wondering what, if anything, the U.S. Congress and the Obama Administration are likely to enact this year in terms of an over-the-counter (“OTC”) derivatives reform bill. This article attempts to respond to these inquiries by reviewing where things now stand and why passage of a comprehensive new oversight regime for OTC derivatives trading is quite likely in 2010. It also discusses some of the political forces currently impacting the legislative process in Washington and their likely consequences for compliance professionals.

Background

The recent surprising election of a relatively unknown Massachusetts Republican Scott Brown to former Senator Kennedy’s Senate seat is widely seen as a loud “wake-up” call to the Democratic leadership. To regain the political momentum, Democrats have made it clear that they intend to reestablish their populist credentials. One obvious way to reclaim the mantle of defenders of the people against the “fat-cats” of Wall Street is through successful enactment of some sort of comprehensive financial services reform bill. Despite provisions in the current legislation directing U.S. regulators to coordinate with their foreign counterparts to establish a consistent approach to regulation, it is my contention that any financial services reform bill that emerges will inevitably lead to certain differences between how OTC derivatives trading is regulated in the U.S. and European Union (“EU”).

The Wall Street Reform and Consumer Protection Act of 2009

The most likely legislative vehicle that the Obama Administration and Congressional Democrats will use to “get tough” on Wall Street is the lengthy and comprehensive bill passed late last year by the House of Representatives. The *Wall Street Reform and Consumer Protection Act* (H.R. 4173)(the “House Bill”) is a comprehensive and far reaching bill designed to fundamentally restructure and improve federal oversight of the financial service industry in the United States.

Technically, the House Bill is currently before the Senate Banking Committee. However, the House Bill is not a bipartisan package and thus is a poor indicator of what the Senate might be willing to approve – especially now that the Democrats have lost their supermajority vote.¹

¹ Democratic House Members widely supported the House Bill in December (223 – 27) while Republican House Members unanimously rejected the bill (0 – 175). The House bill includes a number of provisions that are unrelated to OTC derivatives and therefore will not be discussed in this article. These provisions basically expand the authority of the Federal Reserve; establish a new federal systemic risk regulator; provide the FDIC with resolution authority to wind down failing financial firms; create a new Consumer Financial Protection Agency and greater oversight of credit rating agencies; increase the Federal regulation of the insurance industry; expand certain investor protection provisions; enhance the regulation of hedge funds; and expand the regulation of certain executive compensation practices at banks and broker/dealers.

The Senate Banking Committee is therefore focused on developing its own financial regulatory reform proposal, using a discussion draft circulated by Chairman Dodd last fall as its starting point. To achieve the Chairman's desired goal of developing a more bipartisan bill before Congress reconvenes in late January, Chairman Dodd asked Committee members late last year to voluntarily form two-member working groups to address member concerns regarding specific aspects of the proposed legislation. The team addressing the regulation of the OTC derivatives markets is Senators Jack Reed (D-RI) and Judd Gregg (R-NH).² I suspect that a bipartisan bill generally reflecting these efforts will be introduced in the Senate sometime in the next few weeks.

Forces Likely to Shape the Final OTC Derivatives Reform Bill

There are several aspects of the current U.S. political climate that suggest any successful reform legislation will be fairly prescriptive and punitive on both derivative dealers and the OTC markets in which they operate. These characteristics are (i) the suddenly populist tone coming out of Washington (i.e., the sudden need for legislators and regulators to appear tough on Wall Street firms prior to the mid-term elections); (ii) Congress' general inclination not to approach derivatives reform in a manner consistent with internationally agreed upon standards; and (iii) Congress' propensity to sometimes legislate in a vacuum (thereby ignoring the considerable investments market participants have already made in both settlement and disclosure systems and market practices to reduce risks and improve the infrastructure supporting the global OTC derivatives markets).

Let take them each in order.

1. The Increasingly Populist Tone Coming out of Washington.

Enactment of sweeping financial services reform legislation remains an extremely high priority for Democrats in Washington these days. This is especially true now that health care reform is now widely viewed as stalled thanks to the Democrats losing their filibuster proof majority in the Senate on January 20th.

All hopes for a quick and significant legislative "victory" by Democrats prior to the mid-term elections now rest on legislation pending in the Senate to reform the financial services sector. As mentioned earlier, President Obama has reacted swiftly and forcefully to the election of an unknown Republican into the seat previously held by Senator Kennedy. The Administration has thus signaled its clear intent to use passage of financial services reform legislation in 2010 as a catalyst for the mid-term elections.

This shift has actually been underway for some time now. But it clearly accelerated this week. The first hint that something was up occurred when President Obama made time to meet with soon-to-be-retired Senate Banking Committee Chairman Christopher Dodd to specifically discuss how to efficiently sheppard reform legislation through the Senate. A renewed anti-bank

² The other working groups are: prudential regulation (Chairman Dodd and Ranking Member Richard Shelby (R-AL)), consumer financial protection (Chairman Dodd and Ranking Member Shelby), resolution authority for failed financial firms (Senators Mark Warner (D-VA) and Bob Corker (R-TN)), and executive compensation and corporate governance (Senators Charles Schumer (D-NY) and Mike Crapo (R-ID)).

sentiment amongst Democrats became even clearer with the President expressing the view in a private interview this week that “[w]e’ve got a financial regulatory system that is completely inadequate to control the excessive risks and irresponsible behavior of financial players all around the world.” Most importantly, the day after this interview, the President held a White House press conference where he unveiled a significant proposal to go after the banks by curbing excessive risk taking by financial services firms.³

It is at time like these (think Sarbanes-Oxley and Enron) when legislators and regulators who might otherwise engage in more prudent policymaking, face the political reality of getting reelected (or reconfirmed). In this case, the sudden upshot of populist anger is likely to be legislation designed to generally “penalize” banks and thus pay little heed to either the bill’s impact on the need for a harmonized international regulatory approach or any potential decline in the competitiveness of U.S. OTC wholesale financial markets or its financial centers as a whole. In other words, U.S. fixed income and derivatives compliance fixed professional at major banks should begin preparing for the worst.

2. Unwillingness to Approach Regulation in a Manner More Consistent with the Europeans and IOSCO’s Recommendations.

There is a growing realization in some quarters that the U.S and Europe may very well end up with slightly dissimilar approaches to the regulation of OTC derivatives markets and market participants, especially with respect to dealer ownership, governance and access to any non-exchange affiliated swaps clearing corporations. In my view, any such divergence would be the result of disagreement between legislative bodies and not due to a lack of consensus amongst international regulators. It would also most likely arise if regulators are unable to convince legislators in the U.S. that they should be granted fairly broad exemptive authority with respect to swap dealers, swap execution facilities and other regulated entities. However, the adoption of a unique, prescriptive and somewhat bifurcated approach by the U.S. to the regulation of swap dealers and swap markets in general would not be surprising especially given the current battle amongst U.S. banking, securities and commodities regulators over who should take the lead in regulating our swaps and swaptions markets.

Such a result would be disappointing for U.S. based dealers and their customers that are seeking competitive pricing for execution and clearing services. However, it will be even more disappointing to U.S. and European regulators who have worked long and hard in recent years to ensure a coordinated and consistent approach to the oversight of the international OTC derivatives markets. After all, creating opportunities for financial firms to engage in legal or regulatory arbitrage by shifting their derivatives trading activities to another jurisdiction was just the outcome U.S. regulators were seeking to prevent.

If the U.S. and European approaches to regulating the OTC derivatives markets ultimately do diverge it certainly won’t be due to a lack of effort by the globe’s leading regulators. Building off of the 2005 Council of European Securities Regulators (“CESR”) Recommendations for

³ “Obama Hammers the Banks”, Financial Times, Jan 22, 2010.

Central Counterparties and similar guidance by the International Organization of Securities Commissions (“IOSCO”), regulators have sought in recent years to reach specific agreement on the regulation of OTC derivatives, including in the area of recommended practices by central counterparties (“CCPs”) that clear such derivatives. For instance, with respect to credit default swap (“CDS”), leading international regulators recently agreed not only that dealers and significant swap participants should be required to be shareholders in any CCP and control the terms of any CDS product that is accepted for clearing, but also that such CCPs should meet the CESR Recommendations for CCPs (“CESR CCP Recommendations”).⁴

Likewise, a large group of the leading financial regulators just recently established an “OTC Derivatives Regulators’ Forum.” This forum was the result of several previous meetings aimed at improving international coordination including a February 19, 2009 at the New York Fed where the development of a global framework for cooperation amongst regulators of CCPs that clear CDS was discussed.⁵ The primary focus of their earlier discussions were on mutual support in applying consistent standards and achieving similar policy objectives as well as a general effort at coordinating their approaches to the oversight of CDS CCPs. The mission of the OTC Derivatives Regulators’ Forum was later expanded to include adopting, promoting, and implementing consistent standards, such as the CPSS-IOSCO Recommendations for Central Counterparties, in setting oversight and supervisory expectations as well as the coordination of the sharing of information routinely made available to regulators or to the public by OTC derivatives CCPs and trade repositories.

It is also important to note that this type of international coordination is not new to financial services regulators. Members of IOSCO and the Basel Committee on Banking Supervision (“BCBS”) have long understood that modern financial markets are truly interdependent and global and money is both fungible and extremely portable. In fact, even before the first Basel capital accord, significant multilateral efforts have sought to foster a coordinated approach to bank capital rules and the adoption of common recommendations in the area of disclosure, legal documentation, risk management, banking supervision and the general regulation of these markets.

Today, IOSCO, the BCBS, the European Central Bank (“ECB”), CESR, the U.K. Financial Services Authority (“FSA”) and the members of the U.S. President Working Group on Financial

⁴ The CESR CCP Recommendations are similar to the IOSCO/CPSS CCP Recommendations while more specifically addressing CCP corporate governance issues such as preventing derivative dealers’ from exercising undue influence over a CCP. They call for the appropriate representation of users in the governance of a CCP and consultation by the CCP with dealers and other users regarding any material decisions. This recommendation sharply contrasts with the language in the Lynch Amendment that was added to the House Bill. That amendment seeks to bar derivative dealers as a whole from having a significant financial stake in a CCP or a say in its governance.

⁵ Attendees at that meeting included representatives from the Fed, the CFTC, the U.K. Financial Services Authority, the German Federal Financial Services Authority (“BaFin”), the Deutsche Bundesbank, the New York State Banking Department, the SEC, and both the ECB and the Hungarian Financial Services Authority in their roles as co-chairs of the joint ESCB-CESR Working Group on Central Counterparties.

Markets (“PWG”) all recognize the international nature and critical role of these markets. As a result, they have all agreed to try and promote a coordinated and consistent approach to oversight of these markets. There is a clear and broad consensus today among international regulators regarding the systemic importance of OTC derivatives markets, their significant role in the 2008 crisis and the changes needed in order to reduce and contain future risks arising from these markets. International regulators agree that under collateralized (and sometimes, uncollateralized) counterparty credit exposures of systemically significant financial institutions arising from the CDS markets contributed to the 2008 financial crisis and lead directly to the U.S. government having to take over control of AIG. They also have already reached a general consensus (such as within IOSCO) on two immediate steps for reducing such risks to the global financial system – centralizing the risks so they can be more closely supervised and enhancing transparency within the price discovery process so manipulation can be detected and investor confidence in these markets better ensured. As a result, both the Obama Administration and the EU are now widely expected to require standardized swaps (single name and index CDS as well as other standardized interest rate, commodity and equity swaps) to generally be traded only on an exchange (or similarly regulated execution system) and settled through a CCP.

Despite regulators reaching a general agreement on a common approach to reigning in the OTC derivatives markets, I anticipate that there will still be key differences between in how these principles are implemented in a new statutory regime by the U.S. and Europe, especially given the bifurcated nature of the U.S. regulatory regime. Unfortunately, this will mean plenty of headaches and challenges for compliance professional as they scramble during the period after any reform bill is signed into law but not yet in effect to review rule proposals, and generally come into compliance with the new regime.

And, if I am correct that the Congress will ultimately require a U.S. approach that is more prescriptive and restrictive than Europe’s, the relative competitiveness of certain parts of the U.S.’s wholesale OTC derivatives markets are likely to be the first casualty of the reform process.⁶

3. Propensity to Legislate in a Vacuum Thereby Ignoring Recent Improvements Adopted by the Industry

There is a propensity, in my view, for legislators to sometimes fail to realize that statutory reform efforts do not occur in a vacuum. Attempting to reform financial markets always involves hitting a moving target, especially when a market is already under considerable regulatory pressure to improve its infrastructure and modify market practices. In the case of OTC trading in CDS, for instance, the industry is rapidly moving closer to completing its migration towards centralized clearing, in both the U.S. and Europe, of index CDS.⁷ Likewise, the SEC, the CFTC and other

⁶ Not that such inconsistency is all bad. In fact, they also create unique opportunities for sophisticated market participants to gain competitive advantage by duly taking into account the potential for new regulatory restrictions (such as those the Obama Administration has proposed on proprietary trading) when making strategic decisions regarding the products, counterparties and markets where they want to expand their OTC derivatives operations.

⁷ See “CDS Clearing Reaches \$5 Trillion on a Global Basis; ICE Clear Europe Crosses euro 1 Trillion” Jan 25, 2010 PRNewswire via COMTEX News Network.

domestic and foreign regulators have not simply been waiting for someone to grant them new authority before trying to reign in and reform the OTC derivatives markets.

With respect to recent industry efforts to learn from the crisis, there has been progress made by the market participants and key service providers to improve the post trade infrastructure supporting the OTC swaps markets in both the U.S. and Europe. This has been especially true for the credit default swaps (“CDS”) markets in the U.S. where exemptive orders by the Securities & Exchange Commission (“SEC”)⁸ has facilitated the migration to centralized clearance and settlement of index CDS trades as well as some single name CDS transactions.

Likewise, the industry has also been working, since before the global financial crisis of 2008, to reduce the backlog of unconfirmed or unsettled CDS transactions and to generally ensuring that the OTC derivatives markets reduce the level of bilateral counterparty credit risk and operational risk unnecessarily overhanging the marketplace. For over three years now, the industry has been under significant and coordinated pressure from regulators to significantly improve transparency and operational efficiency in the OTC derivatives markets in general and the OTC CDS market in particular.

Much of this progress has been facilitated by the International Swaps and Derivatives Association (“ISDA”). ISDA has spearheaded several initiatives designed to reduce risk and improve efficient and transparency within the post-trade infrastructure (i.e. greater standardization, improved documentation, clearer trading practices, and more robust clearance, settlement, margining, and other related infrastructure supporting OTC derivatives trading.) These steps have included the establishment in March of 2009 of a Credit Derivatives Determination Committee and the development of a special ISDA protocol (the “Big Bang Protocol”) whereby parties to a preexisting CDS transactions can adhere to a new auction settlement process.

Other steps have been achieved under the auspices of a public/private partnership in the form of a joint industry working group formed by the Federal Reserve Bank of New York (“NY Fed”). The NY Fed has so-far hosted six meetings with the major participants in the OTC derivatives markets and their supervisors to discuss efforts to improve the infrastructure currently supporting the market. At these meetings market participants update U.S. and international regulators on developments in the OTC derivatives market in general while also agreeing to make further improvements to support the overall goals of reducing risk and increasing transparency. This effort has resulted in a meaningful reduction of the risks posed by, and improvement in the transparency of, the OTC derivatives markets without the need to enact substantial reform legislation. As a result, there has been an expansion of centralized clearing and novation of interest rate and credit derivatives trades that are already eligible to be cleared as well as improvements in regulatory reporting on OTC derivatives transactions thereby helping regulators identify and target opportunities for improvements to increase clearing and standardization.

⁸ See SEC Release No 34-59164 (Dec. 24, 2008); SEC Release 34-59165 Dec. 24, 2008).

Still, it seems unlikely that there will be fully consistent approach by Washington and Brussels in regards to enacting a new statutory regime for the OTC derivatives markets. This is unfortunate and will occur despite the noble efforts of many regulators and several international coordinating bodies. The reason is simple: the upcoming elections in the U.S. will mean legislators will be more interested in obtaining “payback” from the big banks it had to recapitalize than in ensuring New York and Chicago operate at a level playing field with London.

Therefore, despite reaching a general agreement on a common approach to reigning in the OTC derivatives markets, the unfortunate news is that key differences between the U.S. and E.U. approaches will remain. The good news, I guess, is that this will mean plenty of work for compliance professional in late 2010 and well into 2011.

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