



Reforming the US financial architecture: the regulation of derivatives, rating agencies, and hedge funds

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for the Foundation for European Progressive Studies
January 2010**

Executive Summary

In the last couple of years, financial regulatory reforms have occupied a pivotal place in the agenda of policymakers in the European Commission, European Parliament, and member states. The crisis has demonstrated the capacity of European institutions to act decisively and quickly drafting several important pieces of legislation charting the post-crisis financial regulatory architecture. However, the course of action of European institutions has constantly been influenced by parallel regulatory initiatives in the US. While in some cases, European policymakers have been able to bring new issues and regulatory solutions into the international agenda, in other cases they have lagged behind Washington's leadership. Moreover, one of the crucial challenges policymakers will face in the next years is how the respective regulatory approaches could be harmonized in order to minimize the unnecessary frictions generated by diverging set of rules. These elements highlight the importance of understanding the reform process in the regulation of finance that has been unfolding in the US since the beginning of the crisis.

This working paper tries to make a contribution to this debate by analyzing the reform proposed and implemented in the United States to regulate three important sets of actors and markets in the global financial market: derivatives, credit rating agencies, hedge funds. Within the regulatory debate that has developed in the US since the beginning of the crisis in the summer of 2007, these three sectors have been placed under the spotlight by regulators and lawmakers. Credit derivatives stand accused of having encouraged excessive risk-taking prior to the crisis; while the opacity and size of the derivatives markets traded outside regulated exchanges (OTC) are blamed for having exacerbated the current crisis. Credit rating agencies provided a rating that enabled mortgage-backed securities to be sold across the global financial markets stand accused of having significantly underestimated the risk attached to these products. Hedge funds have not been at the origin of the crisis, but they have been accused of being a source of systemic risk and having accelerated the falls in equity prices, while the Madoff scandal has raised significant investor protection concerns.

Despite these three sectors have played a very different role in the context of the crisis, they have been object in a short period of time of very extensive reforms in the way they are regulated in the US. The regulatory reforms analyzed in this working paper represent only a small part of the large set of regulatory reforms introduced since the beginning of the crisis in the US. However, their analysis is useful to suggest a few possible conclusions about the direction in which the reform of the US regulatory architecture is moving.

1. From self-regulation to direct regulation → *The crisis has led regulators to abandon the soft-touch approach to the regulation of financial markets that characterized the decade prior to the crisis and to extend their regulatory oversight to new markets and instruments that had been left only loosely regulated or self-regulated.* This shift has only been gradual. At the beginning of the crisis, regulators in the US have actively encouraged financial market actors to address the deficiencies in their regulation through self-regulatory initiatives. However, the growing severity of the crisis has created incentives to bring the regulation and oversight of derivatives and hedge funds firmly within the perimeter of the public regulatory oversight.

In the case of credit rating agencies, regulators have used the regulatory authority already granted under the CRA Reform Act of 2006 to introduce new requirements.

2. The widening range of actors shaping the content of financial regulation → *The crisis had the effect of widening the number of actors seeking to influence the content of regulation and shifting the centre of the regulatory process from outside Congress to within it.* Prior to the crisis, financial regulation had been shaped primarily by a close coalition formed by regulatory agencies and financial industry participants. This exclusionary coalition has continued to dominate the policymaking process also during the initial regulatory response to the crisis. However, the unprecedented politicization of financial regulatory politics triggered by the collapse of Lehman Brothers and the bailouts in the fall of 2008 have created the incentive for the US Congress and the newly-elected Obama Administration to become more deeply involved in the design of financial regulation, as highlighted by the analysis of the numerous legislative proposals discussed in the text. Also other interest groups beyond the financial sector have increasingly acknowledged the impact of the upcoming regulatory reforms upon their business and increased their efforts to lobby Congress. These developments have shifted the centre of the regulatory process from outside Congress to within it, and made it more permeable to voices external to the financial industry. A new coalition has emerged at the helm of the regulatory process formed by Treasury officials and the Democratic leadership in the main Congressional Committees.
3. The content of regulation: towards a middle ground? → What has been the impact of the change in the policymaking process and the shift in the dominant coalition over the content of regulation? The increased role of Congress had the effect of widening the range of regulatory solutions on the table, as Congressmen have introduced more radical and intrusive proposals than those initially supported by federal regulatory authorities. However, the mobilization of corporate interest groups and financial interest has increased the opposition to more radical regulatory solutions. For instance, corporate end-users of derivatives have warned on how tougher regulation of OTC derivatives markets could increase the cost of hedging their risks, and formed a coalition with Wall Street interests against excessively intrusive measures. While it is too early to reach definitive conclusions, it is possible to argue that the opposition of corporate and financial interest groups has led to the marginalization of the more radical regulatory proposals within Congress, while the new dominant coalition formed by Treasury officials and the Democratic leadership in Congress has steered the regulatory response towards a “middle ground”. Examples of this middle ground are the significant exemptions granted to corporate end-users of derivatives, the absence of measures interfering with the business model of rating agencies to prevent conflicts of interest, and the absence of measures seeking to mitigate the excessive risk-taking of hedge funds by interfering with the trading activities.
4. Europe vs. US → How is the content of the US regulatory initiatives described in this working paper different from the parallel initiatives emerging in Brussels? The three trends described above present significant similarities with the European policymaking process. Similarly to the US, the regulatory proposals presented by the European Commission place have introduced a European public regulatory regime for derivatives, hedge funds, credit rating agencies, placing the responsibility to regulate and oversee these sectors in the hands of member-states or EU regulatory bodies. Also the European regulatory debate seem to be converging towards a middle ground, as the opposition coming from business groups and financial interest groups not limited to the City of London, and from member states (in particular the UK) are forcing significant revisions in the European directive to regulate hedge funds and introduced important exemptions in the proposals to regulate OTC derivatives. It is possible to argue that Europe has lagged rather than led the US in the regulation of credit rating agencies and derivatives, and the proposals coming from Brussels do not go

significantly beyond those already developed in Washington. Hedge funds represent an exception, as this issue has remained an afterthought in the reform of US regulatory architecture. As a result, the Alternative Investment Fund Managers directive remains significantly more ambitious and detailed than the regulatory proposals advanced in the US.

Structure of the paper

The first part of this paper will describe the reforms in the US in the regulation of OTC derivatives markets. The first section (**Section 1.1**) will describe the regulatory initiatives undertaken by the main market actors through a close dialogue with the Federal Reserve Bank of New York. The goal of these largely self-regulatory measures was that of enhancing the operational infrastructures (the “plumbing”) of derivatives markets. The bailout of Bear Stearns in March 2008, and the collapse of Lehman Brothers and AIG in September have shifted the focus of regulators from the operational risk to the counterparty risk in derivatives markets. The second section (**Section 1.2**) will therefore analyze the different regulatory initiatives that have sought to address the counterparty risk in OTC derivatives markets through the creation of centralized clearinghouses for the clearing of derivatives traded bilaterally (over-the-counter). The third section (**Section 1.3**) analyzes in greater details the plan presented in 2009 by US federal regulators and the US Treasury to regulate derivatives markets. While during the Congressional debates that preceded the passage of the Commodity Futures Modernization Act in 2000 federal regulators (with the exception of the CFTC) discouraged Congress from bringing OTC derivatives market under the federal regulatory oversight, the crisis has pushed federal regulatory agencies and the US Treasury to present detailed plans to regulate these markets. The fourth section (**Section 1.4**) analyzes how the politicization of financial regulation that followed the collapse of Lehman Brothers has created pressures for Congressmen and interest groups to enter the debate over the regulation of these markets. The greater involvement of the Congress has widened the range of regulatory proposals and brought to the table more radical solutions, while the mobilization of interest groups has led Congress to grant important exemptions to corporate end-users.

The second part of this paper focus instead on the regulation of credit rating agencies. The first section (**Section 2.1**) analyzes how the regulatory regime regulating credit rating agencies has evolved since the 1970s and become the object of significant reforms introduced by federal regulators and the US Congress very soon after the beginning of the crisis. The rest of this part instead discusses the content of the measures taken by US regulators to improve the quality of rating process by enhancing its transparency (**Section 2.2**), to mitigate the conflicts of interest in the rating business (**Section 2.3**), to reduce the excessive reliance on their ratings in financial regulation (**Section 2.4**), and to increase the liability of the agencies for their ratings under securities laws (**Section 2.5**). The final section (**Section 2.6**) describes how the crisis has also brought to a strengthening in the SEC authority over credit rating agencies.

The third part of this paper analyzes the regulation of hedge funds. The first section (**Section 3.1**) analyzes the regulation of hedge fund from an historical perspective, highlighting how the crisis has

led US authorities to depart from the focus on indirect regulation and on industry-driven codes of best practices that characterized their approach in the decade before the crisis, and to endorse direct regulation. The second section (**Section 3.2**) analyzes the central pillar of all the proposals to regulate hedge funds presented in the US: mandating the registration of hedge fund advisers with the Securities and Exchange Commission. The third section (**Section 3.3**) analyzes those measures going beyond simply requesting hedge funds managers to register, focusing in particular on the two-layered regulatory regime introduced by US Treasury.

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I. DERIVATIVES

This section describes how the regulation of OTC derivatives markets has evolved in the US since the beginning of the financial crisis. This section will focus in particular on the regulation of credit derivatives and other financial derivatives, the group of derivatives that played the most direct role during the crisis. The reforms discussed in this section had also an impact over agricultural

Short Summary

- 1) The first section (**Section 1.1**) will describe the regulatory initiatives undertaken by the main derivatives markets players in a close dialogue with the Federal Reserve Bank of New York. The goal of these largely self-regulatory measures was that of enhancing the operational infrastructures - the “plumbing” - of derivatives markets.
- 2) The bailout of Bear Stearns in March 2008, and the collapse of Lehman Brothers and AIG in September of the same year have shifted the focus of regulators from the operational risk in derivatives markets to the counterparty risk in these markets. The second part of this section (**Section 1.2**) will therefore analyze the different regulatory initiatives that have identified in the creation of a centralized clearinghouse for the clearing of derivatives traded bilaterally (over-the-counter) the solution to address the counterparty risk in OTC derivatives markets. Two sets of political struggles have surrounded the establishment of CCPs. First, regulators have engaged in a bargain with the main market actors to ensure the establishment of running CCPs, as well as to ensure adequate access to buy-side actors (**section 1.2.1**). Second, an even more heated political struggle has occurred *among* regulators to determine which regulatory agency should be granted the authority to regulate these entities (**section 1.2.2**), which has spilled over into the Congressional agenda (**section 1.2.3**).
- 3) The third section analyzes in greater details the plan presented in 2009 by US federal authorities regulate OTC derivatives markets. While during the Congressional debates that preceded the passage of the Commodity Futures Modernization Act in 2000 federal regulators (with the exception of the CFTC) discouraged Congress from bring OTC derivatives market under the federal regulatory oversight, the crisis has brought federal regulatory agencies (**section 1.3.1**) and the US Treasury (**section 1.3.2**) to present detailed plans to regulate derivatives markets.
- 4) The fourth section (**Section 1.4**) analyzes how the politicization of financial regulation that followed the collapse of Lehman Brothers has created pressures for Congressmen and interest groups to enter the debate over the regulation of these markets. The greater involvement of the Congress has widened the range of regulatory proposals and brought to the table more radical solutions such as banning “naked” credit default swaps and forcing derivatives onto exchanges (**section 1.4.1**). However, the mobilization of interest groups (**section 1.4.2**) had a clear impact over the Congressional agenda, and it has led Congress to grant important exemptions to corporate end-users (**section 1.4.3**).

derivatives and other commodity derivatives. However, the regulation of these sectors followed a partially independent course, driven by the impact these financial products had on the integrity of these markets rather than the risk they posed to the stability of the financial system.¹

¹ This section partially draws upon Helleiner, E. and S. Pagliari (2009). The End of Self-Regulation? Hedge Funds and Derivatives in Global Financial Governance. Global Finance in Crisis. The Politics of International Regulatory Change. E. Helleiner, S. Pagliari and H. Zimmermann. London, Routledge.

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1.1 Fixing the plumbing in OTC derivatives markets

Relatively obscure terms such as credit derivative swaps reached the first pages of mainstream media in the fall of 2008, following the bankruptcy of the US investment bank Lehman Brothers and the bailout of the largest insurance firm in the world AIG. However, in the US regulatory initiatives to bring order into these markets had started well before these events, since the very early stage of the financial crisis.

During this phase, regulation focused on the “plumbing” of derivatives markets, that is, on strengthening the infrastructures of these markets, and these measures were coordinated in a series of closed-door meetings between supervisors and market participants. On the side of public authorities, the leadership was taken by the Federal Reserve Bank of New York. Its chairman, the current US Treasury Secretary Timothy Geithner, summoned on a regular basis a senior industry leadership group – called the Operations Management Group formed by the major derivatives dealers, buy-side actors, and major financial industry groups such as the International Swaps and Derivatives Association, the main US hedge fund managers’ group - Managed Funds Association, and the Securities Industry and Financial Markets Association (SIFMA). These informal meetings hosted by the New York Federal Reserve were also extended to the major European regulatory authorities

(e.g. France's Commission Bancaire, the UK's Financial Services Authority, the German Bafin, and the Swiss Federal Banking Commission, European Central Bank). Since September 2009, this informal group of transatlantic regulators was put on a more formal basis through the established the OTC Derivatives Regulators' Forum.²

This dialogue between the Federal Reserve Bank of New York and the major derivatives industry participants had begun in September 2005, but received a renewed boost by the outbreak of the crisis.

The day before the bailout of the US investment bank Bear Stearns by the Federal Reserve on March 14 2008, the main US federal regulatory authorities who constitute the President's Working Group on Financial Markets published a report addressing the regulation of derivatives markets.³ The report acknowledged that the infrastructure designed by the industry before the crisis had not kept pace with the explosion in these instruments complexity and the surging trading volumes, and it identified different areas where the operational infrastructures of credit default swaps and over-the-counter derivatives markets required enhancements (see Box 1.1). However, instead of jumping on the

Box 1.1 - President's Working Group's Recommendations – March 2008

Federal regulators recommended:

- Improvements in the accuracy and timeliness of trade data submission and trade resolutions of trade matching errors for OTC derivatives;
- the introduction of cash settlement of obligations stemming from a credit event;
- greater standardization, greater use automation and use of electronic processing platforms;
- better management of counterparty risk, through netting and collateral agreements by promoting portfolio reconciliation and accurate valuation of trades;
- extending these operational infrastructure should have addressed all major classes of derivatives, and encompassed both the buy side and the dealer community.

Source: President's Working Group on Financial Markets. Policy Statement on Financial Market Developments, Washington, DC, March 13, 2008. President's Working Group on Financial Markets consists of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the

regulatory toolbox and mandating these reforms, US federal authorities invited the industry to address shortcomings in the infrastructure of derivatives markets through self-regulatory initiatives.⁴

Derivatives market actors have been quick in reacting to the detailed requests coming from the President's Working Group Report as well as other recommendations advanced by the Federal Reserve Bank of New York, and in committing to implement these changes through self-regulatory

² Federal Reserve Bank of New York, A Global Framework for Regulatory Cooperation on OTC Derivative CCPs and Trade Repositories, New York, 24 September 2009

³ President's Working Group on Financial Markets. *Policy Statement on Financial Market Developments*, Washington, DC, March 13, 2008.

⁴ The language adopted by the President's Working Group is explicit in avoiding to recommend that federal regulators should be put in charge of overseeing derivatives markets. The task of federal regulators is to “insist that the industry promptly set...”, to “urge the industry to amend...” and “ask the industry to develop...” regulatory initiatives to address these shortcomings. This focus on industry-driven initiative is consistent with the approach adopted in the decade that preceded the crisis, when US authorities refrained from extending the visible hand of regulation and relied instead on self-regulatory measures and on the discipline imposed by the invisible hand of markets.

measures. The improvements in the operational infrastructure of the OTC derivatives market implemented by the industry in this period focused on six areas:

- 1) Trade processing
- 2) Auction-settlement mechanisms
- 3) Reduction in the volume of outstanding trades
- 4) Collateral Management
- 5) Transparency
- 6) Governance

1.1.1 Enhancement of trade processing

Starting from March 2008, industry participants have committed to take several steps to enhance the processing of derivatives traded over-the-counter.

First, they have committed to expand automation of credit derivatives trade processing and to submit a greater number of electronically eligible credit derivatives (and later also OTC equity and interest rate derivatives) on electronic confirmation platforms.⁵

Second, market participants have pledged to reduce OTC trade confirmation backlogs. Industry-driven initiatives to achieve these goals had been developed since 2005, and at the beginning of the crisis the industry claimed to have made significant progresses in this direction. The number of credit derivatives traded on electronic platforms has increased from 53% to more than 90%, while the number of credit derivatives confirmations outstanding more than 30 days had been reduced by 86%.⁶

Third, market players have also committed to increase the standardization of OTC contracts. Starting from March 2008, market participants pledged to work towards the universal use of standard reference data. The Big Bang Protocol introduced by ISDA in April 2009 introduced a standardized pricing system for CDS contracts in the US.

⁵ All the press releases by the NY Federal Reserve and the letters sent from market participants are available on the website of the New York Federal Reserve Bank: http://www.newyorkfed.org/newsevents/otc_derivative.html. See Federal Reserve Bank of New York (2008). Press Release: New York Fed Welcomes New Industry Commitments on Credit Derivatives Federal Reserve Bank of New York, March 27. See also Federal Reserve Bank of New York (2008). Press Release: New York Fed Welcomes Further Industry Commitments on Over-the-Counter Derivatives Federal Reserve Bank of New York, October 31.

⁶ Federal Reserve Bank of New York (2008). Press Release: Statement Regarding June 9 Meeting on Over-the-Counter Derivatives, Federal Reserve Bank of New York, June 9. See also Operations Management Group, Letter to Timothy Geithner (President of the New York Federal Reserve), 31 October 2008, available on website of the New York Federal Reserve Bank: http://www.newyorkfed.org/newsevents/otc_derivative.html

1.1.2 Auction-settlement mechanisms

Following a request from the Federal Reserve Bank of New York, market participants committed in June 2008 to take measures to increase the certainty and transparency of a settlement process following a corporate default or another “credit event”. The primary solution identified by the industry and regulators was the use of auctions to determine the cash settlement price for assets in the case of default. The auction settlement methodology had been developed by the International Swaps and Derivatives Association since 2005. During the financial crisis ISDA organized several protocols and auctions for the cash settlement of credit derivative contracts in the aftermath of major corporate credit events such as in the case of Lehman Brothers, Washington Mutual, Fannie Mae and Freddie Mac in 2008. The main limitation of these auctions is the fact that they remained custom-tailored and voluntary. To address this problem, ISDA has published in March 2009 the documentation to “hardwire” an auction-based settlement mechanism into standard CDS documentation. Derivatives dealers have agreed to incorporate this mechanism into their contracts.⁷

On 8 April 2009, ISDA introduced the “Big Bang” Protocol to replace the ISDA master agreement that had governed OTC derivatives markets since 1999. This significant upheaval of derivatives markets made the use of auction settlement mandatory in future credit events related to CDS, as well as mandated to creation of “determination committee” formed from leading dealers and investors in charge of making market-wide binding decisions about whether a company’s default has triggered the CDS contract.⁸ While this protocol was designed to govern settlement process for credit derivatives in the US, ISDA developed an alternative protocol called “Small bang” for the European derivatives market.⁹

1.1.3 Reducing the volume of outstanding credit derivatives trades

Regulators also pointed out that counterparty credit exposure and operational risk in OTC derivatives markets were increased by the enormous amount of outstanding trades. Following a specific request by US federal regulators, market participants also committed in June 2008 to reduce the volume of outstanding credit derivatives trades through a process called “portfolio compression”, that is, tearing up contracts that have essentially opposite positions over the same risk.

In 2008, market participants had reduced the CDS trade notional amount outstanding by \$32 trillion, plus \$7 trillion up to April 2009, while committing to coordinate trade compression cycles for other derivatives classes.

⁷ 12-March-2009, ISDA, “ISDA Launches Hardwiring Supplement and Protocol, Further Enhancing Consistency, Transparency and Liquidity in CDS”

⁸ Federal Reserve Bank of New York. Press Release: New York Fed Welcomes CDS Auction Hardwiring”, 12 March 2009

⁹ International Swaps and Derivatives Association, Press Release: ISDA Launches 'Small Bang Protocol' and Restructuring Supplement, 14 July 2009.

1.1.4 Collateral Management

A Collateral Committee established within ISDA has worked on improving collateral management for OTC derivatives. This included measures such as “valuation methodologies for collateral exposure calculations, efficient timing of margin calls, margin dispute resolution practices and weekly portfolio reconciliation”.¹⁰ The major derivatives dealers also committed in June 2009 to execute daily collateralized portfolio reconciliations for collateralized portfolios. In September 2009, the International Swaps and Derivatives Association, together with the Managed Funds Association and the Securities Industry Financial Regulatory Authority have also released a paper to address margin-related risks.¹¹

1.1.5 Transparency and Trade Repositories

Closed-door meetings between the Federal Reserve Bank of New York and industry participants also continued after the collapse of Lehman Brothers on September 2008. This episode demonstrated the significant risks arising from the lack of transparency in the OTC derivatives market, as panic in the market was heightened by the uncertainty about which economic agents were holding credit default swaps on Lehman’s debt.

Market participants committed to implement measures to increase transparency in the OTC derivatives markets. In particular, the attention of market participants and regulators focused on the implementation of data repositories for non-cleared transactions in these markets, in order to increase the information about CDS available to the public and assist supervisors in the oversight of derivatives markets. The main market participants committed to report all credit derivatives to the Trade Information Warehouse operated by the Depository Trust & Clearing Corporation (DTCC). Moreover, on November 2008, the DTCC started to publish weekly aggregate market data on outstanding gross and net notional values and numbers of CDS contracts registered in its worldwide central trade registry. The pursuit of greater transparency on the market was further reinforced by the commitment of dealers to provide a range of pricing information to the public via a vendor portal, and by central counterparties to release information about their activities.

Market participants have also committed to developing plans for central trade repositories and universal recording of trades beyond credit derivatives, including interest rate and equity derivative trades.

1.1.6 Governance

Many commentators and market participants have argued that the delay of the derivative industry in reforming its infrastructures was influenced by the dominance of banks (dealers) within the industry and within its main association (ISDA). Funds and buy-side actors complained that dealers had

¹⁰ 2 June 2009 - Operations Management Group letter to William C. Dudley

¹¹ Derivatives Week, White Paper On Margins To Be Released Today, 15 September 2009

delayed certain regulatory reforms that could shed lights upon these markets to guard their profits, since dealers have traditionally been able to exploit the opaque nature of OTC derivatives markets to boost their margins.

The Federal Reserve Bank of New York has therefore pressured derivative dealers (the sell-side) that have traditionally dominated the market to cede part of their control in the governance of the sector to buy-side actors investors, and to “make the decision making processes encompassing of a wider set of viewpoints”.¹²

ISDA has responded to these pressures by reforming its decision-making structure in order to be more encompassing of the buy-side and introduced a super-majority vote for the decisions to become binding “so as neither buy- nor sell-side participants in the market can dominate decision making”.¹³

Finally, regulators have urged market participants to progressively expand the self-regulatory measures described above beyond the initial focus on credit derivatives market, in order to cover other derivatives traded over-the-counter, such as OTC equity, interest rate, foreign exchange, and commodity derivatives.

1.2 The centralized clearing of OTC derivatives

The focus on strengthening the operational infrastructures of OTC derivatives markets that characterized the first phase of the financial crisis was gradually replaced by a growing attention on counterparty risk. This term indicates the risk that the counterparty in a derivative contract will not live up to its contractual obligations. In particular, the collapse of Lehman Brothers, followed by the bailout of AIG, demonstrated the systemic effects of the collapse of a major counterparty and the risks arising from the lack of transparency in the OTC derivatives market.

The main regulatory solution identified by public authorities and market participants to mitigate the counterparty risk in OTC derivatives transactions revolved around the clearing of bilateral trades through central counterparties (CCPs).

Central counterparties reduce systemic risk by making possible that the two counterparties are no longer exposed to each other's credit risk. Besides reducing counterparty risk, CCPs are also a tool to

¹² Federal Reserve Bank of NY, Press Release “Statement Regarding April 1 Meeting on Over-the-counter derivatives”, 1 April 2009

¹³ ISDA, “Letter to Mr. Dudley: ISDA Outlines Next Phase in Industry Efforts to Increase Efficiency and Reduce Risks in OTC Derivatives Business”, 2 June 2009

reduce the operational risks associated with OTC derivatives trading by ensuring that trades are cleared and settled in a timely manner, as well as to increase the transparency of these markets.

This section will describe the politics that surrounded the creation of CCPs in the United States. Two important political struggles have occurred. First, regulators have engaged in a bargain with the main market actors to ensure the establishment of running CCPs, as well as to ensure adequate access to buy-side actors (section 1.2.1). Second, an even more heated political struggle has occurred *among* regulators to determine which regulatory agency should be granted the authority to regulate these entities (section 1.2.2 and 1.2.3).

1.2.1 Creating CCPs

In order to mitigate the counterparty risk in OTC derivatives transactions, the Federal Reserve Bank of New York has pressured market participants to go beyond the previous initiatives to strengthen the plumbing through which the derivatives markets flow and to redirect these flows through central counterparties where bilateral trades could be cleared.

After their meeting with the NY Fed on July 31, 2008 the major dealers represented in the Operations Management Group declared their commitment to “(i) support a clearing platform and (ii) utilize such platform to clear all eligible products where practicable”.¹⁴ Similar proposals to move “over-the-counter” trading onto central clearinghouses had in the past been resisted by the major derivative dealers. However, the increasing threat of more stringent regulation, and in particular the threat of forcing the trading of OTC derivatives into regulated exchanges, created significant incentives for the main banks to accept this solution.

Another incentive for the major derivatives dealers to endorse the centralized clearing of OTC trades has been their attempt to gain control of the emerging business. The major dealer banks started the clearing race by taking control of the Clearing Corporation. In May 2008 they announced the establishment of a central platform for clearing certain types of OTC credit derivatives – called ICE US Trust - in partnership with the Atlanta-based electronic exchange Intercontinental Exchange Inc. Other participants entering this clearing race were a joint venture between the Chicago Mercantile Exchange, the world’s largest futures exchange, and Citadel, a Chicago-based hedge fund, Frankfurt-based Eurex, and NYSE Euronext. Despite the pressures from the New York Federal Reserve to start the clearing of OTC CDS by the end of the year,¹⁵ the first trades on indices of credit derivatives were cleared only in March 2009 by ICE US Trust. The support from the main dealers that partially owned the clearing venture proved to be determinant in allowing ICE US Trust to beat its rivals and win the clearing race.¹⁶

¹⁴ Federal Reserve Bank of New York, “New York Fed Welcomes Expanded Industry Commitments on Over-the-Counter Derivatives”, 31 July 2008

¹⁵ Federal Reserve Bank of New York, “New York Fed to Host Meeting Regarding Central Counterparty for CDS”, 10 October 2008

¹⁶ Financial News Online, Tom Fairless, “ICE off the mark in CDS clearing race”, 18 March 2009

The NY Federal Reserve did not limit his action to facilitating the establishment of running CCPs, but it also asked sell-side actors to take steps to grant greater access to the clearing of derivatives as well as greater protection from counterparty failures to buy-side actors (hedge funds and other investors).¹⁷ Investors had accused banks of limiting access to the single clearinghouse they co-owned (ICE Trust), while not supporting other solutions. Some hedge funds have requested dealers to segregate their initial trade margins after that some of them had lost their assets in bankruptcy proceedings after the collapse of Lehman Brothers.¹⁸ As a result of the pressures coming from regulators and buy-side actors, derivative dealers have committed to enable “customer access to clearing through either direct access as a clearing member or via indirect access, including the benefits of initial margin segregation and position portability”.¹⁹ In accordance with this commitment, ISDA has submitted to regulators a report drafted by eight dealers and eight buy-side representatives regarding buy-side access to central counterparties for CDS clearing, as well as to introduce segregated accounts into an amendment to the ISDA Master agreement between banks and customers.²⁰

More recently, US regulatory authorities have also pushed market participants to expand central clearing to cover a wider range of products. They have received in response from the major derivative dealers a commitment to clear the majority of interest rate derivatives and credit default swaps through central counterparties by the end of the year.²¹ NYSE Euronext and the The Depository Trust & Clearing Corporation have announced they would launch the first clearing service for US fixed income derivatives,²² while the Options Clearing Corporation plans to offer the first central clearing facility in the US for the over-the-counter equity derivative market.²³

1.2.2 Regulating CCPs

While the Federal Reserve, the Securities and Exchange Commission, and the Commodities and Futures Trading Commission have created a unified front in pushing the derivatives markets participants to establish central clearinghouses for OTC derivatives, a turf war has been brewing among them over who should be given authority to regulate and oversee these entities.

The Federal Reserve has been presented at the beginning as the most likely candidate to take this role. As described above, the Federal Reserve Bank of New York had played a leading role in the regulation of credit derivatives markets and pushed market actors to establish running CCPs. Both the Commodity Futures Trading Commission and the Securities and Exchange Commission have questioned the dominance of the Federal Reserve and sought greater authority to oversee the newly

¹⁷ Federal Reserve Bank of New York, “New York Fed Welcomes CDS Central Counterparty Legal Analysis”, 13 July 2009

¹⁸ Reuters, Dealers expand CDS clearing amid fund complaints, 2 June 2009

¹⁹ Operations Management Group. Letter to William C. Dudley, 2 June 2009

²⁰ ISDA, “ISDA submits report on CCP buy-side access to centralized CDS clearing”, 13 July 2009

²¹ Federal Reserve Bank of New York, Market Participants Commit to Expand Central Clearing for OTC Derivatives, 8 September 2009

²² Business Exchange, Clearing momentum gathers pace, 18 June 2009

²³ Financial Times, OCC in derivatives clearing initiative, 12 November 2009

launched central counterparty clearing platforms. The SEC and CFTC have requested Congress to grant them legal authority to regulate elements such as margin requirements set by the CCP, their risk management and stress testing, transparency and disclosure-requirements.

Each of the three agencies has been accused of leaning towards a different private clearing solution. The Federal Reserve Bank of New York became the regulator of ICE US Trust Proposal, the clearing solution created by the main derivative dealers that were already regulated by the Fed. The Securities and Exchange Commission has instead pushed to have credit default swaps recognized as securities in order to have the authority to impose reporting and antifraud requirements on this market, and it was said to be leaning towards the clearing solution announced by the NYSE. The CFTC was said to be supportive of the solution proposed by the CME Group, whose commodities business is already under its jurisdiction.²⁴ When the SEC and the Federal Reserve approved the clearing bid by ICE US Trust, this was criticized by the CFTC as a “one-sided action”, meant to give ICE an advantage over CME Group.²⁵ This turf war among the agencies and the need for the approval from multiple authorities seem to have delayed the establishment of running clearinghouses in the US, which has lagged behind Europe despite an early start.

The three agencies have headed off this brewing turf war by signing on 14 November 2008 a “memorandum of understanding” to share information on the supervision of central counterparties. Under this agreement, the three agencies committed to consult with each other and share information in approving, reviewing and regulating any proposed central counterparty.²⁶

1.2.3 The Turf War within Congress

This memorandum of understanding could be described as a ceasefire between federal regulators rather than a peace settlement. The turf war between regulatory agencies has not come to an end but rather it has simply moved within the US Congress where lawmakers have expressed different preferences about which agency should be granted regulatory authority.

On this specific issue, the main cleavage within Congress has not run across party lines, but rather between, on the one hand, the House and Senate Financial Services and Banking committees, and, on the other hand, the House and Senate Agriculture committees. These committees have traditionally represented a distinct set of economic interests: the financial services, and the agriculture and commodity-related interests. While the former revolve around New York and Wall Street, the latter revolve around Chicago, the birthplace of commodity futures markets.²⁷

²⁴ Michelle Price, “Clearing Up”, *The Banker*, 1 February 2009,

²⁵ MarketWatch, SEC Approves ICE Credit-Default Swap Clearing Plan, 6 March 2009

²⁶ PWG (2008). Memorandum of Understanding between the Board of Governors of the Federal Reserve System, The U.S. Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps, President's Working Group on Financial Markets, November 14.

²⁷ Paul J. Davies, “Wall Street and Chicago set for resumption of turf wars”, *Financial Times*, 13 February 2009

The interests most closely connected to Wall Street have traditionally found a more sympathetic audience within the House Financial Services and at the Senate Banking Committee. These committees oversee the Securities and Exchange Commission and banking regulators such as the Federal Deposit Insurance Corporation. Banking industry interest groups have maintained a privileged relation with the New York Federal Reserve, and lobbied Congress to make this body the main US regulator for the credit derivatives market.

Agricultural and other commodity-related interest groups have perceived this move as an intrusion of the banking sector into their traditional turf.²⁸ These groups have been represented mainly within the House and Senate Agriculture committees, which maintain jurisdiction over the CFTC because of its history regulating farming commodities. Not surprisingly, these committees have endorsed proposals to give the CFTC oversight power over credit default swaps.

House Agriculture Committee Chairman Collin Peterson argued to be “flat opposed” to the possibility that the Federal Reserve could become the main regulator for the credit derivatives market. Peterson explained the preference of most banks to have the Fed as the primary authority overseeing this market as the product of the “cozy relationship” between most banks and Fed members, “plus, they probably think it is a good idea to have a regulator with the resources to bail them out when things go south”. With the exception of the influential Senator from New York Charles Schumer, the option of granting the responsibility to oversee derivatives markets to the Federal Reserve has not found a significant support within Congress and it has quickly been sidelined.²⁹

Rep. Peterson also raised doubts about the SEC’s ability to regulate these markets³⁰ and introduced in February 2009 a bill giving the CFTC the primary authority over credit derivatives and other swaps.³¹ Another bill introduced in the Senate Agriculture Committee by Senator Susan Collins - the “Financial Regulation Reform Act of 2008” - requested to report over-the-counter contracts to the CFTC.

The House Financial Services Committee and the Senate Banking Committee opposed proposals coming from the Agriculture Committee giving the CFTC the leading role. A bill reintroduced in the Financial Services Committee by Rep. Edward Markey in October 2008 (the “Derivatives Market Reform Act of 1999”) requested derivative dealers to register with the SEC, thus granting this body “exclusive jurisdiction regarding accounts, agreements, transactions, and markets in derivatives”. The Chairman of the House Financial Services Committee Barney Frank has suggested instead limiting the

²⁸Paul J. Davies, “Wall Street and Chicago set for resumption of turf wars”, *Financial Times*, 13 February 2009

²⁹ Joanne Morrison, “Lawmaker says Fed should regulate OTC clearinghouse”, Reuters, 8 July 2008

³⁰ Sarah Lynch, “Rep Peterson Is 'Flat Opposed' To Fed, SEC Regulating Swaps”, Dow Jones Newswire, 3 February 2009

³¹ This bill mandated that all over-the-counter trades must be cleared by a CFTC-approved organization, or in the case of financial derivatives, a firm regulated by the Securities and Exchange Commission. Peterson’s bill denied the Fed any authority to regulate the clearing of OTC transactions, forcing banks to register with either the SEC or CFTC in order to clear OTC credit default swaps. The Agriculture Committee approved this proposal on February 12, 2009 but it could not proceed to the House floor without the approval from the House Financial Services Committee. See Bill Swindell and Jerry Hagstrom, “Peterson's CFTC Measure Sparks A Major Jurisdictional Battle With Frank”, *CongressDaily*, 12 February 2009.

authority of the CFTC to commodities that are “edible” (e.g. futures on agricultural products), while letting everything else under the jurisdiction of the SEC.³²

After the intervention of the U.S. House Speaker Nancy Pelosi, the Democratic leaders of the Financial Services and Agriculture Committee have sought to settle this turf war by splitting the jurisdiction over the supervision of the clearing of OTC derivatives between the SEC and CFTC.³³ This solution gained steam especially after the proposal to merge the SEC and the CFTC stumbled into multiple vetoes within Congress and from the same agencies.

After weeks of behind-the-scenes negotiations, the same SEC and CFTC reached in June 2009 an agreement over how to split regulatory authority of the over-the-counter derivatives market between the two agencies. The Chairwoman of the SEC Mary Schapiro and the Chair of the CFTC Gensler presented a united front before a Senate hearing, requesting Congress to grant the SEC primary responsibility for derivatives tied to securities (including credit-default swaps) and the CFTC control of other derivatives, such as those based on underlying values of interest rates, foreign exchange, commodities, energy and metals.³⁴

Also legislative proposals presented by Rep. Frank and Rep. Peterson in September 2009 (discussed in Section 1.3.4) and the US Treasury plan (Section 1.3.2) would divide jurisdiction between the SEC and CFTC.³⁵

An alternative proposal presented by Rep. McMahon has put the US Treasury at the helm in regulating and supervising the clearing of OTC derivatives has been. McMahon introduced in July 2009 a bill (“Derivatives Trading Accountability and Disclosure Act of 2009”) which would create an Office of Derivative Supervision located within the US Treasury. This office would be given the task of coordinating the regulation of derivatives with the SEC and CFTC two regulatory agencies, while maintaining the veto power over any rules set by these agencies. According to McMahon, giving the US Treasury ultimate control over the decision taken by the CFTC and SEC would have been a way to increase the accountability in the regulation of derivatives.³⁶ However, the Congress did not take up this proposal, and the supervision of OTC derivatives remains in the hands of independent regulatory agencies rather than in the hands of elected policymakers such as the US Treasury.

³² Kara Scannell, “Derivatives Oversight Spurs House Turf Battle”, *Wall Street Journal*, 13 February 2009

³³ Reuters, “Pelosi to enter US House credit derivatives row”, 27 April 2009,

³⁴ Bloomberg, “2 Agencies Seek Joint Control Over Derivatives Markets”, 23 June 2009

³⁵ According to the Frank and Peterson bills, the SEC would have jurisdiction over securities-based derivatives, while the CFTC would have jurisdiction over commodity-based derivatives. The legislative proposal sent to Congress in August 2009 suggested an alternative division of jurisdiction, giving the SEC authority over single security-linked swaps and swaps tied to narrow-based indexes, and the CFTC authority over broad-based indexes and other derivatives products like energy or interest-rate swaps. This solution has been criticized by the Securities and Exchange Commission, which has requested the authority to oversee all “securities-related” OTC derivatives. In a testimony before the US House of Representatives Committee on Agriculture, she argued: “Congress should consider modifying the [Obama administration’s] proposal so that all securities-related OTC derivatives are regulated more like securities; and commodity and other non-securities-related OTC derivatives are regulated more like futures”. Moreover, the US Treasury called for greater harmonization between the “principles-based approach” employed by the CFTC and the “rules-based approach” employed by the SEC, and recommended that the two agencies reported to Congress about the changes required in order to eliminate these differences. The US Treasury proposal kept banking regulators in the mix by giving them the authority to oversee banks that deal in derivatives.

³⁶ 22 July 2009 - US Treasury has prime role in derivatives bill

1.3 After Lehman, derivatives under the public sphere

The section analyzes in greater details the plan presented in 2009 by US policymakers to regulate OTC derivatives markets. These regulatory initiatives go well beyond the regulation of CCPs described in the previous section, but they also covered the regulation of derivatives products, the regulation of OTC derivatives dealers, measures to ensure market integrity, the division of jurisdiction among regulatory authorities.

1.3.1 SEC and CFTC, a decade later

During the Congressional debates that preceded the passage of the Commodity Futures Modernization Act in 2000, US federal regulatory authorities with the exception of the CFTC discouraged Congress from bringing OTC derivatives market under the federal regulatory oversight, arguing that these markets were not susceptible to manipulation.

During the initial stage of the financial crisis, federal regulators have continued to downplay the need for any action by Congress to give them greater oversight and regulatory authority over OTC derivatives markets. Kathryn Dick from the Office of the Comptroller of the Currency, the body which oversee some of the largest banks that deal in the CDS markets, told a Senate Banking subcommittee hearing in July 2008: “[W]e do not see a need for legislative intervention to supplement our ability to regulate the credit derivatives of national banks”³⁷. In the same way, other federal regulators such as the Securities and Exchange Commission, the Federal Reserve, and the CFTC also did not ask Congress for any new legislation in the period that preceded the collapse of Lehman Brothers. On the contrary, in order to strengthen the infrastructure of derivatives markets, public authorities have limited their role to steering self-regulatory steps undertaken by the financial industry towards public policy goals and monitoring their effectiveness.

³⁷ Greg Robb, “Regulators take a pass on credit default swaps”, *MarketWatch*, 9 July 2008

Box 1.2 – SEC Plan to regulate OTC Derivatives - June 2009

- 1) **Jurisdiction:** the SEC requested Congress to legislate in order to place the regulation of all securities-related derivatives – both those traded over-the-counter and those traded on an exchange - under the jurisdiction of the SEC. According to Schapiro's plan "securities-related" derivatives would include credit derivatives, such as credit default swaps, as well as equity derivatives and other fixed income derivatives.
- 2) **OTC Dealers:** all the dealers in securities-related OTC derivatives would be subject to the supervision and regulation by the SEC, which would have the authority to set capital requirements for these dealers. This would not apply to the OTC derivative dealers that are banks, which would continue to be supervised by their federal banking regulators, but it would extend the regulatory net to other non-banks derivative dealers. The SEC also requested authority to "establish business conduct standards and recordkeeping and reporting requirements for all these securities-related OTC derivatives dealers and other firms with large counterparty exposures in securities-related OTC derivatives".
- 3) **Clearing and Trading:** the SEC has sought authority over exchanges and clearing agencies handling securities-related OTC derivatives, requesting these actors to register."

SOURCE: Testimony Concerning Regulation of Over-The-Counter derivatives by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, Washington, DC, 22 June 2009

These twin shocks had the effect of politicizing the debate over the regulation of derivatives and to create significant incentives for elected policymakers to intervene. They also triggered a significant shift in the position of US federal regulatory agencies that came to endorse since the fall of 2008 legislative measures to bring derivatives under the public regulatory umbrella.³⁸

This time around, both the chairman of the SEC and CFTC explicitly asked Congress to legislate in order to grant federal regulators the authority to supervise the OTC markets. Speaking in front of the Senate Banking Committee a few days after the collapse of Lehman Brothers, the chairman of the Securities and Exchange Commission Christopher Cox expressed concerns for the significant opportunities for manipulation in the credit default swaps markets. In particular, Cox highlighted the risks created by the use of "naked derivatives" where speculators do not own the instrument upon which the credit default swap is based. As a consequence, he urged Congress "to provide in statute the authority to regulate these products to enhance investor protection and ensure the operation of fair and orderly markets."³⁹

Also the new SEC Chairwoman, Mary Schapiro, who replaced Cox after the election of President Barak Obama, requested a legislative act to grant her agency oversight over credit derivatives markets.⁴⁰ Moreover, Schapiro went even further and presented in June 2009 a plan for the regulation of over-the-counter derivatives (see Box 1.2).

³⁸ A clear indication of this shift can be identified in the new report published by the President's Working Group on Financial Market in November 2008, which unlike the previous report published in March, directed most of its recommendations towards the same released by the US federal regulators instead of market participants. The PWG Report recommended regulators to "establish consistent policy standards and risk management expectations for CCPs or other systemically important derivatives market infrastructures and apply those standards consistently", "set consistent standards for regulated entities that transact in OTC derivatives instruments", "require participants in a central counterparty arrangement to clear all eligible contracts through that CCP". PWG (2008). Policy Objectives for the OTC Derivatives Market. President's Working Group on Financial Markets, November 14.

³⁹ Joanna Chung, Aline van Duyn, and Paul J Davies, "Calls to curb credit derivatives", *Financial Times*, 23 September 2008.

⁴⁰ Michael R. Crittenden, "SEC Nominee: Fed Govt Needs To Regulate Credit-Default Swaps", *Dow Jones Newswire*, 15 January 2009.

Box 1.3 – CFTC Plan to regulate OTC Derivatives - June 2009

- 1) **Jurisdiction:** the CFTC suggested to divide the authority to regulate derivatives markets between the CFTC and the SEC.
- 2) **OTC dealers:** the CFTC requested that all derivative dealers, regardless of type of firm, method of trading or the derivative or swap involved, be subject to capital requirements, business conduct standards, recordkeeping and reporting requirements. This would also include mandatory reporting of any trade not centrally cleared to a regulated trade repository.
- 3) **Clearing and trading:** OTC derivatives would be cleared through central clearinghouses, as well as to move onto regulated exchanges or regulated electronic trading systems “whenever possible”. According to the CFTC plan, it would be the same clearinghouses that would determine which products are sufficiently “standardized” to be cleared, while the responsibilities of public authorities would more modestly to ensure that they meet “international standards” in risk management and security.
- 4) **Position limits and foreign exchanges:** the CFTC requested the authority to impose position limits, including aggregate limits across markets, “on OTC derivatives that perform or affect a significant price-discovery function on regulated markets”. Also foreign exchanges should adopt position limits and reporting requirements matching the US rules in order to have access to customers in the United States.

Source - Testimony by Gary Gensler, Chairman, Commodity Futures Trading Commission Washington, DC - June 4, 2009

Shortly after the bankruptcy of Lehman Brothers, also the Commodity Futures Trading Commission demanded in front of Congress to be granted regulatory authority.⁴¹ It also requested an increase in its staffing and resources to undertake these additional tasks.⁴²

The newly elected Obama administration appointed Richard Gensler to head the CFTC. This appointment was contested by a few Congressmen, who highlighted the role Gensler had played as undersecretary of the Treasury in 2000, when the Congress exempted OTC markets from regulatory oversight with the Commodity Futures Modernization Act. After his *mea culpa* for not having pushed harder to bring OTC markets under greater regulation a decade earlier, Gensler asserted the need to bring standardized derivatives into central clearinghouses and exchanges, and greater reporting for the derivatives remaining over-the-counter.⁴³ Around the same time as the SEC, Gensler also disclosed a set of proposals to regulating derivatives dealers and the same derivatives markets (see Box 1.3), which share several similarities with the plan delineated by the SEC.

1.3.2 The Treasury Plan

The most encompassing proposal to regulate OTC derivatives markets has been presented by the US Treasury. As derivatives regulation had been a crucial issue for Timothy Geithner during his tenure at the New York Fed, his appointment as the new Secretary of the US Treasury simply raised the profile of this issue within the US administration.

⁴¹ Sarah N. Lynch, “CFTC Calls For Regulatory Reform For OTC Derivatives”, *Dow Jones Newswire*, 15 October 2008

⁴² Reuters, “CFTC member asks mandatory clearing of CDS”, 28 January 2009

⁴³ Jessica Marron, “Gensler assures critics he will curb speculation, tighten OTC regulation”, *Inside F.E.R.C.'s Gas Market Report*, 6 March 2009

Geithner released its long-awaited proposal to regulate derivatives in May 2009, further refined one month later in its report “Financial Regulatory Reform: a New Foundation”, and delivered to US Congress in August (see Box 1.4).

This document represents the most comprehensive plan to regulate derivatives presented so far. It also became the model for the most important legislative proposals presented by Congressional leaders in the fall of 2009 (see section 1.3.4).

1.4 Widening the range of actors: Congress and interest groups

1.4.1 Congress enters the scene: forcing OTC onto exchanges and banning “naked” CDS

The politicization of financial regulation that followed the collapse of Lehman Brothers and the bailout of AIG has created pressures for Congressmen to enter the debate over the regulation of these markets.

The rising anger towards Wall Street and the financial sector that followed the bailout plan announced by the US Treasury motivated some Congressmen to re-introduce towards the end of legislature bills that had originally been introduced in previous sessions before the crisis but which had failed to become law.⁴⁴

While these bills were cleared from the books at the end of the Congressional session, the new session that inaugurated at the beginning of 2009 witnessed an unprecedented legislative activism of Congress in the regulation of OTC derivatives, with at least a dozen different bills introduced in the year that followed the US election.

What has been the impact of this flurry of legislative proposals? The involvement of Congress certainly broadened the range of regulatory proposals on the table beyond those regulatory solutions endorsed by the US Treasury and the federal regulatory agencies (SEC and CFTC). Some Congressmen presented regulatory solutions regarded by most market participants as significantly more radical than those endorsed by the US federal authorities and derivatives industry-representatives. Two regulatory solutions stand out: forcing all derivatives on exchanges, and banning “naked” credit default swaps.

⁴⁴ For instance, Rep. Edward Markey reintroduced in October 2008 the “Derivatives Market Reform Act of 1999”, firstly introduced a decade before after the collapse of the hedge fund Long-Term Capital Management. The Markey bill was followed by the “Derivatives and Hedge Fund Regulatory Improvement Act of 2008”, introduced by Sen. Byron Dorgan. Both bills were cleared from the books at the end of the Congressional session

Forcing derivatives onto exchanges

The “Derivatives Trading Integrity Act of 2009”, introduced in January 2009 by the Chairman of the Senate Committee on Agriculture Senator Tom Harkin, proposed to force all derivatives contracts

Box 1.4: The US Treasury Plan

- 1) **Clearing:** The plan requires “clearing of all standardized OTC derivatives through regulated central counterparties”. Regulators would need to regulate CCP to ensure they impose “robust margin requirements and other necessary risk controls”. The Treasury plan delegates to the same clearinghouses the task of defining determining what derivatives contracts were sufficiently “standardized” to be cleared. The plan maintains that “if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared”.
- 2) **Trading on Exchanges:** The US Treasury plan calls for a reform of securities laws in order to impose “the movement of standardized trades onto regulated exchanges and regulated transparent electronic trade execution systems for OTC derivatives”. This represents a significant change compared to the approach taken by the same US Treasury and other federal regulators in the President’s Working Group Report of October 2008. The PWG had maintained that the use of exchange or similar trading platforms for standardized CDS contracts should only be “encouraged”.
- 3) **Regulation of OTC dealers:** The US Treasury plan does not propose to outlaw OTC derivatives markets or to force all customized products to go through clearinghouses. Instead of banning those customized bilateral transactions that would not be accepted by a CCP, the US Treasury plan suggests that the counterparty risk associated with these transactions could be mitigated through a regulation of the counterparties in these bilateral transactions. The plan requires “all OTC derivatives dealers and all other firms who create large exposures to counterparties should be subject to a robust regime of prudential supervision and regulation”. These regulatory requirements would include capital requirements, reporting requirements, business conduct standards, and initial margin requirements with respect to bilateral credit exposures. Higher capital requirements for customized and non-centrally cleared OTC derivatives are also supposed to “encourage greater use of standardized OTC derivatives and thereby to facilitate substantial migration of OTC derivatives onto central clearinghouses and exchanges”.
- 4) **Transparency:** the proposal authorizes the CFTC and the SEC to impose requirements for all trades not cleared by CCPs to be reported to a regulated trade repository, which would make aggregate data available to the public, while making data on individual counterparty’s positions available to federal regulators. Also the central counterparty through which derivatives contracts are cleared should disclose aggregate information.
- 5) **Market Manipulation and abuses:** in order to prevent market manipulation and market abuses, the CFTC and the SEC should be granted the authority to set position limits on OTC derivatives. The same agencies were also given the task of tightening the standards governing the participation in the OTC derivatives markets, in order to “guard against the use of inappropriate marketing practices to sell derivatives to unsophisticated individuals, companies, and other parties”.

SOURCE: US Treasury (2009). Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation. Department of the Treasury, June 17; Secretary Timothy F. Geithner Written Testimony House Financial Services and Agriculture Committees Joint Hearing on Regulation of OTC Derivatives, July 10, 2009

onto regulated exchanges.⁴⁵

⁴⁵ More specifically, the Harkin bill would terminate the authority of the CFTC to exempt swap transactions from the requirement to be traded on a regulated board of trade. In order to achieve this goal, the bill would amend the Commodity Exchange Act to eliminate the distinction between “excluded” and “exempt” commodities and transactions, and commodities and transactions traded or conducted on regulated exchanges

This measure would have a more radical impact on the derivatives markets than any other measure endorsed by federal regulators. By forcing all the derivatives onto exchanges, the bill would mark the end of the derivatives that are traded bilaterally over-the-counter. A spokesman from the Securities Industry and Financial Markets Association (SIFMA) commented: “the bill effectively ends the over-the-counter business as it exists today”⁴⁶.

Moreover, forcing OTC derivatives on exchanges would also mark the end of “customized” derivatives tailored to the specific needs of users, since only derivatives that are sufficiently “standardized” can be traded onto exchanges.

Another bill that would have led to similar outcomes is the “Credit Default Swap Prohibition Act of 2009”, presented by Congresswoman Maxine Waters on July 2009. Instead of forcing derivatives onto exchanges, this bill would introduce a total ban on customized credit default swaps.

While a few market actors, including the famous hedge fund manager George Soros⁴⁷ have supported proposals to force exchange trading or to ban customized products, in general these proposals have raised significant concerns among derivatives market participants. As described in the next section (1.3.4), the cohesive front created by banks, exchanges, and corporate actors made it impossible for this measure to make progress in the legislative process within Congress. Neither the Harkin Bill nor the Waters bill has ever been brought up for a vote by their respective committees. Moreover, similar provisions have not been endorsed by the US federal regulators or by the Obama administration. The SEC did not endorse any ban for OTC derivatives, acknowledging: “there are legitimate economic reasons to engage in customized transactions”.⁴⁸ Also the plan presented by US Treasury in June 2009 did not endorse pushing all OTC derivatives through exchanges. Timothy Geithner commented on this point saying: “If we were to mandate central clearing of all products, we would in effect be banning customized products ... We’re not proposing to do that.”⁴⁹

The US Treasury plan instead forces exclusively *standardized* OTC derivatives to be processed through clearinghouses, as well as to migrate onto regulated exchanges or electronic execution systems. Rather than outlawing OTC contracts, the plan would subject dealers and companies using OTC derivatives to adopt stricter capital requirements and reporting requirements. These higher charges would incentivize rather than mandate greater standardization, and therefore greater use of clearing and exchange-trading, without at the same time banning OTC trading.

Ban on Naked Credit Default Swaps

Another regulatory proposal presented in the US Congress and significantly expanding the scope of regulatory intervention in OTC derivatives markets was the introduction of a ban on “naked” credit default swaps. This measure was introduced in the “Derivatives Markets Transparency and

⁴⁶ Sarah Hansard, “Securities industry worries that swap legislation could be far-reaching”, *Investment News*, 7-December-2008,

⁴⁷ Press Release, Congresswoman Waters introduces Credit Default Swap Prohibition Act, 10 July 2009

⁴⁸ SEC, Testimony concerning regulation of over-the-counter derivatives by Chairman Mary Schapiro, 22 June 2009

⁴⁹ Sarah N. Lynch and Ian Talley, “Geithner Tries To Sell Obama Derivatives Plan To Congress”, Dow Jones Newswire, 10 July 2009

Accountability Act of 2009” presented in January 2009 by the Chairman of the House of Representatives Agriculture Committee Collin Peterson. The Peterson bill in its initial formulation would ban the trading of credit default swaps unless investors owned the underlying asset on which the credit insurance was bought. The so-called “naked” credit-default swaps have been used to bet against the credit-worthiness of companies when investors have no ownership interest in the bonds. Peterson’s proposal would have significantly reduced the size of derivatives markets, since only a fifth of all CDS trades are conducted by a trader who owns the underlying bond.

Peterson justified the ban on naked-derivatives as a complementary measure to the temporary ban imposed by the Securities and Exchange Commission on short selling and declared that the former should be imposed only if the latter was also in place.⁵⁰

A similar provision was also introduced by bill released jointly by Peterson and the Chairman of the House Financial Services Committee Barney Frank in July 2009. In order to limit speculation, the bill considered the option of prohibiting any purchase of credit protection using a CDS contract unless the economic agent 1) owned the referenced security or the security in an index of securities; 2) had a bona fide economic interest protected by the contract; or 3) was a bona fide market maker. Rep. Barney Frank later presented a bill in the House Financial Services Committee empowering regulators to ban swaps deemed “abusive” or bad for market stability and participants.

Finally, a similar provision banning CDS was contained in a different bill to regulate OTC derivatives introduced by Rep. Bart Stupak within the House Energy and Commerce Committee in the context of the legislation on the climate bill. The bill would give federal regulators the authority to oversee all over-the-counter and carbon derivatives and ban the trading of naked CDS.

However, none of provisions to ban “naked” CDS made significant progress in the legislative process. The Stupak bill was referred to the House Financial Services Committee but never brought up for a vote. Instead, both Peterson and Frank removed the provisions banning naked CDS before their respective committees approved these bills. In the revised version of the Peterson bill approved by the Agriculture Committee on February 12, 2009 the outright ban on naked CDS was removed in favor of a “circuit breaker”. This measure would empower the CFTC to “summarily suspend trading in any credit default swap” when this is “in the public interest” and “for the protection of investors”, as well as to obtain information on any OTC market position to determine whether they should be subject to position limits.

Similarly, before submitting his proposal to the vote of the House Financial Services Committee in October 2009, Frank removed the proposal to empower regulators to ban “abusive swaps”, which Frank said some found “unsettling.” Instead, the bill would require the CFTC and the SEC to conduct a study on swaps that “are detrimental to the stability of a financial market or participants in a financial market.”⁵¹

⁵⁰ Sarah N. Lynch, “House Panel to Debate Sweeping Derivatives Regulation Plan”, *Dow Jones*, 2 February 2009

⁵¹ Platts Commodity News, “US House panel seeks to preserve enduser leeway in OTC deals”, 14 October 2009

The decision by Peterson and Frank to remove from their respective bills the ban of “naked” credit default swaps certainly reflects the lack of support among interest groups. This proposal was supported by some commodities markets players such as the National Farmers Union and the Petroleum Marketers Association, which defended the importance of this ban to reduce speculation and volatility in the oil and agricultural commodity markets. Also a former director at the CFTC supported the proposed ban, arguing: “Had naked credit-default swaps been banned in the passage of the Commodity Futures Modernization Act in 2000, it is my firm belief that the outlawing of that product, in and of itself, would have substantially mitigated the worldwide financial meltdown we are now experiencing”.⁵² However, these voices were only a small minority.

Financial industry groups lobbied the Congress, arguing that a ban on naked CDS would have destroyed the credit default swaps market and driven a significant portion of OTC business offshore. As the next section will discuss in details, the emergence of a coalition formed by financial industry interest groups and corporate end-users posed an apparently insurmountable stumbling block for any legislative proposal to ban “naked” CDS.

Also as a result of these pressures, proposals to ban naked CDS have not found the support of US Federal regulators and of the US Treasury Secretary Timothy Geithner. The US Treasury Plan only endorses comprehensive oversight of these instruments, but it does not support any ban.⁵³

1.4.2 Interest Groups: Financial and Corporate interest groups go to Washington

The legislative proposal presented by the US Treasury and the myriad of bills to regulate derivatives introduced within Congress in 2009 have pushed the regulatory agenda in the derivatives market way beyond what private market actors had committed to on a voluntary basis since the beginning of the crisis. It is not surprising how these bills have immediately triggered an intense mobilization of interest groups. What is more unexpected is instead the fact that this mobilization has not been limited to the major players in OTC derivatives markets - the banks acting as dealers - but it has extended also to large range of corporate end-users.

What have been the preferences of the interest groups active in derivatives markets? And how have they influenced the legislative process in the US so far?

Financial industry

The economic actors whose profits would be more severely curtailed by the US Treasury plan and other legislative proposals are certainly the major banks that act as dealers in derivatives markets.

⁵² Testimony of Michael Greenberger Before the U.S. House Committee on Agriculture Regarding Discussion Draft: The Derivatives Market Transparency and Accountability Act of 2009, Tuesday, February 3, 2009

⁵³ Michael R. Crittenden, “Treasury’s Geithner: Not Necessary To Ban Credit-Default Products”, Dow Jones Newswire, 23 September 2009

Banks have won several battles in the regulation of OTC derivatives. First, they have scored a partial victory with the decision not to make exchange-trading mandatory for all derivatives, as suggested by the Harkin Bill. Banks opposed this measure, which would cause a significant reduction in their profit margins. Proposals to mandate derivatives onto exchanges have been criticized by those same exchanges or electronic trading execution facilities, which would have seen their business boosted by this proposal. Instead, exchanges have argued that this measure could force the clearing of OTC products that are not sufficiently standardized to be cleared safely, and thus create risks for all the actors in the derivatives markets.

Second, banks have scored a partial victory with the cancellation of provisions banning “naked” credit default swaps, since for the major part financial institutions trading in these instruments do not own the underlying asset.

Less successful have been their attempts to lobby Congress to drop several provisions in the US Treasury plan. Banks contested the provisions in the US Treasury plan mandating the clearing of standardized OTC and pushing these contracts onto exchange trading platforms. These proposals would reduce the profits for banks by enhancing transparency and compressing bid-offer spreads.

The major winners from this regulatory proposal appears to be clearinghouses, electronic platforms, and exchanges, which for several years had tried to break into the OTC markets, and would now see their profits increased by the Treasury plan. At the same time, the largest banks would reap part of the benefits of this change since they own a significant stake in ICE US Trust, the major clearinghouse for credit default swaps.

Major dealers have also criticized the imposition of capital requirements for cleared swaps in addition, claiming that clearinghouses provide adequate protection to swap counterparties. However, with the exception of more radical regulatory proposals, such as the ban on “naked” CDS or proposals to outlaw OTC markets, financial industry actors have found much more difficult than a decade earlier to successfully lobby Congress and the US administration. Derivatives dealers have complained that the US Treasury has intentionally blindsided them in an attempt to maintain control of the legislative output, giving it almost no opportunity to review the bill presented to Congress before its publication.⁵⁴

Corporate end-users

As the implications of the US Treasury plan for market participants beyond banks and exchanges became clear, the range of market participants seeking to influence the regulation of derivatives widened dramatically.

The list of corporate end-users lobbying Congress, the Treasury, and Federal regulators on this issue is impressive. This range from the Electric Power Supply Association – a trade group representing

⁵⁴Derivatives Week, “OTC Proposals Intentionally Blindsided Industry”, 28 August 2009; Christine Harper, Matthew Leising and Shannon Harrington, “Wall Street Stealth Lobby Defends 35 billion Derivatives Haul”, Bloomberg, 31 August 2009.

power generators to the National Association of Manufacturers (NAM)--the nation's largest industrial trade association, from the Association of Food, Beverage and Consumer Protection Companies to the Business Roundtable, from aircraft producers such as Boeing to carriers such as Delta Air Lines.⁵⁵

These corporate actors that use customized derivatives to hedge commodity price, currency, and interest rate risks complained that the Treasury plan would have made it more difficult for them to hedge their commercial risk. They highlighted two impediments created by the regulatory plan. First, the Treasury plan would have made it more difficult to access customized derivatives traded on the OTC markets, and therefore to accurately hedge risks. Second, corporate end-users usually make deals directly with banks, which either give companies credit lines that can be used as collateral against derivatives contracts or use other assets. Instead, the US Treasury plan would have not made possible for them to use underlying assets as collateral and required them to put up cash against outstanding swaps. The specter of a “liquidity drain” generated by the US Treasury proposal in an already weak economic outlook proved extremely unpopular among policymakers.

The emergence in the summer of 2009 of corporate end-users as a crucial actor in the debate over the regulation of derivatives has triggered a shift in the strategy adopted by financial industry actors in their lobbying to Congress and to the US Administration. In order to leave their footprint in the legislative process, financial industry actors sought to build bridges with this “unusual ally” and to highlight the part of legislation that would have posed severe costs not only on Wall Street but also on Main Street. For instance, in opposing the proposal to force OTC derivatives onto exchanges, the International Swaps and Derivatives Market declared that the bill “would make it harder for American companies to hedge risk and could potentially lead to less liquid, more volatile markets”⁵⁶. Similarly, the Futures Industry Association argued that the proposal “would remove important liquidity from our credit markets and could operate to make credit itself more expensive for those in struggling businesses that now thirst for credit”.⁵⁷

Some Congressmen and commentators have come to see the hand of the major banks behind the sudden activism of corporate-end users lobbying the US Congress. For instance, at a House Agriculture Committee hearing, Peterson declared: “It’s my impression that some of the big financial players sent some of the end-users to talk to you guys”.⁵⁸

1.4.3 The Frank Bill and the Peterson Bill

What has been the impact of the mobilization of interest groups described above on the legislative process?

First, they had the effect of marginalizing within the policymaking process those more “radical”

⁵⁵Targeted News Service, “Manufacturers Seek Continuity in Regulation of Derivatives”, 22 September 2009; Kara Scannell, “Big Companies Go to Washington to Fight Regulations on Fancy Derivatives”, *Wall Street Journal*, 10 July 2009; Mark Peters, “Power Generators Voice Concern On OTC Trading Regulations”, *Dow Jones Newswire*, 18 September 2009

⁵⁶AP Business Writer - “House panel adopts bill that would expand oversight of financial instruments blamed in crisis”, 12 February 2009

⁵⁷ Charles Abbott, “Consensus for derivatives reform-US House chairman”, *Reuters News*, 4 February 2009

⁵⁸ Derivatives Week, “Congressman Sees Dealer Hand Behind User Lobbying”, 23 September 2009

legislative proposals emerged within Congress, such as the proposal to force derivatives onto exchanges or to ban naked credit default swaps. Forces steering the legislative process away from more “radical” solution could be found also within Congress, where different Congressmen tried to scale-back the extent of the US Treasury plan and suggesting a less stringent regulatory approach. The main opposition within Congress to the US Treasury plan came from the Republican Party.⁵⁹ However, support for a softer regulatory solution also came from a group formed by 54 democratic Congressmen, called the New Democrat Coalition. A member of the coalition, Representative Michael McMahon described other legislative proposals seeking to move standardized trades onto exchanges and clearinghouses as “extreme” and criticized them for ignoring the benefits derivatives create for several companies, as well as the job losses that excessively stringent legislation would cause in its electoral district, New York City.⁶⁰

The presence of countervailing forces within and outside Congress had the effect of killing almost any proposal to toughen up the US Treasury Plan. When the House of Representatives started to address the US Treasury Proposal in July 2009, the regulatory debate within Congress remained confined within the boundaries set by three key actors: the US Treasury, the Chairman of the House Financial Services Committee Barney Frank, and the Chairman of the House Agriculture Committee Collin Peterson, who have introduced in their respective committees two distinct proposals.⁶¹

The main differences and similarities between the Treasury Proposal, the Financial Services Committee proposal (Frank Bill) and the Agriculture Committee proposal (Peterson bill) are summarized in the Box 1.5, originally compiled by the US House Agriculture Committee. The information in the table relates to the original drafts presented by Rep. Frank and Rep. Peterson, and therefore do not take into account later amendments.

BOX 1.5: Comparison of the US Treasury plan, the Frank Bill, and the Peterson Bill (Source: House Agriculture Committee)

| | TREASURY PROPOSAL (08/11/09) | | | | FINANCIAL SERV. COM. INITIAL DRAFT (10/02/09) | | | | AGRICULTURE COM. INITIAL DRAFT (10/09/09) | | | |
|-------------------|------------------------------|------------|---------|----|---|------------|---------|----|---|--|--|--|
| Rulemaking | Joint | rulemaking | between | | Joint | rulemaking | between | | CFTC (consulting with SEC and | | | |
| & | CFTC | and SEC | | | CFTC | and SEC | | | Prudential Regulators) regulate | | | |
| Rulemaking | | | | | | | | | swap-related provisions; SEC | | | |
| Disputes | | | | | | | | | (consulting with CFTC and | | | |
| | | | | | | | | | Prudential Regulators) regulate | | | |
| | Treasury | writes | rules | if | Treasury | writes | rules | if | security-based swap provisions | | | |

⁵⁹ For instance, Rep. Scott Garret criticized the Treasury plan as “fundamentally flawed” and “unnecessarily complicated and overly prescriptive”, see Dow Jones NewsService, “Industry Conference Voices Concerns Over Derivatives Overhaul”, 15 September 2009

⁶⁰ McMahon introduced in July 2009 the “Derivatives Trading Accountability and Disclosure Act of 2009”. See States News Service, “REP. MCMAHON, NEW DEM MEMBERS UNVEIL LEGISLATION TO REFORM DERIVATIVES TRADING”, 22 July 2009

⁶¹ Frank and Peterson released in July a joint proposal. See Sarah O'Connor, “Derivatives plans spark doubt on CDS”, *Financial Times*, 30 July 2009. In a second moment they presented two distinct bills in their respective committees.

| | | | |
|---|--|--|--|
| | CFTC/SEC cannot jointly agree to rules | CFTC/SEC cannot jointly agree to rules | Either CFTC or SEC can initiate expedited challenge in U.S. Court of Appeals for DC |
| Clearing requirement for swaps | derivative clearing organizations and CFTC/SEC determine which swaps must be cleared | CFTC/SEC determine which swaps must be cleared The bill was later amended | DCOs/clearing agencies determine which swaps must be cleared |
| Clearing requirement determination | <p>"Standardized" swaps/security-based swaps are required to be cleared</p> <p>Swaps/security-based swaps accepted by DCOs/clearing agencies presumed "standardized"</p> <p>Agency can designate a swap/security-based swap "standardized"</p> | Agencies makes determination whether a swap/security-based swap must be cleared based on enumerated factors | <p>Only swaps/security-based swaps that will be accepted by a DCO/clearing agency are required to be cleared</p> <p>Agencies review DCO/clearing agency for safety/soundness, anti-competitive practices, risk management prior to application of clearing requirement</p> |
| Clearing exceptions | <p>a) DCO/clearing agency won't take swap,</p> <p>or</p> <p>b) one of counterparties</p> <ul style="list-style-type: none"> - is not a dealer or major swap participant, and - does not meet the eligibility requirements of DCO/clearing agency | <p>a) DCO/clearing agency won't take swap,</p> <p>or</p> <p>b) one of counterparties is not a dealer or major swap participant</p> | <p>a) one of the counterparties:</p> <ul style="list-style-type: none"> - is not a swap dealer or major swap participant, and - can demonstrate appropriate business/risk management practices for non-cleared swaps; <p>and</p> <p>b) none of the counterparties are a Tier 1 financial holding company</p> |
| Trading Requirement | Yes, swaps determined to be cleared must also be traded on regulated exchange or alternative swap execution facility | Initially no trading requirements (the bill was later amended to mandate trading) | Yes, swaps determined to be cleared must also be traded on regulated exchange or alternative swap execution facility |
| Trading Exceptions | None | N/A | <p>a) Trading not required if no regulated exchange or alternative swap execution facility will list the swap, and</p> <p>b) Voice brokers still permitted to enter and execute swaps subject to clearing requirement provided they</p> |

| | | | |
|---|--|--|---|
| | | | process swap through regulated exchange or alternative swap execution facility |
| Capital requirements for swap dealer or major swap participant who is also a bank | a) Established by Prudential Regulator b) greater than zero for cleared swaps, c) higher for swaps that are not cleared | a) Established by Prudential Regulator b) greater than zero for cleared swaps, c) higher for swaps that are not cleared | a) Established by Prudential Regulator b) Appropriate for the risk associated with non-cleared swaps being held as a swap dealer or major swap participant as determined by the respective regulator |
| Capital requirements for swap dealer or major swap participant who is <u>NOT</u> a bank | a) Established by CFTC/SEC b) Requirements must be same or higher as for a swap dealer or major swap participant who is a bank | a) Established by CFTC/SEC b) Requirements must be same or higher as for a swap dealer or major swap participant who is a bank | a) Established by CFTC/SEC b) Appropriate for the risk associated with the non-cleared swaps being held as a swap dealer or major swap participant as determined by the respective regulator |
| Margin requirements for non-cleared swaps held swap dealer or major swap participant who is also a bank | a) Prudential Regulators impose initial and variation margin requirements on all swaps b) Prudential Regulators may exempt requirements for swaps where one of the counterparties is: - not a swap dealer or major swap participant, - using the swap as hedge under GAAP - predominantly engaged in activities that are not financial in nature | a) Prudential Regulators impose initial and variation margin requirements on all swaps b) Prudential Regulators may exempt requirements for swaps/security-based swaps where one of the counterparties is not a swap dealer or major swap participant | Prudential Regulators impose initial and variation margin requirements only for swap dealers and major swap participants under their jurisdiction |
| Margin requirements for non-cleared swaps held swap dealer or major swap participant who is <u>NOT</u> a | a) CFTC/SEC impose initial and variation margin requirements b) Requirements must be same or higher as for a swap dealer or major swap participant who is a bank | a) CFTC/SEC impose initial and variation margin requirements b) Requirements must be same or higher as for a swap dealer or major swap participant who is a bank c) Requirements must provide for use of non-case assets as | CFTC/SEC impose initial and variation margin requirements only for swap dealers and major swap participants under their jurisdiction |

| bank | | collateral | |
|--|--|---|---|
| Position Limits for swaps | a) CFTC/SEC may impose position limits on swaps that perform a significant price discovery function b) CFTC/SEC may require aggregate limits across markets | a) CFTC may impose position limits on swaps that perform a significant price discovery function and require aggregate limits across markets b) SEC may impose position limits on security-based swaps as necessary or appropriate in the public interest to prevent fraud and manipulation | a) CFTC may impose position limits on swaps that perform a significant price discovery function and require aggregate limits across markets b) SEC may impose position limits on security-based swaps as necessary or appropriate in the public interest to prevent fraud and manipulation |
| Addressing Excessive Speculation on Regulated Markets | No provision | No provision | a) CFTC to set position limits on futures contracts for physically deliverable commodities on regulated markets (H.R. 977) b) Redefines who is eligible for hedge exemption and can exceed position limits (H.R. 977) |
| Foreign Board of Trade | Allows CFTC to require registration by foreign boards of trade (FBOTs) | Allows CFTC to require registration by FBOTs | No explicit registration authority applied to FBOTs |

The second impact of the mobilization of interest groups was that corporate end-users were able to carve out some important exemptions in the US Treasury plan. The distinct bills presented by Rep. Frank and Rep Peterson and approved respectively by the House Financial Services and House Agriculture Committee did not depart from the main pillars of US Treasury plan. However, both bills introduce significant exemptions for corporate end-users in key provisions of the Treasury Plan, such as those mandating clearing and exchange trading for standardized derivatives, and those regulating counterparties in non-cleared transactions (see Box 1.6).

These exemptions have been object of criticism from the SEC and CFTC. Federal regulators warned against the risk that exemptions created for corporate end users could originate regulatory loopholes promptly exploited by financial actors. Before the House Financial Services Committee, the Chairman of the CFTC Gensler declared: "We would not want an unintended consequence of an end-user

BOX 1.6 – Exemptions for Corporate End-users in the Frank and Peterson Bill (October 2009)

- 1) **Clearing:** Exemptions were introduced in requirement for all standardized OTC derivatives to be cleared through regulated central counterparties. The bill presented by Rep. Frank in October 2009 within the Financial Services Committee requires clearing for transactions that are clearable only when both counterparties are either dealers or "major swap participants". The Frank Bill initially excluded from the definition of "major swap participants" end-users that use derivatives to hedge commercial risk on commercial businesses, thus exempting these actors from the requirement to clear centrally their transactions in standardized swap. The bill introduced by Peterson in October 2009 within the House Agriculture Committee initially granted the exemption from clearing only if both trading partners were not considered big financial firms. However, during the discussion within the House Agriculture Committee, this exemptions was widened, allowing big banks to avoid clearing requirements if they are trading with smaller market players.
- 2) **Trading:** Where the US Treasury plan required standardized trades to move onto regulated exchanges and regulated transparent electronic trade execution systems, the Frank and the Peterson bill introduced exemptions to corporate end-users. The Frank bill maintains that a standardized and cleared derivative must be executed on a board of trade, a national securities exchange or a "swap execution facility" when both counterparties are either dealers or major swaps facilities. Corporate end-users instead would be exempt from trading on exchanges, unless their positions were so large to cause a risk to their counterparties.
- 3) **Regulation of OTC dealers:** Neither the Frank bill nor the Peterson bill depart from the provision in the US Treasury plan imposing more stringent capital, reporting, and initial margin requirements to counterparties engaged in non-centrally cleared OTC derivatives in order to encourage a migration onto central clearinghouses and exchanges. However, also in this case the Frank bill introduced exemptions for end-users, permitting for them the use of non-cash collateral when they are counterparty to a transaction. Moreover, the bill does not require regulators to set margin in transactions where one of the counterparties is not a dealer or major swap participant.

exception to be that hedge funds...would be able to evade the clearing requirement ... I think it would be best not to have [the exception] at all"⁶². Gensler has called for any exemption to be "very narrowly defined to include only nonfinancial entities that use swaps as an incidental part of their business to hedge actual commercial risks".⁶³ Also the SEC criticized the Frank bill, arguing that the exception for firms using derivatives for "risk management" is too vague, calling instead for "narrower, objective and verifiable" standards⁶⁴.

Objections such as those raised by Gensler found in part their way into the legislation. For instance, Barney Frank amended his bill before this was voted by the House Financial Services Committee on

⁶² 7 October 2009 – Regulators See Holes in Frank's Derivatives Bill For Gensler, all the transactions where one counterparty is a financial firm, hedge fund and other investment funds should be cleared through a clearinghouse. At the same time, Gensler relaxed his position by allowing corporate end-users not to post cash collateral, requiring them instead to work with the financial institutions that enter into transactions for them to determine the most appropriate credit arrangement 7 October 2009 – Frank Pledges to Revise Derivatives Draft

21 October 2009 - CFTC Gensler backs limited end-user exemptions

⁶⁴ 7 October 2009 – Regulators See Holes in Frank's Derivatives Bill

October 15 to widen the definition of “major swap participants”, including in this definition “any person “whose outstanding swaps create substantial net counterparty exposure and would expose counterparties to significant credit losses that could have material adverse effect on capital of the counterparties”.⁶⁵ The final version of the Peterson’s bill voted by the House Agriculture Committee differed instead from the Frank’s proposal by defining major swap participants as those firms that are “systemically important or can significantly impact the financial system”.

Who decides what can be cleared/traded?

Another contentious issue on which the Treasury plan, the Frank bill and the Peterson bill differ is the definition of what constitute a “standardized” derivative. The US Treasury plan introduced the principle that “if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared”.

Despite being described as the main beneficiaries of the regulatory overhaul, exchanges and clearinghouses have expressed their concern that the US Treasury plan could bring regulators to mandate what contracts must be cleared or to legislate a strict definition of “standardized derivative” that would force customized products into clearinghouses. ISDA contested the Treasury proposal, arguing: “due to commercial considerations, the willingness of a clearinghouse to accept a transaction for clearing should not create a presumption of standardization”⁶⁶. Financial industry actors pled regulators to keep mandatory requirements to a minimum, and let them be in charge of deciding what products could be cleared safely. In particular exchanges and clearinghouses expressed two concerns. First they argued that forcing customized products into clearinghouses would create risks for the same clearinghouses since customized products are less liquid than standardized products. Second, they argued that any rigid definition of standardization would be inadequate for the dynamic and innovative nature of financial markets, and would be outdated rapidly.⁶⁷ According to market participants, it should be the market and not the intervention of legislators deciding which OTC products should be cleared.

The bill presented by Barney Frank took a different approach, requiring clearing organizations to seek approval from the CFTC or the SEC before a swap or class of swaps can be accepted for clearing

The decision to empower regulators was questioned by the same federal regulators. In particular the Chairman of the CFTC Richard Gensler argued that this responsibility would be too burdensome for the CFTC, and that the task was best delegated to the clearinghouses: “Though there must be appropriate regulation of the clearing process, I believe it is best for a clearinghouse that is managing its risk to determine if a particular product should be cleared. The market regulators would oversee those determinations.”⁶⁸ Frank ultimately amended his bill and introduced a provision similar to the

⁶⁵ 14 October 2009 - US House Panel Alters Derivatives Bill To Include More Big Cos

⁶⁶ ISDA, “Press Release: ISDA Ceo Addresses US House Agriculture Committee”, 17 September 2009

⁶⁷ Jeremy Grant, “Geithner’s OTC plans alarm exchanges”, *Financial Times*, 10 June 2009

⁶⁸ House Financial Services Committee Hearing - Reform of the Over-the-Counter Derivative Market: Limiting Risk and Ensuring Fairness,

US Treasury Plan and Peterson bill to mandate that all swaps accepted by a regulated clearinghouse or exchange must be cleared.⁶⁹

However, also the choice of granting clearinghouses the authority to define whether or not a trade can be cleared presents some problems. Commentators have pointed out the conflict of interests between dealers and clearinghouses. The largest derivative dealers had a stake in ICE Trust, the largest clearinghouse for credit default swaps. As a consequence, they would have an incentive in declaring that those derivatives that are the most profitable when traded OTC are not clearable.⁷⁰

To address this issue, Rep. Stephen Lynch introduced an amendment in the Frank bill to limit to 20% the voting rights of dealers into clearing facilities, although the proposal was criticized because it could have been anticompetitive and it would have limited the number of clearinghouses.⁷¹

7 October 2009

⁶⁹ Derivatives Week, “Frank Toughens Derivative Bill”, 14 October 2009

⁷⁰ Gretchen Morgenson, “Don’t let Exceptions Kill the Rule”, *New York Times*, 18 October 2009

⁷¹ Reuters, Frank letter to Schapiro and Gensler, 3 November 2009.

II. CREDIT RATING AGENCIES

Credit rating agencies have blamed of being among the primary responsible for the subprime mortgage crisis, by having significantly underestimated the risk attached to mortgage-backed securities and by enabling these products to be sold across the global financial markets. As the shortcomings of credit rating agencies have rapidly become evident, the regulation of rating agencies has come to occupy an important place in the US regulatory reaction to the financial crisis since the

Short Summary

1. The first section (**Section 2.1**) analyzes the evolution of the regulatory regime regulating credit rating agencies prior and after the crisis. Unlike in the European Union, a regulatory framework for rating agencies has been in place since the 1970s (**Section 2.1.1**), although it fully developed only after the Enron scandal and the Credit Rating Agency Reform Act of 2006 (**Section 2.1.2**). **Section 2.1.3** describes how this regulatory regime has become very soon after the beginning of the crisis the object of significant reforms introduced by federal regulators and the US Congress.
2. The rest of this part will instead analyze the content of these regulatory reforms. **Section 2.2** will summarize the measures taken by US regulators to improve the quality of the rating process by enhancing its transparency. Measures have been introduced to shed light upon the rating history, performance, and methodologies (**Section 2.2.1**), the information used by an agency to formulate the rating (**Section 2.2.2**), and to differentiate ratings on structured finance products from other products (**Section 2.2.3**).
3. **Section 2.3** analyzes the measures taken by US regulatory authorities to mitigate the conflicts of interest in the rating business. This part summarizes the disclosure requirements introduced to shed lights upon conflicts of interests (**Section 2.3.1**), the new prohibition on potential sources of conflicts of interests (**Section 2.3.2**), and the measures taken to discourage the so-called “rating shopping” (**Section 2.3.3**). US regulators have instead decided not to tackle directly what most observers consider the primary source of conflicts of interests in CRA activities: the issuer-pays business model (**Section 2.3.4**).
4. **Section 2.4** discusses how regulators have addressed what had been perceived as an important factor in the financial crisis: the excessive reliance on their ratings.
5. **Section 2.5** analyzes the proposals to improve the quality of credit ratings by increasing the liability of the agencies for their ratings under securities laws.
6. **Section 2.6** describes how the crisis has also brought to a strengthening in the SEC authority over credit rating agencies

early stage of the crisis.

Credit Rating Agencies – Table of Content

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2.1 The regulation of CRAs before the Crisis

2.1.1 The “Nationally Recognised Statistical Rating Organization” status

Credit rating agencies have been subject a regulatory regime in the US since 1975, when the SEC established the Nationally Recognised Statistical Rating Organization (NRSRO). This regulatory regime was established to distinguish among grades of debt creditworthiness and to identify those agencies whose ratings could be used in various regulations under the federal securities laws.

Under this regime, the SEC assessed whether a rating agency was “nationally recognized” by the predominance of securities rating users and could qualify as NSRSO. In that case, the SEC would release no-action letters, stating that it would not recommend enforcement action against broker-dealers who used the agency’s credit ratings for regulatory purposes. However, the NRSRO accreditation did not give the SEC any statutory regulatory authority. The SEC did not oversee ratings methodologies, or carried out any regulator oversight of the way the agencies operate.

The SEC received regulatory authority over CRAs only after the Enron collapse in 2001. The US Congress expressed concerns about the role that CRAs played in the failure of Enron, which remained highly rated until the wake of its collapse. In response to a Congressional directive contained in the Sarbanes-Oxley Act of 2002, the SEC submitted in January 2003 to Congress its Report on the role and functioning of credit rating agencies, followed in June by a Concept Release to seek comments about the appropriate degree of regulatory oversight that should be applied to credit rating agencies. The SEC did not call for a transfer of regulatory responsibility, but rather most regulators maintained that the “agencies should themselves be responsible for policing conflicts of interest, and ensuring the integrity of their analysis”.⁷²

⁷² Davies, H. and D. Green (2008). Global financial regulation : the essential guide. Cambridge, MA, Polity, page. 70

2.1.2. The Credit Rating Agency Reform Act of 2006

The SEC report did not satisfy the US Congress, who decided to legislate on this issue by approving the Credit Rating Agency Reform Act of 2006. This piece of legislation ended the self-regulatory status of the industry that had lasted for one century. The NSRSO accreditation was replaced with a new status of Statistical Rating Organizations and the bill provided the SEC authority to regulate these agencies and to examine their records to assess the compliance with these rules. Under the CRA Reform Act, each agency seeking to be recognized as an NRSRO must apply for registration with

Box 2.1: Regulatory requirements introduced by the CRA Reform Act of 1996:

- 1) **Disclosure:** registered rating agencies are required to disclose a general description of its procedures and methodologies, as well as certain performance measurement statistics.
- 2) **Conflicts of Interest and Prohibited Practices:** the CRA Reform act requires rating agencies to maintain policies to manage and disclose their conflicts of interest. The SEC has then adopted rules to prohibit certain conflicts of interest. In most cases, conflicts of interest need simply to be disclosed in order to allow users to assess whether the conflicts impact the agency's judgment. SEC rules also prohibit certain abusive practices from CRAs, such as threatening to modify a credit rating based on whether the issuer purchases the credit rating.
- 3) **Record-keeping:** the CRA Act requires CRAs to maintain certain records, such as documentation of its established procedures and methodologies, as well as records of the internal and external communications. The SEC is requested by the bill to examine periodically all the records of an NRSRO when this is deemed necessary for the protection of investors or it is in the public interest. The CRA must also provide, on a confidential basis, certain information regarding its revenues and compensations of credit analysts.
- 4) **Ratings and methodologies:** While the CRA Act gives the SEC the authority to police CRAs conduct to penalize them for wrongdoing, regulators cannot second-guess ratings and sanction an agency for a poor rating record. The CRA Reform Act expressly stated that the Commission has no authority to regulate "the substance of the credit ratings or the procedures and methodologies".

the Commission and comply with certain regulatory requirements (see Box 2.1).

The provisions in the CRA Reform Act are consistent with the IOSCO Code of Conduct but are significantly more detailed. The most significant difference is that instead of the 'comply or explain' approach under the IOSCO Code, the US regulatory approach empowers the SEC to police CRAs and to undertake enforcement actions.

2.1.3 CRAs come under the spotlight

The regulatory regime introduced by the CRA Reform Act of 2006 has become effective only a few months before the beginning of the crisis in June 2007. However, very shortly after its introduction, this regulatory regime became the object of significant reforms.

Indeed, it did take too long in between the emergence of turbulence in the US mortgage markets and the moment when federal regulators started to focus their attention on the role played by credit rating agencies.

As early as the end of July 2007, the SEC announced an investigation into the role played by rating agencies in the crisis, and on whether they had been influenced by issuers and underwriters in improperly inflating their ratings of mortgage-backed securities. The results of this investigation, released in July 2008, showed that rating agencies had struggled to stay abreast of the increase in the number and complexity of subprime mortgage-backed securities and collateralized debt obligations since 2002, they lacked comprehensive written procedures for rating these instruments, and did not

Box 2.2 - President's Working Group recommendations to CRAs

- 1) To disclose what qualitative reviews they perform on originators of assets that collateralize asset-backed securities (ABS) rated by the CRA and to require underwriters of ABS to represent the level and scope of due diligence performed on the underlying assets;
- 2) To enforce policies and procedures that manage conflicts of interest, including implementing changes suggested by the SEC's broad review of conflict of interest issues;
- 3) To publish more information about the assumptions underlying their credit rating methodologies and models, so that users of credit ratings can understand how a particular credit rating was determined;
- 4) To make changes to the credit rating process that would clearly differentiate ratings for structured products from ratings for corporate and municipal securities;
- 5) To make ratings performance measures for structured credit products and other ABS readily available to the public in a manner that facilitates comparison across products and credit ratings;
- 6) To work with investors to provide the information investors need to make informed decisions about risk, including measures of the uncertainty associated with ratings and of potential ratings volatility;
- 7) To ensure that adequate personnel and financial resources are allocated to monitoring and updating its ratings.

Source: President's Working Group on Financial Markets. Policy Statement on Financial Market Developments,

manage appropriately their conflicts of interests in relation to these deals, nor effectively monitor these ratings.⁷³

In addition to the investigation conducted by the Securities and Exchange Commission, the President's Working Group has also analyzed the role of CRAs in lending practices and in the repackaging and selling of assets. In the report released in March 2008, the federal regulators acknowledged that CRAs had contributed to the market turmoil by underestimating the credit risk of subprime mortgage-backed securities. They thus stressed the need for rating agencies to improve their practices, and for investors to have a better understanding of the limitations of these ratings and to rely less on them. Similarly to what occurred in the regulation of derivatives, the approach adopted by federal regulators in the first stage of the crisis has been to recommend the same rating agencies and market actors to undertake self-regulatory initiatives to address the regulatory gaps highlighted by the crisis (see Box 2.2). Moreover, similarly to what occurred in the case of hedge funds discussed later, federal regulators announced that they would “form a private-sector

⁷³ SEC, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, 08 July 2008

committee to work toward implementation of these rating agency recommendations and develop additional ones, as needed”.⁷⁴

However, this opportunity to self-regulate offered to the CRAs by the President’s Working Groups came with the threat of “changes to CRA oversight if the reforms adopted by the CRAs are not sufficient to ensure the integrity and transparency of ratings”.⁷⁵ In fact, it did not pass too long before the SEC started to use the regulatory authority granted by the CRA Reform Act of 2006 to propose a wide range of regulatory reforms. The measures taken by the SEC were complemented by a regulatory plan presented by the US Treasury in July 2009.⁷⁶

Another crucial actor that has emerged prominently in the debate over the regulation of credit rating agencies is the US Congress. Three bills were introduced throughout the course of 2009 by Rep. Darrell Issa, Senator Johnny Isakson, and Rep. William Delahunt to ask the establishment of a commission to investigate the role of credit rating agencies in the financial crisis. But US Congressmen went beyond simply investigating rating agencies and introduced several legislative proposals regulating different aspects of the rating business (see Box 2.3)

⁷⁴ A group composed by different stakeholders and led by the Securities Industry and Financial Markets Association was created in July 2008.

⁷⁵ President’s Working Group on Financial Markets. *Policy Statement on Financial Market Developments*, Washington, DC, March 13, 2008

⁷⁶ US Treasury, “Press Release: Administration’s Regulatory Reform Agenda Moves Forward. Credit Rating Agency Reform Legislation sent to Capitol Hill”, 21 July 2009

Box 2.3: Summary of legislative initiatives to regulate credit rating agencies introduced in the US Congress in 2009

- January 2009: “Financial Oversight Commission Act of 2009” (or “Issa bill”) → this bill was introduced by Rep. Darrell Issa to establish a Commission to investigate the role of credit rating agencies in the crisis. Similar bills were introduced by Sen. Johnny Isakson and Rep. William Delahunt
- February 2009: “To direct the Securities and Exchange Commission to establish both a process by which asset-backed instruments can be deemed eligible for NRSRO ratings and an initial list of such eligible asset-backed instruments” → Rep. Gary Ackerman and Rep. Michael Castle reintroduced a bill which would require the SEC to set the criteria for the kind of structured finance products eligible to receive ratings from credit rating agencies designated as NRSRO. The SEC would thus have the authority to prohibit CRA to rate those structured finance products whose future performances cannot be reasonably predicted, such as those without established track records and proven default rates, and securitization that are not comprised of homogeneous securities.
- March 2009: “Credit Rating Agency Reform Act” → Introduced by Rep. Patrick McHenry this bill would require CRAs to provide additional disclosures to ensure that CRAs have received from issuers and originators adequate information on the assets underlying a structured security, as well it required CRA to institute procedures for receiving these data
- April 2009: “Credit Rating Agency Responsibility Act” → This bill presented by Sen. Mark Pryor requires the SEC to annually audit each NRSRO to ensure that their rating methods and procedures are “sound, adhered to and disclosed”.
- May 2009: “Rating Accountability and Transparency Enhancement Act of 2009” (or “Reed bill”) → Introduced by Sen. Reed, this bill presented several regulatory provisions similar to those already introduced by the SEC (e.g. creation of an office within the SEC for regulating NRSRO, require certification if due diligence has been conducted on the information used by a CRA, enhancing disclosure requirements about models, methodology, fees, and performance, revolving door policies and independent compliance officer to manage conflicts of interest). The bill also introduced a liability regime for rating agencies by scaling back some of the protections they have long been afforded to credit-rating agencies in the Private Securities Litigation Reform Act of 1995. The bill also “requires the SEC to explore alternative means of NRSRO compensation, and requires a Government Accountability Office study on payment methods, in order to create incentives for greater accuracy”. This bill was firstly introduced in March 2009 as “Credit Rating Reform Act of 2009”.
- July 2009: “To amend the Federal Reserve Act to authorize Federal Reserve Banks to examine the methodologies of used by nationally recognized statistical rating organizations in analyzing and rating asset backed securities and structured finance products (H.R. 3128)” → Introduced by Rep. Keith Ellison, this bill would give the Federal Reserve authority over the credit rating agencies when they analyze and rate structured financial products. Under this program, the Fed had announced a review of the methodologies employed by CRAs analyzing the assets eligible to be financed in the Term Asset-Backed Securities Loan Facility (TALF) program.
- October 2009: “Accountability and Transparency in Rating Agencies Act” → Introduced by the House Financial Services Capital Markets Subcommittee Chairman Paul Kanjorski, the bill requested the SEC to review ratings, policies, procedures and methodologies of rating agencies, required each credit rating agency to have a Board of Directors with one-third independent directors, introduced a collective liability regime for credit ratings (this provision was later dropped).

The next section will discuss the content of the regulatory measures suggested by US federal authorities and the US Congress to regulate credit rating agencies.

2.2 Disclosure requirements

2.2.1 Transparency on rating history and methodologies

In order to address the failure of rating agencies in assessing the riskiness of structured finance products, the first approach undertaken by Securities and Exchange Commission throughout 2008 and 2009 consisted in the introduction of enhanced disclosure requirements (see Box 2.4). According to the SEC these disclosure requirements would provide market participants with the information they needed to monitor and compare how rating agencies originally rated an entity or a security and to make a better use of credit ratings.

BOX 2.4 – Disclosure Requirements introduced by SEC

- 1) Ratings history and performance:
 - a. *Rating history:* The SEC required credit rating agency to record and disclose all rating actions (e.g. initial ratings and following changes) in order to allow examiners to track the history of all current ratings. While the initial proposal released by the SEC in February 2009 requested CRAs to disclose only a random sample of 10% of its outstanding issuer-paid credit ratings, in September this threshold was raised to request disclosure of ratings history information for 100% of all issuer-paid credit ratings.
 - b. *Rating Performance:* Rating agencies are required to provide greater information about how the ratings hold up over time. In particular, CRAs were required to provide annual reports detailing all upgrades and downgrades for each asset class of credit ratings as well as default statistics over one-, three, and ten-year periods. Rating agencies are also requested to supply default statistics for the securities they rate, including after a rating is withdrawn.
- 2) Ratings Methodologies: The SEC has requested rating agencies to enhance disclosure concerning the procedures and methodologies they use in rating structured finance products as well as in the surveillance of these ratings
 - a. *Quality of underlying data:* In particular, the SEC asked CRAs to disclose information about the quality of information concerning the assets underlying a structured finance product they rate, if they rely on the due diligence of others to verify the assets underlying a structured products or if they performed a verification, and whether the quality of this information factored into the determination of the ratings.
 - b. *Surveillance:* More information is also requested with respect to rating surveillance (e.g. frequency of ratings reviewed, models used, whether changes to rating or surveillance models are applied retroactively).
 - c. *Record of model deviation:* in the case a quantitative model is a significant element in the determination of a credit rating for a structured finance product, the SEC required rating agency to explain the rationale for any material difference between the rating implied by the model and the final rating issued.



It is important to notice is that only very few of these proposals sought to directly influence the methodologies used by the rating agencies. For instance, the US authorities have requested rating agencies to disclose the level of due diligence conducted on the underlying assets of structured securities product but they did not require them to conduct such due diligence. In response to criticism for the lack of this provision, the Treasury assistant secretary for financial institutions argued that requiring rating agencies to perform such due diligence would problematically involve the government in dictating the kind of methodology that the rating agencies should use. This would violate the mandate granted by the CRA Reform Act of 2006, which explicitly states that that the Commission has no authority to regulate “the substance of the credit ratings or the procedures and methodologies”, thus not allowing the SEC to sanction an agency that fails to maintain a suitable level of reliability.

Moreover, according to the US Treasury, this would put the government in the position to validate private sector actors and it would likely exacerbate over-reliance on ratings. According to federal regulatory agencies, the role of public authorities in the regulation of ratings should be limited to requiring more transparency so that investors can “judge for themselves whether the kind of due diligence has been done on a rating is satisfactory or not”.⁷⁷

2.2.2 Transparency on information underlying a rating

An alternative set of measures has sought to increase the quality of ratings of structured finance products by giving the other agencies a chance to rate the product even if they are not paid by the issuers. The SEC has approved a proposal requesting CRAs rating structured finance products to disclose to other rating agencies all information provided by issuers and underwriters used in determining the initial credit rating and performing credit rating surveillance.⁷⁸

CRAs have questioned the viability of disclosing such information to their competitors. According to Deven Sharma of Standard & Poor's, “this would constitute an unprecedented intrusion into competitive businesses and fundamentally subvert intellectual property rights in a manner that would undoubtedly chill robust analysis by NRSROs and otherwise restrict development and innovation in the ratings industry”.⁷⁹

While the SEC proposal would not oblige other agencies to rate these products, an alternative proposal to achieve this goal has been presented by the Senate Charles Schumer. Schumer has proposed that the SEC should randomly choose a credit rating agency to provide a back-up random rating different from the one paid for by the issuer.⁸⁰

⁷⁷ Assistant Secretary for Financial Institutions Michael S. Barr, Written Testimony Senate Committee on Banking, Housing, and Urban Affairs, 5 August 2009

⁷⁸ An earlier version of this proposal would have requested CRAs to disclose this information publicly.

⁷⁹ S&P's (2009). Testimony of Deven Sharma, Washington, DC, United States House of Representatives Committee on Financial Services and Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, 30 September 2009.

⁸⁰ Schumer seeks to have the SEC randomly assign a second rating for products. According to Dodd this second rating would not be required for all securities but it would only conducted periodically. Dodd suggested that every tenth debt security produced by a corporation could be

The US Treasury supported the goal of encouraging second ratings, but it did not go as far as “picking” raters or mandating this. On the contrary the solution endorsed by the SEC and US Treasury requires issuers to provide the same data they provide to one credit rating agency as a basis of a rating to other raters. According to the US Treasury Assistant-secretary Michael Barr Schumer's random assignment could provide a "seal of approval to the rating" that would give investors an artificial sense of comfort with the rating.⁸¹

2.2.3 Differentiating Ratings for Structured Finance Products

In the report published by the President's Working Group in March 2008, federal regulators also recommended industry-participants to “make changes to the credit rating process that would clearly differentiate ratings for structured products from ratings for corporate and municipal securities”.⁸²

This reform was endorsed by the SEC, which in June 2008 discussed a revision to its rulebook to require CRAs to differentiate the rating symbols applied to ratings of structured finance products from the symbols for non-structured products, or a requirement for CRAs to issue a report disclosing the differences between ratings of structured products and other securities. However, in a second moment the SEC decided to drop this amendment.

The proposal was instead included in the legislative proposal that the US Treasury sent to Congress. The bill stated: “One of the challenges in the current crisis was that investors did not fully realize that the risks posed by structured products such as asset-backed securities are fundamentally different from those posed by corporate bonds, even with similar credit ratings”. The US Treasury plan thus required “rating agencies to use different symbols for structured finance products as an indication of these disparate risks”⁸³

Moody's has published a consultation survey to seek feedbacks from market participants on the possibility of differentiating structure finance ratings from non-structured finance ratings and suggesting different solutions to achieve this goal (see Box 2.5).⁸⁴ Also Standard & Poor's proposed to differentiate structured ratings by adding an “identifier” to new and existing securitisation ratings. However, both agencies have in a second moment announced that they would not create a separate

subject to a second rating produced by a random rater, or every tenth security produced by all the rating shops be subject to a back up second rating in order to surprise raters and issuers. According to Dodd this random evaluation “would provide a check against ratings shopping and other conflicts of interest inherent in the system.” Moreover, this CRAs would not be selected exclusively among the big three rating agencies

⁸¹ Reuters, “Treasury: Government shouldn't be involved in credit ratings; Schumer seeks to have the SEC randomly assign a second rating for products”, 5 August 2009

⁸² PWG (2008). Policy Statement on Financial Market Developments, Washington, President's Working Group on Financial Markets,, March 13.

⁸³ US Treasury, “Press Release: Administration's Regulatory Reform Agenda Moves Forward. Credit Rating Agency Reform Legislation sent to Capitol Hill”, 21 July 2009

⁸⁴ Moody's (2008). Should Moody's Consider Differentiating Structured Finance and Corporate Ratings? Request for Comment, New York, Moody's Global Credit Policy, February 2008.

rating scale for structured finance products given the negative feedbacks they had received from market participants.

Indeed, different financial actor groups, ranging from the American Securitisation Forum to the Commercial Mortgage Securities Association, from the Securities Industry Financial Markets Association to the European Banking Federation have opposed the introduction of separate scale for structured finance products.⁸⁵ Both issuers of structured finance products and investors argued that this change could damage capital markets by leading to a sudden sale of structured finance securities in an already illiquid market and increase the cost of raising capital. Moreover, this move would have forced market actors to adjust their investment guidelines with uncertain outcomes. Since ratings with existing symbols are frequently embedded within the existing regulations, laws, corporate and investment guidelines, and bilateral contracts, differentiating ratings could generate significant market disruption and it would also require substantive revisions of these rules.

Box 2.5: Moody's proposals to differentiate structured finance ratings:

1. Move to a completely new rating scale for structured securities, for example, numerical rankings of 1-21. These would continue to contain ordinal rankings of expected credit risk and would probably map to corporate ratings.
2. Add a modifier to all structured ratings utilizing the existing rating scale, e.g., Aaa.sf. This would designate the issue as structured, but add no other additional information.
3. Add a suffix to the existing rating scale for structured ratings that contains additional information – for example, estimates of multi-notch rating transition risk. This could be Aaa.v1, Aaa.v2, etc. We would derive these gradations through an analytical process that would be disclosed to the market.
4. Use the existing rating scale for structured securities, and put additional analytical information in a separate scale that would exist in a separate data field. For example, an issue could have a “Aaa rating, with a ratings change risk indicator of v1”. The added field would be analogous to our existing ratings outlooks and watchlists.
5. Make no changes to the rating scale, but provide additional information and commentary through written research.

Source: Moody's (2008). Should Moody's Consider Differentiating Structured Finance and Corporate Ratings? Request for Comment, New York, Moody's Global Credit Policy, February 2008.

2.3 Conflict of Interest

Trying to explain the failure of credit rating agencies to assess the riskiness of structured finance products prior to the crisis, many analysts have pointed the finger towards several conflicts of interests that characterize the relation between agencies and the issuers of these securities. Not only the large majority of rating agencies are paid by the same issuers of the products they rate, but they also engage in discussion with them on how to structure a financial product given their rating

⁸⁵ European Banking Federation, “European Banking Federation response to CESR”, 24 June 2008; SIFMA, “Proposal for a Regulatory Framework for CRAs and Embedded Ratings Policy Options Securities Industry and Financial Markets Association”, 5 September 2008.

methodologies.

2.3.1 Disclosure of conflicts of interests

The first set of measures introduced by the SEC to address the conflict of interests in the rating of structured finance products was to beef up its disclosure requirements in relation to conflicts of interests. The SEC approved new disclosure requirements forcing CRAs to publicly disclose the percentage of the net revenue attributable to the 20 largest users of credit rating services, and the percentage of the net revenue of the agency attributable to other services. These measures also required them to disclose in a consolidated report at the end of the year the name of any person or company that purchased services and the relative percentage of revenues attributable to each client. Also the legislative proposal drafted by the US Treasury introduced a similar provision, requesting each rating report to “disclose the fees paid by the issuer for a particular rating, as well as the total amount of fees paid by the issuer to the rating agency in the previous two years”. These disclosure requirements were meant to provide information to assist investors in assessing the potential conflict of interests that could undermine the rating agency’s objectivity.

2.3.2 Restrictions to CRA activities

The SEC has also amended its rulebook to widen the range of activities forbidden on the ground that they could originate conflicts of interests. First, the SEC has prevented credit analysts and the persons who establish ratings methodologies from participating in fee discussions with issuers, as well as from receiving gifts in any amount over \$25 from those who they rate. Second, the SEC, as well as the US Treasury plan, introduced provisions to bar rating firms from providing consulting services to the firms they rate. A similar provision has been already implemented for audit firms in the passage of the Sarbanes-Oxley Act.

This proposal received several criticisms from issuers and rating agencies. Rating agencies have argued that providing a rating to structured securities constitutes an iterative process between issuers and credit rating agencies. They described this practice as beneficial to the markets, since this interaction helps a rating agency to better understand the product proposed by the issuer, and it helps the issuer to understand the implications of the rating agency’s methodologies for that transaction. Rating agencies have also rejected the allegations that their analysts make recommendations regarding the structure, design, or marketing of structured products, arguing that the discussions they hold with issuers in rating any structured security do not transform rating agencies into advisors. Regulators have also acknowledged that it would be difficult to distinguish between the feedbacks provided during this process and recommendations made to obtain a desired rating.

Third, the legislative plan sent by the US Treasury to Congress also stated that “if a rating agency employee is hired by an issuer and if the employee had worked on ratings for that issuer in the

preceding year, the rating agency will be required to conduct a review of ratings for that issuer to determine if any conflicts of interest influenced the rating and adjust the rating as appropriate". A similar provision was included into the Rating Accountability and Transparency Enhancement Act of 2009, introduced in May 2009 by Senator Jack Reed. Sen. Reed had initially suggested the introduction of a one-year cooling off period, preventing a CRA from grading debt sold by a securities firm if the underwriter employed anyone who assessed bonds at the same rating company in the past year.

Finally, a proposal presented by Rep. Paul Kanjorski in September 2009 but not endorsed by Federal regulators would instead dictate the governance arrangements of rating agencies, requiring them to have a Board of Directors with one-third independent directors whose compensation is not linked to the performance of the NRSRO and whose non-renewable term will not exceed 5 years.

2.3.3 Rating Shopping

The conflict of interest between issuers and rating agencies is amplified by the so-called "rating shopping". The term "rating shopping" indicates when an issuer attempts to "shop" among rating agencies by soliciting "preliminary ratings" from multiple agencies and hiring the agency giving the highest preliminary rating. US regulatory authorities have thus presented some regulatory measures designed with the intent of mitigating the risk that this practice could lead rating agencies to grant inflated ratings.

The draft legislation issued by the US Treasury on July 2009 require an issuer to disclose all of the preliminary ratings it had received from different credit rating agencies.⁸⁶ Also the SEC proposed in September 2009 the introduction of a requirement for issuers to disclose all pre-ratings obtained from a credit rating agency prior to selecting a firm to conduct a rating, as well as final ratings not used by a registrant. These disclosure requirements would have the effect of revealing to investors any offerings that received a more negative rating and pushed the issuer to shop for a better grade, and to learn if the issuer shopped around at several rating firms first.

Moreover, also the provision introduced by the SEC requiring issuers to provide the same information they provide to one credit rating agency as the basis of a contracted rating to all other credit rating firms could limit the potential benefit from rating shopping. The notion that the disclosure of preliminary ratings could deter rating shopping was contested by credit rating agencies. For instance, the CEO of Moody's Raymond McDaniel argued: "as issuers become aware that preliminary ratings will be required to be disclosed, issuers will simply "shop" one stage earlier in the process".⁸⁷

⁸⁶ US Treasury, "Press Release: Administration's Regulatory Reform Agenda Moves Forward. Credit Rating Agency Reform Legislation sent to Capitol Hill", 21 July 2009

⁸⁷ Moody's, Testimony of Raymond McDaniel before the House subcommittee on Capital Markets, Washington, DC, 30 September 2009

Indeed, the three major rating agencies have agreed to overhaul the way they collect fees for rating residential mortgage-backed securities in order to reduce the incentive for “rating shopping”. This change was the outcome of a settlement with the New York Attorney General Andrew Cuomo at the end of his investigation into their role in the mortgage market failure. Under this deal, ratings agencies would be paid for their review of mortgage-backed securities also in the case they were not hired by the issuer.⁸⁸

2.3.4 Business Models

Several commentators and policymakers have criticized the measures adopted by the SEC because they do not tackle what most observers consider the primary source of conflicts of interest in CRA activities, and the main determinant of their shortcomings during the crisis: the issuer-pays business model.

This issue was not completely neglected by policymakers. The new chairman of the SEC Mary Schapiro shortly after having assumed her new position invited CRAs and market participants to a roundtable to discuss possible alternative compensation models. In her opening speech, Schapiro claimed that “the status quo isn’t good enough” and asked the participants whether the Commission should consider additional rules to better align the raters’ interests with the interests of investors. In her speech she raised this question: “does one form of rating agency business model represent a better way of managing conflicts of interest than another? Is there a way to realign incentives so that rating agencies view investors as the ultimate customer?”⁸⁹ Moreover the Rating Accountability and Transparency Enhancement Act of 2009 introduced in May 2009 by Senator Reed gave mandate to SEC “to explore alternative means of NRSRO compensation, and requires a Government Accountability Office study on payment methods, in order to create incentives for greater accuracy”.⁹⁰

Lawmakers such as the influential Democratic Senator Charles Schumer argued there was scope for a new investor-funded ratings structure, that is, where ratings are paid by the investors rather than by issuers.⁹¹ This solution was supported by Egan-Jones Ratings, the only major investor-funded rating agency, which argued that existing proposals would have been ineffective since they did not address the conflict of interest inherent in the investor-paid model.

An alternative solution would require issuers to finance a “common pool” from which rating agencies would be selected, thus severing the link between issuers and raters. Insurance regulators, who use ratings to determine capital reserves for insurance companies, suggested a similar solution to obtain “self-funded, independent buy-side ratings”. Under the scheme proposed by the National Association of Insurance Commissioners, insurance commissions would collect a small fee from insurance

⁸⁸ Financial News Online, “Ratings agencies to overhaul fee collection”, 6 June 2008

⁸⁹ SEC, Speech by SEC Chairman: Statement at SEC Roundtable on Credit Rating Agencies, 15 April 2009

⁹⁰ Press Release: Reed Offers Credit Rating Reform Bill, 19 May 2009

⁹¹ Eoin Callan and Krishna Guha, “Break-up of ratings agencies suggested”, *Financial Times*, 27 September 2007

companies to purchase publicly available bond ratings. Eric Dinallo, former Superintendent of Insurance for New York State, argued: “this approach would solve the conflict-of-interest problem, because the primary users of the ratings are the ones who will be paying for them”.⁹²

Lobbying against any change in the governance model were – quite understandably – the major rating agencies, which have defended the benefits of the “issuer pays” model vis-à-vis alternative models. In particular, they have argued that while issuer-pays agencies make their public ratings available to the market free of charge, in the case of subscription model ratings the dissemination of ratings would be more limited and exclusive to subscribers, giving wealthier parties an advantage over their smaller rivals. According to S&P Vice Chairman Vickie Tillman, “Not only would this result in less, not more, information in the market, but it would also take away an important check on ratings quality — the constant scrutiny of a broad market”.⁹³

S&Ps released on April 10, 2009 a White Paper arguing that alternatives business models are not exempt from conflicts of interests. In the case of a subscriber-pays model, “it is possible to envision a small number of large investors representing enough of a 'bloc' to attempt to wield significant influence over the ratings process”, in particular given the fact that in certain types of structured securities a small group of investors often purchases the whole initial offering. Also in the case of a “government utility model” (or “common pool” models run by a public body), the state would have “a natural interest” in protecting or stimulating the growth of issuer companies that are important to the economy.⁹⁴

This interpretation has been supported also by the other major issuer-pays agencies. Moody’s Raymond MacDaniel has thus argued: “If the industry adopted an alternative business model in which investors rather than issuers pay for ratings, this would not relieve the perceived conflict – it would only shift it.”⁹⁵ According to CRAs then, the central issue “is not whether there are potential conflicts of interest in the “issuer-pays” model, but whether they can be effectively managed” and whether the rating agency has taken appropriate steps to preserve its independence.⁹⁶

During the course of the crisis, rating agencies have taken steps to reform their governance procedures in order to strengthen the case that their internal policies to manage their conflicts of interests were adequate.⁹⁷

⁹² Eric Dinallo, “Buyers Should Pay for Bond Ratings; the insurance industry is where a new model can be launched”, *Wall Street Journal*, 3 March 2009.

⁹³ Testimony of Vickie Tillman, Executive Vice President of Standard & Poor’s Credit Market Services before the Committee on Banking, Housing and Urban Affairs, United States Senate, 26 September 2007

⁹⁴ S&P’s (2009). Executive Comment: An Examination Of How Investor Needs Are Served By Various Ratings Business Models: Ensuring Analytical Independence And Preventing Conflicts Of Interest At Credit Rating Firms, New York, Standard & Poor’s, 10 April 2009.

⁹⁵ Testimony by Moody’s Raymond MacDaniel before the House Oversight and Government Reform Committee, 22 October 2008, Washington, DC

⁹⁶ Testimony of Vickie Tillman, Executive Vice President of Standard & Poor’s Credit Market Services before the Committee on Banking, Housing and Urban Affairs, United States Senate, 26 September 2007

⁹⁷ S&P has also established an Office of the Ombudsman to address concerns related to potential conflicts of interest raised by issuers and investors, hired a Chief Compliance Officer, and engaged an external firm to review compliance and governance processes, established an independent Risk Assessment Oversight committee assessing risks to the rating process and feasibility of rating new types of securities,

According to the major issuer-based rating agencies, these measures taken together provide robust safeguards against the potential conflict of interest inherent in the “issuer pays” model. Therefore, regulators should not mandate what business model is viable, but rather to let market participants to choose the firms and business model that best serve their needs.

This approach has also been adopted by US regulatory authorities, who have refrained from mandating changes in the business model of credit rating agencies. The US Treasury Assistant Secretary for Financial Institutions Michael S. Barr the approach of the US administration with these words: “Our approach is to solve these problems within the current framework rather than prohibiting specific models of rating agency compensation as some have advocated. Both issuer pay and investor pay models exist today and we do not believe it is the place of government to prescribe allowable business models in the free market. Our proposal will make it simple for investors to understand the conflicts in any rating that they read and allow them to make their own judgment of its relevance to their investment decision.”⁹⁸

2.4 Use of Ratings in Regulation

The intervention of public authorities in the regulation of rating agencies has also addressed what was perceived as an important factor in the financial crisis: the excessive reliance on their ratings. In particular, regulators have identified as an important cause of this the incorporation of ratings into financial regulation. The reliance on ratings in regulation seemed problematic in light of their poor performance in the period prior to the crisis. As the SEC Chairman Christopher Cox has argued, the agency’s explicit reference to ratings in its rules “may be contributing to an uncritical reliance on credit ratings as a substitute for independent evaluation”.⁹⁹

The comprehensive plan to reform financial markets presented by the US Treasury stated: “regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible”.¹⁰⁰ Indeed, the SEC introduced a set of amendments to its rulebook seeking to reduce investors’ reliance on credit ratings by [removing references to NRSRO credit ratings in different parts of the Investment Company Act and the Securities Exchange Act](#).¹⁰¹ Similar proposals have also been

providing for five year client rotations for all analysts to prevent them from becoming too close to clients, study the track record of analysts who leave to work for issuers. Moody’s has reorganized its internal structure, separating into two different business units the ratings-related and non-rating activities, as well as taking “further steps to separate the Credit Policy function from parts of the rating agency with revenue-generating responsibility”. See S&P’s (2009). Testimony of Deven Sharma, United States House of Representatives Committee on Financial Services and Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, Washington, DC, 30 September 2009.

⁹⁸ Assistant Secretary for Financial Institutions Michael S. Barr Written Testimony Senate Committee on Banking, Housing, and Urban Affairs, 5 August 2009

⁹⁹ 2008-06-25 – SEC aims to curb ratings dependency

¹⁰⁰ US Treasury (2009). Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation, Department of the Treasury, June 17.

¹⁰¹ The SEC had initially suggested wiping references to NRSRO in several of its own rules at the end of 2008. Among these rules, the SEC dropped the norm requiring money market funds to buy exclusively the most liquid and highest-rated debt securities, in particular

introduced within Congress. In September 2009, the House Financial Services Capital Markets Subcommittee Chairman Paul Kanjorski has released a discussion draft on the regulation of credit rating agencies, suggesting to remove references to credit ratings in laws and regulations.

The removal of ratings from prudential regulatory measures has been welcomed by rating agencies, which have opposed the “hardwiring” of ratings in regulation for more than a decade. In the case the use of ratings in rules was not to be reduced, rating agencies demanded that also other measures and benchmarks should be used to complement ratings.¹⁰²

On the contrary, institutional investors and pension funds have argued that removing ratings from securities regulation would also remove important investor protections. Vanguard Group, one of the main US mutual funds, said: “Ratings – even if occasionally imperfect – protect investors by establishing a uniform, minimum credit quality for all money market funds. Removing that investor protection is akin to outlawing seat belts with the hope that drivers will be less likely to be injured if a defective belt fails in a crash”¹⁰³. Also the Securities Industry and Financial Markets Association has acknowledged that while the use of credit ratings in regulation may foster excessive reliance on ratings, it also provides “an appropriate minimum” and “an important data point that should be part of a larger analysis”.¹⁰⁴

A different approach to limit the reliance on ratings in regulation has been suggested in a bill presented in February 2009 in the House Financial Services Committee by Rep. Gary Ackerman and Rep. Michael Castle. This bill would require the SEC to set the criteria for the kind of structured finance products eligible to receive ratings from credit rating agencies designated as NRSRO. The SEC would thus have the authority to prohibit CRA to rate those structured finance products whose future performances cannot be reasonably predicted, such as those without established track records and proven default rates, and securitization that are not comprised of homogeneous securities.¹⁰⁵ Securities that do not meet these criteria could continue to be rated but they could not be designated as NRSRO ratings. The Ackerman-Castle bill would also grant the SEC with the authority to remove the NRSRO designation from those agencies that fails to comply with these requirements.

commercial paper. Securities regulators later dropped this set of amendments from regulatory reforms approved in February 2009, but some of these proposals were re-presented in [September 2009](#).

¹⁰² Testimony of Raymond McDaniel (CEO of Moody’s Corporation) before the House subcommittee on Capital Markets, 30 September 2009

¹⁰³ Duncan Kerr, Vanguard slams SEC’s plan on ratings overhaul, Financial News Online, 20 August 2008

¹⁰⁴ SIFMA (2008). Proposal for a Regulatory Framework for CRAs and Embedded Ratings Policy Options, Securities Industry and Financial Markets Association, 5 September 2008.

¹⁰⁵ Press Release – Ackerman and Castle Introduce Legislation to Impose New Restrictions on Nationally Recognized CRAs, 26 February 2009.

2.5 Private Liability

Another regulatory proposals advanced in the US regulatory debate seeks to improve the quality of credit ratings by increasing the liability of the agencies for their ratings under securities laws. Historically, rating agencies have been shielded by lawsuits since their ratings have been presented as an “opinion” and therefore subject to free-speech protection.

Speaking before the House Financial Services Capital Markets Subcommittee on July 14, 2009 Chairwoman Mary Schapiro encouraged Congress to explore the possibility of introducing private liability for credit rating agencies that issue inaccurate ratings in order to hold them more accountable.¹⁰⁶

In September 2009, the SEC has thus sought comments on an amendment to remove certain protections for credit rating agencies from investor lawsuits. While auditors, banks and other market actors who consent to have their opinions included in prospectuses and securities registration statements are defined as “experts” and can be sued by investors for misstatements, credit rating agencies are currently exempted from this qualification. The SEC has thus discussed the possibility of rescinding the exemption from “expert liability” under the Securities Act.¹⁰⁷ This change would be coupled with another provision requiring them to file the consent of the rating agency when an issuer includes a rating issued by an NRSRO in a registration statement, thus making the rating agency subject to potential Securities Act liability.

Other measures to make rating agencies more liable for their ratings have instead come from Congress. In May, Senator Reed introduced the Rating Accountability and Transparency Enhancement Act of 2009. This bill scaled back some of the protections that have been granted to credit-rating agencies in the Private Securities Litigation Reform Act of 1995. This amendment would make it easier for investors to take legal action against rating firms when “it can be proved that they knowingly failed to review factual elements for determining a rating based on their methodology or failed to reasonably verify that factual information”.¹⁰⁸ According to the bill, “credit rating firms could avoid litigation by conducting thorough reviews or by obtaining assessments from independent firms”.

Instead, a discussion draft on the regulation of credit rating agencies presented on September 2009 by the House Financial Services Capital Markets Subcommittee Chairman Paul Kanjorski introduced a collective liability regime for credit ratings. Similarly to the proposal discussed by the SEC, the Kanjorski bill proposed to amends the Securities Exchange Act to make it easier for investors to sue rating agencies when a rating agency “knowingly or recklessly” failed to conduct a reasonable investigation or failed to review any due diligence reports it received. The point where the Kanjorski proposal radically different from the SEC is the introduction of a collective liability regime, where

¹⁰⁶ CongressDaily/A.M., “Credit-Rating Agencies Eyed For More Regulation By SEC”, 14 July 2009.

¹⁰⁷ Sarah N. Lynch, “SEC to Consider Seeping New Rules for Credit Rating Agencies”, *Dow Jones Newswire*, 17 September 2009

¹⁰⁸ Press Release: Reed Offers Credit Rating Reform Bill, 19 May 2009

rating agencies also share liability for any violation of the securities laws. Rep. Kanjorski ultimately scrapped this provision from his bill.¹⁰⁹

Proposals to introduce new liability standards have been criticized by the rating agencies. They have opposed any measure that would make them liable for their ratings as this could create the potential for an unprecedented number of lawsuits against them any time rated securities default, or even when ratings are simply downgraded. Rating agencies have defended themselves by arguing that their ratings were opinions about future events protected by the First Amendment and that they were not “immune” from liability, since they remained potentially liable for knowingly making false statements, or engaging in fraudulent conduct. Moreover, rating agencies have presented the case that such measures could have a negative impact on the market, pushing the agencies to conform to market sentiment while avoid controversial ratings.

Rating agencies also argued that measures making them liable for their ratings could push agencies to scale back the coverage of ratings to the point of rating only those entities that are least likely to default, thus making it more difficult for new issuers to gain access to credit markets. This could also generate incentives for them to avoid downgrades in order to limit potential legal exposure arising from the lawsuits of investors contesting such choice. Another negative effect of increasing CRA’s liability would be that of encouraging an even greater over-reliance on ratings by investors.¹¹⁰

Rating agencies have also opposed provisions imposing a collective liability regime such as the one presented by Rep. Kanjorski. They argued that this measure would represent a deterrent to new agencies entering the industry knowing that they would be required to act as an insurer for the damage caused by employees of their competitors.

¹⁰⁹ Bill Swindell, “Kanjorski Drops Collective Liability Provision”. Congress Daily, 20 October 2009.

¹¹⁰ See for instance the Testimony of Deven Sharma, Washington, DC, United States House of Representatives Committee on Financial Services and Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises , 30 September 2009.

Box 2.6: US Treasury Proposal to Strengthen the supervision of rating agencies

- **Establish A Dedicated Office For Supervision Of Rating Agencies:** Our legislative proposal establishes a dedicated office within the SEC to strengthen supervision of rating agencies and to carry out the enhanced regulations required.
- **Mandatory Registration:** Unlike the current voluntary system of registration, our proposal would make registration mandatory for all credit rating agencies. This will bring all ratings firms into a strengthened system of regulation.
- **SEC Examination Of Internal Controls And Processes:** The SEC will require each rating agency to document its policies and procedures for the determination of ratings. The SEC will examine the internal controls, due diligence, and implementation of rating methodologies for all credit rating agencies to ensure compliance with their policies and public disclosures.

Source: - Administration's Regulatory Reform Agenda Moves Forward. Credit Rating Agency Reform Legislation sent to Capitol Hill, 21 July 2009

However, other market actors have held a different opinion. For instance the Council of Institutional Investors argued that eliminating the exemption of credit rating agencies from expert liability would increase their diligence.¹¹¹

2.6 SEC Authority reform

The crisis has also strengthened the SEC authority over credit rating agencies. In July 2009, the SEC has created a new monitoring group, which was given the task of conducting both routine and special examinations of the activities of credit rating agencies.

Moreover, further steps to strengthen the supervision of rating agencies were suggested in the legislative proposal sent to Congress by the US Treasury in July 2009 (see Box 2.6).

While the US Treasury proposal seeks to strengthen the lead role of the SEC in the regulation of rating agencies, other proposals coming from Congress have moved in a different direction. For instance, [the Congressional Oversight Panel's Special Report on Regulatory Reform has suggested to give the SEC's role to a Credit Rating Review Board. This body would be modeled around the Public Company Accounting Oversight Board, a non-for-profit corporation overseeing the auditors of public companies created after the Enron scandal by the Sarbanes-Oxley Act. The Credit Rating Review Board would](#) "audit ratings after the fact, perhaps on an annual basis, to ensure that rating agencies are sufficiently disclosing their rating methodologies, the ratings agencies' methodologies are sound, and the rating agencies are adhering to their methodologies".¹¹²

¹¹¹ FinReg 21, "Pressure mounts to make credit agencies legally liable for ratings". 9 October 2009.

¹¹² Congressional Oversight Panel (2009). Modernizing the American Financial Regulatory System: Recommendations for Improving

The bill introduced in July 2009 by Rep. Keith Ellison would instead give the Federal Reserve authority over the credit rating agencies when they analyze and rate structured financial products. The rationale for placing the Fed at the helm derives from the powers that the Federal Reserve has been given with the Term Asset-Backed Securities Loan Facility (TALF) program. Under this program, the Fed had announced a review of the methodologies employed by CRAs analyzing the assets eligible to be financed in the TALF program. The Ellison bill sought to extend these oversight powers beyond the assets financed through the TALF program to cover all asset-backed securities.¹¹³



Oversight, Protecting Consumers, and Ensuring Stability, Washington, DC, Congressional Oversight Panel, January 2009

¹¹³ Targeted News Service, “Ellison Introduces credit rating agency reform bill”, 8 July 2009

III. HEDGE FUNDS

The regulation of hedge funds in the United States presents a paradox. For a decade before the latest financial crisis, hedge funds were able to escape falling under the public regulatory umbrella, also after events such as the collapse in 1999 of the US hedge fund Long-Term Capital Management. However, a decade later, hedge funds could not escape regulation in the aftermath of a crisis in which funds managers saw themselves largely as victims or scapegoats of mistakes generated in the

Short Summary

- The first section (**Section 3.1**) analyzes the regulation of hedge funds in the US from an historical perspective. **Section 3.1.1** describes how since regulators started to debate the regulation of hedge fund in 1999, they have relied on indirect regulation of hedge funds through their counterparties and on industry-driven codes of best practices. **Section 3.1.2** discuss how this approach has lasted well into the last financial crisis. However, since the end of 2009 US authorities have revised their position and endorsed direct regulation of hedge funds.
- The second section (**Section 3.2**) analyzes the central pillar common to all the proposals to regulate hedge funds presented in the US: mandatory registration of hedge fund advisers with the Securities and Exchange Commission. **Section 3.2.1** describes how in the past hedge fund managers have been exempted in US securities laws from registration requirements and how the SEC sought in the fight this exemptions. **Section 3.2.2** presents how the aftermath of the crisis has brought to the emergence of a new consensus in favour of mandatory registration. **Section 3.2.3** summarizes the different legislative proposals presented in the US Congress in 2009 to regulate hedge funds. **Section 3.2.4** explores the debates regarding the *de minimis* threshold for registration.
- The third section (**Section 3.3**) analyzes the regulatory measures going beyond simply requesting hedge funds managers to register. In particular, **section 3.3.2** analyzes two-layered regulatory regime introduced by US Treasury plan, while **section 3.3.3** discusses the request from the SEC to be granted the authority to use adopt new-hedge fund rules as needed.

already regulated banking sector.¹¹⁴

¹¹⁴ This section partially draws upon Helleiner, E. and S. Pagliari (2009). The End of Self-Regulation? Hedge Funds and Derivatives in Global Financial Governance. Global Finance in Crisis. The Politics of International Regulatory Change. E. Helleiner, S. Pagliari and H. Zimmermann. London, Routledge.

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3.1 From self-regulation to direct regulation

3.1.1 From LTCM to Amaranth: the regulation of hedge funds before the crisis

Hedge funds have been on the radar of US regulators for a decade prior to the crisis. In the aftermath of the East Asian financial crisis of 1997-98 some policymakers in East Asia and Australia accused hedge funds of having contributed to this shock. However, regulatory authorities from the US and from other industrialized countries countered this claim, arguing that they had been nothing more than simply “symptoms of a problem caused by weak national policies”.¹¹⁵ However, a few months later, the long wave of the East Asian financial crisis brought the Federal Reserve Bank of New York to organize the bailout of the US hedge fund Long-Term Capital Management in order to avoid a wider collapse in the financial markets. The bailout of LTCM forced American regulatory authorities to acknowledge the risks created by hedge funds and to devise a plan to mitigate them.

The leadership was taken by the President’s Working Group on Financial Markets, which in 1999 published a report entitled “Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management”¹¹⁶. The central recommendation contained in this report was that excessive leverage

Box 3.1: Recommendations in the President’s Working Group Report “Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management”

- More frequent and meaningful information on hedge funds should be made public.
- Public companies, including financial institutions, should publicly disclose additional information about their material financial exposures to significantly leveraged institutions, including hedge funds.
- Financial institutions should enhance their practices for counterparty risk management.
- Regulators should encourage improvements in the risk-management systems of regulated entities.
- Regulators should promote the development of more risk-sensitive but prudent approaches to capital adequacy.
- Regulators need expanded risk assessment authority for the unregulated affiliates of broker-dealers and futures commission merchants.*
- The Congress should enact the provisions proposed by the President’s Working Group to support financial contract netting.
- Regulators should consider stronger incentives to encourage offshore financial centers to comply with international standards.

Source: President’s Working Group (1999), “Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management”, Washington, DC

and risk-taking would be better constrained through market discipline than through direct regulatory oversight. The role of regulators should be that of enhancing market discipline by creating an environment in which investors and counterparties could obtain sufficient information to monitor and limit hedge funds’ riskiness and creditworthiness. The report urged public supervisors and the

¹¹⁵ Eichengreen, B. (2003). *Governing Global Financial Markets: International Responses to the Hedge Funds Problem*. Governance in a Global Economy. M. Khaler and D. Lake. Princeton, Princeton University Press.

¹¹⁶ PWG (1999). *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, Washington, President's Working Group on Financial Markets; see also Eichengreen, B. (2003). *Governing Global Financial Markets: International Responses to the Hedge Funds Problem*. Governance in a Global Economy. M. Khaler and D. Lake. Princeton, Princeton University Press.; Bernanke, B., “Hedge Fund and Systemic Risk”, speech delivered on the 26 May 2008; Robotti, P. (2006). *Mapping the regulatory debate on hedge funds: a political analysis*, London, Financial Markets Group at the London School of Economics; Robotti, P. (2007). *Capture or self-capture? US Domestic Actions to Reach out the World of Hedge Funds: implications for international negotiations*. 2007 International Studies Association Annual Convention, Chicago .

Congress to take initiatives to ensure an effective level of disclosure (for a summary see Box 3.1). Moreover, in order to regulate hedge funds' risk management and internal controls, US federal regulators recommendation that "a group of hedge funds should draft and publish a set of sound practices".

The PWG considered but did not recommend direct regulation of hedge funds. According to regulators, direct regulation would have been ineffective, limiting the fund's ability to provide market discipline, and imposed costs in the form of moral hazard.

The issue of hedge funds regulation returned on the table of the US regulatory authorities almost a decade after the collapse of LTCM. Bringing hedge funds back into the regulators' agenda were this time the collapse of another American hedge funds - Amaranth - as the result of a 6bn dollars single trader's bet on the natural gas market, as well as the pressures exercised by the German government to bring back the regulation of hedge funds in the international agenda. However, the new set of principles to regulate private pools of capitals released by the President's Working Group in 2007 did not depart from the previous support for market-driven regulatory mechanisms (see Box 3.2).¹¹⁷ In this document, US federal regulators argued that "market discipline by creditors, counterparties, and investors is the most effective mechanism for limiting systemic risk from private pools of capital". The role of regulators should not be that of directly regulating and supervising hedge funds, but rather they "should use their existing authorities with respect to creditors, counterparties, investors, and fiduciaries to foster market discipline on private pools of capital".¹¹⁸ Ben Bernanke defended in a speech this approach, arguing that industry-led efforts since the collapse of LTCM to date had been effective, and the primary goal of public authorities remained that of strengthening market discipline.¹¹⁹

3.1.2 After the crisis

The support coming from US regulatory authorities for "indirect regulation" of hedge funds and industry-driven codes of best practices still persisted at the beginning of the crisis in 2007. In September 2007, the President's Working Group intervened directly to foster the emergence of this self-regulatory regime creating two advisory groups, one composed of investors in hedge funds and the other composed of hedge funds managers, with the mandate of creating and publicly releasing a private sector-driven set of best practices for HFs and their investors.¹²⁰

¹¹⁷ PWG (2007). Agreement among PWG and US Agency Principals on Principles and Guidelines regarding Private Pools of Capital, Washington, President's Working Group on Financial Markets,, February 22.

¹¹⁸ PWG (2007). Agreement among PWG and US Agency Principals on Principles and Guidelines regarding Private Pools of Capital, Washington, President's Working Group on Financial Markets, February 22.

¹¹⁹ Bernanke argued: "Continued focus on counterparty risk management is likely the best course for addressing systemic concerns related to hedge funds. This public policy approach does not entail the moral hazard concerns created by authorities' monitoring of positions using a private database. Rather, a focus on counterparty risk management places the responsibility for monitoring risk squarely on the private market participants with the best incentives and capacity to do so".

Ben Bernanke (2006). "Hedge Fund and Systemic Risk", speech at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference, Sea Island, Georgia 26 May 2006

¹²⁰ PWG (2007). PWG Announces Private Sector Groups to Address Market Issues for Private Pools of Capital, Washington, President's Working Group on Financial Markets,, September 25.

The attitude of all the major US federal authorities towards this issue, and their support for self-regulation and indirect regulation over direct regulation have changed since the end of 2008. Three elements could be identified as playing an important role in triggering this change.

The first element is the panic that unfolded in the markets after the collapse of Lehman Brothers in September 2008 and the use of public money to bailout financial institutions. Despite the fact that not a single hedge fund was bailed out and hedge funds did not receive public funding, these events significantly politicized financial regulation politics within Congress and increased the appetite for hedge fund regulation.

The second element is the Madoff scandal. Madoff was not a hedge fund manager; rather, he executed trades for other “feeder funds” through his brokerage firms. Although Madoff was registered with the SEC, the scandal provoked a backlash against the lack of oversight of hedge fund managers.

The third element was the change at the helm of the major federal regulatory agencies and of the US Treasury following the election of President Barack Obama. The Bush administration had maintained a soft-touch approach in the regulation of hedge funds and denied the need to directly regulate hedge funds. Instead, the new course of action introduced by the Obama administration became clear since the confirmation hearings in January 2009. Both the nominee to head of the SEC Mary Schapiro and the Treasury Secretary-nominee Timothy Geithner pledged to pursue mandatory registration of advisers to hedge funds and other private funds with the SEC under the Investment Advisers Act.

Moreover, the new Congressional session that inaugurated at the beginning of 2009 saw several Congressmen presenting bills to regulate hedge funds. As Senator Chuck Grassley acknowledge when presenting his bill, “there was not much of an appetite for this sort of common sense legislation when I first introduced it before the financial crisis erupted. Hopefully, attitudes have changed given all that has happened since the collapse of Bear Stearns last March”.¹²¹

The next section analyze the content of hedge fund regulation that is emerging in the United States, starting from the common denominator of all the regulatory proposals presented in 2009: the mandatory registration of hedge fund advisers with the Securities and Exchange Commission.

The first of these two groups, called “Asset Manager’s Committee” was formed by HF managers and chaired by Erich Mindich, CEO of the American HF Eton Park, and a former colleague of US Treasury Secretary Paulson at Goldman Sachs. Similar to the HFWG, the mandate of this group was to develop guidelines for the areas of valuation, disclosure, risk management, trading and business operations, and, compliance conflicts and best practices (PWG 2007c)

¹²¹ January 29, 2009, Floor Statement of Senator Chuck Grassley of Iowa

3.2 Registration of hedge fund managers

3.2.1 Exemption from registration before the crisis

At the core of most proposals presented by US lawmakers in 2009 there is the mandatory registration with the Securities and Exchange Commission of all advisers to hedge funds whose assets under management exceed a certain threshold.

Before the crisis, hedge funds were able to take advantage of different exemptions in federal securities law to avoid the registration with, and the oversight of, federal regulatory authorities (see Box 3.3). As a result of these exemptions, the ability of the SEC to oversee hedge fund managers remained limited to those funds managers that registered voluntarily with the SEC as investment advisers. Regulators could oversee hedge funds only through the consolidated supervision of their counterparties, in particular the banks that provide them with credit and act as primary broker-dealers.

In 2004 the SEC sought authority to require the registration of hedge fund advisers. In order to achieve this goal, the SEC contested the exemption contained within the Investment Advisers Act of 1940 which allows hedge fund managers to count a single fund with hundreds of millions under management as one “client”. The SEC redefined the term “client” used under the Investment Advisers Act and it required hedge fund advisers to “look through” the funds in counting the number of investors in the fund as clients.

This rule requiring hedge fund advisers to register with the SEC became effective at the beginning of 2006, and by June of the same year over 2500 hedge fund advisers had registered with the SEC.

Box 3.3: Exemptions granted to hedge funds in US federal securities law

1. Securities Act of 1933 → Hedge funds were able to typically avoid registration of their securities under the Securities Act of 1933 by conducting private placements and selling primarily to “accredited investors”. The exemption from the Securities Act allowed hedge funds to remain much less transparent than funds conducting public offerings.
2. Investment Company Act of 1940 → hedge funds usually qualified for exceptions from regulation under the Investment Company Act of 1940 by either limiting themselves to 100 total investors or permitting only “qualified purchasers” to invest. These provisions allowed hedge funds to be exempted from regulatory measures designed to protect retail investors, such as investor redemption rights, application of auditing standards, asset valuation, portfolio transparency and fund governance.
3. Investment Advisers Act of 1940 → hedge funds could be exempted from the Investment Advisers Act of 1940 in the case they have fewer than 15 clients and do not market to the public as an investment adviser. Registered advisers are subject to periodic examination by the Securities and Exchange Commission, as well as to recordkeeping and antifraud requirements, and to hire a chief compliance officer. While this provision was used to identify advisers that were too small to require federal oversight, it was exploited by hedge fund managers who were permitted to count a single fund with hundreds of millions or billions under management as one “client”.

However, most investment managers of hedge funds opposed this rule. They maintained that mandatory registration would impose burdensome costs upon the hedge fund industry. Moreover, they questioned the usefulness of this requirement, arguing that other federal regulators could

already access the vital regulatory information through their counterparties.¹²² Philip Goldstein, manager of the New York fund Bulldog Investors, took exception to the regulation and filed a lawsuit to challenge its enforcement.

The United States Court of Appeals for the District of Columbia in “Goldstein vs. SEC” ruled that in its new definition of “clients”, the SEC was going beyond its statutory authority. After the “Goldstein vs. SEC”, no further efforts were made by federal authorities to directly regulate hedge funds. The SEC declined to appeal and to petition the United States Supreme Court, while the Bush administration adopted since then a light-touch approach to the regulation of hedge funds, based on general best-practices and indirect regulation. Shortly after the ruling by the Court of Appeals for the District of Columbia, Rep. Barney Frank introduced the “Securities and Exchange Commission Authority Restoration Act of 2006” to amend the definition of “client” in line with the SEC proposal but this bill died in committee.¹²³

Despite the fact that the SEC ruling was ultimately tossed out by the federal court, hedge funds did not remain completely outside the oversight of federal authorities. While several hedge funds advisers withdrew their registration with the SEC, a large number of them continued to register voluntarily. Moreover, hedge funds were supervised prior to the crisis by the CFTC when trading on regulated futures and options. In 2008, 29 advisers of the largest 78 US hedge funds were registered as Commodity Pool Operators or Commodity Trading Advisors, and were therefore required to report their futures and options positions above a designated threshold.¹²⁴

3.2.2 SEC registration after the crisis

The crisis has triggered a change in the attitude of all the major US federal authorities towards the issue of hedge funds registration, starting with the Securities and Exchange Commission.

The SEC toughened its position on the regulation of hedge funds. The \$65 billion Ponzi scheme orchestrated by Bernard Madoff also focused the attention on the failure of the SEC to detect this scandal, as confirmed by an internal investigation concluded in July 2009 by the SEC Inspector General David Kotz.¹²⁵

The new nominee to head the SEC Mary Schapiro has since her confirmation hearing in January 2009 put her weight behind proposals requiring hedge fund managers to register with the SEC. The request coming from the SEC found the support from the new US Treasury secretary Timothy Geithner (see section 3.3.2), as well as from the most important lawmakers in Congress (see 3.2.3).

Moreover, mandatory registration was endorsed also from what had been until that the point the major opponents of this proposal: hedge fund managers. In 2009, both the Managed Funds

¹²² Managed Fund Association (2004), *Press Release: MFA issues warning on SEC hedge fund registration proposals*, 17 September 2004

¹²³ Congressional Research Service (2009), *Hedge Funds: Legal Status and Proposals for Regulation*, Washington DC, 27 August 2009

¹²⁴ King, M. R. and P. Maier (2009). “Hedge funds and financial stability: Regulating prime brokers will mitigate systemic risks.” *Journal of Financial Stability*.

¹²⁵ The investigation recommended that hedge funds use an “independent custodian” to maintain investments in separate accounts, similarly to what mutual funds are required to do, as well as to pledge that they conducted due diligence on their advice or face criminal prosecution.

Association¹²⁶ and the Alternative Investment Management Association¹²⁷ - the two major hedge fund associations – declared their support for proposals mandating the registration of hedge funds with the SEC. The MFA also claimed that the regulatory solution it endorsed were going beyond what suggested by US authorities, as it supported the mandatory registration of a wider family of fund managers in order to maintain a playing-level field.¹²⁸

How can we explain this shift in the stance of the major hedge fund groups, which had until the crisis fought mandatory registration with the SEC? The new support from hedge fund groups is largely the result of the combination of the “reputational” and “regulatory” threats triggered by the crisis.¹²⁹

First, the poor performance of hedge funds since the collapse of Lehman Brothers has caused an unprecedented outflow of investors, bringing to a halt the continued growth of the industry that had characterized the previous decade. The Madoff scandal further undermined the reputation of hedge funds, despite the fact that the same Bernard Madoff was not a hedge fund managers. As 1471 funds were liquidated in 2008 according to Hedge Fund Research and the industry’s total capital plunged, hedge fund managers came thus to see a minimum degree of regulatory oversight as beneficial to restore the tarnished reputation of the industry.

Second, hedge funds endorsed mandatory registration with the SEC as they preferred the minimum level of regulatory oversight brought by this solution to more burdensome solutions that could inhibit the way they operate or place restrictions at the product level such as mandatory leverage restrictions and capital requirements (see section 3.3.2).¹³⁰

Indeed, hedge funds managers do not expect that the registration with the SEC will impose an insurmountable burden. While the major costs of registration come from compliance requirements and filling out forms, this solution limits to a minimum the intervention of regulators into their investment strategies (see Box 3.4).

Most importantly, more than half of US hedge-fund managers are already registered with the SEC. According to a report presented by the Government Accountability Office in 2008, the SEC regulated an estimated 1991 hedge fund advisers. Among these there are 49 of the largest US hedge fund advisers which account for one-third of the hedge funds’ assets under management in the US.¹³¹ While the costs of registration would be relatively small for the managers of the largest hedge funds,

¹²⁶ Managed Funds Association (2009), *Press Release: MFA Announces support for registration of Investment Advisers Including hedge funds*, 7 May 2009

¹²⁷ Alternative Investment Management Association, *Press Release: AIMA Supports US Regulatory Reform Proposals*, 23 June 2009; Alternative Investment Management Association, *Press Release: AIMA Reiterates Support for Registration of Hedge Fund Managers in the U.S.*, 3 November 2009

¹²⁸ Managed Funds Association (2009), *Press Release: MFA Announces support for registration of Investment Advisers Including hedge funds*, 7 May 2009

¹²⁹ Haufler, V. (2001). *A Public Role for the Private Sector: Industry Self-Regulation in a Global Economy*. Washington, D.C., Carnegie Endowment for International Peace.

¹³⁰ Helleiner, E. and S. Pagliari (2009). *The End of Self-Regulation? Hedge Funds and Derivatives in Global Financial Governance*. Global Finance in Crisis. The Politics of International Regulatory Change. E. Helleiner, S. Pagliari and H. Zimmermann. London, Routledge.

¹³¹ GAO (2008). *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed*, Washington, United States Government Accountability Office January 2008.

the smaller funds managers would face a relatively larger burden and have thus been less supportive

Box 3.4: Regulatory requirements associated with the SEC registration of hedge funds advisers

1. Provide the Commission with the ability to collect data from advisers about their business operations and the private funds they manage,
2. Empower the Commission to conduct on-site examinations of advisers to identify conflicts of interest and the disclosure level, to determine for instance whether fund assets are subject to appropriate safekeeping or whether the performance represented to them in an account statement is accurate.
3. Empower the SEC to oversee trading activities to prevent market abuses such as insider trading and market manipulation.
4. Require hedge fund advisers to develop internal compliance programs administered by a chief compliance officer.
5. Permit the Commission to screen individuals associated with the hedge fund adviser, in order to deny registration to those individuals convicted of a felony or engaged in a securities fraud.
6. Permit to introduce scalable forms of regulation to differentiate between large and small size businesses.

Source: SEC Division of Investment Management Director Andrew J. Donahue Issues Testimony Concerning Regulating Hedge Funds and Other Private Investment Pools, 15 July 2009

of this kind of regulation.

3.2.3 Congress: regulating funds or their managers?

On the same day when Bernard Madoff was arrested, the US Congress began to legislate to mandate the registration of hedge fund managers. The Sen. Byron Dorgan introduced the “Derivatives and Hedge Fund Regulatory Improvement Act of 2008”, which requested federal regulators to coordinate rulemaking in order to impose reporting rules as well as capital requirements upon hedge funds. While this bill died with the end of the 110th Congress at the end of 2008, the 111th Congress immediately demonstrated a greater appetite for this legislation. Different legislative proposals introduced in Congress throughout 2009 sought to give the SEC the authority to require hedge funds to register with the agency.

At the beginning of 2009, two distinct bipartisan bills were introduced in the Senate and the House of in order to require hedge funds to grant the SEC the authority to monitor the activities of hedge funds. However, in order to achieve the same goal, the two bills were directed to two different targets: respectively the hedge funds and their managers.

The “Hedge Fund Transparency Act” introduced by Senator Chuck Grassley and Senator Carl Levin¹³² would clarify that the SEC has the authority to require hedge funds to register by removing the provision allowing hedge funds to escape the definition of an “investment company” under the Investment Company Act of 1940. Hedge funds could avoid the requirements imposed by the Investment Company Act only by requiring their advisers to register with the SEC, maintaining books and records required by the SEC, cooperate with any request by the SEC for information or

¹³² This bill was modeled after a similar legislative proposal (*Hedge Fund Registration Act*) introduced by Sen. Grassley in May 2007.

examination, file an annual disclosure form with basic information that would be made publicly available.¹³³

By amending the “Investment Company Act of 1940” the Grassley-Levin bill sought to achieve the registration of hedge funds advisers by targeting the underlying fund. This solution has not been endorsed by the US Treasury and federal regulators. They have instead supported regulatory proposals targeting directly the hedge fund advisers by amending the Investment Advisers Act. An example of this approach comes from the “Hedge Fund Adviser Registration Act of 2009” introduced at the beginning of February 2009 by Rep. Michael Castle and Rep. Michael Capuano sought instead to amend the Investment Advisers Act.¹³⁴ In particular, this bill would remove from the Investment Advisers Act the “private adviser”¹³⁵ exemption from registration for investment advisers with fewer than 15 clients, requiring all hedge fund advisers who manage at least \$30 million to register with the SEC. The “private adviser” exemption had already been the target of the failed attempt by the SEC to mandate the registration of funds advisers in 2004.

Amending the Investment Advisers Act of 1940 to remove the private adviser exemption has also been the approach taken by the US Treasury in its plan to bring hedge funds under the federal regulatory umbrella (see section 3.3.2), as well as by other bills, such as the *Private Funds Transparency Act of 2009* introduced in June 2009 by Senator Jack Reed and the “*Private Fund Investment Advisers Registration Act*” introduced in September by 2009 Paul Kanjorski.

This solution has also been endorsed by the major hedge funds group, the Managed Funds Association.¹³⁶ Other hedge funds managers have instead argued that some provisions included in the Advisers Act to provide certain protections for investors (e.g. compensation restrictions) are not well suited for managers of investment pools with high net worth and institutional investors and complex investment strategies such as hedge funds. James Chanos, president of Kynikos Associates LP, argued: “the Advisers Act, which was adopted in largely its current form in 1940, is not well suited to investment structures and strategies developed primarily in the last twenty years”. He recommended instead to draft a new “standalone statute tailored for private investment funds”.¹³⁷ Chanos also argued that requiring registration of hedge fund advisers would be ineffective to

¹³³ 29-January-2009, Press Release

A specific provision of the bill requiring hedge funds to disclose also the names and addresses of each investor in the fund provoked a significant opposition from investors notoriously protective of their privacy. Grassley and Levin subsequently clarified that this disclosure would not be extended to all investors, but only those hedge fund’s beneficial owners who profit from the fees generated by the fund’s operations.

¹³⁴ Castle and Capuano also introduced a second bill (*Pension security Act of 2009*) to require pension funds to disclose each hedge fund in which the plan invested and the amount invested.

¹³⁵ Under the Investment Adviser Act, an investment adviser can benefit from the “private adviser” exemption only if the adviser: has fewer than 15 clients during the preceding 12 months; does not hold itself out generally to the public as an investment adviser; and does not advise any registered investment companies, such as mutual funds, or companies electing to be regulated as business development companies.

¹³⁶ Dow Jones NewsWires, “US Rep Janjorski: Hedge Funds Should register with SEC”, 7 May 2009,

¹³⁷ May 7 2009 – House Financial Services Subcommittee on Capital Markets -James Chanos – President of Kynikos Associates LP

mitigate systemic risk, while at the same time it could degrade investors diligence by causing undue reliance upon SEC regulation.

3.2.4 What Threshold?

According to the US Treasury proposal, registration would not be required for all hedge funds advisers but exclusively those with assets under management that exceed a "modest threshold".¹³⁸ While the initial US Treasury plan did not specify a figure, the US Treasury later recommended that this threshold should be set at \$30 million in managed assets.

Similarly to the US Treasury, also the SEC and the Private Fund Transparency Act introduced by Sen. Reed would require advisers to private funds to register under the Advisers Act if they have at least \$30 million of assets under management, "regardless of the form of its clients or the types of securities in which they invest".¹³⁹ The bipartisan bill introduced by Sen. Grassley and Sen. Levin raised this *de minimis* threshold at \$50 million in assets under management.

More recent proposals have set the *de minimis* threshold at a much higher level. The Private Fund Investment Advisers Registration Act introduced by Rep. Kanjorski was approved by the house Financial Services Committee at the end of October 2009 with a last minute amendment raising the threshold for registration from \$30 million to \$150 million. Also the legislative proposal presented in November 2009 by the Chairman of the Senate Banking Committee Chris Dodd required only advisers of hedge funds with \$100 million or more in assets to register with the US.

This figures are still too low according to the major hedge funds groups. The Alternative Investment Management Association has argued that if the purpose of registration is to allow regulators to monitor the systemically relevant funds, then the threshold for disclosure purposes should be closer to \$1 billion or \$2 billion.¹⁴⁰ The threshold would be influenced by the definition of when a fund is systemically relevant and what defines systemic risk. AIMA's chief Andrew Baker stated: "In our view there is probably no hedge fund on the planet, or maybe two or three at most that are systemically important ... If you are systemically important, it means, when you get into trouble, you get rescued. Who's about to rescue a hedge fund?"¹⁴¹

AIMA has stressed that the reporting and regulatory requirements associated with the registration to the SEC would create excessive costs for smaller funds.

Policymakers have instead tried to reduce the burden that the legislation could impose upon venture-capital funds and private-equity funds. Advisers to these funds were thus exempted from registration by the "Private Fund Investment Advisers Registration Act" introduced in September

¹³⁸ US Treasury (2009). Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation Department of the Treasury, June 17.

¹³⁹ SEC Division of Investment Management Director Andrew J. Donahue Issues Testimony Concerning Regulating Hedge Funds and Other Private Investment Pools, 15 July 2009

¹⁴⁰ Reuters, "Hedge funds oppose tougher rules on operations-AIMA", 20 June 2009

¹⁴¹ Reuters, "Hedge funds oppose tougher rules on operations-AIMA", 20 June 2009

2009 by Rep. Paul Kanjorski and the legislative proposal introduced by Senator Chris Dodd in November 2009.

Other hedge funds groups have instead highlighted the need to maintain a level playing field for all funds. According to the Managed Funds Association, exemptions from registration for the smallest hedge fund advisers “should be narrowly, though appropriately, tailored so as not to create a broad, unintended loophole from registration”.¹⁴²

3.3 Beyond registration

3.3.1 “Enhanced oversight” vs. “granular approach”

While all the regulatory proposals described above agree on introducing a mandatory registration for hedge fund advisers, a few policymakers have argued that the regulatory requirements imposed by these measures are not enough.

The SEC Chairwoman Mary Schapiro declared in April 2009 that registration without any further authority “would not be sufficient”.¹⁴³ Schapiro argued that the SEC should have the authority to impose book-keeping and record-keeping requirements, as well as broader rulemaking authority as situations evolve, including imposing limits on leverage or certain kinds of trading activity if necessary.¹⁴⁴ Similar proposals to legislate on hedge fund liquidity, leverage and capital requirements have been suggested by the Group of 30, chaired by Paul Volcker, chairman of Obama’s Economic Recovery Advisory Board, as well as by Senator Reed.¹⁴⁵

However, these provisions going beyond registration have not fully emerged. Rep. Kanjorski has described the introduction of mandatory registration using the analogy of a “pool pass”: “If they want to continue to swim in our capital markets, they must at a minimum, fill out forms and get an annual pool pass”.¹⁴⁶ However, while the regulation introduced in the US puts regulators in the position to monitor who access the pool and to prevent misconduct, it does introduce significant restrictions to hedge funds’ trading activities. Unlike the Alternative Investment Funds Managers directive presented by the European Commission, what has emerged from Congress is therefore an

¹⁴² Testimony of Richard Baker, President and CEO of Managed Funds Association. Hearing on Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office

¹⁴³ Reuters, “US SEC needs authority over hedge funds: Schapiro”, 28 April 2009

¹⁴⁴ FinReg21, Dorell Delamaide, “SEC’s Schapiro will seek authority to impose limits on hedge fund activity”, 4 May 2009

¹⁴⁵ Christine Williamson, “Industry bracing for round of congressional regulation”, Pensions & Investments, 23 February 2009

¹⁴⁶ Dow Jones NewsWires, “US Rep Janjorski: Hedge Funds Should register with SEC”, 7 May 2009

“enhanced oversight” of hedge funds rather than a “granular approach” to closely regulating their activities, as argued by the MFA president Richard Baker.¹⁴⁷

The next section will analyze the plan presented by the US Treasury. Unlike other bills introduced within Congress, this legislative proposal would introduce more intrusive restrictions on the activities of those funds of systemic importance.

3.3.2 The US Treasury Plan

The Treasury Secretary-nominee Timothy Geithner pledged since the confirmation hearings in January 2009 to pursue mandatory registration of advisers to hedge funds and other private funds with the SEC under the Investment Advisers Act.

However, the plan initially delineated by Geithner in March 2009 and delivered as a legislative proposal to Capitol Hill in July 2009 went beyond simply introducing the registration requirement. The Treasury Plan introduced a tiered approach to registration depending on the systemic relevance of each fund and how it would affect the market.

The first layer applied to all investment advisers with more than \$30 million of assets under management. By removing the 15-client exemption from registration under the Investment Advisers Act, the US Treasury plan required these funds to register with the SEC and subject them to recordkeeping and disclosure requirements. The bill would create an exemption for certain foreign private advisers based with a small number of clients.

At the same time, the US Treasury plan went beyond the legislative proposals presented by Congressmen by introducing a second layer of regulation for systemically important funds. Once registered with the SEC, this regulatory agency would collect on a confidential basis information with respect to amount of assets under management, borrowings, off-balance sheet exposures, counterparty credit risk exposures, trading and investment positions, and other important information. These disclosure requirements were meant not only to police hedge funds but also to collect data “that would permit an informed assessment of how such funds are changing over time and whether any such funds have become so large, leveraged, or interconnected that they require regulation for financial stability purposes”.¹⁴⁸ The SEC would then share this information with a systemic-risk regulator, in particular the Federal Reserve and the newly created Financial Services Oversight Council.

In the case these regulatory agencies determine that a hedge fund poses a threat to the overall financial stability, regulators would have the power to place limits on its activities and leverage. Unlike the Directive originally presented by the European Commission to regulate hedge funds

¹⁴⁷ Associated Press, “Hedge fund industry accepts Obama oversight plan, but seeks more details, assured privacy”, 31 March 2009

¹⁴⁸ US Treasury (2009). Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation Department of the Treasury, June 17.

managers, the US Treasury plan would introduce capital requirements or and leverage restrictions only to those funds deemed to be systemically relevant.

3.3.3 Regulatory Flexibility

An additional regulatory solution going beyond the simple registration of hedge funds advisers has been presented by the SEC. In October 2009, the SEC Commissioner Luis Aguilar argued that, in conjunction with advisers' registration, the Congress could consider granting the SEC the authority to adopt new-hedge fund rules as needed. He said: "The commission should be actively seeking from Congress broader authority to have additional regulatory flexibility to act in the future". Aguilar justified this solution in this way: "Because it is difficult, if not impossible, to predict today what rules will be required in the future to protect investors and obtain sufficient transparency, especially in an industry as dynamic and creative as private funds, an additional option might be to provide the Commission with the authority that allows for additional regulatory flexibility to act in this area"

In this way, the SEC would acquire the rule-making authority to place new conditions on the exemptions that hedge funds have under the Investment Company Act of 1940. "This would enable the Commission to better discharge its responsibilities and adapt to future market conditions without necessarily subjecting private funds to Investment Company Act registration and regulation."¹⁴⁹

¹⁴⁹ SEC Division of Investment Management Director Andrew J. Donahue Issues Testimony Concerning Regulating Hedge Funds and Other Private Investment Pools, 15 July 2009