

SELLERS OF CREDIT DEFAULT SWAPS TO BE REGULATED BEGINNING JANUARY 1, 2009

On September 22, 2008, New York State Governor David Paterson released a statement that certain credit default swap contracts ("CDS") will be regulated as insurance contracts beginning January 1, 2009. CDS will only be subject to the new regulation if the protection buyers thereunder own the underlying reference obligation.

Simultaneously with Governor Paterson's announcement, the New York State Insurance Department ("Department") established new "best practices" (Circular Letter No. 19 (2008)) for financial guarantee insurers ("FGIs") under its jurisdiction in the State of New York. The FGIs that sell CDS are directed to adhere to guidelines set out in the Circular prospectively beginning on January 1, 2009. In addition, to the extent that entering into the CDS itself may constitute "the doing of an insurance business" under Section 1101 of the Insurance Law, the Department states that the protection seller should consider seeking an opinion from the Department's Office of General Counsel to assess whether it should be licensed as an insurer under the Insurance Law. Thus, those entities that sell protection under CDS in New York after January 1, 2009 may have to be licensed as FGIs.

Past Practice

This new development is seen as contrary to an opinion issued by the Department on June 16, 2000. That opinion suggested that a CDS is not an insurance contract as the payment to a protection buyer under a CDS is not dependent on the buyer suffering an actual "pecuniary loss." Because an insurance contract is designed to compensate a party for a loss, a CDS was therefore not held to be an insurance contract. The Department points out, however, that its 2000 opinion did not deal with the issue of whether a CDS is an insurance contract when the protection buyer (at the time the CDS is entered into) owns a "material interest" in the referenced obligation. The Circular states that the Department expects that this omission will be "rectified" in a forthcoming opinion. (See Circular para 7).

Effect of Ruling

Once licensed, in addition to meeting capital adequacy guidelines and reserve requirements of the Insurance Law, the new FGIs will also have to abide by the best practices under the Circular. New York State Insurance Superintendent Eric Dinallo has stated that the Department plans to propose new regulations and legislation to implement the reforms set forth in the best practices. Under the best practices, an FGI would be limited in its participation in the CDS market to those transactions in which the risks most closely match the amount and timing of risks assumed by FGIs when insuring the bonds directly.

In addition, the new regulations will tighten the rules on how an FGI calculates concentration risks. They also require that 95% of the FGI's portfolio of structured finance transactions will be at least investment-grade. The initial capital and surplus requirement of an FGI, as well as its capital and contingency reserves, will also be increased.

Chicago Office

+1 312.583.2300

Frankfurt Office

+49.69.25494.0

London Office

+44.20.7105.0500

Los Angeles Office

+1 310.788.1000

New York Office

+1 212.836.8000

Shanghai Office

+86.21.2208.3600

Washington, DC Office

+1 202.682.3500

West Palm Beach Office+1 561.802.3230

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