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DEVELOPMENTS OF NOTE

Goodwin Procter Partner Mark Holland Honored as Independent Counsel of the Year

For his work in representing the Independent Trustees of the Reserve Funds, Goodwin Procter partner [Mark Holland](#) was honored as the “Independent Counsel of the Year” at the 17th Annual Mutual Fund Industry Awards sponsored by *Fund Directions*, a leading mutual fund industry publication. *Fund Directions*’ highly-coveted Mutual Fund Industry Awards annually recognize the mutual funds, fund leaders, marketers, trustees and independent counsel who were distinctive for their excellence, achievements, innovation and contributions to the field. Serving as their litigation counsel, Holland defended the Independent Trustees of the Reserve Primary Fund in numerous lawsuits, all of which have been dismissed voluntarily. He has advised the Trustees throughout the litigation process, including advocating their positions with the court and the SEC in securing approval of the Fund’s plan of liquidation. He also assisted the Independent Trustees in their extraordinary efforts to distribute the Fund’s assets to shareholders as quickly as possible.

Senators Dodd and Lincoln Propose OTC Derivatives Markets Reform

On April 21, 2010, the Senate Agriculture Committee approved the [Wall Street Transparency and Accountability Proposed Act of 2010](#) (the “Proposed Act”), introduced by Senator Blanche Lincoln, Chairman of the Senate Committee on Agriculture. Subsequently, on April 26, Senator Christopher Dodd, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, and Chairman Lincoln proposed an amended Wall Street Transparency and Accountability Act of 2010 (the “Amended Reform Proposal”). The Amended Reform Proposal would replace the derivatives title of the bill proposed by

Chairman Dodd, the Restoring American Financial Stability Act of 2010 (the “Dodd Bill,” discussed in discussed in the [March 16, 2010 Alert](#)).

The most recent in a long line of proposals, the Amended Reform Proposal puts into effect many of the Dodd Bill’s proposals for derivatives markets reform, as well as proposed rule changes in the derivatives title contained in the Wall Street Reform and Consumer Protection Act of 2009 (the “House Bill”), which was passed by the House Financial Services Committee in December 2009 (discussed in the [December 15, 2009 Alert](#)). (For discussions of the House Bill’s predecessors see the [December 8, 2009 Alert](#) and the [November 2, 2009 Goodwin Procter Client Alert](#).) The Amended Reform Proposal, however, includes some changes from both the Dodd Bill and the House Bill, and few revisions to the Senate Agriculture Committee’s Proposed Act.

Discussed below are key provisions of the Amended Reform Proposal and certain key differences between the Amended Reform Proposal and previous legislative efforts.

- ***Parallel Regimes for Swaps and Security-Based Swaps.*** The Amended Reform Proposal, like the Dodd Bill, the House Bill and Treasury’s initial August 2009 proposal, the Over-The-Counter Derivatives Market Act of 2009 (the “Treasury Proposal”), would maintain parallel regimes for swaps and security-based swaps. (See the [August 27, 2009 Goodwin Procter Client Alert](#).) It would grant the Securities and Exchange Commission (the “SEC”) oversight authority over “security-based swaps” and the Commodity Futures Trading Commission (the “CFTC,” together with the SEC, the “Commissions”) oversight authority over other derivatives instruments included as “swaps.” Banks that are major swap participants and major security-based swap participants (collectively, “major market participants”) and swap dealers and security-based swap dealers (collectively, “dealers”) would be overseen by bank regulators.

The CFTC and SEC would have independent rulemaking authority under the Amended Reform Proposal. The Amended Reform Proposal, however, would impose mandatory consultation among the CFTC, SEC and bank regulators, and the Commissions would be required to consider the views of the bank regulators in promulgating their rules. The Amended Reform Proposal would also require that the CFTC and SEC treat functionally or economically similar products or entities in a similar manner, though they would not be required to adopt joint rules or treat functionally or economically similar products or entities identically.

- ***Resolving Disputes between Parallel Regimes.*** The Amended Reform Proposal would include the dispute resolution mechanism first introduced by the Derivatives Markets Transparency & Accountability Proposed Act approved by the House Agriculture Committee on October 21, 2009. (See the [November 2, 2009 Goodwin Procter Client Alert](#) for a discussion of that proposal.) That dispute resolution procedure was included in the House Bill, but not the Dodd Bill.

In the event of a conflict between their respective rules, each Commission would be entitled to petition the United States Court of Appeals for the District of Columbia (the “Court of Appeals”) for review of the rule adopted by the other Commission. The filing of that petition would operate to stay the rule in question. The standard of review to be applied by the Court of Appeals would be limited to a determination of whether or not the rule in question violated the jurisdictional limitations set forth in the Amended Reform Proposal. (Notably, the provisions of the Amended Reform Proposal and the

Proposed Act dealing with the Court of Appeal's review are identical; accordingly, it is not clear whether the Amended Reform Proposal intended to exclude from the Court of Appeal's review whether the rule in question violated the requirement that functionally or economically similar products or entities be treated in a similar manner as was proposed under the Proposed Act.)

- **Swaps and Security-Based Swaps Defined.** The Amended Reform Proposal would adopt definitions of "swaps" and "security-based swaps" substantially similar to those proposed under the House Bill and the Dodd Bill. Criticism of the dividing line between the SEC and the CFTC regimes created by these definitions has continued. The tension remains strongest in the middle zone of instruments containing elements of both a swap and a security-based swap, referred to in certain cases under the various proposals as "mixed swaps."

In a letter to Chairman Lincoln dated April 20, 2010 ("Chairman Schapiro's Letter"), SEC Chairman Mary Schapiro commented that the Proposed Act "unnecessarily complicates matters by creating an arbitrary line based on the number of securities in a swap," which would "invite users to engineer products to exploit differences in regulation or transparencies." Chairman Schapiro's Letter further noted that certain securities options, exchange traded funds and securities forwards would no longer be regulated as "securities" under federal securities laws but would rather be regulated as "swaps." Chairman Schapiro argued that investors that trade these securities would no longer be able to avail themselves of the protections afforded by federal securities laws, including certain disclosure requirements and anti-fraud prohibitions.

- **Potential Ambiguity.** The definition of "mixed swap" in the Amended Reform Proposal apparently would provide for such contracts to be deemed to be (and treated as) security-based swaps, similar to the proposed treatment under the Dodd Bill, rather than the proposed treatment under the Proposed Act which would provide for such contracts to be deemed to be (and treated as) swaps. Notably, there seems to be some ambiguity in the proposed definition (and thus treatment) of mixed swaps under the Amended Reform Proposal based on differences between proposed amendments in the draft bill to the Commodity Exchange Act and the Securities Exchange Act of 1934, as amended.
- **Key Difference.** As under the House Bill, under the Amended Reform Proposal, the CFTC would have authority to regulate foreign exchange swaps and forwards as "swaps." Unlike the House Bill, however, foreign exchange swaps and/or forwards would no longer be treated as "swaps" upon Treasury's written determination that they should not be regulated as "swaps" and were not structured to evade the Amended Reform Proposal. Notwithstanding any such written determination, all foreign exchange swaps and forwards would be required to be reported to either a swap data repository or, if such repository is unavailable, to the CFTC or SEC, as applicable. Any party to a foreign exchange swap or forward would also be required to conform to the business conduct standards applicable to any party with respect to "swaps" or "security-based swaps."
- **Clearing and Exchange Trading Requirements.** The Amended Reform Proposal would impose mandatory clearing for any swap or security-based swap if a registered

clearing agency would accept that swap or security-based swap for clearing and either the CFTC or SEC were to determine that such swap or security-based swap, as applicable, must be cleared, referencing criteria for standard swaps and security-based swaps consistent with earlier proposals. Like the House Bill, the Amended Reform Proposal would add a requirement of “open access” to registered clearing organizations and clearing agencies. Harkening to Treasury’s Proposal under the Amended Reform Proposal, registered clearing organizations would be required to have rules prescribing that all swaps and security-based swaps, respectively, with the same terms and conditions are economically equivalent and may be offset by each other. Such swaps or security-based swaps would have to be cleared through a registered clearing organization or clearing agency and, if cleared, would also be required to be traded on a registered exchange or a registered swap execution facility.

- **Key Differences.** First, the Amended Reform Proposal would grant narrow exemptions from certain clearing requirements to “commercial end users” and “financial entities.” Commercial end users would include any persons, other than financial entities, whose primary business activities include, among others, ownership, production, manufacturing, distribution, or marketing of goods, services or commodities (other than oil, gas and certain other identified commodities), either individually or in a fiduciary capacity. Financial entities, on the other hand, would include dealers, major market participants, persons registered with the SEC or CFTC and, more broadly, persons predominantly engaged in activities that are financial in nature.

First, with respect to swaps and security-based swaps subject to mandatory clearing, commercial end users would be entitled to elect whether or not to clear such swap or security-based swap, and, if electing clearing, to further select the derivatives clearing organization or clearing agency at which such swap or security-based swap would be cleared.

- **Affiliates.** This exemption would extend to affiliates of commercial end users so long as such affiliates were acting on behalf of the commercial end user and using, as the commercial end user’s agent, the swap or security-based swap to hedge or mitigate commercial risk of that commercial end user. An affiliate would not be permitted to avail itself of this exemption if it were, for example, a dealer, a major market participant, an issuer that would be an “investment company” but for the exemptions provided under the Investment Company Act of 1940, as amended, a commodity pool, or a bank holding company with over \$50 billion in consolidated assets.
 - **Public Companies.** A *public* company would only be able to avail itself of this exemption if such public company’s audit committee had reviewed and approved the decision to enter into a swap or security-based swap in reliance on such exemption.
- Second, although financial entities would be required to clear swaps or security-based swaps subject to mandatory clearing that they entered into with a dealer or major market participant, financial entities would have the sole right to select the derivatives clearing organization or clearing agency at which such swaps or security-based swaps would be cleared.

- Third, with respect to any swap or security-based swap not subject to mandatory clearing and entered into by financial entities or commercial end users with a dealer or major market participant, both a financial entity and a commercial end user would be entitled to require clearing and, if clearing were elected, would have the sole right to select the derivatives clearing organization or clearing agency for clearing such swap or security-based swap.
- **Dealers and Major Market Participants.** The Amended Reform Proposal would adopt a definition for “swap dealer” similar to the one proposed in the Dodd Bill and the House Bill, *i.e.*, any person who, as a significant part of its business, (i) holds itself out as a dealer, (ii) “makes a market in swaps,” (iii) regularly engages in the purchase or sale of swaps, or (iv) engages in any activity that would cause such person to be known as a dealer, with an exception also found in the Dodd Bill.
 - **Key Difference.** The Amended Reform Proposal would except from the definition of swap dealer any “person that buys or sells swaps for such person’s own account, either individually or in a fiduciary capacity, but not as part of a regular business.” While not free of ambiguity (*e.g.*, how a market participant may be engaged in purchasing and selling swaps “in the ordinary course of business” and not also “as part of a regular business”), this exception may offer certain institutional investors and other buy-side participants an exclusion from regulation as a dealer.

The Amended Reform Proposal would also adopt a definition for major market participant that is generally similar to the House Bill’s definition: “major market participant” would include any person who maintains a substantial position in outstanding swaps, excluding positions held for hedging or mitigating commercial risks, or “whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.”

- **Key Difference.** The Amended Reform Proposal’s definition of major market participant would further include any financial entity (as defined above) “that is highly leveraged relative to the amount of capital it holds” and that maintains a substantial position in outstanding swaps. “Substantial position” remains to be defined by the Commissions at a threshold that each agency determines to be prudent for the “effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States.” Such a potentially broad definition could include certain investment funds and other “buy-side” market participants.
- **Capital and Margin Requirements.** As under the House Bill, the Dodd Bill and the Treasury’s Proposal, the Amended Reform Proposal would require bank regulators to impose capital and margin requirements on bank participants in the derivatives markets. The minimum capital and minimum initial and variation margin requirements applicable to all dealers and major market participants would be established to “ensure the safety and soundness of the swap dealer or major swap participant.” The Commissions would establish these requirements in consultation with bank regulators.

- **Key Similarity.** As under the Dodd Bill, the capital and margin requirements would be higher for uncleared swaps and uncleared security-based swaps.
- **Key Difference.** Apparently addressing certain “buy-side” priorities and concerns, the Amended Reform Proposal would not impose initial and variation margin requirements on any counterparties relying on the commercial end user clearing exemption.
- **Key Difference.** The Amended Reform Proposal would require the Commissions to submit legislative proposals intended to facilitate changes to federal laws governing portfolio margining of securities, commodity options, swaps and other financial instruments.
- **Key Difference.** Unlike the House Bill, the Amended Reform Proposal would not expand the authority of the CFTC to set position limits for physically deliverable commodities. Both the CFTC and SEC would, however, be authorized to promulgate rules setting aggregate position limits for “large traders.”
- **Segregation Required; Bankruptcy Treatment.** Consistent with the House Bill, the Amended Reform Proposal would require the segregation of certain assets in connection with certain swap transactions, including any money or other property received to margin, guarantee or secure a swap or security-based swaps cleared by or through a derivatives clearing organization or clearing agency, and prohibit the commingling of such assets other than to the extent deposited in accounts maintained at a bank or trust with a derivatives clearing organization or clearing agency by a registered futures commission merchant, broker or dealer, respectively. Like the Dodd Bill and the House Bill, with respect to any uncleared swaps or security-based swaps, at the request of the counterparty, a swap dealer would be required to segregate funds or other property and maintain such funds with a third-party custodian. If the dealer did not segregate funds at the request of the counterparty, the dealer would be obligated to deliver quarterly reports to the counterparty, certifying that margin and collateral requirements are in compliance with the agreement between the parties.
 - **Key Difference.** Under the Amended Reform Proposal, any cleared swap would be treated for purposes of the United States Bankruptcy Code as a “commodity contract” and thus subject to certain protections under the Bankruptcy Code.
- **Registration, Capital, Conduct and Reporting Requirements.** Under the Amended Reform Proposal, as under previous legislative efforts, dealers, major market participants, derivative clearing organizations and clearing agencies would have to register, subjecting them to minimum capital and margin requirements, as well as a host of new business conduct, reporting and disclosure rules. Under the Amended Reform Proposal, to the extent they transacted with both swaps and security-based swaps, such entities would be subject to dual registration with both agencies under the (regardless of whether or not such entities are already registered with the other agency).
 - **Key Difference.** The Amended Reform Proposal appears to go further. It would make it unlawful for any person that was not registered with the

CFTC as a futures commission merchant to accept funds or other assets (or extend credit in lieu thereof) from a swap customer as margin, guarantee or collateral for any swap cleared through a derivatives clearing organization.

- **Key Difference.** Under the Amended Reform Proposal, swap dealers and major market participants would have a fiduciary duty to certain counterparties, including states, municipalities or other political subdivisions, and pension plans, endowment plans or retirement plans, when such swap dealers and major market participants provide advice regarding, or offer to enter into, swaps or security-based swaps, with such counterparties. The imposition of this fiduciary duty would represent a shift from current market practice, as well as the House Bill's proposed rules.
- **Mandatory Reporting for Transactions.** The reporting elements of the Amended Reform Proposal generally track previous legislative proposals. Clearing agencies, derivatives clearing organizations and swap execution facilities would be required to report transaction information to the applicable Commission (in the case of clearing agencies, to be shared among the Commissions, the Federal Reserve Board, the appropriate prudential regulator, the Financial Services Oversight Council, the Department of Justice, other governmental agencies and federal financial supervisors). Swap repositories would be subject to similar reporting requirements.
 - **Key Difference.** The Amended Reform Proposal would impose “real-time public reporting,” which would entail publicizing transaction and pricing data “as soon as technologically practicable.” Such data would be required to be made publicly available in such form and at such times as the Commissions deem appropriate to “enhance price discovery.”
- **Broad Enforcement Authority.** Under the Amended Reform Proposal, the Commissions would have broad authority to address abuse and prevent evasion of the new regulatory regime.
 - **Abusive Swaps.** The Commissions would be granted authority to collect information and issue reports with respect to any swaps or security-based swaps determined to be detrimental to the stability of a financial market or a participant in a financial market.
 - **Disruptive Practices.**
 - The Amended Reform Proposal would make it unlawful for any person to engage in any trading, *practice* or conduct that would involve disruptive practices, including violating bids or offers, demonstrating intentional or reckless disregard for the orderly execution of transactions during the closing period, or “spoofing” (*i.e.*, bidding or offering with the intent to cancel the bid or offer before execution).
 - The Amended Reform Proposal would further make it unlawful for any person to enter into a swap that the person knows, or acts in reckless disregard of the fact, that its counterparty “will or could use the swap as part of a device, scheme, or artifice to defraud any third

party.” Notably the proposal a week earlier under the Proposed Act would have imposed a heightened requirement to use “reasonable care” when entering into any swap or security-based swap.

- **Foreign Entities.** If either Commission were to determine that the regulation of swaps or security-based swaps markets in a foreign country undermined “the stability of the United States financial system,” then such agency, in consultation with the Treasury, would be authorized to prohibit entities domiciled in such foreign country from participating in the United States derivatives markets.
- **Prohibition against Governmental Assistance.** While the House Bill would provide that it should not be construed as authorizing federal assistance to support the clearing operations or liquidation of a derivatives clearing organization or clearing agency, the Amended Reform Proposal would impose a direct prohibition on “federal assistance” in connection with any “swap entity” with respect to any swap or security-based swap. Federal assistance would include advances from any Federal Reserve credit facility, discount window, or the Federal Deposit Insurance Corporation. Swap entity would include, among others, any dealer, major market participant, swap execution facility, national securities exchange, clearing agency or derivatives clearing organization. This prohibition on governmental assistance would require certain financial institutions to spin off their derivatives practices in order to avail themselves of governmental assistance.
- **Swaps Not to be Regulated as Insurance.** The Amended Reform Proposal would preempt state legislative efforts to regulate swaps as insurance, and, specifically, a swap would not be regulated as “insurance contracts” under the laws of any state.

Given the conflicts between House and Senate legislation on key elements of OTC derivatives markets reform, the final form of any OTC derivatives markets reform still remains uncertain. The *Alert* will report on additional developments in this area as they occur.

FRB Chairman Bernanke Testifies Before House Committee on Lessons from Failure of Lehman

Chairman Ben S. Bernanke of the FRB presented testimony before the U.S. House of Representatives Committee on Financial Services concerning the “*Lessons Learned from the Failure of Lehman*.” In his testimony, Chairman Bernanke noted that Lehman Brothers (“Lehman”) was exempt from FRB supervision because it did not own a commercial bank, but rather owned a federally insured savings association. Chairman Bernanke noted that Lehman’s core subsidiaries were broker-dealers subject to SEC supervision and that Lehman’s parent company was subject only to the SEC’s Consolidated Supervised Entity program, a voluntary program “without the benefits of statutory authorization.”

Chairman Bernanke stated that in March 2008, responding to increasing pressures on primary dealers such as Lehman, the FRB used its statutory emergency powers to establish the Primary Dealer Credit Facility and the Term Securities Lending Facility (the “Facilities”) to provide backup liquidity to primary dealers. The FRB required all participants in Facilities, including Lehman, to provide the FRB with current financial information, but the FRB had no legal authority “to regulate Lehman’s disclosures, capital,

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risk management, or other business activities.” Subsequently, the FRB and SEC shared financial information concerning Lehman and jointly conducted stress tests of Lehman’s liquidity. The results of the stress tests showed that Lehman’s liquidity and capital were significantly deficient.

Lehman was unable to raise a sufficient amount of capital to address its needs, market conditions deteriorated further and, in mid-September 2008, the FRB and other regulators tried unsuccessfully to arrange an acquisition of Lehman by another company or to find another means of saving Lehman. Accordingly, Lehman’s only available option was to declare bankruptcy. Chairman Bernanke pointed out that at the time of Lehman’s bankruptcy neither the FRB nor any other regulatory agency “had the authority to provide capital or an unsecured guarantee, and thus no means of preventing Lehman’s failure existed.”

Chairman Bernanke concluded that Lehman’s failure provides at least two important lessons: (1) We must eliminate gaps in the U.S. financial regulatory framework “that allow large, complex interconnected firms like Lehman to operate without robust consolidated supervision;” and (2) “to avoid having to choose in the future between bailing out a failing, systematically critical firm or allowing its disorderly bankruptcy, we need a new resolution regime, analogous to that already established for failing banks.”

OTHER ITEM OF NOTE

FINRA Reminds Broker-Dealers of Due Diligence Obligations in Regulation D Offerings

FINRA issued [Regulatory Notice 10-22](#) to remind its member broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities offered when they make a recommendation regarding an offering under Regulation D of the Securities Act of 1933. Among other things, the Regulatory Notice includes a list of practices that FINRA has observed firms adopting to meet their due diligence responsibilities.

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