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CFTC's Expanded Authority Over OTC Derivatives

Congress Poised to Grant CFTC Vastly Expanded Authority to Oversee the Over-the-Counter Derivatives Market

SUMMARY

The Commodity Futures Trading Commission ("CFTC") is poised to gain expansive authority over the over-the-counter ("OTC") derivatives market following Senate approval of the "Dodd-Frank Wall Street Reform and Consumer Protection Act" ("Dodd-Frank"), expected during the middle of July. Under the legislation, the CFTC, through extensive rulemakings, will create a comprehensive new regulatory regime for OTC derivatives markets and market participants that will impose significant new requirements on all derivatives market participants. Throughout the legislative process, CFTC Chairman Gary Gensler stated the need for many of these requirements to provide transparency and stability to the OTC derivatives market.¹ The new legislation has incorporated several policy proposals advocated by Chairman Gensler that were not in earlier versions of the legislation.

BACKGROUND

On June 25, 2010, the House-Senate Committee of Conference adopted the conference report on Dodd-Frank, a sweeping financial regulatory reform bill. On June 30, 2010, the U.S. House of Representatives approved Dodd-Frank, by a vote of 237 to 192. If approved by the U.S. Senate, as expected by the middle of July, the legislation will be sent to President Obama for his signature.

Title VII of Dodd-Frank, the "Wall Street Transparency and Accountability Act of 2010" (the "Derivatives Legislation"), is based on the legislative proposals to regulate comprehensively the OTC derivatives industry introduced by the Treasury Department in August 2009,² and legislation passed by the U.S. House of Representatives in December 2009³ and the U.S. Senate in May 2010 (the "Senate Bill").⁴ Under the Derivatives Legislation, the CFTC and the SEC will be given extensive new authority to

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regulate the OTC derivative markets, products and market participants. The CFTC will be given authority over swaps, swap dealers and major swap participants and the SEC will be given authority over security-based swaps, security-based swap dealers and major security-based swap participants. In addition, several Prudential Regulators will be given authority to monitor bank swap dealers and major swap participants. Under the new regulatory regime, swap dealers and major swap participants will be subject to clearing and execution requirements, capital and margin, and business conduct rules.

All swap transactions between swap dealers and major swap participants (a newly created term, to be defined by the CFTC and SEC) must be cleared through a derivatives clearing organization (“DCO”) registered with the CFTC, unless no DCO will clear that swap or one of the counterparties is a non-financial end-user (as discussed below). All swap transactions that are cleared must be executed on an exchange or “swap execution facility” (“SEF”) (also a newly defined term).⁵ Transactions that are not cleared and executed must be reported to a trade repository. All swap transaction, including bilateral transactions, will be reported to a swap data repository or to the regulators, and the CFTC has been given significant new authority to impose position limits on swap transactions, in addition to enhanced antifraud and anti-manipulation authority over swap transactions.

The Derivatives Legislation represents a major expansion of authority of the CFTC and will require the CFTC to promulgate a significant number of rulemakings to implement the new regulatory regime created by the legislation.

MAJOR PROVISIONS

This memorandum will focus on Subtitle A of the Derivatives Legislation, highlighting the relevant issues of the major provisions that relate to commodity-based swaps. This memorandum does not address Subtitle B, which creates a complementary regulatory regime for security-based swaps. For a comprehensive review of Title VII, including an analysis of Subtitle B, please see our memorandum, House of Representatives Approves Historic Revision of Financial Services Regulation, dated July 2, 2010.

Lincoln Push-Out Provision.⁶ The Derivatives Legislation contains a modified Lincoln push-out provision that will allow certain swap activities within insured depository institutions, including hedging or risk mitigation activities directly related to the business of the banking institution and the trading of swaps involving rates or reference assets that are permissible for investment by a national bank, other than non-cleared credit default swaps. This includes interest rate swaps, foreign exchange swaps, gold and silver swaps, and investment-grade credit default swaps. All other swap activity, including commodity swaps, must be pushed out to bank holding company affiliates for banking institutions that use “federal assistance.”

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Federal assistance is defined as “the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act [or] Federal Deposit Insurance Corporation insurance or guarantees.”

There is some uncertainty as to whether non-insured banking institutions, such as U.S. branches of foreign banks, will be permitted to engage in the permitted swap activities, as they are only expressly permitted for “insured depository institutions.” However, if non-U.S. branches are not permitted to engage in the permitted activities, they may still be conducted in the foreign bank or an affiliate of the foreign bank, so long as neither entity uses any federal assistance.

Modified Volcker Rule.⁷ Banks and their affiliates will generally have two years to phase out all proprietary trading, although regulators will have the discretion to provide additional transition time, including up to an additional five years for the divestment of illiquid securities. Following a study of proprietary trading by the banking regulators, the regulators will define proprietary trading and then implement any restrictions on such trading.

Under Dodd-Frank, certain “permitted activities” are not covered by the Volcker rule, including market-making or underwriting transactions, risk-mitigating hedging activities, customer-related transactions, investments in small businesses and insurance products, the organizing and offering of equity and hedge funds, investments in obligations of the United States or any state, or certain government-backed entities, and any trading conducted solely outside the U.S. by a banking entity that is not directly or indirectly controlled by a U.S. banking entity, among other permitted activities. However, none of these activities may be permitted if they:

- Resulted in a “material” conflict of interest (as defined by rule) between the banking entity and its clients, customers, or counterparties;
- Resulted in a “material” exposure to high risk assets or high risk trading strategies (as defined by rule);
- Pose a threat to the safety and soundness of such banking entity; or
- Pose a threat to U.S. financial stability.

Definition of Swap Dealer. The Derivatives Legislation defines swap dealer as “any person who (1) holds itself out as a dealer in swaps; (2) makes a market in swaps; (3) regularly enters into swaps with counterparties in the ordinary course of its business for its own account; or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.” However, the Derivatives Legislation grants the regulators the discretion to exclude market participants that engage in a “de minimus” quantity of swap transactions with or on behalf of their customers. A market participant can be deemed a swap dealer for one swap or one class of swaps, but not for others.

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Definition of Major Swap Participant (“MSP”). The Derivatives Legislation defines an MSP as “a non-swap dealer that (1) maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC (excluding positions held for hedging or mitigating commercial risk and by employee benefit plans); (2) has substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (3) is a financial entity that is not subject to capital requirements imposed by any Federal banking regulators, is highly leveraged relative to the amount of capital it holds, and maintains a substantial position in outstanding swaps in any major swap category.”

Under the Derivatives Legislation, in defining “substantial position,” the regulators must consider “the person’s relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.” As with a swap dealer, a market participant can be an MSP for one particular swap or class of swaps, while not for other swaps.

Non-Financial End-Users. The Derivatives Legislation eliminates the defined term “commercial end-user” that was included in the Senate Bill. Instead, any transaction in which one party is not a financial entity, is using the swaps to hedge or mitigate commercial risk (to be defined by the regulators) and notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps, is exempt from the clearing and execution requirements.

For the purpose of this clearing (and execution) exemption, financial entities are swap dealers, MSPs, commodity pools, private funds under section 202(a) of the Investment Advisers Act of 1940, an employee benefit plan, and a person predominantly engaged in banking activities, including those defined by section 4(k) of the Bank Holding Company Act of 1956.

Non-financial affiliates hedging commercial risk of non-financial end-users are not required to execute or clear transactions. For the purpose of the affiliate clearing exemption, non-financial affiliates do not include MSPs, commodity pools, private funds under section 202(a) of the Investment Advisers Act of 1940, and a bank holding company with over \$50,000,000,000 in consolidated assets.

Margin and Capital Requirements. The margin and capital requirements for swap dealers and MSPs are no longer required to be substantially higher for uncleared swaps, as they were in the Senate Bill. Instead, the regulators must impose margin and capital that is appropriate for the risk associated with uncleared swaps. However, there is no explicit prohibition against the imposition of margin to existing swaps.

In addition, the Derivatives Legislation removes the prohibition against margin requirements for non-financial end-users that was in the Senate Bill. As a result, it is believed that the regulators will have the authority to impose margin requirements on swap transactions with non-financial entity end-users that are not cleared. In response to growing concerns over the imposition of margin to non-financial entity end-

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users, Senate Banking Committee Dodd and Senate Agriculture Committee Chairman Lincoln wrote to House Financial Services Chairman Frank and House Agriculture Committee Chairman Peterson on June 30th (the “Dodd-Lincoln Letter”), stating that “The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk.” The letter also notes that “Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end users, nor can the regulators require clearing for end user trades.” However, these statements do not appear to be supported by any specific provision within the Derivatives Legislation. The Derivatives Legislation does allow regulators to permit the use of non-cash margin, so long as the use of such margin is consistent with the financial integrity of the swaps markets.

Physically-Settled Contracts. The definition of “swap” does not include “any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.” The import of the word “intended,” which is not in the current Commodity Exchange Act (“CEA”), is unclear. In this regard, the Dodd-Lincoln Letter states that this definition “is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC’s established policy and orders on this subject, including situations where commercial parties agree to ‘book-out’ their physical delivery obligations under a forward contract.”

Foreign Exchange Forwards and Swaps. Title VII includes foreign exchange forwards and swaps within the definition of “swap” although the Treasury Secretary is given the authority to exclude them from the regulations imposed by Title VII. Confusingly, it does not appear that the Treasury Secretary has the authority to exclude foreign exchange options since they are not included in the definition of foreign exchange swaps. Title VII requires these exempted foreign exchange forwards and swaps to be reported to a swap repository, and they will be subject to business conduct standards. They will also be subject to the antifraud and anti-manipulation standards of the CEA. In determining whether to exclude a foreign exchange forward or swap from the definition of “swap,” the Treasury Secretary must provide written notification to Congress explaining why the foreign exchange forward or swap is different from other classes of swaps and what objective differences exist between foreign exchange forwards and swaps that warrant the exemption from the new regulatory regime.

Special Duties for Swap Dealers and MSPs. The Derivatives Legislation eliminates the fiduciary duty requirement for swap dealers in the Senate Bill. Instead, a swap dealer acting as an adviser to any Special Entity must act in the “best interest” of the Special Entity, and swap dealers/MSPs acting as counterparties to a Special Entity must comply with any duties established by the regulators and must ensure that the Special Entity is advised by an “independent representative” that has the capability to evaluate transactions. A Special Entity is defined as a governmental entity, state, state agency, city, county, municipality or other political subdivision or a federal agency, as well as employee and governmental benefit plans, and endowments.

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Business Conduct Rules. In addition to the special duties, swap dealers and MSPs must abide by business conduct rules that will require them to verify the status of any counterparty that is an Eligible Contract Participant (“ECP”)⁸, to disclose to any non-swap dealer or MSP counterparty information about the material risks of the swap, any material incentives or conflicts of interest that the swap dealer or MSP may have with regard to the swap, including the daily mark of the swap, and to communicate in a fair and balanced manner on the principles of fair dealing and good faith. However, the Derivatives Legislation eliminates the requirement that swap dealers and MSPs disclose fees and profits from their swap transactions, which was in earlier versions of the legislation.

Position Limits. The CFTC must impose spot month, single month, and all-month combined position limits for all physical commodities other than excluded commodities. For exempt commodities, the limits must be imposed within 180 days of enactment of Dodd-Frank and for agricultural commodities, the limits must be imposed within 270 days of enactment of Dodd-Frank. The CFTC is also directed to establish position limits for any single person that holds swaps that are “economically equivalent” to futures or options contracts or commodities. Finally, the CFTC must establish aggregate single month position limits for contracts based on the same underlying commodity across exchanges (including SEFs), foreign boards of trade, and swaps that perform a significant price discovery function, for swaps held by any person, including “any group or class of traders.” The Derivatives Legislation does not define a “group” or “class” of traders and these terms are not currently used in the Commodity Exchange Act.

Bona Fide Hedging Transactions. In setting these position limits, the CFTC is permitted to provide hedge exemptions to parties for bona fide hedging transactions, as defined in the Derivatives Legislation. A bona fide hedging transaction “(i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel; (ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and (iii) arises from the potential change in the value of

- assets that a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising; liabilities that a person owns or anticipates incurring; or
- services that a person provides, purchases, or anticipates providing or purchasing.

Market Manipulation and Disruptive Practices. The Derivatives Legislation includes the amendment added to the Senate Bill by Senator Cantwell that appears intended to create a “reckless conduct” standard for market manipulation in the futures and derivatives market and to prohibit market manipulation and the reporting and use of false information with regard to swap transactions. The CFTC also will have the authority to impose civil penalties and fines and to issue cease and desist orders for swap transactions that violate the anti-manipulation provisions of the CEA. In addition, certain trading practices that “violat[e] bids or offers; demonstrat[e] intentional or reckless disregard for the orderly execution of transactions during the closing period; or is, is of the character of, or is commonly known to

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the trade as, 'spoofing' (bidding or offering with the intent to cancel the bid or offer before execution)" are now prohibited under the CEA.

FERC Jurisdiction. The Derivatives Legislation explicitly preserves the Federal Energy Regulatory Commission's ("FERC") statutory authority with respect to an agreement, contract, or transaction that is entered into through a tariff or rate that is approved by the FERC or a State regulatory authority and the CFTC is authorized to exempt any such agreement, contract or transaction from the new regulatory regime. In addition, the CFTC and FERC must complete an memorandum of understanding ("MOU") that resolves conflicts concerning overlapping jurisdiction and must avoid conflicting or duplicative regulation and another MOU on sharing information when either the CFTC or the FERC is conducting an investigation into potential manipulation, fraud, or market power abuse in markets that are subject to the CFTC's or the FERC's regulation or oversight.

Block Trading. The Derivatives Legislation requires the CFTC to set public reporting rules for SEFs that execute swap transactions. SEFs will be required to make public timely information on price, trading volume and other trading data on swaps as soon as technologically practicable. The public reporting requirements for SEFs must contain provisions (1) to ensure that such information does not identify the participants, (2) to specify criteria to define a large notional swap or security-based swap transaction (a block trade), (3) to specify the appropriate time delay for reporting block trades, and (4) to take into account whether the public disclosure will materially reduce market liquidity. However, these reporting requirements and in particular the block trading criteria and time-delay exceptions do not appear to apply to swap transactions that are not executed and cleared. Instead, such transactions must be reported, potentially without the ability to time delay block trades, to a swap data repository or to the CFTC if no swap repository will accept the swap. Swap repositories (or the CFTC) will be required to publicly release aggregate trading data that does not disclose the party's transactions or market positions.

Existing Swaps. Swaps that exist as of the date of the enactment of the Derivatives Legislation are exempt from the clearing requirements only if they have been reported to a trade repository or the CFTC. Swaps that have been entered into before the date of enactment of the Derivatives Legislation must be reported within 180 days of the effective date of the legislation. Swaps that have been entered into after the date of enactment but before the application of the new clearing requirement under the Derivatives Legislation must be reported within 90 days of the effective date of the clearing requirement or as required by the CFTC.

In addition, and apparently inconsistently, another provision of the legislation mandates that all existing swaps entered into before the date of enactment of the Derivatives Legislation must be reported to a swap data repository or to the CFTC within 30 days of the issuance of an interim final rule or as required by the CFTC.

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Regulatory Timeframe. Except for the position limits, the Volcker Rule and the Lincoln push-out provision, the effective date of the Derivatives Legislation will be the later of 360 days, or to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provision of this subtitle. The CFTC does have the authority to promulgate rules required under the Derivatives Legislation before the effective date; however any rules promulgated in advance will not go into effect until the effective date.

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ENDNOTES

- ¹ For additional information on this topic, see our Memo to Clients, CFTC Chairman Seeks Additional Authority for CFTC, dated August 31, 2009.
- ² For additional information on the Treasury legislative proposal, see our Memo to Clients, Treasury OTC Derivatives Legislative Proposal, dated August 17, 2009.
- ³ For additional information on the House Legislation, see our Memo to Clients, U.S. House of Representatives Passes Comprehensive OTC Derivatives Legislation, dated December 14, 2009.
- ⁴ For additional information on the Senate Bill, see our Memo to Clients, U.S. Senate Approves Significant Revision of Financial Services Regulation, dated May 22, 2010.
- ⁵ A swap execution facility is a facility trading system or platform (that is not an exchange) in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, through any means of interstate commerce, including any trading facility.
- ⁶ This provision does not apply to insured depository institutions that are major swap participants.
- ⁷ For additional information on the Volcker Rule, see our Memo to Clients, Proposed Financial Services Legislation Implements Volcker Rule, dated June 30, 2010.
- ⁸ To qualify as an ECP under the Derivatives Legislation, a governmental entity must now have \$50 million in investments and individuals must have \$10 million in discretionary investments, rather than \$10 million in total assets (or \$5 million in total assets for hedging only).

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