



Dodd-Frank Considerations for End-Users of Derivatives

More than two years after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), regulations under Title VII of that legislation have reached a sufficiently advanced point that end-users of derivatives will soon be required to take action to ensure their compliance with the regulatory scheme and their continued access to the derivatives market. In this article, we review the current state of play for end-users, the actions they must take or should consider taking, and the likely time frame for the relevant regulations’ implementation.

The considerations highlighted in this article relate to interest rate swaps, foreign exchange transactions, commodity swaps and certain credit swaps, all of which are regulated by the Commodity Futures Trading Commission (the “CFTC”). They do not generally relate to “security-based swaps” subject to the jurisdiction of the Securities and Exchange Commission, whose rule-making process has lagged behind that of the CFTC.

I. Dodd-Frank Protocol

End-users will need to adhere to ISDA’s August 2012 DF Protocol (the “Protocol”) or enter into alternative documentation offered by some swap dealers. The Protocol, an industry-designed mechanism to amend swap agreements to comply with numerous CFTC regulations, addresses, among other regulations, certain of the CFTC’s external business conduct standards¹ that impose on swap dealers and major swap participants additional pre-transaction know-your-customer and due diligence requirements as well as heightened standards for dealing with “Special Entities” such as municipalities and pension plans.

The external business conduct standards are scheduled to go into effect on January 1, 2013, when most swap dealers are expected to be required to register as such. Starting on that date, it is unlikely that any swap dealer will agree to enter into any swap with an end-user who has not yet adhered to the Protocol or entered into alternative documentation with comparable effect.

Similar to other ISDA protocols, the Protocol is a multilateral contractual amendment mechanism through which any two adhering parties may amend the relevant agreements between them. Adhering to the Protocol requires, among other things, the submission of an adherence letter, the payment of an adherence fee, and the completion of a detailed questionnaire. Adherence instructions are posted on ISDA’s website (at www.isda.org).

¹ See generally Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734 (Feb. 17, 2012).

II. Election of End-User Exemption

CFTC regulations mandate that certain swaps will be required to be cleared by clearinghouses. While the regulators' preference for centrally cleared swaps is evident, however, the extent to which cleared swaps will be priced competitively with traditional bilateral swaps remains to be seen. In addition, clearing relationships will require end-users to negotiate additional documentation (discussed in Part III below).

The CFTC has, however, provided an exemption for mandatory clearing (the "End-User Exemption") that applies to certain transactions entered into by certain end-users.² Although there is still some time before any end-user swaps will be required to be cleared,³ end-users should determine the extent to which they and their transactions are likely to qualify for the End-User Exemption and, to the extent practicable, take the required steps to affirmatively elect that exemption. In particular, end-users that are public companies and thus subject to the requirement of a board resolution, as set out below, should move expeditiously to take the steps required to elect the End-User Exemption.

The End-User Exemption is available to end-users who (i) fulfill reporting requirements by providing to a swap data repository ("SDR") information as to applicability of the End-User Exemption, (ii) do not constitute "financial entities" and (iii) use the applicable swap or swaps "to hedge or mitigate commercial risk."⁴

A. Reporting for Purposes of the End-User Exemption

CFTC regulations require end-users to report information to SDRs indicating that the requirements of the End-User Exemption have been met. This information can be reported on a swap-by-swap basis, in the ordinary course of swap data reporting under the CFTC's recordkeeping and reporting requirements. However, much of this information can instead be reported on a yearly basis by an end-user electing the End-User Exemption.⁵ End-users should lay the groundwork for making the first yearly report.

For public companies, that groundwork includes convening a meeting of "an appropriate committee" of the "board of directors (or equivalent body)" to review and approve "the decision to enter into swaps that are exempt" from mandatory clearing requirements.⁶ As a practical matter, public company end-users should consider taking this action as soon as practicable, given meeting schedules, the need to provide board and committee members with appropriate background materials, and the necessity to timely file the required information with an SDR. The other information permitted to be reported on a yearly basis includes confirmation that the relevant swaps will be used to hedge or mitigate commercial risk and the means by which the party electing the End-User Exemption generally meets its obligations associated with swaps that are not cleared.⁷

² End-User Exception to the Clearing Requirement for Swaps; Final Rule, 77 Fed. Reg. 42560 (July 19, 2012).

³ CFTC regulations make clear that no swap with any non-financial end-user eligible to elect the End-User Exemption (see Part II(B) below) will be required to be cleared earlier than 270 days after the date on which the CFTC determines that swaps of the relevant type must be cleared. See Swap Transaction Compliance and Implementation Schedule; Clearing Requirement Under Section 2(h) of the CEA, 77 Fed. Reg. 44441 (July 30, 2012). To date, the CFTC has made no such determination that any swap must be cleared.

⁴ 17 C.F.R. § 39.6(a).

⁵ See 17 C.F.R. § 39.6(b); Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136 (Jan. 13, 2012), 17 C.F.R. § 45.8.

⁶ 17 C.F.R. § 39.6(b)(1)(iii)(D)(2).

⁷ 17 C.F.R. § 39.6(b)(1)(iii).

The yearly report must be filed before an end-user's electing to use the exemption from mandatory clearing. Swap dealers, which are required to document their reasonable basis to believe that the requirements of the End-User Exemption have been met,⁸ will likely require proof that end-users have made required filings.

B. Entities Eligible to Elect the End-User Exemption

Only end-users that are not "financial entities" may elect the End-User Exemption. In order to qualify as a non-financial entity, an entity must not be:

- a swap dealer or major swap participant;
- a security-based swap dealer or a major security-based swap participant;
- a commodity pool;
- a private fund (a subset of investment companies as defined in the Investment Company Act of 1940);
- an employee benefit plan or governmental plan (as defined under the Employee Retirement Income Security Act of 1974); or
- a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature (as defined under the Bank Holding Company Act of 1956).⁹

An affiliate of an entity that qualifies for the End-User Exemption may itself qualify for the End-User Exemption, but "only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity" and the affiliate is not a swap dealer, major swap participant, commodity pool, investment company of a specified type, or a bank holding company with more than \$50 billion in consolidated assets.¹⁰ Further, certain financing subsidiaries using derivatives to hedge interest rate and foreign currency exposures relating to facilitating the purchase or lease of products manufactured by an affiliate are expressly excluded from the definition of "financial entity."¹¹ Also excluded from the definition of "financial entity" are banks and certain similar entities with total assets of \$10 billion or less.¹²

C. Hedging or Mitigating Commercial Risk

There are three ways in which a swap is deemed to hedge or mitigate commercial risk and therefore falls within the End-User Exemption.

First, a swap is deemed to hedge or mitigate commercial risk when it is "economically appropriate," in the context of the management of a commercial enterprise, to reduce risks arising from such factors as the potential change in the value of the assets, liabilities, services, inputs, products, or commodities of the business, including any such change relating to interest rate or foreign exchange movements.¹³

⁸ See "Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants; Final Rule," 77 Fed. Reg. 55904 (Sept. 11, 2012), 17 C.F.R. § 23.505.

⁹ Commodity Exchange Act ("CEA"), 7 U.S.C. 1, *et seq.*, §§ 2(h)(7)(A) and 2(h)(7)(C).

¹⁰ CEA §§ 2(h)(7)(D)(i) and (ii); see also 77 Fed. Reg. at 42563-64.

¹¹ CEA § 2(h)(7)(C)(iii).

¹² 17 C.F.R. § 39.6(d).

¹³ 17 C.F.R. § 39.6(c)(1)(i).

Second, a swap is deemed to hedge or mitigate commercial risk when it qualifies for hedging treatment under certain specified accounting standards, and such swap is not used for a purpose that is in the nature of speculation, investing or trading.¹⁴

Finally, a swap falls within the End-User Exemption if it qualifies as bona fide hedging for purposes of an exemption from position limits under the CEA.¹⁵

III. Swap Clearing Documentation

If an end-user wishes to enter into cleared swaps, or is not certain that all of its swaps will meet the requirements of the End-User Exemption, that end-user should negotiate documentation to facilitate the clearing of swaps. It would be prudent for end-users to commence these negotiations in the near future if they have not yet started them.

There are three forms of documentation that end-users are likely to have to negotiate. The first of these is the customer agreement for clearing transactions, which typically varies from dealer to dealer. In many cases, this will be the standard futures account agreement offered by a futures commission merchant and some end-users may already be party to such an agreement if they are active in the futures markets. The other two have been jointly published by ISDA and Futures Industry Association (“FIA”). These are the FIA-ISDA Cleared Derivatives Addendum, which supplements the terms of customer agreements in relation to cleared swaps, and the FIA-ISDA Cleared Derivatives Execution Agreement, which addresses contingencies that may arise if a swap is rejected for clearing.

IV. Swap Data Reporting Requirements

CFTC regulations impose an extensive swap data reporting regime, under which market participants are required to report detailed swap transaction data (including with respect to existing swaps) to SDRs.¹⁶ For many non-end-users, including swap dealers and major swap participants, reporting requirements are scheduled to go into effect by January 10, 2013.¹⁷ Non-financial end-users, however, will not have any reporting responsibilities until April 10, 2013, and even then, their reporting responsibilities will be modest, arising primarily in limited circumstances when they face other end-users and agree to be the reporting party for the swap.¹⁸

A. Legal Entity Identifiers

There is, however, one reporting-related requirement that end-users would be prudent to attend to in the near future. One piece of data that will be generally reportable for each swap when the reporting requirements go into effect will be each transacting party’s Legal Entity Identifier (“LEI”). Although the relevant CFTC releases appear to contemplate that not all parties will have obtained LEIs at the time when swap data reporting commences,¹⁹ LEIs are requested as part of the Protocol adherence process and end-users would be well-advised to obtain one in the near future. LEIs are available from DTCC-SWIFT (go to <http://www.ciciutility.org/>).

¹⁴ 17 C.F.R. § 39.6(c)(1)(iii).

¹⁵ 17 C.F.R. § 39.6(c)(1)(ii). However, on September 28, 2012, the United States District Court for the District of Columbia vacated the CFTC’s position limit rule, which by its terms applied to end-users, and remanded it to the CFTC. See International Swaps and Derivatives Association, et al. v. United States Commodity Futures Trading Commission, No. 1:11-cv-02146-RLW, 2012 WL 4466311 (D.D.C. Sept. 28, 2012). The Court’s decision appears to leave open the possibility that the CFTC will be able to impose position limits at a later time. See generally Position Limits for Futures and Swaps, 76 Fed. Reg. 71626 (Nov. 18, 2011), 17 C.F.R. § 150.2.

¹⁶ See Real-Time Public Reporting of Swap Transaction Data, 77 Fed. Reg. 1182 (Jan. 9, 2012); 77 Fed. Reg. 2136; Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 77 Fed. Reg. 35200 (June 12, 2012).

¹⁷ See 77 Fed. Reg. at 1228, 2136 and 35200.

¹⁸ 17 C.F.R. §§ 43.3, 45.8 and 46.5.

¹⁹ See, e.g., 77 Fed. Reg. at 2211, 35231.

B. Other Reporting Considerations

In preparation for the end-user reporting requirements to go into effect in April of next year, end-users should determine for which existing swaps, if any, they will be responsible to report data. In addition, end-users should consider implementing procedures to assure that any reporting obligations are met (or, to the extent practicable, that they will have no reporting obligations).

V. Recordkeeping Requirements

Like the CFTC's reporting requirements, the CFTC's recordkeeping requirements are scheduled to go into effect for end-users on April 10, 2013.²⁰ Under the recordkeeping requirements, end-users are required to keep "full, complete and systematic records" for all new swaps and to retain such records for at least five years following final termination of each new swap.²¹ There are separate recordkeeping requirements for existing swaps.²²

Given the recordkeeping requirements for existing swaps, end-users should retain all records relating to existing swaps. In addition, end-users should consider implementing procedures to assure that recordkeeping requirements are met.

VI. OTC Margining and Custodial Documentation

Margin requirements for uncleared swaps are not yet finalized. Under proposed rules that the CFTC released in April 2011, parties facing swap dealers would be required, subject to applicable thresholds, to post both initial and variation margin.²³ After final margin requirements are established, end-users will need to evaluate their credit support arrangements with their dealer counterparties in light of those requirements and determine whether any adjustments or modifications are necessary or appropriate.

Further, Dodd-Frank gives end-users the right to require that any initial margin they post in relation to OTC swaps be held by a third party custodian.²⁴ If an end-user intends to require a custodial arrangement, it will need to negotiate documentation that achieves this goal and otherwise complies with Dodd-Frank and the regulations thereunder.

VII. Large Trader Reporting

Although they are likely to be applicable to only a small subset of end-users, end-users should be aware of books and records requirements in relation to "large traders" of swaps relating to physical commodities.²⁵

The books and records requirements apply to every person who trades in swaps which, when converted into futures equivalent positions in specified futures contracts in accordance with the CFTC's methodology, exceed a specified amount. All such traders in such swaps are required to keep books and records showing all records for the swap and swaption transactions resulting in such positions, transactions in the cash commodity underlying such positions, and all commercial activities that are hedged by such positions.²⁶ The books and records requirements are currently in effect.

²⁰ 77 Fed. Reg. at 2136, 35200.

²¹ 17 C.F.R. §§ 45.2(b), 45.2(c).

²² 17 C.F.R. § 46.2.

²³ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (April 28, 2011), 17 C.F.R. §§ 23.151, 23.155 and 23.156.

²⁴ CEA § 4s(l).

²⁵ Large Trader Reporting for Physical Commodity Swaps, 76 Fed. Reg. 43851 (July 22, 2011).

²⁶ 17 C.F.R. § 20.6(c).

VIII. Potential Benefits to End-Users

Given the extent and complexity of the CFTC's regulations, it is possible to lose sight of the fact that the regulations are motivated, in part, by a desire to level the playing field between swap dealers and end-users and better allow end-users to mitigate their risks in relation to dealers. The CFTC's regulations include requirements that a swap dealer:

- prior to entering into a swap, disclose to its counterparty material information to allow the counterparty to assess the dealer's incentives, including a mid-market mark of the relevant swap;²⁷
- in certain circumstances, provide its counterparty with a scenario analysis that covers a range of assumptions, including severe downside stress scenarios;²⁸ and
- upon a request by a counterparty prior to entering into any swap, provide to such counterparty a written statement of all terms of the swap, other than pricing and other terms to be agreed upon entering into the swap.²⁹

End-users should also take some comfort from the added protections afforded by the cleared swap environment and from the possibility that final CFTC regulations may require swap dealers to post collateral to end-users. End-users should also be aware, however, that the additional costs and burdens of complying with the new Dodd-Frank regime, particularly the increased margin and capital costs associated with swaps activities, may negatively affect liquidity and pricing in the swaps market and thus to some degree offset these benefits.

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²⁷ 17 C.F.R. §§ 23.431(a), 23.431(d).

²⁸ 17 C.F.R. §§ 23.431(b).

²⁹ 17 C.F.R. § 23.501(a)(3)(iii).

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