

Are You Ready for Derivative Reform? Congress to Reconcile Proposed Derivative Legislation

Sweeping derivatives reforms are pending as the House and the Senate hand down new regulations for swaps and security-based swaps, imposing clearing, exchange trading, capital, margin, registration, reporting, recordkeeping, and business conduct requirements.

May 28, 2010

On May 20, the United States Senate passed the Restoring American Financial Stability Act of 2010 (the Senate bill) in response to the current financial crisis. Title VII of the Senate bill, titled the Wall Street Transparency and Accountability Act of 2010, contains significant proposed changes to the manner in which derivatives will be regulated. The Senate bill will be reconciled with a similar bill (H.R. 4173) which was passed by the House of Representatives on December 11, 2009, titled the Wall Street Reform and Consumer Protection Act of 2009 (the House bill), which also provides for sweeping derivatives reform. This LawFlash summarizes certain important aspects of the bills.

Regulation of Swaps and Security-Based Swaps

Both the Senate bill and the House bill seek to regulate the over-the-counter derivatives market by:

- (i) Defining the terms “swap” and “security-based swap” broadly, to include almost any agreement or transaction where payments under the agreement or transaction are determined by reference to the value or level of an underlying asset, index, or quantitative measure, and
- (ii) Imposing clearing, exchange trading, capital, margin, registration, reporting, recordkeeping, and business conduct requirements on such agreements or transactions and certain parties thereto.

A swap under both the Senate and House bills includes, among other things, puts, calls, caps, floors, collars, and options on rates, currencies, commodities, securities, debt, indices, quantitative measures, interests, or property. It also includes transactions where payments are dependent upon the occurrence, nonoccurrence, or extent of an occurrence of an event associated with a financial, economic, or commercial consequence. Finally, the term includes transactions (such as typical swap transactions) that provide for the exchange of payments based upon the value or level of rates, currencies, commodities, securities, debt, indices, quantitative measures, interests, or property and transfer

financial risk associated with the change in value of such underlier without conveying an ownership interest in the underlier. Permutations of and options on all of the foregoing also constitute swaps.

Foreign exchange swaps and forwards are treated differently under the Senate and House bills, with the House bill excluding them from the definition of swap, unless the Commodity Futures Trading Commission (CFTC) determines otherwise, and the Senate bill including them in the definition, unless the Secretary of the Treasury determines otherwise.

Security-based swaps are swaps related to securities, loans, narrow-based securities indices, and events relating to issuers of securities affecting the financial condition thereof, such as credit default swaps.

There are only a few other exclusions from the expansive definition of swap and security-based swap. Generally, those exclusions relate to listed futures, physically settled commodity or security transactions, options subject to the Securities Act and Securities and Exchange Act (e.g., listed options), listed foreign currency options, agreements providing for the purchase of securities registered under the Securities Act and the Securities Exchange Act, debt securities, agreements entered into by issuers as part of the capital raising process, and transactions with the Federal Reserve, the federal government, or certain federal agencies. Attempts by certain legislators to expand the list of excluded transactions have not been successful to date. If no additional exclusions are incorporated into the bills, it is likely that agreements and transactions that customarily would not be considered to be swaps or derivatives may be captured by the bills.

Both the Senate bill and the House bill are worded in goal-oriented terms, and contain only a few specifics as to how they will be implemented if enacted. Each bill gives the CFTC and the U.S. Securities and Exchange Commission (SEC) (and, to some extent, applicable banking authorities) broad authority to promulgate rules relating to the implementation of the legislation. Generally, the CFTC would regulate swaps and participants in that market and the SEC would regulate security-based swaps and participants in that market. The Senate bill requires the two agencies to coordinate and harmonize their respective regulation, whereas the House bill requires joint rulemaking in many cases.

Regulation of Certain Swap Parties

Certain swap parties will be subject to enhanced regulation under the Senate bill and the House bill. Clearing, exchange trading, capital, margin, registration, reporting, recordkeeping, and business conduct requirements will be imposed upon swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants (collectively, covered participants).

Swap dealers and security-based swap dealers will include those persons who hold themselves out as dealers or market makers or who regularly engage in the purchase and sale of swaps or security-based swaps in the ordinary course of business. A person may be a swap dealer or security-based swap dealer with respect to a single type or multiple types of swap activities.

The definitions of major swap participant and major security-based swap participant vary somewhat between the Senate bill and House bill. However, such terms will include:

- (i) Those who maintain substantial positions in swaps or major categories of swaps, excluding positions for hedging commercial risk and, in the case of the Senate bill, positions held by an ERISA plan to hedge risk.

- (ii) Those whose outstanding swaps create substantial exposure that could have adverse effects on the financial stability of the banking system or financial markets.
- (iii) Those who are highly leveraged financial entities.

A person may be a major swap participant or major security-based swap participant with respect to a single type or multiple types of swap activities.

The CFTC and SEC will be able to regulate covered participants in a variety of ways. In addition to imposing clearing, exchange trading, capital, margin, registration, reporting, recordkeeping, and business conduct requirements upon covered participants, the CFTC and SEC will be able to impose prudential requirements upon covered participants other than banks. Prudential requirements for banks will be established by the applicable banking authorities.

Swap transactions effected by insurance companies will not be considered to be insurance and will not be able to be regulated as such. Instead, the applicable regulator of such products will switch from the state insurance commissioner to the CFTC or SEC, as the case may be.

Clearing and Exchange Trading Requirements

Under the Senate and House bill, the CFTC and SEC are required to adopt rules establishing criteria for determining those swaps and security-based swaps that are required to be cleared. Those rules may be adopted under expedited rulemaking authority. Generally, the bills make it unlawful to enter into a swap or security-based swap that is required to be cleared, unless the swap is submitted for clearing. Both bills give the CFTC and SEC the ability to issue temporary stays from this clearing requirement in order to review the terms of the applicable swap or security-based swap.

The Senate bill provides commercial end-users with the option of having their swaps and security-based swaps cleared if they are using the same to hedge commercial risk. Commercial end-users are defined as those entities who use the underlying asset in their primary business and do not include covered participants, persons predominantly engaged in financial activities, certain private funds, commodity pools, or persons registered or required to be registered with the CFTC or the SEC (other than registration as a public company). If the commercial end-user is a public company, the audit committee has to approve any election not to clear the swap or security-based swap. Under the Senate bill, if a swap or security-based swap is not required to be cleared by a derivatives clearing organization and between a covered participant and certain other counterparties, such other counterparties have the option to require clearing of the swap or security-based swap and to select the derivatives clearing organization at which the same will be cleared.

Counterparties are exempt from the clearing requirements of the House bill if:

- (i) The counterparty is not a covered participant
- (ii) Is using the swap to hedge commercial risk and
- (iii) Notifies the relevant commission how it meets its obligations on uncleared swaps or security-based swaps.

If a swap or security-based swap is required to be cleared, it may not be traded except on a board of trade designated as a contract market, on an exchange, or through a swap execution facility, unless the same does not make the swap or security-based swap available for trading.

Both the Senate and House bills prohibit persons other than eligible contract participants (an existing term in the Commodity Exchange Act, intended to identify those parties presumed to be financially sophisticated) from entering into a swap or security-based swap unless the transaction is entered on a board of trade or exchange. Additionally, the bills increase certain asset test levels which must be satisfied in order for certain parties to be considered eligible contract participants.

Registration, Reporting, Recordkeeping, and Business Conduct

Covered participants will have to register as such with the CFTC or SEC or both, as applicable, in accordance with rules and on forms to be prescribed by the CFTC or SEC. Registered parties will have to satisfy reporting, recordkeeping, and business conduct requirements. Although the CFTC and SEC are generally authorized to promulgate rules relating to the business conduct of covered participants, the Senate bill expressly directs the CFTC and SEC to adopt disclosure obligations for covered participants relating to product risks and characteristics, sources of fees and remuneration, incentives and conflicts of interests, and daily valuation of products.

Additionally, the Senate bill imposes fiduciary duties upon any swap dealer or security-based swap dealer that provides advice regarding or offers to enter into a swap or security-based swap with a state, state agency, city, county, municipality, political subdivision, pension plan, endowment, or retirement plan. The exact nature of the fiduciary duty is unclear, and will be left to rules adopted by the CFTC and SEC. This provision is highly controversial, and the House bill does not contain a similar provision.

Capital and Margin

Under the Senate and House bills, the appropriate banking regulator will set minimum capital, initial margin, and variation margin levels for banks. Capital levels must be greater than zero for banks. The CFTC and SEC are authorized to set minimum capital, initial margin, and variation margin requirements for nonbank covered participants that are as strict as or stricter than those set by the banking regulators for banks. Substantially higher capital levels will be required for uncleared swaps or security-based swaps as compared to similar swaps or security-based swaps that are cleared through a clearinghouse.

Significantly, initial and variation margin requirements will not apply under the Senate bill where

- (i) One party to the transaction is not a covered participant, a person predominantly engaged in financial activities, a certain type of private fund, a commodity pool, or a person registered or required to be registered with the CFTC or the SEC, other than registration as a public company, and
- (ii) Such party is eligible to use the commercial end user clearing exemption.

Pre-existing Contracts

Swaps and security-based swaps that are entered into before the enactment of the Senate bill and that are not expired as of the date of the enactment of the Senate bill must be reported to a registered swap data repository or the CFTC or SEC, as applicable, no later than 30 days after the issuance of an interim final rule or such other period as the CFTC or SEC, as applicable, determines is appropriate. The CFTC and SEC are required to adopt such interim final rule within 90 days of the enactment of the Senate bill. Under the Senate bill, if pre-existing swaps and security-based swaps are reported, they will be exempt from the clearing requirements of the Senate bill. Changes made to the Senate bill during its debate confirmed that pre-existing swaps are not exempt from the bill's margin requirements.

The Senate bill also contains a provision that may adversely affect a party's ability to exercise termination or modification rights under pre-existing swaps and security-based swaps. The bill provides that, unless "specifically reserved," neither the enactment of the Senate bill nor any requirement thereunder or amendment thereto will constitute a termination event, force majeure, illegality, increased costs, regulatory change, or similar event under a pre-existing contract, or related credit support arrangement that would permit a party to terminate, renegotiate, modify, amend, or supplement transactions under the contract. Both the meaning and constitutionality of this provision is unclear, and it should cause significant concern for covered participants, who may experience increased costs in maintaining a swap or security-based swap transaction subsequent to the enactment of the bill.

Under the House bill, pre-existing swaps and security-based swaps must be reported within 180 days of effectiveness of the applicable section of the House bill. If reported, such swaps and security-based swaps will be exempt from the clearing requirements of the House bill.

Effectiveness and Rulemaking

If enacted into law, the Senate bill would generally become effective 180 days after enactment, although the requirement to report new uncleared swaps and security-based swaps to a swap data repository or the CFTC or SEC may be effective as soon as 90 days after enactment. Unless a specific section of the Senate bill provides for a different timeframe for the promulgation of rules to implement the bill, the CFTC and SEC are required to individually, and not jointly, promulgate rules and regulations under the Senate bill within 180 days after the enactment of the bill. Both the CFTC and the SEC are authorized to use expedited rulemaking processes, without notice and comment, to adopt rules requiring clearing of certain swaps and security-based swaps.

If enacted into law, the House bill would generally become effective on the later of 270 days from enactment or 60 days after the applicable rulemaking contemplated by the bill, unless otherwise provided in the bill.

Exemptive Authority

If either the Senate bill or House bill is enacted as written, both the CFTC and the SEC would be prohibited from granting exemptions under their respective applicable statutes from the provisions of the bills, except as expressly authorized under the provisions of the bills. There are no expressly authorized exemptions with respect to the definitions of swap, security-based swap, swap dealer, security-based swap dealer, major swap participant, and major security-based swap participant,

although the CFTC and SEC are authorized to adopt rules with respect to certain components of the definitions pertaining to covered participants. The CFTC and SEC are, however, given the authority to further define such terms for the purpose of including transactions that have been structured to evade the bills.

Possible Spin-Off of Bank Swap Activities

The Senate bill would forbid providing any federal assistance (including using funds, making advances under a Federal Reserve credit facility, providing FDIC insurance, or providing other guarantees) to certain entities with respect to any swap, security-based swap, or other activity of that entity. This prohibition would cover covered participants as well as swap execution facilities, designated contract markets, national securities exchanges, central counterparties, and derivative clearing organizations. If enacted, this provision would, among other things, require any FDIC-insured institution to spin-off its swaps activities. The separate entity will likely have to be independently capitalized. The House bill contains no such provision and Rep. Barney Frank (D-Mass.) has publicly expressed his disapproval of this provision in the Senate bill. Additionally, the Treasury Department has indicated that this provision is not part of the core derivative reform supported by the White House.

We will continue to monitor the ongoing developments of Financial Regulatory Reform. If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the author, **Thomas D'Ambrosio** (212.309.6964; tdambrosio@morganlewis.com) or either of the following Morgan Lewis attorneys:

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