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REGULATORY REFORM

Credit Default Swaps: Regulatory Storm Clouds Brewing

By DAVID W. PORTEOUS AND JAMES G. MARTIGNON

In recent weeks, credit default swaps (CDS) have moved front and center in the current financial crisis. CDS are unregulated financial instruments and have been cited as a substantial factor in the sub-prime mortgage meltdown as well as the failure of such firms as American International Group, Bear Stearns and Lehman Brothers.¹ In less than ten years, the CDS market, in which many of the world's major financial institutions actively participate, is estimated to have grown to a staggering \$58 trillion in notional value, creating fears that a default by one large firm could ripple through the

global financial system.² As such, regulators at both the federal and state level are seeking authority to regulate the CDS market,³ and greater pricing and trade transparency, reporting, accounting disclosure, capital requirements, and centralized settlement and clearing of trades are likely to be implemented and reshape the CDS market.

The following is a brief introduction to CDS and report on emerging efforts to regulate the market for these instruments.

What is a Credit Default Swap

A CDS is a contract in which a buyer pays a series of payments to a seller, and in exchange receives the right

¹ Sarah N. Lynch, "SEC-CFTC Turf Battle Revived Over CDS Role in Financial Crisis," *Dow Jones News Service*, Oct. 7, 2008, available at <http://www.lloyds.com/dj/DowJonesArticle.aspx?id=407634>. See also Emily Flitter, SEC Seeks Authority Over Credit Derivatives, *American Banker*, Sep. 24, 2008, available at <http://www.onwallstreet.com/asset/article-print/704401/printPage.html>.

² Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, by Chairman Christopher Cox Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Sep. 23, 2008, available at <http://www.sec.gov/news/testimony/2008/ts0923cc.htm>.

³ *Id.* (urging Congress to provide SEC statutory authority to regulate CDS). See also Statement of CFTC Commissioner Bart Chilton on Regulation of Credit Default Swaps, Oct. 8, 2008 (urging Congress to provide CFTC regulatory authority over CDS), available at <http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/chiltonstatement100808.pdf-31.2KB> - CFTC.gov; and Governor Paterson Announces Plan to Limit Harm to Markets from Damaging Speculation, Sep. 22, 2008 (announcing that as of January 1, 2009, New York will regulate certain types of CDS as insurance products), available at http://www.state.ny.us/governor/press/press_0922081_print.html.

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to a payoff if a referenced debt, such as a bond, loan, or asset-backed security (such as commercial mortgage-backed securities), goes into default or experiences some other “credit event” as defined by the terms of the contract.⁴ Thus, CDS provide lenders or bondholders a form of third-party insurance or hedge against default on a referenced debt, much like a lender might procure a guaranty or surety bond to protect against default on a construction loan.⁵ Stated differently, CDS are mechanisms to transfer credit risk rather than a direct means to raise capital such as is provided by the issuance of stocks or bonds, although they are often used by lenders and investors in the financing process.⁶

But, because a CDS buyer does not have to own the underlying bond or other debt instrument upon which the CDS contract is based, CDS also allows investors to speculate from afar on the likelihood of default or other credit event by the reference debtor. In particular, CDS has enabled investors to: (i) naked short the referenced debt⁷; and/or (ii) pocket the difference in premium spreads between the CDS contracts they sell and then buy on the same credit event. Such trading is often premised on the assumption that the ultimate CDS protection seller in the chain (such as AIG) will make good on the underlying payment obligation for the referenced debt, which will then flow through the chain and net out their respective CDS positions without requiring the investor to dip into its own capital.⁸

By some estimates, such speculative swap activity may constitute up to 80%-90% of the CDS market.⁹ All that is needed is a counter-party willing to sell a CDS

contract to the buyer.¹⁰ And, because CDS are bi-lateral contracts rather than securities, they are unregulated, easy to create, and can be executed or traded quickly between two willing parties.¹¹

Financial Solvency of the CDS Market is Unknown

These factors have drawn not only banks but also a wide array of hedge funds, fund managers, insurance companies and others to the CDS market.¹² Currently, it is unknown whether all these providers of CDS have the financial capacity to fund their contingent CDS obligations in the event of a large failure or series of failures such as has occurred with Lehman Brothers where more than 350 banks and investors have signed up to settle credit-default swaps written on Lehman bonds which may generate more than \$365 billion in CDS claims,¹³ or AIG which issued more than \$440 billion in CDS contracts and is now the subject of a U.S. government bailout that may reach \$150-\$167 billion to prevent a potential “contagion event” from rippling through the financial system should AIG default.¹⁴

Due to the lack of disclosure and reporting requirements for CDS, concern is widespread that: (i) CDS sellers may be insufficiently capitalized to meet their payment obligations; (ii) as a result, banks have and will continue to freeze lending to one another thereby locking up the credit markets; and, (iii) defaults in the CDS markets have and will continue to spill into the equity markets as CDS providers such as hedge funds may be forced to sell assets to raise cash to meet their CDS payment obligations.¹⁵

Counter-Party Litigation

At a minimum, significant counterparty litigation involving financially insolvent or undercapitalized CDS

⁴ Wikipedia, Credit default swap, available at http://en.wikipedia.org/wiki/Credit_default_swap. See also Written Testimony of CFTC Acting Chairman Walter Lukken Before the House Committee on Agriculture, Oct. 15, 2008, available at <http://www.cftc.gov/newsroom/speechestestimony/lukken/index.htm>.

⁵ *Id.*

⁶ Testimony Concerning Credit Default Swaps Before the House Committee on Agriculture, by Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission, Oct. 15, 2008, available at <http://www.sec.gov/news/testimony/2008/ts101508ers.htm>; Written Testimony of Acting CFTC Chairman Walter Lukken Before the House Committee on Agriculture, Oct. 15, 2008, <http://www.cftc.gov/newsroom/speechestestimony/lukken/index.htm>.

⁷ Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, by Chairman Christopher Cox Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Sep. 23, 2008, available at <http://www.sec.gov/news/testimony/2008/ts0923cc.htm>. See also Nicholas Varchaver and Katie Benner, “The \$55 trillion question,” CNNMoney.com (Sep. 30, 2008), available at <http://cnmoney.printthis.clickability.com/pt/cpt?action+cpt&title=Will+credit+default+s;> “SEC Chair

Regulate Credit-Default Swaps Now”, *The New York Times*, Oct. 8, 2008, available at <http://dealbook.blogs.nytimes.com/2008/09/23/sec-chair-regulate-credit-default-swaps-now/>.

⁸ Alex Blumberg, “Unregulated Credit Default Swaps Let to Weakness,” *NPR*, Nov. 16 2008 (New York State Insurance Superintendent Eric Dinallo explaining the same in testimony to Congress), available at <http://www.npr.org/templates/story/story.php?storyID=9695271>.

⁹ Morgan Bettex, “Clearinghouse Needed to Regulate CDS: Experts,” *Law 360*, Oct. 14, 2008, available at http://securities.law360.com/print_article/72510.

¹⁰ Nicholas Varchaver and Katie Benner, “The \$55 trillion question,” by CNNMoney.com (Sep. 30, 2008), available at [http://cnmoney.printthis.clickability.com/pt/cpt?action+cpt&title=Will+credit+default+s.](http://cnmoney.printthis.clickability.com/pt/cpt?action+cpt&title=Will+credit+default+s;)

¹¹ *Id.*

¹² *Id.* See also Shannon D. Harrington and Neil Unmack, “Lehman to Spark Record Payout for Credit Swap Sellers,” *Bloomberg.com*, Oct. 10, 2008, available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aX_FLjiKfbic; Heather Landy, “Lehman Credit-Default Swap Payout Could Climb as High as \$365 Billion,” *Washington Post*, Oct. 11, 2008, available at http://www.washingtonpost.com/wp-dyn/content/article/2008/10/10/AR2008101003050_.

¹³ See also Shannon D. Harrington and Neil Unmack, “Lehman to Spark Record Payout for Credit Swap Sellers,” *Bloomberg.com*, Oct. 10, 2008, available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aX_FLjiKfbic.

¹⁴ Testimony Concerning Credit Default Swaps Before the House Committee on Agriculture, by Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission, Oct. 15, 2008, available at <http://www.sec.gov/news/testimony/2008/ts101508ers.htm>; Written Testimony of Acting CFTC Chairman Walter Lukken Before the House Committee on Agriculture, Oct. 15, 2008, <http://www.cftc.gov/newsroom/speechestestimony/lukken/index.htm>; Update 1 – AIG’s Credit Default Swaps Fall to 19 pct Upfront, *Reuters*, Nov. 10, 2008, available at <http://www.reuters.com/article/marketsNews/idUSN1045504020081110>; SEC Chairman Cox Statement on MOU with Federal Reserve, CFTC to Address Credit Default Swaps, Nov. 14, 2008, available at <http://www.sec.gov/news/press/2008/2008-269.htm>.

¹⁵ *Id.* See also Floyd Norris, “Lehman Day,” *The New York Times*, Oct. 10, 2008, available at <http://norris.blogs.nytimes.com/2008/10/10/lehman-day/?pagemode=print>.

sellers has already begun and is likely to proliferate as CDS sellers default or CDS buyers seek increased collateral to support the obligations.

Two such lawsuits were filed earlier this year by a hedge fund that had sold two independent CDS contracts to Wachovia and Citibank, each representing 20% of the fund's capital under management (or 40% of the fund's total capital). The hedge fund sued to rescind each of the CDS contracts after Wachovia and Citibank separately required it to provide increasing amounts of collateral.¹⁶ While the U.S. District Court for the Southern District of New York has recently dismissed the lawsuit against Citibank, finding unworkable the hedge fund's claim that it was mistaken regarding the credit risk it had agreed to protect against and that it had waived arguments of bad faith margin calls by Citibank because the fund had complied with several such calls¹⁷, the lawsuits are telling regarding the counterparty risks one assumes when entering into such bilateral CDS contracts, including with such a thinly-capitalized CDS provider.

Similarly telling is the case *Aon Financial Products, Inc. v. Societe Generale*¹⁸ in which Aon sold CDS protection to a lender that had financed a condominium development in the Philippines, protecting against default by the developer and a Philippine government agency which had guaranteed the referenced debt. Aon then separately purchased its own CDS protection from Societe Generale to cover the risk it assumed under the first CDS contract, hoping to make a profit on the premium spreads it was owed and paid on the two CDS contracts. The disputes were ultimately litigated in two courts, the first of which found a credit event had occurred under the first CDS contract, thereby obligating Aon to pay on that CDS. The Second Circuit in the second lawsuit, however, determined that Aon could not collect against Societe Generale on the second CDS because the terms of the second CDS contract protected against default by the Philippine government, not the Philippine government agency. In short, Aon had mistakenly bought and sold protection on two different credit risks, leaving it exposed to liability on the front end of the CDS web with no off-setting credit support on the back end as it thought it had procured.

¹⁶ Nicholas Varchaver and Katie Benner, "The \$55 trillion question," CNNMoney.com (Sep. 30, 2008), available at <http://cnmoneypointthis.clickability.com/pt/cpt?action+cpt&title=Will+credit+default+s>; Kevin LaCroix, "Credit Default Swaps: The Newest Subprime Litigation Front," *D&O Diary*, Mar. 5, 2008, available at <http://www.dandodiary.com/2008/03/articles/subprime-litigation/credit-default-swaps-the>.

¹⁷ *VCG Special Opportunities Master Fund Ltd. v. Citibank*, N.A., No. 08-CV-01563, 2008 WL 4809078 (S.D.N.Y. Nov. 5, 2008).

¹⁸ 476 F.3d 90 (2nd Cir. 2007).

Insider trading related to CDS has been an enforcement priority since 2007 for the SEC, which reportedly has been examining cases of suspected insider trading and the illegal use of confidential information in the CDS market.

As can be seen from the foregoing, CDS litigation in many cases will be fact-intensive and unique to the terms of each individual contract, even if the CDS contracts seemingly are related to the same underlying event.

History of CDS Regulatory Efforts

The CDS market is approximately ten years old.¹⁹ In the late 1990s, the Commodity Futures Trading Commission (CFTC) proposed taking an oversight role over the then-emerging CDS market, viewing CDS as a type of futures derivative product. Instead, Congress passed the Commodity Futures Modernization Act of 2000 (CFMA).²⁰ The CFMA specifically excluded non-security-based swap agreements and security-based swap agreements from the definition of "security" contained in the Securities Act of 1933.²¹ The CFMA also specifically prohibited the CFTC from regulating covered swap agreements²² and the SEC from regulating

¹⁹ Speech by SEC Chairman: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System, by Chairman Christopher Cox, Oct. 8, 2008, available at <http://www.knowledgemosaic.com/gateway/Rules/SP.spch100808.htm>. See also Shannon D. Harrington and Neil Unmack, "Lehman to Spark Record Payout for Credit Swap Sellers," *Bloomberg.com*, Oct. 10, 2008, available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aX_FLjiKfbic.

²⁰ Nicholas Varchaver and Katie Benner, "The \$55 trillion question," CNNMoney.com (Sep. 30, 2008), available at <http://cnmoneypointthis.clickability.com/pt/cpt?action+cpt&title=Will+credit+default+s>.

²¹ See Section 2A(a)-(b) of the Securities Act of 1933, 15 U.S.C. § 77b-1(a), (b).

²² See Section 27(e) of the Commodities Exchange Act, 7 U.S.C. § 27e.

security-based swap agreements.²³ Section 10(b)'s anti-fraud provisions and rules promulgated thereunder (except those imposing or specifying reporting or record-keeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation or insider trading), are, however, still applicable to securities-based swap agreements.²⁴

The CDS market has enjoyed explosive growth since that time, doubling in size in the last two years to approximately \$58 trillion in notional size—greater than the gross domestic product of every country in the world and far outstripping the debt they reference.²⁵

Current Regulatory Action—Insider Trading and Market Manipulation

Insider trading related to CDS has been an enforcement priority since 2007 for the SEC, which reportedly has been examining cases of suspected insider trading and the illegal use of confidential information in the CDS market.²⁶ Insider trading surrounding CDS is widely suspected given that information asymmetries are inherent among CDS counterparties themselves²⁷, and due to increasing evidence that trading in CDS have been occurring prior to announcements of pending leveraged buyouts²⁸ as well as other news that

²³ See Section 2A(b) the Securities Act of 1933, 15 U.S.C. § 77b-1, and Section 3A(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c-1(b). See also Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, by Chairman Christopher Cox Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Sep. 23, 2008 (noting that neither the SEC nor any regulator has authority over the CDS market, even to require minimal disclosure to the market, with the exception of enforcement of the securities anti-fraud laws), available at <http://www.sec.gov/news/testimony/2008/ts0923cc.htm>.

²⁴ See Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).

²⁵ Speech by SEC Chairman: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System, by Chairman Christopher Cox, Oct. 8, 2008, available at <http://www.knowledgemosaic.com/gateway/Rules/SP.spch100808.htm>.

²⁶ "U.S. examines possible insider trading in credit-default swaps," *Bloomberg News*, June 25, 2007, available at <http://www.iht.com/bin/print.php?id=6304513>. See also John Carney, "Credit Default Swaps: The Land of Efficient Insider Trading?," *Dealbreaker*, April 17, 2007 (explaining that trading on the basis of material non-public information unavailable to trading counterparts is happening in the CDS market), available at http://dealbreaker.com/2007/04/credit_default_swaps_the_land.php; Shannon D. Harrington and Craig Torres, "Federal Reserve chief says existing laws cover abuses in credit-default swaps," *International Herald Tribune*, May 16, 2007 (Federal Reserve calling on regulators to use insider-trading laws to prevent abuses in the CDS market), available at <http://www.iht.com/bin/print.php?id=5725019>.

²⁷ John Carney, "Credit Default Swaps: The Land of Efficient Insider Trading?," *Dealbreaker*, April 17, 2007 (explaining that trading on the basis of material non-public information unavailable to trading counterparts is happening in the CDS market), available at http://dealbreaker.com/2007/04/credit_default_swaps_the_land.php.

²⁸ "U.S. examines possible insider trading in credit-default swaps," *Bloomberg News*, June 25, 2007, available at <http://www.iht.com/bin/print.php?id=6304513>.

could affect an issuer's credit quality and the value of its stock.²⁹

In light of the current financial crisis, the SEC has accelerated its efforts on this front and undertaken a nationwide investigation of potential fraud related to the securities of financial institutions. This step was fueled by concern that: the CDS market is ripe for not only rumor and misinformation but also for fraud due to the complete lack of information about who is exposed to whom; and the potential for developments in the CDS market to spill into the equity markets as investors are increasingly looking to CDS for signals about the pricing of the debt and equity securities of the referenced issuers. As such, on September 19, 2008, the SEC issued orders requiring certain hedge funds, broker-dealers and institutional investors to file statements under oath regarding trading and market activity in the securities of financial firms, including CDS.³⁰ The SEC is reportedly now creating a database of that information and analyzing it for possible manipulative patterns of trading in both CDS and equity securities.³¹

Representative Barney Frank, Chairman of the House Financial Services Committee, which has jurisdiction over the SEC, the Federal Reserve, and the Treasury Department, has indicated plans to introduce "sensible" regulation of the CDS market when the new Congress convenes in 2009.

In addition, the New York Attorney General and U.S. Attorney for the Southern District of New York have launched a joint investigation into the CDS market to determine whether traders manipulated the unregulated CDS market in support of short-selling activity on bank and financial service firm securities.³²

Emerging Regulatory Proposals

In light of the current financial crisis, a number of federal and state regulators have sought regulatory authority and to take other steps with respect to CDS, including the following initiatives:

²⁹ Shannon D. Harrington and Craig Torres, "Federal Reserve chief says existing laws cover abuses in credit-default swaps," *International Herald Tribune*, May 16, 2007 (noting study of 79 North American companies from 2001 to 2004 finding significant evidence that CDS were occurring prior to news that could affect credit quality), available at <http://www.iht.com/bin/print.php?id=5725019>.

³⁰ Speech by SEC Chairman: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System, by Chairman Christopher Cox, Oct. 8, 2008, available at <http://www.knowledgemosaic.com/gateway/Rules/SP.spch100808.htm>.

³¹ "Cox Notes SEC Action in Swap Market, But Repeats Call for Congressional Action," *BNA, Inc., Securities Regulation & Law*, Vol. 40, Number 40, Oct. 13, 2008.

³² Vikas Bajaj, "Joint U.S.-New York Inquiry Into Credit-Default Swaps," *New York Times*, Oct. 20, 2008, available at <http://www.nytimes.com/2008/10/20/business/20swaps.html?>

(1) *SEC regulatory and anti-fraud authority.* The SEC has urged Congress to provide it statutory authority to regulate CDS³³, including authority to:

- require trade and position reporting by dealers in the CDS over-the-counter market in order to provide transparency;
- require position reporting by market participants with significant positions so that regulators can uncover manipulation and monitor risk;
- require basic recordkeeping of CDS transactions; and
- issue additional anti-fraud rules.³⁴

Representative Barney Frank, Chairman of the House Financial Services Committee, which has jurisdiction over the SEC, the Federal Reserve, and the Treasury Department, has indicated plans to introduce “sensible” regulation of the CDS market when the new Congress convenes in 2009.³⁵

(2) *CFTC regulatory authority.* The CFTC has also urged legislative authority be granted to it to regulate CDS, precursing a likely jurisdictional dispute with the SEC for exclusive or concurrent regulatory authority over the CDS market.³⁶ On November 20, 2008, Senator Tom Harkin, Chairman of the Senate Agriculture Committee which has jurisdiction over the CFTC, stated that he plans to introduce legislation, to be dubbed the Derivatives Trading Integrity Act, that will: (i) force all over-the-counter derivatives, including CDS, onto regulated futures exchanges; (ii) define CDS as futures contracts, thereby granting the CFTC sole regulatory jurisdiction; (iii) require a radical overhaul of risk-

management practices of corporations and financial institutions that participate in the CDS market; and (iv) require standardization of CDS, that they be centrally cleared, and that they be subject to CFTC-imposed speculative position limits and federal reporting requirements.³⁷

(3) *Centralized Exchange and Clearing of CDS.* On November 14, 2008, the President’s Working Group, which includes the Treasury Secretary, and the Chairmen of the Federal Reserve, SEC, and the CFTC, called for greater regulation of CDS and centralized clearing by year-end 2008, and signed a Memorandum of Understanding to consult and share information.³⁸

To this end and for some time, the Federal Reserve Bank of New York, which is headed by Timothy Geithner, President-elect Obama’s choice to head the Treasury Department, has been meeting with banks and investors to create one or more centralized clearing exchanges for electronic trading and clearance of CDS, a step supported by both the SEC and CFTC to reduce systemic risk associated with the CDS market.³⁹ Several groups are now vying to introduce centralized clearing exchanges for CDS including: (i) the CME Group, which is the parent of the Chicago Mercantile Exchange, and Citadel Investment Group⁴⁰; (ii) the Intercontinental Exchange; (iii) NYSE Euronext; and (iv) Eurex.⁴¹ On December 4, 2008, the New York State

³³ Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, by Chairman Christopher Cox Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Sep. 23, 2008, available at <http://www.sec.gov/news/testimony/2008/ts0923cc.htm>.

³⁴ Speech by SEC Chairman: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission’s Disclosure System, by Chairman Christopher Cox, Oct. 8, 2008, available at <http://www.knowledgemosaic.com/gateway/Rules/SP.spch100808.htm>.

³⁵ Rachele Younglai, “House Leader Frank Vows to Regulate Credit Default Swap Market,” *Insurance Journal*, Oct. 14, 2008, available at <http://www.insurancejournal.com/news/nationa/2008/10/14/94622.htm?print=1>.

³⁶ Statement of Commissioner Bart Chilton on Regulation of Credit Default Swaps, Oct. 8, 2008 (urging Congress to provide CFTC regulatory authority over CDS), available at <http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/chiltonstatement100808.pdf>- 31.2KB - CFTC.gov

³⁷ Sarah N. Lynch, “3rd Update: Harkin Seeks to Force Derivatives Onto Exchanges,” *DowJones Newswires*, Nov. 20, 2008, available at http://money.cnn.com/news/newsfeeds/articles/djf500/200811201733DOWJONESDJSONLINE000892_FORTUNE5.htm.

³⁸ SEC Chairman Cox Statement on MOU with Federal Reserve, CFTC to Address Credit Default Swaps, Nov. 14, 2008, available at <http://www.sec.gov/news/press/2008/2008-269.htm>; PWG Announces Initiatives to Strengthen OTC Derivatives and Oversight and Infrastructure, Nov. 14, 2008, available at <http://www.ustreas.gov/press/releases/hp1272.htm>.

³⁹ Testimony Concerning Credit Default Swaps Before the House Committee on Agriculture, by Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission, Oct. 15, 2008, available at <http://www.sec.gov/news/testimony/2008/ts101508ers.htm>; Written Testimony of Acting CFTC Chairman Walter Lukken Before the House Committee on Agriculture, Oct. 15, 2008, available at <http://www.cftc.gov/newsroom/speechestestimony/lukken/index.htm>.

⁴⁰ Shannon D. Harrington and Scott Lanman, “Fed, Dealers Meet on Default Swaps Clearinghouse (Update 1),” *Bloomberg.com*, Oct. 8, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=agglxlogKZjg&refer=home>; “NY Fed Calls for Meeting of Credit Derivative Players,” *CNBC.com*, Oct. 8, 2008, available at <http://www.cnbc.com/id/27091124/print/1/displaymode/1098>; “CME Group, Citadel to Launch CDS Trading,” *CNBC.com*, Oct. 7, 2008, available at <http://www.cnbc.com/id/27066831/print/1/displaymode/1098>; Heidi N. Moore, “Financials Got You down? CME Pitches Credit-Default Swaps the Safer Way,” *Deal Journal*, Oct. 9, 2008, available at <http://blogs.wsj.com/deals/2008/10/09/financials-got-you-down-cme-pitches-credit-default>.

⁴¹ Sarah N. Lynch, “Acting CFTC Chair: Need for New Oversight of Derivatives,” *DowJones Newswires*, Oct. 15, 2008, available at <http://www.lloyds.com/CmsPhoenix/DowJonesArticle.aspx?id=408565>; Jacqueline Bell, “SEC Plans to Clear Path for CDS Clearinghouse,” *Law360*, Nov. 5, 2008, available at http://securities.law360.com/print_article/75599; Testimony Concerning Credit Default Swaps Before the House Committee on Agriculture, by Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange

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Banking Department approved plans by the Intercontinental Exchange to form a state-regulated trust to act as a central clearinghouse for CDS. Approval by the Federal Reserve is still pending.⁴²

From the viewpoint of regulators, the benefits of centralized clearing of CDS include:

- Mitigation of counterparty risk by novating trades to a central clearing party, thereby substituting the collective credit of the clearinghouse and its members for that of a particular CDS counterparty;
- Increasing liquidity by enabling market participants to offset positions against entities other than their original counterparty;
- Establishing and enforcing uniform margining and risk control requirements over clearinghouse members;
- Increasing price transparency by publishing settlement prices each day for each product;
- Facilitating more timely and accurate post-trade processing;
- Decreasing the likelihood that large losses by a single trader could cause a contagion event by adopting such standard clearinghouse functions as twice daily collection of payments from traders with losing positions, thereby preventing build-up of significant losses;
- Decreasing negative impacts of misinformation and rumors regarding particular counterparties that can occur, particularly during high-volume periods;
- Providing a source of records on CDS transactions that will assist regulators in preventing and detecting market manipulation, fraud and other abuse.⁴³

Given that the head of the Federal Reserve Bank of New York will be nominated to be the new Treasury Secretary, it is likely that CDS will be a regulatory priority for the incoming administration, including the creation of central counterparty exchanges for CDS.

(4) *State regulation.* The State of New York has announced plans, beginning on January 1, 2009, to regulate a portion of the CDS market in which the buyer owns the underlying security for which it is buying protection, as an insurance product. The regulation would not apply to so-called “naked” CDS created and traded by speculators with no connection to the underlying reference debt, and for which New York has called on the U.S. government to regulate.

Under New York’s plan, entities selling CDS to bond or debt-holders will be required to be licensed and regulated under New York’s Insurance Law as financial guaranty insurers. Announced best practices for these entities will include:

- Strictly limiting guarantees for collateralized debt obligations which are often based on payments by subprime mortgages pools;
- Measures to limit risks such as concentration risk;
- Written risk control and underwriting policies;
- Increasing the minimum amount of capital and reserves that must be maintained; and
- Expanding reporting requirements.⁴⁴

On November 20, 2008, and in light of recent progress being made to create central counterparties for CDS with federal government oversight, the New York Department of Insurance announced that it will delay implementation of its regulatory plan to allow the federal government time to develop a regulatory plan for the entire CDS market.⁴⁵

(5) *FASB Accounting Standards.* On September 12, 2008, the Financial Accounting Standards Board issued new accounting requirements for increased disclosure by sellers of credit derivatives, including CDS. As of November 15, 2008, sellers will be required to disclose the following information to users of their financial statements:

- the nature of any credit derivative, including its term, the reason for entering into it, events that would require the seller to perform, and current status of payment/performance risk;
- the maximum potential amount of future payments;
- the fair value of the derivative; and
- the nature of any recourse provisions that would enable the seller to recover from third parties any amounts paid and assets held as collateral or by third parties that can be obtained and liquidated.⁴⁶

⁴⁴ “Governor Paterson Announces Plan to Limit Harm to Markets from Damaging Speculation,” Sep. 22, 2008 (announcing that as of January 1, 2009, New York will regulate certain types of CDS as insurance products), available at http://www.state.ny.us/governor/press/press_0922081_print.html; Circular Letter No. 19 (2008): “Best Practices” for financial guaranty insurers, Sep. 22, 2008, available at http://www.ins.state.ny.us/circltr/2008/c108_19.htm; Shannon D. Harrington and Christine Richard, “Credit Swaps Move Closer to Regulation with NY Plan (Update 2),” *Bloomberg.com*, Oct. 8, 2008, available at <http://www.bloomberg.com/apps/news?pid=2061087&reder=home&sid=akmnbe4Mclsl>.

⁴⁵ Recognizing Progress by Federal Government in Developing Oversight Framework for Credit Default Swaps, New York Will Stay Plan to Regulate Some Credit Default Swaps, available at <http://www.ins.state.ny.us/press/2008/p0811201.htm>.

⁴⁶ Financial Accounting Standards Board, News Release 09/12/08, FASB Issues FASB Staff Position (FSP) No. 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161, available at <http://www.fasb.org/news/nr091208.shtml>; FASB Staff Position, No. FAS 133-1 and Fin 45-4; Marine Cole, “FASB rule changes may be too little, too late for some, Fiddles to FAS 133 aimed at providing greater disclosure of credit default swaps,” *Financial Week*, Sep. 16, 2008, available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080916/REG/809159955/10>; Gretchen Morgenson, “The fog of credit default swaps,” *International Herald Tribune*, July 6, 2008, available at <http://www.iht.com/articles/2008/07/06/business/morg07.php>.

Commission, Oct. 15, 2008, available at <http://www.sec.gov/news/testimony/2008/ts101508ers.htm>

⁴² Karen Bretell, “New York state approves ICE plan for CDS clearinghouse,” Reuters, available at <http://www.reuters.com/articlePrint?articleID=USN0449338120081204>.

⁴³ Testimony Concerning Credit Default Swaps Before the House Committee on Agriculture, by Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission, Oct. 15, 2008, available at <http://www.sec.gov/news/testimony/2008/ts101508ers.htm>; Written Testimony of Acting CFTC Chairman Walter Lukken Before the House Committee on Agriculture, Oct. 15, 2008, available at <http://www.cftc.gov/newsroom/speechestestimony/lukken/index.htm>.