



# Finance Digest

Excerpted from the  
**December 2009**  
Issue

## U.S. House of Representatives Passes Derivatives Legislation

*By Conrad G. Bahlke and Tomasz Kulawik\**

On December 11, 2009, the U.S. House of Representatives passed the Derivative Markets Transparency and Accountability Act of 2009 (the "DMA") as part of the Wall Street Reform and Consumer Protection Act of 2009. The DMA is a modified form of legislation drafted by the Obama Administration earlier this year (the "Obama Proposal"). The Obama Proposal was the first comprehensive legislative effort to increase regulation of over-the-counter ("OTC") derivatives and bring them under federal supervision. In addition, Senate Banking Committee Chairman Christopher Dodd's discussion draft on comprehensive financial regulatory reform, Title VII of which focuses on the regulation of the OTC derivatives markets (the "Dodd Bill"), remains outstanding. The Senate will consider financial services reform legislation in the new year. This article describes the key OTC derivatives-related provisions of the DMA and the Dodd Bill (collectively, the "Bills") and the differences between them.

### Regulatory Authority of the Commodity Futures Trading Commission and the Securities Exchange Commission Over Swap Agreements

Under the Bills, the Commodity Futures Trading Commission (the "CFTC") would be given jurisdiction over "swaps," which are very broadly defined to include virtually all kinds of OTC derivatives. It should be noted, however, that the CFTC's jurisdiction would only apply to swaps entered into by entities that would be required to register with the CFTC, such as "swap dealers" and "major swap participants," as more fully described below. The Bills would not apply to sales of "nonfinancial" commodities for deferred shipment or delivery if such transactions are physically settled (or, in the case of the DMA, intended to be physically settled). Under the DMA, the Secretary of the Treasury and the CFTC may jointly determine the extent to which foreign exchange forwards and swaps would be subject to the DMA (and under the Dodd Bill, they would be exempt from regulation as swaps).

The term "swap" would not include "security-based swaps," which under the Bills would fall under the jurisdiction of the Securities Exchange Commission (the "SEC"). Security-based swaps would be defined as contracts that are primarily<sup>1</sup> based on: (i) a narrow-based security index; (ii) a single security or loan, including any interest therein or based on the value thereof; or (iii) the occurrence, non-occurrence, or 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, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer(s). Security-based swaps would not include contracts

referencing or based upon “exempted securities” as defined in the Securities Exchange Act of 1934, as amended which would primarily include US government and municipal securities, with certain exceptions. The Dodd Bill would also provide that certain transactions that share characteristics of both swaps and security-based swaps (“mixed swaps”) would be considered security-based swaps and therefore would fall under the SEC’s jurisdiction.

### Clearing Requirement

Generally under the DMA, a swap or a security-based swap would have to be cleared if the CFTC or the SEC determines that the transaction is required to be cleared. Such transaction would be subject to a derivatives clearing organization (registered with the CFTC) or clearing agency (registered with the SEC) accepting the transaction for clearing. Clearing organizations and clearing agencies would submit to the CFTC or the SEC for prior approval each transaction or group of transactions that they plan to accept for clearing. The CFTC and the SEC would have 90 days to respond to such request for approval. The Dodd Bill would impose a general requirement that all swaps and security-based swaps be submitted for clearing. The Bills would require that the rules of such clearing organizations and agencies provide that swaps and security-based swaps with the same terms and conditions are economically equivalent within the derivatives clearing organization or clearing agency and may be offset with each other within such derivatives clearing organizations or clearing agencies. Under the Bills (subject, in the Dodd Bill, to the CFTC or the SEC issuing an exemption), the clearing requirement would not apply to swaps and security-based swaps where one of the counterparties is not, in the

case of swaps, a swap dealer or a major swap participant or, in the case of security-based swaps, a security-based swap dealer or a major security-based swap participant. The DMA would additionally provide that the clearing requirement would not apply to swaps or security-based swaps entered into by one of the counterparties to hedge or mitigate commercial risk, including operating or balance sheet risk, if such counterparty notifies the CFTC or the SEC how it generally meets its financial obligations associated with entering into non-cleared swaps and security-based swaps.

Each clearing organization or agency would be required to designate a compliance officer, whose duties, among others, would include resolving any conflicts of interest that may arise and ensuring compliance with commodities and securities laws and regulations. The Bills would also establish “core principles” that the clearing organizations and agencies would be required to comply with, including: (i) having adequate financial resources enabling such an organization or agency to meet its financial obligations to its members and participants under “extreme but plausible market conditions;” (ii) establishing and verifying admission and continuing eligibility standards for its members and participants; (iii) having proper risk management and settlement mechanisms as well as rules and procedures ensuring efficient functioning of the organization if one of the members or participants becomes insolvent and (iv) various reporting, information-sharing and record-keeping requirements. An amendment offered by Rep. Stephen Lynch (D – MA), which was subsequently adopted in the DMA, would prescribe certain prohibitions regarding the ownership of swap

execution facilities. No identified financial holding company that is a swap dealer, security-based swap dealer, major swap participant, major security-based swap participant or a person associated with any of them would be permitted directly or indirectly to acquire beneficial ownership of interest(s) in a swap execution facility or in persons with a controlling interest in such a facility, to the extent that such an acquisition would result in restricted owners having voting control over more than 20 percent of the votes entitled to be cast on any matter by the holders of the ownership interests.

### Mandatory Registration of Major Swap Participants

The Bills would require “swap dealers” and “major swap participants” to register with the CFTC. The DMA would define a “swap dealer” as any person who: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly engages in the purchase of swaps and their resale to customers in the ordinary course of a business; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market-maker in swaps. An exception would be provided for entities that engage in a *de minimis* amount of swap dealing in connection with transactions with or on behalf of its customers. The Dodd Bill, on the other hand, would define a “swap dealer” more broadly as any person engaged in the business of buying and selling swaps for such person’s own account, through a broker or otherwise (not including a person that buys or sells swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business).

The definition of a “major swap participant” has been the subject of

much controversy. An amendment was offered by Rep. Scott Murphy (D – NY) during House debate on the DMA and was ultimately adopted. A “major swap participant” would be defined as a person who is not a swap dealer and (i) who maintains a substantial net position in outstanding swaps, excluding positions held primarily for hedging, reducing or otherwise mitigating its commercial risk or (ii) whose outstanding swaps create substantial net counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. The CFTC and the SEC would define (for major swap participants and major security-based swap participants, respectively) “substantial net position” at a threshold they determine prudent for the effective monitoring, management, and oversight of entities which are systemically important or could significantly impact the financial system. The Dodd Bill would define a major swap participant as any person who is not a swap dealer and whose outstanding swaps create net counterparty credit exposures (current or potential future exposures) to other market participants that would expose those other market participants to significant credit losses in the event of the person’s default.

The Bills would also contain parallel definitions of “security-based swap dealers” and “major security-based swap participants” who would have to be registered with the SEC.

The Bills would impose requirements that would have to be met by swap/security-based swap dealers and major swap/security-based swap participants, including: (i) capital and margin requirements prescribed by, in the case of banks, the “prudential regulators” (the Board of Governors of the Federal Reserve System, the Office of the

Comptroller of the Currency and the Federal Deposit Insurance Corporation, as applicable)<sup>2</sup> and, in the case of non-banks, the CFTC and the SEC jointly (the Dodd Bill) and by the CFTC and the SEC with respect to the entities required to be registered with them (the DMA); and (ii) reporting and recordkeeping requirements (including maintaining daily trading records). The Bills would provide that upon the request of a nondealer counterparty, a swap dealer would be required to segregate initial margin for a noncleared swap in an account with an independent third-party custodian. The Dodd Bill would provide relief from margin requirements for a transaction with an end-user, where such user is not a swap/security-based swap dealer or major swap/security-based swap participant, is not a firm predominantly engaged in financial market activities and enters into the derivative transaction as a hedge under Generally Accepted Accounting Principles.

The Bills would also require compliance with “business conduct standards” and “business conduct requirements” which would include: (i) avoiding fraud and manipulation; (ii) verifying that the counterparties meet the criteria for “eligible contract participants”; and (iii) disclosure to the CFTC, the SEC and the bank regulators of various kinds of information. Finally, the entities referenced in this section would have to comply with certain documentation standards, monitor their trading and have mechanisms in place that would address potential conflicts of interest.

### Trading Requirement and Alternative Swap Execution Facilities

The Bills would require that swaps and security-based swaps that are required to be cleared be traded on a

board of trade designated as a contract market or on a swap execution facility,<sup>3</sup> or an exchange or a swap execution facility, respectively, unless they are not accepted for trading. A swap execution facility would be defined as a person or entity that facilitates the execution or trading of swaps between two persons which is not a designated contract market or an exchange, including any electronic trade execution or voice brokerage facility. Every swap execution facility would have to be registered either with the CFTC or the SEC. The Bills set forth certain requirements that would have to be met by the swap execution facilities. They would include: (i) establishing and enforcing trading and participation rules that will deter abuses; (ii) establishing and enforcing trading procedures to be used in entering and executing orders; (iii) ensuring the financial integrity of swaps entered on the swap execution facility; (iv) monitoring and compliance with any of the rules of the facility; (v) permitting trading only in swaps that “are not readily susceptible to manipulation;” (vi) monitoring of trading; (vii) obtaining and providing information to the CFTC or the SEC, as applicable; (viii) adopting position limitations or position accountability for “speculators;” (ix) adopting rules to provide for the exercise of emergency authority; (x) publication of data regarding price, trading volume and other trading data on swaps traded on the swap execution facility; (xi) recordkeeping and reporting; (xii) certain antitrust considerations; (xiii) establishing and enforcing rules to minimize conflicts of interest and (xiv) certain financial resources and system safeguards requirements. Finally, every swap execution facility would be required to designate a compliance officer

whose duties would include, among others, preparing an annual report on the compliance of the swap execution facility with the commodities and securities laws, as applicable.

### Swap Repositories

Under the Bills, the counterparties to a swap or a security-based swap that is not accepted for clearing by any derivatives clearing organization or clearing agency would be required to report such a swap or security-based swap to a “swap repository” or a “security-based swap repository,” respectively. Such repositories would be required to register with the CFTC or the SEC, as applicable. The repositories would accept and maintain swap and security-based swap-related data and provide to the CFTC and the SEC information that those agencies might require. Persons who enter into swaps that are not cleared and are not reported to a swap repository would also be subject to certain reporting and recordkeeping requirements. The Bills would also give the CFTC and the SEC the authority to make available to the public, in a manner that would not disclose the business transactions and market positions of any person, aggregate data on swap and security-based swap trading volumes and positions.

### Changes to Eligible Contract Participant Definition

Under the Bills, any transaction with a person that is not an eligible contract participant would have to be traded on an exchange. The Bills would also revise the definition of eligible contract participant. Previously, governmental entities owning and investing on a discretionary basis \$25 million or more in investments were considered eligible contract participant. This threshold would now be \$50 million or more. Further, an individual would be an eligible contract participant if s/he

has in excess of \$10 million invested on a discretionary basis and not total assets in excess of \$10 million, as the Commodity Exchange Act now provides.<sup>4</sup>

### Position Limits

The DMA would require the CFTC (and the Dodd Bill would give the CFTC the authority) to establish limits (including related hedge exemption provisions) on the aggregate number or amount of positions in contracts based on the same underlying commodity that may be held by any person across contracts listed by designated contract markets, contracts traded on foreign boards of trade and swap contracts that “perform or affect [sic] a significant price discovery function with respect to regulated entities.” In determining whether certain swap contracts perform this function the CFTC would analyze various factors, including: (i) the extent to which such swap contract relies in valuation and settlement on daily or settlement prices of another contract based upon the same commodity; (ii) whether such swap contract’s price is sufficiently linked to the price of another contract based on the same underlying commodity as to allow arbitrage; (iii) the extent to which the price of such swap contract is used to price other contracts; (iv) the extent to which the volume of swaps being traded in the commodity is sufficient to have a material effect on another contract traded on a regulated market; and (v) other factors as the CFTC may later prescribe.

The Bills would also give the SEC the authority (but would not require it to do so) to establish limits (including related hedge exemption provisions) on the size of positions in any security-based swap that may be held by any person. There would be no requirement that the security-based swaps in question perform a

significant price discovery function. The SEC could also require that self-regulatory organizations prescribe position limits for their members or persons for whom a member of such organization effects transactions in security-based swaps. The Dodd Bill tracks the Obama Proposal in that it would give the SEC the authority to establish position limits with respect to securities traded on national securities exchanges and would also provide that the security-based swaps would need to perform a significant price discovery function in order for a position limit to be imposed.

### Foreign Boards of Trade

The DMA would give the CFTC authority not to permit a foreign board of trade<sup>5</sup> to provide its members and other participants located in the United States direct access to its electronic trading or order matching system with respect to contracts that settle against any price of contracts traded on a registered entity unless the CFTC determines that the foreign board of trade: (i) makes public daily trading information with respect to such contracts that is comparable to the information that is made public with respect to the applicable contracts traded on the registered entity; (ii) adopts position limits comparable to those adopted by the respective registered entity; (iii) has the authority to require the market participants to limit, reduce or liquidate any position that might be necessary to prevent or reduce the threat of price manipulation, distortion, disruption of delivery, the cash settlement process or excessive speculation; (iv) agrees with respect to contracts settling against contracts traded on the registered entity to notify the CFTC of any changes regarding information that the foreign board of trade will make publicly available, position limits that will be

adopted and enforced, position reductions mentioned above and any other matters of interest to the CFTC;

(v) provides information regarding large trader positions in such contracts to the CFTC; and (vi) provides the CFTC with information necessary to publish reports on aggregate trader positions for contracts traded on the foreign board of trade that are comparable to such reports for U.S. contracts against which they settle.

- 1 The Dodd Bill does not contain the word “primarily”.
- 2 The Dodd Bill would give such authority to a newly created Financial Institutions Regulatory Administration.
- 3 The Dodd Bill uses the term “alternative swap execution facility.”
- 4 The Dodd Bill would amend the definition in certain other respects as well; for example, the \$50 million requirement for governmental entities will not take into account any proceeds from any offering of municipal securities.
- 5 The Dodd Bill would additionally give the CFTC the authority to require foreign boards of trade to register with the CFTC.

- BEIJING
- BOSTON
- BUDAPEST
- DALLAS
- DUBAI
- FRANKFURT
- HOUSTON
- HONG KONG
- LONDON
- MIAMI
- MUNICH
- NEW YORK
- PARIS
- PRAGUE
- PROVIDENCE
- SHANGHAI
- SILICON VALLEY
- WARSAW
- WASHINGTON, DC
- WILMINGTON

**The Finance Digest Editorial Board**

If you need further information or have questions concerning the contents of this issue, please contact:

Erika L. Weinberg, Editor  
 (Capital Markets)  
 212-310-8910  
[erika.weinberg@weil.com](mailto:erika.weinberg@weil.com)

Corey Chivers (Capital Markets)  
 212-310-8893  
[corey.chivers@weil.com](mailto:corey.chivers@weil.com)

Douglas R. Urquhart (Banking & Finance)  
 212-310-8001  
[douglas.urquhart@weil.com](mailto:douglas.urquhart@weil.com)

Jason A.B. Smith  
 (Structured Finance and Derivatives)  
 212-310-8914  
[jason.smith@weil.com](mailto:jason.smith@weil.com)

Brian A. Waldbaum  
 (Structured Finance and Derivatives)  
 212-310-8706  
[brian.waldbaum@weil.com](mailto:brian.waldbaum@weil.com)

Philip Rosen (Property)  
 212-310-8604  
[philip.rosen@weil.com](mailto:philip.rosen@weil.com)

Finance Digest is published by the Capital Markets, Banking & Finance, Structured Finance and Derivatives, and Property Groups of Weil, Gotshal & Manges LLP, <http://www.weil.com>. ©2009. All rights reserved. Quotation with attribution is permitted. This publication provides general information and should not be used or taken as legal advice for specific situations which depend on the evaluation of precise factual circumstances. The views expressed in these articles reflect those of the authors and not necessarily the views of Weil, Gotshal & Manges LLP. If you would like to add a colleague to our mailing list or if you need to change or remove your name from our mailing list, please log on to [www.weil.com/weil/subscribe.html](http://www.weil.com/weil/subscribe.html) or send an email to [subscriptions@weil.com](mailto:subscriptions@weil.com).

[www.weil.com](http://www.weil.com)