

Financial Services and Products ADVISORY

December 16, 2009

Legislative Changes for the Over-the-Counter Derivatives Market

Last week, the United States House of Representatives approved legislation on regulation for the over-the-counter (OTC) derivatives market. The House bill appears as Title III to H.R. 4173, a broader bill for reform of the financial industry. While the House action is a milestone in the legislative process, several critical steps remain, each of which could change important aspects of the final legislation. This advisory briefly summarizes the current status of the legislative process and outlines key themes that are likely to be part of the final legislation.

Status of the Legislative Process

The next focus in the march toward reform of the OTC derivatives market will be in the Senate. On November 10, 2009, Senator Christopher Dodd, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, put forth a discussion draft of financial reform legislation that includes, as Title VII, provisions regarding OTC derivatives. In addition, the Senate Agriculture Committee held hearings on OTC derivatives on December 2, 2009, and the Committee Chairperson, Senator Blanche Lincoln, announced that the Committee on Agriculture, Nutrition and Forestry intends to introduce its own bill on OTC derivatives reform.

How quickly the Senate will reach consensus remains to be seen, but the progression on the House side, where there was early cooperation between Committees, may be instructive. Congressman Barney Frank, Chairman of the House Finance Committee, and Congressman Collin Peterson, Chairman of the House Agriculture Committee, issued a joint concept release on OTC derivatives reform in July of this year. Each Chairman introduced his own version of a bill, but Peterson's version was an amendment to, and based on, Frank's version. A handful of key differences not reconciled behind the scenes were debated and voted on by the full House. Similar cooperation between the Senate Banking Committee and the Senate Agriculture Committee would expedite the process in the Senate.

Once the Senate Agriculture Committee puts out its bill, any areas of disagreement between Senator Dodd's draft and the Agriculture Committee bill will have to be resolved, and the Senate will need to approve its version of the legislation. The House and Senate will then have to reconcile differences between their respective measures, and both the House and Senate will need to approve the joint resolution before the legislation goes to the President for signature.

Although there is momentum behind OTC derivatives reform, the legislative process will continue into 2010. Adoption of OTC derivatives legislation will likely be part of a larger financial reform package, and progress on the larger package will impact the timing of OTC derivatives legislation.

This advisory is published by Alston & Bird LLP to provide a summary of significant developments to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation. This material may also be considered attorney advertising under court rules of certain jurisdictions.

Key Themes in the Legislation

The various proposals from Congressman Frank, Congressman Peterson and Senator Dodd, as well as the legislation passed by the House, have the same broad structure. It seems likely that the bill put forth by the Senate Agriculture Committee and the final Senate version will be based on the same general framework. Although details of the legislation won't be finalized for some time, the following themes will undoubtedly be part of the legislation.

- **Definition of “Swap” and “Security-Based Swap.”** The focal point for the legislative reform is activity related to “swaps” and “security-based swaps.” “Swap” will likely be defined broadly to include many of the types of products currently traded over the counter and to explicitly include any that may in the future become known as a swap. Treatment of foreign exchange swaps and foreign exchange forwards has been controversial, and it now appears that at least some of those products will be carved out of the definition of swap. “Security-based swap” will likely include swaps based on a single security or loan, a narrow based security index, or the occurrence or non-occurrence of an event related to the financial conditions or obligations of the issuer of a security.
- **Registration and Regulation of Swap Dealers and Major Swap Participants.** Entities that fall within the definition of swap dealer, security-based swap dealer, major swap participant or major security-based swap participant will have to register with the appropriate regulator and will be subject to a host of regulatory requirements, including capital and margin requirements, reporting and recordkeeping requirements, business conducts standards and back office standards. Details of the definitions will likely be the subject of debate. Each market participant will have to carefully consider whether it is included in any of the four categories.
- **Jurisdiction.** Regulatory authority will be divided among the CFTC, the SEC and, for some market participants, banking regulators. Some legislative proposals would create new entities with regulatory authority over swaps. Enforcement authority will be split among regulators, as well.
- **Registration of Security-Based Swaps.** Security-based swaps would likely be considered securities for purposes of the Securities Act of 1933, but the SEC could establish an exemption from registration for security-based swaps. However, a registration statement may be required (and no exemption would apply) with respect to offers, purchases and sales of securities-based swaps to or from a party that is not an eligible contract participant.
- **Clearing.** Most swaps and security-based swaps will have to be cleared. Issues regarding clearing that have been debated and may continue to be debated include: which transactions and categories of transactions must be cleared, who will make that determination, and the extent to which the clearing requirement will apply to transactions with end-users.
- **Exchange trading.** Swaps and security-based swaps that must be cleared may also have to be executed on an exchange or other registered facility. Factors determining whether a particular transaction must be executed on a registered facility may include the nature of the parties to the transaction and the availability of a facility on which to execute the transaction.

- **Segregation of Assets Held as Collateral in Swap Transactions.** Swap dealers and security-based swap dealers may have to segregate and hold collateral with an independent third-party custodian if a counterparty requests segregation. The proposals have not addressed the question of whether a dealer can charge more for a transaction in which segregation is requested and effected.
- **Position Limits.** Position limits may be extended to swaps that perform a significant price discovery function and may also be imposed on an aggregate basis across markets for transactions (including both futures and swaps) based on the same underlying commodity.
- **Reporting and Recordkeeping.** All swaps and security-based swaps will be reported to the appropriate regulator, either by the clearing entity, a swap repository or by the swap parties themselves. Large trader reporting requirements may be imposed with respect to both swaps and security-based swaps.
- **Registration of Execution Facilities, Clearing Entities and Swap Repositories.** The legislation will require registration of facilities on or through which swaps and security-based swaps are executed or cleared or in which records of transactions are maintained. Core principles will apply to execution and clearing entities. The legislation will likely include standards for data maintained by repositories.
- **International Issues.** The legislation will likely address a number of cross border issues: the treatment of foreign boards of trade that reach to participants in the United States, encouraging harmonization of swap regulation, and prohibiting entities from countries with insufficient regulatory schemes from participating in swap markets in the United States.

Beyond the Legislative Process

All of the legislative proposals for reform of the OTC derivatives market leave the determination of significant details to the regulators. The adoption of legislation will mark the start of the rulemaking process. The legislation will likely require coordination and consultation among the various regulators as they promulgate rules to implement the legislation.

Legislative and regulatory changes applicable to the OTC derivatives market will be significant. Although it is too early to know the full extent of the changes, it is not too soon to begin thinking about how businesses should adapt to the new environment.

If you would like to receive future *Financial Services and Products Advisories* electronically, please forward your contact information including e-mail address to financialservices@alston.com. Be sure to put "**subscribe**" in the subject line.

Please visit our blog at <http://www.alston.com/financialmarketscrisisblog>.

For additional information or guidance, please contact any of the following members of our Derivatives Group or our Legislative and Public Policy Group.

Paul M. Architzel
paul.architzel@alston.com
202.756.3492

Willa Cohen Bruckner
willa.bruckner@alston.com
212.210.9596

Zachary B. Chapman
zach.chapman@alston.com
212.210.9450

Anjali D. Desai
anjali.desai@alston.com
202.756.3056

Robert C. Jones
bob.jones@alston.com
202.239.3903

Matthew C. Sippel
matthew.sippel@alston.com
212.210.9581

ATLANTA

One Atlantic Center
1201 West Peachtree Street
Atlanta, GA 30309-3424
404.881.7000

CHARLOTTE

Bank of America Plaza
Suite 4000
101 South Tryon Street
Charlotte, NC 28280-4000
704.444.1000

DALLAS

Chase Tower
Suite 3601
2200 Ross Avenue
Dallas, TX 75201
214.922.3400

LOS ANGELES

333 South Hope Street
16th Floor
Los Angeles, CA 90071-3004
213.576.1000

NEW YORK

90 Park Avenue
New York, NY 10016-1387
212.210.9400

RESEARCH TRIANGLE

Suite 600
3201 Beechleaf Court
Raleigh, NC 27604-1062
919.862.2200

SILICON VALLEY

Two Palo Alto Square
Suite 400
3000 El Camino Real
Palo Alto, CA 94306-2112
650.838.2000

VENTURA COUNTY

Suite 215
2801 Townsgate Road
Westlake Village, CA 91361
805.497.9474

WASHINGTON, D.C.

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.756.3300

www.alston.com

© Alston & Bird LLP 2009