

### **Derivatives**

Derivatives are an integral part of the domestic and global economies. They span all asset classes and enable parties to tailor and isolate risk. Derivatives also enable parties to take nonpublic leveraged positions but, in times of financial crisis, such leverage can have negative consequences. Recent events have demonstrated the negative effects of leverage as loss positions are magnified then further exacerbated by mark-to-market accounting, credit downgrades, and collateral calls. Consequently, demands for the scrutiny and regulation of derivatives are being seriously considered.

Although the Emergency Economic Stabilization Act of 2008 (the “Act”) does not regulate derivatives, it requires the Secretary of the U.S. Department of the Treasury (the “Secretary”) to review the current state of the financial markets and the regulatory system and submit a written report to Congress by April 30, 2009. The Secretary has been specifically tasked with analyzing the effectiveness of the regulatory system at overseeing the over-the-counter swaps market and recommending (i) whether any participants that are outside of the system should become subject to the regulatory system and (ii) enhancements for the clearing and settlement of swaps. The Act also requires the Secretary to determine for certain specified financial institutions whether the public disclosure for such financial institutions with respect to derivatives, off-balance sheet transactions, contingent liabilities, and similar sources of potential exposure is adequate to provide the public sufficient information as to the true financial position of the institutions.

Separately, the Chairman of the Securities and Exchange Commission has identified the potential dangers of credit default swaps and has asked Congress for the authority to regulate these instruments, which historically had been the fastest growing segment of the derivative market. Additionally, the New York Insurance Department now considers credit default swaps to be insurance contracts in circumstances where the buyer of credit protection owns the underlying security and requires such swaps to be issued only by licensed insurance companies.

Hedge funds, mutual funds, investment advisors, corporations, and wealthy individuals, as well as financial institutions, will need to monitor developments in the derivative space in order to understand how increased scrutiny and regulation will affect their businesses. Parties must also continue to be vigilant about analyzing and quantifying the counterparty risk associated with derivatives. Morgan Lewis is ready to assist in these activities.

If you have any questions or would like more details concerning any of the points mentioned in this discussion briefing, please contact the Morgan Lewis attorney with whom you normally communicate or any of the Morgan Lewis attorneys in our Financial Crisis Working Group:

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