



Title VII — Over-the-Counter Derivatives

- **Regulatory Regime.** Historical CFTC/SEC regulatory structure maintained and authorities strengthened as prior statutory exemptions from regulation eliminated.
- **“Spin Out” of OTC Derivative Activities.** Limited “spin out” provision will require certain depository institutions to move their swap/SB swap operations into separately capitalized affiliates. Initial compliance period of up to 24 months for certain dealers, subject to potential extension by Federal banking agencies for up to one further year.
- **Mandatory Clearing.** Mandatory central counterparty clearing and exchange trading of swaps/SB swaps are not as comprehensive as previously proposed but nevertheless may require most transactions to be centrally cleared and traded on a regulated exchange or execution facility, depending on CFTC and SEC rule-making.
- **Exemptions.** Limited exemption from mandatory clearing and exchange trading for end-users of swaps/SB swaps.
- **Dealer and Participant Regulation.** Registration with, reporting to and regulation by CFTC, SEC and prudential regulators of swap/SB swap dealers and major swap/SB swap participants, including capital and margin requirements.
- **Trade Reporting.** Mandatory reporting of virtually all swap/SB swap transactions in real time.
- **Position Limits.** CFTC and SEC authorized to prescribe position and trading limits, potentially on a class-wide basis.
- **Duties to Special Entities.** New responsibilities of swap/SB swap dealers that act as advisors to certain governments, pensions and endowments that engage in swaps/SB swaps.
- **Preemption.** Federal preemption of State regulation of swaps/SB swaps as insurance. Federal preemption of State regulation of SB swaps regulated by the SEC (but no comprehensive preemption for swaps regulated by the CFTC) under State gaming and bucket shop laws.
- **Extraterritorial Effect.** Limited extraterritorial effect of swap/SB swap provisions.

Subtitle A — Regulation of Over-the-Counter Swaps Markets and Subtitle B — Regulation of Security-Based Swaps Markets

- *Elimination of Regulatory Exemptions.* The Act eliminates virtually all exemptions from the Federal securities and commodities laws created by the Commodity Futures Modernization Act of 2000 for OTC derivatives.
- *Bifurcated SEC/CFTC Regulation.* The Act retains the historically-based two-regulator structure within the executive branch and sets up bifurcated regulatory regimes for OTC derivatives, OTC market participants and OTC markets based on whether the OTC derivative is a swap or a security-based swap (“SB swap”). The Act gives the SEC jurisdiction over SB swaps and the CFTC jurisdiction over non-SB swaps. Participants in both swap and SB swap markets will therefore be subject to regulation by both the SEC and the CFTC, as in the case of a dually registered broker-dealer/futures commission merchant (“FCM”). The Act prohibits swaps on agricultural commodities except to the extent specifically permitted by the CFTC pursuant to its general exemptive authority or a CFTC rule or order. The base definition of a “swap” is sufficiently broad to include virtually any OTC derivative with the important exception of options on individual securities or any group or index of securities (whether broad-based or narrow-based) and certain other limited exceptions.¹ SB swaps are then excluded from the “swap” definition. SB swaps are defined as swaps based on single securities or loans, narrow-based securities indices, and credit events with respect to single issuers or the issuers in a narrow-based securities index. Thus, as in the case of other non-option derivatives, jurisdiction over credit default swaps and total return swaps is split between the SEC and the CFTC based upon the broad-based/narrow-based distinction. Options on securities and securities indices are neither swaps nor SB swaps, but remain within the definition of a “security” under the Exchange Act and consequently remain subject broadly to regulation by the SEC.
- *Foreign Exchange.* The definition of “swap” includes foreign exchange forwards and swaps that are cleared through a derivatives clearing organization (“DCO”) or traded on a designated contract market (“DCM”) or swap execution facility (“SEF”). However, OTC foreign exchange forwards or swaps that are not cleared or traded through one of these facilities may be excluded from the requirements of Title VII if the Treasury Secretary determines that they should not be regulated as swaps under Title VII and they were not structured to evade Title VII in violation of a rule adopted by the CFTC. Such foreign exchange forwards and swaps must nevertheless be reported to a swap data repository. In addition, any swap dealer or major swap participant entering into such trades will be subject to business conduct rules. Agreements, contracts or transactions in foreign currency offered or sold to retail investors will continue to be subject to existing CFTC requirements.
- *New Regulation of OTC Dealers and Market Participants.* New substantive regulatory regimes will apply to swap/SB swap dealers and major swap/SB swap participants (“regulated swap entities”). The new regimes include registration with the applicable regulator, record-keeping, reporting, supervision, position limits, business conduct standards, disclosure, balanced communication, restrictions on conflicts of interest, capital and margin requirements, and examination provisions, among other broad areas in which the CFTC and SEC are required to regulate. Each regulated swap entity will be required to appoint a compliance officer.
 - The new regulatory categories are independent of existing regulatory categories, so investment advisers, broker-dealers, banks, other dealers, CTAs, CPOs and FCMs that engage in transactions in swaps or SB swaps would generally be required to register and be regulated under the new categories as well.
 - The Act does not include an express requirement that associated persons (“APs”) of regulated swap entities register with the CFTC or SEC. It is possible that the SEC and/or CFTC will use their broad rule-making

¹ Other exclusions from the base definition include exchange traded futures contracts and commodity options; physically-settled forwards; exchange traded options on currencies; certain securities contracts; foreign exchange swaps and forwards; and counterparty transactions with a Federal Reserve Bank, the U.S. government or an agency backed by the full faith and credit of the United States.

- authority to require APs to register or to pass qualifying exams in order to be associated with a regulated swap entity.
- Certain parties to swaps/SB swaps, even though they do not act as dealers, may nevertheless be subject to registration and regulation under the new major swap/SB swap participant categories, which include:
 - Any market participant with a “substantial position” in swaps/SB swaps in any category specified by the CFTC or SEC, respectively (excluding certain positions that hedge or mitigate commercial risk);
 - Any market participant with substantial counterparty exposure that could have serious adverse effects on U.S. financial stability; and
 - Any financial entity² that is highly leveraged, is not subject to capital requirements established by an appropriate Federal banking regulator and maintains a substantial position in outstanding swaps in any categories specified by the CFTC or SEC, respectively.
 - The second (substantial counterparty exposure) and third (highly leveraged financial companies) categories do not establish distinctions in the scope of regulation based on whether outstanding positions are held for hedging or mitigating commercial risk. Category two could therefore capture non-financial operating companies that engage in no speculative OTC derivatives trading, but merely use OTC derivatives to hedge commercial risks, and category three could capture investment funds that use OTC derivatives solely to hedge non-OTC positions.
 - *No Express Grandfathering from Registration, Substantive Regulation, Capitalization and Margining.* The Act could require market participants with legacy swap/SB swap positions but no ongoing involvement in the swap/SB swap markets to register and become subject to substantive regulation, including minimum capitalization and initial and variation margin requirements for outstanding non-cleared swap/SB swap positions. Minimum capital and margin requirements for major swap/SB swap participants will be set by the respective prudential regulators with respect to those participants subject to regulation by the prudential regulators and by the CFTC or SEC, as appropriate, with respect to all other major swap/SB swap participants. Margin and capital requirements must be appropriate for the risk associated with the positions held by the participant.
 - *Risk Disclosure to Unregulated Counterparties.* The Act requires a regulated swap entity to disclose to a counterparty that is not a regulated swap entity the material risks and characteristics of swaps/SB swaps, conflicts of interest, and receipt of daily marks of the transaction from the clearinghouse (for cleared swaps/SB swaps) or the regulated swap entity (for non-cleared swaps).
 - *Agency Information Gathering.* The Act gives the CFTC and SEC broad authority to gather information about swaps and SB swaps, respectively.
 - *Preemption of State Regulation as Insurance.* The Act provides that neither swaps nor SB swaps may be regulated as insurance under State law. Although this provision is helpful in preventing conflict between Federal and State law with respect to traditional OTC derivatives, such as credit default swaps, that have recently come under scrutiny by State insurance regulators, this new preemption could have unexpected consequences with respect to traditional insurance products that arguably fall within the broad definitions of swap and SB swap under Title VII, with the effect that State insurance regulators could arguably be prevented from exercising jurisdiction over such insurance products.

² “Financial entity” is a broad term that includes an insurance company, a domestic or foreign central bank or government-owned or sponsored enterprise, a development bank or similar international organization, a non-dealer bank, a pension fund, a non-bank mortgage lender, a credit union or other lending cooperative, a hedge fund, commodity pool or an advisor to any of the foregoing.

- *Prohibition against Federal Assistance to Swaps Entities.* Section 716 of the Act, often referred to as the derivatives “spin out” or “push out” provision was significantly revised in the final hours leading up to adoption of the Conference Report. Section 716 prohibits “Federal assistance” to any “swaps entity” with respect to any swap, security-based swap or other activity of the swaps entity. However, the definition of “swaps entity” has been narrowed substantially from previous proposals (with additional exceptions based upon the type of entity and its regulation by a prudential regulator). Compliance periods have also been put in place to attempt to limit disruption to those entities that will be subject to Section 716.
 - “Federal assistance” is defined broadly and generally includes any resort to Federal Reserve lending facilities (other than facilities with broad-based eligibility), including the Federal Reserve discount window, as well as reliance on FDIC insurance, for the purpose of: (1) making any loan to, or purchasing any stock, equity interest or debt obligation of, any swaps entity, (2) purchasing the assets of any swaps entity, (3) guaranteeing any loan or debt issuance of any swaps entity or (4) entering into any assistance arrangement (including tax breaks), loss sharing or profit sharing with any swaps entity.
 - “Swaps entity” has the same definition as “regulated swap entity,”³ except that it excludes: (1) any major swap/SB swap participant that is an insured depository institution and (2) any insured depository institution or covered financial company in conservatorship or receivership, or a bridge bank operated by the FDIC.
 - The prohibition on Federal assistance to a swaps entity does not apply to:
 - An affiliate of an insured depository institution if the depository institution is “part of” a bank holding company or savings and loan holding company. Such affiliate must comply with Section 23A and 23B of the Federal Reserve Act, as well as any requirements of the CFTC, SEC and Federal Reserve Board.
 - An insured depository institution that limits its swaps/SB swaps activities to hedging and other risk mitigating activities directly related to the insured depository institution’s activities, and acting as a swaps entity for swaps/SB swaps involving rates or reference assets that are permissible for investment by a national bank under the National Bank Act (excluding CDS that are not cleared by a DCO or clearing agency). In essence, this exclusion aims to allow insured depository institutions to continue to engage in swap/SB swap activities (other than non-cleared CDS transactions) to substantially the same degree that such institutions can engage in cash market transactions on assets that are bank-eligible under the OCC’s established eligibility rules.
 - *Transition Period.* The Section 716 prohibition on Federal assistance to swaps entities does not apply to swaps/SB swaps entered into by a depository institution prior to the end of a transition period to be determined by the appropriate Federal banking agencies (after consulting with and considering the views of the CFTC and SEC). This transition period will be up to 24 months, during which the insured depository institution may divest itself of, or cease to, conduct the activities that would otherwise require it to be registered as a swaps entity. The Federal banking agencies may extend the foregoing transition period for up to an additional year. The Section 716 prohibition will not be effective until two years after the effective date of the Act.
 - *Prohibition on Unregulated Combination of Swaps Entities and Banking.* Following adoption of rules by the prudential regulators, Section 716 will prohibit a bank or bank holding company from being or becoming a swap entity unless it conducts its swap or SB swap activities in compliance with minimum standards set by its prudential regulator as are reasonably calculated to permit the swaps entity to conduct its swap or SB swap activities in a safe and sound manner and to mitigate systemic risk.

³ The term “regulated swap entity” is used for convenience herein but is not a defined term under the Act.

- *Required Liquidation of Certain Swaps Entities and Termination or Transfer of Swap/SB Swap Activity.* Section 716 requires that any FDIC-insured swaps entity or swaps entity subject to heightened prudential supervision under Section 113 of the Act (*i.e.*, “Designated Company swaps entities”) that is put into receivership or declared insolvent as a result of swap or SB swap activity must have its swap or SB swap activity terminated or transferred. Any funds expended on the termination or transfer of the swap or SB swap activity of a swap entity is required to be recovered out of the disposition of the swaps entity’s assets or through assessments, including assessments on the financial sector. The Act also prohibits: (1) “taxpayer funds” from being used to prevent receivership of *any* swap entity resulting from swap or SB swap activity (note that this prohibition is not limited to FDIC-insured and Designated Company swaps entities) and (2) “taxpayer resources” from being used for the orderly liquidation of any swaps entity that is neither an FDIC-insured institution, nor a Designated Company swaps entity. The terms “taxpayer funds” and “taxpayer resources” are not defined under the Act, raising potentially serious interpretive issues over whether certain forms of “Federal assistance” (most notably reliance on FDIC insurance) could constitute a use of “taxpayer funds” or “taxpayer resources.” The absence of definitions for such terms is particularly important in that the prohibitions on use of taxpayer funds and taxpayer resources are not subject to the transition period described above. It is also unclear whether “taxpayer funds” and “taxpayer resources” should be read as being equivalent to each other.
- *Prohibition on Taxpayer Losses.* Section 716 includes a provision that states that “taxpayers shall bear no losses from the exercise of any authority under [Title VII].” The meaning of this provision and its impact on other provisions of Section 716 and Title VII in general is unclear.
- *Oversight Council Override.* If the Oversight Council determines that other provisions of the Act are “insufficient to effectively mitigate systemic risk and protect taxpayers,” it can prohibit swaps entities from accessing Federal assistance with respect to any swap, SB swap or other activity of the swaps entity. Such an override of the limitations on the Section 716 prohibition would be made on an *institution-by-institution* basis and require the vote of at least two-thirds of the members of the council, as well as the votes of the chairpersons of each of the Oversight Council, the Federal Reserve Board and the FDIC. Any such determination will be subject to notice and hearing requirements consistent with the standards provided in Title I of the Act.
- *Registration of Holders of Collateral.* The Act requires any person that accepts collateral in connection with a swap cleared through the facilities of a DCO to be registered with the CFTC as an FCM. It requires any person that accepts collateral in connection with an SB swap to be registered with the SEC *either* as a broker-dealer or as a SB swap dealer. These requirements are applicable to *any person* that accepts money, securities or property to margin, guarantee or secure a cleared swap/SB swap, whether or not the party holding the collateral has any other involvement in the trade. This could be interpreted to mean that third-party custodians will be required to register in the applicable capacity to hold swap/SB swap collateral. An SB swap dealer may hold customer funds without registration as a broker-dealer, but a swap dealer (*i.e.*, a non-SB swap dealer) must also be registered as an FCM to hold customer property. This is one of the few areas in which the rules for swaps and SB-swaps are not parallel under the Act. An FCM, broker-dealer or SB swap dealer, as applicable, is required to treat and deal with swap/SB swap collateral of customers as belonging to those customers and may not commingle such property with its own property or the property of other non-swap/SB swap customers. The CFTC retains the authority to issue orders permitting the commingling of property of swap and futures customers if it deems appropriate.
- *Clarification of Bankruptcy Treatment of Cleared Swaps.* The Act adds a new provision to the Commodity Exchange Act that provides that swaps that are cleared through a DCO are “commodity contracts” for purposes of Section 761 of Title 11 of the Bankruptcy Code, with regard to property of any swaps customer received by an FCM or DCO. This is an important provision because it clarifies that customers of an insolvent FCM or participants in an insolvent DCO would be given priority over other creditors with respect to claims arising from cleared swaps in a manner that is similar to the treatment of customer claims arising from futures contracts and commodity options. Although the CFTC has taken the position in both an interpretive release and a formal rule-making that cleared

OTC derivatives should be considered “commodity contracts,” this provision of the Act is intended to end lingering uncertainty about the issue. Further steps are needed to clarify the bankruptcy treatment of cleared SB swaps in the event of the insolvency of an SB swaps dealer or central counterparty.

- *Segregation of Collateral.* Outstanding swaps and SB swaps will be subject to new collateral segregation requirements. A trader that is not a regulated swap entity and that posts collateral to a counterparty that is a regulated swap entity in connection with a non-cleared swap or SB swap may require the regulated swap entity counterparty to segregate its initial margin in an account separate from the assets of the regulated swap entity. This account must be held with an independent third-party custodian. If the counterparty that is not a regulated swap entity does not opt to have its initial margin segregated, the regulated swap entity must make quarterly reports to its counterparty indicating that the regulated swap entity’s back office procedures are in compliance with the agreement of the parties. The Act does not indicate whether a non-regulated swap entity will be given only a one-time option to require segregation of initial margin posted to a regulated swap entity or whether the non-regulated counterparty will be able to change its election over the life of either a trade or an associated master agreement governing ongoing trades. Given that certain swaps and SB swaps can have very long durations and master agreements do not generally have defined maturity or termination dates, this will be an important area for clarification by the regulators. It is not clear what will be considered “back office” procedures under the Act, and this is potentially another area in which the regulators may provide clarification.
- *Mandatory Clearing through Regulated Central Counterparty.* The Act requires swaps and SB swaps to be submitted to a DCO or clearing agency, respectively, if the swap/SB swap belongs to a category of swap/SB swap that a DCO/clearing agency has been approved to clear, provided that the CFTC or SEC, as applicable, has mandated that such category of swaps/SB swaps be cleared.
 - Although no new regulatory category is created for clearing organizations that clear swaps or SB swaps, DCOs and clearing agencies will be subject to significant new requirements, including more extensive “core principles” and a requirement that they offer clearing services to unaffiliated SEFs and exchanges on a nondiscriminatory basis.
 - DCOs and clearing agencies that seek to clear swaps or SB swaps will be required to submit proposals to the CFTC or SEC, respectively, for prior approval.
 - The CFTC and SEC must conduct an ongoing review of each category of swaps/SB swaps to determine whether such swaps/SB swaps must be cleared. If the CFTC or SEC determines that a swap/SB swap should be subject to the mandatory clearing requirement but no DCO or clearing agency has “listed” the swap/SB swap for clearing, the applicable agency is required to investigate, issue a report, and take such actions as it determines to be “necessary and in the public interest,” including imposing margin or capital requirements on the parties to such swaps/SB swaps. Note that this authority to impose capital and margin requirements is not limited to regulated swap entities.
 - The Act contains no express authority for the agencies to require a clearing organization to accept any category or class of swaps/SB swaps for clearing, and the agencies are specifically not authorized to require a clearing organization to clear any category or class of swaps/SB swaps if it would “threaten the financial integrity” of the clearing organization. While this appears to be a very limited restraint on the coercive power of the agencies, it seems doubtful that a clearinghouse could be compelled to clear a product against its will absent specific authority. On the other hand, the Act assumes that the CFTC or SEC, as applicable, would have authority to enforce the non-discrimination requirement.
 - The Act exempts swaps/SB swaps entered into before enactment of Title VII or before application of a clearing requirement (*i.e.*, “legacy swaps”) from the mandatory clearing requirement if they comply with applicable reporting requirements under the Act. The mandatory clearing requirements will go into effect no

- sooner than 360 days after enactment of the Act, but the clearing requirement will not apply until the applicable regulator has mandated clearing of the swap/SB swap or group of swaps/SB swaps and until a DCO or clearing agency, as applicable, has obtained permission from the regulatory agency to clear the swap/SB swap.
- The Act requires the CFTC and SEC to prescribe rules to prevent evasions of the Act's mandatory clearing requirements.
 - *End-User Exemption.* The Act's mandatory clearing requirement does not apply to a swap/SB swap if one of the counterparties to the swap/SB swap (*i.e.*, the end-user) is not a financial entity, is using swaps/SB swaps to hedge or mitigate commercial risk, notifies the CFTC/SEC how it generally meets its financial obligations associated with entering into non-cleared swaps, and opts out of mandatory clearing. The SEC and CFTC must also consider whether to exempt certain small banks, savings associations, farm credit system institutions and credit unions from the mandatory clearing requirement. Note that "financial entity" is a fairly broad term that includes all regulated swap entities, commodity pools, private funds (*e.g.*, hedge funds and private equity funds), employee benefit plans and other persons predominately engaged in banking and financial activities. The inability of financial companies to rely on the end-user exemption from the mandatory clearing requirement was a major point of contention in debates about the Act.
 - *Captive Financing Companies.* An affiliate of an end-user that meets the end-user exemption described in the preceding paragraph (including an affiliate that is predominately engaged in providing financing for the purchase of the merchandise or manufactured goods of the end user (*i.e.*, a "captive financing company")) may itself rely on the end-user clearing exemption if the captive financing company, acting as agent on behalf of the end-user, uses the swap or SB swap to hedge or mitigate the commercial risk of the end-user or another affiliate of the end-user that is not a financial entity. Swap/SB swap dealers, major swap/SB swap participants, private funds, commodity pools and bank holding companies with over \$50 billion in consolidated assets would not be eligible to rely on the exemption.
 - *Optional Clearing.* It is possible that some categories of swaps/SB swaps will be accepted for clearing by a clearing organization but will not be subject to mandatory clearing. However, such a swap/SB swap must be cleared if it is entered into by a regulated swap entity with an end-user counterparty and the end-user counterparty elects to require clearing. If the end-user opts into clearing, the end-user has the sole right to select which clearinghouse is used.
 - *Mandatory Exchange Trading.* Swaps and SB swaps that are subject to mandatory clearing must also be executed on a DCM, national securities exchange, registered or exempt SEF or registered or exempt SB-SEF, as applicable.
 - SEFs and SB-SEFs are facilities, trading systems or platforms in which multiple participants have the ability to execute or trade swaps/SB swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, including any trading facility that facilitates the execution of swaps/SB swaps between persons.
 - The terms "facility," "trading system" and "platform" are not defined under the Act. Therefore, the definitions of SEF and SB-SEF in the Act may be sufficiently broad to include so-called "voice brokers," thus potentially permitting such an entity to register and be regulated as an SEF or SB-SEF using its existing business model (subject to favorable agency interpretation of the core principles and approval of its rules).
 - *Exceptions to Exchange-Trading Requirement.* The mandatory exchange-trading requirement will not apply if no such facility lists the swap/SB swap for trading or if the transaction is subject to the end-user exemption described above.

- *Clarification that Certain Swaps are not Treated as Section 1256 Contracts.* Section 1603 of the Act amends Section 1256 of the Internal Revenue Code to exclude from the definition of a Section 1256 contract “any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.” Thus the timing and character of income and expense from these common types of swaps will continue as under current law and will not be affected by being executed on a qualified exchange.
- *Approval of Exemptions by Public Companies.* The appropriate committee of a public company’s board or governing body must review and approve any decision to rely on an exemption from the mandatory clearing or exchange-trading requirements of the Act.
- *Margin and Capital Requirements for Non-Cleared Trades.* The Act gives the CFTC and SEC (and prudential regulators with respect to those parties that have a prudential regulator) broad authority to impose capital requirements and both initial and variation margin requirements on non-cleared swaps/SB swaps. The intent of these provisions is less than completely clear, however. It is unclear who must deposit margin with whom. In existing markets, dealers ordinarily obtain collateral from non-dealer counterparties, but the non-dealer counterparties are much less likely to obtain collateral from the dealer. Other provisions of the Act, however, give counterparties the right to require collateral, but do not compel them to do so. The Act provides no express guidance on whether non-cleared legacy swaps will be subject to margin requirements. The mandate on the regulators to adopt rules requiring margin could be interpreted as allowing no exceptions for legacy swaps, although it is not clear that they must be so interpreted. In any event, no margin requirements will exist until the agencies adopt rules that further define the scope of the requirements.
- *Reporting of Non-Cleared Trades.* The Act requires both parties to a non-cleared swap/SB swap to report the transaction either to a “swap data repository” (a new regulatory category) or to the CFTC or SEC, as applicable. Legacy positions will be exempt from mandatory clearing as long as they are appropriately reported. However, there is no similar exemption from possible agency-imposed margin and capital requirements.
- *Transparency into OTC Markets.* The Act requires the CFTC and SEC to provide for real-time public reporting of data with respect to virtually all swaps/SB swaps, whether or not they are cleared, required to be cleared or exempt from clearing. The specific data required to be reported will be determined by agency rule-making.
- *Position Limits.* The Act provides new authority to the CFTC and SEC to set position and trading limits.
 - The Act expands the CFTC’s existing authority to set aggregate position limits and trading limits for futures contracts to include limits on transactions in swaps that perform or effect a significant price discovery function with respect to registered entities. The Act also authorizes the CFTC to impose position limits on the amount of a commodity across the futures and swaps markets that can be bought by any person, including a group or “class” (an undefined term) of trader. This power could effectively allow the CFTC to limit futures and swaps positions that unaffiliated traders of the same “class” are permitted to acquire, *e.g.*, the CFTC could impose position limits on a class of unaffiliated index traders in an effort to control what the CFTC may perceive as price fluctuations that the agency does not deem to be appropriate.
 - The CFTC is also required to establish limits on the amount of positions, other than bona fide hedge positions, that may be held by any person with respect to futures contracts, options on futures contracts or commodities traded on or subject to the rules of a DCM. These limits may be set with respect to the spot month, other months, or aggregated across all months. Notwithstanding the longer global rule-making timeframe under Title VII of the Act (as discussed below), these position limits must be established within 180 days of enactment of the Act with respect to “exempt commodities” (*e.g.*, metals and petroleum products) and within 270 days of enactment of the Act with respect to agricultural commodities.

- The Act requires the CFTC to establish position limits on the amount of positions, including aggregate position limits, other than bona fide hedge positions, that may be held by any person with respect to swaps that are economically equivalent to futures or options on futures. The CFTC may also set aggregate monthly position limits for positions in contracts on the same underlying commodity held by any person, group or class of traders.
- The Act requires the SEC to establish limits (including related hedge exemption provisions) on the size of positions in any SB swap that may be held by any person. The SEC may require any person to aggregate positions in an SB swap with positions in related securities or loans. The SEC may also direct a self-regulatory organization (“SRO”), such as the Financial Industry Regulatory Authority (“FINRA”), to establish position limits applicable to the SRO’s members.
- *Large Traders and Position Limits.* The Act creates a new large swap/SB swap trader reporting regime that will apply to market participants that are not otherwise regulated swap entities.
- *Responsibilities to Certain Entities.* The Act imposes special requirements on swap/SB swap dealers and major swap/SB swap participants with respect to swaps entered into with any Federal agency, State, State agency, city, county, municipality, other political subdivision of a State, employee benefit plan, government plan or endowment (each, a “special entity”), as follows:
 - Prohibitions on fraud, deception and manipulation (applicable to a regulated swaps entity that *acts as adviser* to a special entity with respect to a swap/SB swap). This new provision does not seem to require proof of scienter to establish liability, merely that that act or practice operates as a fraud or deceit as to the special entity.
 - Duty to act in the best interests of the special entity and to obtain information necessary to determine that a swap/SB swap is in the best interests of the special entity (applicable *only* to a swap/SB swap dealer that *acts as adviser* to a special entity with respect to a swap/SB swap).
 - CFTC- or SEC-mandated duty to have a reasonable basis to believe that the counterparty has an independent representative (applicable to each swap/SB swap dealer or major swap/SB swap participant that offers to enter into or enters into a swap/SB swap with a *government* special entity). The independent representative must: (1) have sufficient knowledge to evaluate the transaction and its risks, (2) not be subject to a statutory disqualification, (3) be independent of the swap/SB swap dealer or major swap/SB swap participant, (4) undertake to act in the best interests of the counterparty that it represents, (5) make “appropriate disclosures,” (6) provide written representations to the special entity regarding fair pricing and the appropriateness of the transaction and (7) in the case of a special entity that is an employee benefit plan subject to ERISA, must be a fiduciary.
 - Duty to disclose to the special entity, before initiation of a transaction, the capacity in which the swap/SB swap dealer is acting (applicable to each swap/SB swap dealer that offers to enter into or enters into a swap/SB swap with a special entity).
- *Destabilizing Swaps/SB Swaps.* The CFTC or the SEC may collect information concerning the markets for any types of swaps or SB swaps and issue a report on any swaps/SB swaps that they determine to be detrimental to the stability of a financial market or participants in a financial market. Note that this provision, as drafted, would allow the SEC to report on swaps or the CFTC to report on SB swaps, which diverges from the Act’s general bifurcated approach to swaps and SB swaps.
- *Portfolio Margining.* The Act amends the Exchange Act and the Commodity Exchange Act to allow for portfolio margining accounts to be carried by a dually-registered FCM/broker-dealer either as securities accounts or as futures accounts. These provisions, which rely primarily on existing exemptive authority, are designed to facilitate

the comingling of futures and securities in a single account. The development of portfolio margining has been identified by many industry participants as an important goal of modernizing the futures and securities regulatory framework in the United States. Related provisions in Title IX of the Act amend SIPA to facilitate portfolio margining in securities accounts.

- *Ban on Motion Picture Box Office Futures.* The Act amends the definition of “commodity” in the Commodity Exchange Act to exclude motion picture box office receipts (or any index, measure, value or data related to such receipts). The definition had previously excluded only onions and will continue to exclude onions if the Act is enacted. The exclusion of motion picture box office receipts is retroactive to June 1, 2010. The CFTC approved the first listing of motion picture box office receipt futures contracts in June; however, such contracts will become unlawful notwithstanding the CFTC’s approval if the Act is enacted in its current form.
- *Extraterritorial Effect.* The Act’s provisions on swaps and SB swaps do not generally apply to activities outside the United States; however, the provisions of Subtitle A of Title VII relating to swaps do apply to activities outside the United States that: (1) have a direct and significant connection with activities in, or effect on, commerce of the United States or (2) contravene CFTC anti-evasion rules, and the provisions of Subtitle B of Title VII relating to SB swaps do apply to persons that transact SB swap business without the jurisdiction of the United States in contravention of SEC anti-evasion rules. The CFTC and SEC are empowered (but not required) to implement such rules as they deem necessary or appropriate to prevent evasion of any provision of the Commodity Exchange Act or Exchange Act, respectively, added by Title VII of the Act. The differing limitations on the territorial scope of the swaps and SB swaps provisions of Title VII are the result of the CFTC’s and SEC’s historically divergent statutory authorities for and approaches to extraterritoriality, but the practical impact of these differences remains to be seen.
- *Foreign Swaps Regulatory Schemes.* If the CFTC or the SEC determines that the regulation of swaps or SB swaps markets in a foreign country undermines the stability of the U.S. financial system, the agency may, in consultation with the Treasury Secretary, prohibit an entity domiciled in the foreign country from participating in the United States in any swap or SB swap activities.
- *Preemption of State Law.* The Act repeals the current preemption of State gaming and bucket shop laws that applies under the Commodity Exchange Act to certain OTC derivatives entered into by eligible contract participants. The Act does not contain any express comprehensive preemption for swaps, potentially creating uncertainty as to the legality of some swaps under State laws even if transacted between eligible contract participants. The Act does include new preemption of State gaming and bucket shop laws with respect to SB swaps between eligible contract participants or effected on a national securities exchange.
- *Change of Law Provisions in Legacy Swaps.* The Act provides that, unless “specifically” reserved in an applicable swap, neither the enactment of the Act, nor the application of any requirement under the Act or an amendment made by the Act, will constitute a termination event or similar event that would allow a party to terminate, renegotiate, modify, amend or supplement transactions under the swap. This is a very important provision of the bill in that it arguably implicates the “Illegality” termination event provision contained in standard master agreement documentation that is in widespread use in the OTC derivatives market, as well as additional termination event provisions for which market participants routinely bargain. In the absence of the Act’s specificity requirement, the application of various provisions of Title VII to one or both parties to such an agreement could result in a party being construed to be allowed to terminate such an agreement – a result that was probably intended by the drafters of such standard master agreement forms and likely also reflects the intent of most of the parties that use such agreements, particularly those that have incorporated such additional termination event provisions. Whether this provision of Title VII will operate to prevent a wide swath of OTC derivative transactions from being subject to early termination (and attendant marking to market of terminated transactions, as would generally apply in such circumstances) remains to be seen. Given that enactment of the Act constitutes a significant shift in the regulatory

environment that few parties could have anticipated well in advance, this “anti-event” provision seems particularly onerous. In addition, the Act provides no guidance on how “specific” a provision of applicable trading documentation would need to be in order for it to remain effective under the Act to allow for early termination of transactions. Some type of market-wide, voluntary protocol could well emerge from the efforts of major market participants and trade associations in this area to reduce the degree of economic uncertainty that is attendant to such interpretive ambiguities.

- *CFTC Anti-Manipulation Authority.* The Act gives the CFTC explicit anti-market manipulation authority with respect to swaps in addition to its current authority over futures and cash market transactions. This amendment effectively codifies authority the CFTC has successfully asserted under existing law in various enforcement actions commenced against OTC energy traders in recent years.
- *Studies.* Title VII calls for the CFTC and SEC to conduct several major studies and report the results to Congress. These studies include: (1) a CFTC study on the effects of position limits on excessive speculation and on movement of transactions from U.S. exchange to non-U.S. trading venues, (2) a joint CFTC/SEC study on the feasibility of requiring use of standardized algorithmic descriptions for financial derivatives, (3) a joint CFTC/SEC study on swap and clearinghouse regulation in the United States, Asia and Europe and (4) a joint CFTC/SEC study on whether “stable value contracts” are “swaps.” These studies may or may not lead to future legislative or regulatory changes. The Act also creates an inter-agency working group to study oversight of the carbon markets, as well as an energy and environmental markets advisory committee within the CFTC.
- *Jurisdictional Boundaries.* The Act requires the CFTC and the Federal Energy Regulatory Commission (“FERC”) to negotiate a memorandum of understanding to establish procedures for applying their respective authorities in an efficient manner, resolve conflicts concerning overlapping jurisdiction, and avoid conflicting or duplicative regulation. The CFTC and FERC are also required to negotiate a memorandum of understanding regarding information sharing in investigations into potential manipulation, fraud or market power abuse cases. The Act includes provisions clarifying the jurisdictional boundary between the CFTC and FERC.
- *International Harmonization.* The Act requires the CFTC, SEC and prudential regulators to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards for the regulation of swaps, SB swaps and regulated swap entities. The Act also requires the CFTC to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards for regulation of futures contracts and options on futures contracts. The agencies may enter into information sharing arrangements to facilitate this consultation and coordination. Interestingly, the Act does not include a provision requiring the SEC to consult and coordinate with foreign regulators with respect to regulation of the securities markets.
- *Global Rule-making Timeframe and Effective Date.* Unless otherwise provided in Title VII, the provisions of Title VII will be effective 360 days after the date of enactment. To the extent any provision of Title VII requires rule-making, such provision will be effective not less than 60 days after publication of the final implementing regulation. Many of the provisions of the Act are not self-actuating and require some action by the applicable regulatory agencies before they will be effective.

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