Client Advisory

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Financial Services Regulatory Reform Legislation Moves Forward

Executive Summary

Financial services regulatory reform, in particular, the regulation of the over-the-counter derivatives markets and market participants, took a major step forward late last week when the Senate passed the Restoring American Financial Stability Act of 2010. Although the Senate bill in this regard follows the framework for the regulation set out in the companion bill passed by the House of Representatives in December 2009, it also differs from the House bill in several significant respects.

In particular, the Senate bill:

- requires banks to "push out" their swaps desks by denying federal assistance, including FDIC insurance, to any swaps entity;
- authorizes the several bank regulatory agencies to adopt rules prohibiting proprietary trading by banks;
- imposes a fiduciary duty on swap dealers that provide advice regarding swaps or enter into swap transactions with governmental entities, pension plans and retirement plans regarding these transactions;
- grants the CFTC exclusive jurisdiction over foreign exchange swaps and foreign exchange forward contracts, unless the Secretary of the Treasury determines that they should not be so regulated;
- adopts a narrow exemption from the mandatory swaps clearing and trading requirement for "commercial end users"; and
- requires any person that accepts funds or other collateral from a customer with respect to cleared swaps to be registered with the CFTC as a futures commission merchant.

A House-Senate conference committee will meet in June to reconcile the differences between the two bills, with a goal of sending a final bill to the president for signature before the July 4 recess.

Discussion

On May 20, 2010, the Senate passed the Restoring American Financial Stability Act of 2010, its version of a financial services regulatory reform bill (the Senate Bill). Although senators filed more than 400 amendments to the Senate Bill, only a relative handful were considered by the full Senate during three weeks of debate, and still fewer were approved.

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Among other provisions, the Senate Bill: (i) establishes a Financial Stability Oversight Council (Council), whose duties include identifying risks to the financial stability of the United States that could arise from the material financial distress or failure of large, interconnected bank holding companies or nonbank financial companies, and responding to emerging threats to the stability of the U.S. financial markets; (ii) establishes procedures for the orderly liquidation of financial firms whose resolution under other applicable federal or state law would have serious adverse effects on financial stability in the United States; (iii) provides for the regulation of advisers to hedge funds; (iv) provides for the regulation of the over-the-counter (OTC) derivatives markets; (v) authorizes the Federal Reserve Board to exercise supervision over "financial market utilities," including derivatives clearing organizations and securities clearing agencies; and (vi) requires credit ratings to be assigned by a rating agency chosen by a new Credit Rating Agency Board rather than by the issuer of the security.

A conference committee, to be comprised primarily of select members of the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs, will reconcile the differences between the Senate Bill and HR 4173, the Wall Street Reform and Consumer Protection Act of 2009, which the House approved in December 2009 (the House Bill). The Senate conferees are: Christopher Dodd (D-CT); Tim Johnson (D-SD); Jack Reed (D-RI); Charles Schumer (D-NY); Blanche Lincoln (D-AR); Patrick Leahy (D-VT); Tom Harkin (D-IA); Richard Shelby (R-AL); Bob Corker (R-TN); Mike Crapo (R-ID); Judd Gregg (R-NH); and Saxby Chambliss (R-GA). Barney Frank, chairman of the House Committee on Financial Services, will chair the conference committee, but the House is not expected to name its additional conferees until after the Memorial Day recess.

Both bills vest a significant amount of discretion in the several bank regulatory agencies, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) in promulgating rules to implement their provisions. Therefore, the full impact of the financial services regulatory reform legislation will not be known for some time.

This advisory focuses primarily on the provisions of Title VII, the Wall Street Transparency and Accountability Act of 2010, the provisions relating to the regulation of the OTC derivatives. An advisory on the provisions of the Senate Bill relating to the regulation of advisers to hedge funds will be issued separately.

Wall Street Transparency and Accountability Act of 2010

In general, Title VII of the Senate Bill follows the framework that was set forth in the House Bill and comprehensively regulates the OTC derivatives markets and major market participants. Like the House Bill, the Senate Bill encourages the migration of OTC derivatives transactions to regulated exchanges and clearinghouses. To facilitate review, the more significant differences between the two bills will be highlighted before turning to a discussion of those provisions that are similar.

Three provisions in the Senate Bill relating to the regulation of derivatives market participants that differ significantly from the House Bill deserve particular notice:

The "Push Out" Provision

Perhaps the most controversial provision of Title VII is section 716, which prohibits federal assistance to any "swaps entity" with respect to any swap, security-based swap or other activity of the swaps entity. A "swaps entity" is defined to include any swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, swap execution facility, exchange or clearing organization. Federal assistance includes advances from any Federal Reserve credit facility, discount window or, pursuant to the third undesignated paragraph of section 13 of the Federal Reserve Act, relating to emergency lending authority, and Federal Deposit Insurance Corporation insurance. The practical effect of this provision is to force banks to spin off, or "push out," their swaps desks to affiliates.

The House Bill does not contain a similar provision.

Limitation on Proprietary Trading

The Senate Bill includes a provision that could lead to a prohibition on proprietary trading by banks, including derivatives. Set out in Title VI, rather than Title VII, of the bill, section 619 authorizes the federal banking agencies, after consultation with the Council, to adopt rules to prohibit proprietary trading by an insured depository institution, a company that controls, directly or indirectly, an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956, and any subsidiary of such institution or company. In addition, the banking regulators are authorized to adopt rules to prohibit any such institution or company from sponsoring or investing in a hedge fund or a private equity fund.

Before the banking regulators adopt any such rules, the Council must first conduct a study to assess the extent to which such rules would, among other things: (i) promote and enhance the safety and soundness of depository institutions and the affiliates of depository institutions; (ii) protect taxpayers and enhance financial stability by minimizing the risk that depository institutions and the affiliates of depository institutions will engage in unsafe and unsound activities; (iii) limit the inappropriate transfer of federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the federal government to unregulated entities; (iv) reduce inappropriate conflicts of interest between the self-interest of depository institutions, affiliates of depository institutions and financial companies supervised by the Board of Governors, and the interests of the customers of such institutions and companies; (v) raise the cost of credit or other financial services, reduce the availability of credit or other financial services, or impose other costs on households and businesses in the United States; and (vi) limit activities that have caused undue risk or loss in depository institutions, affiliates of depository institutions and financial companies supervised by the Board, or that might reasonably be expected to create undue risk or loss in such institutions, affiliates and companies.

The study must be completed within six months of enactment. The banking regulatory agencies then have nine months to jointly adopt rules implementing the recommendations, if any, made by the Council. Banks and their affiliates will have two years after the adoption of any rules to divest any investments that may be prohibited by the rules.

The House Bill contains a more narrow provision, authorizing the banking regulators to restrict proprietary trading by a financial holding company "subject to stricter standards," i.e., a company the Federal Reserve Board determines could pose a threat to financial stability or the economy.

Fiduciary Duty

The Senate Bill imposes a fiduciary duty on swap dealers and security-based swap dealers that provide advice regarding swaps or security-based swaps or enter into swap transactions or security-based swap transactions with governmental entities, pension plans and retirement plans.

The House Bill contains no similar provision. Rather, the House Bill directs the SEC to promulgate rules imposing a fiduciary duty on brokers and dealers providing personalized advice regarding securities to retail investors.

The Senate Bill differs from the House Bill in other important respects as well.

Foreign Exchange Swaps and Forwards

The Senate Bill grants the CFTC exclusive jurisdiction over foreign exchange swaps and foreign exchange forward contracts, unless the Secretary of the Treasury (the Secretary) determines in writing that either or both of the foregoing should not be regulated as swaps and are not structured to evade the Senate Bill in violation of any rules promulgated by the CFTC. Consequently, such transactions will be subject to the mandatory clearing and mandatory trading requirements, which are discussed in greater detail below. Even if the Secretary makes a written determination that foreign exchange swaps and forwards should not be regulated as swaps, the Senate Bill nonetheless requires all foreign exchange swaps and foreign exchange forwards to be reported to either a swap data repository (described below) or, if no swap data repository is available, to the CFTC.

In contrast, the House Bill excludes foreign exchange swaps and forward contracts from the definition of a swap and consequently the jurisdiction of the CFTC, unless the CFTC finds that they should be regulated as swaps and the Secretary agrees.

Conflicts of Interest

The Senate Bill contains several provisions designed to mitigate potential conflicts of interest. In particular, the bill requires the agencies to determine whether to establish limits on the control of any entity that clears or facilitates the trading of swaps or security-based swaps by a bank holding company with total consolidated assets of $50,000,000,000 or more, a nonbank financial company supervised by the Board of Governors of the Federal Reserve System, an affiliate of such a bank holding company or nonbank financial company, a swap or securities-based swap dealer, major swap participant or major security-based swap participant or their associated persons within 180 days after the date of enactment of the Senate Bill. Each agency must adopt such rules if it determines that they are necessary or appropriate to mitigate systemic risk, promote competition or mitigate conflicts of interest.

The House Bill adopts a significantly different tack in addressing potential conflicts of interest. The so-called Lynch Amendment prohibits "restricted owners" from acquiring, directly or indirectly, in the aggregate, more than 20% of the beneficial ownership of a designated contract market, securities exchange, swap execution facility, derivatives clearing organization or securities clearing organization. Further, a majority of the board of directors of each such entity may not be associated with a restricted owner. A "restricted owner" is defined as: (1) any swap dealer, security-based swap dealer, major swap participant or major security-based swap participant that is an identified financial holding company; (2) a person associated with a swap dealer or a major swap participant that is an identified financial holding company; or (3) a person associated with a security-based swap dealer or major security-based swap participant that is an identified financial holding company.

End-User Exemption

As discussed below, the Senate Bill exempts from the mandatory clearing and mandatory trading requirements transactions entered into between a swap dealer or major swap participant and a "commercial end user." The term "commercial end user" is narrowly defined to mean any person other than a "financial entity" that, as its primary business activity, owns, uses, produces, processes, manufactures, distributes, merchandises or markets goods, services or commodities. A "financial entity" includes swap dealers, major swap participants, banks, commodity pools and investment funds.

Although the House Bill provides a similar exemption from the clearing and trading requirements for entities that are not swap dealers or major swap participants, the bill does not define "end users" and permits entities hedging financial risk to take advantage of the exemption. Specifically, the House Bill provides that, to take advantage of the exemption, the entity (i) must use swaps to hedge or mitigate commercial risk, including operating or balance sheet risk, and (ii) notify the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps.

Swap Execution Facilities

As discussed below, the Senate Bill provides that swaps and security-based swaps that are cleared are required to be executed on an exchange or a swap execution facility. The House Bill contains similar provisions. However, the Senate and House bills differ significantly in the definition of a "swap execution facility." As defined in the Senate Bill, a "swap execution facility" is a facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that (i) facilitates the execution of swaps between persons, and (ii) is not a designated contract market.

The House Bill defines a "swap execution facility" more broadly to include a person or entity that facilitates the execution or trading of swaps between two persons through any means of interstate commerce, but which is not a designated contract market, including any electronic trade execution or voice brokerage facility.

Segregation/Bankruptcy Protection

The Senate Bill provides that any person that accepts funds or other collateral from a customer with respect to cleared swaps must be registered with the CFTC as a futures commission merchant (FCM), and persons who engage in similar activities with respect to security-based swaps must be registered as broker-dealers or security-based swap dealers with the SEC. The Senate Bill imposes segregation requirements on FCMs, broker-dealers and security-based swap dealers with respect to cleared swaps that are similar to those that currently apply to futures transactions. The Senate Bill further provides that cleared swaps shall be deemed to be "commodity contracts" under the Bankruptcy Code, and amends the definition of this term in the Bankruptcy Code to include transactions that are cleared by a derivatives clearing organization (DCO). The purpose of these latter amendments is to assure that customers trading cleared swaps receive the same priority in the event of an FCM default as customers trading futures executed on a designated contract market.

Both the Senate and House Bills require swap dealers to hold customer funds that are received in connection with non-cleared swaps in a separate segregated account. The House Bill, however, is silent with respect to cleared swaps. (The committees considering the bill may have assumed that such requirements would apply.) Moreover, the House Bill does not require any person that accepts customer funds with respect to cleared swaps to be registered as an FCM, although such persons would be registered as swap dealers or major swap participants. Finally, the House Bill does not contain amendments to the Bankruptcy Code.

Retroactive Application

Both the Senate and the House bills provide that swaps entered into prior to date of enactment of the legislation are not required to be cleared. However, although the House Bill further provides that counterparties to such swaps are not required to meet the margin requirements adopted by the CFTC and SEC under the bills, the Senate Bill contains no similar relief.

The remaining provisions of Title VII of the Senate Bill that are discussed below are similar in material respects to the parallel provision of the House Bill.

Expansion of Regulatory Authority Over Swaps

General

The Senate Bill amends the Commodity Exchange Act (the CEA) to remove the broad exemptions applicable to swap agreements under sections 2(d), 2(e), 2(g) and 2(h) of the CEA and give the CFTC exclusive jurisdiction over all swaps other than security-based swaps. The Senate Bill also amends the Securities Exchange Act of 1934 (the Exchange Act) to give the SEC jurisdiction over security-based swaps by revising the definition of the term "security" to include these instruments.[1] It is important to note, however, that the Senate Bill distinguishes between security-based swaps and security-based swap agreements, and that the SEC's authority over both of these types of transactions varies for different purposes under the Exchange Act. Under the Senate Bill, the term "security-based swap" includes only swaps that are based on a single security or a narrow-based security index. By contrast, the Gramm-Leach-Bliley Act's definition of the term "security-based swap agreement" is not so limited, and applies to those instruments and to broad-based securities indices. As a result, the amendments to the Exchange Act reflected in the Senate Bill apply to a more limited set of transactions than the above-cited provisions of the Exchange Act.[2]

The Senate Bill gives the SEC authority over persons that effect transactions in security-based swaps and imposes registration requirements on persons that effect transactions or provide services with respect to these swaps. However, the Senate Bill leaves unaffected the SEC's existing authority over security-based swap agreements (defined in Section 206A

[1] However, swaps involving government securities are not deemed to be security-based swaps under the Exchange Act.

[2] The Senate Bill amends Section 9 of the Exchange Act to apply the anti-manipulation provisions set forth therein to both security-based swaps and security-based swap agreements.

of the Gramm-Leach-Bliley Act) that are based on securities and securities indices under sections 10 (antifraud), 16 (short swing profit recapture), 20 (control person liability) and 21A (civil penalties for insider trading) of the Exchange Act.

We also note that the Senate Bill gives the CFTC jurisdiction over security-based swap agreements by including them within the definition of the term "swap" under the CEA. While it is not clear, this may mean that persons that engage in transactions involving these agreements are subject to the jurisdiction of the CFTC for some purposes (e.g., registration, mandatory trading and clearing, etc.) and are subject to the jurisdiction of the SEC for other purposes (e.g., antifraud, short swing profit recapture, insider trading). In this regard, the agencies are required to jointly adopt rules to define the term "security-based swap agreement."

The Senate Bill allocates jurisdiction over credit default swaps (CDS) to the CFTC and the SEC. Under the Senate Bill, a CDS on a single security or a narrow-based security index is a security-based swap and thus subject to the jurisdiction of the SEC. Subject to the exception for mixed swaps described below, all other CDS transactions are subject to the jurisdiction of the CFTC.

Security-based swaps that are also based on the value of one or more commodities or other measures of value ("mixed swaps") are subject to the joint jurisdiction of the CFTC and the SEC, and the agencies are required to jointly adopt rules and regulations relating to mixed swaps.

Reciprocal Jurisdiction over Exempted Products

The Senate Bill provides that the CFTC or the SEC, as applicable, will have jurisdiction over financial products that the other agency has exempted from its jurisdiction to the extent that such exemption was contingent on the assertion of jurisdiction over such financial product by the other agency. Thus, for example, if the CFTC exempts a financial product from its jurisdiction contingent on the assertion of jurisdiction by the SEC over such financial product, then such financial product shall be deemed to be a "security" for purposes of the federal securities laws.

Novel Derivative Products

The Senate Bill provides that a person who files a proposal to list or trade a novel derivative product that may contain the elements of both a futures contract and a security (or any option thereon) may make such filing with the CFTC and SEC concurrently. Thereafter, each agency may request that: (i) the other agency determine whether the product falls within its jurisdiction, or (ii) the other agency grant such product an exemption from its jurisdiction. Within 120 days after the receipt of this request, the relevant agency must either issue the requested determination or grant or deny the requested exemption and, if applicable, state its reasons for such denial.

Expansion of Registration Requirements

The expansion of regulatory authority noted above will also expand the registration requirements for persons who effect transactions in or advise persons with respect to swaps and other financial instruments. For example, the Senate Bill expands the definition of the term "futures commission merchant" (and with it, CFTC registration and other requirements) to include any person that solicits or accepts orders for swaps, retail foreign exchange transactions, commodity options transactions or leverage transactions and accepts money or property (or extends credit in lieu thereof) as margin in connection therewith. Similarly, any person that raises capital to operate an investment trust that is formed for the purpose of engaging in any of the foregoing transactions will fall within the definition of the term "commodity pool operator" under the CEA.

The expansion of the registration requirements under the federal securities laws is not as straightforward. For example, the Senate Bill amends the definition of the term "security" under the Exchange Act to include security-based swaps. As a result, any person who effects transactions in security-based swaps for the accounts of others will fall within the definition of the term "broker" under the Exchange Act. However, the Senate Bill provides that the term "dealer" only includes persons that effect transactions in securities (which includes security-based swaps) for their own accounts with persons that are not

eligible contract participants, and provides a separate registration category for security-based swap dealers. Further, the Senate Bill does not amend the definition of the term "security" in the Investment Advisers Act of 1940 or in the Investment Company Act of 1940 to include security-based swaps.

The Senate Bill prohibits the National Futures Association (NFA) from issuing any rule or asserting jurisdiction over any security-based swap, except as necessary to examine its members for compliance with its advertising and capital adequacy rules. A similar provision applies to the Financial Industry Regulatory Authority (FINRA) with respect to all other swaps.

Registration Requirements for Significant Swap Market Participants

General

The Senate Bill requires swap dealers and major swap participants" to register as such with the CFTC, and requires security-based swap dealers and major security-based swap participants to register as such with the SEC.[3] Under the Senate Bill, a "swap dealer" is a person that (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly engages in the purchase and sale of swaps in the ordinary course of business; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker. However, the term "swap dealer" does not include a person that buys or sells swaps for its own account, but not as a part of a regular business. The same definitions and exclusions apply to persons that effect transactions in security-based swaps.

A "major swap participant" is a person, other than a swap dealer: (i) that maintains a substantial position in any category of swaps (excluding positions held primarily for hedging or mitigating commercial risk[4] and positions maintained by any employee benefit plan for the purpose of hedging or mitigating risks directly associated with the operation of the plan); (ii) whose outstanding swaps create counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (iii) that is a "financial entity"[5] (other than a financing affiliate of an entity selling merchandise or manufactured goods) that is highly leveraged relative to the amount of capital it holds, and maintains a substantial position (as defined by the CFTC) in outstanding swaps in any major swap category (as defined by the CFTC). The same definitions and exclusions apply to transactions in security-based swaps that are effected by security-based swap dealers and major security-based swap participants.

The definitions of "swap dealer," "security-based swap dealer," "major swap participant" and "major security-based swap participant" in the House Bill are essentially the same.

Capital and Margin Requirements

The Senate Bill requires the CFTC and the SEC to impose minimum capital requirements on all registered swap dealers and all registered major swap participants (other than depository institutions), and requires these minimum capital requirements to be substantially higher for uncleared swaps than cleared swaps (discussed below).[6] The CFTC and SEC must ensure that these requirements are at least as strict as the capital requirements prescribed for swap dealers and major swap participants that are depository institutions. In addition, the Senate Bill requires the CFTC and the SEC to impose minimum margin requirements on uncleared swap transactions, subject to an exception where one of the parties to the uncleared swap is not a swap dealer, major swap participant or financial entity, and such party qualifies for the commercial end-user exemption from mandatory clearing (discussed below).

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[3] A person may be subject to dual registration, and thus may be required to be registered as a swap dealer or major swap participant with the CFTC and as a security-based swap dealer or major security-based swap participant with the SEC.

[4] The Act provides the CFTC with the authority to define the term "commercial risk."

[5] A "financial entity" includes swap dealers, major swap participants, banks, commodity pools and investment funds.

[6] In setting capital standards, the Agencies and the banking regulators may take into consideration any unregulated activities conducted by a registered swap dealer or registered major swap participant.

Other Requirements

All registered swap dealers and all registered major swap participants must (1) comply with various reporting and recordkeeping requirements; (2) conform to certain business conduct, documentation and back-office standards; and (3) comply with requirements relating to position limits, disclosure, conflicts of interest and antitrust considerations, and the Senate Bill requires the CFTC and SEC to adopt rules relating to these requirements. However, the CFTC and SEC may not prescribe prudential requirements for swap dealers and major swap participants for which there is a banking regulator.

Mandatory Clearing

The Senate Bill generally requires any person that is a party to a swap or a security-based swap to submit the swap for clearing to a DCO that is either registered as such under the CEA or exempt from registration or a registered securities clearing agency, as applicable. These mandatory clearing requirements do not apply, however, to transactions in swaps or security-based swaps if no clearinghouse accepts the swap or security-based swap for clearing. Further, if a swap is otherwise subject to mandatory clearing and one of the counterparties to the swap is a commercial end user,[7] the end user has the option to determine whether or not that swap will be cleared. If the end user elects to clear the swap, it may choose the clearinghouse at which the swap will be cleared if it is using the swap to hedge its own commercial risk.

However, the agencies may stay the application of this mandatory clearing requirement to a swap or class of swaps at the request of a counterparty or on their own initiative. At the end of this review, the relevant agency must determine whether the swap or class of swaps must be subject to mandatory clearing or may be excused from this requirement.

The agencies must adopt rules to specify the types of swaps that must be accepted for clearing, and may do so without complying with the notice and comment procedures set forth in the Administrative Procedure Act. Further, the agencies may promulgate rules that are designed to prevent the evasion of the mandatory clearing requirements.

Any clearinghouse that desires to clear swaps or security-based swaps must request the prior approval of the relevant agency before it may clear any swap or security-based swap, and the agencies must take final action on these requests within 90 days after such a request is made. Clearinghouses that desire to clear swaps or security-based swaps generally must do so on a non-discriminatory basis and accept for clearing swaps that were executed on a bilateral basis or on an unaffiliated exchange or swap execution facility. These clearinghouses also must permit the offset of all economically equivalent swaps and security-based swaps that are cleared through their facilities regardless of where the transaction was executed.

For swaps that are subject to mandatory clearing and are between a swap dealer or major swap participant and a financial entity, the financial entity has the sole right to determine where the swap will be cleared. A financial entity or commercial end user that enters into a swap with a swap dealer or major swap participant that is not required to be cleared has the option to require the swap to be cleared and to choose the clearinghouse that will clear the swap.

Customer Protection Requirements

In addition to the segregation requirements and Bankruptcy Code amendments discussed above, the Senate Bill requires a swap dealer or major swap participant, in connection with uncleared swaps, to notify its counterparty at the beginning of a swap transaction that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee or secure the obligations of the counterparty. If the counterparty requests, the swap dealer or major swap participant must segregate the funds or other property for the benefit of the counterparty and maintain the funds or other property in a segregated account separate from its own property. The segregated account must be carried by an independent third-party custodian and must be designated as a segregated account being held for and on behalf of the

[7] The term "commercial end user" means any person other than a "financial entity" (discussed below) who, as its primary business activity, owns, uses, produces, processes, manufactures, distributes, merchandises or markets goods, services or commodities. A "financial entity" includes swap dealers, major swap participants, banks, commodity pools and investment funds.

counterparty. If the counterparty does not choose to require segregation, a swap dealer or major swap participant must notify the counterparty on a quarterly basis that its back-office procedures relating to margin and collateral satisfy the requirements set forth in any agreement between the parties. The same provisions generally apply to transactions in uncleared security-based swaps that are effected by security-based swap dealers and major security-based swap participants. However, this segregation option is not available to counterparties that effect uncleared security-based swap transactions.

The requirements described above do not apply to variation margin payments or preclude any commercial arrangement regarding the investment of segregated funds or other property pursuant to CFTC or SEC rules.

Registration Requirements for Swap Clearinghouses

The Senate Bill requires clearing organizations that clear swaps to register as DCOs with the CFTC, and requires clearing agencies that clear security-based swaps to register with the SEC. The Senate Bill specifies core regulatory principles for these registrants, including standards for minimum financial resources, participant and product eligibility, risk management, and safety of member or participant funds and assets.

A person that is required to be registered as a DCO must register as such with the CFTC regardless of whether it is also licensed as a depository institution or as a clearing agency registered with the SEC. However, any depository institution or clearing agency registered with the SEC that is required to be registered as a DCO under the Senate Bill is deemed to be registered to the extent that it cleared swaps before the Senate Bill becomes law. Further, the CFTC may exempt a DCO from registration if it determines that it is subject to comparable comprehensive supervision and regulation by the SEC or the appropriate government authorities in the home country of the organization.

A DCO that clears security-based swaps is not also required to be registered as a clearing agency with the SEC unless the SEC finds that the DCO is not subject to comparable comprehensive supervisions and regulation by the CFTC. Further, the SEC may exempt a clearing agency from registration if it determines that it is subject to comparable comprehensive supervision and regulation by appropriate government authorities in its home country.

Mandatory Exchange Trading

The Senate Bill amends the CEA and the Exchange Act to require that all swaps and security-based swaps effected by persons who are not eligible contract participants (ECPs) be traded on a designated contract market or a registered national securities exchange. In addition, the Senate Bill amends the CEA to require all transactions in swaps that are subject to mandatory clearing be traded on a designated contract market or a registered swap execution facility (SEF) (described below), and amends the Exchange Act to require all standardized security-based swap transactions to be traded on a national securities exchange or an SEF. These requirements do not apply if no designated contract market, national securities exchange or swap execution facility makes the swap available for trading or to transactions where a commercial end user opts out of the mandatory clearing requirement.

Swap Execution Facilities

As noted above, the Senate Bill generally requires transactions in swaps that are subject to mandatory clearing be effected on a designated contract market, a national securities exchange or an SEF. Thus, the Senate Bill requires a facility for the trading of swaps or security-based swaps to register with the CFTC or SEC, as appropriate, as an SEF. In general, a registered SEF would be subject to certain requirements relating to trading procedures, the deterrence of trading abuses, and the financial integrity of transactions. The Senate Bill also establishes core regulatory principles for SEFs relating to enforcement, position limits, emergency powers, recordkeeping and reporting, and conflicts of interest.

The Senate Bill provides for dual registration, and an SEF that is registered as such with the CFTC also may be required to register as such with the SEC. However, each agency may exempt an SEF from registration if it determines that the SEF is subject to comparable comprehensive supervision and regulation by the other agency or by appropriate government authorities in its home country.

Reporting and Recordkeeping Requirements

The Senate Bill requires parties who enter into uncleared swap transactions to report such transactions to a registered swap data repository (described below) or one of the agencies. Under the Senate Bill, no person could act as a swap data repository unless it is registered with the appropriate agency, and a person that is required to register as a swap data repository with one agency may still be required to register as such with the other agency.

Once registered, a swap data repository is required to accept, maintain and make available swap data as prescribed by the appropriate agency, and is subject to inspection and examination. The Senate Bill directs each agency to adopt rules governing entities that register as swap repositories.

The Senate Bill authorizes the agencies to require the real-time public reporting of swap transaction data for swaps that are subject to the mandatory clearing and swaps that are not subject to the mandatory clearing requirement but which are cleared at a registered swap clearinghouse. For swaps that are not cleared at a registered swap clearinghouse but are reported to a swap data repository or an agency, the agency must make available to the public aggregate data on such swap trading volumes and positions in a manner that does not disclose the business transactions and market positions of any person.

Eligibility Requirements

The mandatory exchange trading provisions proposed in the Senate Bill do not apply to swaps entered into by ECPs, which under existing law includes government entities that invest at least $25 million on a discretionary basis. Under the Senate Bill, this monetary threshold is increased to $50 million. In addition, to qualify as an ECP, an individual must have $10 million in assets invested on a discretionary basis, rather than total assets in excess of $10 million as provided under current law.

The Senate Bill also permits the agencies to establish conduct standards for a swap dealer or major swap participant in dealing with an ECP that is a governmental entity, which requires them to believe that such entity has engaged an independent representative that (i) has sufficient knowledge to evaluate the transaction and risks; (ii) is not subject to a statutory disqualification; (iii) is independent of the swap dealer or major swap participant; (iv) undertakes a duty to act in the best interests of the counterparty it represents; (v) makes appropriate disclosures; and (vi) will provide written representations to the governmental entity regarding fair pricing and the appropriateness of the transaction.

Speculative Position Limits

The Senate Bill authorizes the CFTC to adopt and enforce speculative position limits aggregated across (i) contracts listed on designated contract markets (DCMs); (ii) contracts listed on a foreign board of trade that provides direct access from the United States to its electronic trading and order matching system; (iii) swaps traded on or subject to the rules of an SEF; and (iv) swaps that are not traded on an SEF and perform or effect a significant price discovery function with respect to a DCM or DCO. In determining whether a swap contract performs a price discovery function, the CFTC is instructed to consider, among other factors, the extent to which the swap uses or otherwise relies on a daily or final settlement price, or other major price parameter, of another contract traded on a regulated market based on the same underlying commodity, to value, transfer or convert, or financially settle or close out a position.

Foreign Boards of Trade

The Senate Bill prohibits a foreign board of trade from authorizing direct access from the United States with respect to contracts that settle against a contract listed for trading on a DCM, unless the CFTC determines that the foreign board of trade (i) makes public daily trading information regarding the contract that is comparable to the information made available by the DCM that lists the contract against which the contract traded on the foreign board of trade is settled; (ii) adopts position limits comparable to the position limits adopted by the DCM against which the contract traded on the foreign board of trade is settled; (iii) has authority to require market participants to limit, reduce or liquidate positions that such foreign board of trade determines is necessary to prevent or reduce the threat of price manipulation, excessive

speculation, price distortion or disruption of delivery or the cash settlement process; and (iv) agrees to provide the CFTC with information regarding large trader positions and other information necessary to publish reports on traders' aggregate positions.

The provisions regarding foreign boards of trade will not be effective with respect to those boards of trade that already have direct access to U.S. market participants until 180 days following enactment of the Senate Bill.

The provisions of the House Bill are similar.

Margin

The Senate Bill amends the CEA to permit the CFTC to establish margin requirements for DCOs if such requirements are limited to protecting the financial integrity of the DCO, are designed to protect the financial integrity of transactions, and do not establish specific amounts that must be collected by the DCO as margin.

The provisions of the House Bill are similar.

Miscellaneous Provisions

Over-the-Counter Retail Commodity Transactions

The Senate Bill prohibits any person from entering into, or offering to enter into, a transaction in any commodity with a person that is not an ECP or an eligible commercial entity, on a leveraged or margined basis. The prohibition does not apply if the transaction results in actual delivery within 28 days, or creates an enforceable obligation to deliver between a seller and a buyer that have the ability to deliver, and accept delivery of, the commodity in connection with their lines of business.

Prohibition against Foreign Participation

The Senate Bill generally provides that the CFTC or the SEC, in consultation with the Secretary, may prohibit any foreign entity from participating in swaps or security-based swaps in the United States if they determine that the regulation of these financial instruments in such entity's jurisdiction undermines the stability of the U.S. financial system.

Facilitation of Fraud on Third Parties

Under the Senate Bill, it is unlawful for any person to enter into a swap knowing, or acting in reckless disregard of the fact, that its counterparty will use the swap as part of a device, scheme or artifice to defraud any third party.

Exclusion from Insurance Laws

The Senate Bill provides that swaps and security-based swaps shall not be considered to be insurance, and shall not be regulated as insurance contracts, under any state law.

Implementation

The Senate Bill requires each of the CFTC and the SEC to adopt final rules, within 180 days after the enactment of the Senate Bill, that implement the provisions set forth in the bill. In adopting these rules, the agencies must consult and coordinate with each other to ensure that their rules are consistent to the extent possible and consider the views of the other relevant prudential regulators. The agencies are required to treat functionally or economically similar products and entities in a similar (but not identical) manner. Finally, as noted above, the agencies are required to jointly adopt rules to define the term "security-based swap agreement" and to prescribe regulations relating to mixed swaps.[8]

[8] As noted above, the agencies each appear to have jurisdiction over these types of financial instruments.

Tax Implications

The mandatory exchange trading requirements for swaps and security-based swaps described above may permit these swaps to qualify as Section 1256 contracts under the Internal Revenue Code (the IRC). Under Section 1256 of the IRC, each Section 1256 contract is marked-to-market annually for U.S. federal income tax purposes. Any gain or loss recognized from marking these contracts to market and from the actual disposition of these contracts generally is treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss.

However, the availability of this tax treatment for these transactions may be short lived. President Obama's Fiscal 2011 Revenue Proposals include a provision to require "commodity dealers" (among others) to recognize any income (including mark-to-market income) arising from their day-to-day dealer activities with respect to Section 1256 contracts as ordinary income. For this purpose, a "commodity dealer" is any person who is actively engaged in trading Section 1256 contracts and is registered with a designated contract market.

Significant Banking Issues

In addition to the issues discussed above, the Senate Bill contains many provisions relating to bank regulatory matters that are expected to draw considerable attention during conference. Some of the more significant issues include the following:

Capital Requirements

The Senate Bill requires that bank regulators set minimum capital levels for holding companies that are as strong as those required for their insured depository subsidiaries. The House Bill does not contain a similar provision.

Scope of Federal Reserve Jurisdiction

The Senate Bill permits the Federal Reserve to continue to exercise supervisory and regulatory jurisdiction over state member banks and smaller holding companies. The House Bill limits the Federal Reserve's supervisory jurisdiction to large bank holding companies.

Consumer Protection

The House Bill establishes a new independent Bureau of Consumer Financial Protection, while the Senate Bill provides for this bureau to be a part of the Federal Reserve.

Interchange Fees

The Senate Bill provides for interchange fees (so-called swipe fees) to be curtailed and set by the Federal Reserve under a restrictive "reasonable and proportional cost" per transaction standard. The House Bill does not contain a similar provision.

Federal Preemption of State Law

The Senate Bill preserves the national regulation of U.S. financial institutions by protecting the standard for national bank preemption set forth in the 1996 Supreme Court decision *Barnett Bank of Marion County, N.A. v. Nelson*. The Senate Bill does not contain a requirement that no preemption of state law can occur unless a "substantive standard" regulating the "particular conduct, activity or authority" exists at the federal level. The House Bill contains a similar provision, but the language in the House Bill is not as strong as the language in the Senate Bill.

Savings Bank Charters

The Senate Bill "freezes" the granting of federal thrift charters, while the House Bill continues to allow such charters to be granted and also creates national mutual banks.

"Skin in the Game" Requirement for ABS Issuers

The Senate Bill requires issuers of securitized obligations to retain not less than 5% of the credit risk for any asset that is transferred, sold or conveyed through an asset-backed security, but also provides important exceptions with respect to mortgage securitizations. The House Bill contains a similar provision, but the exceptions to the 5% requirement in the House Bill are not as generous as the exceptions set forth in the Senate Bill.

Text of H.R. 4173 as passed by the Senate may be found here

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173eas.txt.pdf

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