MORRISON | FOERSTER

News Bulletin March 29, 2010 Volume 1, Issue 6

Structured Thoughts

News for the financial services community.

In this issue of *Structured Thoughts*, we continue our discussion of regulatory initiatives affecting structured products in Europe, with **a review of the complex/non-complex product question**. We also provide **a summary table of all current regulatory initiatives in Europe** affecting structured products. This issue also includes a summary of **the SEC's statement on the use of derivatives by funds**, and **a summary of the current state of legislation regulating derivatives and commodities**.

CESR Public Consultation Relating to Application of the Mifid Appropriateness Test to Certain Structured Products

Suitability and Appropriateness Under Mifid

The Markets in Financial Instruments Directive consists of the Directive 2004/39/EC of 21st April 2004 on markets in financial instruments ("Mifid Level 1 Directive" or "Mifid L1"),[1] together with the implementing Directive 2006/73/EC of 10th August 2006 as regards organisational requirements and operating conditions for investment firms and defined terms ("Mifid Level 2 Directive" or "Mifid L2")[2] and the implementing Regulation (EC) No 1287/2006 of 10th August 2006 as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading and defined terms (the "Mifid Level 2 Regulation").[3]

Under Mifid's conduct of business regime, an investment firm must assess the "suitability" and/ or "appropriateness" of a service or product it provides to its clients (or potential clients), depending on the complexity of the investment products involved.

- Suitability test for advised sales: Whenever providing investment *advice* or *discretionary* portfolio management to a client (whether a "retail client" or a "professional client," including "eligible counterparties"[4]), an investment firm must appraise the investor's financial situation and investment

[1] The Markets in Financial Instruments Directive consists of the Directive 2004/39/EC of 21st April 2004 on markets in financial instruments, http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_145/l_14520040430en00010044.pdf.

[2] Directive 2006/73/EC of 10th August 2006 implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_241/l_24120060902en00260058.pdf.

[3] Commission Regulation (EC) No. 1287/2006 of 10th August 2006 implementing Directive 2004/39/EC as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive, http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_241/l_24120060902en00010025.pdf.

[4] Under Mifid L1, Article 24(2), "eligible counterparties" include regulated banks, investment firms, insurance companies, collective investment schemes or pension funds and their management companies, as well as national governments, public bodies, central banks and supranational organisations. Mifid L1, Annex II defines "professional clients" to include, as well as eligible counterparties, (i) large undertakings meeting 2 out of 3 size requirements as to balance sheet total (at least €20 million), net turnover (at least €20 million) and/or

objectives, in addition to the appropriateness of the product or service for the investor. (Mifid L1, Article 19(4); Mifid L2, Articles 36 and 37).

- Appropriateness test for non-advised (execution only) sales: For other investment products or services, the appropriateness test should be applied, to determine whether the investor has the necessary knowledge and experience in the relevant investment field to understand the risks involved. (Mifid L1, Article 19(5); Mifid L2, Article 36).

However, the practical application of the appropriateness test is limited by the fact (i) that firms are entitled to assume that a professional client has the necessary knowledge and experience (Mifid L2, Article 35(2)) and (ii) that certain transactions in "non-complex" financial instruments which are initiated by the investor are exempted (Mifid L1, Article 19(6)) (the "execution only exemption").

Product Categorisation: Complex vs. Non-Complex Instruments

How a particular product or instrument is categorised is significant under Mifid, as one of its key objectives is to prevent complex products from being sold on an "execution only" (i.e., non-advised) basis to retail investors, unless the seller is satisfied that retail investors have the experience and/or knowledge to understand the risks involved.

Consequently, the Committee of European Securities Regulators ("CESR") has focused its analysis on financial instruments which are, or can be, transacted by retail clients.

Non-complex instruments

Under paragraph 6 of Mifid L1, Article 19 (Conduct of business obligations when providing investment services to clients), "non-complex" instruments include:

- shares admitted to trading on a regulated market or in an equivalent third country market;
- money market instruments;
- bonds or other forms of securitised debt (*excluding* those bonds or securitised debt that embed a derivative);
- UCITS (and other collective investment undertakings); and
- other non-complex financial instruments.

For what constitutes other (not automatically) non-complex financial instruments, an in-depth risk-based analysis must be carried out to determine whether the instruments can be classified as complex or non-complex for the purpose of the appropriateness test.

For this purpose, the criteria are laid down in Mifid L2, Article 38 (Provision of services in non-complex instruments) as follows:

- the product or instrument must not fall within paragraphs 4 to 10 of Mifid L1, Annex I (List of Services and Activities and Financial Instruments), Section C (Financial Instruments), which lists practically all forms of options, futures, swaps and other derivatives relating to securities, currencies, interest rates, financial indices, commodities or other assets, as well as derivative instruments for the transfer of credit risk and financial contracts for differences ("CFDs");

own funds (at least €2 million) and other institutions investors under Mifid L1, Annex II (Professional Clients for the purpose of this Directive) and (ii) other clients who have opted in to be treated as professional clients, subject to meeting 2 out of 3 criteria relating to experience, knowledge and size of financial instruments portfolio (at least €500,000, including cash deposits). A "retail client" is a client who is not a professional client. Mifid L1, Article 4(1)(12).

- it does not fall within paragraph 1(18) of Mifid L1, Article 4 (Definitions) ("transferable securities"), sub-paragraph (c), i.e., any other securities which give the right to buy or sell any such transferable securities or which give rise to a cash settlement by reference to transferable securities, currencies, interest rates, indices or commodities;
- there are "frequent opportunities to dispose of, redeem, or otherwise realise" at publicly available prices, i.e., either market prices or prices made available (or validated) by independent valuation systems;
- it does not involve any actual or potential liability exceeding the cost of acquiring the instrument; and
- "adequately comprehensive information on its characteristics is publicly available and is likely to be readily understood" to enable an average retail client to make an informed investment decision.

To such (other non-complex) instruments, the "execution-only" exemption is not available in relation to retail clients and the appropriateness test always applies.

The rationale for such treatment is that the complexity of the instrument impacts an investor's ability to understand the risks involved and consequently the level of investor protection called for. As derivative instruments derive their value from another instrument or asset, embedding a derivatives adds another layer of complexity which investors need to examine before they are able to make an informed investment decision.

It has, however, been noted by some commentators that there is not necessarily a correlation between complexity and risk and the inclusion of a derivative within a product can limit some of the risk the investor would otherwise assume. It has also been noted that some products with embedded derivatives are still relatively easy to understand and the broad brush approach of preventing all products embedding a derivative from applying the execution-only exemption is not necessarily appropriate.

Complex instruments

As indicated above, other financial instruments which are covered by paragraphs 4 to 10 of Mifid L1, Annex I, Section C, or paragraph 1(18)(c) of Mifid L1, Article 4 as described above are deemed to be complex.

CESR Consultation Paper: Mifid Complex and Non-Complex Financial Instruments for the Purpose of the Directive's Appropriateness Requirements (14th May 2009)[5]

Noting that recent market developments have altered the risk profile of many financial instruments, making it even more difficult to gauge the associated risks, particularly for retail investors, on 14th May 2009, CESR launched a public consultation to highlight certain issues relating to how the "appropriateness" requirements apply to "complex" versus "non-complex" financial instruments under Mifid.

In the consultation paper, CESR outlined its views on the interpretation and application of the specified categories of (automatically) "non-complex" instruments under Mifid L1, Article 19(6), and the criteria applied to "other non-complex" instruments under Mifid L2, Article 38, and invited comments from market participants.

Specifically, CESR listed in Annex I a range of types of Mifid financial instruments according to the following three categories:

1. Automatically non-complex (under Mifid L1, Article 19(6)), which lists, among other products (i) ordinary (common & preference) shares; (ii) money market instruments and bonds which do not embed a derivative, specifically including "traditional covered bonds" (but not "structured covered bonds"); and (iii) UCITS.

[5] CESR Consultation Paper: Mifid complex and non-complex financial instruments for the purpose of the Directive's appropriateness requirements (14th May 2009), http://www.cesr.eu/popup2.php?id=5721 (comments deadline: 17th July 2009).

2. Other non-complex instruments to be assessed against the criteria in Mifid L2, Article 38, which lists, among other products, (i) shares not admitted to trading on a regulated market or admitted to trading in a third country market; (ii) depositary receipts for shares or for bonds or other forms of securitised debt; (iii) non-UCITS funds (unless the final Directive on Alternative Investment Fund Managers ("AIFM Directive") prescribes a different treatment);[6] and (iv) other instruments not specifically mentioned in Mifid L1, Article 19(6).

3. "Always complex" according to the criteria in Mifid L2, Article 38(a), which largely lists financial instruments which are covered by paragraphs 4 to 10 of Mifid L1, Annex I, Section C, or paragraph 1(18)(c) of Mifid L1, Article 4, including: (i) swaps, options, futures and other derivatives; (ii) subscription rights, callable shares, convertibles shares; (iii) money market instruments and bonds which embed a derivative, such as structured instruments including convertible bonds, exchangeable bonds, callable/puttable bonds, credit-linked notes, index-linked notes, asset-backed securities ("ABS"), collateralised debt obligations ("CDO") and structured covered bonds; and (iv) warrants and CFDs.

Referring to these lists as illustrative and non-exhaustive lists of examples, CESR then stipulated 33 specific questions for market participants to consider for possible comment. In particular:

- the proposed categorisations of certain instruments, particularly as regards the debt versus equity or UCITS versus non-UCITS distinctions or references and the treatments of subscription rights, convertibles, derivatives, ABS, covered bonds and other forms of securitised debt; and
- the factors potentially relevant to the interpretation and application of Mifid L2, Article 38 (for example, lack of liquidity) and the definition of certain concepts under it (for example, "frequent opportunities to dispose," "publicly available" prices or other information).

CESR Feedback Statement and Q&As

On 3rd November 2009, CESR published a feedback statement,[7] together with a Q&A paper,[8] in relation to its public consultation which closed on 17th July 2009.

In the consultation paper, CESR had sought feedback on its illustrative and non-exhaustive categorisations of Mifid financial instruments and its views on how they were likely to fit within the complex and non-complex categories, for the purposes of the appropriateness test under Mifid L1, Article 19(5) and Mifid L2, Articles 36 (Assessment of appropriateness) and 37 (Provisions common to the assessment of suitability and appropriateness).

The following is a summary of CESR's responses to the principal issues, as set out in its feedback statement:

- Depositary receipts: CESR clarifies that depositary receipts in respect of shares fall outside the definition of "shares" under Mifid L1, Article 19(6) and must be assessed against the Mifid L2, Article 38 criteria.
- Convertible shares: CESR believes that convertible shares (i.e., convertible preference shares) are complex as they fall within the type of transferable securities described in Mifid L1, Article 4(1)(18)(c), which are expressly excluded from eligibility as "other non-complex financial instruments" under Mifid L1, Article 38.

---

6 *See* Morrison & Foerster News Bulletin: Update on the proposed AIFM Directive (25th February 2010), http://www.mofo.com/files/Publication/b75a43ea-af81-42eb-9c29-6a6ed92a397c/Presentation/PublicationAttachment/796feb3f-01be-4e8d-8c44-70f4953d27ae/100225AIFM.pdf.

7 CESR Feedback Statement: Mifid complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements (3rd November 2009), http://www.cesr-eu.org/data/document/09_558.pdf.

8 CESR Q&A: Mifid complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements (3rd November 2009), http://www.cesr.eu/popup2.php?id=6158.

- Subscription rights: CESR accepts that, where subscription rights are being purchased or exercised in the primary market, they should be regarded as part of the relevant share or other financial instrument being offered, not as separate financial instruments in themselves, and given the same categorisation as the share or instrument. However, where subscription rights are being purchased in the secondary market, CESR believes they should be regarded as "complex" under the Mifid L1, Article 38 criteria, as they fall within Mifid L1, Article 4(1)(18)(c).
- Other forms of securitised debt: Although money market instruments and *traditional* bonds (including traditional covered bonds) should continue to be treated as non-complex unless they embed a derivative, CESR believes there are different types of investments that could fall under the category of "other forms of securitised debt," not all of which can accurately be described as non-complex. Although it accepts that some instruments may be easier to understand than others, CESR believes that the majority of these instruments should be categorised as complex, either because they embed a derivative (e.g., all ABS) or because the complexity of their structure makes them difficult to understand. CESR is, however, prepared to revise its previous position for a third group of products (e.g., some structured products) that could be assessed against the Article 38 criteria and treated as non-complex.
- Instruments embedding a derivative: CESR notes that many respondents contested the view that instruments embedding a derivative should always be regarded as inherently complex and that many believed the determining factor should be whether the presence of the derivative creates or increases risks.
- Fixed income products: CESR believes that the general treatment of fixed income products and their categorisation as complex or non-complex should be considered in the forthcoming Mifid review by the European Commission (the "Commission").
- Structured deposits: CESR clarifies its agreement with the Commission's position that deposits are strictly banking products and that only deposits embedding a derivative (with the potential to reduce the initial investment) fall within the scope of Mifid and would be treated as complex.
- Convertible and exchangeable bonds: CESR believes convertible and exchangeable bonds should be regarded as complex because they embed derivatives. CESR notes that if an instrument is explicitly excluded from the non-complex list in Mifid L1, Article 19(6), it cannot gain non-complex status through Mifid L2, Article 38.
- Callable and puttable bonds: CESR believes callable and puttable bonds should be regarded as complex, as they embed a call or a put option. CESR disagrees with respondents which argued that these should either be treated as automatically non-complex or be assessed against the Article 38 criteria.
- Covered bonds: Whilst accepting that the on- and off-balance sheet structures may have a mere difference of legal form rather than substance, CESR considers that only traditional covered bonds fall within the meaning of "bonds" under Article 19(6) which are automatically non-complex. Pending the Mifid review, structured covered bonds should be treated as complex if they embed a derivative or incorporate a complex structure, and otherwise assessed against the Article 38 criteria.
- UCITS and other collective investment schemes: CESR notes that, under Mifid L1, Article 19(6), UCITS is automatically non-complex even if it invests in some complex instruments. Units in other types of collective investment schemes must be assessed against the Article 38 criteria, although CESR notes that the AIFM Directive will have a bearing upon the treatment of funds that are not UCITS.
- Exchange Traded Commodities ("ETCs"): There is a range of different structures in use for ETCs which must be assessed on a case by case basis. However, CESR believes that most of them are likely to be categorised as complex, due to being structured as a CFD or as a debt instrument or other transferable security embedding a derivative.

The Q&A confirms and clarifies CESR's approach to categorisation described in the feedback statement, including the treatment of:

- shares and subscription rights;
- money market instruments, bonds and other forms of securitised debt;
- units in collective investment undertakings, including both UCITS and non-UCITS;
- certain other products, such as ETCs; and
- other non-complex financial instruments according to the Article 38 criteria.

Next Steps

The Commission is due to carry out a post-implementation review of Mifid in 2010.

In its feedback statement on complex vs. non-complex instruments for the Mifid appropriateness test, CESR also expressed the view that the Commission should consider in its Mifid review, *inter alia*, the treatment of (i) shares admitted to trading on an MTF (possibly amending Article 19(6) for automatically non-complex treatment, rather than assessment under Article 38 criteria), (ii) secondary market disposals of subscription rights and (iii) fixed income products.

CESR disclaimed any attempt on its part to address any current or future proposals by the Commission to extend the application of the Mifid standards.

In late 2009, CESR also conducted public consultations on other issues arising under Mifid, including those on "Understanding the definition of advice under Mifid"[9] and "Inducements: Good & poor practices."[10] CESR is expected to publish its feedback statements in due course.

Contacts

Peter Green
+44 20 7920 4013
pgreen@mofo.com

Helen Kim
+44 20 7920 4147
hkim@mofo.com

[9] CESR Consultation Paper: Understanding the definition of advice under MiFID (14th October 2009), http://www.cesr.eu/popup2.php?id=6137 (comments deadline: 14th December 2010).

[10] CESR Consultation Paper: Inducements: Good & poor practices (22nd October 2009), http://www.cesr.eu/popup2.php?id=6146 (comments deadline: 22nd December 2010).

European Regulatory Initiatives Relating to Structured Products

Regulators in Europe have been actively engaged in a number of initiatives that will affect the structured products market. In prior issues of *Structured Thoughts* we have commented on the status of these initiatives. The table below identifies the principal initiatives that bear watching during the coming months.

Topic	Description	Link
UK FSA (LECG) Report	The Regulation of Retail Investment Products: An Initial Assessment of the Impact of Recent Changes	http://www.fsa.gov.uk/pubs/other/lecg.pdf
FSA Retail Distribution Review	Consultation paper (CP09/31): Delivering the Retail Distribution Review: Professionalism; Corporate pensions; and Applicability of RDR proposals to pure protection advice	http://www.fsa.gov.uk/pubs/cp/cp09_31.pdf
FSA report on Structured Deposits	Report of findings on financial promotions of structured deposits	http://www.fsa.gov.uk/Pages/Doing/Regulated/Promo/thematic/structured.shtml
FSA wider implications referral	Update on Lehman-backed structured products	http://www.widerimplications.info/case_studies/wi_13.html
PERG	FSA Consultation Paper (CP09/12) – proposed amendments to the Perimeter Guidance Manual – Guidance on packaged structured investment bonds	http://www.fsa.gov.uk/pubs/cp/cp09_12.pdf
KID	CESR's technical advice to the European Commission on the level 2 measures related to the format and content of its Key Information Document (KID) for UCITS	http://www.cesr-eu.org/popup2.php?id=6149
MiFID Complex vs. Non-Complex instruments	CESR consultation paper and feedback statement on MiFID complex and non-complex financial instruments for the purpose of the Directive's "appropriateness" requirements.	http://www.cesr-eu.org/popup2.php?id=5721
PRIPs	European Commission Communication on Packaged Retail Investment Products	http://ec.europa.eu/internal_market/finservices-retail/investment_products_en.htm
Alternative Investment Fund Managers	European Commission Proposal for a Directive on Alternative Investment Fund Managers	http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm
IOSCO Point of Sale	Consultation Report on Principles of Point of Sale Disclosure for Collective Investment Schemes	http://www.iosco.org/library/pubdocs/pdf/IOSCOPD310.pdf

SEC Staff to Evaluate Use of Derivatives by Funds; Defer Consideration of Leveraged ETFs

On March 25, 2010, the Securities and Exchange Commission (the "SEC") announced that its staff is conducting a review of the use of derivatives by mutual funds, exchange-traded funds, and other investment companies (collectively, "funds").[11] The SEC staff will evaluate the use of derivatives by those funds and, to the extent that the review suggests that additional protections may be necessary under the Investment Company Act of 1940 (the "Investment Company Act"), will determine what changes in SEC guidance or rules may be warranted.

Scope of Review

Although the SEC staff recognizes that funds' use of derivatives is not a new phenomenon, the review will provide it with an opportunity to rethink the SEC's current regulatory protections and conclude whether those protections have kept pace with derivatives' increasing complexity and how fund managers use them.[12] Specifically, the SEC staff expressed its intention to explore at least the following issues relating to the use of derivatives by funds:

- whether current market practices involving derivatives are consistent with the leverage, concentration, and diversification provisions in the Investment Company Act;
- whether funds that rely substantially upon derivatives, particularly funds that seek to provide leveraged returns, maintain and implement adequate risk management and other procedures in light of the nature and volume of the fund's derivatives transactions;
- whether fund boards of directors are providing appropriate oversight of the use of derivatives by funds;
- whether existing rules sufficiently address matters such as, the proper procedure for a fund's pricing and liquidity determinations regarding its derivatives holdings;
- whether existing prospectus disclosures adequately address the particular risks created by derivatives; and
- whether funds' derivatives activities should be subject to special reporting requirements.

Leveraged ETFs

The SEC also announced that, pending completion of the review, the SEC staff will defer consideration of exemptive requests under the Investment Company Act to permit exchange-traded funds to make significant investments in derivatives. While the deferral will not affect any existing fund applications, the SEC noted that it will affect new and pending exemptive requests "from certain actively-managed and leveraged exchange-traded funds that particularly rely on swaps and other derivative instruments to achieve their investment objectives."

Contacts

David H. Kaufman
(212) 468-8237
dkaufman@mofo.com

David A. Trapani
(212) 336-4469
dtrapani@mofo.com

Update on Commodities and Derivatives Reform

The debate concerning the regulation of commodities and derivatives continues. The charts on the following pages provide a brief summary of the principal pieces of legislation.

[11] The SEC's press release is available at www.sec.gov/news/press/2010/2010-45.htm.
[12] Although not expressly stated in the announcement, it appears that the review will address the use by funds of both over-the-counter derivatives and exchange-traded derivatives.

Commodities and Derivatives Reform (as of March 15, 2010)

Late in 2009, the House of Representatives passed a comprehensive financial regulatory reform package. Similar legislation is currently being considered by the Senate. Taken together, the bills move the largely unregulated over-the-counter (OTC) derivatives market one step closer to being subject to a comprehensive and far-reaching regulatory regime.

	Title III (the Derivative Markets Transparency and Accountability Act of 2009) of the Wall Street Reform and Consumer Protection Act of 2009, passed by the House on December 11, 2009	Title VII (the Over-the-Counter Derivatives Markets Act of 2009) of the Senate Discussion Draft of the Restoring American Financial Stability Act of 2009, released by Senator Dodd on November 10, 2009	Title VII (the Over-the-Counter Derivatives Markets Act of 2010) of the Restoring American Financial Stability Act of 2010, released by Senator Dodd on March 15, 2010
Regulatory Framework	– OTC "swaps" regulated by CFTC; OTC "security-based swaps" regulated by SEC; banking regulators retain jurisdiction over certain aspects of banks' OTC derivatives activities (e.g., capital and margin requirements, prudential requirements) – "Swap" excludes, among other things, foreign exchange swaps and forwards (unless otherwise determined by the CFTC and the Treasury); sales of non-financial commodities for deferred shipment or delivery that are intended to be physically settled; any note, bond or evidence of indebtedness that is a security; and security-based swaps – A "security-based swap" is an agreement, contract, or transaction that would be a swap and that is primarily based on, or relates to, a single security or loan, a narrow-based security index, or a single issuer or the issuers of securities in a narrow-based security index but excludes an agreement, contract or transaction if it is based on an exempted security (other than a municipal security) and is not a put, call or other option	– OTC "swaps" regulated by CFTC; OTC "security-based swaps" regulated by SEC; Financial Institutions Regulatory Administration retains jurisdiction over certain aspects of banks' OTC derivatives activities (e.g., capital and margin requirements, prudential requirements) – "Swap" excludes, among other things, foreign exchange swaps and forwards (unless otherwise determined by the CFTC and the Treasury); sales of non-financial commodities for deferred shipment or delivery that are intended to be physically settled; any note, bond or evidence of indebtedness that is a security; and security-based swaps – A "security-based swap" is an agreement, contract, or transaction that would be a swap and that is primarily based on, or relates to, a single security or loan, a narrow-based security index, or a single issuer or the issuers of securities in a narrow-based security index but excludes an agreement, contract or transaction if it is based on a government security	– OTC "swaps" regulated by CFTC; OTC "security-based swaps" regulated by SEC; banking regulators retain jurisdiction over certain aspects of banks' OTC derivatives activities (e.g., capital and margin requirements, prudential requirements) – "Swap" excludes, among other things, foreign exchange swaps and forwards (unless otherwise determined by the CFTC and the Treasury); sales of non-financial commodities for deferred shipment or delivery that are intended to be physically settled; any note, bond or evidence of indebtedness that is a security; and security-based swaps – A "security-based swap" is an agreement, contract, or transaction that would be a swap and that is primarily based on, or relates to, a single security or loan, a narrow-based security index, or a single issuer or the issuers of securities in a narrow-based security index but excludes an agreement, contract or transaction if it is based on a government security
Clearing, Exchange Trading and Reporting	– A (security-based) swap must be cleared if a clearinghouse will accept the derivative for clearing and the CFTC (SEC) has determined (either on its own initiative or upon request by a clearinghouse) that the derivative is required to be cleared – Exception to the clearing requirement applies if one of the counterparties (i) is not a (security-based) swap dealer or major (security-based) swap participant, (ii) is using (security-based) swaps to hedge or mitigate commercial risk, including operating or balance sheet risk, (iii) notifies the CFTC (SEC) how it generally meets its financial obligations associated with entering into non-cleared (security-based) swaps, and (iv) elects in its sole discretion for the clearing exception to apply – Cleared (security-based) swaps must be traded on an exchange or swap execution facility, to the extent that an exchange or swap execution facility makes the (security-based) swaps available for trading – Non-cleared (security-based) swaps must be reported to a (security-based) swap repository or, if none, to the (SEC) CFTC	– A (security-based) swap must be cleared, unless the CFTC (SEC) conditionally or unconditionally exempts it from the clearing requirement, if: i. no clearinghouse will accept it for clearing; or ii. one of the counterparties to the (security-based) swap (I) is not a (security-based) swap dealer or major (security-based) swap participant and (II) does not meet the eligibility requirements of any clearinghouse that clears the (security-based) swap – Each group, category, type or class of (security-based) swaps that a clearinghouse seeks to accept for clearing must be approved by the CFTC (SEC) – The CFTC and SEC must jointly adopt rules identifying (security-based) swaps or any group, category, type or class of (security-based) swaps that, although not submitted for approval by a clearinghouse, should be accepted for clearing – Cleared (security-based) swaps must be traded on an exchange	– A (security-based) swap must be cleared, unless: i. no clearinghouse will accept it for clearing; or ii. the CFTC (SEC), in consultation with the Financial Stability Oversight Council, conditionally or unconditionally exempts it from the clearing requirement if one of the counterparties to the (security-based) swap (i) is not a (security-based) swap dealer or major (security-based) swap participant and (ii) does not meet the eligibility requirements of any clearinghouse that clears the (security-based) swap – A (security-based) swap that is exempt from the clearing requirement must be cleared upon the request of a party to the (security-based) swap

	Title III (the Derivative Markets Transparency and Accountability Act of 2009) of the Wall Street Reform and Consumer Protection Act of 2009, passed by the House on December 11, 2009	Title VII (the Over-the-Counter Derivatives Markets Act of 2009) of the Senate Discussion Draft of the Restoring American Financial Stability Act of 2009, released by Senator Dodd on November 10, 2009	Title VII (the Over-the-Counter Derivatives Markets Act of 2010) of the Restoring American Financial Stability Act of 2010, released by Senator Dodd on March 15, 2010
		or alternative swap execution facility, to the extent that an exchange or swap execution facility makes the (security-based) swap available for trading – Non-cleared (security-based) swaps must be reported to a (security-based) swap repository or, if none, to the (SEC) CFTC	– Each group, category, type or class of (security-based) swaps that a clearinghouse seeks to accept for clearing must be approved by the CFTC (SEC) – The CFTC and SEC must jointly adopt rules identifying (security-based) swaps or any group, category, type or class of (security-based) swaps that, although not submitted for approval by a clearinghouse, should be accepted for clearing – Cleared (security-based) swaps must be traded on an exchange or alternative swap execution facility, to the extent that an exchange or swap execution facility makes the (security-based) swap available for trading • Defines "alternative swap execution facility" as an electronic trading system with pre-trade and post-trade transparency in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the system, but that is not an exchange – Non-cleared (security-based) swaps must be reported to a (security-based) swap repository or, if none, to the (SEC) CFTC
Regulation of Market Participants	– Creates many new types of registrants: (security-based) swap dealers, major (security-based) swap participants, (security-based) swap repositories, and swap execution facilities with respect to (security-based) swaps – A major (security-based) swap participant is any person who is not a (security-based) swap dealer and (i) maintains a substantial net position in outstanding (security-based) swaps, excluding positions held primarily for hedging, reducing or otherwise mitigating its commercial risk, or (ii) whose outstanding (security-based) swaps create substantial net counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets – (Security-based) swap dealers and major (security-based) swap participants are subject to capital and margin requirements, reporting and recordkeeping requirements, business conduct standards, documentation standards, and disclosure standards (both to counterparties and applicable regulators) – CFTC (SEC) authorized to establish aggregate position limits and large trader reporting requirements for (security-based) swaps	– Creates many new types of registrants: (security-based) swap dealers, major (security-based) swap participants, (security-based) swap repositories, and swap execution facilities with respect to (security-based) swaps – A major (security-based) swap participant is any person who is not a (security-based) swap dealer and whose outstanding (security-based) swaps create net counterparty credit exposures (current or potential future exposures) to other market participants that would expose those other market participants to significant credit losses in the event of the person's default – (Security-based) swap dealers and major (security-based) swap participants are subject to capital and margin requirements, reporting and recordkeeping requirements, business conduct standards, documentation standards, and disclosure standards (both to counterparties and applicable regulators) – The CFTC (SEC) is authorized to establish aggregate position limits and large trader reporting requirements for (security-based) swaps – Unlawful for non-ECPs to enter into swaps unless entered into	– Creates many new types of registrants: (security-based) swap dealers, major (security-based) swap participants, (security-based) swap repositories, and swap execution facilities with respect to (security-based) swaps – A major (security-based) swap participant is any person who is not a (security-based) swap dealer and (i) who maintains a substantial net position in outstanding (security-based) swaps, excluding positions held primarily for hedging, reducing, or otherwise mitigating commercial risk, or (ii) whose failure to perform under the terms of its (security-based) swaps would cause significant credit losses to its (security-based) swap counterparties – (Security-based) swap dealers and major (security-based) swap participants are subject to capital and margin requirements, reporting and recordkeeping requirements, business conduct standards, documentation standards,

	Title III (the Derivative Markets Transparency and Accountability Act of 2009) of the Wall Street Reform and Consumer Protection Act of 2009, passed by the House on December 11, 2009	Title VII (the Over-the-Counter Derivatives Markets Act of 2009) of the Senate Discussion Draft of the Restoring American Financial Stability Act of 2009, released by Senator Dodd on November 10, 2009	Title VII (the Over-the-Counter Derivatives Markets Act of 2010) of the Restoring American Financial Stability Act of 2010, released by Senator Dodd on March 15, 2010
	– Unlawful for non-eligible contract participants (ECPs) to enter into swaps unless entered into on an exchange – Unlawful for any person to effect a security-based swap with or for a non-ECP unless entered into on an exchange – Offers and sales of security-based swaps to non-ECPs must be registered, absent an exemption from registration other than under section 3 or 4 of the Securities Act of 1933	on an exchange – Unlawful for any person to effect a security-based swap with or for a non-ECP unless entered into on an exchange – Offers and sales of security-based swaps to non-ECPs must be registered, absent an exemption from registration other than under section 3 or 4 of the Securities Act of 1933	and disclosure standards (both to counterparties and applicable regulators) – The CFTC (SEC) is authorized to establish aggregate position limits and large trader reporting requirements for (security-based) swaps – Unlawful for non-ECPs to enter into swaps unless entered into on an exchange – Unlawful for any person to effect a security-based swap with or for a non-ECP unless entered into on an exchange – Offers and sales of security-based swaps to non-ECPs must be registered, absent an exemption from registration other than under section 3 or 4 of the Securities Act of 1933
Other	– Jurisdictional disputes between the CFTC and SEC may be brought by either Commission for expedited review by the United States Court of Appeals for the District of Columbia Circuit – Disputes as to certain joint rulemaking by the CFTC and SEC may be resolved, at the request of either Commission, by the Financial Services Oversight Counsel – Increases eligibility requirements for eligible ECPs – State and local gaming and bucket shop laws preempted in the case of security-based swaps between ECPs or traded on an exchange and swaps; additionally, security-based swaps may not be regulated as insurance under state law – For purposes of sections 13 and 16 of the Securities Exchange Act of 1934, the purchase or sale of a security-based swap will constitute beneficial ownership of the underlying equity security only to the extent that the SEC determines, in consultation with the Treasury and applicable banking regulators, that such purchase or sale provides incidents of ownership comparable to direct ownership of the equity security and that it is necessary to achieve the purposes of section 13 – At the request of a non-dealer counterparty to a non-cleared (security-based) swap, the (security-based) swap dealer must segregate the counterparty's collateral and hold it at an independent third-party custodian	– Where the CFTC and SEC fail to jointly prescribe uniform rules and regulations where required under the Act, the Agency for Financial Stability, in consultation with the CFTC and SEC, will prescribe the required rules and regulations, which will remain in effect until rescinded by the Agency for Financial Stability or until the effective date of a corresponding rule prescribed jointly by the CFTC and SEC – Increases eligibility requirements for ECPs – State and local gaming and bucket shop laws are preempted in the case of security-based swaps between ECPs or traded on an exchange; the current preemption in the Commodity Exchange Act remains – Sections 13 and 16 of the Securities Exchange Act of 1934 are made applicable to security-based swaps – At the request of a non-dealer counterparty to a non-cleared (security-based) swap, the (security-based) swap dealer must segregate the counterparty's collateral and hold it at an independent third-party custodian	– Where the CFTC and SEC fail to jointly prescribe uniform rules and regulations where required under the Act, the Financial Stability Oversight Council shall, at the request of either Commission, resolve the dispute within a reasonable time after receiving the request, after consideration of relevant information provided by each Commission, and by agreeing with one of the Commissions regarding the entirety of the matter or by determining a compromise position – Increases eligibility requirements for ECPs – State and local gaming and bucket shop laws are preempted in the case of security-based swaps between ECPs or traded on an exchange; the current preemption in the Commodity Exchange Act remains – Sections 13 and 16 of the Securities Exchange Act of 1934 are made applicable to security-based swaps – At the request of a non-dealer counterparty to a non-cleared (security-based) swap, the (security-based) swap dealer must segregate the counterparty's collateral and hold it at an independent third-party custodian • Any such segregation must be made by a (security-based) swap dealer on fair and reasonable terms on a non-discriminatory basis

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, Fortune 100 companies, investment banks and technology and life science companies. Our clients count on us for innovative and business-minded solutions. Our commitment to serving client needs has resulted in enduring relationships and a record of high achievement. For the last six years, we've been included on *The American Lawyer*'s A-List. *Fortune* named us one of the "100 Best Companies to Work For." We are among the leaders in the profession for our longstanding commitment to pro bono work. Our lawyers share a commitment to achieving results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.