

# The Authorizing the Regulation of Swaps Act

May 13, 2009

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## Introduction

On May 4, 2009, Senator Carl Levin (D-Michigan) and Senator Susan Collins (R-Maine) introduced the Authorizing the Regulation of Swaps Act (the “Levin-Collins Bill” or the “Bill”), sweeping legislation that, if adopted, would free multiple federal regulators to regulate swap agreements without mandating how that regulatory authority is to be exercised. While the Bill is intended to fill a regulatory hole, it risks creating a regulatory free-for-all, introducing jurisdictional ambiguities and changes and raising possible questions about the federal preemption of state gaming and bucket shop laws with respect to swaps.

This memorandum provides background on the historical treatment of swaps, summarizes the most significant provisions of the Levin-Collins Bill and provides preliminary analysis of the issues raised by the Bill.

## Swap Regulation and the CFMA

Prior to the passage of the Commodity Futures Modernization Act of 2000 (the “CFMA”), both the Securities and Exchange Commission and the Commodity and Futures Trading Commission at various times sought to assert jurisdiction over swaps. The SEC grounded its claim in the view that certain swaps were “securities” for the purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934 and therefore were subject to SEC oversight. The CFTC based its claim on the Commodity Exchange Act (the “CEA”), taking the view that swaps and certain over-the-counter derivatives were futures subject to its oversight. The CFTC’s assertion that a swap was a future meant that, absent an exemption, trading that type of swap off an exchange was potentially illegal. The result was profound legal uncertainty that caused many swap transactions to be entered into offshore.

In 2000, the CFMA substantially revised then-current law to ensure that neither the SEC nor the CFTC would have regulatory jurisdiction over most swap transactions on financial instruments and indices. For example, the CFMA added Section 2A of the 1933 Act and Section 3A of the 1934 Act to exclude “swap agreements”—*i.e.*, individually negotiated swap transactions

### *Provisions Deleted by the Levin-Collins Bill*

- » Section 2A of the 1933 Act
- » Section 3A of the 1934 Act
- » Sections 403, 404, and 407 of the Legal Certainty for Bank Products Act
- » Sections 2(d), 2(g), 2(h)(1) and 2(h)(2) of the Commodities Exchange Act
- » Section 5(d) of the Commodities Exchange Act
- » Sections 206A, 206B, and 206C of the Gramm-Leach-Bliley Act
- » Additional provisions of the 1933 Act, 1934 Act, and CFMA conforming those Acts to the deletions above

### *Grants of Jurisdiction*

- » The Bill would give exclusive oversight and regulatory authority to the SEC for securities exchanges and clearing agencies and swaps traded or cleared thereon and the CFTC for commodity trading facilities or registered entities and swaps traded or cleared thereon.
- » The Bill seeks to extend the SEC’s antifraud jurisdiction to all swaps.

with eligible contract participants—from the definition of “securities”<sup>1</sup> and to prohibit the SEC from registering any security-based swap agreement or promulgating, interpreting, or enforcing rules that impose reporting or record-keeping requirements with

respect thereto. Securities-based swap agreements, however, are generally subject to anti-fraud, anti-manipulation and insider trading rules, such as Section 10(b) and Rule 10b-5. Similarly, the

CFMA largely ended CFTC oversight of swaps by specifically removing individually negotiated swaps with eligible contract participants<sup>2</sup> and swaps on “excluded commodities,” such as interest rate, currency, credit, and equity swaps, from the purview of the CEA. The CFMA also clarified that individually negotiated swaps between eligible contract participants did not violate the CEA requirement that futures contracts generally must trade on registered futures exchanges.

The CFMA substantially revised then-current law to ensure that neither the SEC nor the CFTC would have regulatory jurisdiction over most swap transactions on financial instruments and indices.

## Summary of Key Provisions of the Bill

The Levin-Collins Bill is intended to open the door to federal regulation of swaps (including, among others, credit default, commodity, equity, interest rate and foreign currency swaps) by undoing significant portions of the CFMA. In particular, the Bill deletes:

- » Section 2A of the 1933 Act and Section 3A of the 1934 Act; thereby eliminating certainty that swaps are not securities for those Acts, but without making clear that they are securities under those Acts;
- » Sections 403, 404, and 407 of the Legal Certainty for Bank Products Act; thereby removing the exemption from the CEA for swaps and certain other identified banking products entered into by banks;

<sup>1</sup> However, certain types of contracts, such as options on securities or securities indices and forward contracts on securities, even if formally documented as swaps, are excluded from the definition of swap agreement and are therefore securities under the 1933 Act and the 1934 Act.

<sup>2</sup> Other than those on agricultural commodities.

- » Section 2(d) of the Commodities Exchange Act; thereby removing the exclusion from most of the provisions of the CEA for agreements, contracts, or transactions in “excluded commodities” that are entered into between eligible contract participants at the time of the agreement and not executed or traded on a trading facility;
- » Section 2(g) of the Commodities Exchange Act; thereby removing the exclusion from most of the provisions of the CEA for agreements, contracts, or transactions in commodities other than agricultural commodities that are entered into between eligible contract participants at the time of the agreement, that are individually negotiated, and that are not executed or traded on a trading facility;
- » Sections 2(h)(1) and 2(h)(2) of the Commodities Exchange Act; thereby removing the exclusion from most of the provisions of the CEA for agreements, contracts, or transactions in “exempt commodities,” defined in Section 1a(15) of the CEA as any commodity other than an excluded commodity or an agricultural commodity, that are entered into between eligible contract participants at the time of the agreement and that are not executed or traded on a trading facility;
- » Section 5(d) of the Commodities Exchange Act; thereby removing the ability to trade on “exempt board[s] of trade”—boards of trade that limit trading to contracts for sale of commodities or options on commodities (though not securities) for future delivery—and for which the commodities have “a nearly inexhaustible deliverable supply,” a large enough deliverable supply and liquid enough cash market to defeat fears of manipulation, and no cash market and on which exchange only eligible contract persons enter into contracts;
- » Sections 206A, 206B, and 206C of the GLB Act; thereby removing the definition of “swap agreement,” “security-based swap agreement,” and “non-security-based swap agreement;” and
- » Additional provisions of the 1933 Act, 1934 Act, and CFMA conforming those Acts to the deletions above.

The Bill authorizes “Federal financial regulators” to “exercise oversight over (A) any swap agreement that is entered into, purchased or sold by any institution, entity or person” subject to the regulator’s jurisdiction and “(B) over

**“Federal Financial Regulators” with Jurisdiction over Swaps under the Bill**

- » **Commodities Futures Trading Commission**
- » **Federal Deposit Insurance Corporation**
- » **Board of Governors of the Federal Reserve System**
- » **National Credit Union Administration**
- » **Office of the Comptroller of the Currency**
- » **Office of Thrift Supervision**
- » **Securities Exchange Commission**
- » **Any other federal agency that is authorized under the provision of federal law to regulate any financial institution that is authorized under any provision of federal law to regulate any financial institution or type or class of financial instrument or offering thereof**

any swap agreement that is subject to” the regulator’s jurisdiction. (Questions regarding the scope of this regulatory authority are discussed below) “Federal financial regulator” is defined to include (i) the CFTC; (ii) the Federal Deposit Insurance Corporation; (iii) the Board of Governors of the Federal Reserve System; (iv) the National Credit Union Administration; (v) the Office of the Comptroller of the Currency; (vi) the Office of Thrift Supervision; (vii) the SEC; and (viii) any other federal agency that is authorized under any provision of federal law to regulate any financial institution or type or class of financial instrument or offering thereof.

The Bill also provides the SEC plenary authority to regulate swaps traded on or cleared through exchanges or clearing agencies and the CFTC plenary authority to regulate swaps executed on, traded on, or cleared through trading facilities or registered entities. The Bill provides that it does not remove any authority previously provided to federal agencies to regulate swaps.

While the Bill seems to give many regulators authority to regulate swaps, it does not require any to exert such authority. Instead, the Bill requires federal regulatory authorities to “consult, work, and cooperate with other Federal financial regulators to promote consistency in the treatment of swap agreements.”

**Analysis of the Bill**

***Potential Regulatory Free-for-All***

The Bill invests at least seven different “Federal financial regulators” with immediate authority to oversee and regulate swaps. The sponsors of the Bill see this as an interim step in anticipation of more specific requirements that would come in subsequent comprehensive financial reform legislation. The Bill’s sponsors argue that this new authority would prevent regulators from using the current regulatory scheme as an “excuse for not regulating swaps.”<sup>3</sup> Stripped of this “excuse,”

The Bill’s sponsors argue that this new authority would prevent regulators from using the current regulatory scheme as an “excuse for not regulating swaps.”

<sup>3</sup> Press Release, Carl Levin, Levin-Collins Bill Would Allow Immediate Regulation of Swap Agreements, Including Credit Default Swaps (May 4, 2009), available at <http://levin.senate.gov/newsroom/release.cfm?id=312437>.

armed with new regulatory authority and prodded by political pressure, it seems likely that regulators would seek to take steps to regulate without waiting for the more comprehensive financial reform the effective date of which is unknowable and not assured.

For example, Section 5 of the Bill, which contains conforming amendments, provides that Sections 9 and 10(b) of the 1934 Act are amended by replacing “security-based swap” with “swap agreement.” The effect of this is to extend the SEC’s authority to enforce anti-manipulation and anti-fraud provisions under the 1934 Act to all swaps. Yet, there is nothing in the Bill that would make this the exclusive jurisdiction of the SEC. With the caveat that certain drafting peculiarities of the Bill (which are discussed further herein) introduce difficult interpretive issues regarding the intended scope of regulators’ authority, it would seem that the general regulatory authority granted to each regulator would permit it to promulgate its own anti-manipulation and anti-fraud provisions.

While the definition of “Federal financial regulator” is complex, it is also intriguingly open-ended. In addition to the seven enumerated regulators, the definition includes “any other Federal agency that is authorized under any provision of Federal law to regulate any financial institution or type or class of financial instrument or offering thereof.” This may have been intended to pick up any new “systemic risk regulator” that may be created as part of coming comprehensive financial reform legislation, but it could equally have the effect of picking up a number of other unanticipated regulators that have jurisdiction over certain non-financial activities of financial institutions.

The Bill attempts to coordinate the potential regulatory and oversight activities of the various regulators over swaps by (i) establishing exclusive regulatory silos for the SEC and CFTC and (ii) requiring cooperative behavior among the regulators (“Play Nice” rules). Unfortunately, each of these provisions is subject to significant ambiguity and uncertainty.

### ***Ambiguity between SEC and CFTC Jurisdictional Silos***

Section 3(b) of the Bill purports to give exclusive oversight and regulatory authority to (i) the SEC for securities exchanges and clearing agencies and swaps traded or cleared thereon and (ii) the CFTC for commodity trading facilities or registered entities and swaps traded or cleared thereon. Yet, Section 3(c) of the Bill provides that the Bill may not (i) limit or reduce the authority of a Federal financial regulator in effect on the date the Bill is adopted

with respect to swaps; (ii) affect the CFTC's exemptive authority under Section 2(h)(3) or 4(c) of the CEA; or (iii) require any swap to be traded on a CFTC board of trade or on or through a securities exchange or broker-dealer.

This section of the Bill, combined with the Bill's deletion of Sections 2A and 3A of the 1933 Act and 1934 Act, respectively, reintroduces legal uncertainty into the question of how swaps would trade and be regulated. Prior to the passage of the CFMA it was unclear whether swaps and other over-the-counter derivatives could be construed as illegal off-exchange futures contracts within the purview of the CEA, absent an exemption by the CFTC. It was also unclear whether certain swaps and other over-the-counter derivatives were securities within the definitions of the 1933 Act and 1934 Act. It was precisely this uncertainty that the CFMA was intended to lay to rest. Its design, for better or worse, was to make clear that swaps were neither securities nor futures contracts. Under the Bill, it would be unclear whether swaps could be traded on securities exchanges or whether they would need to be traded on a commodities exchange.

Drafting peculiarities in the Bill complicate this analysis and present difficult interpretive issues. For example, Section 3(a), entitled "Authorization of Regulation and Oversight," distinguishes between, on the one hand, the authority to "exercise oversight" (Section 3(a)(1)) and, on the other hand, the authority to "promulgate, interpret, and enforce regulations . . ." (Section 3(a)(2)). The oversight authority extends to

- (A) any swap agreement that is entered into, purchased, or sold (or as to which the transaction, purchase, or sale is effected) by any financial institution, entity, or person (for its own account or for the account of others) that is subject to the jurisdiction of the Federal financial regulator; and
- (B) any swap agreement that is subject to the jurisdiction of the Federal financial regulator.

The two prongs of this provision seem disjunctive. Is the intent of this provision to overrun the old product-specific jurisdictional issue by giving oversight authority to any Federal financial regulator so long as it has some jurisdiction over the party to the transaction? Yet, under Section 3(a)(2) the "regulatory authority" extends to

- any swap agreement – (A) that is entered into, purchased, or sold (or as to which the transaction, purchase, or sale is

effected) by any financial institution, entity, or person (for its own account or for the account of others) that is subject to the jurisdiction of the Federal financial regulator; and (B) that is subject to the jurisdiction of the Federal financial regulator.

Note the difference in drafting: these two prongs seem conjunctive. Is the intent of this provision that the old product-specific jurisdictional issue act as a limit on any additional authority granted to Federal financial regulators? How can one distinguish between “oversight” and “regulatory” authority? Are these questions to be left to be decided by future comprehensive legislation? Or are they to be worked out among the Federal financial regulators?

In another example, for a transaction to be a “swap agreement” under the Bill, it must be subject to individual negotiation and entered into between eligible contract participants. As part of its efforts to establish central clearinghouses for over-the-counter derivatives the SEC has expressed the view that standardized, centrally cleared swaps are not “individually negotiated.” Technically, therefore, swaps that trade on, or are cleared through, an exchange or clearing agency would cease to fit within the Bill’s definition of “swap agreement.” Thus, the SEC’s jurisdiction would be limited to swap agreements that fit the definition of securities. Similar interpretational problems would arise for swaps entered into among counterparties other than eligible contract participants (*i.e.*, retail swaps). The CFTC authority has similar ambiguities. Moreover, in the event an identical swap is cleared by both a securities and futures trading house, the Bill gives both the SEC and CFTC exclusive authority over that swap.

### ***Expansive Use of “Swap Agreement”***

The CFMA defined “swap agreement” broadly to exclude swaps from regulation as securities or futures. The Bill uses the same definition to empower federal financial regulators to regulate swaps, with surprising results. For example, “swap agreement” includes a contract with a payment dependent on the occurrence of any event with financial, economic, or commercial consequence. This would seem to encompass all insurance contracts, thus apparently giving all federal financial regulators oversight authority over insurance activities, or at least over those of regulated entities.

### **Identified Banking Products**

» **Defined in Section 206(a) of the Gramm-Leach-Bliley Act to include:**

- **Deposit accounts;**
- **Savings accounts;**
- **Certificates of deposit, or other deposit instruments issued by a bank;**
- **Banker's acceptance;**
- **Letters of credit;**
- **Loans;**
- **Debit accounts arising from credit cards or similar arrangements; and**
- **Loan participations sold to qualified investors or certain other persons.**

### ***The Limitations of the “Play Nice” Rules***

Under Section 3(d) of the Bill, each Federal financial regulator is required to “consult, work, and cooperate with other Federal financial regulators to promote consistency in the treatment of swap agreements” prior to taking regulatory action. Given long-standing jurisdictional turf battles between the CFTC and SEC, recently evidenced by jockeying for jurisdiction over CDS, these admonitions will likely be ineffective. The broker-dealer “push-out rules” under the Gramm-Leach-Bliley Act serve as a prime example of the challenges of regulatory cooperation. They were adopted on an interim basis to implement the provisions of the 1999 legislation, repropoed by the SEC in 2004 in the face of banking agency opposition, and only adopted cooperatively in 2007 after Congress mandated joint rulemaking by statute in 2006.

### ***A Shift in Regulatory Responsibility for Bank Products Away from the Fed***

The CFMA included provisions under the title, Legal Certainty for Bank Products Act of 2000 (the “Bank Products Act”), that excluded the application of any provision of the CEA to certain bank products. The Levin-Collins Bill would delete Sections 403, 404 and 407 of the Bank Products Act.

- » Section 403 provides an unqualified exclusion for “identified banking products” that have been certified by an appropriate banking agency as having been commonly offered, entered into or provided in the United States by any bank on or before December 5, 2000.
- » Section 404 provides an exclusion for banking products first offered after that date if the relevant product is not linked to and does not provide for delivery of any commodity (as broadly defined) or the product or commodity is otherwise excluded from the CEA.
- » Section 407 excludes “covered swaps” entered into by U.S. depository institutions, foreign banks and U.S. branches or agencies of foreign banks and certain other institutions from the CEA (except for Section 5b with respect to the clearing of covered swaps). “Covered swaps” are defined generally to include swaps involving nonagricultural commodities that are entered into between eligible contract participants and not on a trading facility.

These deletions would subject identified banking products, including swaps entered into by banks, to potential CFTC regulation. It is unclear what is



driving this shift or whether it is an unintentional side effect of the Bill's broad removal of the many interconnected provisions of the CFMA. Notwithstanding the Play Nice rules, this shift in regulatory responsibility away from the Federal Reserve Board might cause internecine friction.

***Contract Non-Enforceability Concerns and the Viability of the 1989 Swaps Policy Statement and the Part 35 Swap Exemption***

Section 2(d)(1) of the CEA was a central provision of the CFMA in that it resolved the long-standing concern that a court might apply the CEA to swaps, thereby making them unenforceable illegal off-exchange futures. The Bill removes Section 2(d)(1) and could reintroduce a concern that swaps are illegal off-exchange futures.

This concern is mitigated by the continuing viability of CFTC positions taken prior to the CFMA. In 1989, under exemptive authority in Section 4(c) of the CEA, the CFTC issued a Swap Policy Statement, which set out the criteria necessary for the CFTC to conclude that a swap was not an off-exchange future. While the Policy Statement was largely made irrelevant by the passage of CFMA and promulgation of the Part 35 Swap Exemption, it has continued to have potential application to swaps for which the Swap Exemption is not available, for example those entered into between parties of which at least one is not an "eligible contract participant." In addition, in 1993, the CFTC again used its Section 4(c) authority to promulgate the Part 35 Swap Exemption, which also provided a safe harbor for swaps meeting its criteria. In a 2005 decision,<sup>4</sup> the CFTC endorsed the continued viability of the Swaps Policy Statement, finding that "[t]he treatment of swaps under the [Swap Exemption] . . . is not at cross-purposes to the treatment of qualifying swaps under the [1989] Policy Statement," and that "[t]hey are non-exclusive, complementary sources of regulatory relief." The Bill also specifically provides that nothing in the Bill may be construed as affecting any exemption granted under Section 4(c) of the CEA. There is no guarantee that the CFTC would not, in light of the Bill, modify the Policy Statement or the Part 35 Swap Exemption.

The non-enforceability concern is further mitigated by Section 22(a)(4) of the CEA, 7 U.S.C. § 25(a)(4), and by Section 408 of the Banking Products Act, 7

<sup>4</sup> Khorrām Properties v. McDonald Investments, CFTC Docket No. 04-R045 (Oct. 13, 2005).

U.S.C. § 27f(b), provisions inserted by the CFMA but not rescinded by the Bill. Section 22(a)(4), entitled “Contract enforcement between eligible counterparties,” provides that:

No agreement, contract, or transaction between eligible contract participants or persons reasonably believed to be eligible contract participants, and no hybrid instrument sold to any investor, shall be void, voidable, or unenforceable, and no such party shall be entitled to rescind, or recover any payment made with respect to, such an agreement, contract, transaction, or instrument under this section or any other provision of Federal or State law, based solely on the failure of the agreement, contract, transaction, or instrument to comply with the terms or conditions of an exemption or exclusion from any provision of this chapter or regulations of the Commission.

Similarly, Section 408 of the Banking Products Act, entitled “Covered swap agreements,” states that

No covered swap agreement shall be void, voidable, or unenforceable, and no party to a covered swap agreement shall be entitled to rescind, or recover any payment made with respect to, a covered swap agreement under any provision of Federal or State law, based solely on the failure of the covered swap agreement to comply with the terms or conditions of an exemption or exclusion from any provision of the Commodity Exchange Act or any regulation of the Commodity Futures Trading Commission.

From a plain reading of these provisions, it would appear that many swap transactions would still be enforceable even if found to be illegal off-exchange contracts so long as they are entered into between the appropriate parties.<sup>5</sup> However, there may be interpretive issues around an enforceability claim with

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<sup>5</sup> In *Cary Oil Co. v. MG Ref. & Mktg.*, 230 F. Supp. 2d 439 (S.D.N.Y. 2002), the issue was whether 22(a)(4) would be applied retroactively to make enforceable transactions entered into prior to 2000 that were found to be illegal off-exchange contracts. The court refused to apply the section retroactively, but in dicta admits to the possibility that the section, if applicable, would make off-exchange futures enforceable.

respect to a transaction that fails to comply with an exemption or exclusion that no longer exists in the statute.

### ***Questions Concerning Federal Preemption of State Gaming Laws***

Section 12(e)(2) of the Commodities Exchange Act, 7 U.S.C. § 16(e)(2), contains an express preemption of state gaming and bucket shop laws (other than the general applicability anti-fraud laws) in the case of:

(A) an electronic trading facility excluded under section 2(e) of this Act; and (B) an agreement, contract, or transaction that is excluded from this Act under section 2(c), 2(d), 2(f), or 2(g) of this Act or title IV of the Commodity Futures Modernization Act of 2000, or exempted under section 2(h) or 4(c) of this Act (regardless of whether any such agreement, contract, or transaction is otherwise subject to this Act).

In addition, Sections 408(b) and 408(c) of the Banking Products Act contain provisions addressing the preemption of state gaming law. 408(b) states that a covered swap agreement will not be void, voidable or unenforceable and that the counterparty to a covered swap agreement will not be able to rescind or recover any payment in respect of a covered swap under federal or state law based solely on the failure of the covered swap agreement to comply with the terms or conditions of an exemption or exclusion from any provision of the CEA or any regulation of the CFTC. Section 408(c) preempts state gaming and bucket shop laws (other than the general applicability anti-fraud laws) for covered swaps and hybrid instruments that are predominantly banking products.

The Bill would delete Sections 2(d), 2(g) and paragraphs (a) and (b) of 2(h) of the CEA. The Bill, however, does not delete the contract enforcement and preemption provisions of the Banking Products Act. On the plain language of Sections 408(b) and 408(c), it would appear that the preemption they provide would remain effective. On the other hand, the exclusions they refer to would be deleted by the Bill and this may lead to interpretive issues.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk & Wardwell contact.

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## References

- » [The Authorizing the Regulation of Swaps Act](#) (May 4, 2009)



*This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.*