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Regulatory Reform Over-The-Counter (OTC) Derivatives

The crisis of the past 20 months has exposed critical gaps and weaknesses in our financial regulatory system. As risks built up, internal risk management systems, rating agencies and regulators simply did not understand or address critical behaviors until they had already resulted in catastrophic losses. Those failures have caused a dramatic loss of confidence in our financial institutions and have contributed to a severe recession.

Last March, Secretary Geithner laid out new regulatory rules of the road to ensure we never face a crisis of this magnitude again. An essential element of reform is the establishment of a comprehensive regulatory framework for over-the-counter derivatives, which under current law are largely excluded or exempted from regulation.

As the AIG situation has made clear, massive risks in derivatives markets have gone undetected by both regulators and market participants. But even if those risks had been better known, regulators lacked the proper authorities to mount an effective policy response.

Today, to address these concerns, the Obama Administration proposes a comprehensive regulatory framework for all Over-The-Counter derivatives.

Moving forward, the Administration will work with Congress to implement this framework and bring greater transparency and needed regulation to these markets. The Administration will also continue working with foreign authorities to promote the implementation of similar measures around the world to ensure our objectives are not undermined by weaker standards abroad.

Objectives of Regulatory Reform of OTC Derivatives Markets

- **Preventing Activities Within The OTC Markets From Posing Risk To The Financial System** – Regulators must have the following authority to ensure that participants do not engage in practices that put the financial system at risk:
- The Commodity Exchange Act (CEA) and the securities laws should be amended to require clearing of all standardized OTC derivatives through regulated central counterparties (CCP):
 - CCPs must impose robust margin requirements and other necessary risk controls and ensure that customized OTC derivatives are not used solely as a means to avoid using a CCP.
 - For example, if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared.
- All OTC derivatives dealers and all other firms who create large exposures to

counterparties should be subject to a robust regime of prudential supervision and regulation, which will include:

- Conservative capital requirements
 - Business conduct standards
 - Reporting requirements
 - Initial margin requirements with respect to bilateral credit exposures on both standardized and customized contracts
- **Promoting Efficiency And Transparency Within The OTC Markets** -- To ensure regulators would have comprehensive and timely information about the positions of each and every participant in all OTC derivatives markets, this new framework includes:
 - Recordkeeping and reporting requirements (including audit trails).
 - Requirements for all trades not cleared by CCPs to be reported to a regulated trade repository.
 - CCPs and trade repositories must make aggregate data on open positions and trading volumes available to the public.
 - CCPs and trade repositories must make data on individual counterparty's trades and positions available to federal regulators.
 - The movement of standardized trades onto regulated exchanges and regulated transparent electronic trade execution systems.
 - The development of a system for the timely reporting of trades and prompt dissemination of prices and other trade information.
 - The encouragement of regulated institutions to make greater use of regulated exchange-traded derivatives.
- **Preventing Market Manipulation, Fraud, And Other Market Abuses** The Commodity Exchange Act (CEA) and securities laws should be amended to ensure that the CFTC and the SEC have:
 - Clear and unimpeded authority for market regulators to police fraud, market manipulation, and other market abuses.
 - Authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to futures markets.
 - A complete picture of market information from CCPs, trade repositories, and market participants to provide to market regulators.
- **Ensuring That OTC Derivatives Are Not Marketed Inappropriately To Unsophisticated Parties** Current law seeks to protect unsophisticated parties from entering into inappropriate derivatives transactions by limiting the types of counterparties that could participate in those markets. But the limits are not sufficiently stringent.
- The CFTC and SEC are reviewing the participation limits in current law to recommend how the CEA and the securities laws should be amended to tighten the limits or to impose additional disclosure requirements or standards of care with respect to the marketing of derivatives to less sophisticated counterparties such as small municipalities.