

COMMITTEE ON CAPITAL MARKETS REGULATION PROPOSES FED-REGULATED CLEARINGHOUSES TO REDUCE SYSTEMIC RISK

CCMR's Letter Puts Core Issue of Regulatory Reform on Congress's Agenda

WASHINGTON, D.C., March 5, 2010—The Committee on Capital Markets Regulation (CCMR), an independent, non-partisan research organization and a leading proponent of carefully considered financial regulatory reform, has proposed a comprehensive approach to reforming regulatory oversight of derivatives markets to reduce systemic risk in the financial system, through greater use of derivatives clearinghouses, to be overseen by the Federal Reserve.

In a 28-page letter to the Chairmen and Ranking Members of the Senate Banking Committee and House Financial Services Committee, the CCMR has provided a framework for legislating on many of the largest and thorniest financial reform issues on the Congressional agenda.

Prof. Hal S. Scott, President and Director of the CCMR said, “Meaningful financial regulatory reform depends on reducing the risks posed by over-the-counter derivatives. We’ve all heard the charges that on the topic of derivatives, there is substantial disagreement among industry participants. Nonetheless, the atmosphere of this debate has changed dramatically since last spring. The Committee includes a diverse array of financial market participants with diverse views on many financial and market related issues, but as our letter and release demonstrate, there is now agreement on many of the core problems and the needed solutions. Specifically, Committee members agree that the most effective approach to reducing systemic risk centers on well-capitalized, closely monitored and effectively regulated clearinghouses comprised of market participants. Such clearinghouses will spread out the risk of counterparty defaults, thus avoiding chain reactions of financial institution failures.”

Prof. Scott continued, “There also is a widespread conviction that monitoring and regulating those clearinghouses should be entrusted to no less knowledgeable or experienced an institution than the Federal Reserve. Our letter amounts to an urgent plea to Congress to get on with this vital mission as quickly as possible.”

The key areas of agreement among CCMR members include the following:

1. Derivatives trades should be required to be conducted through a clearinghouse, as a significant protection against systemic risk.
2. To protect against systemic risk from the failure of a large clearinghouse, regulators must carefully monitor clearinghouses and ensure that they require sufficient margin and use other appropriate risk management techniques.
3. The Federal Reserve should be the exclusive regulator of clearinghouses based on their extensive experience with payment systems, their superior expertise in systemic risk, and because having one neutral regulator will avoid intense turf wars like those that have plagued the SEC and CFTC.

4. Contracts should be subject to central clearing requirements only if they are standardized and liquid. Customized contracts should not be prohibited by legislation. At the same time, industry must continue efforts to achieve greater standardization.
5. All standardized and liquid derivatives contracts that only involve clearinghouse members should be centrally cleared. To ensure that generally limiting the central clearing requirement to contracts between clearinghouse members does not exclude systemically important institutions from coverage, the Committee recommends that the proposed legislation require all institutions that exceed defined net exposure thresholds be made clearinghouse members if they qualify under reasonable and non-discriminatory standards. If parties with substantial net exposures do not qualify for clearinghouse membership, they should be required to put their trades through a clearinghouse with a member guarantee.
6. All requirements for clearinghouse membership and access should be reasonable and non-discriminatory and should be enforced by the Federal Reserve and antitrust officials.
7. We do not believe most commercial firms will be either required to belong to, or to use, a clearinghouse because they will not have substantial net exposures.
8. There are benefits from having multiple, well-capitalized clearinghouses, with strong margining procedures. Since counterparties may be from different jurisdictions, clearinghouses should, to the extent possible, be international in scope, at least insofar as they clear the same contract. Regulators should also establish standards for recognizing clearinghouses operating in other jurisdictions to limit the possibility of cross-border arbitrage in global markets. While a smaller number of clearinghouses would lead to greater netting and less costly margining, multiple clearinghouses will not increase systemic risk as long as clearinghouses and their regulators ensure that clearinghouses are adequately regulated and require sufficient margin.
9. There should not be limitations on who can own clearinghouses, because such restrictions will discourage the formation of and membership in clearinghouses, and because such restrictions are likely to be ineffective. Congress should adopt a more direct solution to potential conflicts by subjecting clearinghouses to strict regulatory oversight.
10. The Committee's May 2009 Report recommended the adoption of reporting requirements for derivatives transactions to increase liquidity and improve price formation. Nevertheless, because continuous reporting of all trades would be costly, the Committee supports a modest delay in reporting normal trades. Furthermore, to preserve market liquidity, the Committee recommends that the Federal Reserve consider permitting more substantial delays in reporting transactions that are large compared to average daily volume, much like the case of large equity block trades.
11. While exchange trading of derivatives would further reduce systemic risk over and above what can be achieved through central clearing (due to better price formation and more liquidity), exchange trading should not be required, but encouraged where appropriate.
12. The regulators of financial institutions should carefully scrutinize the adequacy of capital requirements for non-centrally cleared derivatives contracts and mandate minimum capital levels to ensure sufficient reserves against the risk these contracts create. Capital

requirements used by U.S. regulatory authorities should be harmonized with capital requirements arising from international agreements.

The full letter can be found at: www.capmksreg.org

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