Derivatives Rules under the Dodd-Frank Act Affecting End-Users – An Update

- CFTC End-User Exception from Clearing and Exchange Trading
- Proposed Guidance on Cross-Border Application of Swap Rules
- Proposals on Swap Margin Requirements
- End-User Reporting and Recordkeeping Requirements

August 6, 2012

BACKGROUND – THE DODD-FRANK ACT

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) provides for new Federal regulation of the swaps market, and, when fully implemented, is expected to make fundamental changes in the way the swaps market operates. Title VII seeks to reduce systemic risk, increase transparency and improve efficiency in the swaps market by requiring centralized clearing and exchange trading of swaps as well as real-time and regulatory reporting of swap transactions. Under the Dodd-Frank Act, the Commodity Futures Trading Commission (the “CFTC”) will regulate most swaps on interest rates, commodities and currencies and the Securities and Exchange Commission (the “SEC,” together with the CFTC, the “Commissions”) will regulate swaps, including equity and credit default swaps, on single securities and narrow-based securities indices. The term “swap” is defined broadly in the Dodd-Frank Act, and includes certain foreign exchange transactions, such as non-deliverable foreign currency forwards, that may not be characterized as swaps for other purposes.

Generally, the Dodd-Frank Act contemplates transforming the “over-the-counter” market for swaps, in which swap counterparties transact privately, entering into bilateral transactions involving ongoing credit exposure to a single counterparty on negotiated collateral terms, into a market that will bear a strong resemblance to today’s futures markets, including standardized terms and daily “mark to market” cash margin requirements. Because of the sweeping nature of these changes, the market transition contemplated by the Dodd-Frank Act is expected to take several years to be implemented fully. While most of its provisions are directed at “swap dealers” and “major swap participants,” the Dodd-Frank Act will affect all companies that use swaps to hedge exposures in their businesses. Moreover, certain provisions are directed specifically at swap “end-users.”

1 Title VII of the Dodd-Frank Act is codified in scattered sections of the Commodity Exchange Act, 7 U.S.C. § 1 et seq.


3 For details on the definitions of the terms “swap dealer,” “security-based swap dealer,” “major swap participant” and “major security-based swap participant” see the joint SEC and CFTC rulemaking “Further Definition of ‘Swap Dealer,’ ‘Security-Based Swap Dealer,’ ‘Major Swap Participant,’ ‘Major Security-Based Swap Participant’ and ‘Eligible Contract Participant,’” 77 FR 30596 (May 23, 2012).
In this memorandum we discuss:

- **The CFTC End-User Exception**, which provides an exception from the CFTC’s mandatory clearing and exchange trading rules for entities that (i) are not “financial entities,” (ii) are using a swap to “hedge or mitigate commercial risk” and (iii) notify the CFTC of certain information about their eligibility for the exception. The exception also requires SEC reporting companies to obtain “appropriate board committee approval” of the decision to utilize the exception.

- **Proposed CFTC Guidance on the Cross-Border Application of the Swaps Rules**, which would, among other things, (i) define the term “U.S. Person” and (ii) clarify the application of the CFTC’s derivatives rules under the Dodd-Frank Act to non-U.S. Persons, including the application of the mandatory clearing, exchange trading and reporting rules where one party is a non-U.S. Person.

- **Proposals to Require End-Users to Post Margin for Over-the-Counter Swaps**, which would require end-users to establish marginging arrangements and possibly post and collect margin for all over-the-counter swaps, although the CFTC may soon issue a proposal that may alter this requirement for inter-affiliate transactions.

- **General End-User Recordkeeping and Reporting Requirements**, which will require end-users to maintain certain records, provide certain information to swap dealers for reporting to a swap data repository (“SDR”) and themselves report information regarding historical and new swaps between their affiliates or with other end-users.

**CFTC END-USER EXCEPTION FROM MANDATORY CLEARING AND EXCHANGE TRADING OF SWAPS**

On July 10, 2012, the CFTC adopted final rules addressing the circumstances in which a particular swap would be entitled to the “end-user exception” from mandatory clearing and exchange trading (the “CFTC End-User Rule”). Though the SEC issued proposed end-user rules for security-based swaps (the “Proposed SEC Rule”) in December 2010, when the CFTC also issued its proposed end-user rules, the SEC has yet to issue any final rules on the end-user exception.

**Overview**

Under the Dodd-Frank Act, an entity may invoke the end-user exception with regard to a swap transaction only if that entity:

- is not a “financial entity,”
- is using swaps to hedge or mitigate commercial risk, and
- notifies the relevant Commission in the manner specified by each Commission as to how the counterparty meets the financial obligations of entering into a non-cleared swap transaction.

In addition, any SEC reporting company, or, as noted below, controlled persons (collectively referred to as “SEC Filers”) wishing to avail itself of the end-user exception may do so only if an appropriate committee of the SEC Filer’s board or governing body has reviewed and approved its decision to enter into swaps that are subject to the end-user exception from mandatory clearing and exchange trading.

The CFTC End-User Rule will become effective on September 17, 2012. However, even after the CFTC End-User Rule becomes effective, the CFTC notes that compliance “will not be necessary or possible until swaps become subject to the clearing requirement.” The CFTC’s clearing implementation schedule provides that a clearing requirement for a particular class or type of swaps will become effective for swaps involving a non-financial end-user party no less than 270 days after the effective date of a final clearing requirement determination for that particular class of swaps. Non-financial end-users will have 270 days after the effective date of a final clearing requirement determination as to a particular swap class or type to meet the requirements of the exception in the

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6 See “Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA,” 77 FR 44441 (July 30, 2012).
CFTC End-User Rule or comply with a clearing requirement for swaps in the covered swap class or type. The CFTC has recently issued its first proposed determination of mandatory clearing, relating to interest rate swaps and index-based credit default swaps. End-users would have 270 days after the CFTC publishes a final version of that clearing determination to prepare to meet the requirements of the End-User Rule. However, swap dealers will be required to report their swap transactions well before that time. As a result, swap dealers are likely to begin to gather supporting documentation from end-users over the next several months.

We generally expect that most companies that are not financial institutions will qualify for the end-user exception for most of the swaps they routinely use to hedge business risks, such as interest rate and commodity risks. It is, however, difficult to predict at this time how extensively this exception will be used. The need to consider use of the end-user exception will be driven in the first instance by whether the desired transaction is one that the Commissions have determined must be cleared and that a clearinghouse has agreed to clear. The CFTC’s first proposed determination of mandatory clearing relates to classes of swaps that are, in part, already being centrally cleared on a voluntary basis. However, it is not clear how rapidly final mandatory clearing determinations will be made and how broadly they will apply, particularly for those classes of swaps that are not currently centrally cleared. A particular swap or type of swap may continue to be traded over-the-counter, without regard to the applicability of the end-user exception, until a mandatory clearing determination covering that particular class or type of swap is fully effective.

Companies faced with the choice of whether to enter into a cleared and exchange-traded swap versus an over-the-counter non-cleared swap would, we expect, make their decisions mainly on the basis of commercial considerations of cost (including the cost of posting margin for a cleared swap or potentially providing collateral or other credit support for an over-the-counter swap), liquidity (the cleared and exchange-traded swap should be more liquid than an over-the-counter transaction), credit risk (to the clearinghouse or the swap dealer) and the relative effectiveness of the available transactions to hedge the risk sought to be mitigated.

Below, we discuss how the CFTC End-User Rule addresses each of the above requirements that entities must meet to invoke the end-user exception with respect to a particular swap transaction.

**Eligibility as “not a financial entity”**

The end-user exception requires that the party invoking the exception must not be a financial entity as defined in the Dodd-Frank Act. The term financial entity means:

- a swap or security-based swap dealer,
- a major swap or security-based swap participant,
- a commodity pool as defined under the Commodity Exchange Act (the “CEA”),
- a private fund as defined in the Investment Advisers Act of 1940,
- an employee benefit plan as defined in the Employee Retirement Income Security Act of 1974, or

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7 The CFTC proposed clearing requirement determination as to interest rate swaps sets forth several broad specifications for each of four core types of interest rate swaps as to which a clearing requirement would apply, and requires the parties to any particular swap meeting of these broad specifications to verify whether a designated clearing organization approved by the CFTC (a “DCO”) will clear the particular swap. The requirement to “use reasonable efforts to verify whether a swap is required to be cleared” would appear to apply to both parties to a swap from the time a clearing requirement applies. However, the CFTC’s proposal would require the CFTC to post on its website a list of swaps that are required to be cleared and a list of eligible DCOs; each DCO would also be required to post a list of swaps it would accept for clearing. See “Clearing Requirement Determination under Section 2(h) of the CEA,” available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister072412.pdf.
• a person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in the Bank Holding Company Act of 1956 (the “BHC Act”), including, for example, engaging in investment transactions, including derivatives transactions, as a principal). 8

As discussed below, there are limited exceptions for certain finance affiliates and other entities.

**Hedging or Mitigating Commercial Risk**

The CFTC End-User Rule defines swaps that hedge or mitigate commercial risk and clarifies that the determination of whether a particular swap is used to hedge or mitigate commercial risk will be made on a swap-by-swap basis at the time the swap is entered into. The CFTC rejected an element of the Proposed SEC Rule, which would require companies to fulfill a specific documentation requirement to demonstrate the effectiveness of the hedge position of each security-based swap.

The CFTC End-User Rule provides that a swap is used to hedge or mitigate commercial risk if:

1) The swap meets one of the following three tests:

   a) The swap is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from:

      i) the potential change in the value of assets that a person owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of business of the enterprise;

      ii) the potential change in the value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise;

      iii) the potential change in the value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise;

      iv) the potential change in the value of assets, services, inputs, products, or commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of business of the enterprise;

     v) any 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

     vi) any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person’s current or anticipated assets or liabilities; or

   b) the swap qualifies as bona fide hedging for purposes of an exemption from position limits under the CEA; 10 or

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8 Agencies have taken a broad view of the activities that are “in the business of banking” or “financial in nature.” In February 2011, the Board of Governors of the Federal Reserve published a notice of proposed rulemaking defining the term “Predominantly Engaged in Financial Activities” for the purpose of determining whether a non-bank financial company “could pose a threat to the financial stability of the United States” and should be subject to oversight by the Financial Stability Oversight Council established under Title I of the Dodd-Frank Act. See “Definitions of ‘Predominantly Engaged in Financial Activities and ‘Significant’ Nonbank Financial Company and Bank Holding Company,” 76 FR 7731, at 7731 (February 11, 2011) (the “February 2011 NPR”). In response to comments on February 2011 NOPR, the Board of Governors published a supplemental notice of proposed rulemaking clarifying the scope of activities that would be considered to be “financial activities” for purposes of the February 2011 NOPR. See “Definition of Predominantly Engaged in Financial Activities,” 77 FR 21494 (April 10, 2012) (the “April 2012 NOPR”). Amended Regulation Y, as proposed in the April 2012 NOPR, includes among a list of enumerated financial activities “engaging as a principal in foreign exchange…[and] forward contract, options, futures, options on futures, swaps and similar contracts, whether traded on exchanges or not, based on any rate, price financial asset…nonfinancial asset or group of assets.” Id. at 21503. Both the February 2011 NOPR and the April 2012 NOPR also state that a company is “predominantly engaged” in financial activities if over 85% of either consolidated revenues or consolidated assets of the company and all of its subsidiaries derive from such activities. Id. at 21495.

9 The CFTC also states that portfolio and dynamic hedging may be economically appropriate and could therefore qualify under this requirement.

10 These exemptions are set forth in Section 737(c) of the Dodd-Frank Act, 7 U.S.C. § 6A(c). See also “Position Limits for Futures and Swaps,” 76 FR 71626 (November 18, 2011).
c) the swap qualifies for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133) or Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments; AND

2) The swap does not fail either of the following two tests:

a) the swap is not used for a purpose that is in the nature of speculation, investing, or trading; and

b) the swap is not used to hedge or mitigate the risk of another swap or security-based swap position, unless that other position itself is used to hedge or mitigate commercial risk.

**Special treatment for certain entities**

**Financial entity affiliates of non-financial entities**

**Affiliates Acting as Agents:** The Dodd-Frank Act provides that affiliates that are financial entities may invoke the end-user exception for swaps if the entity (1) is an affiliate of a person that qualifies for the end-user exception, (2) acts on behalf of the person that qualifies for the end-user exception **and as an agent** for that person (emphasis added) and (3) uses the swap to hedge or mitigate the commercial risk of the person that qualifies for the end-user exception. Such affiliates may only take advantage of this provision if they are financial entities only by virtue of being engaged in activities that are in the business of banking or financial in nature, as defined under the BHC Act. An affiliate that is a financial entity by virtue of any of the other provisions (for example, as a swap dealer or major swap participant) cannot use the end-user exception. In addition, the requirement that the entity seeking the end-user exception must act “as an agent” for its end-user affiliate greatly limits the usefulness of this provision in the over-the-counter swaps market, which is generally a “principal to principal” market.

**Captive Finance Companies:** Entities whose primary business is providing financing and who use derivatives to hedge underlying commercial risks related to interest rate and foreign currency exposures are specially exempted from the definition of a financial entity and thus may be able to invoke the end-user exception for their swap transactions. For such “captive financing companies” to claim this exception, (i) at least 90% of the these commercial risks must arise from financing that facilitates the purchase or lease of products and (ii) at least 90% of these products must be manufactured by the parent company or another subsidiary of the parent company. In response to commenters, the CFTC clarifies that the second 90% requirement relates only to the final product “manufactured” by a parent company or subsidiary, but does not require that 90% of the components of the final product be manufactured by the parent company or subsidiary. Similarly, the phrase “products” is to be read broadly and may include service, labor, component parts and attachments that are related to the products sold or leased.

**Possible Additional Relief:** In its final release describing the timing for implementation of a particular clearing mandate, the CFTC notes that it will consider the issue of inter-affiliate transactions in an upcoming proposal.

**Small financial institutions**

The CFTC End-User Rule also excludes small financial institutions with less than $10 billion in assets from the clearing requirement. In its discussion of the CFTC End-User Rule, the CFTC pointed out that this exclusion would apply to about 99% of banks, savings associations, farm credit system institutions and credit unions in the United States.

**Foreign governmental entities and multinational entities**

Relying on principles of international comity, the CFTC includes in the release accompanying the CFTC End-User Rule an interpretive statement that exempts foreign governments, foreign central banks, and international financial institutions from the clearing and exchange trading requirement. The discussion emphasizes that such foreign and multinational entities do not fall under the end-user exception; instead, they are not subject at all to the Dodd-Frank Act’s clearing requirement and thus need not hedge or mitigate commercial risk to be exempt from the clearing requirement. However, the discussion does not extend

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11 Under a transitional exception, affiliates, subsidiaries or wholly owned entities of a person that meets the requirements to use the end-user exception are exempt from both clearing and margining requirements. To qualify for this transitional exception, the affiliate, subsidiary or wholly owned entity must be predominantly engaged in providing financing for the purchase or lease of merchandise or manufactured goods of the person that qualifies for the end-user exception. This exception may have expired on July 21, 2012, two years following the enactment of the Dodd-Frank Act; however, the CFTC could choose to extend the period during which this transitional exception can be claimed.
this exemption to sovereign wealth funds and similar entities “due to the predominantly commercial nature of their activities.” The CFTC also did not extend any per se exemption to U.S. state and local government entities, noting that state and local governments are disproportionately engaged in non-financial activities and are accordingly unlikely to be deemed financial entities.

SEC Filers—Board Committee Review and Approval

As stated above, SEC Filers are required to have board or committee approval of the decision to use the end-user exception from mandatory clearing and exchange trading. In the adopting release the CFTC included several clarifications and interpretations of this requirement:

• Although the rule and the Dodd-Frank Act limit the approval requirement to circumstances where the “counterparty” is the “issuer of securities” covered by the registration or reporting requirements of the Exchange Act, in the adopting release the CFTC states that it will adopt the SEC’s approach, as set forth in the release relating to the SEC Proposed Rule that a “counterparty…is considered…to be an issuer of securities…if it is controlled by person that is [such] an issuer of securities.….” Accordingly, subsidiaries and other controlled persons of SEC Filers will themselves be subject to the requirement to obtain board or committee approval.

• A board committee would be appropriate, and may approve the use of the exception for subsidiaries and affiliates, “if it is specifically authorized to review and approve the SEC Filer’s decision to enter into swaps.”

• SEC Filers are not required to obtain board or committee approval on a transaction-by-transaction basis, but instead can approve transactions on a general basis. However, the approval must cover both (i) the exception from the clearing requirement and (ii) the exception from the exchange trading requirement.

• The CFTC stated that it “would expect an SEC Filer’s board to set appropriate policies governing the SEC Filer’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 by the original board approval).”

• As discussed in further detail below, confirmation of board approval would be reported to an SDR or the CFTC either in an annual filing by the party using the end-user exception or on a transaction-by-transaction basis by the party that is required to report each swap transaction relying on the end-user exception.

Companies that anticipate relying on the end-user exception should develop and implement board approval policies so that they are in place before the need to rely on the exception arises. Similarly, companies may also wish to consider making the annual filing described below in advance of the need to rely on the exception to expedite the documentation of their first swap transaction under the end-user exception.

Reporting of Transactions under the End-User Exception

The Dodd-Frank Act requires all transactions in swaps, whether cleared or non-cleared, to be reported to an SDR or, if no registered SDR is available, the appropriate Commission. These general reporting and recordkeeping rules are further discussed below. In addition, the CFTC End-User Rule includes a set of notification requirements specific to the use of the end-user exception. As discussed below, in many cases an end-user will not be the “reporting party.” However, inter-affiliate swaps are subject to the reporting requirements and, in such cases, one of the affiliates will be the reporting party.

The CFTC End-User Rule and the SDR reporting rule described below establish a “check-the-box” reporting format for each swap in which a party relies on the end-user exception. On a transaction-by-transaction basis, the “reporting party” (generally the swap dealer, as set forth below under “General Swap Reporting and Recordkeeping Requirements”) must “check the box” to provide notice of:

• the election of the end-user exception;

• the identity of the party to the swap which is invoking the exception (the “electing counterparty”); and

• whether the electing counterparty has provided an additional set of information about itself by means of an annual filing.
The third item in the “check-the-box” reporting format refers to information about the electing counterparty, listed below, that the CFTC does not expect to change frequently. As a result, the CFTC End-User Rule allows electing counterparties to report this information in an annual filing in anticipation of electing the end-user exception for one or more swaps within 365 days following the date of the report.\textsuperscript{12} However, if the electing counterparty has not made such an annual filing at the time a particular swap transaction occurs, the reporting party for that swap transaction must report the same set of information on a transaction-by-transaction basis. This information is:

- whether the electing counterparty is a financial entity and, if so, under what provision the electing counterparty is eligible for the end-user exception;\textsuperscript{13}
- whether the electing counterparty uses the swap being reported to hedge or mitigate commercial risk;
- how the electing counterparty intends to meet its financial obligations associated with the non-cleared swap by one or more of:
  - a written credit support agreement;
  - pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise);
  - a written third-party guarantee;
  - the electing counterparty’s available financial resources; or
  - means other than those described above;
- whether the electing counterparty is an “SEC Filer” or the electing counterparty is a subsidiary of an SEC Filer, and if so:
  - the SEC Filer’s Central Index Key (CIK) number; and
  - confirmation that an appropriately authorized committee of the board of directors or equivalent governing body of the SEC Filer has reviewed and approved the decision generally to enter into swaps exempt from clearing and exchange trading requirements.

Whether or not the electing counterparty makes an annual filing, reporting counterparties must have a reasonable basis to believe that an electing counterparty meets the requirements for the end-user exception. In its discussion of the CFTC End-User Rule, the CFTC stated that a reasonable basis to believe depends on specific facts and circumstances. For example, a reporting party that has a long-standing business relationship and repeatedly enters into the same hedging transaction with a particular electing counterparty can likely rely on its due diligence for the first hedging transaction to establish a reasonable basis to believe the electing counterparty qualifies for the end-user exception. More in-depth due diligence may be required for reporting parties with a less extensive relationship with the electing counterparty. The CFTC rejected comments that sought to lower the burden on reporting parties by allowing them to rely entirely on the written representations of an electing counterparty in determining whether the electing counterparty qualifies for the end-user exception.

**CROSS-BORDER APPLICATION OF SWAP RULES**

Title VII provides that it does not apply to activities outside the United States unless those activities “have a direct and significant connection with activities in, or effect on, commerce of the United States” or contravene CFTC anti-evasion rules. The CFTC recently issued proposed interpretive guidance regarding the cross-border application of Title VII (the “Cross-Border Proposal”) seeking to

\textsuperscript{12} If appropriate to reflect material changes to the information filed, the annual filings must be updated during the 365-day period after filing.

\textsuperscript{13} As discussed above, certain small financial entities may elect the end-user exception, as may captive financing companies and affiliates acting as agents in certain circumstances.
clarify, among other things, how the Dodd-Frank Act’s derivatives requirements will apply to the activities of non-U.S. subsidiaries of U.S. Persons.\textsuperscript{14}

\textbf{U.S. Person.} The Cross-Border Proposal defines a “U.S. Person” to include any corporation, partnership or limited liability company in which the direct or indirect owners thereof are responsible for the entity’s liabilities if one or more of such owners is a U.S. Person. However, it further states that a foreign affiliate or subsidiary of a U.S. Person would not be considered a U.S. Person, even where a U.S. Person guarantees its swap obligations.

\textbf{Swap Dealers that are not U.S. Persons.} The Cross-Border Proposal clarifies that for non-U.S. Persons, the determination as to whether registration with the CFTC as a swap dealer or major swap participant is required would be made by reference to its activities with U.S. Persons, and would allow substitute compliance with home country (rather than U.S.) regulations in certain cases. The Cross-Border Proposal also addresses the treatment of non-U.S. branches, agencies and affiliates of U.S. swap dealers, and non-U.S. Persons whose swap transactions are guaranteed by a non-U.S. Person.

\textbf{End-User Impact.} For derivatives end-users, the principal impact of the Cross-Border Proposal is to clarify that the CFTC rules requiring mandatory clearing, exchange trading and reporting will generally apply when one party to a swap is a U.S. Person, regardless of the location of the transaction. Specifically:

- a swap between a U.S. end-user and a foreign bank or other entity registered as a swap dealer in the U.S. would be subject to the Dodd-Frank Act’s “transaction level” requirements, including mandatory clearing, exchange trading, real-time public reporting, SDR reporting and trading documentation.

- a swap between a non-U.S. end-user (including the non-U.S. subsidiary of a U.S. Person) and foreign bank registered as a U.S. swap dealer would not be subject to the “transaction level” requirements unless the performance of the non-U.S. end-user were guaranteed by a U.S. Person. However, the Cross-Border Proposal would also apply “transaction level” requirements to swaps of “conduit” foreign entities that are majority owned, directly or indirectly, by a U.S. Person, are consolidated subsidiaries of a U.S. Person for financial statement purposes and regularly engage in swaps with U.S. affiliates.\textsuperscript{15}

\section*{STATUS OF SWAP MARGIN REQUIREMENTS}

\textbf{Cleared Swaps}

Under the Dodd-Frank Act and regulations thereunder, swaps that are cleared by a central clearinghouse will generally be subject to margin requirements, including initial cash margin deposits and variation margin posted daily based on the “mark to market” value of swap positions. Margin requirements would generally be determined by the clearinghouse and its clearing members based on the risk associated with a particular swap, rather than the credit quality of the swap counterparty or its status as an end-user of swaps to hedge commercial risk.

\textbf{Non-Cleared Swaps}

Currently, swap dealers are not subject to any regulatory requirement to collect margin from end-users. If as a function of its commercial judgment and internal credit processes a swap dealer determines to request that a particular swap counterparty post collateral for one or more swap transactions, the swap dealer will negotiate the nature and specifics of the collateral arrangement with that swap counterparty. However, the Dodd-Frank Act directs the CFTC and the banking regulators to impose on swap dealers and major swap participants a requirement to collect margin from their swap counterparties. Though both sets of regulators issued


\textsuperscript{15} For its swaps involving a foreign “conduit” of a U.S. Person or a foreign entity with a U.S. guarantee, a non-U.S. bank registered as a U.S. swap dealer would be permitted to substitute compliance with its home country transctional requirements for compliance with the Dodd-Frank Act’s transaction-level requirements if the home country requirements are found to be “comparable” by the CFTC and, as to SDR reporting, if the CFTC is given access to the foreign trade repository.
proposed margin regulations in the spring of 2011, neither has been finalized to date; the CFTC recently reopened, through September 14, 2012, the comment period for its margin proposal.\footnote{See “Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,” 76 FR 23732 (April 28, 2011) for the CFTC margin proposal and “Margin and Capital Requirements for Covered Swap Entities,” 76 FR 27564 (Apr. 12, 2011) for the margin proposal of the banking regulators. The SEC has not yet proposed margin rules for security-based swap transactions entered into by entities not regulated by the Prudential Regulators.}

The margin proposals of the CFTC and the banking regulators differ, though the differences may be resolved when regulations are finalized. However, from the perspective of end-users, apart from significant differences in theory and approach between the CFTC and the banking regulators, it is somewhat difficult to discern the extent to which the different proposals would, as a practical matter, result in different margin requirements being imposed on end-users. Neither proposal requires the collection of initial margin from end-users that are not financial entities; both proposals allow swap dealers significant discretion to determine variation margin requirements applicable to non-financial end-users. Under the CFTC proposal, swap dealers would not be required to impose specific margin requirements of any kind on end-user swap counterparties, “consistent with Congressional intent.”\footnote{76 FR 23732, at 23736.} The CFTC margin proposal would, however, require that swap dealers enter into “credit support arrangements” documenting the collateral terms negotiated and agreed by the parties, and would require swap dealers and counterparties to comply with the terms of those arrangements.\footnote{The meaning of the term “credit support arrangement” as used in the CFTC margin proposal is not entirely clear. The term is not defined in the CFTC margin proposal. Instead, the CFTC margin proposal states that credit support arrangements should be in place that are consistent with the CFTC’s proposed customer documentation rule released in February of 2011, which specifies that swap trading relationship documentation should be in writing and should (a) contain all terms governing the trading relationship, such as events of default, close-out netting, and governing law, (b) include confirmations of swap transactions and (c) include credit support arrangements, which should themselves incorporate any applicable margin requirements under CFTC or banking regulator margin proposals. See “Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants,” 76 FR 6715 (February 8, 2011).}

On the other hand, the banking regulators’ margin proposal clearly takes the view that the Dodd-Frank Act requires that all non-cleared swaps be subject to risk-based margin requirements, with no “per se” exception for commercial end-users. However, the banking regulators margin proposal permits swap dealers, where they deem appropriate as a function of their credit processes and taking into account the “lesser risk” posed by end-user counterparties, to establish threshold exposures for commercial end-users below which no collateral would be required from the end-user. For non-financial end-users, neither the CFTC proposal nor the banking regulators proposal would prohibit a swap dealer from entering into a “two way” or bilateral margin arrangement in which either the swap dealer or the end-user could be required to deliver collateral to the other party if net exposure exceeds a designated threshold.

The Dodd-Frank Act and regulations thereunder permit end-users to require that any initial margin deposits delivered to swap dealers on non-cleared swaps be segregated and held at a third-party custodian.

\section*{GENERAL SWAP REPORTING AND RECORDKEEPING REQUIREMENTS}

\subsection*{The Reporting Party; SDR Reporting}

The CFTC has issued final rules governing reporting of swap transactions to an SDR for the purpose of facilitating regulatory oversight of the swaps markets (the “SDR Reporting Rule”).\footnote{See “Swap Data Recordkeeping and Reporting Requirements,” 17 CFR Part 45 (January 13, 2012).} The SDR Reporting Rule specifies which party to a swap will be the reporting party, as follows:

- Where only one counterparty to a swap is a swap dealer, the swap dealer is the reporting party.
- Where neither counterparty to a swap is a swap dealer and only one counterparty is a major swap participant, the major swap participant is the reporting party.
- Where neither counterparty is a swap dealer or a major swap participant, but one counterparty is a financial entity, the financial entity is the reporting party.
• With respect to any other swap, the counterparties are to agree as a term of the swap as to which counterparty is the reporting party, except that if only one counterparty is a U.S. Person, the U.S. Person is the reporting party.

The SDR Reporting Rule also mandates that required information be reported as soon as technologically possible after the transaction and in no case later than deadlines established in the SDR Reporting Rule.

Generally, the SDR reporting and recordkeeping requirements applicable to a particular swap are determined based on the date on which that swap is entered into. The requirements in the SDR Reporting rule will become effective for end-users on the date (the “End-User Reporting Date”) which is 240 days after the Federal Register publication of final rules defining the term “swap” and will generally apply to swaps entered into after that date. On May 18, 2012, the CFTC adopted separate reporting and recordkeeping rules that apply to “historical swaps” (the “Historical Swaps Rule”). Historical swaps are comprised of swaps entered into before July 21, 2010 (the date of enactment of the Dodd-Frank Act) and in effect on that date (“pre-enactment swaps”) and swaps entered into between July 21, 2010 and, as to end-users, the End-User Reporting Date (“transition swaps”).

End-User Swaps under the SDR Reporting Rule

As noted above, end-users are unlikely to be the reporting party responsible for transmission of information to the SDR, except as to swaps with other end-users (including affiliates). However, swap dealers and others who will serve as reporting parties will be required to begin reporting information as to their swap activities (including swaps with end-users) as soon as 60 days after the Federal Register publication of a final rule defining the term “swap,” and will likely need to begin to revise their required documentation and processes before that date to enable them to comply with the SDR Reporting Rule. In addition, under the SDR Reporting Rule, both parties to a swap are responsible for keeping records related to the swap.

The SDR Reporting Rule requires that end-users keep “full, complete and systematic records, together with all pertinent data and memoranda” for each swap transaction, including all records demonstrating that the end-user was entitled to rely on the end-user exception from the clearing requirement. These records may be kept in electronic or paper form, must be retained for five years following each swap’s end date, and must be retrievable within five business days during the retention period. The CFTC specifically declined, in response to comments on the proposed reporting rule, to specify the particular documents that must be retained by an end-user, noting that parallel requirements have been in place in the futures market for some time. In the absence of further guidance, we expect that end-users would retain written agreements such as transaction confirmations, master agreements and related agreements such as guarantees and credit support agreements where applicable.

In addition, the SDR Reporting Rule requires that records kept for each swap include a “unique swap identifier,” a number assigned to each individual swap. This identifier is to be assigned by either the SDR, for swaps in which an end-user is the reporting party, or the swap dealer or major swap participant, for swaps in which those entities are the reporting party. Records must also include the legal entity identifier (“LEI,” alternatively known as a “CICI”) assigned to each counterparty to the swap by a CFTC-approved provider using a system approved by the CFTC. On July 23, the CFTC approved DTCC-SWIFT as an interim provider of LEIs for purposes of the SDR Reporting Rule, subject to certain conditions that could lead to DTCC-SWIFT becoming a permanent provider of LEIs. Under the SDR Reporting Rule, reporting parties are required to report a considerable amount of information to the SDR at the inception of the swap.

20 For many purposes, the SDR Reporting Rule and the CFTC rule requiring reporting of certain “historical” swaps (swaps in existence before the compliance date of the SDR reporting rule) treat all parties that are not swap dealers, major swap participants, clearing agencies or other market intermediaries in the same way; we refer to these parties as “end-users” for purposes of the General Swap Reporting and Recordkeeping discussion in this Memorandum.

21 The CFTC and SEC approved final rules defining the term “swap” on July 10, 2012 at the same open meeting at which the CFTC approved its end-user rule. The text of those final rules and the accompanying adopting release have been made available on the CFTC website but have not yet been published in the Federal Register. See “Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012c.pdf.

22 See “CFTC Approves Final Rule on Swap Data Recordkeeping and Reporting Requirements for Pre-Dodd-Frank and Transition Swaps,” available at http://www.cftc.gov/PressRoom/PressReleases/pr6259-12; “Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps,” 77 FR 35200 (June 12, 2012). This final rule superseded an interim final rule related to recordkeeping and reporting for pre-enactment swaps issued on October 14, 2010 and an interim final rule related to recordkeeping and reporting for transition swaps issued on December 17, 2010. Both interim final rules required swap counterparties to retain information then in their possession pertaining to pre-enactment and transition swaps pending publication of a permanent final rule.

23 See “Order Determining the Availability of a Legal Entity Identifier Meeting the Requirements of Commission Regulations, and Designating the Provider of Legal Identifiers to be Used in Recordkeeping and Swap Data Reporting Pursuant to the Commission’s Regulations,” available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/ciciorder.pdf.
and confirmation of a swap transaction, as specified in the Rule for each type of swap, and to report valuation data and changes to previously filed information throughout the life of the swap. For transactions in which there is no swap dealer or major swap participant as reporting party, end-users must report certain primary economic terms data (defined in the SDR Reporting Rule) within 48 business hours of execution of a new swap during the first year following the End-User Reporting Date, within 36 hours during the second year, and within 24 hours thereafter. For the first 180 days following the End-User Compliance Date, end-users may report primary economic terms information by transmitting an image of the swap confirmation, but after that date, electronic reporting is required.

Real-Time Public Reporting

In addition to the SDR Reporting Rule, the CFTC has also adopted a separate set of reporting rules to effect the Dodd-Frank Act requirements to make swap transaction and pricing information publicly available in real time (the “CFTC Public Reporting Rule”). Under the CFTC Public Reporting Rule, the framework for determining the reporting party is generally the same as under the SDR Reporting Rule. However, from the perspective of end-users, the CFTC Public Reporting Rule differs from the SDR Reporting Rule in one important respect. Consistent with its goal to facilitate price discovery by market participants, the CFTC Public Reporting Rule applies exclusively to swaps that are “arm’s-length transactions between two parties that result in a corresponding change in the market risk position between the two parties.” The CFTC Public Reporting Rule provides that “internal swaps between one-hundred percent owned subsidiaries of the same parent entity . . . may” not satisfy the arm’s-length requirement and would therefore be excluded from public reporting. This should exempt most or all swap transactions between entities with common ownership that are not financial institutions. In addition, the CFTC Public Reporting Rule prohibits disclosure of the names of the parties to any swap transaction. The CFTC Public Reporting Rule provides for specified time delays for public reporting of certain block transactions and other swap transactions based on the type of execution, the underlying asset and the market participant.

Historical Swaps Reporting and Recordkeeping

The requirements applicable to end-users under the Historical Swaps Rule vary based on whether the swap is a pre-enactment swap or a transition swap (determined by the date the swap is entered into) and whether the swap terminated or expired before April 25, 2011, the publication date of proposed permanent CFTC historical swap reporting and recordkeeping rules. Consistent with the SDR Reporting Rule, the reporting party for historical swaps is determined based on the status of the parties to the swap. The initial compliance date for end-users under the Historical Swaps Rule is the End-User Reporting Date, consistent with the SDR Reporting Rule.

For each historical swap terminated or expired prior to April 25, 2011, end-users must retain, for five years after the swap termination date, in paper or electronic form, retrievable within five business days, information and documents as to that swap in their possession, as of either October 14, 2010 in the case of pre-enactment swaps or December 17, 2010 in the case of transition swaps. No LEI or unique swap identifier requirements apply to records relating to swap transactions terminated or expired prior to April 25, 2011.

For historical swaps (both pre-enactment and transition swaps) in existence on or after April 25, 2011, end-users are required to retain records of the minimum primary economic terms specified for the type of swap in an appendix to the Historical Swaps Rule, together with any confirmations, master agreements or credit support agreements relating to that swap in the end-user’s possession on or after April 25, 2011. These records must be retained for five years after the swap termination date, in paper or electronic form, retrievable within five business days.

For each historical swap terminated or expired prior to April 25, 2011, the reporting party must report, via any method selected by the reporting party, any information relating to the terms of the swap transaction that was in its possession on or after October 14, 2010, in the case of pre-enactment swaps, or December 17, 2010, in the case of transition swaps. No LEI or unique swap identifier requirements apply to SDR reporting of swap transactions terminated or expired prior to April 25, 2011.

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25 Id. at 1187.

26 The parties’ status is determined as of the compliance date for the Historical Swaps Rule. For end-users, the compliance date for the Historical Swaps Rule is the End-User Reporting Date, consistent with the SDR Reporting Rule.
For historical swaps (both pre-enactment and transition swaps) in existence on or after April 25, 2011, the reporting party is required to report all minimum primary economic terms specified for the type of swap in an appendix to the Historical Swaps Rule, that is in the reporting party’s possession on or after April 25, 2011. The reporting party must also report its LEI, its internal transaction and counterparty identifiers. Throughout the term of the swap, the reporting party must also report any changes to the minimum primary economic terms information previously reported for that swap.

This memorandum relates to general information only and does not constitute legal advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments.