

“What keeps you up at night?”

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Insurance issues not considered in Treasury Department proposed regulatory reform of derivative markets

By James S. Gkonos and Mark C. Cawley

On May 13, 2009, the Treasury Department announced the federal government's plans to regulate the over-the-counter (“OTC”) derivatives market—a long-anticipated move designed to bring federal oversight to a largely unregulated segment of the market that is widely blamed for causing the financial crisis. Previously, Congress had exempted derivatives and capital markets transactions from federal and state regulation through the Commodities Futures Modernization Act of 2000. In a letter to Senator Harry Reid and others, Treasury Secretary Timothy Geithner outlined regulatory and legislative initiatives to achieve comprehensive federal regulation of the OTC derivatives market. Geithner wrote that regulation of the OTC derivatives market should be designed to achieve four broad objectives: (1) preventing activities in the OTC market from posing systemic risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties like small municipalities.

To achieve these goals, the Treasury Department will seek amendment of the Commodity Exchange Act and the securities laws to require clearing of all standardized OTC derivatives through approved central counterparties, who must impose “robust” margin requirements and other risk controls to prevent the now all-too-familiar scenario of counterparties not having enough collateral to meet their obligations under derivatives contracts. Other risk controls will be established to ensure that customized OTC derivatives, which otherwise will not be subject to clearing, are not used to circumvent the use of a central counterparty. All OTC derivatives dealers and all other firms whose activities in the OTC derivatives market create large exposures to counterparties will be subject to a “robust and appropriate regime” of “prudential supervision and regulation.” Secretary Geithner did not provide extensive detail about the nature of this new regime, but it will include conservative capital requirements for participants in the OTC derivatives market, business conduct standards, reporting requirements, and margin requirements on counterparty credit exposures.

The Treasury Department also intends to increase transparency in OTC derivatives transactions. It will do so by seeking amendment of the Commodity Exchange Act and the securities laws to

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authorize the Commodity Futures Trading Commission (“CFTC”) and the SEC to impose recordkeeping and reporting requirements, mandatory reporting to a regulated trade repository of all trades not cleared by central counterparties, and a corresponding requirement that central counterparties and trade repositories make public aggregate data on open positions and trading volumes. Central counterparties and trade repositories also will be required to make individual counterparty trades and positions available to federal regulators. The Treasury Department will seek to enable the CFTC and SEC to police fraud and to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to futures markets.

Finally, Secretary Geithner indicated that the SEC and CFTC are investigating ways to prevent marketing of derivatives to “unsophisticated parties.” This portion of the Secretary’s letter appears to address perceived abuses in the marketing of derivatives to municipalities—some of which are now facing financial difficulties stemming from derivatives contracts purchased to increase yields on municipal bond escrow accounts. The SEC and CFTC will likely restrict the ability of brokers and other OTC derivative market participants to sell derivatives products to municipalities and other unsophisticated participants.

The details of this comprehensive regulatory reform have not been threshed out between the Obama Administration and Congress. Additionally, no mention was made of the interplay between insurance laws and these proposed federal statutory and regulatory reforms. Both the New York and Missouri Insurance Departments have declared certain swaps and derivatives to be “insurance.” The New York Insurance Department announced in November 2008 that

it would hold in abeyance its regulation of these capital markets products while the state and federal governments work to develop a comprehensive regulatory scheme. No comment has been forthcoming from the National Association of Insurance Commissioners (NAIC), or the New York and Missouri Insurance Departments. Further details on the federal proposals and state insurance department responses will likely emerge in the coming months. Saul Ewing LLP will keep you apprised of future developments as they occur.

Please contact the authors if you have any questions or need any additional information.

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