INCREASED REGULATION OF OTC DERIVATIVES

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To Our Clients and Friends:

This week, the federal government announced its plan for a comprehensive framework of increased regulation and oversight of the over-the-counter (OTC) derivatives market. In a letter addressed to Senator Harry Reid, Treasury Secretary Timothy F. Geithner broadly outlined the four objectives of the new regulatory framework: (1) preventing activities in the OTC derivatives markets from posing risk to the financial system, (2) promoting the efficiency and transparency of the OTC derivatives market, (3) preventing market manipulation, fraud and other market abuses, and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

Under current law, a number of OTC derivatives have been largely excluded from regulation in the United States. To implement the new regulatory framework, Treasury Secretary Geithner asked for the amendment of the Commodities Exchange Act and various federal securities laws.

The proposed regulatory framework includes the following key reforms:

Clearance of Standardized OTC Derivatives. The proposal would require all standardized OTC derivatives to be cleared through regulated central counterparties (CCPs), commonly known as clearinghouses. Regulators would also require the CCPs to adhere to more stringent margin requirements and other risk control measures. New regulations would also seek to encourage the movement of standardized trades to regulated exchanges and electronic trading execution systems, and to promote greater use of exchange-traded derivatives.

Enhanced Oversight of Important Market Participants. Market participants that have the potential to pose systemic risk to the marketplace, such as derivatives dealers and institutions with large counterparty exposure, would be subject to more rigorous supervision covering areas such as capital requirements, standards for business conduct, reporting and initial margin posting for both standardized and customized OTC derivatives.

Recordkeeping and Reporting of Transactions. The SEC and the CFTC would be authorized to impose recordkeeping and reporting requirements regarding OTC derivatives transactions. For standardized derivatives transactions that are cleared through a CCP and for customized transactions that are reported to a regulated trade repository, the CCP and the repository would be required to publish aggregate data on open positions and trade volumes. In addition, individual counterparty's trades and positions would be required to be disclosed on a confidential basis to the CFTC, the SEC and other applicable regulators.

Prevention of Market Abuses. The proposal seeks additional regulatory authority to investigate and police instances of fraud, market manipulation and other market abuse, including the ability to set position limits on OTC derivatives that play a significant role in price discovery with respect to regulated markets. More robust recordkeeping and reporting measures as those described above are intended to help regulators uncover abusive market practices.

Protection of Less Sophisticated Parties. New efforts would be made to protect market participants who are less familiar with OTC derivative transactions by imposing more disclosure or standard of care with respect to the marketing of OTC derivatives products to entities such as small municipalities.

It is important to note that yesterday's announcement only covers the broad framework of the proposed regulatory reforms, and it remains to be seen what shape the proposed legislation will take in Congress in the weeks and months ahead. Treasury Secretary Geithner also emphasized that the new framework would not "call into question the enforceability of OTC derivatives contracts" and that the U.S. government would need to work with "authorities abroad to promote implementation of complementary measures in other jurisdictions" to prevent the outflow of OTC derivatives transactions to jurisdictions with less regulations.

We plan to monitor future developments in this area and will report on any important developments.

Please feel free to contact us with any questions.

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