

The Derivatives Markets Transparency and Accountability Act of 2009: A Summary of the House Derivatives Legislation

January 29, 2010

I. Background

On December 11, 2009, the House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009 (the "Financial Reform Legislation").¹ Title III of the Financial Reform Legislation, the Derivatives Markets Transparency and Accountability Act (the "Act"), is based upon the August 11, 2009 proposal of the Obama administration (the "Treasury Proposal") to provide comprehensive regulation and oversight of the over-the-counter derivatives industry. Since the Treasury Proposal was introduced, a number of different legislative proposals have been introduced in the House and the Senate by various committees. While the Act is based upon the Treasury Proposal, there are significant differences between the two items of legislation, and the Act incorporates a number of provisions from the other legislative proposals as well as amendments that were proposed during floor debate.

While the Act is intended to provide strict oversight of the derivatives markets, it is not as broad and sweeping as the Treasury Proposal and clarifies certain of the ambiguities contained in the Treasury Proposal. While clarifying some of the interpretive issues in the Treasury Proposal, the Act itself is unclear at points and delegates certain rulemaking and interpretations of key provisions to applicable regulators, namely the Securities and Exchange Commission (the "SEC"), the Commodities Futures Trading Commission (the "CFTC") and certain banking regulators.

II. Overview

The Act in large part repeals all of the exemptions and exclusions from regulation that the derivatives industry enjoyed as a result of the passage of the Commodity Futures Modernization Act of 2000 (the "CFMA"), which amended the Commodity Exchange Act (the "CEA"). As a general matter, the Act would bring under federal regulation heretofore largely unregulated transactions and would require registration of certain unregulated entities.

¹ The Financial Reform Legislation must be approved by the Senate before it can be enacted into law. See Part XIV below for a description of the hurdles preceding the legislation's enactment.

This Client Alert summarizes the following topics covered by the Act: (1) the scope of the Act, (2) the regulatory jurisdiction granted by the Act, (3) the geographical reach of the Act, (4) the regulation of Dealers and Major Participants (as defined in Part VI), (5) clearing and trading requirements, (6) the regulation of derivatives clearing organizations, (7) the imposition of position limits, (8) securities markets issues, (9) the segregation of collateral, (10) improvements to the federal insolvency laws and (11) the preemption of state law. It concludes with a look ahead to the hurdles facing the enactment of the Act (including reconciliation with legislation passed by the Senate) and the timetable for implementing the Act, if enacted.

III. Scope of Act

Regulated Transactions

The Act creates two categories of derivatives transactions that are subject to regulation – Swaps and Security-Based Swaps (as defined below). Consequently, the Act itself is divided into two main parts: Subtitle A is dedicated to the regulation of Swap markets and Subtitle B sets forth provisions for the regulation of Security-Based Swap markets. The provisions of Subtitle A primarily amend the CEA while the provisions of Subtitle B amend relevant provisions of the Securities Act of 1933 (the “Securities Act”) and the Securities Exchange Act of 1934 (the “Exchange Act”).

The reach of the Act is enhanced by a number of anti-evasion provisions such that, even though a transaction or the related entity technically may not fall within the proscriptions of the Act, the appropriate regulators are provided with the authority to regulate that transaction if it has been structured so as to evade the requirements of the Act.

Swaps

The definition of “Swap” is fairly broad and includes many of the transactions that are currently included within the definition of “swap agreement” contained in the Gramm-Leach-Bliley Act of 1999 (the “GLBA”). Specifically excluded from the definition of “Swap” under the Act are a number of products that are currently excluded from the regulatory requirements of the CEA, including the following:

1. futures contracts traded on an exchange;
2. any option on a security, certificate of deposit or group or index of securities that is subject to the Securities Act and the Exchange Act;
3. any transaction providing for the purchase or sale of one or more securities on a fixed basis subject to the Securities Act and the Exchange Act;
4. any transaction providing for the purchase or sale of one or more securities on a contingent basis that is subject to the Securities Act and the Exchange Act, unless such transaction is based upon the occurrence of a contingency that might reasonably be expected to be affected by the creditworthiness of an entity that is not a party to the transaction (this exception from the exclusion appears intended to capture credit default swaps);
5. any note, bond or evidence of indebtedness that is a security as defined under the Securities Act;
6. underwriting agreements unless any such agreement is entered into to manage a risk associated with capital raising;
7. transactions with the Federal Reserve Board (the “FRB”), the United States government or an agency thereof that is backed by the full faith and credit of the US;
8. Security-Based Swaps;
9. sales of a nonfinancial commodity for deferred shipment or delivery as long as the transaction is intended to be physically settled;
10. any foreign currency option entered into on a registered securities exchange; and
11. foreign exchange swaps and forwards.

With respect to the last exclusion, the House ultimately rejected a number of proposals to include foreign exchange forwards and swaps within the scope of the Act, but permits the CFTC to determine, with the consent of the Secretary of the Treasury, that foreign exchange forwards and swaps should be regulated as Swaps under the Act. Further, the Act contains a broad provision that permits a Swap to include any agreement, contract or

transaction that is, or in the future becomes, commonly known to the trade as a Swap.

Security-Based Swaps

“Security-Based Swaps” include swaps that are primarily based on an index that is a narrow-based security index, a single security or loan and on the occurrence or non-occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-base security index, which event directly affects the financial statements, financial condition or financial obligations of the issuer. The last type of Security-Based Swaps appears to be targeted at single name credit default swaps or credit default swaps on a narrow-based security index. Credit default swaps on broad based indices or baskets would likely be excluded under this definition, but would be included under the definition of “Swap.” Swaps based on government securities are also excluded from this definition.

The Act also amends the definition of “security” under the Exchange Act and the Securities Act to include Security-Based Swaps, thereby repealing provisions which had restricted the SEC’s regulatory authority over Security-Based Swaps. The potential effect of treating Security-Based Swaps as “securities” could be far-reaching. Certain of the provisions of the Exchange Act, the Securities Act and other laws, which were intended to apply to stocks and bonds, may now apply to Security-Based Swaps.

Exclusion of Identified Banking Products

The Act also retains the exclusion of “identified banking products” (as defined in the GLBA), including bank deposits and loan participations, from regulation by the CFTC and the SEC, unless such product meets the definition of “Swap” or “Security-Based Swap” and has become known in the trade as a Swap or a Security-Based Swap or the product has been structured for purposes of avoiding the Act’s requirements.

Variable Annuity Products

Some interpretive questions are raised by the definitions of “Swap” and “Security-Based Swaps.” For example, certain variable annuity products which provide on an executory basis for payments made on the basis of the value or level of indices or other quantitative measures could also fall within the definition of “Swap” or “Security-Based Swap.” Previously this was not an issue because, even though these products fell within the definition of “swap agreements,” they were not subject to regulation due to the CFMA. Under the Act, however, Security-Based Swaps would be subject to regulatory requirements (apart from anti-fraud provisions) and

accordingly whether these insurance products are Security-Based Swaps has real consequences.

IV. Regulatory Jurisdiction

CFTC and SEC

As a general matter, the Act grants the CFTC jurisdiction over Swaps and the SEC jurisdiction over Security-Based Swaps, and tasks each to separately adopt rules relating to the transactions and entities under their respective jurisdictions. The CFTC and the SEC are tasked with joint rulemaking for certain issues such as the definitions of “Swap” and “Security-Based Swap” and record maintenance for non-cleared swaps, and the Financial Services Oversight Council is appointed to resolve any disputes arising from their joint rulemaking. In addition, if either commission believes that a regulation of the other commission fails to treat functionally or economically similar products/entities similarly or oversteps its jurisdiction, it may obtain review in the U.S. Court of Appeals for the DC Circuit.

The registration requirements of the Act also divide roughly along these functional lines, generally with Swap Dealers and Major Swap Participants (as defined in Part VI) regulated by the CFTC and Security-Based Swap Dealers and Major Security-Based Swap Participants (as defined in Part VI) regulated by the SEC. However, Swap Dealers, Major Participants, Security-Based Swap Dealers and Security-Based Swap Major Participants (collectively, “Dealers and Major Participants”) can be required to register with both agencies, as the Act does not exclude from registration entities that are under the authority of another regulator. Existing Dealers and Major Participants must register within one year of the effective date of the Act.

Prudential Regulators

Dealers and Major Participants for which there is a Prudential Regulator (such entities, “Bank Dealers and Bank Major Participants”; all other Dealers and Major Participants, “Non-Bank Dealers and Non-Bank Major Participants”) are subject to the authority of such regulators and not the CFTC or the SEC with respect to prudential requirements such as capital and margin requirements. A “Prudential Regulator” is defined as (a) the Board of Governors of the FRB in the case of a state chartered bank that is a member of the Federal Reserve System or a state chartered branch or agency of a foreign bank; (b) the Office of the Comptroller of the Currency for a national bank or a federally chartered branch or agency of a foreign

bank; and (c) the Federal Deposit Insurance Corporation in the case a state-chartered bank that is not a member of the Federal Reserve System. The SEC and the CFTC, however, have the authority to prescribe business conduct, reporting and recordkeeping requirements even with respect to those entities that are subject to prudential requirements by the Prudential Regulators.

V. Geographic Reach of Act

The geographical reach of the Act is based on an “effects test.” The Act provides that it will not apply to activities outside the United States unless those activities:

- have a direct and significant connection with activities in or effect on US commerce; or
- contravene such rules or regulations as the CFTC may prescribe as necessary or appropriate to prevent any evasion of the Act.

Presumably, this test will give the CFTC discretion to determine under what circumstances Swaps conducted through a non-US subsidiary of a US entity have a direct and significant connection with activities in or effect on US commerce. Rather than the imposition of US regulatory standards on non-US activities, the goal of the Act is that the CFTC, the SEC and Prudential Regulators coordinate with foreign regulatory authorities on the establishment of international standards and information sharing.

VI. Regulation of Dealers and Major Participants

Definitions

A “Swap Dealer” or a “Security-Based Swap Dealer” (collectively, “Dealers” and each, individually, a “Dealer”) is a person who:

1. holds itself out as a dealer of Swaps/Security-Based Swaps;
2. makes a market in Swaps/Security-Based Swaps;
3. regularly engages in the purchase or resale of Swaps/Security-Based Swaps in the ordinary course of business; or
4. engages in any activity causing that person to be commonly known in the trade as a dealer or market maker in Swaps/Security-Based Swaps.

The CFTC or the SEC, as applicable, may exempt an entity from designation as a Swap Dealer if its swap dealing is *de minimis*.

A “Major Swap Participant” or a “Major Security-Based Swap Participant” (collectively, “Major Participants” and each, individually, a “Major Participant”) is a person who:

- 1) is not a Swap Dealer or Security-Based Swap Dealer, respectively, and
- 2) either:
 - a) maintains a "substantial net position" in outstanding Swaps/Security-Based Swaps, excluding positions held primarily for hedging, reducing or otherwise mitigating its commercial risk, or
 - b) whose outstanding Swaps/Security-Based Swaps create "substantial net counterparty exposure" that could have serious adverse effects on the financial stability of the US banking system or financial markets.

The CFTC is required to define “substantial net position” and “substantial net counterparty exposure” by rule or regulation at prudent thresholds, taking into consideration the entity’s position in non-cleared Swaps. Such thresholds are to be set at levels that the CFTC determines prudent to regulate those entities which are systemically important or can impact the financial system through counterparty risk. The SEC is required to do the same for Security-Based Swaps.

In each case, a person may be a Dealer or Major Participant for just one or more type, class or category of Swaps or Security-Based Swaps, as applicable, and not for other types, classes or categories. These definitions are subject to further rulemaking by the CFTC and the SEC. As currently drafted, the provisions provide a reasonable basis for optimism about freedom from classification as a Major Participant to commercial end users whose derivatives activities are incidental to their commercial enterprise, but the provisions are likely to affect the business of hedge funds.

Registration

As discussed above, all Dealers and Major Participants are required to register with the CFTC or the SEC, as applicable. All registered Dealers and Major Participants (including Bank Dealers and Bank Major

Participants) are subject to reporting, recordkeeping, business conduct and internal systems and procedures requirements, as described below. The CFTC, the SEC or the Prudential Regulators are required to adopt rules implementing these requirements within one year of the effective date of the Act. The CFTC and SEC have authority to provide conditional or unconditional exemptions from some or all of these requirements and rules, except with respect to capital and margin requirements imposed by the Prudential Regulators on Bank Dealers and Bank Major Participants.

Capital and Margin

Dealers and Major Participants are subject to minimum capital requirements and minimum initial and variation margin requirements. The CFTC is required to adopt rules fleshing out these requirements with respect to Swap Dealers and Major Swap Participants for which there is no Prudential Regulator, and the SEC is required to do the same for Security-Based Swap Dealers and Major Security-Based Swap Participants for which there is no Prudential Regulator. The Prudential Regulators, in consultation with the CFTC or the SEC, as applicable, are required to do the same with respect to Bank Dealers and Bank Major Participants.

The rules are required to impose capital and margin requirements for non-cleared Swaps and Security-Based Swaps. However, unlike the Treasury Proposal and the draft bill introduced by Senator Christopher Dodd, under the Act, capital and margin requirements for non-cleared Swaps and Security-Based Swaps are not required to be more stringent than those for cleared Swaps and Security-Based Swaps.

Reporting & Recordkeeping

The Act imposes stringent reporting and recordkeeping requirements. Registered Dealers and Major Participants are required to report on their trades, positions and financial condition, and to maintain certain books and records.

Business Conduct Standards

The CFTC is required to adopt rules governing business conduct standards for Swap Dealers and Major Swap Participants, that it determines are necessary or appropriate in the public interest, for the protection of investors or to otherwise further the purposes of the Act. The SEC is required to do the same for Security-Based Swap Dealers and Major Security-Based Swap Participants. At minimum, the rules should:

- establish a standard of care for Dealers and Major Participants to verify whether a counterparty qualifies as an eligible contract participant, and
- require disclosure by Dealers and Major Participants to their swap counterparties (other than counterparties that are Dealers or Major Participants) of the material risks and characteristics, daily mark (upon request of the counterparty), and any material incentives or conflicts of interests relating to their Swaps and/or Security-Based Swaps.

Internal Systems and Procedures

The Act requires Dealers and Major Participants to establish and implement certain internal systems and procedures in order to ensure compliance with the Act, provide information to the appropriate regulators and to avoid conflicts of interest.

VII. Clearance and Trading

Clearing Requirement

The Act requires Swaps/Security-Based Swaps to be cleared if:

- a derivatives clearing organization registered under the CEA or the Exchange Act (each, a “DCO”), as applicable, and as discussed below, will accept the Swap/Security-Based Swap for clearing; and
- the CFTC or the SEC, as applicable, has determined that the Swap/Security-Based Swap is required to be cleared.

The Act is a departure from the controversial designation of swaps as “standardized” or “customized,” and leaves open the theoretical possibility of swaps sufficiently standardized to be cleared but not required to be cleared.

Initiation of Reviews

The CFTC/SEC can initiate a review of a Swap/Security-Based Swap, or group, category, type or class of Swaps/Security-Based Swaps to determine if clearance should be required. In addition, each DCO is required to submit to the CFTC/SEC each Swap/Security-Based Swap, group, category, type or class of Swaps/Security-Based Swaps that it plans to accept for clearance. In the latter case, the CFTC/SEC is required

to make its determination as to whether clearance is required within 90 days (or such longer period as agreed by the DCO), and in each case it is required to provide at least a 30-day public comment period about the clearance requirement.

Criteria for Determination of Clearance Requirement

The criteria to be considered by the CFTC/SEC in determining the clearance requirement are informed (as the Treasury Proposal was not) by considerations of the readiness, capacity, operational and legal risks of central clearing as balanced against the notional exposures, liquidity and its risk mitigation benefits. The determination that a Swap/Security-Based Swap (or group, category, type or class) is required to be cleared is not necessarily final, and the requirement may be stayed and subject to reconsideration on application of a counterparty or of the CFTC/SEC. As with many other provisions of the Act, the CFTC and the SEC are each separately to adopt rules governing the presentation of Swaps/Security-Based Swaps for review and relating to such review within one year of enactment of the Act.

Grandfathering

Swaps entered into before the effectiveness of the Act or after the effectiveness of the Act but before such Swaps are required to be cleared are exempt from clearing, if reported to a registered swap repository (as discussed below) or the CFTC.

Clearing Exceptions

Notwithstanding the clearance requirement there exists an end-user exemption available on an individual basis to a counterparty who:

- is not a Dealer or Major Participant;
- is using swaps to hedge commercial risk, including operating or balance sheet risk; and
- notifies the CFTC or the SEC, as applicable, how it meets its financial obligations under non-cleared swaps.

It is unclear how broadly this exemption will operate. It gives the CFTC/SEC discretion to interpret the scope of the hedging requirement of the second prong of the requirement and to evaluate the adequacy of a counterparty's ability to satisfy its financial obligations for the purpose of the third prong.

Execution Requirements

As with the Treasury Proposal, the Act requires that each Swap/Securities-Based Swap that is required to be cleared also be traded on an exchange or a “swap execution facility,” unless no such entity accepts the Swap/Securities-Based Swap for trading. A “swap execution facility”² is defined broadly to be a person or entity that facilitates the execution or trading of swaps, including any electronic trade execution or voice brokerage facility.

Swap Reporting

If a Swap/Security-Based Swap is cleared, the DCO is required to provide the CFTC or the SEC, as applicable, all information determined to be necessary by the CFTC or SEC, as applicable, to perform its responsibilities. If a Swap/Security-Based Swap is not accepted for clearing by any DCO, the counterparties will determine which party will report the Swap/Security-Based Swap (but if only one counterparty is a Dealer, that party will report) to a swap repository or, if no swap repository will accept the Swap/Security-Based Swap, directly to the CFTC or the SEC, as applicable. The swap reporting requirement extends to Swaps/Security-Based Swaps entered into prior to enactment of the Act. The CFTC and the SEC are authorized to share information with each other, the FRB, federal banking authorities, the Financial Services Oversight Counsel, the Department of Justice and such other persons as the CFTC and the SEC deem appropriate, including foreign financial supervisors and foreign central banks. In addition, the CFTC and the SEC, directly or through any DCO or swap repository collecting information on its behalf, is authorized to make available to the public, in a manner that does not disclose specific market positions, an entity’s aggregate swap trading volumes and positions.

Eligible Contract Participant

In addition to the broad requirements for clearing, trading and reporting, the Act significantly limits access of persons who are not eligible contract

² The intent and potential utility of “swap execution facilities” as alternatives to regulated exchanges are not clear. Such facilities are subject to difficult to satisfy requirements, including: (1) the facility may only permit swaps “not readily susceptible to manipulation”; (2) there are required to be rules and procedure for “ensuring the financial integrity of swaps” entered on or through the facility; (3) trading is required to be monitored in real-time to prevent manipulation, price distortion and disruption; and (4) position limits are required to be implemented for speculators.

participants to Swaps and Security-Based Swaps. The definition of “eligible contract participant” is proposed to be amended to protect: (1) small municipal investors by increasing the threshold of investments owned and invested on a discretionary basis from \$25 million to \$50 million, and (2) individuals by requiring \$10 million in assets invested on a discretionary basis, rather than the former standard of \$10 million in assets. Perhaps surprisingly, the threshold for eligible contract participants that are corporations, partnerships, trusts or other entities remains at \$10 million in total assets. The Act makes it unlawful for a person who is not an eligible contract participant to enter into a Swap/Security-Based Swap unless that Swap/Security-Based Swap is traded on an exchange regulated by the CFTC or the SEC, as applicable. The Securities Act is also to be amended to provide that Security-Based Swaps are securities for all purposes of the Securities Act, and that offers and sales of Security-Based Swaps to persons who are not eligible contract participants may only be made pursuant to an effective registration statement.

VIII. Regulation of Derivatives Clearing Organizations

Registration

Each DCO clearing Swaps/Security-Based Swaps is required to be registered with the CFTC or SEC, as applicable. Exemptions exist for clearing organizations subject to comparable, comprehensive supervision (in the view of the applicable regulator) by a foreign governmental authority, the SEC or the CFTC, as applicable, or a Prudential Regulator.

Core Principles

Each registered DCO is required to comply with core principles relating to its financial, operational and managerial resources, its membership standards, risk management controls, margin requirements, settlement procedures, treatment of member and participant funds, procedures in the event of a member default, reporting and recordkeeping.

Limited Federal Assistance

The Act evidences the legislators’ recognition that DCOs are a source not only of risk mitigation, but also of risk concentration and potentially of anti-competitive behavior. In order to disavow any view that the Act is facilitating a new class of “too-big-to-fail entities,” the Act provides that no provision thereof “shall be construed to authorize” the use of public funds to provide federal assistance to a DCO, except where explicitly provided by an act of Congress.

Prohibition of Self-Dealing

In an amendment adopted during floor debate, several provisions were added to the Act designed to prohibit self-dealing:

- Dealers and Major Participants that are also “identified financial holding companies” cannot hold in the aggregate more than 20 percent of the voting interest of a DCO;
- an entity having a material interest in a DCO through a debt or equity investment may have its ability to conduct business with the DCO limited; and
- a majority of the directors of a DCO may not be “associated with” Dealers or Major Participants which are “identified financial holding companies.”

The foregoing does not require divestiture of ownership in a DCO which was “established and operational” prior to January 1, 2010.

Annual Compliance Certification

A registered DCO is required to designate a compliance officer who will be required to certify annually as to the compliance with the Act, including the code of ethics and conflict of interest policies of the DCO.

IX. Position Limits

Swaps

Section 4a(a) of the CEA, without giving effect to the Act, provides the CFTC with the authority to set position limits on trading on exchanges and swap execution facilities as it finds is necessary to prevent undue burdens on interstate commerce resulting from excessive speculation.³ The Act would extend the jurisdiction of the CFTC to non-exchange traded “swaps that perform or affect a significant price discovery function with respect to registered entities.” Such swaps, together with contracts traded on foreign exchanges that provide direct access to US participants to its electronic trading and order matching system, are to be aggregated with exchange

³ On January 14, 2010, in a proposed exercise of such authority, the CFTC issued a notice of proposed rulemaking entitled “Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations.” The notice of rulemaking proposes to re-establish speculative position limits on derivatives on four major energy commodities that are traded on any CFTC-regulated exchange.

traded contracts for the purpose of determining compliance with position limits. The CFTC is charged with influencing foreign exchanges to set comparable limits so that price discovery does not shift to foreign exchanges. Criteria are also established for determining whether a swap performs or affects a significant price discovery function, or constitutes a bona fide hedging transaction.

Security-Based Swaps

Similarly, and presumably motivated in part by an interest in curtailing naked short positions in credit default swaps, a new Section 10B is proposed to be added to the Exchange Act which would give the SEC the authority, by rule or regulation, to limit (including hedge exemption provisions) the number or amount of positions that may be held by any person in any Security-Based Swap and any security or loan or group or index of securities or loans which such Security-Based Swap references and “any other instrument relating to such security or loan or group or index of securities or loans.” The SEC is also to have the authority to direct any self-regulatory organization similarly to adopt position limits for its members.

Swap Execution Facilities

In addition, any swap execution facility is directed to set its own position limits in appropriate circumstances as well as to enforce those established by the CFTC or the SEC.

X. Securities Market Issues

Sections 13 and 16

The Act amends Section 13 of the Exchange Act to provide that the reporting requirements of Sections 13(d) and 13(g) shall apply to any person who becomes or is deemed to become a beneficial owner of more than five percent of any equity security listed in these sections upon the purchase or sale of a Security-Based Swap or other derivative instrument that the SEC may define by rule. Because of the definitional amendments (mentioned above) to include Security-Based Swaps within the definition of “security,” the disclosure requirements and short-swing profit rule in Section 16 of the Exchange Act could apply to interests in securities deemed to have been acquired by virtue of the purchase or sale of a Security-Based Swap. The Act provides, however, that Security-Based Swaps will not be considered for beneficial ownership for purposes of Sections 13 and 16 of the Exchange Act unless the SEC determines, after consulting with the Prudential Regulators and the Secretary of the

Treasury, that being a party to a Security-Based-Swap is akin to ownership of the underlying security and that the determination is necessary to achieve the purposes of Section 13 of the Exchange Act. If the SEC so determines, this result may have a particularly burdensome effect on equity derivatives dealers (trading with an issuer counterparty) who are hedging their positions dynamically across possibly many different transactions and different trading desks. They would have to ensure that they had the monitoring and compliance systems in place to track and report when the Section 16 threshold had been breached.

Structured Products and Structured Finance

The status of structured notes linked to an equity or fixed income index does not change under the Act as they do not technically fall within the definition of “Swap” or “Security-Based Swap” and, accordingly, such products will likely be exempt from the Act’s requirements. They may fall within the definition of “hybrid instrument” (depending on their features). There are, however, certain circumstances under which these products or the issuers of these products may fall within the Act. If the products are structured so as to evade the requirements of the Act, the anti-evasion provisions may be triggered. In addition, if the issuers of such products are significant users of such Swaps or Security-Based Swaps, it is possible that they may be considered Major Swap Participants or Major Security-Based Swap Participants, respectively, and therefore would be subject to the Act’s registration requirements.

With respect to many structured finance vehicles and issuances, such as synthetic CDOs and large notional market value swaps, the only assets of such vehicles may be swaps and they may therefore have “significant” positions in Swaps or Security-Based Swaps which are not for hedging purposes. Subjecting these structures, which by and large have been issued through special purpose vehicles, to margin and capital requirements may force the sponsors of these vehicles to place them back onto their balance sheets.

XI. Segregation of Collateral

Under the Act, if requested by their counterparty, Swap Dealers and Security-Based Swap Dealers are required to segregate initial margin or collateral for non-cleared Swaps/Security-Based Swaps and to hold them in an account carried by an independent third-party custodian. This requirement does not apply to subsequently posted margin or collateral or to cleared Swaps/Security-Based Swaps. A custodian is not considered independent if a Swap or Security-Based Swap counterparty who is a

Dealer or Major Participant substantially owns (*i.e.* owns more than 20 percent) or substantially controls (*i.e.* has more than 50 percent representation on the board of directors) that custodian.

XII. Improvements to Insolvency Laws

The SEC, the CFTC and the Prudential Regulators are tasked with providing recommendations to Congress on how to improve the federal insolvency laws. Among other things, they are required to provide recommendations on how to provide greater legal certainty for the clearing of non-proprietary swap positions with a clearinghouse in the event the clearinghouse or a swap participant becomes insolvent, including with respect to the recovery of margin deposits or custodial property held by the insolvent clearinghouse or participant, and the portability of customer swap positions (and associated margin) upon the insolvency of a swap participant.

XIII. Preemption of State Law

The Act generally preserves federal preemption of state regulation of Security-Based Swaps, but state gaming and bucket shop laws may be applicable to Swaps unless traded on a regulated exchange or swap execution facility.

Swaps

Section 12(e)(2) of the CEA preempts the application of state or local laws that prohibit gaming or the operation of bucket shops (other than anti-fraud provisions of general applicability) for certain transactions excluded from the CEA, including transactions excluded from the CEA by the CFMA. Since the Act repeals the exclusion of swaps (as defined in the CEA) from the CEA effected by the CFMA, Swaps no longer benefit from this exclusion. However, the Act provides that a Swap may not be regulated as insurance under state law. In addition, the preemption for hybrid products is retained by reference in Section 12(e)(2)(B) of the CEA to Section 2(f) of the CEA.

Security-Based Swaps

The Act generally maintains preemption of state law for Security-Based Swaps. The Exchange Act, as amended, would 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 security futures product. However, state laws regulating wagering or gaming contracts or the operation of bucket shops are applicable to a Security-Based Swap

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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unless entered into between eligible contract participants or on a registered national securities exchange.

XIV. Steps Ahead

There are a number of hurdles to overcome before any derivatives legislation can be enacted. The Senate Committee on Banking, Housing & Urban Affairs is currently working on a parallel bill regulating derivatives. A discussion draft submitted on November 16, 2009 by Committee Chairman Chris Dodd was sent back to the drawing board, where Committee members Senators Judd Gregg and Jack Reed are leading an effort to produce a draft that would garner bipartisan support. Meanwhile, the Senate Committee on Agriculture, Nutrition and Forestry is also working on a competing derivatives bill. Assuming both are finalized, both Senate bills would have to be reconciled before they can be approved by the Senate. The bill that is ultimately passed in the Senate would then have to be reconciled with the Act before the resulting derivatives legislation can be enacted into law.

If enacted, the timetable for implementation of the Act is very ambitious. Its provisions generally become effective within 270 days of the Act's enactment and for registration requirements, its provisions are effective within one year of enactment. Position limit rules become effective on the day of the Act's enactment.

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