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# DODD-FRANK DERIVATIVES 101: WHAT IN-HOUSE COUNSEL NEEDS TO KNOW NOW

So—you are in-house counsel to a company that, either occasionally or on a regular basis, enters into swaps. Perhaps you're hedging interest rate or currency risk, or maybe you're even using derivatives to address credit risk on some of your major customers. You've been hearing a lot about "Dodd-Frank," but you're not sure whether it will affect you—after all, you haven't seen too many changes in the two years since Dodd-Frank was enacted. Is there anything you really need to know?

Unfortunately, the answer to that question is "yes." The development and publication of final rules implementing the derivatives provisions of Dodd-Frank have taken longer than Congress anticipated, but we are finally entering the home stretch. You will start seeing changes to swap documentation within the next few months, and you will need to begin to address reporting, recordkeeping, and clearing requirements by early 2013.

## THE BASICS

Dodd-Frank took the derivatives market from an effectively unregulated market (at least for entities that qualified as "eligible contract participants") to a regime in which virtually all swaps are regulated by either the Commodity Futures Trading Commission (the "CFTC") or the Securities and Exchange Commission (the "SEC"). Some swaps (called "mixed swaps") will actually be regulated by both regulators. Eventually, many swap transactions will have to be cleared through central clearinghouses and traded on designated contract markets, on swap execution facilities, or on national securities exchanges rather than being executed bilaterally as they are today. This shift will be phased in over time as the CFTC and SEC designate particular types of swaps for clearing, and the change will result in a major shift in how swaps are negotiated and executed. Importantly, however, the law and the regulations issued by the CFTC with respect to swaps regulated by the CFTC contain an exception to the clearing and trading

mandates for swaps executed by "end-users" under certain circumstances.[1]

## THE END-USER EXCEPTION: WHAT'S IN A NAME?

Does your company qualify as an "end-user" that can take advantage of the exception? The short answer is, "it depends"—on both your company and the swap in question. To qualify, (i) your company must not be a "financial entity," (ii) you must be using the swap to hedge or mitigate commercial risk, and (iii) you must satisfy certain reporting and board approval requirements.

**Are You a Financial Entity?** "Financial entities" for purposes of the exception include certain types of entities that are subject to special regulation under Dodd-Frank, including swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants. If your company is not (i) engaging in swap transactions with a gross notional amount in excess of $8 billion annually, (ii) engaging in uncollateralized rate swaps having an outward exposure (that is, negative mark-to-market value) exceeding $3 billion (or $1 billion in the case of credit, equity, or commodity swaps), or (iii) creating more than $5 billion of average daily uncollateralized outward exposure aggregated across all of your swap positions, chances are you don't need to worry about falling into one of these categories (although you can certainly check with your legal advisors to be sure). "Financial entities," however, also include commodity pools, private funds (e.g., companies that are utilizing the 3(c)(1) or 3(c)(7) exclusions under the Investment Company Act of 1940), certain employee benefit plans, and entities predominantly engaged in activities that constitute the business of banking or are financial in nature, as defined in section 4(k) of the Bank Holding Company Act. Thus, you will need to make sure your company does not fall into one of these categories if you want to use the exception. Captive finance companies, broadly defined as entities whose primary business purpose is to provide financing and that use derivatives for the purpose of hedging underlying commercial risks related to interest rate and currency fluctuations of financed products manufactured by affiliates, are excluded from the definition of "financial entity," as are banks, savings associations, farm credit system institutions, and credit unions with total assets of less than $10 billion.

What if you have a family of companies, some of which might fall into the definition of "financial entity" and some of which might not? An affiliate that is a financial entity may avail itself of the exception when, as agent for a nonfinancial entity affiliate, it enters into an otherwise qualifying swap. In order to claim the benefit of this rule, the financial entity affiliate may not be a swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, private fund, commodity pool, or bank holding company with more than $50 billion in consolidated assets.

**Are You Using Swaps to Hedge or Mitigate Commercial Risk?** If your company is not a financial entity, the second hurdle you must cross to take advantage of the end-user exception is the requirement that your swap is being used to hedge or mitigate commercial risk. To meet this requirement, a swap must be economically appropriate to the reduction of the following risks in the conduct and management of your business:

- Potential change in the value of assets that your company owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course;
- Potential change in the value of liabilities that your company has incurred or reasonably anticipates incurring in the ordinary course;
- Potential change in the value of services that your company provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course;
- Potential change in the value of assets, services, inputs, products, or commodities that your company owns, produces, manufactures, processes, merchandises, leases, or sells or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course;
- Potential change in value related to any of the foregoing arising from interest, currency, or foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or

- Any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities.

Alternatively, if a swap qualifies as bona fide hedging for purposes of an exemption from position limits under the Commodities Exchange Act or qualifies for hedging treatment under certain financial accounting standards, it would also satisfy the requirement that it be used to hedge or mitigate commercial risk.

However, it is important to note that even if your swap satisfies one of the tests above, it will be deemed not to satisfy the hedging/mitigation requirement if the swap is used for a speculative, investing, or trading purpose or is used to hedge or mitigate the risk of another swap or security-based swap position, unless that other position is itself used to hedge or mitigate commercial risk.

Finally, in order to use the end-user exception to opt out of the Dodd-Frank clearing and trade execution requirements, you must satisfy certain reporting and board approval requirements, which are further described below.

## REPORTING AND BOARD APPROVAL REQUIREMENTS FOR END-USERS

**Reporting.** In order to use the end-user exception to clearing and exchange trading, one of the parties to the swap (as determined by the CFTC's swap data reporting rules discussed below) must provide specific information about the swap to a registered swap data repository (an "SDR") or, if no SDR is available, directly to the CFTC. The following information must be reported on a swap-by-swap basis:

- Certain information about the swap terms, parties, etc.;
- Notice of the election to utilize the exception; and
- The identity of the counterparty electing to use the end-user exception.

If one of the parties to the swap is a swap dealer, it will be the reporting party for this information. However, CFTC rules require a swap dealer reporting information about a swap executed pursuant to the end-user exception to have a reasonable basis for believing that its end-user has satisfied the requirements for electing the end-user exception. Therefore, it is likely that swap dealers will require that end-users deliver representations to the swap dealers confirming, among other things, that the requirements for taking advantage of the end-user exception have been satisfied.

Additional information must be reported either on a swap-by-swap basis or, at the end-user's election, may be reported by the end-user directly to the CFTC annually in anticipation of electing the end-user exception for swap activities:

- Whether the electing counterparty is a "financial entity" that is permitted to make the election (and if so, what exception it is using);
- Whether the swap or swaps for which the electing counterparty is electing the exception are used by the electing counterparty to hedge or mitigate commercial risk as required by the exception;
- How the electing counterparty generally meets its financial obligations associated with entering into uncleared swaps (specifying one or more of the following categories: written credit support agreement, pledged or segregated assets, written third-party guarantee, general available financial resources, or other means); and
- Whether the electing counterparty is an issuer of securities registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") or required to file reports pursuant to Section 15(d) of the Exchange Act (if so, such entity must provide its SEC Central Index Key and confirmation that an appropriate committee of the entity's board of directors or governing body has reviewed and approved the entity's decision to enter into the swap(s) in question).

Your swap dealer counterparties may not be willing to fulfill these more entity-specific reporting requirements, so you may want to consider taking advantage of the option to file this information yourself. An annual filing will be valid for 365 days following the date of the filing, but the end-user company is responsible for amending and updating the reporting provided on the filing as necessary.

**Board Approval Requirements.** As noted in the discussion on reporting above, if your company is an issuer of securities registered under Section 12 of the Exchange Act or required to file reports pursuant to Section 15(d) of the Exchange Act (an "SEC Filer"), an "appropriate committee" of your company's board of directors or governing body must review and approve the company's decision to enter into uncleared swaps. How and when should you satisfy this requirement? There are multiple considerations.

One key issue is determining the "appropriate committee." You will need to review your company's existing corporate governance policies and committee charters to see if they provide any guidance. To the extent that these documents do not provide an answer, the board will have the ability to determine which committee is appropriate. You may want to consider whether any of the standing committees—typically audit, compensation, and nominating—are appropriate, or whether you should establish a new, specially created committee. If the board already has one committee that oversees the company's risk management, that might be a logical choice. For some companies, this might be the standing risk management committee or risk oversight committee, while for others the audit committee might oversee risk. Further, you will need to decide whether the committee to be used depends on the swap at issue. If your company has a finance committee, should that committee handle the financial swaps (e.g., interest rate and credit swaps) while the commodity swaps are handled by the audit committee, or is it better to have all of the issues addressed by the same committee? In any event, the committee or committees should be specifically authorized by the board. The CFTC's adopting release states, "[t]he Commission considers a committee to be appropriate if it is specifically authorized to review and approve the SEC Filer's decision to enter into swaps."

Another issue for companies with multiple subsidiaries is which entity's committee must approve the use of the exception. Many companies are publicly traded holding companies that conduct their operations through their subsidiaries. Does the board of the ultimate parent (the SEC Filer) need to authorize uncleared swaps on behalf of all of its subsidiaries, or are the boards of the subsidiaries responsible for this? The CFTC's adopting release suggests that a committee of the board of the ultimate parent can make the determination for its affiliates and subsidiaries, but that it is not required to do so ("The SEC Filer's board would have reasonable discretion to determine the appropriate committee for approving decisions on swaps for its subsidiaries or affiliates."). Thus, theoretically, a subsidiary that directly enters into swaps in its own name (which would be considered an SEC Filer because it is controlled by an SEC Filer parent) could make its own determination with respect to its swap activities (via committee action). The decision as to which committee should make the required election should be made in the context of the overall risk management policies of the organization. This may require that all decisions on swap clearing be made by the parent board regardless of size, or it could permit action by a subsidiary board with respect to all or some of its own swaps within specified limits. If a subsidiary board takes its own actions with respect to uncleared swaps, it would be prudent to have the board of the ultimate parent designate such board or committee as the appropriate committee for approving decisions on swaps for that subsidiary.

Once you figure out which committee needs to provide the approval, you will have to address the nuts and bolts of that approval. The determination of the committee will need to be a thoughtful one and will need to weigh the pros and cons of cleared and uncleared swaps—if a major counterparty default occurs on an uncleared swap following a committee's election to utilize the end-user exception, the decision-making process could be subjected to scrutiny. A well-crafted presentation to the committee, together with robust discussion, may be advisable. The committee will have to decide whether to elect the end-user exception on a global basis (for all qualifying swaps executed by the entity) or whether to establish policies to determine when to clear and when to elect the end-user exception on a swap-by-swap basis.

It is important to note that one committee meeting will not be enough. At a minimum, the CFTC has indicated that it believes that the committee should review its policy on the use of swaps subject to the end-user exception at least annually (most likely to coincide with the updated

annual certification provided by the end-user to the CFTC), with such review to occur more often if there is a triggering event such as a change in hedging strategy. In addition, because rules that will affect a decision to choose cleared or uncleared swaps, including rules such as margin and capital requirements that are likely to affect the relative cost of such swaps, have not all been finalized at this point, rendering a comprehensive, thoughtful decision for all swaps at the initial meeting may prove difficult. Further, the move to mandated clearing (and therefore the requirement for board/committee approval of uncleared swaps) will occur on a product-by-product basis. For each particular type of swap (e.g., standard interest rate swap, single name credit default swap, etc.), the regulators will make a determination about whether such swaps must be cleared, followed by a phase-in period after which clearing will be obligatory for that type of swap. It may therefore be prudent to plan for multiple committee actions during the initial change-over period, to address additional information and clearing mandates as they become available, with at least annual committee actions thereafter.

## ARE INTER-AFFILIATE SWAPS EXEMPT?

Many affiliated groups of companies centralize their external swap relationships into one entity and then execute inter-affiliate swaps as necessary to achieve desired economic and hedging results for their subsidiaries/affiliates. If this describes your company, you may be wondering whether the new clearing rules apply to your inter-affiliate swaps. Without an exemption from the CFTC, these inter-affiliate swaps will be subject to the clearing requirements described in this *Commentary*, and you will need to use the end-user exception to exempt such inter-affiliate swaps (if possible). However, on August 16, 2012, the CFTC released a proposed rule that would allow counterparties to certain inter-affiliate swaps to elect not to clear such swaps if the financial statements of both counterparties are reported on a consolidated basis. Under the proposal, to be exempted as an inter-affiliate swap, the swap must be documented in writing and subject to a centralized risk management program, and the parties to the swap may be required to pay and collect variation margin if they are "financial entities." Affiliates claiming this exemption are also required to satisfy one of four additional conditions: the affiliate is located in the United States; the affiliate is located in a jurisdiction with a comparable and comprehensive clearing requirement; the affiliate is required to clear all swaps it enters into with non-affiliate counterparties; or the affiliate does not enter into swaps with nonaffiliate counterparties. These swaps will still be subject to reporting and board approval requirements described in the proposed rule (which appear in large part to mirror the end-user exception reporting requirements).

While this is a proposed rather than final rule at this point, it should provide some comfort to companies concerned about inter-affiliate swaps. You should consult with your legal advisers to determine whether the proposed exemption will adequately protect your company's inter-affiliate swaps and to determine what compliance mechanisms will need to be put in place to satisfy the reporting obligations for these types of swaps. As the rule develops from a proposed to a final rule, you should also consider whether the end-user exception or the inter-affiliate swap exemption will be more advantageous for your company; if both exemptions are available, you may want to choose the exemption that imposes the least onerous reporting requirements. It is important to realize that for inter-affiliate swaps, regardless of whether the end-user or affiliate exemptions are used, the full reporting burden (discussed later in this *Commentary*) will fall on your company as there is no swap dealer involved to shoulder the load.

## DOCUMENTATION CONSIDERATIONS FOR EXEMPTED SWAPS

Even if your company elects to use the end-user exception for its swaps and thus avoids the mandatory clearing requirements, Dodd-Frank is likely to have an impact on your swap documentation. New business conduct, disclosure, know-your-customer, and reporting requirements imposed on swap dealers will require them to provide additional information to your company and collect additional information from your company. These new requirements will need to be reflected in your existing and new ISDA Master Agreements. In August, ISDA published the "August 2012 DF Protocol" as a

proposed way to amend ISDA and other master agreement documentation to address many of these new requirements; it remains to be seen how many parties choose to amend their documentation by way of adherence to the August 2012 DF Protocol and how many choose to make changes on a bilateral basis (or to employ a combination of the Protocol and side letters). A second ISDA protocol, intended to address swap documentation requirements and the end-user exception, is currently in draft form and is expected to be released by the end of November. In addition, under the new rules, swap dealers will be required to implement credit support arrangements that comply with margin regulations with end-user counterparties, which may result in changed or additional credit support documentation. Finally, swap dealers may need to negotiate additional modifications to swap documentation with end-users in order to comply with the internal business standards relating to trade documentation that are being applied to swap dealers and major swap participants. You can be sure that your swap dealer counterparties will be bringing up the issue of updating documentation with your company soon, if this discussion has not already taken place. Generally speaking, your existing swap documents with your swap dealer counterparties will need to be modified, via the Protocol or otherwise, by the end of the year.

## TO CLEAR OR NOT TO CLEAR

Even if the end-user exception applies to a particular swap to be executed by your company, Dodd-Frank is likely to influence the terms and manner of execution of your swap. Swap dealers who enter into swaps with your company will be required to comply with new requirements set forth by their regulators. The capital requirements imposed on uncleared swaps are expected to be higher than the capital requirements imposed on cleared swaps, so dealers may charge their customers a premium when executing uncleared swaps. Further, swap dealers will be required to put credit support arrangements in place with respect to the uncleared swaps executed with your company. If you have not previously been required to put these arrangements in place with your swap counterparties, this will require negotiation of additional documentation. In connection with the new credit support requirements, swap dealers may require your company to post new or additional amounts of collateral.[2] Additionally, as discussed earlier, you may need to obtain board review and approval in order to enter into uncleared swaps. Given these additional costs and potential compliance burdens, you may conclude that the potential costs of bilateral execution exceed the relative costs of central clearing and exchange-style execution. Said another way, these requirements and changes could actually make it cheaper for you to execute a cleared swap even if you are an end-user.

If you choose (or are required) to use cleared swaps, a separate set of considerations will apply. Once Dodd-Frank is fully in effect, rather than going to your swap dealer for a price (as you would in the current market), you will need to obtain a price from a swap execution facility. Once you have agreed on a price for your trade, you will need to have a registered intermediary (futures commission merchant, broker, swap dealer, or security-based swap dealer, as applicable based on the type of swap and your existing relationships) submit your trade for you to a clearinghouse. Rather than executing a confirmation under an ISDA Master Agreement, a trade confirmation will be prepared at the clearinghouse level. The documentation executed by your company will reflect the arrangement between the intermediary and your company, and it is likely to look very much like a futures and options agreement (in fact, it may well be in the form of an addendum to any existing futures and options agreement you might have). For a cleared swap, the clearinghouse will set minimum initial and variation margin posting requirements, but your intermediary may well impose requirements in excess of those imposed by the clearinghouse on your company. If you expect to use cleared swaps, you need to start negotiating these new arrangements with intermediaries, and you need to carefully choose your counterparties, as the terms of the standard futures and options agreements used by these entities can vary significantly.

## REPORTING AND RECORDKEEPING OBLIGATIONS

Other than the reporting obligations highlighted above that are required in connection with the use of the end-user exception, most reporting obligations relating to your company with respect to swaps with third parties are likely to fall on your swap dealer counterparties. However, if you choose to enter into uncleared swaps with entities that are not themselves swap dealers or major swap participants,[3] including inter-affiliate swaps, either your company or your counterparty will be required to report certain information about those swaps to a swap data repository in electronic form both initially and on an ongoing basis (including quarterly mark-to-market valuations of the swaps). Thus, if you engage in any inter-affiliate swaps or any swaps with other end-users, you will need to put systems (and potentially third-party service providers) in place to comply with these reporting requirements. You will also need to report all previously executed inter-affiliate or end-user-to-end-user swaps by April 10, 2013, although the reporting requirements for these swaps are a bit more relaxed (electronic submission of images of documents will be permitted, for example).

To facilitate compliance with swap data reporting requirements, all swap participants must have legal entity identifiers (initially, CFTC Interim Compliant Identifiers or "CICIs"). DTCC-SWIFT has been appointed by the CFTC to provide CICIs to participants. Companies will have to register with DTCC-SWIFT to obtain a CICI. Companies can self-register or can request that a third party, such as a dealer, register and obtain a CICI on their behalf.

In addition, regardless of the identities of your counterparties, your company will be required to keep full, complete, and systematic records with respect to each of its swaps. These records must be kept until at least five years after the swap has terminated and are subject to inspection by the CFTC; records with respect to any particular swap must be accessible within five business days of a request for the records. You should review your current recordkeeping practices and standards to confirm whether any changes may be needed.

## TIMING TO NOTE

If your company continues to actively engage in swaps, you should expect to see requests from your dealer counterparties to update or revise documentation very soon. Swap dealers are required to comply with the new business conduct, disclosure, and swap reporting obligations starting on the date on which they register as swap dealers, which is expected to be the end of the year for most swap dealers. These swap dealers will be looking to execute any changes to your existing ISDA documentation that they believe are required prior to that time.

The clock is also ticking with respect to clearing requirements for end-users. The CFTC's initial proposed clearing determination (for interest rate and credit swaps) was published in the Federal Register on August 7, 2012. The CFTC has up to 90 days from the date of its proposed clearing determination to finalize the terms of its proposal. Accordingly, the clearing mandate for these swaps is expected to be finalized in late November. Generally, end-users will be required to clear their trades in swaps of the type subject to the clearing mandate within 270 days of the finalization of this mandate (expected to be September 2013).

Finally, your company will be required to comply with the new recordkeeping and reporting requirements (including CICI registration) by April 10, 2013.

Unfortunately, it is also important to note that the foregoing discussion generally applies to swaps regulated by the CFTC but not to swaps regulated by the SEC. While similar clearing requirements and end-user exceptions are expected to be adopted for SEC-regulated swaps, the SEC has been slower than the CFTC in issuing final regulations addressing these issues. Accordingly, your company will need to revisit these issues when SEC rulemaking becomes final.

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## ENDNOTES

1 Comparable regulations relating to the "end-user" exception for swaps regulated by the SEC ("security-based swaps"), which generally consist of swaps based on a single issuer, security, or loan (including single-name credit default swaps) and swaps based on security indexes including nine or fewer issuers, have not yet been issued. Accordingly, this *Commentary* describes the end-user exception available for swaps regulated by the CFTC (which generally include all swaps other than those regulated by the SEC).

2 Current draft regulations for swap dealers regulated by the prudential regulators (Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency) require collection of margin from end-users above certain threshold amounts, while current draft regulations for entities regulated by the CFTC do not require collection of margin from end-users but do require collateral arrangements to be in place. Even if not required by the final regulations, swap dealers may decide they need to collect additional amounts of collateral.

3 (or, with respect to security-based swaps, security-based swap dealers, or major security-based swap participants)