



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 13, 2009

The Honorable Harry Reid  
United States Senate  
Washington, DC 20510

Dear Senator Reid:

In late March I laid out in congressional testimony a broad framework for regulatory reform. As I indicated then, one essential element of reform is the establishment of a comprehensive regulatory framework for over-the-counter (OTC) derivatives, which under current law are largely excluded or exempted from regulation. Since then, the Treasury Department has been consulting with the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and other federal regulators regarding the design of such a framework. Today I am writing to follow up with further details on the amendments to the Commodity Exchange Act (CEA), the securities laws, and other relevant laws that I believe are needed to enable the government to regulate the OTC derivatives markets effectively for the first time.

Government regulation of the OTC derivatives markets should be designed to achieve four broad objectives: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties. To achieve these goals, it is critical that similar products and activities be subject to similar regulations and oversight.

To contain systemic risks, the CEA and the securities laws should be amended to require clearing of all standardized OTC derivatives through regulated central counterparties (CCPs). To ensure that this measure is effective, regulators will need to take steps to ensure that CCPs impose robust margin requirements and other necessary risk controls and to ensure that customized OTC derivatives are not used solely as a means to avoid using a CCP. For example, 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.

All OTC derivatives dealers and all other firms whose activities in those markets create large exposures to counterparties should be subject to a robust and appropriate regime of prudential supervision and regulation. Key elements of that robust regulatory regime must include conservative capital requirements, business conduct standards, reporting requirements, and conservative requirements relating to initial margins on counterparty credit exposures. Counterparty risks associated with customized bilateral OTC derivatives transactions that would not be accepted by a CCP would be addressed by this robust regime covering derivative dealers.

The OTC derivatives markets should be made more transparent by amending the CEA and the securities laws to authorize the CFTC and the SEC, consistent with their respective missions, to impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. Certain of those requirements could be deemed to be satisfied by either clearing standardized transactions through a CCP or by reporting customized transactions to a regulated trade repository. CCPs and trade repositories should be required to, among other things, make aggregate data on open positions and trading volumes available to the public and to make data on any individual counterparty's trades and positions available on a confidential basis to the CFTC, SEC, and the institution's primary regulators.

Market efficiency and price transparency should be improved in derivatives markets by requiring the clearing of standardized contracts through regulated CCPs as discussed earlier and by moving the standardized part of these markets onto regulated exchanges and regulated transparent electronic trade execution systems for OTC derivatives and by requiring development of a system for timely reporting of trades and prompt dissemination of prices and other trade information. Furthermore, regulated financial institutions should be encouraged to make greater use of regulated exchange-traded derivatives. Competition between appropriately regulated OTC derivatives markets and regulated exchanges will make both sets of markets more efficient and thereby better serve end-users of derivatives.

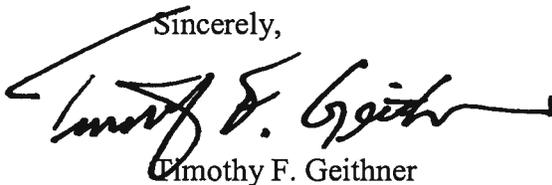
Market integrity concerns should be addressed by making whatever amendments to the CEA and the securities laws which are necessary to ensure that the CFTC and the SEC, consistent with their respective missions, have clear, unimpeded authority to police fraud, market manipulation, and other market abuses involving all OTC derivatives. The CFTC also should have authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets. Requiring CCPs, trade repositories, and other market participants to provide the CFTC, SEC, and institutions' primary regulators with a complete picture of activity in the OTC derivatives markets will assist those regulators in detecting and deterring all such market abuses.

Current law seeks to protect unsophisticated parties from entering into inappropriate derivatives transactions by limiting the types of counterparties that could participate in those markets. But the limits are not sufficiently stringent. The CFTC and SEC are reviewing the participation limits in current law to recommend how the CEA and the securities laws should be amended to tighten the limits or to impose additional disclosure requirements or standards of care with respect to the marketing of derivatives to less sophisticated counterparties such as small municipalities.

I am confident that these amendments to the CEA and the securities laws and related regulatory measures will allow market participants to continue to realize the benefits of using both standardized and customized derivatives while achieving the key public policy objectives expressed in this letter. I look forward to working with Congress to shape U.S. legislation implementing these measures. We will need to take care that in doing so we do not call into question the enforceability of OTC derivatives contracts. We also will need to work with

authorities abroad to promote implementation of complementary measures in other jurisdictions, so that achievement of our objectives is not undermined by the movement of derivatives activity to jurisdictions without adequate regulatory safeguards.

Sincerely,



Timothy F. Geithner

Identical letters sent to:

The Honorable Nancy Pelosi  
The Honorable Mitch McConnell  
The Honorable John Boehner

CC:

The Honorable Christopher Dodd  
The Honorable Richard Shelby  
The Honorable Tom Harkin  
The Honorable Saxby Chambliss  
The Honorable Barney Frank  
The Honorable Spencer Bachus  
The Honorable Collin Peterson  
The Honorable Frank Lucas