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Credit Derivatives: Recent Developments

Credit derivatives, particularly credit default swaps, recently are the subject of increased scrutiny in both the media and the courtroom. Hunton & Williams LLP is actively working with clients to address the issues that have arisen in this environment, including handling of two ongoing federal litigation cases and, prior to filing, settling of multiple cases based on state law claims. We discuss certain of the recent developments below.

Recent Regulatory Developments

New York Investigations — In October, New York State and Federal prosecutors agreed to collaborate in their efforts to investigate and prosecute misconduct in trading of credit default swaps. *The New York Times* reports that prosecutors are looking into whether traders manipulated the largely unregulated market for credit default swaps to drive down the price of financial shares over the last year. It is rare that the New York Attorney General, Andrew M. Cuomo, and the United States Attorney in Manhattan, Michael J. Garcia, work together to pursue investigations in the financial industry. Though subpoenas have been issued, the investigation is in its early stages.

SEC Investigations — In September, the SEC announced an expansion of its market manipulation investigation to address concerns in the market for credit default swaps. As part of this investigation, hedge

fund managers, broker-dealers, and institutional investors with significant trading activity in financial issuers or positions in credit default swaps can be subpoenaed to disclose, under oath, those positions to the SEC and provide certain other information. While the SEC has recorded an increase in enforcement actions, it is not certain how many stem from abuses in the credit default swap market.

NYS Insurance Department — Also in September, the New York State Insurance Department announced that it will, for the first time, begin regulating covered credit derivatives as contracts of insurance. A number of details remain unclear, including the types of credit derivatives to which the new regulations will apply, the interests of a credit protection purchaser that will cause its credit derivatives to be deemed to be “covered,” the extent of the Department’s jurisdiction to regulate credit derivatives and the date or dates as of which the new regulations will become effective. The International Swaps and Derivatives Association, Inc. (ISDA), a trade organization representing credit derivatives market participants, has held discussions about these details with the Department, and ISDA is both lobbying the executive branch and planning to testify before the legislative branch of New York State government with regard to the prospective insurance regulation. The Department may be willing to defer

to more comprehensive federal or other regulation but, in light of recent events, appears to believe that it is incumbent upon the Department to act if no other regulator does so.

Disputes Regarding Credit Derivatives

Litigation, arbitration and other claims regarding credit derivatives have become commonplace with the turmoil in the financial markets. Many of these disputes pertain to credit default swaps, formerly popular with hedge funds and used in many structured credit products, such as synthetic CDOs. While occa-

sionally the terms of a credit agreement are in dispute, often the conflict arises over discretionary actions such as market valuation, collateral retention and reference obligation rights. In certain cases, the outcome of the dispute translates to life or death of one counterparty. Other cases are not so dramatic, but nonetheless involve complex issues associated with unwinding the credit derivative.

How We Can Help

Hunton & Williams LLP currently is advising multiple clients in adversarial

actions arising out of credit derivatives. Our firm regularly represents market participants in entering into a wide variety of derivatives, including credit default swaps and total return swaps. We also represent several financial institutions in litigation and arbitration matters arising out of disputes under derivatives and in related counterparty risk mitigation techniques. In these turbulent global markets, we have the substantive transactional and litigation expertise to guide our clients across the shifting legal and regulatory derivatives landscape.

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