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Clients&FriendsMemo

Over-the-Counter Derivatives Markets Act of 2009

August 20, 2009 (substantially revised)[1]

The Administration has published a significant piece of proposed legislation, the "Over the Counter Derivatives Markets Act of 2009" (the "**Legislation**")[2] that would govern the swaps market, both the transactions and participants. The Legislation reaches far beyond the swaps markets, having application to spot or cash market trading, and potentially to entities such as operating companies that would not ordinarily be regarded as swap market participants. Among other things, the Legislation would (i) require that certain swaps to be defined by the regulators as "standardized" be traded on exchanges and centrally cleared; (ii) require the registration with potentially both the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**") of both dealers in, and large end users of, swaps, including private funds, operating companies, insurance companies and **banks**; (iii) authorize the CFTC and the SEC (in many cases subject to floors set by the banking regulators) to establish a comprehensive regulatory system applicable to these registrants; (iv) require the establishment of new swap market mechanisms, including exchanges, clearing organizations and swap information "repositories"; and (v) give the CFTC and the SEC new powers, including powers as to cash market positions, often overlapping powers, that they would in many instances be required to use jointly, sometimes in conjunction with, or under the direction of, the banking regulators or Treasury.

Many of the key terms in the Legislation are either undefined or are left for the regulators to fill in. Further, leaving aside the question of whether one agrees or disagrees with the goals of the Legislation, there are provisions of the Legislation that may not be readily feasible to implement, such as (i) the authority given the regulators over end-users and (ii) the information collection requirements. As a result, it is difficult to know whether some of the more expansive aspects of the Legislation are intended or are just the results of early-stage rough drafting.

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1 This memo has been revised to reflect a broader interpretation of the applicability of the Act to banks engaging in swaps. The proper interpretation for the scope of the Legislation is that it applies to "Identified Banking Products" as defined by the CFMA. This revised memorandum also addresses the application of the requirement of central trading and clearing for so-called "standardized" swaps (see Section VI). Please insure that this revised memo is forwarded to all recipients of the original memo.

2 The Legislation is available at http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf.

Among the most important unexplained items is what it means for a trade to be "standardized," and what the consequences of such standardization would be. Open questions as to this issue are discussed in Part VI of this Memorandum.

The "Section by Section Analysis" of the Legislation provided with the Legislation is just eight pages and does not provide guidance to answer all these questions.

This Memorandum is broken into seven parts and is structured as follows:

Part I. Sets out in chart form the **overall structure** of the Legislation

Part II. Discusses how the Legislation deals with **overlapping jurisdiction** among the CFTC, SEC, and banking regulators

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

Part IV. Defines which **parties to swaps must register** with the CFTC or SEC

Part V. Describes the **regulations applicable to parties that have registered**

Part VI. Describes the new central market mechanisms to be created under the Legislation: **swap exchanges**, **clearing corporations**, and information **repositories** and the treatment of standardized swaps This Part raises a number of significant questions as to the treatment of **standardized but not fungible** swaps.

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, including as to cash market positions

Part I. Structure of the Legislation

The Legislation is divided into two parts: Part A governs those transactions that would be primarily regulated by the CFTC (defined in the Legislation as "Swaps") and Part B governs those transactions that would be primarily regulated by the SEC (defined in the Legislation as "Security-Based Swaps"). These two Parts run roughly parallel, so we will discuss the Parts together in each part of this memo, while identifying where there are material differences between them.

The chart below is intended to provide a guide to the structure of the Legislation. In addition, it is intended to provide enough of a link between the memo and the Legislation that we can avoid excessive footnoting of the Memorandum.

Concept	**Part A** *(pages 1-69)* Commodity Exchange Act	**Part B** *(pages 69-115)* Securities Act; Securities Exchange Act
"Swap" *(CWT Memo page 7, 9)*	Section 711, pages 1-6	Section 751, page 71 (definition incorporated by reference from Part A)
"Security-Based Swap" *(CWT Memo page 7, 11)*	Section 711, pages 6-8	Section 751, page 71 (definition incorporated by reference from Part A)
"Identified Banking Products" Exemption *(CWT Memo page 10)*	Section 713, pages 30-31 (definition is in CFMA Section 402, which itself is based on a portion of the definition in Gramm-Leach-Bliley Act)	n/a, but relevant provisions in Part A speak of an evasion of the securities laws as well as the CEA
"Security-Based Swap Agreement" *(CWT Memo page 8, 11)*	*n/a*	Section 751, page 72 (definition)
"Standardization" of Contracts *(CWT Memo page 11, 19)*	Section 713, Pages 15-18 (Defined: Mandatory Clearing: Mandatory Exchange Trading; Exceptions)	Section 753, Pages 76-78 (Defined: Mandatory Clearing: Mandatory Exchange Trading; Exceptions)
"Dealer" Registration *(CWT Memo page 12)*	Section 717, pages 8 (definition), 35-37 (registration requirement)	Section 753, pages 72 (definition incorporated by reference from Part A), 88-89 (registration requirement)
"Participant" Registration *(CWT Memo page 14)*	Section 711, page 8 (definition), Section 717, pages 35-37 (registration requirement)	Section 753, pages 71 (definition incorporated by reference from Part A), 88-89 (registration requirement)

Concept	Part A *(pages 1-69)* Commodity Exchange Act	Part B *(pages 69-115)* Securities Act; Securities Exchange Act
Capital Requirements *(CWT Memo page 15)*	Section 717, page 39	Section 753, pages 90-92
Margin Requirements *(CWT Memo page 16)*	Section 722, page 54	Section 753, page 93
Reporting and Recordkeeping Requirements *(CWT Memo page 17)*	Section 713, pages 17, 26-28, 49-50 (clearing corporations, exchanges) Section 716, pages 34-35 (counterparties generally)	Section 753, pages 77, 79-81, 85-87 (clearing corporations, exchanges) Section 754, pages 111-112 (counterparties generally) Section 754, page 112 (§13 reports regarding beneficial ownership) Section 754, page 112 (§15(f) reports by Institutional Investment Managers)
Associated Persons *(CWT Memo page 18)*	Section 711, pages 10-11 (definition), 36 (requirements)	Section 753, pages 71 (definition incorporated by reference from Part A), 99-103 (requirements)
Exchanges *(CWT Memo page 18)*	Section 719, pages 46-52 ("Alternative Swap Execution Facilities" generally) Section 720, page 52 (repeal of exemption for DTEFs and BOTs) Section 721, pages 52-54 (DCMs)	Section 753, pages 82-88 ("Alternative Swap Execution Facilities" generally)
Regulatory Authority Over Foreign Exchanges *(CWT Memo page 13)*	Section 725, pages 58-62	*n/a*
Clearing Corporations *(CWT Memo page 19)*	Section 713, pages 15-30	Section 753, pages 76-81
Swap Repositories *(CWT Memo page 22)*	Section 715, pages 11-12 (definition), 32-34 (registration requirement)	Section 753, pages 108-110 (registration requirement)
Public Reporting by Regulators *(CWT Memo page 23)*	Section 714, pages 31-32	Section 753, page 108

Concept	Part A *(pages 1-69)* Commodity Exchange Act	Part B *(pages 69-115)* Securities Act; Securities Exchange Act
Large Trader Reporting *(CWT Memo page 23)*	Section 731, pages 67-69	Section 753, pages 106-107
Position Limits *(CWT Memo page 23)*	Section 719, page 49 (limits established by exchanges) Section 723, pages 54-56 (limits established by CFTC)	Section 753, pages 84 (limits established by exchanges) Section 753, pages 104-105 (limits established by SEC)
Retail Transactions *(CWT Memo page 23)*	Section 730, pages 65-67	Section 756, pages 114-115
Joint CFTC-SEC Rulemaking *(CWT Memo page 6)*	Section 711, pages 12-13 (definitions and interpretation) Section 713, page 16 ("standardization" of contracts) Section 713, pages 19 (clearing corporations and exchanges) Section 717, pages 37-38, 41-43 (requirements of counterparties generally)	Section 753, pages 76-77 ("standardization" of contracts) Section 753, pages 81-87 (clearing corporations and exchanges) Section 753, pages 90-91, 94, 95, 97, 110 (requirements of counterparties generally)
Treasury Tiebreaking Authority *(CWT Memo page 6)*	Section 711, pages 12-13	Implicitly incorporated by reference
Jurisdiction *(CWT Memo page 6)*	Section 712, pages 14-15	Section 758, page 152
Primary Enforcement Authority	Section 728, pages 63-64	Section 753, pages 100-101
Conflicts of Interest (Research) *(CWT Memo page 18)*	Section 717, page 45 (counterparties generally) Section 718, page 46 (FCMs and introducing brokers)	Section 753, pages 98-99 (counterparties generally)
Limits on Exemptive Authority *(CWT Memo page 7)*	Section 711, pages 13-14 (exemptive authority generally) Section 713, page 20 (clearing corporations) Section 715, page 34 (swap repositories) Section 719, page 52 (exchanges) Section 723, page 56 (position limits)	Section 758, page 115 (exemptive authority generally) Section 753, page 89 (counterparties generally) Section 753, page 110 (swap repositories) Section 753, page 87 (exchanges) Section 753, page 105 (position limits)

Concept	Part A *(pages 1-69)* Commodity Exchange Act	Part B *(pages 69-115)* Securities Act; Securities Exchange Act
State Gaming Law (Pre-emption)	*n/a* *See* Commodity Futures Modernization Act, Section 117	Section 755, page 113 *See also* Commodity Futures Modernization Act, Section 117

Part II. Who Makes the Rules Under the Legislation

A. CFTC, SEC and Prudential Regulators.

Generally, the CFTC would make the rules applicable to persons and trades subject to Part A (basically Swaps not on securities other than broad indices), with the SEC responsible for persons and trades subject to Part B ("Security-Based Swaps"). In addition, where a banking entity is required to be registered under the Legislation, certain of the regulatory requirements would be established by the bank's primary federal regulator, referred to as its "Prudential Regulator."[3]

B. Overlapping Regulation.

It is a clear theme of the Legislation that there is a preference for a considerable degree of regulation, very often regulation of the same matter, such as capital, by two agencies (the CFTC and the SEC) or by three agencies (the Prudential Regulators as well).

C. Treasury Oversight.

Where the CFTC and the SEC cannot agree on a rule as required under the Legislation, the Treasury is given the authority to make rules and impose them on the two agencies until agreement is reached. This gives the Treasury influence over both agencies and over rules to be adopted under the Legislation (particularly in light of the next two points).

D. The Bank Floor.

Another interesting feature of the Legislation is that, in cases where there are similar or overlapping rules, the CFTC/SEC may not make rules unless these rules are "as strict or stricter" than those set by the Prudential (banking) Regulators. This means that in many cases the regulations applicable to

[3] The Prudential Regulators are as follows: (i) *Board of Governors of the Federal Reserve:* state chartered banks that are members of the federal reserve system; and state chartered branches and agencies of foreign banks; (ii) *OCC:* national banks, federally charted branches and agencies of foreign banks; and (iii) *FDIC:* insured state chartered banks that are not federal reserve system members. The Office of Thrift Supervision is not included in the list of Prudential Regulators.

banks (the "**Bank Floor**") set the floor below which other entities may not descend. We are not sure whether this is intended: it seems counterintuitive in that one might expect that banks, which are allowed to take federally insured deposits from retail customers, would be subject to the strictest capital regulation rather than having them set the floor. The existence of the Bank Floor is primarily significant as to capital regulation and margin regulation as discussed in Part V of this Memorandum below.

E. Limited Exemptive Authority.

Another feature of the Legislation relevant to the establishment of the rules thereunder is that the exemptive authorities of the CFTC and the SEC are quite limited. As a general matter, they are permitted to grant exemptions "only as expressly authorized" under relevant provisions of the Legislation, rather than having a general exemptive authority. This means that if there are portions of the Legislation which, for one reason or another, simply do not work, the relevant agencies would not be able to "exempt" around the problems—a legislative fix would be required.

This limited exemptive authority is notable. First, it is against the general trend of legislation, which has been to provide the regulators with complete exemptive authority.[4] Second, it seems inconsistent to trust the regulators to define terms central to the Legislation such as "standardized" and "substantial net position," which make the Legislation effective and define to whom the Legislation will apply, while not giving them authority to grant exemptions.

Part III. Definition of a "Swap"

A. Before the Street Address, a Road Map.

The 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. The specific meanings may be hard to discern and a quick read based on plain English can be misleading. In brief, the key defined terms around swaps are structured as follows:

"**Swap**": This term is defined in Part A of the Legislation, and is effectively used to mean a derivatives transaction (other than a listed future) that is governed by the Commodity Exchange Act ("**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."

[4] *See, e.g.,* Section 36 of the Exchange Act, which gives the SEC very broad exemptive authority under that Act.

"**Security-Based Swap**": This term is also defined in Part A and incorporated by reference into Part B. The term "Security-Based Swap" means transactions that would, in form and economics, be regarded as "Swaps," but that reference individual securities or loans, or narrow indices. It is effectively a transaction that is governed by the SEC pursuant to Part B of the Legislation.

"**Security-Based Swap Agreement**": This term is used only in Part B of the Legislation. It appears essentially to mean a transaction that would be a transaction that (i) in economics is a swap and (ii) that relates to securities, but that is not a Security-Based Swap either because (a) it is a Swap on a broad-based securities index over which the CFTC (and not the SEC) has authority or (b) it is a transaction outside of either CFTC or SEC regulatory authority, such as a swap on a U.S. government security. It appears that this definition is used where necessary in the securities laws to give the SEC anti-fraud authority with respect to instruments that relate to securities, but that are not Security-Based Swaps.[5]

"Security" in the Securities Act and the Exchange Act is expanded by adding the term "security-based swap agreement" to the list of instruments within that definition. This generally has the effect of making the securities laws, including the antifraud provisions and the regulatory requirements applicable to registrants, applicable to security-based swap agreements.

Most of the other definitions in the Legislation effectively turn on the definitions above. That is, the various types of dealers and participants required to register and be regulated pursuant to the Legislation would only be regulated if their activities involved either "Swaps" or "Security-Based Swaps" or "securities" as the definition is newly expanded.

B. A Swap by Any Other Name.

This Memorandum uses the following terminology conventions:

"**Swap**": Consistent with its use in the Legislation, as a transaction that would be regulated by the CEA.

"**Security-Based Swap**": Consistent with its use in the Legislation, as a transaction that would be regulated by the SEC.

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[5] The term is used in Section 10, 16, 20 and 21A of the Exchange Act and in Section 17 of the Securities Act. (See Section 752 of the Legislation on page 72.) These provisions are generally anti-fraud provisions as to which it would make sense for the SEC to have anti-fraud authority; *e.g.,* to give the SEC anti-fraud authority over transactions relating to the S&P 500 or U.S. governments even if the CFTC, for example, otherwise regulates the trades. However, Section 16 (which relates to large insider positions in a corporation) does not seem to have any advisor relationship to "Security-Based Swap Agreements."

"**Security-Based Swap Agreement**": Consistent with its use in the Legislation, a swap over which the SEC has anti-fraud authority, but not regulatory authority.

"**Regulated Swap**": Either a Swap or a Security-Based Swap, but not a Security-Based Swap Agreement over which neither the SEC nor the CFTC has regulatory authority.

C. Transactions Subject to the Legislation: More Precisely Defined.

As stated above, understanding of the Legislation necessarily begins with the definition of the term "Swap" **and the various exclusions.**

i. *Swap—Starting Definition.* A "swap" is defined to mean a contract that is (i) an option on virtually anything,[6] (ii) a credit default swap ("**CDS**"); (iii) an agreement that provides on an executory, fixed, or contingent basis for the exchange of one or more payments based on the value of virtually anything;[7] and (iv) any combination or permutation of the above.

ii. *Swap—General Exclusions.* From the above broad definition, there are then excluded: (i) listed futures and security futures; (ii) any sale of a nonfinancial commodity for deferred shipment or delivery, so long as such transaction is **physically settled**; (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 (which is a swap); (vii) a note or other evidence of indebtedness that is a "security" as defined in the Securities Act; (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**; (ix) foreign-exchange swaps and forwards; (x) an agreement with the U.S. government or a Federal Reserve Bank; or (xi) a Security-Based Swap; *provided, however,* an agreement may be both a Swap and a Security-Based Swap.[8]

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6 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.

7 This prong of the Swap definition picks up the instruments that we would refer to economically as "swaps," including total return swaps.

8 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). In the Legislation, any such dually regulated trade is referred to as a "Mixed Swap."

iii. *Swap—Exclusion for Identified Banking Products.* The Legislation provides that nothing in the CEA shall apply to an "identified banking product." This is a reference to that definition in the CMFA (which itself is a reference from part of the definition in Gramm-Leach-Bliley). As used in the CFMA, the term includes a deposit account, a banker's acceptance, a letter of credit, a debit account at a bank, and a loan participation sold to a qualified investor.[9]

iv. *Some Uncertainties as to These General Exclusions.* We have discussed below the exclusionary language that seems unclear, as explained.

(a) *"Physical Settlement."* 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 physical delivery or an expectation of physical delivery. Historically, there was uncertainty, and considerable resulting litigation, over what it meant to have an "expectation" of physical delivery, *i.e.,* whether the parties "intended" to settle by delivery. That said, it has always been clear that commercial users of a product were not actually required to take physical delivery in order to fall within the forward contract exclusion. If they were, it could be impossible to close out of physical delivery contracts since they would thereby become (potentially) illegal transactions.

(b) *"That is Subject to the Securities Act and the Exchange Act."* This phrase is used throughout the Legislation. By definition, an option on a security is subject to the Securities Act and the Exchange Act if it is sold in the United States; accordingly, it is not clear if this phrase has any meaning or what its meaning would be. One could assume that it is just surplusage, except that the current carve out from the CEA for securities options does not use this phrase.

(c) *"On a Fixed Basis*." The term "fixed" is used in various places in the Legislation, where it is not clear whether the term is meant to require (i) a definite number (as in not a "variable" number) or (ii) certainty as to the occurrence of an event (as in not subject to a "contingency," in contrast to a CDS, which is subject to a credit contingency).

(d) *Based on a Security; Through an Underwriter; Managing Risk.* We assume that the provision using these terms is intended to allow an issuer to hedge the risk of its capital raising without falling into the scope of the Legislation. However, the drafting does not seem to match our expectation as to the reason for the exclusion, so that a transaction would be deemed to be regulated or not based on whether it was based on a "security" (what about interest rates?) and entered into through an underwriter (presumably the underwriter of the security, but what about an affiliate of the underwriter or a third party?).

[9] The broader GLB definition (which is not the definition used in the Legislation) includes a swap.

v. *Security-Based Swap.* 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.

This split between CFTC and SEC jurisdiction over Swaps and Security-Based Swaps, respectively, thus generally tracks the split that exists today with respect to futures involving securities, where the CFTC owns futures on broad indices and the two regulators share all other futures on securities. Note that many of the drafting uncertainties that we have pointed out above with reference to a "Swap" are also relevant to the definition of a Security-Based Swap. Note also that the definition may include transactions involving loans, which is potentially problematic for unregulated entities trading loans.

(a) *Security-Based Swap – Government Securities Exclusion.* The term Security-Based Swap does not include a swap based on a U.S. government security. However, trades on other sovereigns would be within the definition.

vi. *Security-Based Swap Agreement.* This is a rather confusing definition. It is a transaction that (a) is a swap agreement as defined in Gramm-Leach-Bliley Section 206A (which is a broad definition as to types of transactions) and (b) is based in part on the "price, yield, value, or volatility of any security or any group or index of securities" but (c) the term does not include a "Security-Based Swap." In sum, it would include those swap transactions that relate to securities, but that are not Security-Based Swaps; *e.g.,* those trades that relate to broad indices or to U.S. governments.

D. Swaps that are "Standardized".

i. *Legislative Use of the Term*.

As to instruments subject to the Legislation, a distinction is made between those Regulated Swaps that are (i) "standardized" and (ii) those that are not. Regulated Swaps that are standardized are subject to various additional requirements, such as that (absent on exemption) they be centrally traded and cleared, which requirement is not applicable to non-standardized transactions.

Although the definition of "standardized" is central to the Legislation, it is undefined. Rather, the CFTC and the SEC are instructed that they are to define the term "standardized" as "broadly as possible, after taking into account" such factors as (i) which of the terms of the trade, including price, are disseminated to third parties, (ii) the volume of transactions, (iii) the extent to which the Regulated Swap is similar to other Regulated Swaps that are centrally cleared, (iv) whether the

Regulated Swap is similar to other Regulated Swaps in ways that are of economic significance, and (v) whatever else the CFTC or the SEC think relevant.

ii. *Common Industry Use of the Term.*

The term "standardized" is commonly used in the financial industry as to exchange-listed products, such as listed options. Thus, it may seem that its use in the Legislation is a rather routine matter, of no particular note. In fact, the Legislation is using the term in quite a different way from its ordinary use. This may be illustrated by reference to the use of the term "standardized" in the market for listed securities options. A "standardized" option on a security has (i) terms that are set by the exchange, (ii) a defined maturity, (iii) fixed exercise procedures and times, and (iv) a fixed strike price. In addition, if there are any adjustments to be made to the option in light of extraordinary events as to the underlying issuer, the clearing corporation will make the same adjustments to all options pursuant to its rules. In other words, standardized options are **not merely similar**: they are **identical.** If the term "standardized" is be defined under the Legislation as "broadly as possible," presumably to mean having terms that are as **dissimilar as possible**, then that is a different use of the term "standardized" from the one that is common in the market. **This different use of the term has significant implications as discussed in Part VI of this memo.**

Part IV. Registration Requirements

A. Registration Requirements for Dealers.

The Legislation contains two sets of registration requirements, one applicable to those involved with "Swaps" (who must register with the CFTC) and one applicable to those involved with "Security-Based Swaps" (who must register with the SEC). As these two sets of registration requirements run in parallel, they are discussed in parallel below. We will refer to both "Swaps Dealers" and to Security-Based Swap Dealers" as "Dealers." Regulatory requirements applicable to Dealers and Participants (as defined below) are discussed in Part V of this Memorandum.

i. *Definition of Dealer.* The definition of a Dealer is based upon the definition of a "[securities] dealer" in Section 3(a)(5) of the Exchange Act. Generally speaking, a "Dealer" is a person (i) engaged "in the business" of buying and selling Regulated 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 Legislation in a manner consistent with the Exchange Act, it would serve to exclude from the Dealer definition many end users, potentially including hedge funds, insurance companies, operating companies and the like. Of course all of these entities would be required to conduct an analysis of

their activities to determine whether they might fall within the Dealer definition. However, even if these "traders" are excluded under this definition, they may be required to register under the Participant registration categories (discussed further below).

ii. *Registration Exemptions.* The Legislation provides that the CFTC and the SEC would be permitted to grant exemptions " to Dealers only as expressly authorized" under relevant provisions of the Legislation.

(a) *No Bank Exemption.* The Legislation by its express terms is quite clear that there is no bank exemption (which is surprising to some readers and writers).

(b) *Other (Offshore?) Exemptions.* The SEC is given authority under the Legislation to provide an exemptions for Dealers of Security-Based Swaps that are "subject to substantially similar requirements as [securities] brokers or dealers." Presumably, this provision is intended allow the SEC to adopt an exemption for Dealers of Security-Based Swaps that is "substantially similar" to the exemption for non-U.S. broker-dealers under Rule 15a-6 (but as there is no explanation of what is intended, we may be presuming too much).[10]

The CFTC does not have similar authority to provide exemptions for persons operating outside the United States. Moreover, the only language in the Legislation that relates to non-U.S. transactions actually subjects non-U.S. persons to greater CFTC authority by (i) requiring foreign boards of trade that provide direct electronic access to U.S. customers to register with the CFTC and (ii) imposing regulatory requirements (such as position limits) upon such boards offering trading in so-called "linked" contracts (contracts that settle against the price of listed U.S. contracts). However, as a practical matter, it would seem that there must be some device to restrain the CFTC's territorial jurisdiction similar to the existing Part 30 exemptive authority that it currently exercises for foreign futures and options.

iii. *Broker Registration.* The 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)(5) of the Exchange Act apply as to brokers in Security-Based Swaps.

[10] We note that a Rule 15a-6 exemption might arguably mitigate the burden of certain parts of the Legislation applicable to Securities-Based Swaps Dealers, since it would seem possible that major Securities-Based Swaps Dealer would elect to operate within the exemption.

B. Registration Requirements for Major Participants.

As stated above, the Legislation provides very extensive registration requirements for certain end-users, referred to as "Major Swap Participants" (as to Swaps who must register with the CFTC) and as Major Security-Based Swap Participants (as to Security-Based Swaps who must register with the SEC). We refer to both categories of registrants as "Major Participants."[11]

The Legislation's end-user registration requirements actually go well beyond any comparable provision in the CEA or the securities laws. For example, they could apply to entities that have no public investors or that are primarily operating companies; likewise, they could apply to entities that are already regulated in other capacities, such as banks, insurance companies, 1940-Act registered investment companies, and public commodity pools.

i. *Major Participant.* The term Major Participant is defined as an entity (other than a Dealer) that maintains "a substantial net position" in Regulated Swaps other than to create and maintain an effective hedge under GAAP.

The term "substantial net position" is left to the CFTC and the SEC to define. Note that the "hedge exemption" is quite a narrow one, as many transactions that may be hedges for business purposes would not be hedges under GAAP. Further, because the definition of the term "Swap" may pick up many types of contracts that would historically have been regarded as "forwards," it is entirely possible that many industrial, agricultural, transportation, energy or other operating companies, such as airlines, will fall within this definition. Likewise, it would seem possible that many financial companies, such as banks, insurance companies, and private funds would fit within the definition of Major Participant. We also note that the definition, combined with the limited exemptive authority allowed the regulators, would not seem to provide for discretion to determine that particular types of entities should be carved out from the registration requirement.

ii. *Registration Exemptions.* As stated above with respect to Dealers, there are very limited registration exemptions and the powers of the agencies to grant exemptions are also limited.

(a) *Bank Exemption.* The Legislation does not provide for a bank exemption.

(b) *Other (offshore?) Exemptions.* The SEC is given the same authority to provide an exemption from registration for Major Participants as it is for Dealers: those exemptions must be

[11] By contrast, the "dealer" definition in Section 3(a)(6) of the Exchange Act is amended to carve out Security-Based Swap Agreements. 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.

"subject to substantially similar requirements as [securities] brokers or dealers."[12] See our comments on this point above.

The CFTC does not have similar authority to provide exemptions for persons operating outside the United States. However, as a practical matter, it would seem that there must be some device to restrain the CFTC's territorial jurisdiction.

Part V. Regulatory Requirements Applicable to Dealers and Major Participants

The rules that are to be adopted by the CFTC/SEC as to Dealers and Major Participants (collectively, "**Registrants**") do not, at least under the terms of the Legislation, make a distinction between being a financial intermediary (Dealer) and an end-user (Major 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 Legislation does not provide much detail in this regard, leaving that to the CFTC, SEC and Prudential 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.

The capital requirements are the most problematic, and perhaps counter-intuitive, part of the whole registration scheme. They are also among the most interesting in that they may indirectly work to give a good deal of power to the Prudential (banking) Regulators.

i. *As to Banks.* As a starting matter, the Prudential Regulators would set capital requirements as to banks that are Registrants. The regulations that the Prudential Regulators impose would have to be higher for non-cleared Bank Swaps than for cleared Bank Swaps. These capital regulations set by the Prudential Regulators set the "Bank Floor."

ii. *As to BHCs.* The Board would have authority to set capital requirements for BHCs and Tier 1 FHCs on a consolidated basis, subject to the Bank Floor.

[12] As is the case with dealer registration, we note that the Legislation would provide some incentive to move entities, business, personnel and activities outside the United States.

iii. *All Other Registrants.* The CFTC/SEC would set capital requirements as to all other Registrants, again **subject to the Bank Floor**.

(a) *What Would be the Procedures.* As a general matter, it is not clear how this capital requirements would be implemented. Capital requirements must be set on the basis of an entity's entire business, not just its swaps book. That is, it would not be useful to say that a Registrant had $1 billion in swaps equity if the entity otherwise had a $10 billion deficit on its operating assets or its pension liabilities. This means that the CFTC/SEC must be able to set capital requirements, subject to the Bank Floor, for every type of entity that might potentially be a Registrant*; e.g.,* insurance companies, operating companies, airlines, private funds, municipal government entities. Obviously, developing and enforcing the rules applicable to so many types of entities would be a substantial job.

(b) *Failure.* It is unclear what would happen if a Registrant 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 Regulated 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?

B. Margin Requirements.

The margin requirements to some extent follow the scheme by which capital requirement are set.

i. *As to Banks.* The Prudential Regulators would set *initial and variation* margin requirements as to banks. Again, these margin requirements would set the Bank Floor.

An exemption from the requirement of establishing margin might be available if the counterparty to the bank (i) is not itself a Registrant, (ii) is using the trade as a hedge under GAAP, and (iii) is predominantly engaged in activities that are not financial in nature as defined in Section 4(k) of the BHCA. The policy of this potential exemption is unclear as the conditions do not seem closely related to the risks associated with the particular trade.

ii. *As to All Other Registrants, Including BHCs.* The CFTC/SEC would set margin requirements as to all other Registrants, subject to the Bank Floor.

It is not clear how this will work where both parties are required to post collateral to each other. Similarly, it is not clear whether the Legislation is intended to make uncollateralized Regulated Swaps illegal (or, put differently, to require the posting of margin on all Regulated Swaps).

C. Books and Records; Recordkeeping; Reports.

The CFTC and the SEC each have authority to establish books and records requirements as to those Registrants that are registered with them. It appears that the CFTC and the SEC could adopt regulations governing books and records that would go beyond matters relating to Regulated Swaps, which is likely 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."[13] 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."

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.

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.

E. Documentation and Back Office Standards.

As to Registrants within their respective jurisdictions (but consulting with the Prudential 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 the right direction, 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 ISDA documentation be made mandatory?).

[13] 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.

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 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.

G. Associated Persons.

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

Part VI. To-be-Created Swaps Market Institutions

Among the most significant features of the Legislation is that it is intended to create a centralized swaps market that would include various new institutions: (i) exchanges, (ii) clearing corporations, (iii) Swap (information) Repositories, and (iv) requirements as to the public distribution of information collected by the CFTC and SEC. Certain swaps would have to be executed on the exchanges, standardized Regulated Swaps would have to go through an exchange and clearing corporation, and information as to virtually all swaps would have to be reported to a "Swaps Repository."

Although the Legislation contains general provisions as to certain of these new bodies, which provisions are generally modeled after language in the CEA, it is significant that these entities do not yet exist. Thus, it is to be determined how these entities will come into existence (who will own them and how they will make a profit), whether there will be numerous competing entities of each type, whether there will be open competition to establish these entities, what would happen if one of these entities were to fail, and so on.

A. Exchanges, including ASEFs, and Clearing Corporations.

Establishment and Regulation of Exchanges. The Legislation provides for the establishment of alternative swap execution facilities ("**ASEFs**") for (i) Swaps, which facilities are to be regulated by the CFTC and (ii) Security-Based Swaps, which facilities are to be regulated by the SEC. In terms of the regulatory requirements applicable to these new types of exchanges, the Legislation generally follows the CEA model, and thus give the execution facilities a fair amount of leeway to do

what works.[14] That said, among the requirements to which the execution facilities will be subject are that they (i) have trading rules, (ii) have procedures to monitor for improper trading, (iii) be able to provide for the financial integrity of trades executed through their markets, including clearance and settlement, (iv) have the ability to obtain any necessary information and be wiling to provide that information to regulators, including non-U.S. regulators, (v) set position limits where required, and (vi) publish trading information.

It would be possible for (i) Swaps to be traded on both the new CFTC-regulated ASEFs and on fully regulated futures exchanges and for (ii) Security–Based Swaps to be traded on both SEC-regulated ASEFs and fully regulated national securities exchanges.

B. Establishment and Regulation of Clearing Corporations.

The Legislation provides for the establishment of clearing organizations for (i) Swaps, which facilities are to be subject to the CFTC, and (ii) Security-Based Swaps, which facilities are to be subject to the SEC. The new clearing corporations for ASEFs would be subject to various "Core Principles" that are largely based on language in the CEA. These Core Principles include matters such as adequate financial resources, governing of participant and product eligibility, risk management procedures, settlement procedures, rules governing the handling of margin, default procedures, system safeguards, reporting to the regulators, recordkeeping, reporting to the public and participants, information sharing, management of legal risk, conflicts of interest, and appropriate governance.

A principal requirement of the Legislation that is applicable to any clearing organization is that it would be required to "prescribe that all swaps with the same terms and conditions are fungible and may be offset with each other." Above, in Part III of this Memorandum, we discussed the fact that the Legislation uses the term "standardized" in a manner that differs from its current common usage, and that would treat Regulated Swaps as "standardized" even when they are not identical and thus are not fungible. **That is, in theory, there could be an infinite number of "standardized" swaps that may have similar terms, but that do not have identical terms.**

This creates some difficulties as discussed below

[14] That the alternative swap execution facilities must undergo registration – rather than simply be designated by the CFTC – presumably means that they will be subject to greater scrutiny before they are allowed to operate.

C. Standardized Regulated Swaps Between ECPs: Rule and Two Exceptions.

The Legislation imposes a "mandatory" exchange-trading and clearing requirement for standardized Regulated Swaps, requiring, **unless an exception is available,** that they (a) be executed, (i) in the case of a Swap, on a fully regulated futures exchange or an ASEF regulated by the CFTC or (ii) in the case of a Security-Based Swap, either on a national securities exchange or an ASEF regulated by the SEC and (b), in both cases, cleared on the clearing organization for that market; unless **one of two exceptions** is available.

The first exception is available if **no clearing organization will accept** the Regulated Swap.

The second exception is available if **one of the parties to the trade (i) is not a Registrant and (ii) does not meet the eligibility requirements of any clearing organization willing to take the trade.**

Both potential exceptions create difficulties, which we discuss below.

i. *Standardization without Fungibility.* The fact that there are **"standaridized" but "not identical"**; *i.e.,* **not fungible, Regulated Swaps,** leads to at least **three possible results of what the Legislation intended**.

1. In theory, the Legislation may have been intended to **require a clearing organization to be able to handle (and value) a potentially infinite number of standardized transactions that may not be actually fungible.** Is this practical? How would the clearing organization analyze the infinite variants from 1000s of members to determine the appropriate margin on a non-fungible trade? Who at the clearing organization could review and evaluate all the potential variant terms?

2. A second possibility is that what is really intended by the Legislation is that if a Regulated Swap is deemed to be within a **class** of Regulated Swaps that is standardized, then it must be centrally cleared.[15] **However**, if no clearing corporation will accept that particular variant of the standardized Regulated Swap for clearing, the counterparties to the trade must amend the terms of the Regulated Swap so that the clearing corporation will accept it. That would reduce firms' ability to tailor transactions and would be time consuming. **In effect, that would mean that the purpose of the Legislation is to make OTC Regulated Swaps illegal if they are Standardized. (This reading does not follow the literal language of the Legislation, which**

[15] This is not what the Legislation says, but it seems consistent with the notion of defining Standardization broadly.

does not speak of a class of Standardized Regulated Swaps, but it seems a possible intent of the Legislation.)

3. A third possible interpretation, **consistent with the words of the Legislation**, is that it would be permissible to trade OTC a Standardized Regulated Swap if no clearing organization would accept the trade. That is what the Legislation says, but it also raises **interpretative issues**. First, as a practical matter, it would be necessary to determine as to each variation of a Regulated Swap whether a clearing organization would accept it. How would this process work? Second, it seems to **render largely moot the determination by the SEC and the CFTC that a Regulated Swap is standardized**. That is, under this interpretation of the Legislation, the only test of "standardization" that actually matters is whether a clearing organization will accept the trade for clearing: (i) if the clearing organization accepts the Regulated Swap, **"it shall be presumed to be standardized,"** regardless of how the regulators might otherwise define the term; and (ii) if no clearing organization will accept the transaction, the fact that regulators have defined the transaction to be standardized is largely irrelevant since the **trade is exempted** from the central trading end requirement that is supposed to apply to a standardized trade. If this understanding of the Legislation is correct, **what is the purpose of the regulators defining the term "standardized**? **Their definition would serve no purpose.**

For example, if an exchange and clearing corporation were to (i) offer facilities as to Regulated Swaps in Asset X that terminate on the 15th day of the month and (ii) the CFTC and the SEC were to determine that the day of the month on which a Regulated Swap terminates does not have any effect on whether it is "standardized," then (iii) what would follow? Under Theory 1 above, the clearing organization would be required to accept the trade. Under Theory 2 above, the parties would have to amend the trade so the clearing organization would accept it. Under Theory 3 above, the parties could enter into the trade away from the clearing corporation, which would seem to make irrelevant the fact that the regulators had deemed the trade to be standardized. In short, it is not clear what the Legislation intends.

ii. *Exception Based on Counterparty Status.* The Legislation also provides an exception from central trading and clearing for a Standardized Regulated Swap if one of the parties to the trade (i) is not a Registrant **and** (ii) does not meet the eligibility requirements of any clearing organization willing to take the trade.

Read literally, this means that a **trade between two Registrants could never benefit from the exemption** since the first prong of the exemption would never be met.[16]

[16] We assume that this not a drafting error since otherwise the reference to Registrants would be not necessary.

A trade between (ii) two non-Registrant ECPs or (ii) one Registrant and one non-Registrant ECP would qualify for the exemption **only if one of the non-Registrants did not meet the eligibility requirements of a clearing corporation. One of the potentially unintended effects of the Legislation is that it might be advantageous to be or become ineligible to become a member of a clearing organization, since such ineligibility would allow for OTC trading.**

The central clearing requirement could give clearing organizations substantial market power to enlarge their membership, as they could **effectively require any Registrant or any eligible ECP that wanted to trade in a particular standardized Regulated Swap to become a member of that clearing organization.** [17]

Currently, entities must apply for membership in a clearing organization. Such membership is a time consuming and somewhat burdensome process, due to the financial and credit risks involved for both parties, not to mention the risks for all the other members of the clearing agency should any clearing member become insolvent, since all losses of the insolvent member may be redistributed among the solvent members. That is, each member of a clearing organization is benefited if the other members and the clearing organization itself are financially strong. Under current practice, a clearing organization is an exclusive club: it generally does not admit non-U.S. institutions that are not subject to U.S. bankruptcy laws, or unregulated entities such as hedge funds and industrial companies or entities subject to uncertain bankruptcy regimes such as pension plans.

By contrast to current practice, the Legislation seems to presume that, as a general matter, virtually any Registrant would become a member of any clearing organization that would clear the Regulated Swaps it traded. That raises a number of interesting questions as to the types of entities that might be required or permitted to become a member of a clearing agency, what the membership requirements and procedures would be and how the clearing organizations would deal with insolvency risk of foreign members and of entities such as pension plans.

D. Which Regulator Will Oversee Clearing Organizations.

The CFTC or the SEC, as the case may be, could provide an exemption for the registration with it of a clearing agency otherwise regulated by it, if that clearing organization is otherwise regulated by

[17] Further, this problem of forced membership is not one that could be readily solved by competition among clearing organizations. Suppose, for example, that there were three clearing agencies offering trading in a particular standardized swap (supposedly creating price competition). Now, suppose, there were three financial institutions, each of which was a member of just one of the clearing organizations. There would be no way for them to trade with each other since they are not members of the same clearing organization. The solution would be for each of the institutions to become members of every clearing organization (tripling the fees and effectively eliminating the competition) or for the clearing organization to merge into one (actually eliminating the competition).

the SEC or the CFTC, a banking regulator or a non-US governmental regulatory authority in the case of a non-US clearing organization. Although this exemptive authority seems generous, at least as compared to the rest of the Legislation, it is not entirely clear how it would work. For example, given that the CFTC has fairly plenary authority over Swaps on energy, for example, it would seem difficult for the clearing organization to operate under the jurisdiction of the SEC or of the banking authorities unless the CFTC were given so much insight into the clearing organization that it was effectively a second regulator. On the other hand, it is also possible that this "exemptive" provision could serve as an intermediate measure toward the banking regulators taking charge of all swaps clearing organizations, or perhaps even of all clearing organizations.

E. Swap Information Repositories.

The most novel type of new organization—and in some sense the one as to which we would have the most questions—are "Swaps Repositories" which are intended to (i) collect data as to every Regulated Swap, (ii) make that data available to the regulators, and (ii) publish that data in some aggregated form to the general public, albeit without revealing the positions of any particular entity.[18]

This type of organization is novel in that we are not aware of any organization which performing a similar function as a business. That is, there are numerous exchanges and clearing corporations of varying types, but there is no one in the business of being a "Swaps Repository." In this regard, we raise the question as to whether this is in fact a "business," or would more properly be regarded as a governmental function. That is, unlike exchanges and clearing facilities which provide services to their members, the Swaps Repository would not: it would be acting at the behest and direction entirely of the government and the various regulators, and it would provide its information solely at the direction of the government and the various regulators. In sum, it would seem that this would be a governmental function, one presumably to be performed either by the CFTC and the SEC internally or at their behest.

Equally fundamentally, we are not sure what is to be done with this information and how it can be used. On the one hand, potentially thousands of large financial and commercial organizations would be flooding the Swaps Repository on a daily basis with information regarding their trading of Regulated Swaps. Potentially, if the Legislation works as intended, there would arguably be an unmanageable amount of information. On the other hand, if the goal of the Swaps Repository is for the regulators to know the positions of all major organizations involved in the swaps market, even that information would not be sufficient. That is, the regulators would have to know not only swaps

[18] Both parties to a swap that is not accepted by a swaps clearing organization would be required to report the swap to an "Swaps Repository."

positions, but also cash market positions in securities, physical market positions, listed futures, and then be able to relate all those positions each to the other, not only as to particular entities, but also to entire holding companies and advised groups. It seems a challenge, and it might be prudent for the various agencies to confirm that they could actually process and use such data before requiring its collection.

F. Public Disclosure by Regulators.

Each of the CFTC and the SEC would be required to publicly report aggregated position information (without disclosing the positions of individual market participants) that they derived from (i) clearing organizations, (ii) Swaps Repositories and (iii) persons otherwise required to report directly to these regulators.

Part VII. Regulatory Requirements Applicable to Entering into Regulated 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, Regulated Swaps. This discussion is thus relevant both to Registrants, and also to other persons that might enter into Regulated Swaps.

A. Eligible Contract Participant Definition.

Trades between Eligible Contract Participants ("ECPs") are today outside the scope of the CEA. The Legislation somewhat tightens the standards applicable to the ECP definition as to governmental entities and as to individuals.

B. Retail Regulated Swaps.

The Legislation makes it unlawful for any person other than an Eligible Contract Participant 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 were registered under the Securities Act.

C. Position Limits and Large Trader Reporting Requirements.

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

i. *Position Limits*. The CFTC and the SEC would have authority to establish position limits as to Regulated 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 US exchange, and (ii) Security-Based Swaps that perform or affect "a significant price discovery function" in regulated markets.

We read these provisions to mean that the CFTC and SEC would have the power to establish position limits on specified Regulated 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. Further, one noteworthy aspect of the authority granted to the SEC is that it would seem to be permitted to establish position limits on securities without regard to whether the relevant person has entered into any Security-Based Swap.

For purposes of these limits and the large trader reporting requirements, the CFTC and the SEC are intended to determine whether a Regulated Swap performs or affects a "significant price discovery function" by reference to a series of factors. These factors include (i) whether the Regulated Swaps use or rely on a daily or final settlement price linked to related commodities contracts/securities, (ii) whether the Regulated Swaps are sufficiently linked to their related contracts/securities to permit arbitrage, (iii) the extent to which prices in the related markets reference the Regulated Swaps, (iv) the extent to which the Regulated 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. We believe that the SRO rulemaking authority would be limited to the SEC's rulemaking authority as described above. In addition, every CFTC and SEC-regulated exchange would have to have power to establish position limits.

D. Reporting Requirements Applicable to Persons Generally.

Any person who enters into a Regulated Swap that is not centrally cleared and not reported to a Swaps Repository would be (i) required to make such reports as may be required by the relevant regulator and (ii) **be open to inspection by** the relevant regulator, a banking agency, the Financial Services Oversight Counsel and the Department of Justice.

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

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

The existing reporting requirements that apply under Sections 13(d) and (g) of the Exchange Act as to 5%, 10% and 20% "beneficial ownership" would apply to persons that have positions in securities, in Security-Based Swaps and in any "other derivative instrument" that the SEC may determine. However, it is not entirely clear that the changes in the Legislation would be effective since the Section 13 concept of "beneficial ownership" turns on having voting rights or the power to dispose, which would generally not be present with a Security-Based Swap. It is possible that the SEC could "deem" entry into a Regulated Security-Based Swap to constitute beneficial ownership of the underlying security.

The reporting provisions applicable to Institutional Investment Mangers (which generally apply to entities that manage $100 million of assets) would be similarly expanded by reference to Security-Based Swaps and other derivative instruments identified by the SEC.

The Legislation provides that, as to Section 16, the SEC should take account of "Security-Based Swap Agreements," which, as described earlier, relates to trades involving U.S. governments and broad indices. However, Security-Based Swap Agreements (meaning, for example, trades on U.S. governments) would generally not be of a type that would be relevant to Section 16, which generally applies to "equity securities." This reference seems to be a mistake in the drafting of the Legislation.

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