CLEARY GOTTLIEB

Alert Memo

NEW YORK AUGUST 28, 2009

www.clearygottlieb.com

Obama Administration's Legislative Proposal for Regulatory Reform of Over-the-Counter Derivatives Markets

On Tuesday, August 11th, the Obama Administration delivered proposed legislation to Capitol Hill entitled the "Over-the-Counter Derivatives Markets Act of 2009" (the "Act"). The Act would codify the legislative framework for over-the-counter ("OTC") derivatives originally summarized in the Administration's June 17th white paper, "Financial Regulatory Reform: A New Foundation" and in Treasury Secretary Geithner's May 13th letter to Congress.[1]

I. Overview; Jurisdictional and Legislative Landscape.

A. Summary.

The Act would largely repeal provisions of the Commodity Futures Modernization Act of 2000 ("CFMA") that restrict substantive regulation of a broad range of OTC derivatives under the Commodity Exchange Act ("CEA"), the Securities Exchange Act of 1934 ("Exchange Act") and the Securities Act of 1933 ("Securities Act"). In addition, it would supplement the CEA, the Exchange Act and the Securities Act by establishing substantially parallel regulatory frameworks for OTC derivatives involving certain securities, on the one hand, and swaps involving other financial interests and commodities, on the other hand. Very generally, the Securities and Exchange Commission ("SEC") would regulate securities-based swaps and the market participants that enter into them; the Commodity Futures Trading Commission ("CFTC") would regulate other swaps and the market participants that enter into them.

Mandatory Clearing/Exchange Trading. The Act would, among other significant modifications, require that broad categories of standardized OTC derivatives be cleared in regulated clearinghouses and traded on exchanges or exchange-like trading facilities. All market participants that are "eligible" to clear under applicable

[1] *See* CGS&H Alert Memoranda: "Administration Proposal for Comprehensive OTC Derivatives Regulation" (May 15, 2009); "President Obama's Financial Regulatory Reform Plan: Key Issues for Market Participants" (June 18, 2009); and "President Obama's Financial Regulatory Reform Plan: A Closer Look" (June 23, 2009).

© Cleary Gottlieb Steen & Hamilton LLP, 2009. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

clearinghouse rules (discussed further in Section III(C) below) would be subject to the mandatory clearing and exchange trading requirement.

Regulatory Framework. The Act would direct the CFTC and the SEC to prescribe new reporting, recordkeeping and position limit requirements for market participants generally, as well as new registration, business conduct and related requirements for dealers and major market participants. The Act would also establish regulatory frameworks for swap clearing organizations, "alternative swap execution facilities" and "swap repositories".[2]

Margin. Specified federal banking regulators would be required to adopt margin requirements for all transactions by the banks they supervise that are not cleared, but would be permitted to except transactions involving a non-financial end-user that is not a major market participant and that enters into the transaction for hedging purposes in accordance with GAAP. The CFTC and SEC would be required to adopt margin requirements for entities not supervised by a specified federal banking regulator that are at least as stringent as those adopted by the federal banking regulators. Additionally, capital charges in excess of zero would be required with respect to cleared transactions. Capital requirements with respect to transactions that are not cleared would be required to be higher than the capital requirements with respect to corresponding cleared transactions.

Listed Derivatives. In relation to listed derivatives, the Act would expand existing regulatory standards and enhance the authority of the CFTC to more directly regulate exchanges and clearinghouses. It would also expand the application of U.S. commodities laws to foreign exchanges by requiring the registration with the CFTC of foreign exchanges that authorize direct terminal access from the U.S. to their electronic matching engines. Any such foreign exchange that lists contracts tied in value to U.S. exchange-listed contracts would be subject to extensive CFTC regulation, particularly in relation to large trader reporting and position regulation.

Joint Rulemaking. The Act would generally require the CFTC and SEC to act jointly in prescribing rules governing OTC derivatives. Joint rules would be required to be uniform and to treat functionally or economically equivalent products similarly. In addition, the Act would require the agencies to engage in joint rulemaking within prescribed timeframes, and if they do not, would require the Treasury Department to prescribe the required rules. Any interpretation of the new framework would also be required to be issued jointly. Finally, the Act would flatly preclude the agencies from

---

[2] A "swap repository" is defined under the Act as an entity that "collects and maintains the records of the terms and conditions of" swap and security-based swap transactions.

granting exemptions from the Act's provisions regarding swaps and security-based swaps, except in very limited circumstances specified in the Act.[3]

B. Observations.

The general legislative objectives of the Act have garnered broad market acceptance. Market participants largely support more widespread clearing of standardized products by market professionals, regulation of swap dealers and enhanced transparency with respect to the market and major market participants. As drafted, however, the Act goes well beyond these objectives. The Act would establish regulatory requirements that are both duplicative and substantially more detailed than any other statutory model for financial market regulation. These regulations would impose standards significantly more stringent in certain respects than current law governing the most comprehensively regulated retail markets.

As a result of modifications made to the definition of "swap agreement" in Section 206A of the Gramm-Leach-Bliley Act of 1999 ("GLBA"), the Act would also reintroduce pre-CFMA concerns regarding the legality of broad categories of OTC derivatives, resurrecting a regime under which certain swap transactions—even those by institutional counterparties that are conducted for *bona fide* commercial or risk management purposes—would potentially become crimes *per se*.

If enacted, the Act would present significant challenges for market professionals as well as end-users. The wholly extraterritorial activities of internationally active banks would be subject to CFTC and SEC business conduct rules. Internationally headquartered banks that conduct their swap business in non-U.S. branches would additionally be subject to CFTC and SEC capital, margin and other prudential regulation, without regard to the internationally recognized principle of deference to home country regulation. These concerns are magnified by the Act's broad restrictions on administrative exemptive relief.

The Act goes significantly beyond legislative measures currently contemplated in Europe with respect to OTC derivatives. Indeed, unlike European proposals, the Act is as much market engineering as it is market regulation. The Act thus has the potential to create significant incentives for market professionals and end-users to maximize the scope of activities they are able to conduct outside the U.S. and with non-U.S. counterparties—a particularly unfortunate prospect for an economy and a financial sector already under significant stress.

[3] The Act does not address the status of existing CFTC and SEC exemptive relief that is inconsistent with the Act's provisions.

In this memorandum, we provide a high level summary of the key elements of the Act. This memorandum is not intended to be a comprehensive summary of all of the provisions of the Act. Many issues, some quite substantive, are raised by the interaction of the Act and the existing statutory frameworks it would modify. This memorandum does not attempt to detail all such issues or similar technical issues.

II. Covered OTC Derivatives.

The Act would generally divide OTC derivatives into two categories: "swaps" subject to regulation by the CFTC and "security-based swaps" subject to regulation by the SEC. In each category, certain products conventionally regarded as swaps would be excluded from the relevant regime. The Act would also authorize the CFTC and SEC to adapt the definitions of "swap" and "security-based swap", if necessary, to curtail evasion of the Act. Curiously, unlike other statutory schemes, the CFTC and SEC would additionally be required to further define many of the defined terms included in the Act, although the Act does not specify the objectives or parameters of such rulemaking or the extent to which the CFTC and SEC are, or are not, to expand, contract or otherwise substantively modify the Act's definitions.

A. Swaps.

The proposed definition of "swap" is based largely on the GLBA Section 206A definition of "swap agreement" and includes transactions commonly regarded by the industry as swaps. Among the key modifications to the original GLBA definition are the following:

- the definition no longer includes the requirement that transacting parties be eligible contract participants ("ECP") (although substantive legislative provisions elsewhere would effectively impose a somewhat more restrictive formulation of this requirement in the context of transactions that are not conducted on a regulated futures or securities exchange);

- consistent with the Act's emphasis on mandatory clearing and exchange (or exchange-like) trading of "standardized" contracts, the definition no longer includes the requirement that the material economic terms of a transaction be subject to individual negotiation; and

- the provision in the GLBA swap agreement definition including contracts for purchase or sale on a fixed or contingent basis is deleted, as a result of which "swaps" would appear to be limited to cash-settled instruments, with the exception of conventional and "digital" options under clauses (i) and (ii) of the definition.

Significantly, as a result of the change described in the last bullet, so-called "delta 1" bilateral executory swaps providing an election for physical settlement and forward contracts providing for the possibility of cash settlement or netting would be excluded from the definition of "swap" and potentially subject to regulation or prohibition as futures contracts under the CEA.[4]

Exceptions.

The swap definition lists a number of notable exceptions, including the following:

- futures contracts listed on a contract market (*i.e.*, futures exchange) designated by the CFTC ("DCM");[5]
- any non-financial deferred delivery contract that is physically settled;[6]
- security options subject to the Exchange Act and the Securities Act;[7]
- foreign currency options listed on a national securities exchange;
- security-based swaps;
- contracts for the fixed or contingent purchase or sale of securities subject to the Exchange Act and the Securities Act (with a carve out from the exception that appears intended to capture credit default swaps ("CDS"));[8]

[4] Analogous OTC derivative contracts involving securities could similarly be subject to regulation or prohibition as security futures contracts.

[5] As discussed further below, there is no general exclusion from the swap definition for futures contracts that are not traded on a DCM, thus raising the question of the status of certain swaps as futures contracts under the CEA.

[6] Note that, as a result of the modifications to the original GLBA definition, nothing in the proposed swap definition would include as a swap a physically settled contract for the purchase or sale of a non-financial commodity, thus rendering the scope of and need for this exception unclear.

[7] It is unclear what the references to security options and (further below) to contracts for the purchase or sale of securities "subject" to the Exchange Act and the Securities Act are intended to exclude from the exception (*i.e.*, treat as "swaps"). (Compare the language used in relation to the exception for notes, bonds and evidence of indebtedness.)

[8] As noted above, the first part of the swap definition would not include the securities contracts described in this exception.

- foreign currency swaps[9] and forwards (but not OTC foreign currency options, which would remain subject to regulation as swaps);[10]
- notes, bonds and evidence of indebtedness that are securities as defined in the Securities Act;
- underwriting agreements (with a carve out from the exception for incidental hedging transactions that would otherwise qualify as swaps); and
- transactions with a Federal Reserve System bank or the U.S. government or a federal agency that is expressly backed by the full faith and credit of the U.S. government.[11]

Notable Inclusions.

Surprisingly, nothing in the Act would exclude traditional insurance products from the prong of the swap definition applicable to payments based on the occurrence of a contingent event. Previously, this was not an issue because the purpose of the relevant swap agreement definition was to clarify that swap agreements (like traditional insurance) were not subject to regulation as securities. However, because the Act's swap definition would be used to convey jurisdiction and impose affirmative regulatory requirements, this is a potentially significant issue. Globally, swaps are conducted on the assumption that they are not insurance based on the absence of a loss requirement as a condition to performance. The Act presents a valuable opportunity to develop a constructive functional distinction between insurance and derivatives and alleviate the potential for inconsistent regulation or, worse, state laws that might effectively prohibit broad categories of *bona fide* swap activity.

Additionally, certain forms of annuities and insurance products, as well as forms of indebtedness that are not securities or identified banking products (such as non-bank mortgages) but that have indexed or variable rate returns, would be subsumed within

---

[9] The term "foreign exchange swap" is very narrowly defined in the Act and would not, for example, include contracts such as non-deliverable foreign currency forwards or "bullet" swaps.

[10] Shortly following publication of the Act, Gary Gensler, Chairman of the CFTC, sent a letter to the Chairman and Ranking Member of the Senate Committee on Agriculture, Nutrition and Forestry dated August 17, 2009 ("Gensler Letter") stating that among other modifications to the Act, the exception for foreign exchange swaps should be deleted and the exception for foreign exchange forwards should be significantly narrowed.

[11] No comparable exception exists for transactions with a foreign central bank, foreign sovereign or multi- or supra-national organization and, as noted earlier, the agencies would be prohibited from granting exemptive relief in such cases.

the swap definition. Similarly, commercial contracts with fee or rate escalation clauses would also, as a technical matter, potentially be captured. We presume these results were unintended. Nonetheless, they highlight the risks inherent in a complex and esoteric regulatory regime administered by agencies that lack appropriate exemptive authority.

Finally, in an apparent effort to track the CFTC-SEC jurisdictional allocation under the so-called "Shad-Johnson Accord" applicable to listed derivatives, the Act would allocate primary regulatory authority over swaps on government securities and broad-based indices of securities (including broad-based index CDS) to the CFTC. As noted in Section II(C) below, however, to the extent such products qualify as "security-based swap agreements", the SEC would retain certain anti-fraud and anti-manipulation authority over them. The apparent grant of jurisdiction to the CFTC with respect to broad-based index CDS is arguably a departure from the Shad-Johnson Accord. Because CDS are not outright obligation contracts, but instead create contingent rights and obligations based on the occurrence of certain events, there are compelling arguments that CDS are more closely analogous to options than to futures contracts. Under the Shad-Johnson Accord, the SEC, and not the CFTC, exercises jurisdiction with respect to options on broad-based security indices.[12]

In any event, business units that trade CDS and equity derivatives do not, of course, bifurcate their businesses in the manner contemplated by the Act's proposed allocation of regulatory jurisdiction. The resulting imposition of duplicative regulatory regimes and potentially inconsistent standards, which could be avoided through appropriate regulatory exemptions, would be an unwelcome inefficiency for such businesses.

Jurisdictional Exclusions.

Although the Act would largely repeal the CEA exemptions and exclusions enacted in the CFMA, certain exclusions would be retained.

- Hybrids. The CFMA exclusions for qualifying hybrid securities and hybrid bank deposits would be retained under the Act. ("Hybrid" instruments for these purposes refer to securities or depositary instruments whose returns are determined by reference to indexation to changes in one or more market factors.)
- Treasury Amendment. The so-called "Treasury Amendment", although significantly modified, would also be retained.[13] Very generally, under

[12] *See infra* note 19.

[13] The "Treasury Amendment" excludes from the CEA, among other transactions, transactions in foreign currencies, government securities and mortgages.

the Act, the CFTC would not have jurisdiction over Treasury Amendment products (*e.g.*, government securities and foreign currency), unless they are futures contracts or options traded on a DCM or are "swaps".[14] The Act would, as a result, subject "off-exchange" foreign currency options to CFTC regulation as swaps, but would exclude foreign currency spot, swap and forward transactions.[15]

- Identified Banking Products. Identified banking products (other than swap agreements) under the GLBA would also be excluded from CFTC and SEC regulation under the Act, subject to potential exceptions at the discretion of federal banking regulators in the event they perceive a bank to be evading the Act's provisions through the structuring of such products.

B. Security-Based Swaps.[16]

The definition of "security-based swap" would include only "swaps" (as defined in the Act) that are based on:

- narrow-based security indices[17] and single securities and loans; and
- single name and narrow-based index CDS.[18]

As noted above, the security-based swap definition would, as a result, appear to exclude broad-based index CDS,[19] broad-based security index swaps as well as swaps on government securities.

---

[14] Recall that the swap definition excludes certain foreign currency swaps and forwards.

[15] The Act would also give the CFTC broadened authority with respect to retail commodity transactions that do not result in physical delivery within a specified settlement period.

[16] It is notable and surprising that the definition of "security-based swap" and several of the provisions governing SEC rulemaking with respect to security-based swaps would be codified under the Act as provisions in the CEA.

[17] Narrow-based indices are defined in CEA Section 1a(25). Indices that are not "narrow-based indices" are "broad-based indices" under the federal securities and commodities laws.

[18] We note that the provision of the security-based swap definition addressed to CDS would require that each credit event under a CDS qualifying as security-based swap "directly affect the financial statements, financial condition, or financial obligations of the issuer". Not all credit events (*e.g.*, restructurings) would necessarily have such an impact, although, as a general matter, credit events are expected to have one or more of such impacts. As a result, this definition would be underinclusive.

Additionally, under the Act, a swap that combines the characteristics of a swap and the characteristics of a security-based swap (a so-called "mixed swap") would be treated as a security-based swap as well as a swap. However, in light of the fact that most security-based swaps include periodic payments based on a variable financing rate (a feature that would bring them within the definition of a "swap"), the definition of mixed swap would appear to encompass the vast majority of security-based swaps, thus subjecting such security-based swaps to concurrent regulation by the CFTC. It seems unlikely that this result was intended.

The Act would also expand the definition of "security" in the Exchange Act and Securities Act to include security-based swaps. By adding security-based swaps to the definition of "security" under these statutes, the Act would effectively repeal the provisions enacted as part of the GLBA and the CFMA that limit the SEC's authority to regulate security-based swaps.

C. Security-Based Swap Agreements.

The Act would, however, leave intact the limitations on the SEC's authority with respect to products that qualify as "security-based swap agreements", but would modify the definition and thus the limitations. These products would only be subject to Sections 10 (anti-fraud), 16 (short-swing profit rules), 20 (control person liability) and 21A (insider trading) of the Exchange Act and Section 17 (anti-fraud) of the Securities Act.

The definition of "security-based swap agreement" tracks, in part, the definition of that term in the GLBA, defining a "security-based swap agreement" as any swap "of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein". Unlike the GLBA, however, the Act's definition of "security-based swap agreement" would specifically exclude security-based swaps. As a result, this new modified definition of "security-based swap agreement" would notably be limited to swaps on broad-based indices of securities (as noted above, presumably including broad-based index CDS). Therefore, although, as discussed above, the Act would grant the CFTC primary regulatory authority over swaps on broad-based indices of securities, the SEC would still retain certain anti-fraud and anti-manipulation authority with respect to such products.

[19] The conclusion that the Act would give the CFTC jurisdiction with respect to broad-based index CDS is predicated on the assumption that such CDS are not carved out from the definition of "swap" as options on securities. *See supra* text accompanying note 12.

D. General Observations.

CEA.

The Act would not exclude swaps from the definition of a futures contract or commodity option under the CEA, although the Act would preclude the application of most provisions of the CEA to swaps. An exception of unclear scope applies in the case of provisions of the CEA applicable by their terms to registrants. As noted above, the swap definition expressly excludes purchase and sale contracts that provide for physical delivery (or a physical delivery option) as well as swaps that permit cash settlement and physical settlement, suggesting that these widely transacted products could be subject to regulation or prohibition as futures contracts under the CEA.

Clarification of the scope of the CFTC's permitted rulemaking authority with respect to swaps and registrants generally would assist in ensuring harmonized regulatory regimes for swaps and security-based swaps along the lines outlined in the Act.

Of greater concern, by failing to include cash or physical settlement contracts of the types described immediately above within the definition of "swap", the Act has the potential to return us to a pre-CFMA world of disputes about what is and what is not a futures contract and the prospect that these common types of OTC transactions would become *per se* illegal under the CEA.[20]

Exchange Act.

As noted above, the Act would amend the definition of "security" under the Exchange Act (and the Securities Act) to include security-based swaps. At a minimum, the authority to regulate security-based swaps as though they were also securities under the Exchange Act would appear flatly inconsistent with the goal of ensuring harmonized regulatory regimes for swaps and security-based swaps along the lines outlined in the Act.[21]

Of greater concern, security-based swaps—for all their securities-like economic features—are, manifestly, very different than securities. The hundreds of securities law provisions and rules currently in place were written with securities, and not security-based swaps, in mind. The public and private sector effort, resources and expense

[20] The grant of exclusive jurisdiction to the CFTC with respect to swaps conducted on a "board of trade, exchange, or market" may similarly lead to litigation as to what constitutes a "board of trade, exchange, or market".

[21] The Exchange Act modifications proposed under the Act would address this issue only in part by excluding security-based swap dealers that engage in transactions exclusively with ECPs from the definition of a security "dealer".

that would be required to review, modify or develop an exemption (ignoring for these purposes the absence of exemptive authority under the Act) for each of these provisions would be prodigious. Additionally, a myriad of other federal and state statutes and regulations, corporate governance documents, investment guidelines and similar materials refer to "securities" assuming that the definition of "security" refers to conventional stocks and bonds and perhaps other instruments traditionally considered to be securities. Unintended consequences could result to the extent these provisions expressly refer to the federal securities laws, or a court or other body looks to the federal securities laws for guidance in interpreting the relevant provisions.[22]

An alternative to defining security-based swaps as securities that avoids these pitfalls while accomplishing the Act's objectives with greater clarity would be to specify the scope of the SEC's authority to prescribe rules governing security-based swaps—whether that authority is coextensive with the Act's narrower provisions governing security-based swaps and related market participants, or whether it is coextensive with the SEC's broader existing authority under the Exchange Act with respect to securities.

III. Clearing and Trading.

A. Mandatory Clearing.

The Act would require that any "standardized" swap be cleared[23] through a CFTC-registered derivatives clearing organization ("DCO")[24] and that any "standardized" security-based swap be cleared through an SEC-registered clearing agency.[25] The Act

[22] For instance, investment authorities and restrictions for many states, governmental entities, municipalities, corporations, trusts and investment professionals often reference product types such as "securities". Many of these provisions were likely not intended to permit investments in security-based swaps. In fact, their references to "securities" may have been intended to prohibit or limit such transactions.

[23] Although the Act does not define what it means to "clear" a transaction for these purposes, the requirement that the clearing be conducted by a registered DCO together with the regulatory requirements applicable to DCOs would appear to foreclose the use of alternative structures to achieve multilateral netting and risk mitigation where current clearing paradigms may not be possible, appropriate or desirable.

[24] The Act would authorize the CFTC to exempt from registration as a DCO: a clearing agency; a DCO subject to regulation by a qualifying federal banking regulator; and a DCO subject to regulation by a qualifying home country regulator. The Act separately would provide that clearing agencies could clear swaps and DCOs could clear security-based swaps. However, the Act's mandatory clearing requirement would not be satisfied, by its terms, in the case of a standardized swap cleared by a clearing agency or a DCO (such as ICE Trust U.S. LLC) that is exempt (or eligible for exemption) from registration by the CFTC. We assume this result was not intended.

[25] The Act would also narrow the provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") that permit banks and certain foreign clearinghouses, called "multilateral clearing organizations", to clear "over-the-counter derivative instruments" as defined in FDICIA, by excluding from

would also require that DCO and clearing agency rules provide that all swaps and security-based swaps with the same terms and conditions are fungible and may be offset with each other.[26]

The Act does not define the term "standardized". Instead, the Act would require that, within six months of its enactment, the agencies[27] jointly define "as broadly as possible" what constitutes a "standardized" contract for purposes of the clearing mandate, based on the following statutory criteria:

- the volume of transactions in the contract;[28]
- the extent to which the contract's terms are disseminated to third parties or referenced in other trades;
- the similarities between the terms of the contract and others that are centrally cleared;
- the differences between the terms of the contract and others that are centrally cleared which are of "economic significance";[29] and
- "any other factors" that the agencies "determine to be appropriate".

The Act would further provide that acceptance of a product by a clearinghouse for clearing would create a "presumption" that the relevant product is "standardized". Clearing arrangements frequently result in contract terms that can vary in

---

the definition of "over-the-counter derivative instrument" any product that qualifies as a swap or security-based swap.

[26] The import of this requirement is not entirely clear. It could be read to mean that economically fungible OTC derivatives must be treated by the clearinghouse as fungible with each other regardless of the execution venue that originated the trade. Read in this way, the provision appears intended to promote competition, at least across execution venues, if not across clearing organizations. For reasons that are unclear, however, this requirement would apply only to the clearing of swaps and security-based swaps, and would not apply to the clearing of futures contracts. The absence of fungible treatment of futures contracts by clearing organizations has been cited by a number of constituencies as a significant factor in inhibiting competition by new entrants in the U.S. futures markets.

[27] The Act does not contemplate participation by federal banking regulators in these determinations.

[28] The Act provides no guidance as to the significance of volume in this determination or the criteria that should be considered in determining whether the volume of relevant transactions supports a "standardization" determination.

[29] The Act does not define or provide any guidance as to how the term "economic significance" should be interpreted.

more or less significant ways from the terms on which related OTC derivatives transactions are documented. The extent to which clearing a product with a given set of terms would impose a clearing requirement on closely related products is unclear, although, as noted above, in defining the term "standardized" the agencies are to consider the differences between the terms of the contract and others that are centrally cleared that are of "economic significance". It is unclear how the agencies are expected, *ex ante*, to make such a determination without evaluating the specific cleared and uncleared contracts at issue.[30]

As the Act itself indicates, the criteria for determining standardization are inherently qualitative and subjective in nature, driven by a facts-and-circumstances analysis of individual contracts. As a result, the requirement that firms evaluate for themselves whether the standard is met in a particular case would inherently result in considerable uncertainty, with potentially significant adverse legal consequences. The proposed presumption also has the potential to produce other highly undesirable results. It could tend to concentrate clearing volume in the very first clearinghouse to offer clearing for a product, without regard to considerations such as whether the first-offered clearing solution is the most appropriate or desirable, whether the product has matured sufficiently that it is ready to become the *de facto* market trading standard, whether competition is fostered by immediate application of the requirement, or whether the clearinghouse has the wherewithal, credit infrastructure, resources and capacity to clear the entire market for a given product.

The objectives of the Act could as readily be achieved, without the risk of such unintended consequences, by requiring the agencies to review market activity periodically, and to identify, by notice and comment, those specific contracts that they conclude meet the "standardization" test and are otherwise suitable for mandatory clearing.

It merits noting that, while European political leaders have indicated their intention to create regulatory incentives, such as adjusted capital requirements, to incentivize clearing, they have not indicated an intention to criminalize the failure to clear standardized OTC derivatives.

B. Mandatory Exchange or "ASEF" Trading.

The Act would further require that all standardized swaps and security-based swaps be traded on a DCM or a national securities exchange, respectively, or on an "alternative swap execution facility" ("ASEF"). In addition, swaps and security-based swaps involving non-ECPs would be required to be executed on a DCM or a national

[30] The agencies would, however, also be authorized to independently determine whether particular contracts or classes of contracts subject to their respective jurisdictions should be considered "standardized" for purposes of the clearing mandate.

securities exchange, respectively. The Act would also narrow the category of ECPs by increasing the qualification criteria for certain governmental entities from $25 million to $50 million in assets owned and invested on a discretionary basis and by modifying the requirement for natural persons from $10 million in "total assets" to $10 million in assets invested on a discretionary basis.

The mandatory clearing and exchange/ASEF trading requirements have no jurisdictional limits and are not eligible for any exemptive relief. By the terms of the Act, these requirements would apply to non-U.S. end-users, including foreign sovereigns, that transact with U.S. counterparties. Indeed, if a foreign bank were a swap dealer subject to the Act, these requirements would by their terms apply even to a transaction in the London branch of the bank conducted with a London counterparty entirely in London.

C. Exception to Mandatory Clearing/Trading.

The Act would provide a narrow exception to its mandatory clearing and exchange/ASEF trading requirements where either

- no clearinghouse will accept the contract for clearing, or
- one of the counterparties is not a dealer or major market participant and also does not meet the "eligibility requirements" of any clearinghouse that clears the contract.[31]

It is unclear whether the exception's reference to "eligibility requirements" is intended to refer to those requirements that clearinghouses establish only for their clearing members or whether it also refers to eligibility criteria for customers. Customer eligibility requirements generally relate to a customer's status as an ECP, if there are any such requirements at all. To the extent that the term "eligibility requirements" is intended to encompass customer eligibility requirements, the Act could be interpreted as requiring that any periodic end-user of OTC derivatives that qualifies as an ECP clear and exchange/ASEF trade all of its standardized contracts. It appears from the Gensler Letter[32] that the CFTC does not read the provision in this way, but would like to see it operate in this manner.

---

[31] Oddly, but we assume unintentionally, there is no exception to the exchange/ASEF trading requirement in circumstances where either the contract is not listed on any exchange or ASEF or the counterparty is not eligible to trade in the relevant venue. In regard to the latter, it is possibly the Act's intent that neither exchanges nor ASEFs be permitted to impose any restrictions on eligible participants, a result that would be inconsistent with the practices of existing alternative trading venues.

[32] *See supra* note 10.

It is not clear that the end-user community will perceive the incremental benefits of clearing and trading on regulated trading facilities as offsetting the costs and operational and administrative resources necessary in order for them to utilize such facilities.

In the event that a swap (or security-based swap) is not cleared, the Act would require that both counterparties report the trade either to a swap (or security-based swap) repository or, if no such trade repository will accept the information, then to the CFTC or SEC, as applicable.[33] The Act would thus become the first U.S. statute regulating financial markets to impose routine transaction reporting requirements on end-users.

IV. Dealers and Major Market Participants.

The Act would require dealers and major market participants to register with the SEC, the CFTC, or both, depending on the nature of their activities,[34] within one year of the Act's enactment.[35] There would be no exemptions for banks, state or local governmental agencies, or persons otherwise registered, and, in contrast with its treatment of market facilities discussed in Section VII, the Act would not authorize the agencies to exempt from their respective jurisdictions entities subject to comparable regulation by another regulator.[36] Notably, under the Act, dealers and major market participants would be subject to essentially equivalent regulation.

[33] In addition, OTC derivatives entered into prior to the Act's enactment would be required to be reported to a trade repository or to the CFTC or SEC, as applicable, no later than six months after the Act's effective date. OTC derivatives entered into on or after the Act's enactment would be required to be reported to a trade repository or to the CFTC or SEC, as applicable, by the later of (i) 90 days after the Act's effective date or (ii) such other time after entering into the OTC derivative as prescribed by the CFTC or SEC, as applicable.

[34] As a practical matter, given the Act's proposed jurisdictional divisions, it is difficult to envisage a firm required to register with the SEC as a security-based swap dealer that would not also be required to register with the CFTC as a swap dealer.

[35] Security-based swap dealers that engage in transactions exclusively with ECPs would be excluded from the definition of security "dealer" and would, therefore, not be required to become members of a self-regulatory organization, such as the Financial Industry Regulatory Authority, under the Exchange Act. Similarly, the Act would not, by its terms, require that swap dealers become members of the National Futures Association.

[36] The SEC would, however, have the authority to provide exemptions from rules affecting security-based swap dealers and major security-based swap participants for security brokers or dealers subject to "substantially similar" requirements, except with respect to registration and capital and margin requirements.

A. Dealers.

Any person "engaged in the business" of buying and selling swaps or security-based swaps for such person's own account would be subject under the Act to registration with the CFTC as a "swap dealer" or the SEC as a "security-based swap dealer", as applicable. However, a person who buys or sells OTC derivatives, but "not as a part of a regular business", would not be considered a swap or security-based swap dealer. This definition parallels the definition for a security "dealer" under the Exchange Act and is, therefore, presumably intended to capture the Exchange Act distinction between security dealers, on the one hand, and traders (such as hedge funds), on the other hand.

The Act would not require registration as a swap or security-based swap "broker" by any party that effects swaps or security-based swaps for the accounts of customers. At the same time, firms engaged in clearing swaps or security-based swaps for customers could potentially be subject to registration as futures commission merchants or security brokers, respectively. This prospect could create significant incentives for dealers to restructure their swap business with a potential loss of efficiencies resulting from intra-portfolio netting to the extent they determine to bifurcate their swap activities between a dealing entity and a clearing entity.

B. Major Market Participants.

A non-dealer that maintains a "substantial net position"[37] in outstanding OTC derivatives (other than to create and maintain an effective hedge under GAAP)[38] would be required to register with the CFTC as a "major swap participant" or the SEC as a "major security-based swap participant", as applicable. The CFTC and SEC would have joint rulemaking authority to further define who qualifies as a "major swap participant" or "major security-based swap participant". Notably, depending on how the CFTC and SEC define the qualifications for major market participants, many hedge funds and non-financial companies would likely be subject to further regulation, including joint CFTC-SEC capital and margin requirements, as described below.

[37] The Act provides no guidance as to what a "substantial net position" means for these purposes. There is no indication that it is intended as a measure of systemic significance, and no statutory standards or objectives are specified for the purpose of informing the determination.

[38] It is unclear whether the drafters expressly intended to limit this requirement in a way that excludes compliance with IFRS.

C. Banks; Non-U.S. Persons.

It should be noted that the Act would not limit its proposed registration and related regulatory requirements to U.S. persons. Additionally, the agencies' regulatory regimes would, by their terms, apply to the registered entity as a whole and would not be limited to a particular branch or even, necessarily, a U.S. branch of a foreign person such as a bank.

These consequences are particularly significant in light of the fact that the Act would preclude the agencies from granting exemptions, such as those available to foreign futures commission merchants and foreign broker-dealers under CFTC Part 30 and SEC Rule 15a-6, respectively, to ameliorate the unfettered extraterritorial application of the Act's provisions. Similarly, as noted above, if a foreign person were to become subject to the Act by virtue of its activities in the U.S. or with U.S. counterparties, nothing in the Act would appear to limit the extraterritorial application of substantive regulatory requirements, such as dealer confirmation requirements, to activities of the foreign person conducted outside the U.S. with non-U.S. counterparties.[39]

Prudential Requirements.

Swap and security-based swap dealers and major market participants that are banks subject to oversight by a "Prudential Regulator" would remain subject to the capital, margin and related prudential requirements set by such Prudential Regulator. The CFTC and SEC would, however, have the authority to prescribe business conduct, reporting and recordkeeping requirements with respect to such banks' swap and security-based swap activities.

For purposes of the Act, a Prudential Regulator would include:

- The Board of Governors of the Federal Reserve System ("FRB") in the case of a dealer or major market participant that is—
    - a state chartered bank that is a member of the Federal Reserve System; or
    - a state chartered branch or agency of a foreign bank;

[39] The SEC would, however, have limited exemptive authority with respect to persons subject to "substantially similar" requirements as security brokers or dealers. *See supra* note 36. Arguably, this exemptive authority might extend to non-U.S. persons exempt from registration as a security broker or a dealer under SEC Rule 15a-6. It seems more likely, however, to be intended to apply to firms registered with the SEC as OTC derivatives dealers (so-called "b-d lite" firms) or as broker-dealers subject to the SEC's regime for consolidated supervised entities.

- The Office of the Comptroller of the Currency in the case of a dealer or major market participant that is—
  - a national bank; or
  - a federally chartered branch or agency of a foreign bank; and
- The Federal Deposit Insurance Corporation in the case of a dealer or major market participant that is a state-chartered bank that is not a member of the Federal Reserve System.

As a result of this definition, a bank holding company group member or a foreign bank (with or without a U.S. branch) that conducts its swap business with U.S. counterparties from a foreign branch would not have a Prudential Regulator for these purposes and would be subject, potentially globally, to prudential and other substantive regulation by the CFTC and/or SEC depending on the scope of its activities. Foreign banks that are members of Tier 1 financial holding companies regulated as bank holding companies by the FRB, which are subject to comprehensive consolidated home country supervision deemed comparable to U.S. supervision by the FRB, will, with good reason, wonder why they should not be regarded as having the FRB as their "Prudential Regulator" for these purposes. The failure to recognize such home country supervision and FRB oversight can also be expected to raise eyebrows in the foreign supervisory community.

Prudential Regulators would be required to set minimum capital and initial and variation margin requirements for the bank dealers and major market participants they regulate. Specifically, the Act would require Prudential Regulators to set a non-zero capital requirement for cleared OTC derivatives, and higher capital requirements for those OTC derivatives that are not cleared.[40] Prudential Regulators would also be required to set initial and variation margin requirements for transactions that are not cleared OTC derivatives, except that such margin requirements would be optional in cases where one counterparty is (i) not a dealer or major market participant, (ii) using the OTC derivative as a hedge and (iii) predominantly engaged in non-financial activities[41] (as defined under the Bank Holding Company Act of 1956).[42] End-users entering into swaps for risk management or risk diversification purposes would not benefit from these provisions.

---

[40] Additionally, the FRB would be required to adopt capital requirements for both swaps and security-based swaps of bank holding companies, and for swaps of Tier 1 financial holding companies (as defined in the Administration's recently proposed systemic risk legislation) that are at least as strict as those adopted by Prudential Regulators.

[41] It is unclear why the Act would restrict this exception to persons engaged in non-financial activities.

[42] Although not clear, as drafted, it would appear that, in such cases, neither party to the transaction would be obligated to post margin.

With respect to dealers and major market participants that are not subject to oversight by a "Prudential Regulator", the CFTC and SEC would be required to jointly set minimum capital and initial and variation margin requirements. Rather than requiring that the agencies harmonize their capital and margin requirements with those set by the Prudential Regulators, the Act mandates that they impose requirements that are "as strict or stricter" than those set by Prudential Regulators.

Other Requirements.

Dealers and major market participants would additionally be subject to a comprehensive range of detailed substantive regulatory requirements, including:

- reporting and recordkeeping requirements, including maintenance of daily trading records and a complete audit trail;
- business conduct requirements, including verification of counterparty eligibility as an ECP and disclosure to counterparties of contract characteristics, fees, any "material incentives" and conflicts of interest;
- back office standards addressing timely and accurate confirmation, processing, netting, documentation and valuation of OTC derivatives;
- conflicts of interest, including information barriers between research and analysis personnel and trading and clearing personnel;[43] and
- antitrust considerations.

The level of detail specified with respect to the regulatory requirements set out in the Act here and in other provisions represents a marked departure from other statutory regimes for the regulation of financial markets. Certain of these business conduct requirements, in particular, such as required disclosure of any "material incentives" and contract characteristics, are extremely unclear and could go well beyond current disclosure obligations or practices, including in the context of retail securities transactions. These provisions raise the prospect of expanded disclosure that is not additive, but that is made purely for the sake of disclosure, simultaneously diluting the import of truly material disclosures and unnecessarily increasing compliance costs.

[43] The Act would also apply this requirement to futures commission merchants and introducing brokers.

V. Reporting and Recordkeeping Requirements.

In order to promote market transparency, the Act would require market facilities and, in certain circumstances, market participants, to comply with reporting and recordkeeping requirements.

- DCOs and swap repositories would be required to report information to the CFTC.

- Clearing agencies and security-based swap repositories would be required to report information to the SEC.

- Trade repositories would be required to make available, on a confidential basis, data (including individual counterparty trade and position data) to the CFTC, SEC, appropriate Federal banking agencies (as defined in Section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)), the Financial Services Oversight Council, the Department of Justice, foreign financial supervisors and others deemed appropriate by the CFTC or SEC, as applicable. Such disclosure, even on a confidential basis, may pose concerns for some market participants, particularly with respect to disclosure to, for instance, the Department of Justice.

- ASEFs would be required to maintain records, including a complete audit trail of transactions, and report information to the CFTC or SEC, as applicable.

- As discussed in Section III(C) above, any person entering into a swap or security-based swap transaction that is not centrally cleared would be required to report the transaction to a trade repository or to the CFTC or SEC, as applicable.[44] Any person entering into a transaction that is not cleared or submitted to a trade repository would additionally be required to keep books and records regarding its swap and security-based swap transactions open to inspection by the CFTC, SEC, appropriate Federal banking agencies (as defined in Section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)), the Financial Services Oversight Council and the Department of Justice. These reporting and recordkeeping requirements would be applicable to all persons, regardless of the level of their activities.

[44] These reporting requirements similarly would go well beyond the current reporting requirements applicable to futures and securities market participants.

The Act would not prescribe real time reporting, nor generally set forth specific standards for data collection, maintenance or frequency of reporting. Rather, the CFTC and SEC would prescribe such standards for swaps and security-based swaps, respectively.

The CFTC and SEC, or their designees, would be required to make publicly available aggregate data regarding trading volumes and positions for swaps and security-based swaps, respectively. This data would be made available in a manner that does not disclose the business transactions and market positions of any person. The Act does not specify the timing or format for publication of such data.

VI. Position Limits.

In measures designed to enhance the agencies' abilities to prevent fraud and market manipulation, the Act would significantly expand large trader reporting and position limit regulation.[45] The CFTC would be authorized to set position limits not only for U.S. listed futures contracts, but also for swaps that perform or affect a significant price discovery function with respect to regulated markets. In addition, the Act would authorize the CFTC to establish aggregate position limits across commodity contracts traded on DCMs and foreign boards of trade that permit remote terminal access in the U.S., as well as swaps that perform or affect a significant price discovery function with respect to regulated markets.

The SEC would be authorized under the Act to establish aggregate position limits for security-based swaps that perform or affect a significant price discovery function with respect to regulated markets. Perhaps more significantly, the SEC would also be authorized to impose aggregate position limits for securities listed on a national securities exchange. In addition, the Act would authorize the SEC to require that self-regulatory organizations set position limits for security-based swaps and the securities on which such security-based swaps are based.

The imposition of position limits with respect to listed securities such as single stock futures and listed options is not controversial. The application of such limits to common stock, however, would represent a potentially significant development, fraught with significant policy implications that go well beyond the objective of reforming the OTC derivatives markets. It is unclear how or why the Act intends the SEC to regulate corporate ownership through the imposition of position limits on listed securities. It is equally unclear why the drafters thought the Act would be an appropriate vehicle for the imposition of potentially far reaching restrictions on corporate ownership.

---

[45] The Act would also make other amendments to the CEA and the securities laws that enhance the agencies' anti-manipulation and anti-fraud authority with respect to swaps and security-based swaps.

The Act would also impose large trader reporting and recordkeeping requirements with respect to market participants' swap and security-based swap positions that perform or affect a significant price discovery function with respect to regulated markets that are similar to the program the CFTC currently has in place for futures contracts.

In determining whether a contract performs a "significant price discovery function" for position limit and reporting purposes, the agencies would be required to consider factors similar to those introduced into the CEA by the CFTC Reauthorization Act of 2008 with respect to exempt commercial markets[46] ("ECMs"), such as price linkage and reference, use for arbitrage purposes and liquidity.[47] Given these factors, it seems likely that reporting and position limit requirements under the Act would cover a broad range of OTC derivatives, well beyond those OTC derivatives overlying commodities that are deliverable under regulated futures contracts.

VII. Regulated Market Facilities.

As outlined in Section I above, the Act would generally impose parallel regulatory requirements under the CEA and the Exchange Act with respect to entities that intermediate or otherwise facilitate swap and security-based swap trades, and require that the CFTC and SEC adopt joint uniform rules with respect to their regulation of such market facilities. The Act would also require dual registration of such entities with the CFTC and SEC, but would generally authorize the agencies to exempt from their respective registration requirements entities subject to comparable, comprehensive supervision and regulation by certain other enumerated regulators, including Prudential Regulators.[48]

A. Clearinghouses.

The Act would, as discussed in Section III above, require that standardized swaps be cleared through a CFTC-registered DCO and standardized security-based swaps be cleared through an SEC-registered clearing agency. As discussed further in Section X,

---

[46] ECMs are electronic trading facilities that list derivatives on exempt commodities and are subject to CEA Section 2(h)(3).

[47] The Act would, however, otherwise repeal the ECM exemption from the CEA. Markets relying on this exemption would need to qualify as a DCM, an ASEF or a foreign board of trade if the Act were to become law.

[48] Note, however, that unlike its treatment of entities required to register as ASEFs, trade repositories and DCOs, the Act would not, by its terms, give the SEC similar exemptive authority with respect to entities required to register with it as clearing agencies with respect to their security-based swap activities, although, as noted above, DCOs would be permitted to clear security-based swaps under the Act.

the Act would also expand the regulatory core principles with which DCOs are currently required to comply under the CEA. Although the Act does not include a comparable set of core principles for clearing agencies, presumably because the requirements already imposed on clearing agencies under Section 17A of the Exchange Act were considered to be sufficient, it would, however, mandate that the CFTC and SEC harmonize their rules with respect to the regulation of DCOs and clearing agencies.

B. ASEFs.

Under the Act, any entity that operates a "facility for the trading of" swaps or security-based swaps would be subject to registration and regulation as an ASEF. The Act, however, includes no definition of an ASEF.[49] It is unclear how broad a universe of facilities this requirement is intended to capture. It is difficult to discern any principled basis on which to limit the scope of the requirement even in the context of facilities (*e.g.*, instant messaging systems or single dealer screens) that enable the communicating parties to enter into or terminate a swap. Although not clear, we assume that such a broad sweep was not intended.

The Act would subject ASEFs to many exchange-like regulatory requirements, including, notably, the establishment of rules regarding:

- trading and participation criteria;
- the financial integrity of transactions entered into on or through its facilities (including the clearing and settlement of such transactions);
- market surveillance and rule enforcement; and
- position limits and accountability.[50]

It seems clear from the foregoing that the Act contemplates that ASEFs will very closely resemble fully regulated exchanges. Many existing trading facilities will find it a challenge to comply with these requirements. Many existing trading facilities may also find that the Act's regulatory requirements effectively foreclose operation under their current business models.

[49] As described above, absent an exemption, the Act would require an ASEF to register with the CFTC even if it already is registered with the SEC and *vice versa*. The Act also includes no exemption from registration with the CFTC as a DCM, in the case of swaps, or from registration with the SEC as a national securities exchange, in the case of security-based swaps.

[50] It is unclear how an ASEF that has no clearinghouse would be expected to monitor, much less enforce, position limits.

C. Trade Repositories.

Under the Act, trade repositories that collect and maintain records of the terms and conditions of swaps and security-based swaps would also be subject to parallel registration and regulatory requirements under the CEA and Exchange Act, including inspection and examination requirements, as well as specific duties with respect to the repositories' acceptance, maintenance and reporting of trade data.

VIII. Certain Securities Law Issues.

A. Exchange Act Issues.

The Act would amend the beneficial ownership reporting provisions of Sections 13(d)(1), 13(f)(1) and 13(g)(1) of the Exchange Act to require reporting by any person who "becomes or is deemed to become a beneficial owner of [a reportable security] upon the purchase or sale of a security-based swap or other derivative instrument that the [SEC] may define by rule". The Act would also amend Section 16(f) of the Exchange Act to apply the provisions of Section 16 to ownership of and transactions in security-based swaps.[51]

It is not clear whether the proposed Section 13 amendments are intended to mean that a long security-based swap position automatically gives rise to beneficial ownership,[52] or could give rise to beneficial ownership depending on the circumstances, or whether the SEC is to define by rule[53] the circumstances in which such a long position would give rise to beneficial ownership (and, if either of the latter two, whether the criteria are different than those already applicable under SEC rules to an actual or deemed beneficial ownership determination).

The more persuasive reading of this provision may well be that security-based swaps would themselves give rise to beneficial ownership or deemed beneficial

[51] SEC rules under Sections 16(a) and 16(b) currently apply reporting and short swing profit disgorgement requirements to derivative securities, such as security-based swaps, leaving the import of this provision unclear. The reference to "ownership" of a security-based swap could be read to suggest that the drafters intended Section 16(b) to apply to persons whose only position in a stock is comprised of one or more security-based swaps.

[52] In this regard, the Act's reference to the "sale of a security-based swap" giving rise to beneficial ownership is confusing.

[53] An alternative, and perhaps more natural, reading of the SEC's rulemaking authority under this provision is that it extends only to defining which derivative instruments, other than security-based swaps, may confer beneficial ownership.

ownership of the underlying security. Read this way, the provision would resolve the issue litigated in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al*. (regarding the circumstances in which the long party to a total rate of return equity swap may be regarded as the beneficial owner of the underlying security). The resolution of this issue through deemed beneficial ownership, rather than by imposition of an independent reporting obligation (as the FSA has adopted in the U.K.), would represent a particularly unfortunate policy choice given the consequences of beneficial ownership under Exchange Act Section 16.

Beneficial ownership status by virtue of a security-based swap position would, under Section 16, give rise to "insider" status and, as a result, subject the "long" swap counterparty to short swing profit disgorgement liabilities. That status could, in addition, have a significant effect on large equity derivative transactions, such as certain issuer transactions, where the issuer's counterparty hedges through the establishment of a long security-based swap position that, when combined with its direct ownership position, would exceed the Section 16 threshold.

B. Securities Act Issues.

By including security-based swaps within the definition of "security", the Act would have the effect of requiring that each offer or sale of a security-based swap be registered with the SEC or exempt from registration. The Act's definition of "security-based swap", however, does not distinguish between long and short positions, suggesting that both parties to a security-based swap would be subject to Section 5 (*i.e.*, because each party can be viewed as offering or selling a security).[54] As a result, even an offer to acquire or acquisition of a long position would appear to require registration in the absence of an available exemption. This approach is inconsistent with the approach otherwise taken by the federal securities law regime, which generally does not impose a registration requirement in the context of the acquisition of a security.[55]

The proposed changes to Section 5 of the Securities Act would appear to confirm the Act's approach to registration. Section 5 would be amended to prohibit any person from offering to sell or selling, or offering to buy or purchasing, a security-based swap to or from[56] any person that is not an ECP unless there is a registration statement in

[54] The Act also would define the "purchase" or "sale" of a security-based swap to be deemed to cover a wide range of events—specifically, the "execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap".

[55] One exception to this general approach is the SEC position that a rescission offer following a violation of Section 5 by an issuer requires registration.

[56] The word "from" does not appear in the proposed statutory text, but would appear to be required to render it grammatically correct with respect to offers to buy and purchases.

effect for such security-based swap, even if the securities or the transactions otherwise would be exempt from registration under Section 3 or Section 4 of the Securities Act. Although it is not entirely clear how to construe this provision, it would appear to require each party to register its side of the trade if either the counterparty is not an ECP or an exemption from registration is unavailable (*e.g.*, where the counterparty is not an accredited investor and a private offering exemption is therefore unavailable). As a result, an ECP intending to take a synthetic long position in a security by entering into a security-based swap with a non-ECP counterparty would not be able to do so absent a registration statement covering the offer and sale by the ECP to the non-ECP, even if the counterparty were an accredited investor and the offer and sale were otherwise a good private placement.

Separately, as noted in Section III(B) above, the Act would prohibit the offer or sale of a security-based swap to a non-ECP other than on a national securities exchange. The bilateral registration requirements described above, however, could be read as effectively precluding participation on an exchange by non-ECPs (or even ECPs) if the registration requirement were read literally to apply to such persons and to require registration each time a new security-based swap is written.[57] It may be that, despite the foregoing provisions, it is the intent of the Act to implement a registration regime for clearing and exchange trading that is akin to that used for standardized stock options. Under that framework, the clearing agency, which acts as the counterparty to each side of each security-based swap, would in effect be the "issuer" for Section 5 purposes. Assuming it enjoyed the requisite exemptive authority with respect to security-based swaps, this approach would open the way for the SEC to develop a modified registration regime, as it did originally for standardized stock options, or to introduce an analog to Rule 238 under the Securities Act[58] to exempt such transactions from registration.[59]

In addition, the Act would, for purposes of the Securities Act, define an offer or sale of a security-based swap by or on behalf of the issuer of the underlying security, an affiliate of the issuer or an underwriter to be an offer or sale of the underlying security. Accordingly, in these cases, both the swap itself and the underlying security

---

[57] Presumably, such an approach would not be construed to raise general solicitation and general advertising concerns, which would render unavailable the ability to structure trades as private placements.

[58] Prior to the introduction in 2002 of Rule 238, the Options Clearing Corporation had a special shelf registration statement in place to satisfy Securities Act registration requirements. (The CFMA currently exempts security futures products from Securities Act registration directly at the statutory level.) *See* SEC Release No. 33-8171 (Dec. 23, 2002) (adopting Rule 238, as well as rules exempting standardized options from Exchange Act registration, and discussing the corresponding exemptions for security futures products under the CFMA).

[59] By contrast, to avoid the need for registration, the market for non-standardized security-based swaps would likely be limited to private placements in which each party is an ECP and an accredited investor.

would have to be registered or exempt from registration. For example, if an underwriter of a debt security in a registered offering were left with an unsold allotment, it might wish to hedge its exposure through a CDS. The underwriter presumably would structure the CDS as a private placement. In respect of the underlying debt security, however, the underwriter would have prospectus delivery obligations, which it generally could satisfy using a notice under Rule 173 under the Securities Act.

As noted in Section III(B) above, the Act would change the portion of the ECP definition relating to individuals from a test based on total assets of $10 million (or $5 million in certain circumstances) to a test based on amounts invested on a "discretionary basis". The Act does not, however, provide any guidance on how the term "discretionary basis" should be interpreted. Rather, it would require the CFTC and SEC to adopt joint rules regarding the ECP definition within 180 days of the Act's enactment. In developing this definition, the agencies could look to Rule 144A under the Securities Act, which excludes securities of an affiliate from the calculation of amounts invested on a "discretionary basis". If the agencies were to adopt the approach taken under Rule 144A, individuals who are able to qualify currently as ECPs based on their holdings of affiliate securities (*e.g.*, a CEO with a significant position in his employer's stock) potentially could be excluded.

IX. State Law.

The Act does not include a general preemption of potentially inconsistent state regulation of OTC derivatives.

A. Swaps.

However, under Section 2(a)(1)(A) of the CEA, as it would be amended by the Act, the CFTC would have exclusive jurisdiction with respect to swaps traded on a DCM or "any other board of trade, exchange, or market".

Additionally, Section 12(e)(2) of the CEA would provide for the preemption of state gaming and "bucket shop" laws (other than antifraud provisions of general applicability) in the case of exempt hybrid instruments and Treasury Amendment products (*e.g.*, certain foreign exchange products).

B. Security-Based Swaps.

The Act also includes a provision that would amend the Exchange Act to provide that: "No provision of State law regarding the offer, sale, or distribution of securities shall apply to any transaction in a security-based swap or a security futures product, except that this sentence shall not be construed as limiting any State antifraud law of general applicability."

While it seems clear that this provision should preempt state securities laws regarding the registration and qualification of securities (similar to the scope of preemption for "covered securities" under the National Securities Markets Improvement Act of 1996), it is unclear to what extent it might extend further.

It seems unlikely that this provision would preempt state insurance laws (*e.g.*, the model state insurance law initiative to regulate covered CDS as insurance and prohibit the sale of CDS that do not insure a specific risk). First, the McCarran-Ferguson Act of 1945 requires that any federal preemption of state insurance law be explicit. Additionally, the Obama Administration in a May 20, 2009 memorandum adopted a policy requiring that executive departments and federal agencies only preempt state law in their regulations when certain specified criteria are satisfied. These considerations suggest that this provision would likely not be construed as preempting the application of state insurance laws to OTC derivatives.

The Act would explicitly preempt the application of state gaming and "bucket shop" laws to (i) securities (except those that have a pari-mutuel payout or that are otherwise determined by the SEC to be appropriately subject to such laws), (ii) security-based swaps between ECPs and (iii) security-based swaps effected on a national securities exchange. The Act does not, however, appear to preempt state gaming or "bucket shop" laws with respect to retail OTC derivatives, a result that is not surprising given that the Act generally outlaws such transactions unless conducted on a national securities exchange.[60]

X. **DCO and DCM Core Principles**.

The Act would also expand the core principles with which DCOs and DCMs are currently required to comply under the CEA. With respect to DCOs, the expanded core principles would include enhanced standards for minimum financial resources, participant and product eligibility, risk management, settlement procedures, safety of member or participant funds and assets, default rules and procedures, system safeguards, disclosure, governance arrangements, conflict of interest mitigation, board composition and legal risk. Core principles applicable to DCMs would also be expanded

[60] Because the Act would expressly preempt the application of state gaming and "bucket shop" laws with respect to securities (except for those that have a pari-mutuel payout or that are otherwise determined by the SEC to be appropriately subject to such laws) and amend the Exchange Act to include security-based swaps within the definition of security, it could be interpreted as providing for preemption with respect to all those security-based swaps that do not have a pari-mutuel payout and are not otherwise determined by the SEC to be appropriately subject to state gaming and "bucket shop" laws. However given the Act's express preemptions for security-based swaps between ECPs and for listed security-based swaps, it seems relatively unlikely that such an interpretation was intended.

to include standards for trade execution that protect the price discovery process, minimum financial resources and system safeguards.

XI. **Foreign Boards of Trade**.

Similar to the House Agriculture Committee's "Derivatives Markets Transparency and Accountability Act of 2009" (H.R. 977), the Act would require the CFTC to adopt rules requiring foreign exchanges that permit remote terminal access in the U.S. to register with the CFTC and to adopt reporting and position limits requirements comparable to those applicable to CFTC-registered entities for all contracts that settle against the price of any U.S. listed futures contract or any swap traded on an exchange or on an ASEF.

The proposed registration requirement for foreign boards of trade is a step backward under the CEA and one that is certain to delay international progress on mutual recognition.

* * *

Please feel free to contact any of your regular contacts at the Firm or any of our partners or counsel listed under Derivatives in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax