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Economic Crisis Response Group

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New Swaps Legislative Initiative

On May 14, Treasury Secretary Timothy F. Geithner sent a two-page letter to Congressional leaders asking for quick enactment of legislation in accordance with his proposal to regulate most derivatives in the United States, including credit default swaps ("CDS"). CDS are promises by one party to pay another party for its real or theoretical losses if the issuer of a loan or bond is insolvent or in bankruptcy, or otherwise fails to pay. Geithner's proposal would give either the Securities and Exchange Commission ("SEC") or Commodity Futures Trading Commission ("CFTC"), as determined by Congress, the lead role in regulating derivatives and would remove many existing exemptions from regulation, and would affect much of the trillions of dollars of derivatives that are traded worldwide each day.

Secretary Geithner's proposal would require that many derivatives, including CDS, be regulated and traded on exchanges, would permit regulators to set new capital requirements requiring issuers of derivatives to hold additional capital to protect against the consequences of a default, and would impose new rules on the large companies that issue CDS and other derivatives. The proposal is intended to:

1. Reduce major risks to the financial system by reducing risky trading practices;
2. Increase the transparency and efficiency of derivatives markets;
3. Reduce and discourage fraud and market manipulation; and
4. Protect investors.

Investor protections would focus, among other things, on ensuring that most over-the-counter derivatives are not marketed improperly to unsophisticated persons. Standard and uniform derivatives would have to be traded on exchanges or through clearing houses, which would be required by regulatory authorities to mandate substantial initial margin requirements and other risk controls. Derivatives that have unique characteristics and are negotiated between the parties thereto could still be traded privately, off exchange. The proposal also would require recordkeeping and prompt reports of trades of derivatives. Aggregate data on open positions and trading volumes would be available to the public and information on any counterparty's trades and positions would be available on a confidential basis to regulatory authorities. The proposal would amend the Commodity Exchange Act and securities laws to give regulatory authorities greater ability to prevent and prosecute fraud and to set position limits on certain important OTC derivatives.

Robert Pickel, Executive Director and Chief Executive Officer of the International Swaps and Derivatives Association, Inc., and the Chairman of the SEC, Mary Schapiro, publicly supported the proposal. Gary Gensler (confirmed by the Senate on May 19 as Chairman of the CFTC) has made statements to Congress supporting comprehensive regulation of derivatives.

House Financial Services Committee Chairman Barney Frank and House Agriculture Committee Chairman Colin Peterson have supported Geithner's proposal, and bills to regulate derivatives are already in the House and Senate. On May 4, Senators Carl Levin and Susan Collins introduced a bill entitled "Authorizing the Regulation of Swaps Act of 2009" to repeal existing legislation, including portions of the Commodity Futures Modernization Act of 2000, that shields swaps from most federal regulation. Under that bill, federal regulatory authorities would be permitted to regulate the swaps markets, including CDS. As a result of the proposed amendments to existing legislation, future laws also could include specific regulation of swaps. The bill would apply to swaps marketed or traded in the United States and is aimed at providing greater reporting and transparency requirements for swaps.

Regulatory authorities already are considering means of implementing such legislation, including use of Trace, the bond-price reporting system of the Financial Industry Regulatory Authority, as a model for reporting for derivatives.

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