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Congressional Overhaul of the Derivatives Market in the United States

I. Introduction

On July 15, 2010, the U.S. Senate passed by a 60-39 vote the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), following earlier passage of the legislation by a 237 to 192 vote in the U.S. House of Representatives on June 30, 2010. On July 21, 2010, President Obama signed Dodd-Frank into law.

Dodd-Frank constitutes the most sweeping financial reform package since the 1930s. Title VII of Dodd-Frank, the Wall Street Transparency and Accountability Act of 2010 (“Title VII”), brings about a complete overhaul of the OTC derivatives market in the United States. The primary objectives of Dodd-Frank are to bring about greater transparency and to enable U.S. regulators to better manage individual counterparty and broader systemic risks that are inherent in the OTC derivatives market.

The enactment of Dodd-Frank will not be the final word on the reform of derivatives. Regulators will promulgate several dozen regulations to implement Dodd-Frank, and Congressman Barney Frank (D-MA) recently stated that a subsequent bill will be considered in early 2011 to make technical amendments to Dodd-Frank and to clarify, *inter alia*, an important exception for certain end-users from the requirement to centrally clear certain derivatives that are currently traded over-the-counter (“OTC”)¹.

The principal ways in which the drafters of Dodd-Frank intend for these objectives to be accomplished include:

- Imposing substantial requirements on the most active OTC derivatives market participants, major swap participants (“MSPs”) and swap dealers (“SDs”), including reporting, capital and margin requirements;
- Subjecting many derivatives that are currently traded OTC to central clearing and exchange trading in regulated trading systems; and
- Establishing more clearly the jurisdiction of the key regulators of derivatives, the Securities and Exchange Commission (the “SEC”) and the Commodity Futures Trading Commission (the “CFTC”), and repealing exemptions and exclusions that stood in the way of their regulation of the multi-trillion dollar OTC market.

¹ Congressman Frank made this statement on the record during the final day of Congressional conference committee deliberations on June 29, 2010. See Section VI below for a discussion of the term “end-user” and the exception available to such parties.

Title VII will mark the beginning of an intensive regulatory process to implement its provisions. While some of these provisions will become effective immediately, Congress has designed Dodd-Frank so that its parts will become effective in several stages. Congress has also delegated significant regulatory authority to regulatory agencies, with a mandate to adopt rules or conduct studies within prescribed times from enactment. Unless otherwise provided, Title VII becomes effective on a date that is the later of: (a) 360 days following the enactment of Dodd-Frank into law; or (b) to the extent that a provision thereof requires rulemaking, not less than 60 days after publication of the applicable final rule or regulation. A separate two-year phase-in period permits derivatives providers that now receive certain forms of federal assistance, including access to the discount window of the Federal Reserve, to divest themselves of certain derivative-related activities and investments.

For brevity, most of the following discussion is based primarily upon Title VII's amendments to the Commodity Exchange Act ("CEA"), but there are parallel amendments to the securities laws in almost all cases.

II. Regulatory Agencies' Authority

Title VII grants the CFTC extensive new authority over commodities derivatives markets as well as over swaps ("Swaps"), SDs and MSPs. Title VII also grants the SEC corresponding authority over security-based Swaps ("SBS"), security-based SDs ("SBSDs") and major security-based swap participants ("MSBSPs").² Swaps and SBS are differentiated within Title VII by the asset class or underlier of the trade. Generally, SBS are defined as Swaps that are based on equities, bonds, or narrow-based security indices of these instruments,³ and are

² See Sections III and IV below for a discussion of the meaning of these terms.

³ The term "narrow-based security index" is generally defined as an index: (i) that has nine or fewer component securities; or (ii) in which a component security comprises more than 30 percent of the index's weighting; or (iii) in which the five highest weighted component securities, in the aggregate, comprise more than 60 percent of the index's weighting; or (iv) in which the lowest weighted component securities

to be subject to the jurisdiction of the SEC. All other Swaps are to be regulated by the CFTC, with certain exceptions discussed below.

Both the CFTC and SEC are granted extensive authority throughout Title VII to define which products come within their exclusive jurisdiction, which products are to be centrally cleared and which market participants must comply with the mandates of Title VII.

SDs and MSPs are generally required to execute Swap transactions through an exchange facility and to clear these transactions through a derivatives clearing organization or agency ("DCO"). SDs and MSPs must comply with capital and margin requirements, as well as business conduct standards.

A. Demarcation of Jurisdiction of SEC and CFTC; "Mixed Swaps"; "Credit Default Swaps" and "Identified Banking Products"

The demarcation between the jurisdiction of the CFTC and the SEC was a point of some controversy in the legislative process for derivatives regulation, and some material jurisdictional ambiguities remain in Dodd-Frank.

Dodd-Frank generally grants the CFTC jurisdiction over Swaps (other than SBS), participants in the markets for Swaps (such as SDs and MSPs and their associated persons) and swap execution facilities. The CFTC also is granted jurisdiction over foreign exchange Swaps and foreign exchange forwards unless the Secretary of the Treasury makes a written determination that either or both instruments: (i) should not be regulated as Swaps; and (ii) are not structured to avoid the purpose of the legislation. (See discussion in Section III below.) Unlike security futures (which include futures on a single security or loan or a narrow-based index of securities), where the CFTC and the SEC have joint jurisdiction, the SEC will have sole jurisdiction over

comprising, in the aggregate, 25 percent of the index's weighting, have an aggregate dollar value of average daily trading volume of less than \$50 million (or in the case of an index with 15 or more component securities, \$30 million), with special ranking rules for certain securities that have an equal weighting.

SBS and participants in SBS markets such as SBSDs and MSBSPs and their associated persons, as well as security-based swap execution facilities. It is not clear how the agencies are to exercise their jurisdiction over dealers and major participants that transact in both Swaps and SBS, but these firms are required to register with both agencies.

While the CFTC will generally have jurisdiction over Swaps and the SEC will generally have jurisdiction over SBS, Title VII addresses in a particular way the peculiarities of derivatives instruments that have features of both Swaps and SBS, referred to as “Mixed Swaps.” A Mixed Swap has some elements of a SBS, and also is based upon the value of one or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or other property of any kind (except for a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (again, except for an event relating to a single security or a narrow-based security index). Mixed Swaps will be jointly regulated by the CFTC and the SEC, in consultation with the Federal Reserve Board. The definitions of Title VII suggest a few ways in which products may be regulated by the SEC, the CFTC, or both regulators:

- An equity swap that is structured as an option to purchase emissions credits would come within the jurisdiction of the CFTC;
- An equity swap that is an option to purchase shares of an equity security would come within the jurisdiction of the SEC;
- An equity swap with payments that depend on the movement of an equity security and the price of a mineral such as gold would likely be deemed a “Mixed Swap,” in which case both the SEC and CFTC would share jurisdiction and both would jointly regulate that equity swap.

While there are straightforward examples of how products would likely be regulated under Title VII, ambiguity remains, including in the division of

jurisdiction over derivatives such as credit default Swaps (“CDS”) and equity Swaps (“ES”). If a CDS or ES is tied to the securities issued by a publicly-traded company, or of a narrow-based index of publicly-traded companies, that CDS or ES will be under SEC jurisdiction. Conversely, if a CDS or ES is tied to a broad-based index of publicly-traded companies, that CDS or ES will be under CFTC jurisdiction. Nonetheless, some CDS or ES may be subject to joint CFTC-SEC jurisdiction. For example, if a CDS or ES is based upon the debt of governmental entities, or is tied to mortgage-backed or asset-backed securities, it is not clear upon which side of the jurisdictional divide the instrument belongs. It is to be hoped that the agencies will clarify this issue so that market participants are not subject to duplicative or inconsistent regulation.

Certain “identified banking products” are excluded from the jurisdiction of the CFTC and the SEC (and the definitions of “security-based swap” and “security-based swap agreement”).⁴ However, an appropriate federal banking agency that has jurisdiction over a SD is authorized to make an *exception* to the *exclusion* for any particular identified banking product that it determines, in consultation with the CFTC and the SEC: (i) would meet the definition of Swap or SBS; and (ii) is known to the trade as a “swap” or “security-based swap” or otherwise has been structured to evade the CEA or the Securities Exchange Act of 1934, as amended (the “Exchange Act”). If the bank is not under the jurisdiction of an appropriate federal bank regulatory agency,⁵ the “identified banking

⁴ “Identified banking products” consist of: (1) deposit accounts, savings accounts, certificates of deposit, or other deposit instruments issued by a bank; (2) banker’s acceptances; (3) letters of credit issued or loans made by a bank; (4) debit accounts at a bank arising from a credit card or similar arrangement; and (5) participations in a loan which the bank or affiliate of the bank (other than a broker or dealer) funds, participates in, or owns, that is sold to certain persons. The exclusion from jurisdiction and from the definitions of swap and security-based swap does not extend to agreements that would otherwise qualify as identified banking products under Section 206 of the Gramm-Leach-Bliley Act.

⁵ Dodd-Frank defines this term by reference to the Federal Deposit Insurance Act (*i.e.*, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation), the Federal Reserve Board in

products” exclusion will not apply even if the above conditions are satisfied.

B. Extraterritoriality

Dodd-Frank amends the CEA to provide that the CEA “shall not apply to activities outside the United States” unless those activities “have a direct and significant connection with activities in, or effect on, commerce of the United States” or contravene CFTC rules promulgated to prevent the evasion of Dodd-Frank. With respect to SEC jurisdiction, Dodd-Frank generally provides that no provision of the federal securities laws added by Dodd-Frank or any rule there under shall apply to any person that transacts a business in “security-based swaps” outside the jurisdiction of the United States” unless the person “transacts such business in contravention of SEC rules promulgated to prevent evasion of any provision” of the provisions added by Title VII. Dodd-Frank also provides, however, that it shall not be construed to limit the SEC’s jurisdiction as in effect prior to the enactment of Dodd-Frank.

Dodd-Frank provides for more robust extraterritorial application of the anti-fraud provisions of the Securities Act of 1933, as amended (the “Securities Act”), and of the Exchange Act, by granting jurisdiction to the district courts of the United States to hear an action or proceeding brought or instituted by the SEC or the United States (*i.e.*, the Department of Justice) alleging conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors, provided that the alleged conduct occurring outside the United States has a foreseeable and substantial effect within the United States.

C. International Harmonization

Title VII requires the CFTC and SEC to consult and coordinate with their counterparts overseas to promote effective and consistent global regulation of derivatives and other products. It is to be hoped that this will help provide a unified, consistent framework for regulation of OTC derivatives

markets globally in a manner that does not place U.S. market participants at a competitive disadvantage relative to participants in other jurisdictions. In addition, the authority of the CFTC and the SEC to prohibit entities from certain countries from participating in the OTC derivatives markets in the United States in certain circumstances, as described below in Section X, may be used to try to bring about international harmonization of the regulation of Swaps and SBS.

III. Definitions of “Swap” and “Security-Based Swap”

A. Generally

Title VII defines a “Swap” as any agreement, contract or transaction that: (i) provides for an exchange of payments based upon the value or level of interest or other rates, currencies, commodities, securities, debt instruments, indices, quantitative measures, or other financial or economic interests or property of any kind that transfers financial risk without transferring ownership risk; (ii) is an option on such interests or property; or (iii) provides for any purchase, sale, payment, or delivery that is dependent upon the occurrence, non-occurrence or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence. Examples of Swaps cited in Title VII include, among others, interest rate swaps, currency swaps, credit default swaps, energy swaps, and metal swaps.

Title VII defines a SBS as a Swap that is based on a narrow-based security index, a single security *or a loan*, or the occurrence, non-occurrence or the extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index. It will be important for investment managers to bear this in mind when reviewing trading operations and compliance programs under Dodd-Frank.

B. Special Issues

Dodd-Frank amends but preserves much of the pre-existing definition of “swap agreement” in Section 206A of the Gramm-Leach-Bliley Act. As

the case of a noninsured state bank, and the Farm Credit Administration for farm credit system institutions.

amended, it would appear materially broader than the new and distinct definition of “swap” in the CEA. Its legal application is not clear in light of that new CEA definition.

The definition of a Swap in Title VII excludes any “sale” of a “nonfinancial” commodity or security for “deferred shipment or delivery” so long as the transaction is “intended to be physically settled.” It is anticipated that many commercial entities involved in the purchase and sale of physical commodities will seek to rely on this exclusion for, at a minimum, all forward contracts. Ultimately, what constitutes an intent to physically settle and the proof necessary to establish such intent will be critical to determining the scope of the exclusion. For example, the plain terms of the exclusion could fairly be interpreted to include a sale that the parties intended to settle by physical delivery when the contract was formed, even though they later financially settled it due to changes in their commercial needs or circumstances. But what the CFTC will require to demonstrate the original intent to physically settle will have to await its later rulemakings or case decisions.

In applying the existing forward contract exemption under the CEA, the CFTC and many courts have evaluated the legal character of transactions retrospectively, giving weight to such matters as the nature of the parties (commercial or retail investors), the nature of the transaction (commercial or investment), the prior dealings of the parties (what percentage of transactions resulted in deliveries), and a host of other factors.⁶ The CFTC has said that

⁶ See, e.g., *Andersons, Inc. v. Horton Farms, Inc.*, 166 F.3d 308, 320 (6th Cir. 1998) (citing seven factors evidencing intent to deliver: (1) the defendant entered into these contracts only with farmers and producers of grain rather than with speculators from the general public; (2) each plaintiff was in the business of growing grain and had the ability to make delivery on the contracts; (3) the defendant was in the business of obtaining grain under contracts for resale and relied on actual delivery of that grain to carry out its business; (4) the defendant had the capacity to take delivery of the grain subject to the contracts; (5) on their faces, the contracts were clearly grain marketing instruments to accomplish the actual delivery of grain in exchange for money; (6) it was undisputed that delivery and payment routinely occurred between the parties in past dealings; and (7) the plaintiffs received cash payment on the contracts only upon delivery of the actual commodity.). See also *Characteristics Distinguishing Cash*

a transaction must be viewed as a whole with a critical eye toward its underlying purpose and that no bright-line definition or list of characterizing elements is determinative. This precept was criticized by some, however, for failing to provide sufficient prospective legal certainty for commercial dealings.⁷ The new Swap exclusion provides an opportunity for the CFTC to consider its approach anew.

Another issue of significant controversy during the formulation of Dodd-Frank was whether currency derivatives should be outside of the legislative framework considering the special features of the currency derivatives markets and the sheer size of those markets. As enacted, Title VII includes currency derivatives (*i.e.*, foreign exchange forwards and foreign exchange Swaps) in the definition of Swap *unless* the Secretary of the Treasury makes a written determination, submitted to the House and Senate Agriculture Committees, that these instruments should not be regulated as Swaps. In making this determination, the Treasury Secretary is required to consider, among other matters, whether bank regulators provide adequate supervision of these products and the extent and adequacy of payment and settlement systems. If the Treasury Secretary makes such a determination, foreign exchange forwards and Swaps would still be required to be reported to a Swap repository or the CFTC, and SDs and MSPs that are parties thereto would be subject to business conduct standards. This treatment of OTC currency derivatives thus reflects a compromise position concerning the extent to which such instruments should be subject to regulation. Whether or not foreign exchange forwards and Swaps are traded on exchanges or cleared, they would be subject to statutory anti-fraud and anti-manipulation proscriptions.

and Forward Contracts and “Trade” Options, 50 Fed. Reg. 39656, 39657 (Sept. 30, 1985).

⁷ “It is essential to know *beforehand* whether a contract” is covered by the CEA because “[c]ontracts allocate price risk, and they fail in that office if it can’t be known until years after the fact whether a given contract was lawful.” *Nagel v. ADM Investor Services, Inc.*, 65 F. Supp. 2d 740, 752 (N.D. Ill. 1999) (Easterbrook, J.), *aff’d.*, *Nagel v. ADM Investor Services, Inc.*, 217 F.3d 436 (7th Cir. 2000). See also, e.g., *In re Competitive Strategies for Agric., Ltd.*, [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,635 (CFTC Nov. 25, 2003) (dissent of Commissioner Sharon Brown-Hruska).

Dodd-Frank repeals provisions of the Commodity Futures Modernization Act and Gramm-Leach-Bliley Act that prohibit the SEC from regulating SBS. Section 762 of Title VII amends Section 2A of the Securities Act and Section 3A of the Exchange Act. In general terms, these provisions excluded Swaps (as defined in Section 206 of the Gramm-Leach-Bliley Act) from the definition of security while subjecting SBS to anti-fraud provisions and to the limited reporting obligations under Section 16 of the Exchange Act. Significantly, these provisions also prohibit the SEC from promulgating, interpreting or enforcing rules or issuing orders of general applicability regarding SBS. Title VII would amend these provisions by making conforming changes to reflect that “security” includes SBS. However, it would not eliminate the limits on the SEC’s regulatory authority. This would appear to be inconsistent with other provisions of Dodd-Frank, such as those discussed above, that specifically call on the SEC to set margin requirements and make other determinations or interpretations with respect to SBS. This is another area of jurisdictional ambiguity that must be clarified through further legislative action, perhaps in a “technical corrections” Dodd-Frank, and subsequent rulemaking. See Section XIII for a discussion of Exchange Act beneficial ownership reporting relating to SBS.

Title VII provides for the CFTC and the SEC to conduct a joint study within 15 months of enactment of Dodd-Frank into law to determine whether “stable value contracts” fall within the definition of a Swap and, if so, whether an exemption for stable value contracts from the definition of Swap is in the public interest. Title VII also provides that its provisions do not apply to stable value contracts during the term of that study. This relief was granted after Congress became aware of how the financial services reform legislation could inadvertently do great harm to stable value funds, which are popular investment options under many defined contribution retirement plans such as 401(k) plans and 457(b) plans and are also used outside the retirement plan context, such as in section 529 qualified tuition plans. However, the relief granted only applies to defined contribution plans, deferred compensation plans and qualified tuition plans. This raises the question of whether the CFTC and the SEC have exemptive authority with respect to stable value

contracts in funds that are part of defined benefit plans and also raises the question of whether such funds within defined benefit plans are subject to Title VII.

IV. Definitions of Swap Dealers and Major Swap Participants; Security-Based Swap Dealers and Major Security-Based Swap Participants

A. Swap Dealer; Security-Based Swap Dealer

Under Title VII, a SD is defined as: “any person who (1) holds itself out as a dealer in Swaps; (2) makes a market in Swaps; (3) regularly enters into Swaps with counterparties as an ordinary course of business for its own account; or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in Swaps.” A person may be designated as a SD for a single type or single class or category of Swap, but not for other types, classes, or categories of Swaps. The term SD, however, does not include a person that enters into Swaps for such person’s own account, either individually or in a fiduciary capacity, but not as part of a regular business. Also, the CFTC is authorized to exempt from designation as a Swap dealer any entity that engages in “*de minimis*” Swap dealing with or on behalf of customers, and to promulgate regulations to establish factors that would govern such an exemption.

Title VII contains similar definitional provisions for a SBS, but with references to Swaps being to SBS and references to the CFTC being to the SEC.

B. Major Swap Participant; Major Security-Based Swap Participant

Title VII defines a MSP as a non-Swap dealer that: (1) maintains a “substantial position” in Swaps for any of the major Swap categories as determined by the CFTC (excluding positions held for hedging or mitigating commercial risk); (2) has substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S.

banking system or financial markets; or (3) is a financial entity (see discussion of this term below) that is highly leveraged relative to the amount of capital it holds, is not subject to the capital requirements of a federal banking regulator, and maintains a substantial position in outstanding Swaps in any major Swap category. Positions maintained by any employee benefit plan for the primary purpose of hedging or mitigating any risk directly associated with the plan's operation are also excluded from the "substantial position" threshold, thus enabling employee benefit plans to be excluded from the definition of MSP.

Title VII contains similar definitional provisions for a MSBSP, but with references to Swaps being to SBS and references to the CFTC being to the SEC.

The CFTC and the SEC will separately be required to define the term "substantial position" in the MSP and MSBSP definitions in such a way that is "prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States." Therefore, entities whose Swap transactions are not considered to create systemic risk potentially may be able to avoid designation as a MSP or MSBSP. For example, an entity transacting only in a relatively small niche market among a small number of counterparties could be deemed to pose no systemic risk and thus not come within the MSP or MSBSP definition. The MSP definition also excludes entities whose primary business is to provide financing and that use derivatives to hedge commercial risks related to interest rate and currency exposures, where at least 90 percent of the exposures arise from financing that facilitates the purchase or lease of products, if 90 percent or more of the products are manufactured by the entity's parent company or another subsidiary of the parent company. As with SDs, a person may be designated as a MSP for one or more categories of Swaps or SBS, as appropriate, without being classified as a MSP for all classes of Swaps.

V. Clearing

A. Title VII Requirements

It is important to recognize that Title VII does not require that all derivatives in the U.S. OTC derivatives market be centrally cleared. The general rule is that, if the CFTC or SEC determines that a Swap or SBS (as appropriate) must be cleared, then counterparties to that Swap or SBS are prohibited from entering into and settling that instrument unless they submit it to a DCO or clearing agency in the absence of an exception to the clearing requirement. If the CFTC or SEC takes no action, but a DCO accepts for clearing instruments of the relevant type, an end-user may elect that the Swap be submitted to the clearing organization for clearing in accordance with that organization's rules and procedures or the derivative may be settled OTC, but other requirements (*e.g.*, reporting and recordkeeping) still apply to the trade.

In order to be authorized to clear a derivative, a DCO must file an application with the CFTC or SEC, as applicable. The CFTC or the SEC must act on the submission within 90 days, unless the DCO agrees to an extension of time. A DCO must provide for Swaps or SBS to be cleared on a non-discriminatory basis, whether they were executed bilaterally or through an unaffiliated exchange. In addition, if no DCO is requested to clear a particular Swap or SBS otherwise subject to mandatory clearing, that is, neither party thereto qualifies for an exemption from mandatory clearing, the CFTC must conduct an investigation and issue a public report within 30 days, and take such action as the CFTC deems necessary and in the public interest, which may include requiring the parties to retain adequate margin or capital. However, the CFTC could not require a DCO to clear a Swap or SBS if the clearing of that instrument would threaten the financial integrity of the DCO. If a SBS must be cleared under Title VII, the counterparties to the SBS must submit the SBS to a DCO or a clearing agency.⁸

⁸ DCOs and clearing agencies are typically organizations that are either owned by exchanges or are operated separately from exchanges, and for purposes of this discussion, both are referred to as "DCOs."

B. Clearing Mechanics, Documentation and Technology

DCOs, through a novation by the counterparties to a Swap or SBS, in essence step in between the counterparties and become the buyer to the counterparty that is the seller, and the seller to the counterparty that is the buyer, thereby ensuring the performance of both counterparties' obligations under the Swap. While the clearing mechanics, documentation and technology are not expressly mandated by the sections within Title VII, a brief discussion of how clearing works in the Dodd-Frank regulatory regime is necessary.

To centrally clear those Swaps or SBS that are designated for clearing, a member of a DCO must be designated to submit the Swap to the DCO. Not all Swap counterparties are members of DCOs. DCO membership, which is not prescribed by Title VII or other provisions of Dodd-Frank, is open to parties to Swaps that meet certain prudential and other requirements, which typically include a certain level of assets, as well as other undertakings such as the posting of collateral to a large default insurance fund of the DCO.

In the current OTC derivatives market, generally only the largest dealers and end-users are members of DCOs. If neither of the two counterparties that face each other in the derivatives transaction is a member of a DCO, one must "give up" the Swap to a member of a DCO by entering into a contract with a DCO member, which in turn clears the Swap through the DCO. DCO members generally guarantee the performance of the Swap by the original counterparties and employ certain remedies and other mechanisms in the event of a member default.

Not all requirements (including documentation and margin arrangements) are the same for all DCOs, and not all members of DCOs use the same technology or margin arrangements. Title VII does not harmonize the divergent clearing arrangements that exist in the market today. Some DCOs allow their members to hold the margin that the DCOs require to secure performance of the derivatives that are cleared. Other DCOs themselves hold the counterparties' margin.

The documentation that is required to centrally clear a Swap or SBS under Title VII varies according to the DCO that clears the Swap or SBS. In some cases, the DCO adds an annex to the existing ISDA Master Agreement, Schedule and Credit Support Annex documentation; the annex supplements the existing ISDA and incorporates new clearing requirements for "Covered Transactions" that are subject to the DCO rules. Title VII does not prescribe any particular technology to satisfy the clearing requirements imposed by the SEC or the CFTC. Each DCO generally has a clearing platform that is adopted by end-users and members to a cleared trade.

Swaps and SBS will not be subject to Title VII clearing (and exchange-trading and margining) requirements if the counterparties entered into the transactions before the enactment of Dodd-Frank or prior to the effectiveness of a clearing requirement that is imposed by the SEC or CFTC, if the end-user exception is met (as described below), or if certain other requirements are satisfied as described below.

VI. The End-User Exception to the Clearing Requirements; Treatment of Eligible Contract Participants

There is an exception to the requirement that certain Swaps or SBS be centrally cleared under Title VII, for instruments to which one of the counterparties is a commercial end-user⁹ that hedges or otherwise manages commercial risk through the Swap. A counterparty that qualifies for this exception: (i) is *not* a "financial entity"; (ii) uses Swaps to hedge or mitigate "commercial risk"; (iii) notifies the

⁹ The term "end-user" is not defined in Dodd-Frank, but, in OTC derivatives industry parlance, the term generally refers to the party that faces the SD dealer in the trade. End-users to swaps include those that hedge or mitigate "commercial risk." Whether an end-user will qualify for the exception to the clearing mandate in Section 723 of Dodd-Frank will turn in large part on whether the end-user is a "major swap participant" or a "financial entity," as discussed more fully below. The CFTC and the SEC are granted authority to define the term "commercial risk."

appropriate regulatory agency how it meets its financial obligations related to non-cleared Swaps; and (iv) is not a SD or MSP.

The exclusion of “financial entities” from the commercial end-user exception means that a large swathe of participants in OTC derivatives markets are not eligible for this exemption. The term “financial entity” for this purpose is broadly defined and includes SDs, SBSDs, MSPs, MSBSPs, commodity pools, Private Funds,¹⁰ employee benefit plans, and entities predominantly engaged in banking or financial activities.¹¹ However, there are important exceptions to the definition of “financial entity,” particularly for the financing arms of manufacturers. Furthermore, the CFTC and the SEC also may exempt “small” depository institutions, farm credit system institutions, and credit unions with total assets of \$10 billion or less.

In the case of publicly-traded companies, the commercial end-user exemptions from clearing and exchange-trading of Swaps are available only if an appropriate committee of the board or governing body reviews and approves its decision to enter into OTC derivatives trades. The end-user may use an affiliate to conduct its Swaps activity, provided that the affiliate is not a SD, SBSD, MSP, MSBSP, Private Fund, commodity pool, or a bank holding company with over \$50 billion in consolidated assets.

However, under Title VII a person that is not an “eligible contract participant” as defined in the CEA¹² (an “ECP”) may not enter into a Swap or

¹⁰ A “Private Fund” for these purposes is defined in Section 202 of the Investment Advisers Act of 1940, as amended by Dodd-Frank, as a fund that would be an “investment company,” as defined in the Investment Company Act of 1940, as amended, but for the exclusions of Section 3(c)(1) or Section 3(c)(7) thereunder.

¹¹ By covering MSPs and MSBSPs as “financial entities,” Title VII creates a risk that commercial or manufacturing entities with large derivatives trading activity may not be eligible for the exemption from central clearing.

¹² Generally speaking, an ECP is a financial institution, an insurance company, investment company, commodity pool, corporation or other legal entity, an employee benefit plan, governmental entity, or certain other types of entities and individuals, in each case having a minimum required total assets, net worth or total amount invested, as applicable, or

SBS except on a board of trade, and SBS are subject to the registration requirement of Section 5 of the Securities Act unless each counterparty to the SBS is an ECP. Title VII also narrows the definition of the term “eligible contract participant”. Subject to the foregoing limitations, it appears that ECPs will continue to be able to enter into non-standard derivatives that are not centrally cleared and exchange-traded, as long as the SEC and the CFTC do not require that the derivatives be centrally cleared.

Prior to the passage of Dodd-Frank in the House of Representatives on June 30, 2010, the Congressional conference committee on Dodd-Frank (the “Committee”) reconvened on June 29, 2010 to consider a \$19 billion bank tax, which the Committee removed from Dodd-Frank. During its June 29, 2010 meeting, the Committee considered an amendment to re-open Title VII to clarify the end-user exemption, but the amendment failed on a 6-6 vote among the members of the Committee from the Senate. Congressman Frank subsequently stated on the record that he expects that a bill in early 2011 will be necessary not only to make technical corrections to Dodd-Frank but also to make more substantive changes to clarify the end-user exception.

Since the final meeting of the Committee, Senators Christopher Dodd and Blanche Lincoln wrote a letter to House leadership (the “Dodd-Lincoln Letter”) stating that the design of the end-user exception (and the scope of the definition of MSPs) is to enable certain classes of end-users that hedge or otherwise manage commercial risk through derivatives to continue to use derivatives for those purposes without having to centrally clear or margin their trades.

VII. Trading Venues

Swaps will generally be required to be traded on designated contract markets, or exchanges (“DCMs”), or a type of newly created facility referred to as a “swap execution facility (“SEF”).

meeting other specified requirements. See Section 1a(12) of the CEA.

Unlike a SEF, a DCM can also serve as a trading platform for futures. Title VII requires that both DCMs and SEFs satisfy certain core principles. In order for cleared swaps to be traded on SEFs, the SEFs must satisfy criteria imposed by Title VII, which includes: (i) prohibiting trading of derivatives that are susceptible to manipulation; (ii) imposing internal controls to monitor the trading of swaps to prevent manipulation, price distortion and disruptions in trade processing; (iii) facilitating information dissemination to regulators; and (iv) implementing rules that are in line with those set by the SEC and CFTC (*e.g.*, rules on position limits).

VIII. Reporting of Transactions

Dodd-Frank imposes comprehensive daily recordkeeping requirements on MSPs and SDs, requiring them to maintain daily trading records of trades, along with all recorded communications, electronic mail and instant messages relating to Swaps. Complete audit trails for conducting comprehensive trade reconstruction are mandated and trade details are to be stored under Title VII.

In addition, all Swaps or SBS must be reported to a registered trade repository for Swaps or SBS, as the case may be, regardless of whether they are cleared or uncleared and regardless of whether they are entered into by financial entities or commercial end-users.

Real-time public reporting of transaction data, including price and volume, is required, which is defined as being as soon as technologically practicable after the Swap transaction is executed. “Real-time public reporting” in Title VII means the reporting of the salient terms of the Swap (*e.g.*, volume, price). For cleared Swaps, Title VII imposes the real-time public reporting obligation. The CFTC or the SEC, as appropriate, is required to adopt regulations to ensure that parties to a transaction are not identified, and to specify criteria to define a large notional Swap transaction (a block trade) and to specify the appropriate time delay for reporting block trades to the public, taking into account whether public disclosure will materially reduce market liquidity. This requirement was intended to address the concerns of market

participants that real-time reporting of block trades could make dealers reluctant to assume the risks of block trades, because other market participants might then be able to trade ahead of the dealers’ transactions to hedge or liquidate the position. Every six months, the CFTC and the SEC are required to issue a written report to the public regarding the trading and clearing in the major categories of Swaps and SBS, and the market participants and developments in new products, on an aggregate basis.

For uncleared Swaps, the reporting obligation is imposed upon SDs as long as a SD is a party to the transaction, regardless of whether the counterparty is a MSP or not. If the Swap does not have a SD as one of the parties, and if one party is a MSP, then the MSP must report; otherwise, the parties shall select which one shall report.

Even Swaps and SBS that are entered into before the clearing requirement becomes effective¹³ would have to be reported to a registered Swap data repository or the CFTC or a registered SBS depository or the SEC, as appropriate. Swaps or SBS entered into before the date of enactment must be reported within 180 days after the effective date of Title VII (about a year and one-half after enactment), and Swaps entered into on or after the date of enactment must be reported within 90 days after such effective date or such other time as the CFTC or SEC, as applicable, may prescribe by rule or regulation.

IX. Capital and Margin Requirements

A. General

The CFTC or the SEC, as appropriate, in consultation with the banking regulators, must

¹³ Within one year of the President’s signing of Dodd-Frank into law, Dodd-Frank requires the CFTC and the SEC to promulgate rules for DCOs to submit to the regulators certain categories of Swaps that the DCOs seek to accept for clearing. The CFTC and SEC are required by Dodd-Frank to review on an ongoing basis each “swap” or groups, categories or types of Swaps for purposes of determining whether the derivatives must be cleared.

establish capital requirements as well as requirements for margin on uncleared Swaps or SBS for SDs, SBSDs, MSPs and MSBSPs. DCOs and exchanges will set margin for cleared Swaps and SBS. The margin requirements for uncleared Swaps, to be set by the regulators, are intended to account for the greater risk presented by uncleared Swaps as compared to cleared Swaps, and to ensure the safety and soundness of the SD, SBS, MSP and MSBSP. It is not clear how the regulators will set margin levels for uncleared Swaps. The regulators will not be able to move as swiftly as the exchanges and DCOs to adjust margin levels, particularly if they wish to increase margin requirements. Presumably, they will establish a certain formula or percentage calculation for parties to use in determining the amount of margin to be posted for uncleared Swaps. The CFTC/SEC margin levels are, therefore, likely to exceed those established by exchanges and DCOs.

OTC derivatives are generally collateralized by cash and liquid securities such as U.S. Treasuries, but contractual arrangements also permit letters of credit and other assets as eligible collateral to support out-of-the-money positions and are commonly used by commercial end-users. Many end-users argued during the legislative deliberations that the imposition of cash margin requirements would be financially burdensome and inconsistent with longstanding market practice. The CFTC is directed to permit the use of non-cash collateral as margin for counterparty arrangements of end-users with SDs and MSPs, if it determines that would be consistent with preserving the financial integrity of markets trading Swaps and preserving the stability of the U.S. financial system.

The International Swaps and Derivatives Association, Inc. issued on June 29, 2010 a press release, referenced in the final meeting of the Congressional conference committee, which stated that U.S. companies may be faced with \$1 trillion in capital and liquidity requirements due to the requirements of Title VII. The Dodd-Lincoln Letter clarifies that Dodd-Frank is intended to exempt certain end-users from clearing and margining requirements and recognizes that imposing the clearing and exchange trading requirement on commercial end-users could contravene public policy by raising transaction costs where there is a

substantial public interest in keeping such costs low in order to protect consumers, promote investments and create jobs.¹⁴ Interestingly, by precluding the imposition of margin requirements for commercial end-users, the terms of the Dodd-Lincoln Letter would effectively work against one of the legislative objectives for margin requirements (driven by the perception of AIG's use of derivatives), which is to prevent SDs and MSPs from engaging in Swaps that could adversely affect their creditworthiness.

Title VII does not include a provision that expressly prohibits regulators from applying margin requirements retroactively. However, following the concerns expressed about this issue by, among others, Warren Buffett and the American Bar Association Section on Business Law Derivatives and Futures Law Committee, it appears that margin requirements will not be imposed retroactively on existing Swaps. The Dodd-Lincoln Letter states that Congress did not intend for Title VII to have retroactive effect regarding margin for existing Swaps.

In setting the capital requirements, the CFTC must take into account all of the activities of SDs and MSPs, including activities that are not required to be regulated. This raises a question of whether the CFTC would be authorized to impose capital requirements on an entity that is generally treated as a commercial end-user, if the entity is a MSP for a particular type of Swap. Dodd-Frank appears to authorize the CFTC to impose capital requirements based on all of the transactions entered into by a regulated entity.

B. Segregation

Swap customers providing margin for Swaps that are cleared through a DCO will retain ownership of that margin in much the same way that futures customers retain ownership of collateral pledged to

¹⁴ Letter from Chairman Christopher Dodd, Senate Committee on Banking, Housing, and Urban Affairs, United States Senate and Chairman Blanche Lincoln, Senate Committee on Agriculture, Nutrition, and Forestry, United States Senate, dated June 30, 2010 to Chairman Barney Frank, Financial Services Committee, United States House of Representatives and Chairman Collin Peterson, Committee on Agriculture, United States House of Representatives, at 2-3.

futures commission merchants. Swap customer margin is to be segregated, separately accounted for, and not commingled except in certain specified circumstances. For uncleared Swaps, the SD or MSP will be required to notify its counterparty at the beginning of a transaction, that the counterparty has the right to require segregation of initial (but not variation) margin. Segregated funds may be invested in permissible investments under CFTC regulations, and the parties to the Swap may arrange how to allocate gains and losses on such investments.

X. Registration and Regulation of SDs and MSPs

SDs and MSPs will be required to register as such under the CEA, and SBSDs and MSBSPs will be required to register with the SEC under the Exchange Act. Such registration will be required even if the person is a depository institution or is registered with the other regulatory agency in accordance with the provisions of Title VII. Title VII defines an “associated person” of a SD or MSP as a person engaged in the solicitation or acceptance of Swaps or SBS, as the case may be, or the supervision of a person so engaged, unless the person’s functions are solely clerical or ministerial. Although Title VII does not speak specifically to registration of associated persons, regulations promulgated by the CFTC and the SEC will undoubtedly require it, with attendant fitness and proficiency examination requirements.

A. Recordkeeping and Reporting Requirements

As discussed in greater detail in Section VIII above, all SDs and MSPs will have to maintain daily trading records of Swaps and all related records (including related cash or forward transactions); recorded communications, including electronic mail, instant messages and telephone calls; daily trading records for each customer or counterparty; and a complete audit trail to enable comprehensive and accurate trade reconstructions. The records will have to be maintained for the time period required by the CFTC and the SEC. The CFTC currently requires records to be kept for five years, and

records must be readily available during the first two years.

B. Business Conduct Standards

Generally. Title VII will impose business conduct requirements on SDs and MSPs. These include requirements (1) to verify that any counterparty is an ECP and (2) to disclose to their counterparties that are not SDs or MSPs (a) information about the material risks and characteristics of the Swap; (b) any material incentives and conflicts of interest associated with the Swap transactions; (c) the DCO’s daily mark for cleared Swaps, if the counterparty requests it; and (d) the SD’s or MSP’s daily mark for uncleared Swaps. In addition, SDs and MSPs will be required to communicate in a fair and balanced manner based on principles of fair dealing and in good faith.

Duties of SDs and MSPs to Governmental Entities and Retirement Plans. In addition, under Title VII, SDs, SBSDs, MSPs and MSBSPs will have special duties to governmental entities, pension plans, and endowments, which are referred to as “Special Entities.” If a SD or SBSD acts as an advisor to a Special Entity, it must act in the best interests of the Special Entity and have a reasonable basis for determining that any Swap recommended to the Special Entity is in the best interests of the Special Entity. If a SD, a SBSD, a MSP or a MSBSP acts as a counterparty to a Special Entity, it must have a reasonable basis to believe that the Special Entity has a representative independent of the SD, SBSD, MSP or MSBSP that is capable of evaluating the risks of the transaction, is not subject to a statutory disqualification from registration, and will act in the best interests of the Special Entity. The SD must also disclose in writing before the initiation of the transaction the capacity in which it is acting. In any dealings with Special Entities, SDs and MSPs are prohibited from engaging in fraudulent, deceptive or manipulative acts. This provision of Title VII replaces a proposal in the Senate bill that would have imposed a fiduciary duty on SDs or SBSDs that (1) provide advice regarding, (2) offer to enter into, or (3) enter into a Swap or SBS with a government entity or agency, pension plan, endowment or retirement plan. This provision was highly controversial because of the concerns of state governments and retirement plans that the

imposition of a fiduciary duty would effectively close the market for Swaps and SBS to Special Entities.

C. Conflicts of Interest

Under Title VII, SDs, SBSs and MSPs must implement conflict-of-interest protocols that separate any research and analysis personnel from trading and clearing personnel. Specifically, these entities will be required to separate, by appropriate information barriers within the firm, employees conducting research or analysis of the price or market for any commodity, Swap or SBS, or acting in a role of providing clearing activities or making determinations as to accepting clearing customers, from the review, pressure and oversight of persons involved in pricing, trading or clearing activities.

D. Position Limits

Title VII grants the CFTC authority to impose aggregate position limits for contracts in non-financial commodities that are traded on designated contract markets and Swap execution facilities, as well as Swaps that are not centrally executed if they perform a significant price-discovery function with respect to exchange-traded contracts. It also will grant the SEC authority to impose aggregate position limits across SBS that may be held by any person, including positions in any SBS and any security or group or index of securities, the price, yield, value, or volatility of which, or of which any interest therein, is the basis for a material term of such SBS.

These provisions will significantly expand the authority of the CFTC and the SEC to limit the size of an entity's overall portfolio by limiting or eliminating the entity's ability to take positions in the OTC market as it reaches the position limits in the futures market. The CFTC is also directed to seek to ensure that trading on foreign boards of trade in the same commodity will be subject to comparable limits and that any limits imposed by the CFTC will not cause price discovery in the commodity to shift to trading on foreign boards of trade. In addition, if the CFTC or the SEC determines that the regulation of the Swaps or SBS markets in a non-U.S. country undermines the stability of the U.S. financial system, the CFTC or

the SEC, in consultation with the Secretary of the Treasury, may prohibit an entity from that country from participating in any U.S. Swap or SBS activities, as the case may be. This represents a significant expansion of the CFTC's jurisdictional reach. While this provides a potentially important tool to bring about international harmonization of the regulation of Swaps and SBS, it is unlikely that the regulators would take such action very often because of the severe consequences that such a trading ban could have on a wide range of market participants and relationships.

XI. Prohibition on Federal Assistance to Swaps Entities

Incorporating a version of the "Lincoln Rule," Title VII prohibits, subject to a two-year phase-in period, any "swaps entity" from receiving enumerated types of funding or credit support from the U.S. government with respect to any activity, regardless of whether related to Swaps or SBS.¹⁵ However, the prohibition would not apply to Swaps entities whose activities are limited to trading interest rate Swaps, foreign exchange Swaps, government securities, AAA-rated debt instruments or entering into Swaps to hedge their own risk. CDS and ES could only be entered into if cleared by a registered DCO or securities clearing agency, or a DCO or securities clearing agency that is exempt from registration by the CFTC or SEC, respectively.

The categories of proscribed assistance (referred to in Title VII as "Federal assistance") include advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act, Federal Deposit Insurance Corporation ("FDIC") insurance or guarantees for the following purposes: (A) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any Swaps entity; (B) purchasing the assets of any Swaps

¹⁵ Dodd-Frank defines the term "swaps entity" generally to include a registered SD, SBS, MSP, MSBSP and a swap execution facility, designated contract market, national securities exchange, central counterparty, clearing house, clearing agency and derivatives clearing organization.

entity; (C) guaranteeing any loan or debt issuance of any Swaps entity; or (D) entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any Swaps entity.

Swaps entities will be required to “push out” much of their Swap trading activity that is not covered by the safe harbor described above, that is, conduct it through a separately capitalized affiliate in order to insulate these activities from the prohibition on Federal assistance.

The prohibition on Federal assistance also precludes the use of taxpayer funds to prevent the receivership of any Swap entity resulting from that entity’s Swap activity if the entity is FDIC-insured or has been designated as systemically important. If a FDIC-insured or systemically important institution is put into receivership or declared insolvent because of Swap activity, then its Swap activity will be subject to termination or transfer in accordance with applicable law. All funds that are expended on the termination or transfer of Swap activity of a Swaps entity must be recovered, either through the disposition of assets of the Swap entity or by assessments, including on the financial sector. Title VII expressly provides that taxpayers are to bear no loss as a result of the exercise of any authority related to winding up the Swap activity of an entity that is FDIC-insured or systemically important, and no taxpayer resources are to be used for the orderly liquidation of any Swaps entity that is not FDIC-insured or systemically important.

XII. Special Considerations Relating to Investment Funds

Like many other provisions of Dodd-Frank, Title VII has potentially far-reaching effects on investment funds that are registered under the Investment Company Act of 1940, as amended (the “1940 Act”), as well as those that are not, but engage in OTC derivatives trading as part of their business. Investment companies registered (or that seek registration) under the 1940 Act that use Swaps must reconsider their regulatory status and may need to reconsider their investment strategies. Unregistered funds must consider the implications of possibly being caught up in multiple regulatory schemes.

A. Registered Investment Funds.

Dodd-Frank revises the CEA to make all Swaps, generally other than SBS, subject to CFTC jurisdiction by repealing the statutory provisions that had exempted Swaps from the CEA. As a result, the operators (general partners or managing members) of funds that invest in Swaps will become subject to regulation as commodity pool operators, like their cousins that invest in futures contracts. More important for registered investment companies, Dodd-Frank revises the Securities Act and the Exchange Act to include SBS within the definition of “security.” The new definition of SBS includes only Swaps that reference a narrow-based security index or a single stock. As a result, Swaps based on broad-based securities indices (as well as non-SBS like commodity Swaps) are excluded from the definition of security, but subject to CFTC jurisdiction.

This revision creates new uncertainties for funds that want to register as investment companies under the 1940 Act. The definition of “investment company” under the 1940 Act turns on whether a fund invests in securities; before Dodd-Frank, a fund that primarily invested in Swaps based on securities could register as an investment company because of the ambiguous status of these instruments.¹⁶ However, under Dodd-Frank, a fund

¹⁶ SBS and non-SBS had been specifically excluded from CFTC jurisdiction under law in effect prior to the enactment of Dodd-Frank. Therefore, the operator of a fund that invested only in swaps (as opposed to futures) on securities has not been subject to CFTC oversight as a commodity pool operator. SBS and non-SBS also had been specifically excluded from the definition of “security” under the Securities Act and the Exchange Act prior to the enactment of Dodd-Frank. Nevertheless, the SEC permitted funds that primarily invest in SBS (including Swaps based on broad-based securities indices, narrow-based securities indices, and single stocks) to register as investment companies, despite the argument that such funds may not be engaged in investing in “securities.” Presumably, the rationale for having permitted such funds to register with the SEC as investment companies is based in large part on the argument that the definition of “security” under the 1940 Act is broader than the corresponding definition under the Securities Act and the Exchange Act. The Staff of the SEC has been more tentative as to whether to treat swaps that do not reference securities as securities under the 1940 Act. However, it has allowed funds that primarily invest in currency swaps to register as investment companies under the 1940 Act. It has also permitted funds that primarily invest in commodity swaps to register as investment companies under the 1940 Act,

that primarily invests in Swaps based on a broad-based securities index, now may be treated as a fund that does not invest in “securities,” and is specifically subject to CFTC jurisdiction. As a result of the new legislation, registered funds and funds seeking to register with the SEC may have to rethink their use of Swaps if they wish to be regulated as investment companies rather than as commodity pools.

B. Private Funds

A “Private Fund,” or the investment manager of a Private Fund, might be deemed to be a SD, SBS, MSP or a MSBSP and be required to register as such with the CFTC, the SEC, or both, depending on the degree to which its investment program employs Swaps or SBS. As noted, relevant considerations under Dodd-Frank include the “regularity” with which the fund or its adviser enters into Swaps “in the ordinary course of business” and the degree of leverage employed. Managers also must carefully consider how the instruments they employ in their investment programs might be characterized and regulated.¹⁷ The subjective nature of these determinations pose new regulatory risks to Private Fund managers and their counterparties that will not be resolved, if at all, until the rulemaking process is completed or clarifying legislation is enacted.

It appears that Dodd-Frank does not affect the ability of a general partner or managing member of a Private Fund to rely upon the exemptions from registration as a commodity pool operator provided by CFTC Regulation 4.13(a)(3) or (4), for certain otherwise regulated entities to rely upon the exclusion from the definition of commodity pool operator provided by CFTC Regulation 4.5, or for such managers to rely upon the exemption from registration as a commodity trading advisor provided by CFTC regulations for advisors to entities that come within the scope of the foregoing regulations.

although, for tax purposes, such funds typically invest in commodity swaps through wholly-owned subsidiaries.

¹⁷ *E.g.*, see the discussion regarding the use of Mixed Swaps, forward contracts on securities that, by their terms, are to physically delivered, and CDS/ES in Sections II(A), III and XIII, respectively.

XIII. Exchange Act Beneficial Ownership Reporting and Anti-Fraud Provisions Relating to Security-Based Swaps

Title VII includes SBS within the definition of the term “security” under both the Securities Act and the Exchange Act. Furthermore, because SBS is defined to include securities *or loans*, Title VII may expand the scope of coverage of OTC derivatives as securities beyond those in current law.

A. Exchange Act Beneficial Ownership Reporting

Title VII provides that, for purposes of Section 13¹⁸ and Section 16¹⁹ of the Exchange Act, a person is deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a SBS, but only to the extent that the SEC, by rule, determines, after consultation with the prudential regulators and the Secretary of the Treasury, that the purchase or sale of the SBS, or class of SBS, provides incidents of ownership comparable to direct ownership of the equity security, and that it is necessary to achieve the purposes of this section of the Exchange Act – that the purchase or sale of the SBS, or class of SBS, be deemed the acquisition of beneficial ownership of the equity security.

¹⁸ The Dodd-Frank Act amends Section 13(d) of the Exchange Act to extend the reporting obligations thereunder to any person who “becomes or is deemed to become a beneficial owner of [more than 5 percent of a class of specified equity securities] upon the purchase or sale of a security-based swap that the [SEC] may define by rule.”

The Dodd-Frank Act also amends Section 13(f) of the Exchange Act to extend the reporting obligations thereunder to any institutional investment manager who “becomes or is deemed to become a beneficial owner of any security of a class described in subsection (d)(1) [in excess of specified amounts] upon the purchase or sale of a security-based swap that the [SEC] may define by rule.”

¹⁹ Dodd-Frank amends Section 13(g) of the Exchange Act to extend the reporting obligations thereunder to any person who “becomes or is deemed to become a beneficial owner of [more than 5 percent of] any security of a class described in subsection (d)(1) upon the purchase or sale of a security-based swap that the Commission may define by rule.”

Consequently, Dodd-Frank does not resolve the issues raised by the ruling in *CSX Corporation v. The Childrens' Investment Fund Management (UK) LLP and 3G Fund L.P.*²⁰ That court ruling called into question a basic expectation of the equity derivatives market, which is that the long party to a total return swap ("TRS") does not acquire beneficial ownership of the reference securities absent a supplemental arrangement outside of the TRS that provides a contractual right to vote or dispose of such securities, and therefore does not have reporting obligations under Section 13(d) of the Exchange Act. This result, if upheld, could be unfavorable to Swaps purchasers. It is to be hoped the SEC will resolve this issue through its rulemaking process so that market participants will be able to plan their activities to avoid reporting obligations, and not be subject to potential litigation risk and potentially inconsistent results in different courts.

B. Anti-Manipulation Provisions

Title VII will expand the anti-manipulation and anti-fraud provisions of the Securities Act and the Exchange Act to include transactions in SBS as defined in Title VII. This means that the law and regulations applicable to insider trading will also apply to SBS transactions.

XIV. Oversight of Carbon Markets

Title VII creates an interagency working group comprised of the Chairman of the CFTC, the Secretary of Agriculture, the Secretary of the Treasury, the Administrator of the Environmental Protection Agency and other federal energy officials to conduct a study on carbon market oversight. The study is designed to ensure the development of an efficient, transparent and secure carbon market (including spot and derivatives markets), and the working group is required to issue a report within 180 days of the enactment of Dodd-Frank.

²⁰ 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *aff'd in part*, 292 Fed. Appx. 133 (2d Cir. 2008).

XV. Bankruptcy Treatment

Title VII provides that a Swap cleared by or through a DCO shall be considered to be a "commodity contract" under Section 761 of the U.S. Bankruptcy Code. Accordingly, cleared Swaps will be subject to the exclusion from the automatic stay that is applicable to commodity contracts. Uncleared Swaps may qualify for similar treatment, because the definition of commodity contract was also amended to include any other contract, option, agreement, or transaction similar to others described in the commodity contract definition. In addition, Section 761(4)(I) of the U.S. Bankruptcy Code, which refers to master agreements, has been retained. Thus, although there was some discussion during the legislative process about removing Swaps from the exclusion to the automatic stay provision, it appears that Swaps will remain excluded. This result should serve to promote certainty regarding the treatment of Swaps in a bankruptcy proceeding.

XVI. Conclusion

Title VII provides the framework for a new landscape of exchange-trading and clearing of Swaps. For those Swap transactions that would still be permitted to be traded bilaterally on an off-exchange basis, transaction reporting will be required, and certain other regulatory requirements, such as capital and margin requirements, might be imposed as well. The regulators are charged with promulgating dozens of rules over the next year, and further legislative action during that time is also possible. Many details of the new regulatory framework remain to be developed, and the focus of the Swaps debate will now shift to the regulatory agencies.

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In the event that you have any questions concerning the foregoing, please do not hesitate to contact one of the authors of this Alert.

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