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Derivatives regulation could sweep up steel

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NEW YORK --The U.S. government has outlined plans to regulate the over-the-counter (OTC) derivatives market in a move intended to shine light on complex instruments like credit-default swaps but which might lead to an overhaul of the nascent iron ore and steel trading markets as well.

Under the proposed regulations, all standardized OTC derivatives would go through central clearing houses, a requirement that would help guarantee trades and cushion the market in case of collapse. Additionally, they would require that all OTC trades use an electronic trading platform, allowing a regulator to better record and track transactions that might otherwise take place over the phone.

Steel trading sector insiders had mixed reactions.

"We are pleased the Treasury (Department) and others recognize the important benefits (that) clearing offers the marketplace. Central counterparty clearing provides safety and soundness to the financial market system," said a spokeswoman for CME Group Inc., the derivatives exchange company behind the New York Mercantile Exchange.

Jonathan C. Putman, chairman and chief executive officer of Birmingham Futures Inc., Birmingham, Ala., agreed that government oversight is a necessary next step in the financial sector. "Congress seems to be following a rational approach to increasing the safety of the U.S. financial system through improved oversight, accountability and transparency," he said, citing the principles laid out in the outline of the Derivatives Markets Transparency and Accountability Act of 2009.

But while most sources praised the Obama administration's push for increased transparency, many also questioned whether the steel and iron ore derivative markets really need the same regulation as more "problematic" assets.

"There is a reality of life that says, over time, people tend to do what they perceive to be in their own best interest. Any system that relies on people to do otherwise is doomed to failure. There is a reason people trade contracts worth trillions of dollars in the OTC market: they perceive it to be in their own best interest," Putman said.

"I would urge the President to focus on this reality rather than on pontificating from on high based on how he thinks things should be. The law of unintended consequences is the only law we rigorously enforce," he said. "If Obama had mandated the reading of Ayn Rand's *Atlas Shrugged* by his administration before it set out to mandate the details of our financial system, I would have far more confidence that the necessary changes will eventually take place."

Even CME Group seems to wonder whether increased regulation in all derivatives is the right step. "There are certain products that provide value to investors that simply would not be conducive to clearing," the spokeswoman said.

Although CME Group said more details of the plan are needed before the company can fully determine the impact of such a law on its business, insiders predict that increased OTC regulation could lead to more business on the exchanges, an idea supported by CME Group's 6-percent share price increase on news of the proposal.

Paul Shellman, a consultant to CME Group, said it is estimated that 10 times more business is done off the exchange than on the exchange, meaning such a regulation could lead to as many as 10 times more clients for CME.

But Putman said it's also possible the exchanges might not see much change at all. "My feeling is if the government is sort of heavy handed like it has been in other things, (traders) will just work around it in some way," he said.

Shellman noted that "the idea of creating more transparency and regulatory oversight and eliminating some of the structural risk is already happening." He pointed to CME ClearPort Clearing Services as an example, a flexible clearing services open to OTC market participants who elect to list on the exchange. "It's available, so if you want that you can have it," he said.

But if the government succeeds in its push for increased oversight, the option to list OTC trades on the exchange will no longer be simply an option. "The idea that you *have* to do it is a bit draconian, but I think we're in that new area of government draconian legislation," Shellman said.

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