2009

Ask the Professor: Who Has, Or Who Should Have, Jurisdiction Over CDS Clearing?

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Recommended Citation
29 Fut. & Deriv. L. Rep., 11 (January 2009)

7. In the aftermath of being caught asleep at the switch (or perhaps also because they were wink-wink lied to) in the case of Enron, the major credit rating agencies suddenly woke up to the concept of credit cliffs - the immediate cash needs of a company for margin in the event of a downgrade, as it descended a stair step or two in the credit ratings matrix of all their collateral support arrangements with all of their counterparties. See, e.g., Standard and Poor's, *Credit Policy Update: Changes to Ratings Process Address Economic Conditions and Market Needs* (Jan. 25, 2002).
8. Largely due to the banks' influence, one-way termination has become a thing of the past. Banks typically refused to agree to it in their ISDA agreements, because banking regulators had long denied them netting benefits to hedges entered into under ISDAs with one-way termination. Then, largely due to the banks' influence, an express option for one-way termination called "First Method" was eliminated by ISDA when it issued the 2002 form of ISDA Agreement. Then, to completely eliminate the possibility of one-way termination for bank ISDAs, in the Netting Improvement Acts of 2006, Congress rendered one-way termination clauses unenforceable against federally chartered banks.
9. Litigated defaults requiring judicial review of ISDA contracts have been few and far between, as cases have typically settled. This leaves the field open for creative lawyers to develop new arguments to enable them to help their clients avoid or delay paying a bankrupt party the out-of-the-money value (see, e.g., Weinstein, MacIntyre & Henze, *Escape from the Island of the One-Way Termination: Expectations and Enron v. TXU*, Futures & Derivatives Law Report, Nov. 2004), and for potentially surprising judicial decisions to come from those cases, with attendant market reaction as they hit the advance sheets.

Ask the Professor: Who Has, or Who Should Have, Jurisdiction Over CDS Clearing?[1]

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Are you as confused as I am regarding this question? It reminds me of the time when I gave a lecture on the U.S. futures markets during Career Week to my son's 7th Grade class at Wilmette Jr. High back in 1987. After my brief talk about my career, I asked if any of the students had any questions. One of my son's classmates asked: "Why is the price of gold different in New York than in London"? As most lecturers do when asked a question that they do not know the answer, I punted and asked the class what they believed the answer to this question is.[2] I probably should play some football again and ask the FDLR readers what they think about the question raised above in the title but will try and give it the old college try.

The Commodity Futures Modernization Act of 2000[3], commonly referred to as the CFMA, was very innovative and significant legislation at the time as it brought important legal certainty to the OTC derivatives world.[4] However, in light of the current economic conditions,[5] legislative changes are now needed regarding OTC derivatives, in particular to determine how, and to what degree, credit default swaps ("CDS") must or should now be subject to clearing. But, first, let's take a look back at the CFMA[6] before reaching that conclusion.

As we all know, a futures contract must be traded on a board of trade[7] unless the Commodity Exchange Act ("CEA")[8] provides for a statutory exemption. Prior to the CFMA, there was a concern that OTC derivatives might just constitute a contract that must be traded on a U.S. regulated futures exchange. The CFMA removed this legal uncertainty by providing, in essence, that the CEA does not apply to any transaction in an excluded commodity[9] if that transaction is entered into (a) between eligible contract participants ("ECP")[10] and is not conducted on a Trading Facility,[11] or (b) between ECPs trading on a principal-to-principal basis, and the transaction is conducted on an electronic trading facility.[12] Accordingly, a large number of OTC derivative transactions, including CDS instruments, are excluded from regulation by the CFTC. The CFMA also exempted transactions in exempt commodities[13] from the provisions of the CEA, applying, in essence, a similar two-prong test as for an excluded commodity.[14]

Similarly, the CFMA exempted CDS instruments from SEC jurisdiction by adding a definition of a "swap agreement" to the Gramm-Leach-Bliley Act ("GLBA")[15] which states that a "security" under Section 2A of the Securities Act of 1933 ("1933 Act") does not include any non-security-based swap agreement (as defined in Section 206C of the GLBA) or any security-based-swap agreement (as defined in Section 206B of the GLBA.[16] To qualify for this exemption, the CDS must be entered into between ECPs, and the terms, other than price and quantity, must be individually negotiated.

Now, what does this all mean, or what legislative changes, if any, are now needed if CDS and other swap instruments are cleared.[17] We do know that several global clearing houses[18] are now vying to capture the market share from what is obviously a huge revenue-generated product if CDS instruments become subject to mandatory clearing or even industry-or-governmental pressured clearing. Each of the U.S. clearinghouses, often referred to as central counterparties or CCPs, are registered as a derivatives clearing organization ("DCO") with the CFTC but are taking different tactics to obtain the requisite regulatory approvals in order to be in a position to commence CDS clearing. Some have worked solely with the CFTC while others have sought approval from the FED. It will be interesting to see, unless new legislation dictates otherwise, which approach will have the preferred consequences. The SEC has also expressed its own interest to become a governmental watchdog over CDS clearing by taking the position that, if CDS instruments "were standardized as a result of centralized clearing or exchange trading or other changes, and no longer individually negotiated, the 'swap exclusion' from the securities laws under the CFMA would be unavailable".[19] I, for one, do not accept this legal argument as the mere clearing of CDS instruments do not necessarily result in the exemption being removed.

Since the U.S. clearing houses involved in this CDS clearing race are all registered as DCOs and to ensure that CDS clearing may soon commence, one could reasonably argue that the CFTC should, at least for now, take responsibility over CDS clearing. Legislation has even been recently proposed, by both Senator Harkin (Chairman of the Senate Committee on Agriculture) and by Congressman Peterson (Chairman of the House Committee on Agriculture) to give jurisdiction over CDS clearing to the CFTC. But is this the right approach? There is no definitive answer to the question raised above but a solution is needed and needed soon.

Collectively, these varying actions have created much confusion at a time when solidarity is required among the regulatory agencies and Congress. It is important that such actions are taken and taken soon if CDS instruments must or should be cleared. Without any coordinated action, the market share noted above might just be captured by the non-US clearinghouses.

NOTES

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   PLEASE SEND ANY QUESTIONS THAT YOU MIGHT WANT ADDRESSED IN FUTURE ISSUES TO PROFESSOR FILLER AT: RONALD.FILLER@NYLS.EDU. THANKS

   This column was written on January 1, 2009 and reflects one of my many resolutions for 2009, including my promise to prepare provocative and interesting "Ask the Professor" columns for FDLR this year.

2. A young girl in my son's class answered this question in a very thorough and detailed manner. I told her, to the dismay of her fellow teachers, that she should quit school now and trade for a living. I later learned that her father was a CBOT member. So, for those of you who still have young children at home, it pays to discuss what you do at work at the dinner table.
3. P.L. 106-554, 114 STAT. 2763 (2000)
4. See Title III of the CFMA.
5. In terms of actual dollar amounts, these past few months have resulted in the largest market losses in history.
6. For a good overview of the CFMA, see "The Commodity Futures Modernization Act of 2000", by Dean Kloner, as published in Securities Regulation Law Journal (2001).
7. See Section 1a(2) of the CEA, 7 U.S.C. 1A(2).
8. 7 U.S.C. 1 et al
9. See Section 1a(13) of the CEA, 7 U.S.C. 1a(13), which includes, among other things, "an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure". This grouping clearly includes CDS agreements.
10. See Section 1a(12) of the CEA, 7 U.S.C. 1a(12).
11. See Section1a(33) of the CEA, 7 U.S.C. 1a(33).
12. See Section 1a(10) of the CEA, 7 U.S.C. 1a(10).
13. An "exempt commodity" is defined as "a commodity that is not an excluded commodity or an agricultural commodity". See Section 1a(14) of the CEA, 7 U.S.C. 1a(14).
14. For exempt commodities, the appropriate party is an exempt commercial entity" ("ECM"), as defined in Section 1a(11) of the CEA, 7 U.S.C. 1a(11), rather than an ECP, but the tests for both types are quite similar.
15. P.L. 106-102, 113 STAT. 1338, 15 U..S.C. 78c
16. The principal difference between these two types of swap agreements is that a "security-based swap agreement" is still subject to the anti-fraud and the insider trading provisions of the federal securities laws whereas a "non-security-based swap agreement" is not.
17. For purposes of this article, the reference to CDS and other swap instruments shall collectively be referred to as "CDS".
18. These clearing houses include, among others, Chicago Mercantile Exchange (in partnership with Citadel Trading), The Clearing Corp., ICE Clear, EUREX Clearing, NYSE Euronext, LCH Clearnet and International Derivatives Clearing Group.
19. See testimony by Erik Sirri, Director of the SEC's Division of Trading and Markets, before the House Committee on Agriculture, October 16, 2008.