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Clients&FriendsMemo

The New Scheme for the Regulation of Swaps, with Appendices on Retroactivity, Special Entities and Tax, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*

July 20, 2010

Title VII (the "**Derivatives Legislation**" or the "**Legislation**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**") is among the most far-reaching and controversial sets of statutory changes included within the Act. The Derivatives Legislation will give primary authority to the Commodity Futures Trading Commission (the "**CFTC**") and the Securities Exchange Commission (the "**SEC**" and, together with the CFTC, the "**Commissions**") to regulate the swaps market, both as to transactions and participants, although the various banking regulators (the "**Bank Regulators**" and, together with the Commissions, the "**Regulators**") will retain substantial authority with respect to banks.

Among other things, the Derivatives Legislation will (i) require that certain "swaps" be traded on exchanges, centrally cleared and publicly reported; (ii) require the registration of both dealers in swaps and large end users with one or both of the Commissions; (iii) authorize the Commissions to establish a comprehensive regulatory system applicable to these registered dealers and end users; (iv) require the establishment of new swap market mechanisms, including exchanges, clearing organizations and swap information "repositories"; and (v) give the Commissions broad and often overlapping powers that they would, in many instances, be required to use jointly, sometimes in conjunction with, or under the direction of, the Bank Regulators. The impact of the Derivatives Legislation reaches far beyond the swaps markets, having at least indirect application to spot or cash market trading.

Many of the key terms in the Derivatives Legislation are either undefined or are left for the Regulators to fill in. Further, there are provisions of the Legislation that may not be readily feasible to implement, such as the authority given the Regulators over the capital requirements of end users,

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* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Appendix A links to the various topic-focused memoranda) or visit our website at http://www.cadwalader.com/list_client_friend.php.

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or that may require substantial clarification or amendment, including the definition of the term "swap," which is, of course, fundamental to the scope of the Legislation. We also note that the manner in which the Derivatives Legislation will be applied to international transactions, which are a large component of the swaps markets, is not apparent.

This Memorandum is broken into 7 parts as follows:

Part I. Sets out in the **overall structure** of the Legislation and certain issues of **regulatory jurisdiction.**

Part II. Discusses the various definitions in the Derivatives Legislation relating to the terms "**swap**," "**security-based swap**," and "**security-based swap agreement**" and the new definition of "**security.**"

Part III. Discusses new mandatory central clearing, trade execution and reporting requirements for swaps.

Par IV. Discusses collateral segregation requirements in connection with regulated swaps and bankruptcy reforms intended to protect counterparties of swap intermediaries.

Part V. Defines which **parties (both dealers and end users) to swaps must register** with the CFTC or SEC.

Part VI. Describes the **regulations applicable to parties that have registered**, including the obligations that they owe to their counterparties. Appendix A to this memorandum provides more detail as to the particular requirements that are owed by swap dealers and major swap participants when entering into swaps with "special entities" (a term that includes many governmental entities and plans).

Part VII. Describes certain of the **new trading rules** that would apply to swaps, such as the prohibition on non-exchange traded swaps being sold to non-eligible contract participants ("**ECPs**") and the regulators' new authority to establish **position limits** and **large trader reporting.**

One of the major concerns that the Act has raised is with respect to its retroactive impact on existing swaps. This issue is discussed in Appendix B of the memorandum.

Title XVI of the Act, which is discussed in Appendix C to this memorandum, makes certain amendments to section 1256 of the tax code so as to preserve the existing tax treatment of certain swaps. In addition, the Act effectively mandates the standardization of many swaps. Standardized

swaps will require upfront payments. Significant upfront payments on swaps may give rise to tax consequences for end users and dealers.

We have also provided two other memoranda that are particularly significant to the Derivatives Legislation. The effect of the Derivatives Legislation on end users is the particular topic of our memorandum titled *Regulation of End Users of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*. New limitations on banks' authority to enter into swaps are discussed in our memorandum titled *Changes to the Regulation of Banks, Thrifts, and Holding Companies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*.

Part I. Structure of the Legislation; Who Makes the Rules

A. Three Parts to Title VII, Split into Two Subtitles

The Derivatives Legislation is divided into two Subtitles (A and B), but effectively is in three parts. Part I of Subtitle A is largely concerned with the division of regulatory authority between the various regulators, and particularly as to how the CFTC and the SEC may resolve any differences between them as to the scope of their respective regulatory jurisdictions. Part II of Title A describes the authority of the CFTC over those transactions that it regulates, defined as "swaps" and "security-based swap agreements"; Subtitle B describes the authority of the SEC over "security-based swaps." Part II of Subtitle A and Subtitle B run roughly parallel, so we will discuss similar provisions together in each part of this memo, while identifying where there are material differences between them.

B. CFTC, SEC and Prudential Regulators; Limitations on State Insurance Regulators.

Generally, the Derivatives Legislation amends the Commodity Exchange Act (the "**CEA**") to provide authority to the CFTC to regulate transactions defined as "swaps" and persons who participate in the swaps market, and amends the Securities Exchange Act of 1934 (the "**Exchange Act**") to give the SEC jurisdiction over "security-based swaps" and persons who participate in the security-based swaps market. In addition, the Derivatives Legislation provides for (i) joint jurisdiction over "mixed swaps," which could prove to be a point of contention between the Commissions and (ii) sets out procedures by which the Commissions may determine which of them (if not both) has jurisdiction over "novel derivative products."[1] Where a banking entity is required to be registered under the Derivatives Legislation, certain of the regulatory requirements would be established by the bank's primary federal regulator, referred to as its "prudential regulator."[2]

One interesting feature of the Act (at Section 722 and Section 767) is that it specifically provides that swaps and security-based swaps may not be considered to be insurance and may not be regulated as insurance under the law of any state. While this provision was likely adopted to clarify that state insurance regulators do not have jurisdiction over credit default swaps ("**CDS**"), the provision is not limited to CDS. Given the very broad definition of the term "swap" (as discussed below), questions may arise as to the boundaries between the jurisdiction of the Commissions and the state insurance regulators.

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[1] Derivatives Legislation Sec. 718.

[2] Derivatives Legislation Sec. 721 (defining "prudential regulator").

C. Overlapping Regulation.

It is a clear theme of the Derivatives Legislation that there is a preference for a considerable degree of regulation, often regulation of the same matter, such as capital, and in many cases regulation of the same legal entity, by two agencies (the CFTC and the SEC) or by three agencies (the Commissions and the relevant Bank Regulator). While the various regulators are directed to co-operate and adopt similar rules governing similar subject matters, it remains to be seen how this sharing of jurisdiction will work and whether it will prove collegial and efficient.

D. Limited Exemptive Authority.

Another feature of the Derivatives Legislation relevant to the establishment of the rules thereunder is that the exemptive authorities of the CFTC and the SEC are limited, rather than absolute (*see*, *e.g.*, Section 772 of the Act). This means that if there are portions of the Derivatives Legislation which, for one reason or another, simply do not work, the Commissions may not be able to "exempt" around the problems—a legislative fix will be required.

Part II. Definitions

A. Before the Road Map, an Overview.

The Derivatives Legislation turns on the meaning of the term "swap" and on certain related definitions. These definitions are often complex, and convoluted, and rely on cross-references and incorporation by reference. In brief, the key defined terms around swaps are structured as follows:

"**Swap**": This term is defined in Subtitle A of the Derivatives Legislation, and is effectively used to mean a derivatives transaction (other than a listed future) that is governed by the CFTC under the CEA. The term "swap" carves out a "security-based swap," so that, as a general matter, a transaction would not be both a "swap" and a "security-based swap"—unless of course it is a "mixed swap."

"**Security-based swap**": This term "security-based swap" is used to mean those trades regulated by the SEC under the Exchange Act. This definition works by carving out a portion of the transactions that would otherwise fit within the definition of the term swap.

"**Security-based swap agreement**": Note that this is a **different term than** "security-based swap" immediately above and it is used differently for Subtitles A and B. For purposes of Subtitle A, the term applies to a transaction that is (i) a "swap agreement" for purposes of Gramm-Leach-Bliley (*e.g.*, what we currently think of generically as swaps) and (ii) that relates to securities, *but* (x) is primarily regulated by the CFTC, (y) while the two Commissions are required to issue joint rules

regarding books and records and to share information and (z) the two Commissions will share anti-manipulation enforcement authority. For purposes of Subtitle B, the term is also used to describe swap agreements that relate to securities, but it is limited to those as to which the CFTC has primary authority (*e.g.,* a swap on a broad-based securities index) and excludes "security-based swaps." This definition is used where necessary in the securities laws to give the SEC anti-fraud authority with respect to swaps that relate to securities, but that are primarily regulated by the CFTC.

"**Mixed swap**": This term is used to mean those transactions that have elements of both (i) "swaps" that are regulated by the CFTC and (ii) "security-based swaps" that are regulated by the SEC. Both Commissions will have authority over trades meeting this definition.

"**Security**": The scopes of the Exchange Act and several of the other securities laws are expanded by adding the term "security-based swap" to the list of instruments within the definition of a "security." This generally has the effect of making the securities laws, including the registration and regulatory requirements applicable to registrants, applicable to transactions in security-based swaps.

Other Definitions. Most of the other definitions in the Derivatives Legislation effectively turn on the definitions above. For example, Subtitle A of the Derivatives Legislation provides for the registration and regulation of "swap dealers" and "major swap participants," entities whose activities involve "swaps" regulated by the CFTC; Subtitle B of the Legislation provides for the registration and regulation of "security-based swap dealers" and "major security-based swap participants," entities whose activities involve "security-based swaps" regulated by the SEC.

A Word on CFTC Jurisdiction and CEA Amended Definitions: While the CEA is not amended to bring "swaps" into the definition of the term "future," the CFTC is given broad general authority to regulate swaps and persons who trade swaps, just as it has jurisdiction over persons that trade futures. (In fact, the CFTC's new jurisdiction over end users of swaps is actually broader in many respects that its jurisdiction over end users of futures.) This means, for example, that corporations, funds and advisers that are participants in the swaps market must consider whether they are now within the amended definitions of a commodity trading advisor (because of giving advice with respect to swaps) or as a commodity pool operator (because of operating a fund or other entity that transacts in swaps).

B. A Closer Look at "Swaps."

Understanding of the Derivatives Legislation necessarily begins with the definition of the term "swap" and the various exclusions.

i. *Swap—Starting Definition.* A "swap" is defined in Section 721 of the Act to include (albeit subject to exclusions that will follow) a contract that is (i) one of a laundry list of swap transactions familiar to readers of the Bankruptcy Code; *e.g.*, equity swaps, interest rate swaps, currency swaps, energy swaps, and so on; (ii) an option on virtually anything;[3] (iii) a CDS; (iv) an agreement that provides for the exchange of payments based on the value or level of any property, rate or quantitative measure and that transfers financial risk associated with a future change in any such value or level without also conveying a current or future ownership interest in the underlier; (v) an agreement that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; and (vi) any combination or permutation of the above.

ii. *Swap—General Exclusions.* From the above broad definition, there are then excluded: (i) listed futures, security futures and other transaction types already regulated by the CFTC; (ii) any sale of a **nonfinancial commodity** for deferred shipment or delivery, so long as such transaction is **intended to be physically settled** (what we would commonly call a "**forward**"); (iii) an option on a security that is "subject to" the Securities Act or the Exchange Act; (iv) foreign currency options listed on U.S. securities exchanges; (v) an agreement as to the sale of one or more securities on a "fixed basis" and that is "subject to" the Securities Act and the Exchange Act; (vi) an agreement as to the sale of one or more securities on a contingent basis and that is "subject to" the Securities Act and the Exchange Act, but not a CDS (a CDS is a swap or a security-based swap); (vii) a note or other evidence of indebtedness that is a "security" as defined in the Securities Act (be aware that the definition of the term "security" includes other types of instruments that are not within this exclusion and which, if they have contingencies associated with them, might be "swaps"); (viii) any agreement that is based on a security and entered into directly or through an "underwriter" (as defined in the Securities Act), by the issuer of the security for the purposes of managing a risk associated with capital raising (which we understand to be a reference to the "greenshoe" portion of an underwriting); (ix) an agreement with the U.S. government, a Federal Reserve Bank or a federal agency that is fully backed by the full faith and credit of the United States; or (x) a "security-based swap" (a term which is further discussed below) other than a "mixed swap."[4]

iii. *Some Uncertainties and Oddities as to the Definition of Swap.* We mention below a few of the prongs of the swap definition and exclusionary language that are likely to raise

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[3] More specifically, an option may be on, among other things, securities, commodities, instruments of indebtedness, and quantitative measures. As defined in the CEA, the term "commodity" is completely open-ended; it means any tangible or intangible item that may be traded in a market.

[4] For example a swap based on both a single equity security and a broad-based securities index would be both a security-based swap (because of the equity) and a swap (because of the index).

the greatest uncertainty. **The legal uncertainties around two of these issues (forwards and contingent contracts) are discussed in more detail in our related memorandum titled "*Regulation of End Users of Swaps Under the Dodd Frank Wall Street Reform and Consumer Protection Act*."**

(a) *"Intent to Settle by Physical Delivery: Forwards."* Since its adoption in 1922, the CEA has made a distinction between "futures contracts" and contracts for "deferred delivery" (more commonly known as forward contracts). Speaking generally, a forward contract is one where there is, to quote the Act, an "intent" of physical delivery. That said, historically there was great uncertainty and substantial litigation over what it meant to have an "intent" to settle by physical delivery. We are concerned that the adoption of the Act is likely to re-create the legal uncertainty that was prevalent in the commodity market prior to the adoption of the CMFA.

(b) *Contracts Involving a "Contingency."* Under the Act, the term "swap" includes "**any agreement, contract, or transaction . . . that provides for any . . . payment or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.**"[5]

This definition includes a wide variety of non-purchase contracts which include contingencies such as most credit agreements and certainly all floating rate commercial loans, success fee contracts and similar arrangements, and **most forms of insurance.** While this expansive reading of the term "swap" may seem unlikely,[6] in fact prior to the promulgation of a variety of statutory interpretations by the CEA and the eventual adoption of the CMFA, there had been substantial legal uncertainty as to transactions that the CEA might regulate as "futures." Now that the Act has expanded the CFTC's jurisdiction so that it is significantly broader than it was before the adoption of the CMFA, questions as to the scope of the CFTC's jurisdiction over "contingent" contracts will likely move again to the forefront of legal worries, as they were before the adoption of the CMFA.

(c) *Contracts on Foreign Exchange.* Under the Act, the term "swap" includes not only any foreign exchange swap, but also any foreign exchange forward (generally a foreign exchange forward is one that settles by delivery in more than 2 business days); *provided*, *however*, the Secretary of the Treasury may take certain steps, including making a report to various Congressional committees, carving out such trades from the definition of swap. (The carve out

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[5] Derivatives Legislation Sec. 721 (defining "swap").

[6] In some respects, it may be worrisome that Congress thought it necessary to carve out the "greenshoe" of a securities underwriting from the definition of the term "swap" - as that is a type of contingent right that would not have come to mind readily as within the common understanding of a "swap."

would not apply to trades on futures exchange or with retail investors.) However, even if the Secretary of the Treasury takes the required actions—and we assume that he will given the potential for disruption to the economic system if parties could not transact freely cross-border in currencies—foreign exchange swaps and forwards will remain subject to reporting requirements under the Act. Given the volume of trades in currency that will now have to be reported, this is a surprising requirement, particularly as we are not aware of any suggestion that currency trading, which is a traditional banking activity, contributed to the economic crisis.

iv. *Security-Based Swap.* The term "swap" carves out a "security-based swap," which are those swap-type transactions regulated by the SEC. The term "security-based swap" is limited to the following types of trades that would otherwise be swaps: (i) those referencing a narrow-based security index, (ii) those referencing a single security or a loan, and (iii) CDSs relating to single issuers or the components of a narrow-based security index. Agreements, contracts or transactions that would otherwise satisfy the definition of "security-based swap" only because they reference government securities are "swaps" excluded from the definition of "security-based swaps," though options on government securities appear to fall outside of both definitions (and thus would continue to be "securities" regulated by the SEC).

The effect of this relatively narrow definition of "security-based swap" is that the CFTC has jurisdiction over swaps referencing a broad index of securities (a broad index is generally an index composed of ten or more securities) or CDS relating to a broad index—that is, since a swap on a broad index is not a "security-based swap," it remains within the definition of a "swap." The Act's definitions leave open the question of whether a swap on a basket of securities is (i) a swap on numerous individual securities (subject to SEC jurisdiction), (ii) a swap on a broad index (subject to CFTC jurisdiction) or (iii) either, depending on the specifics of the documentation. Further, the market will have to revisit the difficult question of when, for example, an in-the-money option on a broad index of securities is an option regulated by the SEC and when it is a swap regulated by the CFTC. In any case, one effect of this split in jurisdiction over transactions that relate to securities is that most entities that enter into swaps with respect to securities are likely to be regulated by both the SEC and the CFTC.

We also note that transactions having components of both "swaps" and "security-based swaps" are subject to regulation as "mixed swaps" by both the CFTC and the SEC. Many, if not most, security-based swaps have an interest rate component to them; for example, one party receives an equity-related return, and the other party receives a return based on LIBOR or another floating rate of interest. Since a transaction involving a rate of interest may be a swap regulated by the CFTC, under the literal words of the Act, such a trade could be a mixed swap regulated by both Commissions, which will hopefully not prove to be the case as regulations are adopted.

Part III. Mandatory Clearing, Trade Execution and Reporting

As finally passed by both houses of Congress, the mandatory clearing and trade execution portions of the Derivatives Legislation are based on the original House version of the legislation, but include significant compromises with the Senate conferees that were hammered out in the conference committee. The mandatory reporting and collateral segregation requirements are based on the Senate version of the legislation.

For purposes of the following discussion, we will use the term "swap" to refer to both "swaps" regulated by the CFTC and "security-based swaps" regulated by the SEC, unless otherwise indicated. Also, we will use the term "swap dealer" and "major swap participant" generically to refer to entities regulated by the CFTC or the SEC.

*Mandatory Clearing. S*waps are subject to mandatory clearing only if a derivatives clearing organization or clearing agency has been approved to clear the swap, **and** the relevant Commission has determined, after at least a 30-day notice and comment period,[7] that the relevant "swap, or group, category, type, or class of swaps" described in the submission is required to be cleared. Swaps entered into before application of the clearing requirement will not need to be cleared if they are reported within the Act's specified time frames.

In determining whether a swap is to be subject to mandatory clearing, the relevant Commission is required to consider whether the "derivatives clearing organization" (for "swaps") or "clearing agency" (for "security-based swaps") has adequate risk management policies and procedures and take into account the following factors:

- the existence of significant outstanding notional exposures, trading liquidity and adequate pricing data;
- the availability of infrastructure to clear the swap on terms that are consistent with the material terms and trading conventions on which the contract is then traded;
- the expected mitigation of systemic risk, taking into account the size of the market and the resources of the clearing house;
- the effect on competition, including appropriate fees; and

[7] The notice and comment period may not be longer than 90 days unless the derivatives clearing organization or clearing agency submitting the application for clearing consents to a longer period.

- the existence of reasonable legal certainty in the event of the insolvency of the clearing house or one or more of its members with respect to the treatment of counterparty positions and collateral.[8]

As we noted in our August 20, 2009 memorandum on an earlier version of the legislation, Congress' decision to establish a mandatory clearing requirement for certain swaps (rather than, for example, encouraging clearing primarily through capital regulation of financial institutions), creates difficult issues of line drawing for regulators and swap counterparties. Namely, since swaps and bilaterally negotiated contracts and the clearing houses will necessarily need to specify many, if not all of the contractual terms of the swaps that they will clear, a question will arise as to when a bespoke contract is sufficiently dissimilar from a clearable swap (or a combination of clearable swaps) to be permissible without clearing. Similarly, what happens in situations where a clearing house is available to clear all swaps with certain basic structural characteristics and terms, but the consequence of such clearing is the forced use of terms specified by the clearing house in place of terms that may be preferred by the parties?

The Derivatives Legislation does not directly address these issues, but includes an attempt to minimize the difficulty by providing that the Commissions must consider the extent to which a clearing house is proposing to clear transactions on terms that are consistent with existing OTC contracts. While this may be useful as a basis to prevent offerings from clearing houses that are unduly narrow, the line between swaps that will be required to be cleared and those that will not is likely to be uncertain. Parties to swaps that are not intended to be cleared will need to consider how they can demonstrate that such swaps are sufficiently dissimilar to cleared swaps to avoid the mandatory clearing requirement.

The Commercial End User Exemption. The Derivatives Legislation provides an optional exception from mandatory clearing to any person that (i) is not a "financial entity," (ii) is using the swap to "hedge or mitigate commercial risk" and (iii) notifies the relevant Commission as to how it generally meets its financial obligations associated with entering into uncleared swaps. For the purpose of the optional exemption, the term "financial entity" means a swap dealer, a major swap participant, a commodity pool, a "private fund" as defined in the Investment Adviser's Act (*e.g.*, a hedge fund), an employee benefit plan, or a person predominantly engaged in the business of banking, or in activities that are financial in nature. The definition excludes certain captive finance companies and the Commissions are authorized to exempt small banks and certain other entities.

One oddity of the mandatory clearing requirement and the commercial end user exception is the extent to which they interfere with the normal process of contracting. Where one party to the

[8] Pursuant to Title VIII of the Act, the relevant Commission is also required to consult with the Board of Governors prior to making a mandatory clearing determination. See Section 812 of the Act.

transaction is not a swap dealer or major swap participant, the Derivatives Legislation provides that party with the **sole** right to elect clearing (where the swap is clearable but not subject to mandatory clearing) and to select the clearing house at which the swap will be cleared. The implications of this aspect of the Derivatives Legislation for swap dealers and major swap participants is currently uncertain. For example, what happens when a swap dealer is not a member of a particular clearing house? Is it permissible to clear swaps for customers in this circumstance? What happens if the parties have agreed to terms for a swap that is not cleared and the non-swap dealer subsequently demands clearing? Can the swap dealer re-price the swap to reflect its change in costs? As discussed further below, the ability of a swap dealer to hold and use collateral posted in connection with a swap also depends on whether the swap is cleared, and only certain swap dealers may hold collateral for customers in connection with cleared swaps.

For further discussion of the commercial end user exception and the challenges it poses to commercial institutions that use swaps, see our accompanying memorandum titled "*Regulation of End Users of Swaps Under the Dodd Frank Wall Street Reform and Consumer Protection Act*."

(Partially) Open Access in Clearing. The Derivatives Legislation requires derivatives clearing organizations and clearing agencies to clear swaps executed over-the-counter or at an unaffiliated trading platform on a nondiscriminatory basis. However, the Derivatives Legislation does not require swap trading platforms to have the capacity to clear swaps traded on their markets with multiple clearing houses, nor does the Derivatives Legislation require fungible clearing of swaps across clearing houses or for clearing houses to provide for transferability. Thus it remains to be seen whether, and the extent to which, market structure will facilitate competition in clearing.

Trade Execution Requirements. Transactions that are subject to mandatory clearing are also required to be traded on a designated contract market or "swap execution facility" (for "swaps") or a national securities exchange or "security-based swap execution facility" (for "security-based swaps"), unless no such venue accepts the transaction. Where an end user opts to exercise the end user exception for clearing, the trade execution requirements do not apply. Conversely, where a counterparty to a swap is not an eligible contract participant, the swap must be traded on designated contract market or a national securities exchange (trading on swap execution facilities is not permitted).

Notably, mandatory trade execution does not require a considered determination of the CFTC or SEC comparable to the required mandatory clearing determination. That is, the mandatory trade execution requirement is effectively self-executing once a swap is subject to mandatory clearing. While the listing rules of the various trade execution facilities are subject to Commission review, the Derivatives Legislation gives significant power to the trade execution facilities to control the manner in which swaps must be traded. For additional discussion of the new "swap execution facilities" see below.

Trade Reporting Requirements. All swaps, including those that are exempt from mandatory clearing, are subject to reporting requirements. With respect to swaps that are cleared, regulatory reporting and public dissemination of swap information is handled by the relevant clearing house and/or trade execution facility. Swaps that are not accepted for clearing at a clearing house must be reported to a "registered swap data repository" or a "registered securities-based swap data repository" (together, "**swap data repositories**") or, if no swap data repository will accept the report, directly to the relevant Commission.

To a large extent, swap reporting requirements are the obligations of swap intermediaries rather than end users. For swaps where only one of the parties is a swap dealer or major swap participant, the swap dealer or major swap participant is required to report. Where one of the parties is a swap dealer and the other is a major swap participant, the swap dealer is required to report. However, where neither party is a swap dealer nor major swap participant (or where both parties are swap dealers or major swap participants), then parties must decide between themselves which party will report.[9] Therefore, all parties to swaps will be required to develop and implement compliance procedures to satisfy reporting requirements and to provide for the timely submission of reports when they are required.

Swaps counterparties will need to consider several questions when developing these reporting procedures. First and foremost, swap counterparties will need to assess the scope of the reporting requirement and identify contracts to which it applies; *i.e.*, they must determine which contracts are "swaps." As noted in Part III above, the scope of the definition for "swap" is deceptively broad.[10] Accordingly, swap counterparties must develop the capacity to identify contracts that may be deemed to be swaps and/or manage the risk of unintentional reporting failures.

Additionally, market participants may be required to deal with difficult issues relating to what information is required to be reported and when. While both the timing and content of regulated swap reports is largely in the discretion of the Commissions, the Derivatives Legislation does require the Commissions to promulgate rules to provide for the "real time public reporting" of swap data, including for swaps that are exempt from clearing. For this purpose, the Derivatives Legislation defines "real time public reporting" as public dissemination of data, including price and volume, "as soon as technologically practicable after the time at which swap transaction has been executed." As to swaps subject to clearing, this may mean pressure from the Commissions to

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[9] The Derivatives Legislation does not make clear whether the parties are jointly liable for a failure to report under this circumstance, or whether the parties can rely on an agreement that one of the parties will report to limit potential liability for a compliance failure to one of the parties.

[10] For a fuller discussion of this topic, *see* our separate memo titled *Regulation of End Users of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*.

effectuate give-ups and submission for clearing as quickly as possible. As to uncleared swaps, it is likely that the parties will be required to report more or less immediately upon "execution."

Lastly, we note that market participants should be mindful to monitor for announcements as to start dates for reporting. Overlapping transition rules in the Derivatives Legislation create ambiguity as to when reporting of pre-enactment swaps will be required. Sections 723 and 763 of the Derivatives Legislation provide for the reporting of swaps (i) entered into before enactment of the Derivatives Legislation within 180 days of the general effective date of the legislation (*i.e.*, 540 days after enactment) and (ii) entered into after enactment but prior to the effective date within 90 days of the general effective date or by such other time as the relevant Commission prescribes by rule. However, Sections 729 and 766 require the Commissions to adopt reporting rules for pre-enactment swaps within 90 days of enactment, and require reporting of such swaps within 30 days of enacting the rules, unless the Commissions determine another period to be appropriate.

Part IV. Collateral Segregation and Bankruptcy

While the mandatory clearing requirement is the headline item in the Derivatives Legislation, the provisions of the Derivatives Legislation relating to collateral segregation and bankruptcy will also have a profound restructuring effect on the derivatives market.

Collateral Segregation for Cleared Swaps. With respect to cleared swaps, the Derivatives Legislation provides that **only a registered futures commission merchant** is permitted to accept collateral of a swaps customer that requires the use of an intermediary in order to effectuate clearing (*e.g.*, because the customer is not a direct member of a clearing house). That is, Congress has effectively mandated that the FCM model for clearing swaps is the only acceptable way to provide intermediated clearing. Other models that provide for intermediation by banks or other financial institutions are effectively prohibited. Given that many common swaps will be required to be cleared, this means that most swap dealers will be required to be CFTC-registered FCMs. Moreover, this requirement will also likely affect the choice of entities that sell-side financial conglomerates will use to deal in security-based swaps, as there will be significant efficiencies in selecting an entity that can be dual-registered as an FCM in order to clear swaps.

Substantively, the segregation requirements for cleared swaps are generally modeled after current CEA requirements for futures contracts and related collateral. FCMs are required to segregate customer collateral from proprietary assets and treat them as belonging to customers, provided that assets of multiple customers can be segregated in a single custody account with a third-party custodian for convenience. Customer funds and property may be withdrawn from segregation to the extent necessary to margin or settle the customer's cleared swaps with the relevant derivatives clearing organization, and customer cash may be invested in government securities, municipal securities or other assets prescribed by the CFTC. Under these rules, it would be possible for

customers who wish to satisfy margin requirements imposed by a swap dealer (or the CFTC) with assets that would not qualify as margin at the relevant derivatives clearing organization to do so, but it would effectively require the swap dealer to provide financing to the customer. To avoid this result, the parties will likely need to make separate arrangements for the swap dealer or an affiliate to provide eligible margin against the margin provided by the customer in a repurchase or lending transaction.

Bankruptcy Reform Relating to FCMs. Special rules under the U.S. Bankruptcy Code and the CEA that are applicable to FCMs provide protection to "customers" of FCMs with respect to their "commodity contracts." Specifically, these rules protect the "net equity" claims of customers from the general creditors of the FCM and require the bankruptcy trustee for an insolvent FCM to use "best efforts" to effectuate a bulk transfer of open commodity contracts and related collateral to a solvent FCM.

Section 724 of the Derivatives Legislation amends both the CEA and the Bankruptcy Code to provide that cleared swaps will be considered "commodity contracts" subject to these special bankruptcy rules. This reform is intended to resolve uncertainty as to whether cleared CDS would qualify for the special bankruptcy protection available to FCM customers, as there is currently some uncertainty as to whether CDS would qualify as contract of sale of a "commodity" for future delivery under the CEA.[11]

Collateral Segregation for Cleared Security-Based Swaps. With respect to cleared securities-based swaps, the Derivatives Legislation provides that only a broker-dealer or security-based swap dealer may accept collateral from a security-based swap counterparty. As only such persons may deal in security-based swaps, this requirement is not particularly restrictive, though it does limit the options of buy-side institutions for avoiding intermediation by swap dealers. In other respects, the segregation requirements applicable to security-based swaps mirror those applicable to swaps.

Bankruptcy Reform Relating to Stockbrokers. The Derivatives Legislation is intended to provide bankruptcy protections for security-based swaps that are equivalent to the "customer" protections for counterparties clearing swaps through an FCM. The Bankruptcy Code provides special bankruptcy rules for "stockbrokers" and their "customers" that are similar (though not identical) to the bankruptcy rules for FCMs. Section 763 of the Derivatives Legislation inserts language in the

[11] We note one technical drafting error in the Derivatives Legislation regarding this amendment. The Derivatives Legislation amends the text of the CEA to provide that all swaps cleared with "derivatives clearing organization" shall be considered protected "commodity contracts" as used in the Bankruptcy Code with regard to collateral of a swaps customer received by an FCM. However, the amendments made to the Bankruptcy Code itself may technically only treat swaps that are cleared on a **registered** derivatives clearing organization as "commodity contracts." As a result, some uncertainty may remain as to the bankruptcy treatment of swaps cleared with exempt derivatives clearing organizations (*e.g.*, non-U.S. clearing houses).

Exchange Act that provides that a security-based swap will be "considered to be" a "security" for purposes of the Bankruptcy Code and an account that "holds" a security-based swap (other than a portfolio margin account subject to FCM regulation) will be "considered to be" a "securities account" for purposes of Section 741 of the Bankruptcy Code. Putting aside the puzzling choice to amend the Bankruptcy Code through the Exchange Act, the point of this amendment appears to be to establish that (i) a security-based swap dealer would qualify as a "stockbroker" for purposes of the Bankruptcy Code and (ii) a security-based swap counterparty would qualify as a "customer."[12]

By establishing that a securities-based swap is a customer position of a stockbroker, the Derivatives Legislation would provide that the claim of each such customer with respect to such swap and related collateral is protected from the general creditors of the security-based swap dealer as a "net equity" claim under the Bankruptcy Code. Generally, this would mean that a counterparty's claim with respect to a security-based swap would be valued as of the filing date, and that any in-the-money amount would be a protected cash claim. It is somewhat less clear however, to what extent the Derivatives Legislation provides for the bulk transfer of cleared security-based swaps in a manner equivalent to the bulk transfer of customer positions of an FCM. While the CFTC has issued regulations pursuant to bankruptcy authority granted under the CEA which require the bankruptcy trustee for an insolvent FCM to use its best efforts to effect a bulk transfer of open commodities contracts, no similar regulation (or specific grant of authority to the SEC) exists with respect to stockbrokers.[13]

Additionally, we note that while the Derivatives Legislation provides for the bankruptcy of a security-based swap dealer as a "stockbroker" under the Bankruptcy Code, it does not amend the Security Investor Protection Act of 1970 ("**SIPA**"). SIPA effectively overrides the Bankruptcy Code with respect to broker-dealers that are members of the Securities Investor Protection Corporation ("**SIPC**") and contains its own definitions of "security" and "customer." Thus, the Derivatives Legislation does not appear to provide special bankruptcy protections to persons who clear their security-based swaps through SIPC members, other than mandatory segregation of collateral.

A Note About Liquidation Under Title II. While the Derivatives Legislation provides for the applicability of special customer protection rules under the Bankruptcy Code to the counterparties of swap dealers as discussed above, it is also possible that an insolvent swap intermediary could be liquidated under the "orderly liquidation authority" for systemically significant institutions

[12] The Derivatives Legislation explicitly excludes the claims of security-based swap counterparties with respect to uncleared security-based swaps from this special bankruptcy protection, except to the extent that such a counterparty has a claim for the return of margin for which the SEC has established a customer protection or segregation requirement.

[13] Where a security-based swap dealer is subject to the special regime for resolution of systemically significant entities by the FDIC under Title II of the Act, the FDIC would have separate transfer authority with respect to security-based swaps.

provided in Title II of the Act. Title II includes a provision preserving the special status of "customer" claims against FCMs and stockbrokers (at least insofar as customers receive distributions of customer property held by the intermediary prior to distributions to general creditors). However, in addition to providing special powers to the FDIC, Title II also imposes obligations particular to cleared swaps and to "qualified financial contracts," which, among other things, limit the FDIC's general power to transfer assets to a bridge-bank or solvent institution.[14] Thus, swap counterparties will need to assess their intermediary risk in light of each bankruptcy regime which may apply. For additional discussion of Title II, see our accompanying memorandum titled *"Orderly Liquidation of Financial Companies, Including Executive Compensation Clawback, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act"*.

Optional Collateral Segregation for Swaps that are Not Cleared. Swap dealers and major swap participants are required to segregate collateral received with respect to uncleared swaps at the sole discretion of their counterparties, provided that variation margin is not subject to this requirement. Where both parties to a swap are either swap dealers or major swap participants, each may be required to segregate at the option of the other. Each swap dealer and major swap participant is required at the outset of a swap transaction to notify its counterparty of the option to segregate, and to "report . . . on a quarterly basis . . . that [its] back office procedures...are in compliance with the agreement of the counterparties" in cases where the counterparty does not opt for segregation. Segregated collateral is required to be carried by an "independent" third-party custodian in an account designated as a segregated account for the counterparty.

Part V. Registration Requirements

In reviewing the requirements below, note that many institutions may become subject to registration with both the CFTC as a result of activities in regard to swaps and with the SEC as a result of activities in regard to security-based swaps.

A. Registration Requirements for Swap Dealers.

The Derivatives Legislation contains two sets of registration requirements, one applicable to those involved with "swaps" (who must register with the CFTC as "swap dealers") and one applicable to those involved with "security-based swaps" (who must register with the SEC as "security-based swap dealers"). As these two sets of registration requirements run in parallel, they are discussed in parallel below. In this part of the memorandum, we will refer to both types of registrants as "swap dealers" and we will refer to both "swaps" and "security-based swaps" as "swaps."

[14] See Section 210(c) of the Act. For example, to prevent "cherry picking" of contracts by the FDIC, Title II requires the FDIC to transfer **all** of a creditor's "qualified financial contracts" with the seized company to an alternative financial institution (including swaps and non-swaps) if it transfers any of such contracts to such institution.

Definition of Swap Dealer. The definition of a "swap dealer" is based upon the definition of a "[securities] dealer" in Section 3(a)(5) of the Exchange Act. Generally speaking, a "swap dealer" is a person (i) engaged "in the business" of buying and selling swaps as principal, including through a broker, (ii) but not a person who does not do so as part of a "regular business."

The exclusion for those entering into transactions "not as part of a regular business" is, in the securities laws, commonly known as the "trader" exemption." If the phrase is interpreted in the Derivatives Legislation in a manner consistent with the Exchange Act, it would serve to exclude from the swap dealer definition most end users. Of course all market participants should conduct an analysis of their activities to determine whether they might fall within the swap dealer definition. However, even if these "traders" are excluded under this definition, they may be required to register under the end user registration categories (discussed further below).

i. *No Bank Exemption.* The Derivatives Legislation does not provide a bank exemption from registration. In fact, Section 716 of the Act effectively prohibits an insured depository institution from acting as a swap dealer. The prohibition on a U.S. bank acting as a swap dealer is discussed in significant detail in our related memorandum titled "*Changes to the Regulation of Banks, Thrifts and Holding Companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act.*"

ii. *Offshore Exemption?* Notably, the registration requirements that apply to swap dealers do **not** contain the standard jurisdictional limitation to persons and activities in "interstate commerce." Read literally, this could mean that the Act is intended to have extra-territorial reach.

Section 772 generally excludes from the regulation of security-based swaps by the SEC those persons who transact a business "without the jurisdictions of the United States." While this should serve to protect persons outside the United States who do not trade with persons inside the United States, it does not protect foreign persons who transact using "interstate commerce" with U.S. persons. The jurisdictional limitation on the CFTC under Section 722 is even less comforting: activities outside the United States may be regulated by the CFTC if they have a direct and significant connection with activities in the United States.

In short, we are not certain as to how the Commission will apply the requirements of the Act to non-U.S. persons. It is far from certain that the exemptions that currently apply to, for example, securities transactions pursuant to Rule 15a-6 under the Exchange Act, will be available with respect to security-based swaps.

iii. *Securities Broker Registration.* The Derivatives Legislation requires the registration of brokers in security-based swaps by virtue of its expansion of the definition of the term

"security" to include a security-based swap. This would make Section 3(a)(4) of the Exchange Act apply as to brokers in security-based swaps.

B. Registration Requirements for Major Swap Participants.

The Derivatives Legislation provides very extensive registration requirements for certain end users, referred to as (i) "major swap participants" as to swaps who must register with the CFTC, and (ii) as "major security-based swap participants" (as to security-based swaps who must register with the SEC). For purposes of this section, we refer to both categories of registrants as "major swap participants."[15]

Major Swap Participant. The term "major swap participant" is defined as an entity that fits one of three tests:[16]

- The **first test** covers an entity that maintains a "**substantial position**" in swaps in any "**major swaps category.**"
- The **second test** covers an entity whose "**swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.**"
- The **third test** covers a "**financial entity**" that is "**highly leveraged relative to the amount of capital that it holds**," that is not an entity subject to U.S. bank capital requirements, and that maintains a "substantial position" in swaps in any "major swaps category."

For purposes of the first test only, swaps held "for hedging or mitigating commercial risk"; are not included in the determination of a substantial position.[17] The first test also excludes positions held by any employee benefit plan as defined in Section 3(3) and 3(32) of ERISA "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan."[18]

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[15] By contrast, the "dealer" definition in Section 3(a)(6) of the Exchange Act is amended to carve out security-based swap agreements with eligible contract participants. As a result, a "dealer" in such agreements would not fit within that definition, but rather would fit within the definition of a security-based swap dealer in the Legislation.

[16] Derivatives Legislation Sec. 721; Sec. 761.

[17] The term "hedging or mitigating commercial risk" is not defined in the Derivatives Legislation. There is a somewhat similar term—bona fide hedge—which is used in the provisions regarding position limits, which are discussed in Section V of this memorandum.

[18] It should be noted that the hedging exclusion for plans may not apply, absent clarification, to certain employee benefit plans that use swaps for more than just, for example, mitigating interest rate risk or currency risk of cash market investments made by the plan. In this regard, some employee benefit plans use swaps for what could be characterized as investment purposes; *e.g.*, to gain exposure to an asset class.

i. Note that **all of the key terms** ("substantial position;" "major swaps category;" "substantial counterparty exposure;" "highly leveraged") in the three tests are **undefined by the Act** and await rulemaking action by the Commissions. Further, as to corporate groups that enter into swaps for the purpose of hedging commercial risk, the Act contains some fairly complicated provisions that may effectively limit the benefit of one member of the group entering into swaps to hedge the commercial risk of another member of the corporate group. For a fuller discussion of the scope of this definition, see our related memorandum titled "*Regulation of End Users of Swaps Under the Dodd Frank Wall Street Reform and Consumer Protection Act*."

ii. *Bank Activities as End Users.* The Derivatives Legislation limits, but does not prohibit, a bank from acting as an end user of swaps, or even from registering as a major swap participant. Nonetheless, banks are significantly limited in their swaps activities. For a fuller discussion of these limitations, see our related memorandum titled "*Changes to the Regulation of Banks, Thrifts and Holding Companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act*."

iii. *Jurisdiction.* As discussed above, the extent of the Commissions' jurisdiction over non-U.S. entities and activities is very unclear. That said, end users will not want to be subject to registration as a major swap participant and therefore the Act may provide a significant inducement to move financial activities offshore.

iv. *Commodity Pool, Commodity Pool Operators, Commodity Trading Advisors.* Users of CFTC-regulated swaps should also be mindful that, even if they are not major swap participants, the Act adds a new definition of "commodity pool" and amends the existing definitions of "commodity pool operator" and "commodity trading advisor" to take account of activity involving swaps, so that funds and advisors may become subject to registration or regulation on account of these expanded definitions even if they escape regulation as a major swap participant.

Part VI. Regulatory Requirements Applicable to Swap Dealers and Major Swap Participants

The rules that are to be adopted by the Commissions, pursuant to Sections 731 and 764 of the Act, as to swap dealers, security swap dealers, and major swap participants and major security-based swap participants (collectively, "**Registrants**") do not, in many respects, make a significant distinction between being a financial intermediary (swap dealer) and an end user (major swap participant). The particular areas that are to be governed include (i) registration procedures; (ii) associated persons; (iii) capital; (iv) margin; (v) reporting and recordkeeping; (vi) trading records; (vii) business conduct; (viii) documentation; (ix) back office procedures; (x) supervisory requirements; and (xi) the monitoring of conflicts.

The following discussion briefly summarizes the different types of regulations that are required to be adopted. The Derivatives Legislation does not provide much detail in this regard, leaving that to the CFTC, SEC and Bank Regulators. Registration procedures are also left to the discretion of the CFTC and the SEC, respectively, as is the case generally now.

A. Capital Requirements.

i. The capital requirements are the most problematic, and perhaps counter-intuitive, part of the whole swaps registration scheme. In short, both swap dealers and major swap participants would be subject to capital regulations that would be based on the capital rules that generally apply to banks. As most entities, and certainly most end users, would find it difficult if not impossible to comply with bank capital rules (not so much because of the limitations on leverage, but because of their complexity and the fact that they are intended for banks), organizations subject to capital requirements as to their swap activities will likely have to isolate these activities in a specific legal entity so as not to have the swap capital rules apply to their business generally.

ii. It appears that Congress was somewhat mindful of the difficulty of applying capital regulations to end users. For example, the Act provides that, in setting capital requirements, the Regulators may take into account, "the risks associated with . . . the other activities conducted by the person that are not otherwise subject to regulation by virtue of the status of that person" as a Registrant under the Act. This implies that, to some extent, the Regulators could set individual capital transactions for every firm—a task that would seem difficult to accomplish.

iii. It is unclear what would happen if a Registrant, particularly a major swap participant as opposed to a swap dealer, were to fail to comply with the various regulations, particularly the capital regulations. Would it be put out of business? Would it be required to close out all of its swap positions? Would it be prohibited from entering into new trades? How would this work for overseas entities? How would it work for governmental entities, insurance companies, plans?

B. Margin Requirements.

Generally, the expectation is that cleared swaps will be subject to margin requirements imposed by central clearing counterparties in the first instance. The Derivatives Legislation requires the Regulators to impose mandatory *initial and variation* margin requirements on all swaps that are not cleared.

The Bank Regulators, in consultation with the Commissions, will jointly set the initial and variation margin requirements as to Registrants that are banks. The relevant Commission will set the initial and variation margin requirements for all other Registrants. Margin rules are required to "be

appropriate for the risk associated with non-cleared swaps." In setting such rules, the Regulators are required to periodically consult with each other and to set comparable margin requirements to the extent practicable (the Bank Regulators are also required to consult with the Commissions before jointly promulgating any rules).

Applicability to End Users. One of the principal purposes of exempting end users from mandatory clearing with respect to swaps used to hedge commercial risk was to allow these end users to avoid margin requirements set by central clearing counterparties. However, the Derivatives Legislation does not include a carve-out from the mandatory margin requirements that will be imposed on Registrants for non-cleared swaps. As of today, this contradiction is not fully resolved. Senators Dodd and Lincoln have stated in an open letter that the intent of the Legislation is not to require end users to post initial margin with respect to their exempt swaps. However, it may be difficult for regulators required to be responsible for the safety and soundness of Registrants to provide the effective equivalent of a blanket exception for trades with end users.

Swaps Between Registrants. Where both parties to a non-cleared swap are Registrants, the Derivatives Legislation appears to require each to post initial and variation margin to the other. It is not clear how the requirements with respect to initial margin will work in practice, particularly as each party will have the sole option to require segregation of initial margin received by the other.

C. Books and Records, Recordkeeping, Reports.

The CFTC and the SEC each have authority to establish books and records requirements as to those Registrants over which they have authority. We think it likely that, as a practical matter, the CFTC and the SEC could adopt regulations governing books and records that would go beyond matters relating to swaps, which would likely be necessary if they are to regulate a Registrant's capital.

The CFTC and the SEC must require a Registrant to maintain daily records of its swaps and of related cash market and forward trades. Registrants would also be required to maintain "recorded communications," including e-mails, instant messages and "recordings of phone conversations."[19] These records would have to be broken down by counterparty or customer and would have to constitute a "complete audit trail for conducting comprehensive and accurate trade reconstructions."

[19] We believe this means that Registrants would be required to maintain records relating to phone calls if such recordings were created, but the Legislation does not appear to mandate the recording of telephone conversations.

Each of the CFTC and the SEC would have authority to require such reports of its Registrants as the agency requires of the Registrant's transactions, positions and financial condition.

D. Business Conduct and Special Rules Applying to Trades with Special Entities.

As to Registrants within their respective jurisdictions, the CFTC and the SEC would be required to adopt "business conduct" rules relating to (i) fraud prevention, (ii) general supervision of its business, (iii) compliance with position limits, (iv) verifying the regulatory status of any counterparty, (v) disclosures of risks to counterparties, and (vi) anything else that the agencies believe appropriate.

A variety of additional conduct requirements applies to transactions in which one of the parties is a "special entity"—a term that includes federal agencies, states and their instrumentalities, endowments and various pension plans. For a fuller discussion of these special requirements, see Appendix A to this memorandum.

E. Documentation and Back Office Standards.

As to Registrants within their respective jurisdictions (but consulting with the Bank Regulators as to banks), the CFTC and the SEC would be required to adopt rules governing "confirmation[s], processing, netting, documentation and valuation" of swaps. Although this sounds reasonable, it is in fact quite unclear as to what it would mean for the CFTC and the SEC to adopt rules governing "netting," or even documentation (would certain types of trade documentation be made mandatory?).

F. Research (Conflicts of Interest).

Registrants (plus futures commission merchants and introducing brokers otherwise regulated under the CEA) would be required to establish "structural and information safeguards" between, at a minimum, those within the firm engaged in (i) "activities relating to research or analysis of the price or market" for any asset underlying a transaction, on the one hand, and (ii) those involved with clearing or trading activities on the other. Some of the statutory language is oddly drafted, requiring that persons involved in "providing clearing activities" are required to be "separated by appropriate information partitions" from persons involved in "clearing activities." The meaning of this will have to await explanation by the Commissions.

G. Associated Persons, Chief of Compliance.

Registrants would be generally barred from permitting the involvement in a swap of any individual who is subject to a "statutory disqualification."

Registrants would be required to appoint a chief compliance officer ("**CCO**") who shall report directly to the Registrant's board or senior officer. The CCO has substantial responsibilities for establishing compliance procedures, for conducting reviews of those procedures and for providing a related certification. These responsibilities, particularly the required certification, add the potential for personal liability.

Part VII. Regulatory Requirements Applicable to all Persons entering into Swaps

This Section of the Memorandum describes a variety of additional requirements that apply to persons that enter into, or might seek to enter into, swaps or security-based swaps. This discussion is thus relevant both to Registrants, and also to other persons that might enter into regulated transactions.

A. Retail Regulated Swaps, Eligible Contract Participant Definition.

The Act makes it unlawful for any person other than an "eligible contract participant" (as defined in the CEA and now in the Exchange Act) to enter into (i) a swap unless the swap is entered into on or subject to the rules of a fully regulated futures exchange (ii) or a security-based swap unless the trade is entered into on a national securities exchange. Further, it would be illegal to sell a security-based swap to a non-ECP unless the trade was registered under the Securities Act.

The Act somewhat tightens the financial standards applicable to certain categories of persons within the ECP definition.

B. Position Limits and Large Trade Reporting Requirements.

The Act would apply in a variety of ways to persons (and their affiliates) that may have large positions with respect to swaps.

i. *Position Limits*. The CFTC and the SEC would have authority to establish position limits as to swaps. More specifically, the CFTC would have authority to establish aggregate position limits for (i) listed commodities contracts, (ii) contracts traded by U.S. participants on foreign boards of trade and (iii) swaps that perform or affect "a significant price discovery function" with respect to regulated markets, while the SEC would have authority to establish aggregate position limits to with respect to (i) securities traded on a U.S. exchange, and (ii) security-based swaps that perform "a significant price discovery function" in regulated markets.[20]

[20] In addition, the Act (at Section 719) requires the CFTC (in consultation with the exchanges) to conduct a study of effects of position limits "on excessive speculation and on the movement of transactions from exchanges in the United States to

We read these provisions to mean that the CFTC and SEC would have the power to establish position limits on specified swaps grouped together with the securities and commodities contracts to which they relate, rather than just setting an overall limit on a person's aggregate investment in the U.S. markets.

For purposes of these limits and the large trader reporting requirements described below, the CFTC and the SEC are intended to perform a determination as to whether a category of swaps performs or affects a "significant price discovery function" by reference to a series of factors. These factors include (i) whether the swaps use or rely on a daily or final settlement price linked to related commodities contracts/securities, (ii) whether the swaps are sufficiently linked to their related contracts/securities to permit arbitrage, (iii) the extent to which prices in the related markets reference the swaps, (iv) the extent to which the swaps trade in sufficient volume to effect the prices of the related contracts/securities and (v) such other factors as the CFTC and SEC shall determine.

The SEC could also delegate to any self-regulatory organization ("**SRO**") the authority to adopt position limits as to any security-based swap and any security on which such security-based swap is based. In addition, every CFTC and SEC-regulated exchange would have to have power to establish position limits.

ii. *Large Trader Reporting.* The CFTC would have authority to establish quantitative levels at which positions held in swaps become reportable. As with the large trader reporting system currently in place for futures, it would be unlawful for any person to hold a position that equals or exceeds quantities specified by the CFTC unless such person files reports of those positions in accordance with CFTC rules. Persons subject to such requirements would also be required to maintain books and records of such swap transactions open for inspection and examination by either the CFTC or SEC (in the case of security-based swap agreements). Similar authority to establish large trader reporting levels and requirements is granted the SEC in the case of security-based swaps.

C. Reporting Requirements Applicable to Persons Generally.

Any person who enters into a swap that is not centrally cleared and not reported to a swap Repository would be (i) required to make such reports as may be required by the relevant regulator

trading venues outside the United States." This requirement appears to be in response to concerns expressed by some CFTC commissioners and others that the imposition of strict limits in the United States could have the effect of pushing trade to offshore markets.

and (ii) be open to inspection by the relevant regulator, a banking agency, the Financial Services Oversight Counsel and the Department of Justice.[21]

How would these inspection rights be implemented? Would the Department of Justice require a subpoena? What are the extra-territorial effects of this?

D. Potential Expansion of Existing Exchange Act Reporting Requirements for Beneficial Owners and Institutional Investment Managers and the Section 16 Provisions.

The SEC is given authority to amend the existing reporting requirements that apply under Sections 13(d) and (g) of the Exchange Act and Section 13(f) of the Exchange Act to treat persons that have a position in security-based swaps as the beneficial owner of the underlying security if the SEC determines that the security-based swap "provides incidence of ownership comparable to direct ownership of the security . . . ." A person aimed to be a beneficial owner for purposes of Section 13 would also be deemed a beneficial owner for purposes of Section 16.

E. Bad Trades and Actors.

The Commissions are directed to collect such information as they may need to issue a report concerning any swaps that may be "detrimental" to the "stability of a financial market" or "participants in a financial market." See Section 714 of the Act (called "Abusive Swaps"). Presumably, this is directed at CDS or other swaps that go "short" an entity or the market. Notably, under the revisions to Title IX of the Act, the SEC is given increased authority over securities borrowing and lending, as well as over short sale transactions, likely on the view that the regulators may stop market declines by inhibiting trading.

The Commissions are given the authority to prohibit an entity from doing business in the United States if it is located in a foreign country where the regulation of swaps activity is sufficiently liberal as to "undermine the stability of the United States." See Section 715 of the Act.

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[21] *See* Derivatives Legislation Sec. 729; Sec. 766.

Appendix A

Special Entities Appendix to the New Scheme for the Regulation of Swaps

This Appendix highlights provisions of the Act that are unique to a Swap Dealer or Major Swap Participant regarding Swaps with governmental entities (at the federal, state or local level), endowments, ERISA plans and public pension plans (such entities being defined as "Special Entities" in the Act).[1]

Special Entity

The term Special Entity includes, among other things, a federal agency; a state, state agency, city, county, municipality, or other political subdivision of a state; any employee benefit plan, as defined in Section 3 of ERISA; any governmental plan, as defined in Section 3 of ERISA; or any endowment. It is unclear whether "employee benefit plan" includes funds or other entities that are deemed to hold "plan assets" under ERISA. Such deeming can occur when 25% or more of the value of one or more classes of equity in the fund or entity is beneficially owned by an employee benefit plan or plans. A similar question exists for entities that hold the assets of governmental plans, with the added ambiguity that, because there is no 25% rule for governmental plans, it is not clear as to what rule would be applied to funds that may have significant investment by governmental plans. The inclusion of such entities within the definition of "Special Entity" could complicate compliance. Given the complexities involved in dealing with plan asset and/or governmental plan entities, this ambiguity requires expedited clarification.

[1] Provisions specifically addressing Swaps are contained in Title VII of the Act and the provisions discussed in this memorandum, unless otherwise indicated, are set forth under substantially identical subsections entitled "Business Conduct Standards" set forth in Sections 731 (relating to "Swaps" and adding Subsection 4s(h) to the Commodity Exchange Act) and 764 (relating to "Security-based Swaps" and adding Subsection 15F(h) to the Securities Exchange Act of 1934). The significance of the existence of two such sections is primarily jurisdictional – which regulatory entity will have primary responsibility for promulgating regulations and monitoring compliance for the related categories of derivatives – and, for ease of reference, unless otherwise required by the context each reference to a Swap, Swap Dealer or Major Swap Participant is equally applicable to, respectively, a Security-based Swap, Security-based Swap Dealer or Major Security-based Swap Participant. Accordingly, references to Subsection (h) in this memorandum are applicable to that subsection of the amendments effected by each of Sections 731 and 764, and references to the Commission are to the CFTC with respect to Swaps or the SEC with respect to Security-based Swaps. Provisions affecting Swap Dealers would affect Major Swap Participants in substantially the same manner.

Changes in Treatment of Special Entities Effected by the Act

General

In comparison to the base text of the legislation initially considered by the conference committee convened by the House of Representatives and the Senate to reconcile the legislation enacted by each house of Congress, the Special Entity provisions contained in Subsection (h) of the Act vary in several significant respects.

Fiduciary Duty

The Act does not impose a "fiduciary duty" on a Swap Dealer entering into an arm's length Swap involving a Special Entity.

Fee Disclosure

The Act does not require that a Swap Dealer disclose the source and amount of any fees or other material remuneration it directly or indirectly expects to receive in connection with a Swap.

Eligible Contract Participant

The clause of the definition of "Eligible Contract Participant" in the Commodity Exchange Act that currently includes governmental entities that invest at least $25 million is revised by the Act to include only those governments that invest at least $50 million (Section 721(a)(9) of the Act), but does not exclude investments of bonds proceeds, as had been proposed in the House bill. The Act also leaves in place the existing "Eligible Contract Participant" alternative to the investment of a specified dollar amount for governmental entities entering into a Swap with specified types of financial institutions.

Clearing Exception

The Act excludes from the clearing requirements of the Act certain end user Swaps, which may include many Swaps with Special Entities. The Act provides that, at the option of the counterparty that is not a "Financial Entity," the requirements that a swap be centrally cleared will not apply if one of the counterparties:

- is not a Financial Entity,
- is using Swaps to "hedge or mitigate commercial risk", and
- notifies the Commission, in a manner prescribed by the Commission, how it generally meets its non-cleared-Swap financial obligations.

"Financial Entities" are defined to include Swap Dealers, Major Swap Participants, a "commodity pool," a "private fund," an employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of ERISA and certain other financial institutions (subject to the Commission's right to exempt certain of those other financial institutions).

The Act leaves unclear whether Swaps to "hedge or mitigate commercial risk" include Swaps that "manage" risk. Would a governmental end user, for example, be engaging in a transaction excepted from the clearing requirements if it creates synthetic variable rate exposure through issuance of fixed rate debt and entry into a fixed-to-floating interest rate Swap? Similarly, would an endowment be able to create synthetic exposure to equities through the use of equity derivatives without being subject to the clearing requirements? In a letter to Congressmen Frank and Peterson dated June 30, 2010, Senators Dodd and Lincoln expressed their view that, among other things, the Act does not authorize regulators to impose margin or capital requirements on certain end users and used the phrases "hedge or mitigate" and "hedge or manage" interchangeably; this may be an indication to the regulators of Congressional intent. Moreover, would risks being hedged or mitigated by a Special Entity be considered "commercial risks" since such entities generally are not considered to be engaged in commercial activities? If the regulators view the phrases "hedge or mitigate" or "commercial risk" narrowly, they may deny Special Entity end users access to effective and noncontroversial tools for managing risk.

Rulemaking Requirements

Clauses (3) and (6) of Subsection (h) require the Commission to prescribe business conduct standards that establish a duty for Swap Dealers (i) to verify that any counterparty meets the eligibility standards for an Eligible Contract Participant, (ii) to disclose to any counterparty that is not a Swap Dealer (A) material risks and characteristics of the Swap, (B) material incentives or conflicts of interest, and (C) the daily mark of the Swap transaction, and (iii) communicate in a fair and balanced manner based on principles of fair dealing and good faith. Each Commission is also authorized to promulgate additional rules that it determines to be appropriate. Each Commission is required by the terms of the Act to promulgate the rules and regulations required by Subsection (h) within 360 days after the date of enactment.

Requirements Imposed Upon Swap Dealers

General

The Act requires each Swap Dealer to conform with the business conduct standards established by the Commission, including those that relate to (i) fraud, manipulation and other abusive practices involving Swaps (either offered or entered into), (ii) diligent supervision of the business of the Swap Dealer or Major Swap Participant, (iii) adherence to position limits, and (iv) the matters enumerated

above under “Rulemaking Requirements”. These requirements apply regardless of whether the counterparty is a Special Entity.

Arm’s Length Transactions

Any Swap Dealer or Major Swap Participant that enters into (or offers to enter into) a Swap with a Special Entity must, in addition to the above requirements, (i) before initiation of the transaction, disclose to the Special Entity in writing the capacity in which the Swap Dealer or Major Swap Participant is acting and (ii) comply with any duty imposed upon it by the Commission to have a reasonable basis to believe that the Special Entity has an independent representative that:

- has sufficient knowledge to evaluate the transaction and risks,
- is not subject to a statutory disqualification,
- is independent of the Swap Dealer or Major Swap Participant,
- undertakes a duty to act in the best interests of the Special Entity,
- makes appropriate disclosures,
- will provide representations to the Special Entity regarding fair pricing and the appropriateness of the transaction, and
- in the case of ERISA plans, is a fiduciary as defined in Section 3 of ERISA.

Because of the ambiguities of clause (ii), the Commission must establish what constitutes an *independent advisor*, as well as set out appropriate means of demonstrating a reasonable basis to believe that each applicable qualification has been met. Moreover, it will be important to many end users to have input as to whether they should be required to retain an independent representative.

Advisory Roles

Subsection (h) imposes parameters for any Swap Dealer acting as an advisor to a Special Entity, including prohibitions against (i) fraudulent devices, schemes or artifices, (ii) fraudulent or deceitful transactions, practices or courses of dealing, and (iii) fraudulent deceptive or manipulative acts, practices or courses of business. Any such Swap Dealer acting in such a capacity also has a duty to act in the best interests of the Special Entity and to make reasonable efforts to obtain sufficient information to make a reasonable determination that any Swap recommended by the Swap Dealer is in the best interests of the Special Entity, including information relating to:

- the financial status of the Special Entity,
- the tax status of the Special Entity,
- the investment or financing objectives of the Special Entity, and
- any other information prescribed by the Commission.

Section 975 of the Act sets forth discrete requirements under the Securities Exchange Act of 1934 for Municipal Advisors (a term which is defined separately from, but does not expressly exclude, Swap Dealers or Major Swap Participants).[2] One important issue for consideration by the regulators is whether the parameters imposed upon Swap Dealers serving in advisory roles to Special Entities will (or should) be uniform with the requirements imposed upon Municipal Advisors.

Stable Value Contracts

With respect to Stable Value Contracts, which are used in connection with stable value options offered in many participant-directed defined contribution plans (*e.g.*, participant-directed 401(k) plans), the Act mandates that the Commissions conduct a joint study within 15 months of the enactment of the Act to determine whether such contracts fall within the definition of a "Swap". In making the required determination, the Commissions shall consult with the U.S. Department of Labor, the Department of Treasury and State entities that regulate stable value contract issuers. The Act provides that if it is determined that a Stable Value Contract meets the definition of a "Swap", the Commissions must determine whether any exemption for these contracts is appropriate and in the public interest, and issue regulations implementing the Commissions' determinations. Until the effective date of any regulations, Stable Value Contracts will not be subject to the requirements applicable to "Swaps". Further, Stable Value Contracts in effect before the date of any such regulations will not be considered "Swaps". For these purposes, "Stable Value Contract" means any contract, agreement or transaction that provides for a crediting interest rate and guaranty or financial assurance of liquidity at contract or book value prior to maturity that is offered by a bank, insurance company or other State or federally regulated financial institution for the benefit of any individual or commingled fund available as an investment in an employee benefit plan (as defined in Section 3(3) of ERISA, including "governmental plans" described in Section 3(32) of ERISA) subject to participant direction, an eligible deferred compensation program described in Section 457 of the Internal Revenue Code that is maintained by an eligible employer described in Section 457(e)(1)(A) of the Internal Revenue Code, an arrangement described in Section 403(b) of the Internal Revenue Code or a qualified tuition program under Section 529 of the Internal Revenue Code.

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[2] A Municipal Advisor is a person (including a financial advisor, guaranteed investment contract broker, third-party marketers, placement agents, solicitors, finders, and Swap advisors) who is not a municipal entity or an employee of a municipal entity who provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to structure, timing, terms or other similar matters concerning such financial products, or undertakes the solicitation of a municipal entity. The definition excludes, among others, brokers, dealers or municipal securities dealers serving as an underwriter, any registered investment adviser or commodity trading advisor who is providing advice related to Swaps.

Timing of Implementation

As with many other provisions of the Act, a meaningful understanding of the Special Entity requirements cannot be reached until each Commission provides regulations detailing the implications for each party when a Major Swap Participant or Swap Dealer interacts with a Special Entity as a counterparty or advisory client. The Act provides that rules and regulations must be finalized and published no later than 360 days after enactment of the Act. The Act will become effective on the later of 360 days after the date of enactment or, in the event a provision requires a rulemaking, 60 days after publication of the rule or regulation implementing such provision.

Appendix B

Retroactivity Appendix to the New Scheme for the Regulation of Swaps

This Appendix highlights provisions of the Act that may be applied to existing transactions on a retroactive basis.

Potentially Retroactive Provisions

Certain provisions of the Act are expressly to be applied on a prospective basis only[1] and certain provisions are expressly to be applied on both a retroactive and prospective basis.[2] However, with respect to certain other requirements – specifically, the margin requirements contained in Sections 724, 731, 763 and 764 – the Act is silent as to retroactivity.[3]

- Sections 731 and 764 require, in part, that registered swap dealers and major swap participants satisfy minimum initial and variation margin requirements to be established by the applicable Commission[4] or prudential regulator with respect to non-cleared swaps.
- Sections 724 and 763 provide, in part, that the counterparty to any non-cleared swap with a swap dealer or major swap participant may request that any initial margin it provides be segregated for the benefit of the counterparty.

This silence may or may not be intentional and, therefore, creates uncertainty as to whether retroactivity is intended. Additionally, Section 739[5] appears to expressly prohibit using the passage of the Act as grounds for terminating or renegotiating the terms of existing swaps, unless the right

[1] For example, the clearing requirements of Sections 723 and 763 do not apply to existing swaps whose terms are reported to the applicable Commission pursuant to other provisions of the Act, and the push-out provisions of Section 716 will not apply to existing swaps. Additionally, Section 739 expressly excludes, under certain circumstances, existing swaps from the position limits established under Section 737. We note, however, that the Act does not provide a similar exclusion in respect of position limits for security-based swaps.

[2] For example, Sections 729 and 766 expressly require that all existing swaps be reported to the applicable Commission or a registered swap data repository within a prescribed time period.

[3] Generally, as a matter of statutory interpretation, for a law to be applied retroactively, Congress must show its clear intent; absent express language to the contrary, the presumption is that a law only applies on a going-forward basis. However, in certain circumstances, legislative intent can be inferred from the absence of language.

[4] "Commission", as used herein, shall mean either the U.S. Securities Exchange and Commission or the U.S. Commodity Futures Trading Commission, as applicable.

[5] We note that Section 739 does not govern security-based swaps and a parallel provision covering security-based swaps is absent under the Act.

to do so is provided for under an existing swap. The existence of such a provision may imply that retroactive effect is intended.[6]

Some Problems with Margin Retroactivity

If the margining requirements are applied retroactively, practical difficulties may result. For example, retroactive margining will likely result in a liquidity drain on providers required to post, as it could unreasonably increase costs without permitting parties to renegotiate pricing. The liquidity drain - or simply even the perception of it - could result in rating downgrades, which could trigger even more stringent posting requirements. As a result, in the event a party does not possess the required collateral, it may be unable or unwilling to perform under its existing swaps. In addition, it may be impossible for certain parties to comply with their governing corporate documents and the requirements of the Act. For example, credit derivative product companies, or "CDPCs," are generally prohibited from posting collateral by the terms of their charters, and special purpose entities typically used in securitizations do not own treasuries or hold excess cash capable of being posted. At this point, it is unclear how affected parties will navigate through such conflicting mandates.

Termination of Existing Swaps

Retroactive requirements could also lead to the early termination of existing swaps. Parties to an existing swap that contains a termination event, illegality provision or similar event that is triggered by enactment of the Act may have the option to exercise their rights to terminate or renegotiate the

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[6] We note that on June 30, 2010, Senators Dodd and Lincoln co-authored a letter (the "Letter") addressed to Representatives Frank and Peterson, which, in part, discusses the retroactivity of the margin and capital requirements contained in the Act. The Letter states, in relevant part, as follows:

> "Congress recognized that the capital and margin requirements in this bill could have an impact on swaps contracts currently in existence. For this reason, we provided legal certainty to those contracts currently in existence, providing that no contract could be terminated, renegotiated, modified, amended or supplemented (unless otherwise specified in the contract) based on the implementation of any requirement in this Act . . . . It is imperative the we provide certainty to these existing contract for the sake of our economy and financial system."

While the Letter was intended to provide clarity as to retroactivity, we believe that Congressional intent remains unclear. One reading of the provision above is that margin provisions are to be applied retroactively and that parties are prohibited from terminating based upon those new requirements. However, another interpretation is that margin requirements are retroactive, but that parties are not required to amend their contracts (whether those documents already require the posting of collateral or not) to comply with the Act, which would seem to have the effect of making margining requirements non-retroactive. In the absence of further interpretation by the regulators, it is difficult to confidently determine Congressional intent with respect to Section 739.

swap.[7] However, termination may also result from a swap party's failure to perform under the economic burden of retroactive margin requirements or from a ratings downgrade that may result.

Constitutional Challenge

The Supreme Court has defined retroactivity in terms of the nature of the effect it has on parties. Generally, a provision's retroactivity turns on whether it would impair rights a party possessed when it acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed.[8] Further, the Supreme Court has held that the rule against retroactive application of laws should only be applied to "substantive" laws and not necessarily to "procedural" laws or laws that merely provide for "prospective relief."[9] Accordingly, retroactivity of the Act may be impermissible based upon the substantive effect it has upon parties to existing contractual agreements.

Conclusion

The ability to clarify the retroactivity of the Act now rests with the applicable Commission, which must promulgate applicable rules and regulations within 360 days of enactment of the Act. As discussed above, the retroactive application of the Act's margin requirements has the potential to disrupt the financial markets and impair existing swaps.

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[7] Standard ISDA documentation and other derivatives contracts give parties the right to terminate the agreement when certain events occur that materially undermine the contract. For example, under the ISDA Master Agreement's illegality provision, a contract is terminable if any material aspect of either party's performance under the contract (including payment and delivery) becomes illegal after the contract is entered into. Additionally, other existing swaps may contain terms allowing the parties thereto to take certain actions – including increasing fees or terminating - upon the incurrence of increased costs due to a change in law.

[8] *Landgraf v. USI Film Products*, 511 U.S. 244 (1994).

[9] *Id.*

Appendix C

Federal Income Tax Appendix to the New Scheme for the Regulation of Swaps

This Appendix highlights certain provisions of the Act that were required in order to prevent the Act from having negative unintended tax consequences for dealers and investors.

Federal Income Tax Issues

I. Section 1256 of the Internal Revenue Code

Section 1601 of the Act amends section 1256 of the Internal Revenue Code (the "**Code**") to provide that "section 1256 contracts" do not include:

> 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.[1]

If these swaps had been treated as section 1256 contracts, they would have been required to be marked-to-market annually, and any gain or loss would have been 60% long-term capital gain or loss and 40% short-term capital gain or loss. This would have created serious character mismatch issues for dealers that are parties to cleared swaps and timing issues for investors who use cleared swaps to hedge capital assets.[2]

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[1] Note that the list of the various financial instruments that are excluded from section 1256 treatment is not the same as the list of financial instruments that are "swaps" or "security-based swaps" under Title VII of the Act. Further, the financial instruments excluded from section 1256 treatment are generally not defined for federal income tax purposes and, in fact, may be subject to different federal income tax treatment depending on the economic terms of the instrument. For example, an equity swap may be constructed as either a "notional principal contract", a forward contract, or an option, each of which is treated differently for federal tax purposes, and a credit default swap may be constructed as an option, a notional principal contract, or possibly insurance, each of which is treated differently for federal tax purposes. In addition, the open-ended category of "or similar agreement" certainly appears to include a variety of financial instruments. Thus, exclusion from section 1256 treatment does not appear to depend on the tax characterization of a financial instrument. Regulatory guidance will be necessary to clarify the scope of the exclusion from section 1256.

[2] For example, although dealers generally mark-to-market their securities and treat all gains and losses as ordinary gains and losses under section 475 of the Code, section 1256 contracts are not treated as securities for these purposes and therefore give rise to capital gains and losses. Since capital losses cannot be used to offset ordinary income, a dealer that uses a section 1256 contract to hedge a security will not generally be able to use a capital loss generated by a section 1256 contract to offset the ordinary gain on the hedged security. Dealers may elect to treat section 1256 contracts as securities for purposes of section 475 of the Code, but the election is available only if the dealer clearly identifies the section 1256 contract in its records before the close of the day on which the section 1256 contract is acquired or entered into. In certain circumstances, making this identification may not be practical.

The Act, by unambiguously amending section 1256 of the Code to provide that most swaps and "similar agreements" are not section 1256 contracts, avoids this issue. Accordingly, swaps will not be treated as section 1256 contracts by reason of being cleared and traded.

II. The Federal Income Tax Issues Associated with Upfront Payments on Cleared Swaps

The Act does not resolve a second issue that exists today for standardized swaps and will become more important as cleared swaps are standardized.

Under existing Treasury regulations, a swap or other notional principal contract that provides for a "significant non-periodic payment" is bifurcated into an "on-market" swap and a deemed loan.[3] The Treasury regulations do not define "significant" for this purpose, although one example in the regulations provides that an upfront payment on an interest-rate swap equal on a present value basis to approximately 9.1% of the total fixed rate payments due under the contract is not treated as significant, while another example indicates that an upfront payment equal on a present value basis to 66.7% of the total fixed rate payments due under the swap, or 40% of the present value of the total fixed payments on an on-market swap, is treated as significant.[4]

If a standardized swap that provides for an upfront payment is bifurcated into an on-market swap and deemed loan, the following issues will arise:

- An offshore fund with a U.S. manager that is deemed to make this loan could be treated as engaged in origination activity, and therefore as being "engaged in a U.S. trade or business" and potentially subject to U.S. federal income tax on a net income basis.[5]

Second, periodic payments on swaps are generally treated as ordinary income; however, gain or loss on a section 1256 contract is generally treated as capital gain or loss. Thus, a character mismatch would have arisen to the extent that periodic payments reduce the fair market value of a section 1256 contract.

Third, if an investor uses a section 1256 contract to hedge a capital asset that is not itself required to be marked-to-market, the investor will be required to mark-to-market the section 1256 contract but generally not the hedged asset. In this case, a timing issue will arise. (If the hedged asset is a capital asset, the taxpayer will not be permitted to treat the hedged asset as a hedging transaction under section 1256(e) of the Code or Treasury regulations section 1.1221-2(b)(2).)

[3] Treasury regulations section 1.446-3(g)(4).

[4] Compare Treasury regulations section 1.446-3(g)(6), Example (2) (9.1%) with Example (3) (40; 66.7%).

[5] Section 864(b)(2)(A)(ii) provides a safe harbor under which a foreign person with a U.S. investment manager is not treated as engaged in a trade or business in the United States if it limits its activities to "trading in stocks and securities" for its own account. However, the IRS takes the position that the safe harbor is not available to a foreign corporation that originates loans. See IRS Office of Chief Counsel Memorandum, PRENO-119800-09 (September 22, 2009). Therefore, if the deemed loans are treated as giving rise to origination activity, the foreign person could fail to qualify for the section

- A U.S. tax-exempt organization that is deemed to have received a loan as a result of having received a significant upfront payment on a swap may be treated as having "unrelated debt-financed income," and may be subject to federal income tax.[6]

- A "controlled foreign subsidiary" (a "**CFC**") that is deemed to have made a loan to one of its 10% United States shareholders as a result of having made a significant non-periodic payment on a swap may be treated as having invested in "United States property" and, therefore, under section 956 of the Internal Revenue Code, the 10% United States shareholders of the controlled foreign corporation may be deemed to have received a taxable dividend.[7]

- If a 10% foreign shareholder of a U.S. corporation is deemed to have made a loan to the U.S. corporation as a result of having made a significant non-periodic payment on a swap, to with the U.S. corporation, the foreign shareholder may be subject to a 30% withholding tax on the deemed interest income.[8]

Although there are no evident tax policies that would support these counterintuitive results in the context of upfront payments on standardized swaps, published guidance from the IRS will be necessary to resolve the issues definitively.

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864(b)(2) safe harbor, in which case the foreign person could be treated as engaged in a trade or business in the United States and subject to U.S. federal income tax on a net income basis.

[6] Tax-exempt organizations are generally subject to tax on income or gain from investment property that is financed with indebtedness. This income or gain is generally referred to as "unrelated debt-financed income." See generally section 514(a).

[7] Section 956 provides, generally, that the 10% United States shareholders of a CFC are taxed on the CFC's investment in "United States property" to the extent of the CFC's untaxed earnings and profits. United States property includes an obligation of a United States shareholder. See sections 956(c)(1)(C) and (c)(2)(F). Thus, if a CFC is deemed to make a loan to a United States shareholder, the CFC will generally be treated as having invested in United States property.

[8] Interest paid by a U.S. corporation to a 10% foreign shareholder generally does not qualify for the "portfolio interest" exemption from withholding tax and therefore is generally subject to a 30% U.S. withholding tax. Sections 881(c)(1) and (c)(3)(B).

We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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