Date: December 1, 2008

To: Interested Persons

Re: Credit Default Swap and Regulatory Restructuring Bills Proposed by Senator Harkin and Senator Collins

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Recently, Senators Harkin and Collins separately proposed bills covering OTC derivatives, clearing of credit default swaps and regulatory restructuring, to be presented to the lame duck Congress. Although we do not believe that either bill is likely to be passed, we believe it would be useful for market participants to understand the themes being presented as they may shape the debate when Congress returns in January. Set forth below is a summary of what the two bills would do.

"Derivatives Trading Integrity Act of 2008" – Tom Harkin (D-Iowa) (Chairman, Senate Committee on Agriculture, Nutrition and Forestry)

- **Regulation of Over-the-Counter Derivatives.** The purpose of Senator Harkin's bill is to require most swaps and other derivatives contracts to be traded on an exchange regulated by the Commodity Futures Trading Commission ("CFTC"). If this result were achieved, it would devastate the very large and important OTC derivatives market.

- **Exclusions Eliminated.** The bill proposes to eliminate from the Commodity Exchange Act ("CEA") many of the exclusions that were, after intense debate and compromise, adopted as amendments to the CEA as part of the Commodity Futures Modernization Act of 2000 ("CFMA"). In particular, the bill would remove the exclusion from most of the provisions of the CEA, including the ban on off-exchange trading, that currently applies to "excluded swap transactions" in commodities (other than agricultural commodities) entered into by "eligible contract participants on an individually negotiated basis and not on a "trading facility." It would also eliminate exclusions for OTC transactions between "eligible contract participants" in "excluded commodities" such as interest rates, currencies, securities or securities indexes and for electronic trading facilities.

- **Legal Certainty Called into Question.** The bill would strike the CFMA's critical "legal certainty" provisions and remove the pre-emption of state gambling and bucket shop laws for those types of contracts for which current exclusions are being repealed. Consequently, it would reintroduce the risk that these OTC transactions could be declared void as illegal futures contracts or illegal gaming contracts.

- **Other CFMA Provisions**. The bill would, however, leave in place the exclusion for "qualifying hybrid instruments," and also the Treasury Amendment that excludes from the CEA certain contracts involving foreign currencies and government securities.

- **Swap Exemption**. Since the bill eliminates the CFTC's discretion to exempt certain derivatives from the CEA's off-exchange trading ban, it calls into question certain prior CFTC guidance, such as the Part 35 exemption for swap agreements and the 1989 Swaps Policy Statement. At a minimum, the CFTC would likely reconsider its existing guidance in light of the Congressional intent expressed in the bill. Even if this prior guidance is preserved, the market would revert to a pre-CFMA status of legal uncertainty, under which the off-exchange trading ban and various state laws would potentially be applied to many swaps and other OTC derivatives.

- **Swaps Exclusions Under Securities Laws Maintained**. The bill does not affect any of the provisions of the federal securities laws that remove many swap agreements from the application of most of the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, nor does it alter the basic jurisdictional provisions for certain transactions, such as options on securities, which are securities and not "commodities" subject to the CEA.

"Financial Regulation Reform Act of 2008" – Susan Collins (R-Maine) (Ranking member of the Committee on Homeland Security and Governmental Affairs)

- **Credit Default Swap Clearinghouses.** The bill provides that the SEC, in consultation with the CFTC and the Board of Governors of the Federal Reserve System (the "Board"), would be directed to issue rules to designate clearinghouses for credit default swaps and also to prohibit fraud.

- **Mandatory Use.** Any person engaged in a credit default swap, as defined by the bill, would be required to use a designated clearinghouse.

- **Bifurcated Authority**. The bill's use of the word "Commission" is at times unclear, but the bill appears to establish a highly unusual jurisdictional bifurcation between federal agencies. Rules for the clearinghouses, including rules to prevent fraud and manipulation, would be set by the SEC, while ongoing regulation would be by the CFTC. Rules regarding reporting of positions would be set by the CFTC. The clearinghouses would be capitalized by participants, and would be

required to establish default funds, paid for by assessments on participants.

- **Broad Definition of Credit Default Swap.** The bill defines a "credit default swap" as "a bilateral contract that transfers, in exchange for 1 or more lump-sum or other payments, from 1 party to another, the risk that an entity, regardless of whether owned by the buyer of the protection, may experience a loss of value from a credit event such as a default, credit downgrade, or other contractually agreed-upon adverse event." This language raises the question of whether some ordinary types of commercial contracts, such as letters of credit, guarantees or insurance arrangements could be swept up in the definition, thereby subjecting these contracts to the regulatory scheme.

- **Regulation of Investment Bank Holding Companies.** Senator Collins's bill attempts to deal with the fact that under the current regulatory structure, holding companies of those broker-dealers that are not also bank holding companies are not subject to comprehensive and consolidated supervision. Since all systemically important investment bank holding companies have now opted to become bank holding companies, the lacuna that the bill would presumably fill involves regional investment bank holding companies or other companies such as industrial companies, foreign banks or mutual fund companies that own a broker-dealer.

- **Examination and Reporting.** The proposed text requires the Board to issue final rules to provide for the examination of the safety and soundness and the extent of systemic financial risk posed by entities that control broker-dealers and their "associated persons." The bill also authorizes the Board to require "reasonable reporting of information" by investment bank holding companies. The bill does not, however, give the Board the power to regulate such holding companies or their associated persons, and does not disturb any of the current powers of the SEC, raising the question as to what the Board would do with the information it obtains.

- **Lack of Proportionality.** The proposed text does not contain any proportionality or balance. For example, its inclusion of "associated persons" in the definition of an investment bank holding company could subject large commercial companies with small systemically unimportant broker-dealers to extensive examination and reporting requirements.

- **Extraterritoriality.** The extraterritorial reach of the Board's authority under the bill is unclear, and the proposed bill's text leaves open the possibility that if any controlling person of a broker-dealer or its associated persons is organized or doing business in the United States, the Board may have the authority to examine and require reports from any

such controlling or associated person, irrespective of where it is organized or whether the associated person does business in the United States.

- **Blue Ribbon Independent Commission.** Senator Collins's bill would set up a bipartisan independent commission, similar in type to the 9/11 Commission and other past commissions, which would be charged with a "top-to-bottom" review of the U.S. financial regulatory structure. This is an apparent response to some earlier discussions about setting up a select bipartisan committee to deal with regulatory restructuring.

- **Powers of the Commission.** The new commission would have 15 members appointed by the leadership of the relevant Senate and Congressional committees and, like other similar past commissions, have the power to hold hearings, require witnesses to attend, and to seek evidence from the public and private sector. The Commission would have 120 days after the enactment of the act to submit a report to Congress and the President. The Congressional Oversight Panel of the Emergency Economic Stabilization Act, or EESA, has the mandate to create a similar report.

If you have any questions regarding this memorandum, please contact any of the lawyers listed below or your regular Davis Polk contact.

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