

Derivatives Developments: Private Sector Derivatives Protocols and New Legislation Both Advance

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On December 11, 2009, the House of Representatives passed comprehensive legislation that, if approved by the Senate and signed into law, would overhaul the regulation of the U.S. financial markets, including the over-the-counter (“OTC”) derivatives market. Among other matters, the legislation would require swap dealers and major swap participants to register with the SEC or CFTC and impose capital, margin, business conduct and record-keeping requirements on these large dealers and traders. In addition, “standardized” OTC derivatives would be required to be cleared through a central clearing counterparty and executed on a regulated exchange or traded through a swap execution facility, subject to certain exceptions, including for “end users” using derivatives to hedge commercial risk.

At the same time, the private sector has embarked on a series of efforts designed to provide enhanced oversight of the OTC derivatives market. In early December, the International Swaps and Derivatives Association (“ISDA”), announced the creation of a revamped committee system to oversee market practices and post-trade activities. Comprised of an overarching governance committee, four steering committees relating to individual derivatives product classes, and implementation committees responsible for strategy execution, the new system represents an attempt to enhance industry participation in market oversight.

Although self-regulation through private institutions has long been a hallmark of our nation’s securities markets, the extent to which ISDA will be able to satisfy Congressional, and public, concerns about derivatives regulation remains to be seen. After a few fits and starts, ISDA’s self-regulatory model appears now to be addressing the protracted disputes over the credit derivatives of Mexican cement maker Cemex S.A.B. and Japanese lender Aiful Corporation. This week, after a process that included five delayed votes over nearly two months and required an external decision-making panel after ISDA’s own committee could not reach

a conclusion, Cemex’s August 2009 debt restructuring was found to constitute a “credit event” that would trigger payment under credit default swaps linked to Cemex’s debt. Similarly, the ISDA determinations committee rejected two requests to consider whether actions by Aiful to temporarily suspend principal payments on its loans signified a “credit event,” accepted a third request but reversed its acceptance because its decision had been based on confidential information, and finally agreed to consider the matter again.

While Congress moves forward in its attempts to overhaul the OTC derivatives market, ISDA continues to emphasize its progress in standardizing derivatives markets absent a legislative mandate and favors industry initiatives that permit flexibility rather than additional regulation. ISDA’s ability to effectively and efficiently resolve disputes such as those involving Cemex and Aiful will mark an important data point in this ongoing debate.

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