Davis Polk
CLIENT MEMORANDUM

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Competing Over-The-Counter Derivatives Bills Progress Through the House

Two competing bills to reform the over-the-counter ("OTC") derivatives markets are awaiting action by the House of Representatives: a bill to enact the "Over-the-Counter Derivatives Markets Act of 2009" (the "Frank Bill") reported by the Financial Services Committee, chaired by Barney Frank, and a bill to enact the "Derivatives Markets Transparency and Accountability Act of 2009" (the "Peterson Bill") reported by the Agriculture Committee, chaired by Collin Peterson.[1] Each of the Frank Bill and the Peterson Bill is based on the proposal released by the Obama Administration (the "Obama Proposal") on August 11, 2009, and since their earlier releases as discussion drafts, they have moved incrementally closer to each other. The bills share many common features, but several important differences remain to be reconciled. It is expected that Chairman Frank and Chairman Peterson will work to reconcile the differences before a bill moves to the House floor.

This memorandum describes the key provisions of the Frank Bill and the Peterson Bill, highlighting their similarities and differences.

Classification of OTC Derivatives and Jurisdiction

Both bills would regulate the same group of OTC derivatives and would allocate regulatory authority between the Commodities Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC") in roughly the same manner, giving the CFTC authority over "swaps" generally and the SEC authority over "security-based swaps" (not including swaps on broad-based indices of securities or government securities). The bills exclude from their purview securities options (which are already under the regulatory jurisdiction of the SEC), as well as foreign exchange swaps and foreign exchange forwards, certain traditional banking products and certain physically settled forward sale contracts on securities (other than credit default swaps).

The Frank Bill would require a significant amount of joint SEC-CFTC rulemaking in such areas as prudential requirements, rulemaking for clearinghouses and trade repositories and the definition of swaps and derivatives market participants, and it would give the Secretary of the Treasury rulemaking authority over certain matters if the SEC and the CFTC cannot agree. In contrast, the Peterson Bill avoids sharing authority between the SEC and the CFTC. For example, instead of creating a category of mixed swaps to be regulated jointly by the SEC and the CFTC as does the Frank Bill, the Peterson Bill addresses mixed swaps by defining "security-based swap" more narrowly to include only swaps that are "primarily" based on a security, rather than including swaps based to any degree on a security. The Peterson Bill would, however, require that the agencies consult with each other prior to making rules or issuing orders regarding swaps, derivatives dealers (as defined below), major market participants (as defined below), swap repositories, eligible contract participants and alternative swap execution facilities.

Both bills would require the SEC and the CFTC to consult and coordinate with each other to treat functionally or economically similar products or entities similarly. The Peterson Bill would give the

[1] For the Frank Bill, see the discussion draft (H.R. 3795) released by Chairman Frank on October 2, 2009 and the amendments thereto, approved and reported to the House of Representatives on October 15, 2009. For the Peterson Bill, see the amendment in the nature of a substitute to H.R. 3795 released by Chairman Peterson on October 20, 2009, and the amendments thereto, approved and reported to the House of Representatives on October 21, 2009.

SEC and the CFTC the option to file a petition with the DC Court of Appeals in the event it believed a rule or order conflicted with this principle or if it believed the other agency's rule or order extended beyond that agency's jurisdictional bounds.

The bills take different approaches to exemptive authority. The Frank Bill would give the SEC and the CFTC general authority to grant exemptions that are consistent with the purposes of the bill (though only by rules and regulations, rather than by order). In contrast, the Peterson Bill would limit the SEC's exemptive authority to those areas expressly authorized by the bill and would provide slightly greater exemptive authority to the CFTC, but only with respect to specified provisions of the bill.

The Frank Bill provides for later effective dates, one year after enactment for swaps and 270 days after enactment for security-based swaps, than does the Peterson Bill, which provides for a general effective date for swaps and security-based swap provisions of 180 days after enactment.

Regulation of Derivatives Dealers and Major Market Participants

Both bills would regulate persons actively engaging in OTC derivatives transactions if they fall within the definition of "swap dealer" or "security-based swap dealer" (which we sometimes refer to generally as "derivatives dealers") or "major swap participant" or "major security-based swap participant" (which we sometimes refer to generally as "major market participants"). Both bills contain exclusions from these terms for end users (the terms of which differ between the bills), which is important because many of the bills' requirements do not apply to transactions in which one of the parties is not a derivatives dealer or major market participant.

The bills' definitions of derivatives dealer largely cover the same persons, although the Peterson Bill is slightly narrower in formulation.[2] Significantly, major market participants are defined in both bills in a way that is intended to preserve the ability of many end users to engage in swaps and security-based swaps to hedge everyday commercial and operational risk, to the extent that their activities do not pose significant risks to counterparties or to the financial system. Non-dealers would be considered major swap participants or major security-based swap participants if (1) they maintain a "substantial net position" in outstanding swaps (or security-based swaps), other than positions held primarily for "hedging, reducing, or otherwise mitigating commercial risk"; or (2) their outstanding swaps (or security-based swaps) "create substantial net counterparty exposure." Under the Peterson Bill, net counterparty exposure is based on whether such exposure would have serious adverse effects on financial stability in the United States, whereas the Frank Bill focuses on material adverse effects on the counterparty itself. The Peterson Bill's approach, focused on excessive risk in the system, could cover a smaller universe of end users than the Frank Bill.

The bills allocate differently the authority to further define "substantial net position." The Peterson Bill, in keeping with its avoidance of shared regulatory authority, would require the CFTC and the SEC to independently define such term; the Frank Bill would require jointly determined definitions.[3]

Another point of difference between the two bills is that, under the Peterson Bill, a person could be designated a major swap participant for one or more types of swaps. This provision was removed from the Frank Bill during the mark-up; hence, under the Frank Bill, once a person meets the definition of major swap participant for one type of swap, such person would be a major swap participant for all types of swaps. This could require derivatives dealers and major market participants to become members of, or otherwise ensure access to, more than one clearinghouse with respect to several types of swaps even if their market activities with respect to some of those swaps are quite limited.

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[2] Unlike the Frank Bill, the Peterson Bill defines as dealers only persons for whom derivatives transactions are "a significant part of its business."

[3] The bills require that the term "substantial net position" be set at a level of activity that would allow for effective monitoring and oversight of the financial system.

- ***Regulation of Derivatives Dealers and Major Market Participants***

Swap dealers and major swap participants would be subject to registration and regulation by the CFTC, and security-based swap dealers and major security-based swap participants by the SEC. Under the Frank Bill, the CFTC and the SEC would jointly issue rules for such persons; under the Peterson Bill, the rules would be issued by the agencies independently. The rules would require registered derivatives dealers and major market participants to:

- maintain books and records and make reports;
- comply with business conduct standards addressing fraud, manipulation and adherence to applicable position limits;
- disclose to counterparties risks, conflicts of interest, and, upon request, closing prices from the clearinghouse or their own daily mark regarding the swap;
- disclose certain information pertaining to swaps and security-based swaps to the CFTC, the SEC or (in the case of banks) their Prudential Regulator (as defined below);
- implement conflicts of interest systems and procedures; and
- avoid imposing material anticompetitive burdens on trading and taking actions that would result in any unreasonable restraints on trade.

There is no exemption from registration for US or foreign banks, registered broker-dealers or CFTC-registered entities.

The Frank Bill contains significant provisions, added by amendment at the mark-up, that would limit the ability of "restricted owners," which are defined as any derivatives dealer, major market participant or person associated with them, to directly or indirectly acquire beneficial ownership interests in a swap execution facility, board of trade or exchange that trades swaps or security-based swaps and would limit such person's ability to serve on the board of directors of such entities.[4] These provisions, intended to address potential conflicts of interest, are highly controversial because they would introduce significant new statutory restrictions on ownership and governance. An amendment to the Frank Bill also sought to apply these restrictions to clearinghouses, but the amendment was deemed invalid because it conflicted with another approved amendment. A reworked amendment to this effect could later be considered by the House. This amendment raises the issue of the proper role in the decision-making process of clearinghouses by members whose capital is at risk. The Peterson Bill does not contain similar restrictions on ownership or board of directors affiliation.

- ***Prudential Supervision of Derivatives Dealers and Major Market Participants***

Both the Peterson and Frank bills require regulators to set capital and margin requirements for derivatives dealers and major market participants, though the bills use different approaches.

The Peterson Bill sets standards for how the SEC, the CFTC and the banking supervisors (defined as "Prudential Regulators"), in consultation with the SEC or the CFTC, must independently impose capital and both initial and variation margin requirements on derivatives dealers and major market participants under their jurisdiction. Each agency and Prudential Regulator would be required to impose capital and initial and variation margin requirements that (1) "help ensure the safety and soundness of the swap dealer or major swap participant"; and (2) "are appropriate for the risk associated with the non-cleared swaps" that the derivatives dealers and major market participants hold. There is no explicit

[4] Specifically, restricted owners would not be permitted to acquire beneficial ownership of interests in a swap execution facility or a board of trade, or in persons with a controlling interest in such an entity, to the extent that such an acquisition would result in restricted owners controlling, in the aggregate, more than 20 percent of the votes entitled to be cast on any matter by the holders of the ownership interests. In addition, a majority of the board of directors of such a facility must not be associated with a restricted owner.

authority for the agencies or Prudential Regulators to impose capital or margin requirements on end users.

The Frank Bill sets forth a different framework for setting capital and margin requirements, although the actual requirements that would be imposed on derivatives dealers and major market participants could, ultimately, be similar to the Peterson Bill's requirements. Under the Frank Bill, the Prudential Regulators would establish capital standards for banks, and the Federal Reserve would set equivalent or greater capital standards for bank holding companies. The SEC and the CFTC would jointly establish capital standards for non-bank derivatives dealers and major market participants that are no lower than the standards set by the Prudential Regulators for banks. Higher capital requirements would be required to be prescribed for non-cleared swaps and security-based swaps. The Prudential Regulators would establish margin requirements for bank derivatives dealers and major market participants, and could (but would not be obliged to) set such rules for swaps and security-based swaps in which one of the counterparties is neither a derivatives dealer nor a major market participant (in which case, the requirements must provide for the use of non-cash collateral). The SEC and the CFTC would jointly set margin requirements for non-bank derivatives dealers and major market participants that are at least as strict as those set for banks by the Prudential Regulators.

The Frank Bill and the Peterson Bill provide that the CFTC and the SEC could each exempt, conditionally or unconditionally, derivatives dealers and major market participants subject to their respective jurisdiction from certain requirements. The Peterson Bill would permit the CFTC to exempt swap dealers and major swap participants from any rules that it prescribes for them, whereas the Frank Bill would permit the CFTC and the SEC to provide exemptions from the prudential requirements of the bill if they find that such person is subject to "comparable, comprehensive supervision and regulation on a consolidated basis" by the other agency (the SEC or the CFTC), a Prudential Regulator or the appropriate foreign governmental authorities. Both bills would also permit the SEC to exempt broker-dealers from certain duplicative or conflicting regulatory requirements that might otherwise flow from multiple registrations. The Peterson Bill, unlike the Frank Bill, would otherwise limit the exemptive authority of the SEC and much of the exemptive authority of the CFTC to those areas explicitly authorized under the bill.[5]

- ***Segregation of Collateral***

Both bills would impose segregation requirements on derivatives dealers who hold collateral to secure the obligations of a counterparty to a swap or security-based swap that is not submitted for clearing.

Derivatives dealers would be required, in the case of a non-cleared swap or security-based swap, to segregate funds or property held as margin or collateral if requested by the counterparty. Under the Frank Bill, collateral would need to be held with an independent custodian, whereas the specific requirements of the Peterson Bill's "set aside" mandates would be specified in agency rules.[6] The Frank Bill's segregation requirements for both non-cleared swaps and security-based swaps, and the Peterson Bill's requirements for non-cleared swaps, would be triggered by a request of the counterparty for segregation, but, under the Frank Bill, if no such request is made, derivatives dealers would be required to report quarterly to their counterparties that their procedures for margin requirements comply with their agreements with their counterparties.

The Peterson Bill would impose stricter segregation requirements for swap dealers of non-cleared swaps than for security-based swap dealers, requiring that swap dealers set aside not merely the

[5] The Peterson Bill, if enacted in its current form, would likely override various initiatives by the Financial Industry Regulatory Authority to assert jurisdiction over various non-securities activities of broker-dealers because it contains explicit grants of exclusive regulatory authority to the CFTC over swap dealers and major swap participants.

[6] The Frank Bill's independence requirement for third party custodians would only be met where the derivatives dealer or major market participant that is a party to the transaction does not own 20 percent or more and does not have 50 percent or more representation on the board of directors of the custodian.

collateral received from the counterparty but also an amount of assets equal to the following: (1) minimum margin prescribed by the CFTC, (2) any additional amount agreed to by the counterparties, (3) margin received by the swap dealer from the counterparty, and (4) mark-to-market margin. The Peterson Bill would also require that swap dealers treat and invest such minimum margin amounts in accordance with rules set by the CFTC.

The Peterson Bill would further impose segregation requirements on cleared security-based swaps. A security-based swap dealer or clearing agency by or through which funds or other property are held as margin or collateral for a security-based swap would be required to segregate, maintain and use such funds or other property for the benefit of the counterparty. It would not impose such a requirement for cleared swaps.

These segregation provisions are controversial because of differences in practice between the exchange-traded futures market and the OTC derivatives market as it currently exists. In the current OTC derivatives market, the amount of collateral obtained from a counterparty (or provided to a counterparty) initially and over the life of the contract is a matter of individual negotiation. Likewise, unless one counterparty is a registered broker-dealer, the form of the collateral, where it is held and whether it may be rehypothecated are agreed by the parties and largely based on the perceived creditworthiness of the counterparty and other matters relevant to performance under the agreement.

Clearing Requirements

Both bills would require clearing of all swaps and security-based swaps that are accepted for clearing by a registered derivatives clearing organization or clearing agency, after the CFTC or the SEC published notice of and approved such clearing. Importantly, there are exceptions to these clearing requirements under both bills for end users. The Frank Bill would except from the requirement any swap with a non-swap dealer or non-major swap participant, and any security-based swap with a non-security-based swap dealer or non-major security-based swap participant. The Peterson Bill sets a higher bar for non-derivatives dealers and non-major market participants to take advantage of the clearing exception by requiring that such a counterparty also demonstrate to the CFTC or the SEC how it generally meets its financial obligations for bilateral swaps or security-based swaps. How such a showing would be made is not resolved by the bill. In addition, the Peterson Bill would allow the CFTC and the SEC to prescribe rules or issue rule interpretations as needed to prevent derivatives dealers and major market participants from abusing the exceptions to clearing.

The Frank Bill would require the CFTC and the SEC to approve, conditionally or unconditionally, a request to clear a swap or security-based swap if it found that the request is consistent with the core principles governing clearinghouses. The Peterson Bill, on the other hand, directs the CFTC to consider the core principles for derivatives clearinghouses and sets out specific additional factors for the CFTC and the SEC to consider in reviewing a request for clearing, including:

- the existence of significant outstanding notional exposures, trading liquidity and adequate pricing data;
- the availability of a rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded;
- the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the derivative clearing organization available to clear the contract;
- the effect on competition; and
- the existence of reasonable legal certainty in the event of the insolvency of the relevant derivative clearing organization or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds and property.

Both bills would give the CFTC and the SEC the authority to stay the clearing requirement for a swap or security-based swap on application of a counterparty or by its own initiative.

Mandatory Transaction Reporting

All swaps and security-based swaps that are not cleared by a derivatives clearing organization or a clearing agency would be required to be reported to a trade repository, or, if no trade repository will accept the transaction data, to the CFTC or the SEC.[7]

Trade repositories would be required to register with the CFTC or the SEC, depending on whether they accept data on swaps or security-based swaps, comply with data collection and maintenance standards and provide, on a confidential basis, transaction data to regulators. Under both bills, the SEC and the CFTC would be required to make available to the public aggregate data on swap and security-based swap trading volumes and positions.

Mandatory Exchange Trading

Under both bills, derivatives dealers and major swap participants would be required to execute on a regulated exchange or a regulated swap execution facility all swaps and security-based swaps that are required to be cleared by the CFTC or the SEC, if they are listed on an exchange or swap execution facility.

The Frank Bill would further require that if a swap or security-based swap is required to be cleared but no facility makes the swap available to trade, the counterparties must comply with recordkeeping and reporting requirements as prescribed by the CFTC or the SEC.

The Frank Bill would essentially require exchange trading only for swaps and security-based swaps between derivatives dealers and major market participants. The Peterson Bill appears to similarly except swaps and security-based swaps in which one party is not a derivatives dealer or major market participant based on the bill's clearing exception for these transactions, as described above.

The bills define swap execution facility in part as "an entity that facilitates the execution of swaps between two persons through any means of interstate commerce but which is not a designated contract market," which includes electronic and voice systems. Both bills would give the CFTC and the SEC the authority to conditionally or unconditionally exempt a swap execution facility from registration if it finds that such facility is subject to comparable, comprehensive supervision and regulation by the SEC or CFTC, as the case may be, a prudential regulator or the appropriate governmental authorities in the organization's home country.

The exchange trading and swap execution facility provisions of the bills raise many interesting policy and practical questions. For example, what sort of exchange trading and broader market structure might evolve for swaps? In the equities and listed options markets there are extensive requirements for order handling, intra-market priority, order display, inter-market linkage and inter-market order protection, among others. It remains to be seen whether an exchange trading requirement for swaps and security-based swaps would result in a marketplace where trades are agreed away from the market and then simply "printed" on an exchange or swap execution facility, or whether something more robust would evolve.

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[7] The bills set out different requirements for which counterparty must report transaction data. Under the Peterson Bill, the counterparties could agree who will report the swap, provided that if one of the counterparties is a swap dealer or security-based swap dealer, such counterparty must report the trade. By contrast, the Frank Bill contains duplicative reporting requirements for transactions in which both counterparties are either swap dealers or major swap participants, or, in the case of security-based swaps, are both security-based swap dealers or major security-based swap participants, requiring that both counterparties report the trade. Otherwise the requirements under the Frank Bill and the Peterson Bill are identical in that they would require that where only one counterparty is a swap or security-based swap dealer or a major swap or security-based swap participant, such counterparty must report the trade, and if neither counterparty is a swap or security-based swap dealer or major swap or security-based swap participant, then the parties could agree by contract on who will report the trade.

Another interesting question is the status of swap execution facilities. Under both bills, these facilities would have a responsibility to adopt rules that meet certain minimum standards and to enforce those rules vis-à-vis their members. However, SEC-registered facilities would not seem to be subject to the same filing and public notice and comment requirements concerning rules and fees, or the same limitations with respect to fair access and disciplinary authority, as exchanges. The absence of these requirements and limitations could be significant in practice for market participants, since if a swap execution facility were to trade a particular swap, but no exchange did, a market participant that was subject to the exchange trading requirement would need to obtain access to that facility's services, either via membership or some form of indirect (and possibly more expensive) access.

A third, and extremely important, consideration is how one would be able to determine whether a given swap must be traded on an exchange or swap execution facility. If, for example, two parties wanted to effect a swap referencing LIBOR and the total return on a particular issuer's common stock, with quarterly payment dates on February 1 and the first day of each subsequent quarter, but the only exchange or execution facility that listed a LIBOR/issuer contract provided standard contract terms of quarterly payments on March 1 and the first day of each subsequent quarter, it is unclear whether the parties would be required to trade on the listing exchange or facility.

Transactions with Non-Eligible Contract Participants

Under both bills, transactions with non-eligible contract participants would be required to be exchange traded. Over-the-counter swaps and security-based swaps with such non-eligible contract participants would be prohibited, and any person who acts as a dealer in a security-based swap with a non-eligible contract participant would be required to register as a broker-dealer if they had not already done so. The bills would also raise the bar for natural persons and certain governmental entities to be considered an eligible contract participant. The exchange trading requirement and other restrictions on dealing with persons that are not eligible contract participants would challenge the ability of non-eligible contract participants such as small municipalities and less wealthy investors to engage in customized OTC swap and security-based swap transactions; however, this does open the possibility, at least in theory, of an expanded retail, exchange-traded market for swaps and security-based swaps.

Regulation of Derivatives Clearing Organizations and Clearing Agencies

Unless exempted, derivatives clearing organizations and clearing agencies would need to be registered with the CFTC and SEC, respectively, and would be subject to certain business conduct standards. Under both bills, the rules of derivatives clearing organizations and clearing agencies would be required to prescribe that all swaps and security-based swaps submitted with the same terms and conditions are economically equivalent and may be offset with each other, limited by the Peterson Bill to offsets within the derivatives clearing organization or clearing agency. While the Peterson Bill contains a requirement that derivatives clearing organizations and clearing agencies provide nondiscriminatory clearing of contracts executed on unaffiliated exchanges, neither bill would require complete fungibility and non-discriminatory clearing across markets for swaps.

The Frank Bill would require dual registration of a person that meets the requirements for derivatives clearing organizations and clearing agencies, regardless of whether it is already registered as an organization or agency or is also a bank. By contrast, the Peterson Bill would require that the CFTC and the SEC exempt a clearing agency or derivatives clearing organization from registration as a derivatives clearing organization or clearing agency that is principally engaged in clearing securities and options on securities, or, in the case of a derivatives clearing organization, is principally engaged in clearing commodity futures and options on commodity futures, unless it finds that such entity is not subject to comparable regulation by the SEC or the CFTC.

Both bills authorize exemptions from registration, either conditional or unconditional, where the SEC or the CFTC finds that such person is subject to comparable comprehensive supervision and regulation

on a consolidated basis by a prudential regulator or the appropriate foreign governmental authorities. The Frank Bill would also give the SEC and the CFTC the ability to exempt from registration an entity that it finds is subject to comparable regulation by the other agency. The Peterson Bill would deem a bank, clearing agency and derivatives clearing organization to be registered if it is already registered with the SEC or the CFTC to the extent that the bank cleared swaps as a multilateral clearing organization or the clearing agency cleared swaps or the derivatives clearing organization cleared security-based swaps before the enactment of the clearing sections of the bill.

Position Limits and Large Swap Trader Reporting

Provisions for position limits and large swap trader reporting appear in both bills, although the Peterson Bill is stricter with respect to position limits.

The Peterson Bill would require that the CFTC directly set speculative position limits, other than “bona fide hedge positions” that may be held by any person with respect to certain contracts for physical commodities traded on or subject to a designated contract market. Unlike the Obama Proposal, neither bill would give the SEC authority to prescribe independent position limits for listed securities.

The bills are similar with respect to requirements imposed on the SEC and the CFTC to set position limits for swaps and security-based swaps. Both bills would allow the CFTC to impose position limits on swaps that perform or affect a significant price discovery function and would require aggregation of such limits across markets. The SEC would have more expansive authority to set position limits for security-based swaps (and, under the Frank Bill, security-based swap agreements), as it could do so without limitation as to whether a security-based swap performs a significant price discovery function, and would also be permitted to require an SRO to adopt rules regarding positions that may be held by any of its members or any person for whom its members effect transactions in security-based swaps. The SEC would also be permitted to require persons to aggregate certain related securities and loans in order to establish appropriate position limits. Both bills would authorize the SEC to direct SROs to establish position limits, which may also require such aggregation.

Both bills would permit the SEC to require any person that effects transactions in any security-based swap and certain related securities and loans to report information on their positions in any of these instruments to the SEC. The Frank Bill would give the SEC such authority over security-based swap agreements.

Definition of Security, Beneficial Ownership and Securities Act Issues

The definition of “security” under the Securities Act of 1933 (the “Securities Act”) and the Securities Exchange Act of 1934 (the “Exchange Act”) would be expanded under both bills to include security-based swaps. The Frank Bill, however, would exempt security-based swaps from registration and related disclosure requirements under the Securities Act. Also, as noted above, under the Frank Bill, the SEC would have authority to exempt, conditionally or unconditionally, any person, derivative or transaction from any provision of the Exchange Act added by the bill.

Both the Frank and the Peterson bills would provide for the extension of the beneficial ownership requirements of Section 13 of the Exchange Act (and thereby, indirectly, the short-swing profit rule of Section 16) to include positions underlying security-based swaps, equity securities underlying security-based swaps and other derivatives to the extent defined by SEC rule. The Frank Bill has an important clarifying provision that states that the security-based swap positions cannot be the predicate for application of Sections 13 and 16 unless the SEC determines that such positions are the equivalent of stock ownership.

Concerning the application of the Securities Act to security-based swaps, both bills provide that an offer of a security-based swap by the issuer of the underlying security or an affiliate or an underwriter is treated as an offer of the underlying security (and make no distinction between whether the swap is

"long" or "short" from the issuer's perspective). As mentioned above, the bills would also ban unregistered offers and sales of security-based swaps to non-eligible contract participants (irrespective of any exemption under Sections 3 or 4 of the Securities Act that might otherwise be available). This means that mechanisms, perhaps similar to those in the listed options market, would need to be developed to register the obligations of a clearing agency under the Securities Act, if persons who are not eligible contract participants are to participate in exchange trading of security-based swaps. Finally, unlike the Peterson Bill, the Frank Bill would confer on the SEC the ability to establish registration exemptions by rule for security-based swaps under Section 3 of the Securities Act.

Preemption of state gaming, bucket shop and similar laws and of most state securities laws for security-based swaps is provided for by both bills. There remains, however, a significant ambiguity as to whether the bills would effectively preempt state insurance laws such as the model statute being drafted by the National Conference of Insurance Legislators relating to credit default insurance.

Prevention of Fraud, Manipulation and Market Abuses

Both bills would give the SEC and the CFTC expanded rulemaking and enforcement authority to prevent market manipulation, fraud and other market abuses with respect to swaps and security-based swaps and would impose "statutory disqualification" limitations on persons associated with newly regulated entities.

International Derivatives Markets

There is no general territoriality limitation in either bill that would restrict their regulation of transactions entered into between foreign persons located outside the United States, nor is there any equivalent to existing Exchange Act Rule 15a-6, under which many non-US entities currently engage in securities transactions with US institutions. Limited exemptive authority would be given to the SEC and the CFTC under both bills that could be exercised to exempt certain foreign transactions, persons and entities from some regulation requirements where the SEC or the CFTC find that they are subject to comparable home country regulation.

It is possible that an amendment for a general extraterritorial limitation could find its way into the legislation to be considered by the House. During the mark-up of the Frank Bill, Representative Spencer Bachus submitted and then withdrew an amendment that would limit the bill's extraterritorial reach such that its provisions and any rules or regulations prescribed thereunder would not apply to any swap or security-based swap "between non-U.S. resident persons transacted without the use of the mails or any other means or instrumentality of interstate commerce." Chairman Frank committed to working with Representative Bachus on such an amendment.

Both bills would give the SEC and the CFTC the authority to exempt from registration foreign clearinghouses and swap execution facilities and exempt from regulation foreign trade repositories that they find to be subject to comparable regulation in their home country. The Frank and Peterson bills would also direct the SEC, the CFTC, the prudential regulators and the (future) financial stability regulator to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards for swaps and security-based swaps.

As discussed above, the Frank Bill would give the SEC and the CFTC the authority to exempt derivatives dealers and major market participants from the bill's prudential requirements if they are found to be subject to comparable regulation by their home country regulator. At the same time, the Frank Bill contains a provision that would allow the CFTC or the SEC, in consultation with the Secretary of the Treasury, to prohibit an entity from participating in the United States in any swap or security-based swap activities if it determines that the foreign country in which the entity is domiciled regulates swaps or security-based swaps markets in a way that undermines the stability of the US financial system.

The bills also contain provisions for the CFTC to partially regulate foreign boards of trade that permit remote terminal access in the United States by requiring that they adopt reporting and position limit requirements for certain contracts, and the Frank Bill would allow the CFTC to require registration of such foreign boards of trade.

Prohibition of Government Assistance

Both the Frank Bill and the Peterson Bill contain a provision that prohibits federal assistance (as defined in the bills) to support clearing operations or liquidation of a derivatives clearing organization (and, under the Peterson Bill, a clearing agency), except where explicitly authorized by an Act of Congress. The types of federal assistance described amount to different ways of using public funds to bail out clearinghouses.

Future Studies

Both bills call for future studies concerning regulation of the OTC derivatives markets. The Frank Bill would direct the SEC and the CFTC to present to Congress reports on: "standardized algorithmic descriptions for financial derivatives"; the feasibility of establishing a single regulator for all financial derivatives by January 1, 2012; and recommendations for amending federal insolvency laws to enhance legal certainty regarding margin deposits and portability of customer positions at clearinghouses, harmonize the insolvency law frameworks applicable to jointly registered commodity brokers and securities brokers or dealers and facilitate cross-product portfolio margining. The Peterson Bill would direct the CFTC, in consultation with each entity that is a designated contract market, to study the effects of position limits imposed by the bill on excessive speculation and on the movement of transactions to trading venues outside the United States. It would also direct the Chairman of the CFTC to prepare and submit biennial reports to Congress on the derivatives markets in the United States and abroad, including an analysis of any growth or decline in the markets, the effectiveness of the regulatory regime in mitigating systemic risk and the costs of compliance with regulation.

European Commission OTC Derivatives Regulatory Reform

On a parallel track to the US derivatives reform process, the European Commission, the European Union's executive body, is working towards generating legislative proposals for OTC derivatives reform in 2010. On October 20, it released a Communication that sets out future policy actions in this area.[8] The European Commission's proposals in the Communication are similar to the Frank Bill and Peterson Bill in many respects and share their reform goals, namely, to promote transparency, strengthen market integrity and oversight and reduce counterparty credit and operational risks. Among other things, the Communication proposes to further regulate central counterparties and trade repositories, improve collateralization of cleared contracts, require higher capital for bilaterally cleared contracts and mandate central counterparty clearing for all standardized contracts. Also in line with the Frank and Peterson bills, the Communication states that all standardized derivatives should be traded on exchanges and other organized trading venues and that regulators should set position limits for derivatives. The Communication calls for reporting obligations for market participants, exchanges and clearinghouses and for mandatory reporting of all OTC derivatives transactions to trade repositories. Similar to the Frank and Peterson bills, the European Commission is focused on tailoring its regulatory requirements in a way that would not overburden end users but at the same time would not open up significant regulatory loopholes.

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[8] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank, "Ensuring efficient, safe and sound derivatives markets: future policy actions" COM(2009) 563/4.

Given the similar trajectory of OTC derivatives reform in the United States and Europe, the global nature of the derivatives markets that this reform will impact, and the need to avoid opportunities for regulatory arbitrage, there will likely be initiatives for regulatory harmonization between the United States and the European Commission. The Financial Stability Board and the G-20, which outlined derivatives reform as a key objective on its regulatory reform agenda in its September 25, 2009 meeting, will also have a central role in harmonizing derivatives regulation.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Daniel N. Budofsky	212 450 4907	daniel.budofsky@davispolk.com
Annette L. Nazareth	202 962 7075	annette.nazareth@davispolk.com
Lanny A. Schwartz	212 450 4174	lanny.schwartz@davispolk.com
Robert L.D. Colby	202 962 7121	robert.colby@davispolk.com
E. Ashley Harris	212 450 4780	ashley.harris@davispolk.com

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