Key Dodd-Frank Derivatives Issues for End Users

The Dodd-Frank Act’s swap regulatory regime requires “swap dealers” and “major swap participants” ("MSPs") to register with the CFTC and comply with significant new regulatory requirements. While swap dealers and MSPs will be subject to more swaps-related requirements than will end users under this regulatory regime, there are a number of critical issues that will directly affect end users that use swaps. For example, end users of swaps will need to:

- ensure they are eligible for and – if they determine to do so – elect the “end-user exception” from clearing and exchange-style trading, which will require board approval for SEC filers;
- enter into new, or potentially revise existing, credit support arrangements with swap dealer counterparties for non-cleared swaps;
- develop systems to collect and retain information about swaps; and
- monitor for and comply with position limits.

In addition, many of Dodd-Frank’s provisions will indirectly affect end users of swaps. Due to the new regulatory requirements applicable to swap dealers and MSPs, end users may find themselves facing new legal entities as counterparties to swap agreements and will need to assess the creditworthiness and operational efficiency of these new legal entities. End users who are not eligible for or do not elect to rely upon the end-user exception from clearing also will need to negotiate new execution and clearing agreements, choose the clearinghouses at which they prefer to clear swaps and enter into or negotiate new documentation designed for cleared swaps.

Many of these provisions will be implemented within the next several months. As a result, this memorandum is meant to identify a number of the key areas where planning and action by end users of swaps may be prudent at this time.

1 A description of the definitions of swap dealer and MSP adopted jointly by the CFTC and the SEC is available in our memorandum of May 2, 2012 entitled “CFTC and SEC Adopt Final Swap Dealer, Major Swap Participant and Eligible Contract Participant Definitions.”
Mandatory Central Clearing and Exchange-Style Trade Execution

Dodd-Frank, when fully effective, will require counterparties to categories of swaps that have been specified by the CFTC to clear those swaps through a central counterparty. In addition, Dodd-Frank requires that all swaps that are required to be cleared and are “made available to trade” on a swap execution facility (“SEF”) or a designated contract market (“DCM”) be executed on such a platform, unless an exception applies.

Impact on End Users

Some end users of derivatives will be eligible for a statutory “end-user exception” from Dodd-Frank’s clearing and trade execution requirements. To be eligible to elect this exception, a company must:

- not be a “financial entity”;
- use the swap to “hedge or mitigate commercial risk”; and
- notify the CFTC how it “generally meets its financial obligations associated with entering into non-cleared swaps.”

For reporting companies under the Securities Exchange Act of 1934 (the “Exchange Act”), the decision to elect the exception must be reviewed and approved by an appropriate committee of the board. This effectively requires a reporting company to weigh the potential benefits and costs of central clearing and exchange-style execution against the benefits and costs of bilateral execution without central clearing.

Recognizing that certain companies may employ finance affiliates for certain purposes including hedging transactions, the end-user exception is also available to affiliates acting on behalf of entities that meet the above requirements, so long as the affiliate is not a swap dealer, MSP or one of a list of enumerated entities. Captive finance companies that meet the criteria in the sidebar on the following page are excluded from the definition of “financial entity” and, as a result, are eligible for the end-user exception.

Final CFTC rules released last week provide key additional information that end users need to determine whether they are eligible for the end-user exception and, if so, whether and how to elect it. ²

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² To view the CFTC’s final end-user rule, click here.
“Financial Entity”

The definition of “financial entity” includes:

- a swap dealer, security-based swap dealer, MSP 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, such as securities underwriting and dealing, investment advisory activities, insurance agency or brokerage, and extending credit.

The rule permits certain “captive finance entities” of end users to rely on the end-user exception. This result is accomplished by excluding from the definition of “financial entity” a captive finance entity, defined as “an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.”

The definition also excludes certain banks and other financial institutions with less than $10 billion of total assets.

“Financial Entity”

“Financial entity” is defined to include a number of regulated financial institutions as well as entities whose activities are primarily financial in nature, as described in the accompanying sidebar. In a change from the proposed rules, the CFTC has exempted from the definition of “financial entity” certain banks and other financial institutions with less than $10 billion of total assets.

“Hedge or Mitigate Commercial Risk”

The CFTC’s rule requires that, in order to qualify for the end-user exception, a swap must:

- either:
  - qualify as bona fide hedging under Commodity Exchange Act position limit rules;
  - qualify for hedging treatment under FASB or GASB; or
  - be “economically appropriate” to reduce, in the ordinary course of business of a commercial enterprise, risks arising from a change in: the value of assets that the entity owns, produces, manufactures, processes or merchandises; the value of liabilities that the entity incurs; the value of services that the entity provides or purchases; the value of assets, services or liabilities due to fluctuations in interest, currency or foreign exchange rates; or the interest, currency or foreign exchange rate exposures arising from a person’s assets, services or liabilities; and
  - not be used for a purpose that is in the nature of speculation, investing or trading and not be used to hedge or mitigate the risk of another swap, unless that other swap itself is used to hedge or mitigate commercial risk.

End users must ensure that swaps meet these requirements in order to be exempt from clearing. The end-user exception applies on a swap-by-swap basis, so a nonfinancial entity’s swaps that do not “hedge or mitigate commercial risk” under this definition and that are subject to mandatory clearing will need to be cleared, regardless of whether the nonfinancial entity can use the end-user exception for other swaps.
**Notification**

To satisfy the requirement that the CFTC is notified how the end user “generally meets its financial obligations associated with entering into non-cleared swaps,” the final rules provide that the reporting counterparty must disclose to a registered swap data repository ("SDR") whether the end user’s obligations are being supported by:

- a written credit support agreement;
- pledged or segregated assets (including posting or receiving margin);
- a written third-party guarantee;
- the electing counterparty’s available financial resources; or
- other means.

The reporting counterparty must report to a registered SDR the information provided in the accompanying sidebar. Much of this information can be reported on an annual basis.

**Board Review**

As stated above, Dodd-Frank requires that Exchange Act reporting companies have the decision to use the end-user exception from clearing reviewed and approved by an “appropriate committee” of their board. The CFTC’s rule indicates that an “appropriate committee” is one that is “specifically authorized to review and approve [the issuer’s] decisions to enter into swaps.” The CFTC notes that the board may use reasonable discretion to determine the appropriate committee for approving decisions on swaps for its subsidiaries or affiliates.

The CFTC would expect the board of an Exchange Act reporting company to set appropriate policies governing the company’s use of swaps subject to the end-user exception and to review those policies at least annually and, as appropriate, more often upon a triggering event (e.g., a new hedging strategy is to be implemented that was not contemplated in the original board approval). Reporting entities will be required to report board approval information to the CFTC, but can choose to do so annually or on a swap-by-swap basis.

**Timing**

On September 8, 2011, the CFTC proposed a rule that would phase in clearing and trade execution requirements for a given swap based on the identity of the counterparties to that swap. Under the proposed rules, swaps where one counterparty is an end user would not be required to be cleared, even if the end-user exception does not apply, until 270 days after the CFTC makes its determination that a swap is required to be cleared. Exchange-trading requirements come into effect for a given market participant on the later of the day that market participant is required to clear the swap and 30 days after the swap is “made available for trading.”

Based on a recent statement by CFTC Chairman Gary Gensler, the CFTC may begin proposing clearing determinations this month. As a result, under the proposed rules end users would likely be required to clear their swaps,
or elect the end-user exception, starting in the winter of 2012 or the spring of 2013. End users wishing to use the end-user exception will need to have board approval by that time or be prepared to clear the swap.

### Margin

Under Dodd-Frank and related regulations, swaps that are centrally cleared will be subject to margin requirements imposed by the clearinghouses and their clearing members. Dodd-Frank also provides for margin requirements to apply to non-cleared swaps (also known as “bilateral swaps”). In May 2011, banking regulators and the CFTC proposed rules requiring swap dealers and MSPs under their respective jurisdictions to collect margin from their swap counterparties.

#### Impact on End Users

Clearinghouse margin collection rules are not expected to distinguish between end users and other market participants. As a result, to the extent that an end user does not qualify for or does not elect the end-user exception for a particular swap, the end user will have to post initial and daily variation/mark-to-market margin on that swap. End users will need to develop swap clearing relationships with the large financial institutions that serve that function, which will require new or modified documentation.

End users’ swaps with swap dealers or MSPs will be subject to the CFTC’s and banking regulators’ rules for non-cleared swap margin for those swaps that are not required to be cleared or for which the end-user exception is not elected. As proposed, these margin rules would not require swap dealers and MSPs to collect margin from nonfinancial end users unless the swap exceeds the credit thresholds established by the swap dealer or MSP. The CFTC’s proposed margin rules, however, would require swap dealers and MSPs to have credit arrangements in place with nonfinancial end users, which may not be required by current arrangements. In addition, the treatment for nonfinancial end users would not extend to captive finance companies.

The statute and proposed rules also give an end user the right to require that any initial margin collected from it by a swap dealer for non-cleared swaps be segregated and held by an independent third-party custodian. End users who do not elect such segregation would receive periodic reports about their initial margin.

#### Timing

The banking regulators and the CFTC have not scheduled a definitive date for finalizing their margin requirements. On July 6, the CFTC reopened the comment period for its proposed rule on non-cleared swap margin requirements until September 14 in light of the release of a consultation paper on non-cleared swap margin by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.
On September 8, 2011, the CFTC proposed rules that would phase in margin requirements by counterparties in a way similar to the phase-in proposed for clearing and exchange trading. Non-cleared swap margin requirements would not apply to end users until 270 days after the date of publication of the margin rules in the Federal Register. Since the CFTC’s proposed rules require credit support documentation to be in place, such documentation will likely be required by the effective date of the rule for end users, likely to be at the end of 2013 or beginning of 2014. End users will also need to decide whether to elect to have initial margin collected from them segregated at an independent third-party custodian.

Recordkeeping and Reporting

Dodd-Frank requires market participants to report swaps to SDRs and to collect and maintain information about their swap activity. Some information reported to SDRs will be publicly disseminated. Though the majority of the burden for swaps reporting will fall on swap dealers and MSPs, there are a number of key issues of which end users should be aware.

Impact on End Users

The responsibility for reporting swap information to SDRs will generally fall on the swap dealer or MSP counterparty to the swap or the DCM or SEF on which the swap is executed. The exception to this rule is a non-cleared bilateral swap between two end users, in which case the end users will need to decide between themselves who is responsible for reporting the swap.

All swap counterparties, including end users, will be required to keep full, complete and systematic records with respect to each of their swaps. These records will include data regarding the creation of a swap, and all data elements of the swap on an ongoing basis. Swap records must be kept for the entire life of the swap, plus at least five years thereafter, and are subject to inspection by the CFTC. Unlike swap dealers and MSPs, end users may choose to keep their records electronically or in paper form, regardless of the form in which they were originally produced.

Additional reporting and recordkeeping will be required for “large traders” that meet or exceed reportable position thresholds in specified physical commodity swaps. All counterparties to swaps, whether or not they exceed the reportable thresholds, are subject to recordkeeping requirements in connection with the large swaps trader reporting rules. End users will need to ensure that they have the proper systems in place to collect and maintain this information and file any required reports.

Timing

CFTC rules implementing swap data reporting requirements have been finalized and will come into effect beginning on the date that swap dealers and MSPs are required to register with the CFTC, which is likely to be in late September or early October 2012. Compliance will be phased in by asset class and counterparty type, with end users required to be in
compliance starting 180 days after the first compliance date for swap dealers and MSPs, likely early 2013. The large trader reporting rules are already in effect.

## Position Limits

Dodd-Frank provided the CFTC with new authority to impose position limits, as it deems appropriate for swaps. On November 18, 2011, the CFTC published final rules expanding and revising its existing position limits regime. These rules put in place new or revised position limits for 28 energy, metals and agricultural commodity futures contracts ("core referenced futures contracts") and options on those futures contracts, as well as futures, options, swaps and swaptions that are economically equivalent to the core referenced futures contracts (together, "referenced contracts").

Under the final rules, the position limit levels set the maximum amount of a referenced contract a trader may own or control separately or in combination, net long or short, for both spot and non-spot months. The rules require a trader to aggregate positions or accounts in which the trader has a 10% or greater ownership interest, with exceptions for passive ownership as a limited partner or other types of similar ownership, subject to specified conditions.

### Impact on End Users

End users are subject to the same position limit rules as swap dealers and MSPs. However, the rule provides an exception to the position limits for “bona fide hedging transactions,” as described in the sidebar at left, which may be available for end users. The definition of bona fide hedging under the new position limit rules is different from, and narrower than, the definition under the CFTC’s current position limit rules. In particular, the new bona fide hedging definition would require a CFTC determination that a transaction that was not an enumerated hedge would nonetheless qualify as a bona fide hedge. The position limit rules do not apply to pre-existing positions, except with respect to spot-month limits.

Even if these exemptions apply, however, the rules establish additional compliance and reporting requirements, including visibility reporting obligations, filing and reporting requirements in connection with claiming aggregation and bona fide hedging exemptions. For positions in referenced contracts for which an exemption is not available, end users will be subject to reporting requirements upon exceeding specified visibility levels and position limit levels.

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3 The CFTC has proposed to increase this 10% threshold to 50%, subject to specified conditions. See CFTC Proposed Rule on Aggregation, Position Limits for Futures and Swaps, 77 FR 31767 (May 30, 2012).
As a result, end users will need to have systems in place to monitor compliance with position limits and, where it applies, the bona fide hedging exemption. End users will also need to have in place the systems and procedures to comply with the reporting requirements in the position limits rule.

**Timing**

The position limit rules became effective in January 2012. New spot-month position limits for all referenced contracts and non-spot-month limits for specified agricultural commodities will become effective in the fall of 2012. Other non-spot month position limits will be phased in, based on information the CFTC gathers on the swaps markets through its large trader reporting regime and swaps reporting by swap dealers.

However, the timeline for these position limits may be complicated by legal challenges to the rule. In December 2011, financial industry trade associations filed a suit against the CFTC on the position limit rules, including requesting a stay of the effectiveness of the position limits while the litigation is pending. While no rulings have been issued on the stay or on the rule, it is possible that court action could significantly affect the compliance timeline.