

---

# **Dodd-Frank One-Year Anniversary: Impact on End Users of Swaps**

Presented by

**Daniel N. Budofsky**

**Susan C. Ervin**

**Gabriel D. Rosenberg (Moderator)**

July 28, 2011

**Davis Polk**

Davis Polk & Wardwell LLP

---

---

# Presenters

---



## **Daniel N. Budofsky**

Dan is a partner in Davis Polk's Derivatives and Structured Products Group. He advises financial institutions, corporations and hedge funds on financial products in domestic and international transactions and has worked on numerous convertible, exchangeable and over-the-counter derivatives and financing transactions.



## **Susan C. Ervin**

Susan is a partner in Davis Polk's Financial Institutions Group, practicing in the Washington DC office. She has a unique and powerful mix of direct regulatory and private practice experience in futures, commodities and derivatives, including the new swaps regulatory requirements.



## **Gabriel D. Rosenberg (Moderator)**

Gabe is an associate in Davis Polk's Financial Institutions Group. He advises financial institutions, corporations and industry groups on the requirements, impact and implementation of the Dodd-Frank financial reform legislation, particularly the regulatory treatment, trading and clearing of swaps.

---

# Dodd-Frank Webcast Series

---

**One Year Progress Report**

**July 22, 11:00 a.m. EDT / 8:00 a.m. PDT**

**Impact on Bank Holding Companies**

**July 25, 11:00 a.m. EDT / 8:00 a.m. PDT**

**Impact on Swap Dealers**

**July 26, 11:00 a.m. EDT / 8:00 a.m. PDT**

**Impact on Private Equity/  
Hedge Funds**

**July 27, 11:00 a.m. EDT / 8:00 a.m. PDT**

**Impact on End Users of Swaps**

**July 28, 11:00 a.m. EDT / 8:00 a.m. PDT**

**Emerging Litigation Trends**

**July 29, 11:00 a.m. EDT / 8:00 a.m. PDT**

If you are interested in participating in any of these events, email [\*\*dodd.frank.progress.report@davispolk.com\*\*](mailto:dodd.frank.progress.report@davispolk.com) for registration information.

Archived webcasts are available at [\*\*www.davispolk.com/dodd-frank\*\*](http://www.davispolk.com/dodd-frank).

---

# Key Elements of Derivatives Reform

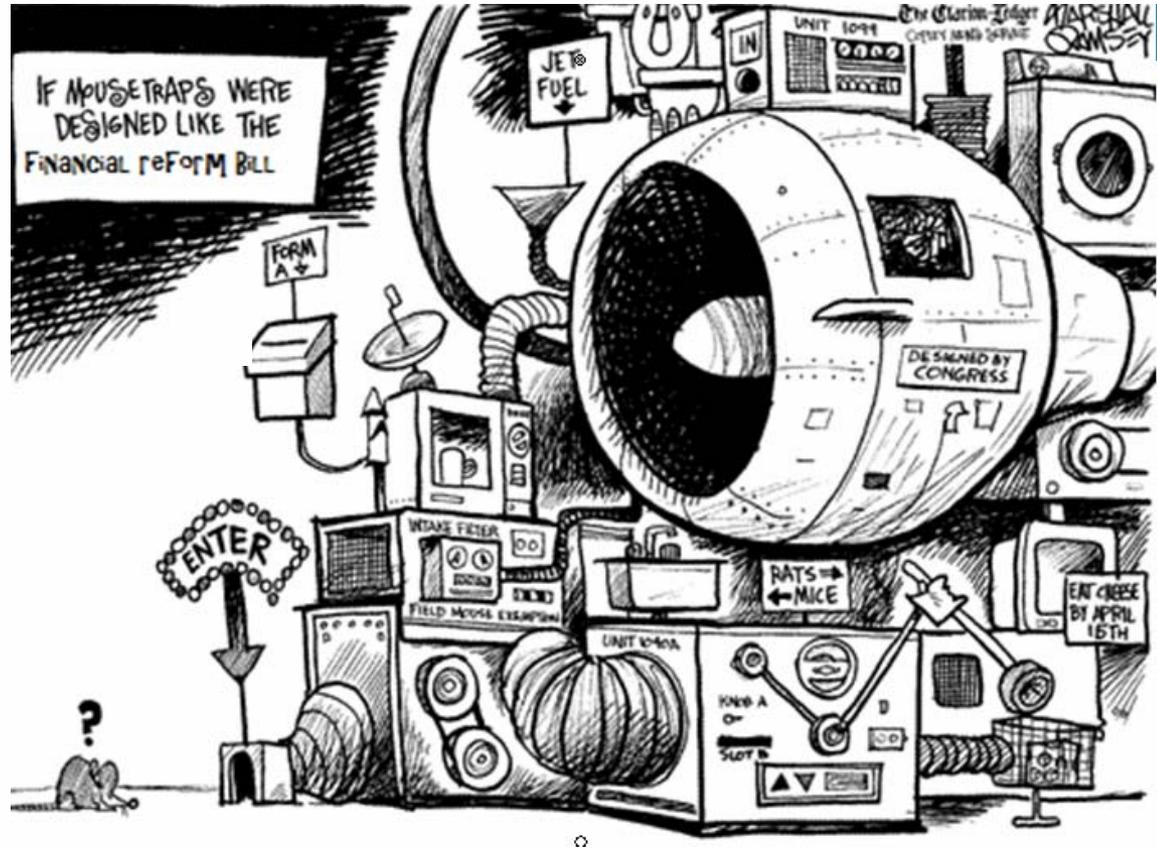
---

**Title VII of the Dodd-Frank Act provides the SEC and the CFTC with the authority to regulate OTC derivatives. It was designed to address gaps in the regulation of OTC derivatives and was intended to promote four principal objectives:**

- (1) transparency of pricing and trading of OTC derivatives so that regulators and market participants can more easily evaluate pricing and trading activity;
- (2) regulation of market participants, trading facilities and transactions;
- (3) counterparty protection; and
- (4) protection against systemic risk

# Key Elements of Derivatives Reform *(cont.)*

- Registration and regulatory requirements for swap dealers and major swap participants
- Margin and capital requirements
- Clearing and exchange trading requirements
- Trade reporting
- Position limits
- Business conduct requirements



# Regulatory Status of Products

## CFTC

- Swaps on non-securities:
  - Interest rate swaps
  - Energy and metal swaps
  - Agricultural swaps
  - Commodity swaps
- Swaps on broad-based indices
- Swaps on government securities
- Cross-currency swaps & NDFs

## SEC

### Security-Based Swaps

- Swaps on narrow-based security indices
- Swaps on a single security or loan
- Swaps on 9 or fewer securities

“Mixed Swaps”

## Exclusions

- Puts, calls, options on securities, indices of securities, CODs
- Contracts for purchase or sale of securities on a fixed basis or based on contingencies not related to creditworthiness
- Commodities contracts and security futures products traded on a contract market
- Sale of a nonfinancial commodity for deferred delivery, where physically settled
- FX forwards and swaps (proposed)

*\*Identified banking products are excluded unless bank regulators find that they are actually swaps or security-based swaps or they are not regulated by a bank regulator and are swaps or security-based swaps.*

# Swap Dealers and Major Swap Participants

- **Swap dealers** and **major swap participants** will need to register and be subject to comprehensive regulation
- **Swap dealer** is any person (subject to limited exceptions) who:
  - holds itself out as a dealer in swaps;
  - makes a market in swaps;
  - regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
  - engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.
- **Major swap participants** are non-swap dealers with high levels of swap activity, excluding certain hedging activity
- **Based on the proposed rules, it appears that corporate end users *generally* will not need to worry about being swap dealers or major swap participants**

---

# Clearing and Trade Execution

---

- **Clearing** - transactions in swaps must be cleared through a clearing agency if they are of a type that the agencies determine must be cleared, unless an exemption applies.
- **Trade Execution** - if a swap is subject to the clearing requirement, then it must be traded on a registered trading platform – a swap execution facility, a designated contract market or an exchange – unless no facility makes such swap or security-based swap available for trading.

**The focus here will be on the CFTC rules. To the extent a client engages in swaps on single or narrow-based indices of securities, additional analysis may be required.**

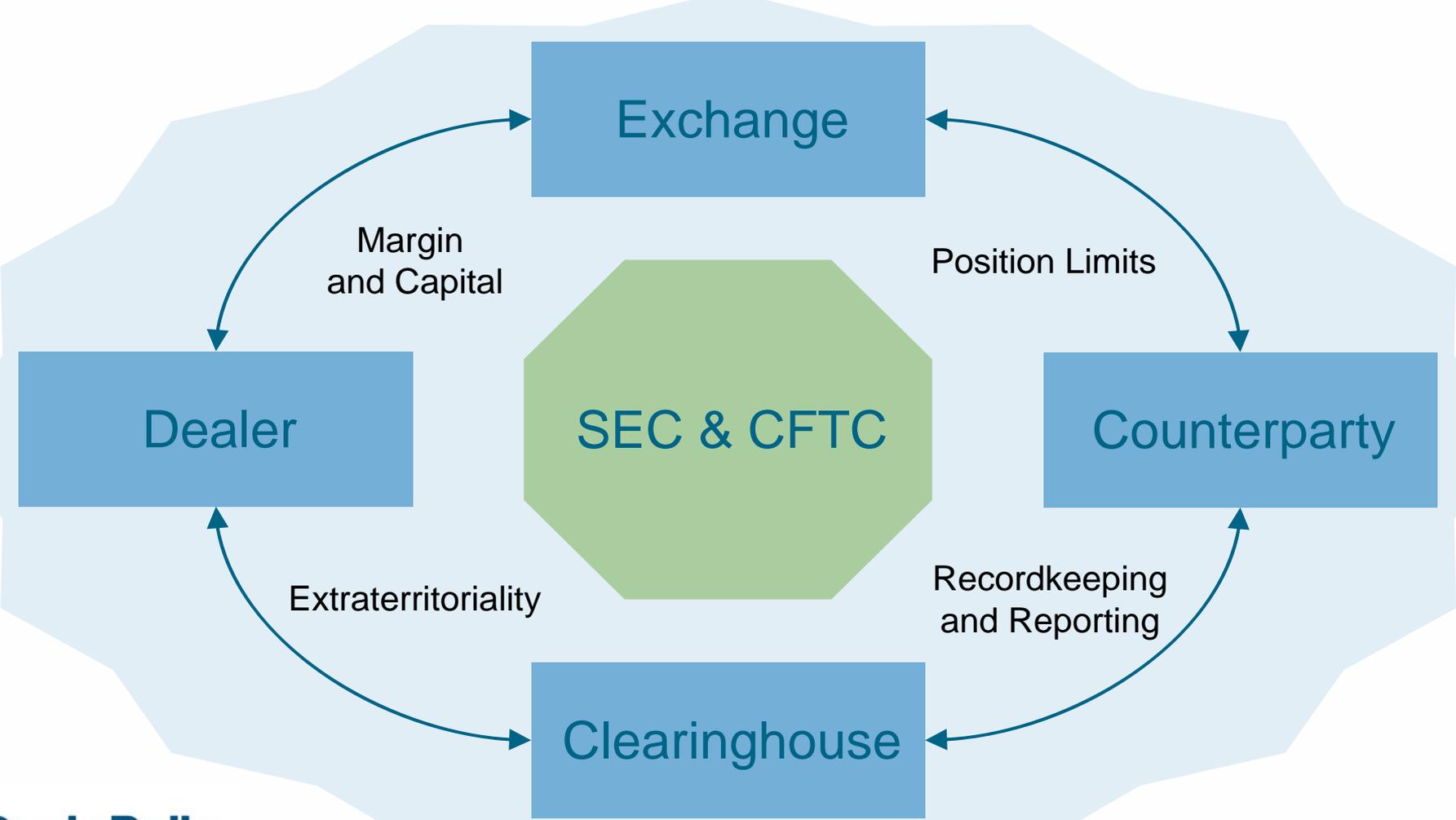
---

# The OTC Derivatives Market Before Dodd-Frank

---



# The OTC Derivatives Market After Dodd-Frank



---

# Direct Effects on End Users

---

- Clearing and exchange trading
  - Implication of clearing swaps
  - End-user exception from clearing
- Margin for cleared and uncleared swaps
- Position limits
- Recordkeeping

# Commercial End User Exception from Clearing and Exchange Trading

---

## **Available to any swap counterparty that**

- is not a financial entity;
- is using the swap to hedge or mitigate commercial risk; and
- notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps

**Available to certain affiliates of exempt swap counterparties to hedge or mitigate the commercial risk of the exempt person using non-cleared swaps.**

**Requires board approval by entities issuing securities registered under the Securities Act or reporting under the Exchange Act**

---

# “Financial Entity”

---

## **Financial entity means a counterparty that is:**

- a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant;
- a commodity pool;
- a private fund;
- an employee benefit plan under ERISA; or
- a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act.

# “Hedge or Mitigate Commercial Risk”

---

## **A swap is deemed to be used to hedge or mitigate commercial risk when it:**

- is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from the potential change in the value of assets, liabilities or services which are part of the ordinary course of the business of the enterprise;
- qualifies as bona fide hedging for purposes of an exemption from position limits; or
- qualifies for hedging treatment under FASB Accounting Standards Codification Topic 815, Derivatives and Hedging.

## **In addition, the swap must not be used:**

- for a purpose that is in the nature of speculation, investing, or trading; or
- to hedge or mitigate the risk of another swap or security-based swap.

**The SEC uses a slightly different definition.**

---

# Notification

---

## Notification

- End users are required to notify swap data repositories each time they use the exception
- If the end user is an issuer of securities or required to file periodic reports with the SEC, the end user is required to confirm that the board has approved the decision not to clear the swap

# Board Approval

---

End users that issue securities or report under Section 15(d) of the Exchange Act must have an appropriate committee of its board or governing body approve the decision to enter into non-cleared swaps.

An “appropriate committee” is one specifically authorized to review and approve the entity’s decision to enter into swaps.

This can be accomplished through a board resolution or amendment to a board committee’s charter authorizing the committee to review and approve decisions not to clear swaps being reported.

The board committee may adopt policies and procedures to review and approve decisions not to clear swaps on a periodic basis.

# Margin for Corporate End Users

---

## ■ Cleared swaps

- End-users that clear swaps will be required to post initial and variation margin to their “clearing member,” who must be a futures commission merchant for CFTC-regulated swaps
- Clearing members must charge clients the clearinghouse minimum but can charge “excess margin”

## ■ Uncleared swaps

- The prudential regulators would require bank swap entities to calculate their own credit exposure limits for nonfinancial end users and collect initial and variation margin from the nonfinancial user when the credit exposure exceeds the calculated limit
- The CFTC does not require swap entities to collect margin from nonfinancial end users

# Other Provisions

---

## Position Limits

- Dodd-Frank requires the establishment of position limits on certain commodities, and the CFTC has published a rule on position limits for 28 physical delivery contracts and related swaps with an exemption for bona fide hedging transactions

## Swap Position Reporting Requirements

- The details of all swaps will be required to be reported to an SDR immediately and kept updated throughout the life of the swap
- Generally, the end-user would be responsible for filing the report only if no DCM, SEF, swap dealer, or major swap participant is involved, but SDRs are required to confirm with end-users the accuracy of the data submitted about that swap
- End-users will be required to obtain a unique identifier from a yet to be determined “standards body”

# Reporting and Recordkeeping

---

## Recordkeeping

- End users will be required to keep full, complete, and systematic records including:
  - Data regarding the creation of the swap, and
  - All data elements of the swap on an ongoing basis
- Must be kept for the entire life of the swap and for five years thereafter

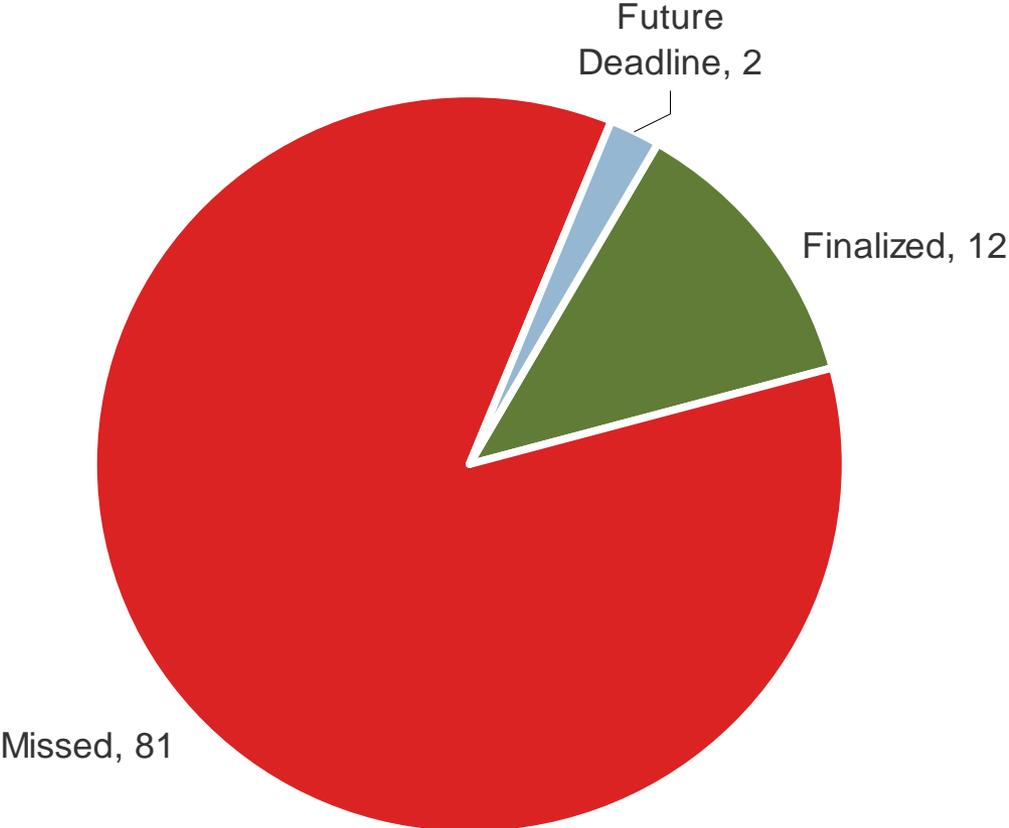
## Segregation of Margin

- End users will have the right to require the segregation of margin collateral in a segregated account.

## New Counterparties, Documentation and Systems

- End-users will find themselves facing new legal entities as their counterparties and will need to assess the creditworthiness of these new entities
- End-users will also need to negotiate new execution and clearing agreements and choose the clearinghouses at which they prefer to clear swaps

# Title VII Rulemaking Progress



# Contact Information

---

## CONTACTS

## PHONE

## EMAIL

---

### *New York*

**Daniel N. Budofsky**

**212 450 4907**

**daniel.budofsky@davispolk.com**

**Gabriel D. Rosenberg**

**212 450 4537**

**gabriel.rosenberg@davispolk.com**

---

### *Washington DC*

**Susan C. Ervin**

**202 962 7141**

**susan.ervin@davispolk.com**