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Treasury Proposes Legislation Overhauling Regulation of Over-the-Counter Derivatives

On August 11, the U.S. Department of the Treasury (the “Treasury”) sent the Over-the-Counter Derivatives Markets Act of 2009 (the “Bill”) to Congress. In general, the Bill would comprehensively regulate the over-the-counter (“OTC”) derivatives markets and major market participants. The Bill follows the framework that was set forth in the Treasury’s June 2009 proposal and, in general, encourages the migration of OTC derivatives transactions to regulated exchanges and clearinghouses.

The Bill is fairly lengthy, and the impact of some of its provisions will not be fully apparent until the joint adoption of certain rules by the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC” and, with the CFTC, the “Agencies”) as required under the Bill. A summary of the more significant provisions of the Bill is set forth below.

Expansion of Regulatory Authority Over Swaps

The Bill would amend the Commodity Exchange Act (the “CEA”) by removing the broad exemptions applicable to swap agreements under Sections 2(d), 2(e), 2(g) and 2(h) of the CEA and give the CFTC exclusive jurisdiction over all “swaps” other than other than “security-based swaps.” However, this broad grant of authority is moderated by proposed Section 2(d) of the CEA, which would generally limit the CFTC’s authority over swaps to the regulation of entities that would be required to register under the Bill (as described below) and to enforcing the anti-manipulation and anti-fraud provisions of the CEA with respect to swaps.

The Bill also would amend the Securities Exchange Act of 1934 (the “Exchange Act”) to give the SEC jurisdiction over “security-based swaps” by revising the definition of the term “security” to include these instruments. It is important to note, however, that the scope of the SEC’s authority over swaps that are based on securities will vary for different purposes under the Exchange Act. Thus, as described below, the Bill would give the SEC authority over persons that effect transactions in “security-based swaps” and impose registration requirements on persons that effect transactions or provide services with respect to these swaps. However, the Bill would leave unaffected the SEC’s existing authority over “swap agreements” (defined in Section 206A of the Gramm-Leach-Bliley Act) that are based on securities and securities indices under Sections 10 (anti-fraud), 16 (short swing profit recapture), 20 (control person liability) and 21A (civil penalties for insider trading) of the Exchange Act.

Under the Bill, the term “security-based swap” includes only swaps that are based on a single security or a narrow-based security index. By contrast, the Gramm-Leach-Bliley Act

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definition of the term “swap agreement” is not so limited and applies to those instruments and to broad-based securities indices. As a result, the amendments to the Exchange Act reflected in the Bill would apply to a more limited set of transactions than the provisions of the Exchange Act cited above.

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

Security-based swaps that are also based on the value of one or more commodities or other measures of value would be subject to the joint jurisdiction of the CFTC and the SEC.

Registration Requirements for Significant Swap Market Participants

The Bill would require “swap dealers” and “major swap participants” to register as such with the CFTC, and would require “security-based swap dealers” and “major security-based swap participants” to register as such with the SEC. In general, the Bill defines a “swap dealer” as any person who is engaged in the business of buying and selling swaps for the its own account, but excludes persons who do not engage in this activity as part of a regular business. The Bill defines a “major swap participant” as any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, but excludes a person who engages in such activity to maintain an effective hedge under generally accepted accounting principles. The same definitions and exclusions apply to transactions in “security-based swaps” that are effected by “security-based swap dealers” and “major security-based swap participants.”

The Bill requires all registered swap dealers and all registered major swap participants to: (1) meet the minimum capital and margin requirements established by prudential regulators (for banks) or jointly by the Agencies (for non-banks); (2) comply with various reporting and recordkeeping requirements; (3) conform to certain business conduct, documentation and back office standards; and (4) comply with requirements relating to position limits, disclosure, conflicts of interest and antitrust considerations. The Bill requires the CFTC and SEC to jointly adopt rules relating to the requirements set forth above. However, these rules will not be applicable to a person who is subject to supervision by a federal bank regulatory agency.

Mandatory Clearing

The Bill would require standardized swaps to be cleared by a derivatives clearing organization that is registered with the CFTC and would required standardized security-based swaps to be cleared by a clearing agency that is registered with the SEC. The Bill requires the Agencies jointly to adopt rules to define the term “standardized,” and creates a presumption that a swap will be deemed to be “standardized” if it is accepted for clearing by a CFTC- or SEC-registered clearinghouse. It also authorizes the Agencies to jointly prescribe rules or issue interpretations as necessary to prevent evasions of the mandatory clearing requirements set forth in the Bill. The Bill’s mandatory clearing requirements do not apply, however, to transactions in swaps or security-based swaps if: (x) no clearing agency accepts the swap or security-based swap for clearing; or (y) one of the parties to the swap or security-based swap is not a swap dealer (or security-based swap dealer) or major swap participant (or major security-based swap participant) and does not meet the eligibility requirements of any clearinghouse that clears such transactions.

The latter half of this exception appears to be designed to serve as an anti-avoidance mechanism. For example, if a customer enters into a swap with a swap dealer that meets the eligibility requirements of a relevant clearing organization but who has refrained from becoming a member of such organization, the transaction is nevertheless subject to the mandatory clearing requirements of the Bill. As a result, the parties to such a transaction would be required to arrange for it to be “given up” for clearing to a third party, which could lead counterparties to transact directly only with persons who are clearing members. Thus, this provision would likely have the effect of encouraging swap dealers and major swap participants to become members of clearing organizations to the extent they are qualified to do so or risk losing potential business.

Registration Requirements for Swap Clearinghouses

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

The Bill requires the Agencies (in consultation with the appropriate federal banking agencies) to jointly adopt uniform rules governing registered swap clearinghouses within 180 days after the Bill becomes effective. The Bill also authorizes each Agency to exempt a clearinghouse from registration if it is subject to comparable comprehensive supervision and regulation on a consolidated basis by another domestic or foreign regulator.

Mandatory Exchange Trading

The Bill would amend the CEA to require that all swaps effected by persons who are not eligible contract participants (“ECPs”) to be traded on a designated contract market. In addition, the Bill would amend the CEA to require all transactions in standardized swaps to be traded on a designated contract market or an alternative swap execution facility (“ASEF”) (described below). Further, the Bill would amend the Exchange Act to require all standardized security-based swap transactions to be traded on a national securities exchange or an ASEF. These mandatory trading requirements would not apply to transactions in swaps (or security-based swaps) if: (x) no clearing agency accepts the swap (or security-based swap) for clearing; or (y) one of the parties to the swap is not a swap dealer (or a security-based swap dealer) or a major swap participant (or a major security-based swap participant) and does not meet the eligibility requirements of any clearing organization that clears such transactions. As noted above, the latter half of this exception seems designed to serve as an anti-avoidance mechanism.

Alternative Swap Execution Facilities

As noted above, the Bill would require all transactions in standardized swaps to be effected on a designated contract market or an ASEF. Thus, the Bill requires a facility for the trading of swaps or security-based swaps to register with the CFTC or SEC, as appropriate, as an ASEF. In general, a registered ASEF would be subject to certain requirements relating to trading procedures, the deterrence of trading abuses, and the financial integrity of transactions. The Bill also establishes core regulatory principles for ASEFs relating to enforcement, position limits, emergency powers, recordkeeping and reporting, and conflicts of interest. The Bill requires the Agencies to jointly prescribe rules governing the regulation of ASEFs and authorizes the Agencies to exempt from registration any ASEF that is subject to comparable comprehensive supervision and regulation by another regulator.

Reporting and Recordkeeping Requirements

The Bill would require that parties who enter into non-standardized (and, therefore, uncleared) swap transactions to report such transactions to a registered swap repository (described below) or one of the Agencies. Under the Bill, no person could act as a swap repository unless it is registered with the appropriate Agency. Once registered, a swap repository would be required to accept, maintain and make available swap data as prescribed by the appropriate Agency, and would be subject to inspection and examination. The Bill directs the Agencies to jointly adopt uniform rules governing entities that register as swap repositories and permits the Agencies to exempt from registration any swap repository subject to comparable comprehensive supervision or regulation by another domestic or foreign regulator.

The Bill also directs the Agencies to make available to the public, in a manner that does not disclose the business transactions or market positions of any person, aggregate data on swap trading volumes and positions. The Bill further subjects persons who enter into swaps that are not cleared and that are not reported to a registered swap repository, to certain reporting and recordkeeping requirements.

Eligibility Requirements

The mandatory exchange trading provisions proposed in the Bill would not apply to swaps entered into by ECPs, which under existing law includes government entities that invest at least \$25 million on a discretionary basis. Under the Bill, this monetary threshold would be increased to \$50 million. In addition, the ECP qualification standards for individuals would be changed from having total assets in excess of \$10 million to having \$10 million in assets invested on a discretionary basis.

Implementation Requirements

The Bill requires the CFTC and the SEC to jointly adopt rules, within 180 days after the enactment of the Bill, that further define key terms including “swap,” “security-based swap,” “standardized,” “swap dealer,” “security-based swap dealer,” “major swap participant” and “major security-based swap participant.” The Bill also requires the Agencies to jointly adopt rules further defining the term “eligible contract participant.” The Treasury would be authorized to prescribe such rules in the event the Agencies fail to act within this time frame.

Other Commodity Exchange Act Provisions

Speculative Position Limits

The Bill authorizes the CFTC to adopt and enforce speculative position limits aggregated across: (i) contracts listed on designated contract markets (“DCMs”); (ii) contracts listed on a foreign board of trade that provides direct access from the United States to its electronic trading and order matching system; and (iii) swap contracts that perform or effect a significant price discovery function with respect to regulated markets. In determining whether a swap contract performs a price discovery function, the CFTC is instructed to consider, among other factors, the extent to which the swap uses or otherwise relies on a daily or final settlement price, or other major price parameter, of another contract traded on a regulated market based on the same underlying commodity, to value, transfer or convert, or financially settle or close out a position.

Foreign Boards of Trade

The Bill authorizes the CFTC to adopt regulations requiring the registration of foreign boards of trade that provide members and other market participants located in the United States with direct access to the foreign board of trade’s electronic trading and order matching system. (This registration requirement would replace the no-action procedure currently employed by the CFTC to authorize direct access from the United States.)

In addition, the Bill prohibits a foreign board of trade from authorizing direct access from the United States with respect to contracts that settle against a contract listed for trading on a DCM, unless the CFTC determines that the foreign board of trade: (i) makes public daily trading information regarding the contract that is comparable to the information made available by the DCM that lists the contract against which the contract traded on the foreign board of trade is settled; (ii) adopts position limits comparable to the position limits adopted by the DCM against which the contract traded on the foreign board of trade is settled; (iii) has authority to require market participants to limit, reduce or liquidate positions that such foreign board of trade determines is necessary to prevent or reduce the threat of price manipulation, excessive speculation, price distortion or disruption of delivery or the cash settlement process; and (iv) agrees to provide the CFTC with information regarding large trader positions and other information necessary to publish reports on traders’ aggregate positions.

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

Margin

The Bill would authorize the CFTC to set minimum margin requirements for all contracts traded on DCMs.

OTC Retail Transactions

The Bill would extend the provisions of the CEA governing OTC foreign currency transactions involving retail clients to OTC transactions in all commodities. The Bill, therefore, would prohibit any person from entering into, or offering to enter into, a transaction in any “commodity” (a term defined in the CEA to include, among other things, any product that is the subject of futures trading) with a person that is not an ECP or an eligible commercial entity, on a leveraged or margined basis, unless the counterparty is one of the permitted entities set forth in Section 2(c)(2)(B) of the CEA, such as an FCM, broker-dealer, material affiliated person of an FCM or broker-dealer, or a bank. This restriction does not apply if the transaction results in actual delivery within 28 days, or creates an enforceable obligation to deliver between a seller and a buyer that have the ability to deliver, and accept delivery of, the commodity in connection with their line of business.

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We expect that the Bill will be subject to hearings and mark-up before various committees in the House and Senate. We will continue to monitor the status of the Bill as it progresses through the legislative process.

Further information on the Bill can be found at the links set forth below:

Treasury Press Release

<http://www.treas.gov/press/releases/tg261.htm>

Treasury Text of Legislative Proposal

<http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf>

Treasury Section-by-Section Analysis

http://www.futuresindustry.org/downloads/Title_VII_sec-by-sec_FINAL.PDF

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