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The Implications of New U.S. Derivatives Regulations on End-Users of Swaps—An Update

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INTRODUCTION

In the wake of the financial crisis, both the U.S. and the EU have enacted legislation to regulate the "over-the-counter" ("OTC") swaps market and are in the process of adopting implementing rules that will make such legislation fully effective. In the U.S., Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), enacted on July 21, 2010, provides for the regulation of the swaps market and grants to the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC," and with the CFTC, each a "Commission" and together, the "Commissions") broad authority to regulate the swaps market and its principal participants.[1] In the EU, the European Market Infrastructure Regulation ("EMIR") is expected to become effective during 2013 and will create a regulatory framework for the swaps markets in all EU member states.

This Client Memorandum focuses on the effects of Title VII of the Dodd-Frank Act on end-users of OTC swaps. While most of its provisions are aimed at swap dealers (each, an "SD" and collectively, "SDs") and major swap participants (each, an "MSP" and collectively, "MSPs"), Title VII will affect all participants in the U.S. swaps markets, including U.S. and non-U.S.-based swap end-users that transact with U.S. persons. As set out below, swaps entered into by such end-users will be subject to mandatory clearing and exchange trading (unless, for example, the transaction qualifies for the "end-user exception" or the proposed "inter-affiliate" exemption), possible requirements to post margin to secure OTC swap obligations, as well as recordkeeping and reporting requirements. Also, as a result of certain "external business conduct standards" imposed on SDs and MSPs, certain documentation and other requirements will change. Finally, an entity that is a significant user of swaps should evaluate whether its swaps activity would require it to register as an SD or MSP. We have previously addressed these issues in our client memoranda "Derivatives Rules under the Dodd-Frank Act Affecting End-Users—An Update"[2], "Proposed Rules for End-User Exception to Clearing of Swaps"[3] and "Reform of the Swaps Market under the Dodd-Frank Act."[4] It is reasonably likely that there will be further changes to the proposed rules as they are finalized. Also, the implementation of certain rules may be delayed.

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[1] The CFTC will regulate most swaps on interest rates, commodities and currencies and the SEC will regulate swaps, including equity and credit default swaps, on single securities and narrow-based securities indices. The Commissions will jointly regulate "mixed swaps." Title VII generally defines swaps and security-based swaps to include a broad array of derivatives transactions. *See* also 77 Fed. Reg. 48208 (Aug. 13, 2012).

[2] "Derivatives Rules under the Dodd-Frank Act Affecting End-Users—An Update," August 6, 2012, available at http://www.cravath.com/files/Uploads/Documents/Publications/3363602_1.pdf.

[3] "Proposed Rules for End-User Exception to Clearing of Swaps," December 28, 2010, *available at* http://www.cravath.com/files/Uploads/Documents/Publications/3258872_1.pdf.

[4] "Reform of the Swaps Market under the Dodd-Frank Act," July 22, 2010, *available at* http://www.cravath.com/files/Uploads/Documents/Publications/3234079_1.pdf.

SCOPE

Title VII of the Dodd-Frank Act grants the Commissions wide authority to regulate the U.S. swaps market and its participants. A "swap" or "security-based swap" is broadly defined to cover numerous classes of transactions in which one or more payment obligations are based on the price or value of underlying instruments, indexes, commodities, currencies or financial or other contingencies, and includes transactions such as interest rate swaps, credit default swaps, commodity swaps, cross-currency swaps, non-deliverable currency forwards, and puts, calls and other options on each of the foregoing.

Importantly, however, the CFTC reaffirmed its position that forward contracts on nonfinancial commodities are not "swaps" as long as they are intended to be physically settled.[5] This is consistent with its pre-Dodd-Frank Act interpretations. Similarly, the CFTC has provided an interim final exemption from certain Title VII requirement for physically settled "trade options" on non-financial commodities purchased by commercial users of the underlying commodity.[6] Additionally, the U.S. Department of the Treasury has issued a final determination that excludes a limited class of physically settled "foreign exchange forwards" and "foreign exchange swaps"[7] from the definition of "swap" under the Commodity Exchange Act (the "CEA"). This determination exempts these foreign exchange transactions from the clearing and exchange trading requirements and any regulatory margin requirements imposed on OTC swaps generally. However, foreign exchange transactions within the scope of the Treasury determination and physically settled "trade options" remain subject to certain reporting obligations, business conduct standards for SDs and MSPs and anti-evasion provisions.

The Dodd-Frank Act states that Title VII shall not apply to activities outside the United States unless those activities (i) have a "direct and significant connection with activities in, or effect on, commerce of the United States"; or (ii) contravene such rules or regulations as the CFTC may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of the CEA, as amended by the Dodd-Frank Act.[8] Generally, a swap will be subject to the requirements of Title VII where at least one of the swap counterparties is a U.S. person, and therefore, a non-U.S. person will need to be aware of these requirements when transacting with a counterparty that is a U.S. person.[9]

The scope of the term "U.S. person" is currently the subject of review and discussion among regulators. On July 12, 2012, the CFTC released proposed guidance regarding the cross-border application of Title VII in which it stated that a "U.S. person" would generally include a foreign branch or agency of a U.S. person, but would not include a foreign affiliate or subsidiary of a U.S. person, even where such affiliate or subsidiary has certain or all of its swap-related obligations guaranteed by a U.S. person.[10] Following expressions of concern by private parties and other regulators regarding the extraterritorial application of Title VII, on December 12, 2012, CFTC Chairman Gary Gensler testified before the Capital Markets and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee that the CFTC is planning to narrow temporarily the definition of U.S. persons to include only U.S. residents and firms incorporated in the U.S., which is significantly narrower than the definition put forth in the July 2012 proposed guidance. The Commission has not yet proposed revised language but

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[5] 77 Fed. Reg. 48208, 48227 (Aug. 13, 2012).

[6] *Id.*

[7] The terms "foreign exchange forward" and "foreign exchange swap" are narrowly defined in the Treasury exemption to exclude transactions that do not involve physical delivery of the underlying currency or currencies. "Foreign exchange forward" means "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange." "Foreign exchange swap" means "a transaction that solely involves—(A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange." *See* 77 Fed. Reg. 69694 (Nov. 20, 2012).

[8] 7 U.S.C. 2(i). Additionally, the SEC intends to propose rules addressing the cross-border implications of Title VII as it relates to the regulation and registration of foreign entities engaged in cross-border security-based swaps. Such rules have not yet been proposed.

[9] 77 Fed. Reg. 41214, 41218 (July 12, 2012).

[10] The CFTC's proposed interpretation assumes such foreign affiliate or subsidiary is a limited company or limited partnership, and thus is not a U.S. person because its "direct or indirect owners" are not "responsible for the liabilities of such entity." *Id.* at 41218. If, however, the foreign affiliate or subsidiary is a sole proprietorship or general partnership, it may be considered a U.S. person if "the direct or indirect owners thereof are responsible for the liabilities of such entity and one or more of such owners is a U.S. person." *Id.* The proposed interpretive release also suggests that non-U.S. "conduit" 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 would be subject to the transaction-level requirements imposed under Title VII, subject to comity principles so as to permit substituted compliance (as defined herein) for transactions between a non-U.S. SD/MSP and such affiliate conduit. *Id.* at 41229.

expects to finalize such narrower definition by January 1, 2013.[11] Moreover, in light of the comments received, as well as the need to coordinate with regulators in other jurisdictions, the final definition of U.S. person may be significantly different from either the originally proposed or interim definition.

MANDATORY CLEARING AND EXCHANGE TRADING

Title VII requires the mandatory clearing and exchange trading of all swaps so designated by the CFTC or the SEC, subject only to limited exceptions. A U.S. end-user will be subject to the mandatory clearing and exchange trading requirements in respect of each swap of a type that has been determined to be subject to mandatory clearing, and a non-U.S. end-user will be subject to the mandatory clearing and exchange trading requirements in respect of each such swap it enters into with a U.S. person, unless in either case the end-user can perfect the end-user exception or the proposed inter-affiliate exemption, as described below.

If a swap or security-based swap is determined by the CFTC or SEC to be subject to a mandatory clearing requirement, it must be cleared through the facilities of a derivatives clearing organization approved by the CFTC (a "DCO"). If the swap is subject to mandatory exchange trading, it must be executed (traded) on a regulated exchange trading platform, such as a designated contract market ("DCM") or a registered swap execution platform ("SEF"), as applicable, unless no DCM or SEF makes the swap available to trade.

On November 28, 2012, the CFTC issued a clearing requirement determination for certain classes of interest rate swaps and credit default swaps (the "Clearing Requirement Determination") which sets forth several broad specifications for each of four core types of interest rate swaps (fixed-to-floating rate swaps, basis swaps, forward rate agreements and overnight index swaps) and credit default swaps (untranched swaps on the CDX North America and iTraxx Europe[12] indices) as to which a clearing requirement will apply. The Clearing Requirement Determination requires the parties to any swap meeting these broad specifications to submit the swap to a DCO for clearing as soon as technologically practicable and no later than the end of the day of execution. The CFTC has established the following implementation schedule:

- SDs will be required to comply with the Clearing Requirement Determination beginning on March 11, 2013 for swaps they enter into on or after that date with other SDs or MSPs.

- Financial entities (other than ERISA pension plans and accounts managed by third-party investment managers) will be required to clear swaps required to be cleared pursuant to the Clearing Requirement Determination beginning on June 10, 2013 for swaps entered into on or after that date with SDs, MSPs or other financial entities (other than ERISA plans and accounts managed by third-party investment managers).

- Swaps in which one party is an end-user, ERISA plan or account managed by a third-party investment manager will generally be required to be submitted for clearing beginning on September 9, 2013 for swaps entered into on or after that date, unless an exception from mandatory clearing is available, such as the "end-user exception" or the proposed "inter-affiliate exemption" (each described below), and the related requirements to elect the exception have been satisfied.[13]

THE END-USER EXCEPTION

The "end-user exception" provides that a counterparty to a swap (the "electing counterparty") may elect not to have its swaps cleared through a central clearinghouse or traded on a formal exchange, notwithstanding that a particular swap is otherwise subject to mandatory clearing and exchange trading. Importantly, such exception would not provide relief from any potential

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[11] *See* Panel I of a Hearing of the Capital Markets and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee Subject: "Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act" Chaired by: Representative Scott Garrett (R-NJ) Witnesses: Gary Gensler, Chairman, Commodity Futures Trading Commission; Robert Cook, Director, Division of Trading and Markets, Securities and Exchange Commission; Location: 2128 Rayburn House Office Building Time: 10:00 a.m. EST Date: Wednesday, December 12, 2012.

[12] If by February 11, 2013 no DCO offers iTraxx for client clearing, the CFTC will delay compliance for those swaps until 60 days after an eligible DCO offers iTraxx indices for client clearing. *See* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister112812.pdf.

[13] *See* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister112812.pdf.

regulatory margin requirement, or from the recordkeeping and reporting requirements, as discussed below. Qualified end-users entering into swaps covered by the Clearing Requirement Determination that want the choice to elect the end-user exception must meet the requirements for the end-user exception on or before September 9, 2013.

To perfect the end-user exception, the electing counterparty must meet certain requirements.

- First, the electing counterparty must not be a "financial entity" as defined in Title VII of the Dodd-Frank Act. The definition of financial entity is broad. It includes an SD, an MSP, a commodity pool, a U.S. registered investment company, a pension plan or a person predominantly engaged in activities that are in the business of banking or in activities that are financial in nature.[14] The list of "activities that are financial in nature" is quite expansive and is generally understood to include, among other things, most funding activities.[15] As a result, the term "financial entity" covers most so-called "treasury affiliates" in a corporate group, regardless of whether they are guaranteed by an affiliate (*e.g.*, a parent company) to which the end-user exception would be available.[16]

- Second, the swap for which the electing counterparty seeks the exception must be used to hedge or mitigate commercial risk. The end-user exception will not be available to swaps used for speculative purposes.

- Third, the electing counterparty must notify the CFTC how it "generally meets its financial obligations associated with entering into non-cleared swaps."[17]

- Fourth, if the end-user electing the end-user exception is an "SEC Filer," meaning that it is an issuer of securities or is controlled by a person that is an issuer of securities that in either case are listed on a U.S. exchange (including American Depositary Shares (ADSs)) or otherwise is registered with the SEC or subject to SEC public reporting requirements, an "appropriate committee" of its board of directors or governing body must approve the decision to enter into swaps subject to the end-user exception. Such board or committee approval may be provided on a broad categorical basis, rather than on a swap-by-swap basis. The CFTC notes in its release adopting the end-user exception that it would expect an SEC Filer's board to review its policies governing the SEC Filer's use of swaps subject to the end-user exception at least annually and, if applicable, more frequently upon a "triggering event" (*e.g.*, a new strategy is implemented that was not contemplated in the initial board approval).[18]

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[14] *See* CEA Section 2(h)(7)(C)(i). 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 the 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 contracts, 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.

[15] The broad list of "activities that are financial in nature" includes, but is not limited to, (a) lending, exchanging, transferring, investing for others or safeguarding money or securities, (b) insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability or death, or providing and issuing annuities, and acting as principal, agent or broker for the foregoing purposes, (c) providing financial, investment or economic advisory services, (d) issuing or selling instruments representing interests in pools of assets, (e) underwriting, dealing in, or making a market in securities or (f) engaging in any activity that has been determined to be "so closely related to banking… as to be a proper incident thereto," including, for example, engaging in investment transactions, including derivatives transactions, as a principal. *See* 12 U.S.C. § 1843(k).

[16] There does not exist a common definition of "treasury affiliate." The CFTC, for the purpose of its proposed rule providing a clearing exemption for swaps between certain affiliated entities, defines a treasury (or conduit) affiliate as "an affiliate that enters into inter-affiliate swaps and enters into swaps with third parties that are related to such inter-affiliate swaps on a back-to-back or aggregate basis." *See* 77 Fed. Reg. 50,425, 50,426 (Aug. 21, 2012). A treasury affiliate that is a separate legal entity and whose sole or primary function is to undertake "activities that are financial in nature." *See* 77 Fed. Reg. 42560, 42563 (July 19, 2012).

[17] 7 U.S.C. 2(h)(7)(A). 7 U.S.C. 2(h)(7)(A). Additionally, as required by Title VII, the SEC has proposed rules regarding the steps a security-based swap counterparty electing to perfect the end-user exception must follow to notify the SEC how it "generally meets its financial obligations associated with entering into non-cleared swaps" when it uses security-based swaps to hedge or mitigate risks. Such rules have not yet been finalized.

[18] *See* 77 Fed. Reg. 42560, 42569 (July 19, 2012).

A non-U.S. end-user need consider electing the end-user exception only for transactions with a counterparty required to apply transaction-level requirements to its swaps with non-U.S. persons. Please see "Effects of Registration on SDs and MSPs—Proposed Cross-Border Application of 'Entity-Level Requirements' and 'Transaction-Level Requirements'" for a discussion of the application of transaction-level requirements.

For purposes of reporting a swap that will not be cleared pursuant to the end-user exception, the reporting counterparty for such swap (discussed below) is required to notify the relevant Commission of the election of the end-user exception and the identity of the electing counterparty on a swap-by-swap basis. Other required reporting information, such as information regarding the eligibility of the electing counterparty to elect the end-user exception (*e.g.*, whether the electing counterparty is a financial entity, whether the swap hedges or mitigates commercial risk, how the electing counterparty generally meets its financial obligations and whether, in the case of an SEC Filer, it has obtained board or committee approval), may be provided in an annual filing by the electing end-user counterparty to a swap data repository ("SDR") or the relevant Commission rather than by reporting (or having its counterparties report) this information on a transaction-by-transaction basis. To facilitate the reporting process, the reporting counterparty will be able to satisfy the reporting requirements relating to the end-user exception as to swaps with an end-user that has made its annual filing by checking three boxes, indicating (i) that the end-user exception has been elected, (ii) the identity of the electing counterparty and (iii) that the additional information has already been provided by the electing counterparty in its own annual filing.

PROPOSED INTER-AFFILIATE EXEMPTION FROM CLEARING FOR "FINANCIAL ENTITIES"

The CFTC has proposed an "inter-affiliate" exemption from mandatory clearing for eligible swaps between affiliates that do not qualify for the end-user exception, either because both counterparties are financial entities or because the relevant transaction is speculative. In these cases, the parties may be eligible to rely on the proposed inter-affiliate clearing exemption.

As proposed, the inter-affiliate clearing exemption would only be available for swaps (i) between majority-owned affiliates, (ii) the financial statements of which are reported on a consolidated basis and (iii) where both affiliated entities elect the exemption. The exemption would be limited to swaps between U.S. affiliates, and swaps between a U.S. affiliate and a non-U.S. affiliate located in a jurisdiction with a comparable and comprehensive clearing regime (the proposed rule anticipates that EMIR will be one such regime) or between a U.S. affiliate and a non-U.S. affiliate that transacts only with affiliates.

In addition, the proposed rules would require that certain additional conditions be satisfied to exempt inter-affiliate swaps from clearing, including:

- inter-affiliate swaps must be subject to a centralized risk management program designed to monitor and manage the risks associated with the inter-affiliate swaps;[19]

- variation margin must be collected for swaps between affiliates that are both financial entities, unless both affiliates are 100% commonly-owned and are commonly-guaranteed;

- such transactions would remain subject to the general reporting requirements (discussed below) and additional reporting requirements specifically for uncleared inter-affiliate swaps, such as a requirement that the reporting counterparty (i) affirm that both counterparties are electing not to clear the swap and meet certain proposed requirements and (ii) submit information regarding how the financial obligations of both counterparties are generally satisfied with respect to uncleared swaps; and

- inter-affiliate swaps must be governed by a written "swap trading relationship document" agreed upon by each affiliate, which "includes all terms governing the trading relationship between the affiliates, including, without limitation, terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures."[20]

[19] It would be left to the discretion of the corporate group how best to implement such risk management program, either at the parent company or a treasury affiliate.

[20] 77 Fed. Reg. 50425, 50429 (Aug. 21, 2012).

As with the end-user exception, it is expected that each party electing the inter-affiliate clearing exemption would be able to make an annual filing to an SDR or the relevant Commission certifying its eligibility for the exemption on an annual basis, and an appropriate committee of the board of directors of SEC Filers will be required to review and approve the decision to enter into the inter-affiliate swaps that are exempt from clearing. The comment period for the proposed inter-affiliate clearing exemption closed on September 20, 2012. No final rule has been issued as of the date hereof.

Although the proposed inter-affiliate exemption is not yet finalized, the CFTC's Division of Clearing and Risk issued a no-action letter on November 28, 2012 which provides relief from the requirement to clear swaps meeting the specifications of the Clearing Requirement Determination, provided that the swap is (i) between majority-owned affiliates, (ii) the financial statements of which are reported on a consolidated basis and (iii) where both affiliated entities agree not to clear the swap. No other conditions need to be satisfied. This no-action relief will remain in effect until the earlier of April 1, 2013 and the date on which the proposed inter-affiliate exemption is effective.[21]

PROPOSED MARGIN REQUIREMENTS

Prior to the enactment of the Dodd-Frank Act, OTC swaps were not subject to any specific regulatory margin requirements. Instead, credit support was (and continues to be) a term of private negotiation between the parties. In contrast, exchange traded futures, options and swaps are subject to requirements to post initial and variation margin. The Dodd-Frank Act extends the requirement for clearing, and therefore the posting of margin, to broad classes of swaps previously traded by end-users primarily on an OTC basis. In addition, both the CFTC and U.S. federal banking regulators ("Prudential Regulators")[22] have issued proposals potentially requiring SDs and MSPs to impose margin requirements on OTC swaps. These proposals were issued in early 2011; however, because of the desire to coordinate with the EU, the CFTC's and Prudential Regulators' proposed rules have not been finalized pending the publication of the BCBS-IOSCO consultation on common international standards, which is expected by the end of 2012.[23]

Although differing in theory and approach, it is not clear that the CFTC's and Prudential Regulators' proposed rules would impose different margin requirements on end-users that are not financial entities in practice. Both proposals grant swap dealers significant discretion in determining variation margin requirements applicable to non-financial end-users and neither proposal requires the collection of initial margin from non-financial end-users.

However, for swaps between an SD or MSP and another SD or MSP, both the CFTC's and Prudential Regulators' proposed rules would require the payment and collection of initial and variation margin. For transactions between an SD and a financial entity that is not a SD or MSP, both proposals would require the SD to collect initial and variation margin from financial entities in many cases. The proposals only permit SDs to adopt credit-based thresholds for the collection of both initial and variation margin for certain "low-risk financial end-users."[24] Neither proposal requires the SD to post initial or variation margin to its financial entity counterparties.

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[21] *See* http://cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-35.pdf.

[22] The Prudential Regulators are the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Farm Credit Administration and the Federal Housing Finance Agency.

[23] As required by Title VII, the SEC has proposed rules establishing capital, margin and segregation requirements applicable to security-based swap dealers and security-based major swap participants. Such rules have not yet been finalized.

[24] Under the Prudential Regulators' proposal, a "low-risk financial end user" (i) does not have "significant swaps exposure," (ii) predominantly uses swaps to hedge or mitigate the risks of its business activities and (iii) is subject to capital requirements established by a prudential regulator or state insurance regulator. The CFTC has indicated that it will use similar definitions. For the purpose of the proposals, "significant swaps exposure" means $2.5 billion in daily average aggregate uncollateralized outward exposure, or $4 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure (and, for security–based swaps, $1 billion and $2 billion, respectively). Neither the CFTC nor the Prudential Regulators have proposed specific credit exposure limits for "low-risk financial end-users," however, guidance suggests that the credit exposure limit, for each of initial and variation margin, would be capped at the lesser of an absolute amount (between $15 million and $45 million) and a percentage of the SD/MSP's Tier 1 regulatory capital (between 0.1% - 0.3%).

RECORDKEEPING AND REPORTING REQUIREMENTS

Title VII requires parties to all swaps subject to the jurisdiction of the CFTC, including swaps between non-U.S. counterparties and U.S.-registered SDs and MSPs, to maintain detailed records for each such swap and sets forth detailed reporting requirements for the reporting counterparty to each such swap, as described below.

- SDs will generally be the reporting counterparty for all swaps to which they are a party and MSPs will be the reporting counterparty in their swaps with parties that are not SDs or MSPs.
- End-users that are U.S. persons must report swaps with other end-users, including entities within their corporate group.
- For swaps between end-users and financial entities that are not SDs or MSPs, the financial entity will be the reporting counterparty.
- In the case of an inter-affiliate swap transaction between a U.S. end-user and a non-U.S. end-user, the U.S. person will be the reporting counterparty.
- The reporting rules will become effective for SDs whose swap dealing activities exceeded the notional thresholds in October 2012 on December 31, 2012 for new interest rate swaps and credit swaps and on February 28, 2013 for new equity swaps, foreign exchange swaps and other commodity swaps.[25]
- The reporting rules will become effective for non-SD/MSPs on April 10, 2013.[26]

Recordkeeping

In general, counterparties to all swaps subject to the jurisdiction of the CFTC must keep "full, complete and systematic records, including all pertinent data and memoranda, with respect to each swap in which they are a counterparty" throughout the existence of the swap and for five years following the termination of the swap.[27] This requirement applies to swaps between a non-U.S. counterparty and a U.S.-registered SD or MSP, as well as any "internal" swap between two non-SD/MSP members of a corporate group where one party is a U.S. person. Swap data must be retrievable by the counterparty within five business days throughout the retention period. Such recordkeeping requirement becomes effective for non-SD/MSP counterparties engaging in new swaps subject to the jurisdiction of the CFTC on April 10, 2013. The rules, with some modifications, also extend to all swaps subject to the jurisdiction of the CFTC and in effect on July 21, 2010, or entered into at any time after that date and prior to the effective date of the reporting requirements for new swaps (collectively, "historical swaps").

The rules do not set forth a list of required records that swap counterparties must maintain; rather, as mentioned above, the rules specify that end-user swap counterparties "shall keep full, complete and systematic records, together with all pertinent data and memoranda, with respect to each swap in which they are a counterparty."[28] However, other rules (applicable to certain historical swaps) suggest that confirmations, master agreements and collateral or credit support documents, if those documents are available, are "records" that should be retained.[29]

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[25] We anticipate that many SDs will have crossed the notional threshold in October 2012 and will register with the CFTC on the registration deadline for that entity—December 31, 2012.

[26] *See* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-32.pdf and http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-41.pdf. As required by Title VII, the SEC has proposed rules regarding trade reporting and real-time public dissemination of trade information for security-based swaps. Such rules have not yet been finalized. Additionally, as required by Title VII, the SEC intends to propose rules regarding the reporting and recordkeeping requirements to which security-based swap dealers and security-based major swap participants will be subject. Such rules have not yet been proposed.

[27] 77 Fed. Reg. 2136, 2141 (Jan. 13, 2012).

[28] *Id.*

[29] CFTC Final Rule 46.2 (a)(2) is titled "Additional records required to be kept if possessed by a counterparty" and specifies that confirmations, master agreements and collateral or credit support documents should be retained if these are in a counterparty's possession, suggesting that these documents would be considered "records" to the extent they are available, for Part 45 purposes as well. However, we believe that it is not necessary for an end-user to document new internal swaps using confirmations and master agreements consistent with market practice for swaps with third party dealers in order to maintain the "full, complete and systematic" swap records required by the Part 45 Rules.

Reporting "External" Swaps

Where an end-user transacts with an SD or MSP, the SD or MSP must report required swap data. The same applies where a non-SD/MSP financial entity transacts with an SD or MSP.

SDs are required to begin reporting on the earlier of (i) the SD registration deadline applicable to that SD (*i.e.*, the last day of the second month following the month in which the SD crosses the registration threshold) and (ii) April 10, 2013. We expect that many U.S. SDs exceeded the notional thresholds to register as an SD in October 2012. Each such SD will be required to begin reporting its new interest rate swaps and credit swaps on December 31, 2012 and its new equity swaps, foreign exchange swaps and other commodity swaps on February 28, 2013. The CFTC has granted time-limited no-action relief for the reporting of historical swaps until the earlier of (i) the date that is 30 days after the date on which the SD is required to begin reporting swap data for the asset class to which the historical swap belongs and (ii) April 10, 2013.[30] MSPs are required to begin reporting all types of swaps on the last day of the second month following the end of the quarter in which the MSP first meets the registration criteria. For many MSPs, that reporting date will be February 28, 2013.

Reporting of Internal Swaps by End-Users

End-users that are U.S. persons are required to report all swap data for new internal (inter-affiliate) swaps and internal historical swaps to an SDR beginning on April 10, 2013. This requirement applies where at least one counterparty to the swap is a U.S. person, including U.S. subsidiaries of non-U.S. persons. A U.S. person must report all internal swaps irrespective of whether the internal swap is hedged by a market-facing swap with a U.S. or non-U.S. SD or MSP or whether the market facing transaction is subject to the end-user exception. If one counterparty is a U.S. financial entity, that counterparty is the reporting counterparty. For internal swap transactions between a U.S. entity that is not an SD or MSP and a non-U.S. entity that is not an SD or MSP, the U.S. person will be the reporting counterparty.

The reporting counterparty will electronically report most reportable swap data to an SDR at the creation of the swap ("swap creation data") and more limited data over the life of the swap until its expiration or termination (such data, "swap continuation data"). Swap creation data includes all primary economic terms data ("PET" data)[31] and all confirmation data.[32] Swap continuation data includes any changes to PET data, periodic valuation data, as well as all "life cycle event" data or "state data" (depending on the reporting method).

REGISTRATION REQUIREMENTS FOR SDS AND MSPS

All persons, including non-U.S. persons, which meet the threshold requirements to be an SD or an MSP must register with the CFTC within a specified length of time after crossing the relevant threshold, as described below. Registered SDs and MSPs will, among other things, be subject to detailed business conduct rules which will affect the swap documentation for swaps between the SD or MSP and an end-user counterparty.[33]

Entities Required to Register as SDs

Under Title VII, an SD is defined as any person, subject to *de minimis* thresholds, that (i) holds itself out as a dealer in swaps or security-based swaps, (ii) makes a market in swaps or security-based swaps, (iii) enters into swaps or security-based swaps with counterparties in the ordinary course of business for its own account or (iv) engages in activity causing it to be known in the trade as a dealer or market-maker in swaps or security-based swaps. For purposes of the SD determination, a person's swap positions in connection with its dealing activity must exceed a *de minimis* effective notional value over the immediately preceding 12 months of $8 billion and its swaps entered into with "special entities" (such as U.S. municipalities, endowments and employee benefit plans) over the immediately preceding 12 months must not exceed $25 million. For purposes of the security-based SD determination, an entity's security-based swap positions in connection with its dealing activity must exceed a *de minimis* effective

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[30] *See* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-32.pdf.

[31] The minimum PET data required to be reported for specific categories of swap is set forth as exhibits to the CFTC final rule for swap data recordkeeping and reporting. 77 Fed. Reg. 2136, 2211 (Jan. 13, 2012).

[32] Generally, PET data consists of all agreed-upon economic terms of a swap and confirmation data consists of all other agreed-upon terms of a swap, including the swap confirmation itself.

[33] As required by Title VII, the SEC has proposed rules regarding the registration process and business conduct of security-based swap dealers and security-based major swap participants. Such rules have not yet been finalized.

notional value over the immediately preceding 12 months of $8 billion for security-based swaps that are credit default swaps and $400 million over the immediately preceding 12 months for other security-based swaps and its security-based swaps entered into with "special entities" over the immediately preceding 12 months must not exceed $25 million. For purposes of the SD analysis, swaps entered into to hedge physical positions, swaps between majority-owned affiliates, swaps by insured depository institutions that are directly related to the financial terms of the loans they originate or are required to be in place as a condition of the loan to hedge borrowers' business-related commodity price risks and swaps between a cooperative and its member are excluded.

For a non-U.S. person, the July 2012 proposed cross-border guidance states that the above tests and *de minimis* exception should be determined on the basis of (i) the non-U.S. person's transactions with U.S. persons, together with any swap dealing transactions between U.S. persons and any of its non-U.S. affiliates under common control, and (ii) the non-U.S. person's transactions which are guaranteed by U.S. persons, together with any swap dealing transactions of its non-U.S. affiliates under common control which are guaranteed by U.S. persons.[34]

An entity will need to determine whether it is a CFTC-regulated SD based on all swaps it has outstanding on and after October 12, 2012, and if it determines that it is an SD, will be required to register with the CFTC by the last day of the second month during which it crosses the threshold to register. For many SDs, that date will be December 31, 2012.[35] Upon registration, an SD will become subject to the entity-level requirements and transaction-level requirements discussed below.

Entities Required to Register as MSPs

Even if it is not an SD, an end-user group that trades extensively in swaps might be required to register as a "major swap participant" (defined above as "MSP"), thereby becoming subject to substantial U.S. regulation, if its swap activity with U.S. persons exceeds certain thresholds. The purpose of this requirement is to capture those non-SD persons, both U.S. and non-U.S., whose outstanding swaps "create an especially high level of risk that could significantly impact the U.S. financial system."[36] While the CFTC has stated that it expects "the number of persons covered by the definition of [MSP] . . . to be quite small, at six or fewer"[37], companies should consider whether their swap activity might trigger a requirement to register as an MSP.

There are three statutory tests that a potential MSP must conduct to determine whether it is an MSP:

- Under the "substantial position" test, a person who is not an SD is an MSP if it maintains a "substantial position" in any of the major swap categories[38], excluding (i) positions held for "hedging or mitigating commercial risk" and (ii) positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan. For a person to have a "substantial position" in a major category of swaps or security-based swaps, the CFTC and SEC final rules require a daily average current uncollateralized exposure of at least $1 billion (or $3 billion for the rate swap category), or a daily average current uncollateralized exposure plus potential future exposure (calculated as set forth in the rules) of $2 billion (or $6 billion for the rate swap category).[39]

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[34] *See* 77 Fed. Reg. 41214, 41221 (July 12, 2012).

[35] The SEC stated that registration as a security-based SD will not be required until the dates provided in the SEC's final rules regarding registration. Such dates have not been provided as of the date of this Client Memorandum.

[36] 77 Fed. Reg. 30596, 30613 (May 23, 2012).

[37] *Id.*

[38] The Commissions have provided that the four "major" categories of swaps are rate swaps, credit swaps, equity swaps and other commodity swaps. The two "major" categories of security-based swaps are debt security-based swaps and other security-based swaps. *See* 77 Fed. Reg. 30596, 30662-3 (May 23, 2012).

[39] The three statutory tests to determine whether an entity is an MSP are calculated using the same two component calculations: "Current Uncollateralized Exposure" and "Potential Future Exposure."

"Current Uncollateralized Exposure" is intended to quantify the amount an entity currently owes to its swap counterparties (*i.e.*, the risk the entity currently poses to its counterparties). It is calculated by (i) determining the dollar value of an entity's swap positions with negative value (subject to netting as discussed below) in each major category of swaps by marking-to-market those swaps using "industry standard practices" and (ii) deducting from that amount the aggregate value of the collateral the entity has posted with respect to such swap positions. The "aggregate uncollateralized outward exposure" is the sum of those amounts over all counterparties that are U.S. persons with which the entity has entered into swaps in that major category. A potential non-U.S. MSP may measure its current exposure to a particular counterparty after giving effect to the terms of the master netting agreements with that counterparty. Such calculation of net current exposure may take into account certain offsetting positions entered into with the particular counterparty involving swaps (in any swap category), security-based swaps and securities financing transactions, to the extent permitted by the master netting agreements.

- Under the "substantial counterparty exposure" test, a person who is not an SD is an MSP if its outstanding swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets." For a person's swap positions to create such "substantial counterparty exposure," the final rules require positions that present a daily average current uncollateralized exposure of $5 billion or more (or $2 billion or more for security-based swaps), or present daily average current uncollateralized exposure plus potential future exposure of $8 billion or more (or $4 billion or more for security-based swaps).

- Under the "highly leveraged financial entity" test, a person who is not an SD is an MSP if it (i) is a "financial entity" (ii) that is "highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate [U.S.] Federal banking agency" and (iii) that maintains a "substantial position" in any of the major swap or security-based swap categories. For a "highly leveraged" "financial entity" to have a "substantial position" in a major category of swaps or security-based swaps, the final rules require a daily average current uncollateralized exposure of at least $1 billion (or $3 billion for the rate swap category), or a daily average current uncollateralized exposure plus potential future exposure of $2 billion (or $6 billion for the rate swap category).

For the purpose of calculating the MSP threshold tests, a potential U.S. MSP should make each of the calculations with respect to swaps with all counterparties, both U.S. and non-U.S. The proposed cross-border guidance provides that a potential U.S. MSP would also have to include in its calculations any swaps where it is the guarantor of a non-U.S. person's swap obligations. A potential non-U.S. MSP should make each of the calculations solely with respect to (i) swaps with counterparties that are U.S. persons and (ii) swaps as to which it is the guarantor of another non-U.S. person's swap obligations to a U.S. person.[40] A person is required to test for MSP status on a quarterly basis. The exposures must be calculated over all business days in a calendar quarter by taking the average of the calculations at the close of each business day. This means that calculations must be made on a **daily basis**. Entities far below the MSP thresholds can alleviate the burden of such daily calculations by meeting one of three safe-harbors.[41] Potential MSPs will need to begin their MSP calculations based on all swaps outstanding on and after October 12, 2012,[42] and will need to register with the CFTC by the last day of the second month after the end of the quarter in which it crossed the registration threshold.

"Potential Future Exposure" is intended to quantify the amount an entity may owe to its swap counterparties (*i.e.*, the risk the entity's positions may pose to its counterparties in the future). It is determined by applying the following formula to each swap and calculating the sum of those amounts for all swaps with U.S. persons:

(Notional Amount) x (Risk Factor) x (Clearing/Margining Factor) x (Netting Factor)

Such formula multiplies (i) the notional principal amount of the entity's swap positions by (ii) a specified risk factor based on the swap category and duration of position (ranging from 0 to 0.15) by (iii) a specific factor based on whether the swap is cleared or subject to daily mark-to-market margining requirements (if cleared, the factor is 0.1; if subject to daily mark-to-market margining, the factor is 0.2; if not cleared or subject to daily mark-to-market margining, the factor is 1) and by (iv) a discount factor based on the number of positions subject to master netting agreements (ranging from 0.4 to 1).

[40] Certain types of transactions, such as foreign exchange swaps and foreign exchange forwards within the scope of the U.S. Treasury determination and forward transactions in physical commodities that are intended to be physically settled, are not "swaps" for the purpose of the MSP calculations.

[41] One of the three safe harbors does not require the MSP calculations to be done at all, while the other two look at modified versions of the MSP calculations at the end of each month, rather than daily.

Under the first safe harbor, a person will not be deemed an MSP if (i) the express terms of the person's arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total Current Uncollateralized Exposure of more than $100 million to all such counterparties, including any exposure that may result from the application of thresholds or minimum transfer amounts established by credit support annexes or similar arrangements; and (ii) the person does not maintain notional swap or security-based swap positions of more than $2 billion in any major category of swaps, or more than $4 billion in the aggregate.

Under the second safe harbor, a person will not be deemed an MSP if (i) the express terms of the person's arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total Current Uncollateralized Exposure of more than $200 million to all such counterparties, including any exposure that may result from thresholds or minimum transfer amounts; and (ii) the person performs the MSP calculations as of the end of every month (rather than daily), and the results of each of those monthly calculations indicate that the person's swap positions lead to no more than one-half of the level of Current Uncollateralized Exposure plus Potential Future Exposure that would cause the person to be an MSP.

Finally, under the third safe harbor, a person will not be deemed an MSP if (i) the person's Current Uncollateralized Exposure in connection with a major category of swaps is less than $500 million (or $1.5 billion for the rate swap category) at the end of each month (rather than at the end of each business day); and (ii) the sum of the Current Uncollateralized Exposure and the notional amount of the person's swap positions across all major categories of swaps (adjusted by the relevant Risk Factor) at the end of each month (rather than based on the average of daily calculations) is less than $1 billion.

[42] Because the definition of U.S. person has not yet been finalized, the CFTC Division of Swap Dealer and Intermediary Oversight issued a No-Action Letter on October 12, 2012 in which it recommends that the CFTC not take enforcement action against a potential non-U.S. SD or MSP for including in its calculations for periods up

Effects of Registration on SDs and MSPs—Proposed Cross-Border Application of "Entity-Level Requirements" and "Transaction-Level Requirements"

Under Title VII of the Dodd-Frank Act, all persons required to register as SDs or MSPs are required to comply with certain requirements regarding risk management, business conduct and reporting. Responding to the concerns of commenters, the CFTC in its proposed July 2012 cross-border guidance conceptually divides these requirements into entity-level and transaction-level requirements.

Entity-Level Requirements

Entity-Level Requirements refer to the management of risks to an SD or MSP as a whole. These requirements apply on a firm-wide basis and include all swaps, regardless of whether the SD's or MSP's counterparty is a U.S. person or non-U.S. person or where the transactions are executed.

These requirements include:

- Capital: the CFTC has proposed rules which would require non-bank SDs and MSPs to hold a minimum level of adjusted net capital;
- Chief Compliance Officer: each SD and MSP must designate a chief compliance officer who would be responsible for administering the firm's compliance policies and procedures;
- Risk Management: each SD and MSP must implement internal risk management policies and procedures;
- Swap Data Recordkeeping: each SD and MSP must keep books and records for all activities related to its business, including trading records for each swap and all related records, as well as a complete audit trail for trade reconstruction;
- SDR Reporting: all swaps, whether cleared or uncleared, must be reported to an SDR; and
- Large Trader Reporting: SDs must submit routine position reports with respect to any account having open positions in certain physical commodity swaps or swaptions above specified reporting levels set by the CFTC.[43]

Transaction-Level Requirements

Transaction-Level Requirements apply on a transaction-by-transaction basis and cover a range of Dodd-Frank Act requirements from financial protection of SDs and their counterparties to market efficiency and price discovery.

These requirements include:

- Clearing and Swap Processing: swaps required to be cleared pursuant to the Clearing Requirement Determination must be submitted to a DCO for clearing unless an exception from mandatory clearing is available and the related requirements to elect the exception are satisfied;
- Margin (and Segregation) Requirement for Uncleared Swap Transactions: the CFTC has proposed rules requiring SDs and MSPs that trade in OTC swaps to collect margin from certain counterparties and in some cases post margin to counterparties on OTC swap transactions;
- Mandatory Trade Execution: unless a clearing exception applies and is elected, a swap that is subject to a clearing requirement must be executed on a DCM or SEF, unless no DCM or SEF makes the swap available to trade;

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to December 31, 2012 only swaps with a narrowly-defined group of U.S. persons. *See* CFTC Letter No. 12-22 (Oct. 12, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-22.pdf.

[43] Non-clearing member swap dealers are not required to comply with the large trader reporting requirements of Part 20 of the CEA until March 1, 2013. *See* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-51.pdf.

- Swap Trading Relationship Documentation[44]: each SD and MSP must conform to CFTC documentation standards;
- Portfolio Reconciliation[45] and Compression[46]: SDs and MSPs are required to perform portfolio reconciliation and compression for all swaps periodically based on the type of counterparty;
- Real-Time Public Reporting: all publicly reportable swap transactions must be reported and will be publicly disseminated in real-time;
- Trade Confirmation: each SD and MSP must have procedures designed to ensure accurate and timely confirmation of swaps;
- Daily Trading Records: SDs and MSPs must maintain daily trading records, including records of trade information related to pre-execution, execution and post-execution data, that would be needed to conduct a trade reconstruction for each swap; and
- External Business Conduct Standards: SDs and MSPs must adhere to certain standards, designed to enhance counterparty protection, when transacting with their counterparties.

The CFTC's July 2012 proposed cross-border guidance would permit a non-U.S. SD/MSP, once registered with the CFTC, to comply with home country regulations instead of U.S. regulations for both entity-level and transaction-level requirements ("substituted compliance") under certain circumstances, should the CFTC find that such requirements "are comparable to cognate requirements under the CEA and Commission regulations".[47] The proposed guidance anticipates that EMIR will be one such regime. On December 4, 2012, leaders of authorities charged with regulating the OTC swaps markets in Australia, Brazil, the EU, Hong Kong, Japan, Ontario, Quebec, Singapore, Switzerland and the U.S. issued a joint press statement expressing their commitment to coordination among jurisdictions regarding the regulation of cross-border swaps activities.[48]

On July 12, 2012, the CFTC issued a proposed exemptive order that would provide market participants with conditional, time-limited relief from certain entity-level and transaction-level requirements. The proposed order would allow non-U.S. persons that are registered SDs and MSPs to delay compliance with entity-level requirements subject to exceptions for SDR reporting and large trader reporting. The proposed order would also permit non-U.S. persons that are registered SDs and MSPs and non-U.S. branches of registered SDs and MSPs that are U.S. persons to delay compliance with the transaction-level requirements with non-U.S. counterparties, subject to substituted compliance. The proposed relief would be effective for one year from July 12, 2012, the date of publication of the proposed exemptive order in the Federal Register.[49]

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[44] The compliance date for swap trading relationship documentation has been deferred until July 1, 2013. *See* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister121812.pdf.

[45] SDs and MSPs are required to periodically reconcile swap portfolios with other SDs or MSPs with varying frequency depending on the size of the particular swap portfolio. SDs and MSPs must engage in portfolio reconciliation with non-SD/MSP counterparties (i) at least quarterly with any counterparty with which it has more than 100 swaps in a calendar quarter and (ii) at least annually for all other counterparties. Discrepancies in material terms must be resolved immediately and discrepancies in valuation must be resolved as soon as possible, but in any event within five business days. The compliance date for portfolio reconciliation has been deferred until July 1, 2013. *See* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister121812.pdf.

[46] Two or more swap counterparties may engage in "portfolio compression" by wholly terminating or changing the notional value of some or all of their swaps submitted to be included in the compression exercise, and replacing the terminated swaps with other swaps whose combined notional value is less than the combined notional value of the terminated swaps included in the portfolio compression exercise. The CFTC rules require that SDs and MSPs establish, maintain and follow written policies and procedures for (i) terminating each fully offsetting swap in a timely fashion, (ii) periodically engage in bilateral portfolio compression exercises and (iii) periodically engage in multilateral portfolio compression exercises. With respect to swaps with non-SD/MSPs, an SD or MSP must have written procedures in place for periodically terminating fully offsetting swaps and engaging in portfolio compression exercises to the extent requested by the counterparty. These requirements and obligations do not apply to swaps cleared by a DCO.

[47] 77 Fed. Reg. 41214, 41229 (July 12, 2012).

[48] *See* http://www.cftc.gov/PressRoom/PressReleases/pr6439-12.

[49] *See* 77 Fed. Reg. 41110 (July 12, 2012).

The charts set forth below summarize the application of the entity-level requirements and transaction-level requirements to U.S. and non-U.S. SDs:

Entity-Level Requirements

Type of SD	Entity-level requirements apply?
U.S.-Based SD	Apply
Foreign Branches/Agencies of U.S.-Based SD	Apply (to the U.S.-Based SD)
Foreign Affiliates of U.S. Persons (Swaps Booked in the U.S.)	Apply[50]
Non-U.S. Based SDs and Foreign Affiliates of U.S. Persons (Swaps Not Booked in U.S. and Regardless of Whether Guaranteed by a U.S. Person[51])	Substituted Compliance may be Permitted

Transaction-Level Requirements

	U.S. Person Counterparty	Counterparty is a Non-U.S. Person Guaranteed by a U.S. Person[52]	Counterparty is a Non-U.S. Person Not Guaranteed by a U.S. Person
U.S.-Based SD	Apply	Apply	Apply
Foreign Affiliate of a U.S. Person, Swaps Booked in the U.S.	Apply	Apply (Except Business Conduct Standards)	Apply (Except Business Conduct Standards)
Foreign Branches / Agencies of U.S.-Based SD	Apply	Substituted Compliance (Business Conduct Standards Do Not Apply)[53]	Substituted Compliance (Business Conduct Standards Do Not Apply)[54]
Non-U.S. Based SDs and Foreign Affiliates of U.S. Persons (Swaps Not Booked in the U.S. Regardless Whether of Guaranteed by a U.S. Person)	Apply	Substituted Compliance (Business Conduct Standards Do Not Apply)[55]	Do Not Apply

[50] If the swaps are booked in a U.S. person, the U.S. person must comply with all of the SD duties and obligations related to the swaps. The foreign affiliate or subsidiary would be required separately to register as a swap dealer and comply with any entity-level and transaction-level requirements applicable to its swap dealing activities. If the market-facing affiliate or subsidiary did not meet the definition of an SD, then it would not fall under the jurisdiction of the CFTC as long as the agency relationship between the subsidiary or affiliate and the U.S.-based SD was properly documented and the U.S.-based SD remained principally responsible for the actions of the affiliate or subsidiary.

[51] For swaps involving foreign affiliates, if the affiliate is the legal counterparty to the swap, but the swap is guaranteed by a U.S. person, substituted compliance will be permitted with respect to SDR reporting only if the CFTC has direct access to the swap data.

[52] The CFTC states that transaction-level requirements would apply to swaps in which: (i) a non-U.S. counterparty is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. counterparty regularly enters into swaps with one or more U.S. affiliates or subsidiaries of the U.S. person; and (iii) the financials of such non-U.S. counterparty are included in the consolidated financial statements of the U.S. person.

[53] With respect to swaps between a foreign branch of a U.S. person and a non-U.S. person counterparty, such branches would be granted a one-year extension of the deadline for compliance with the external business conduct rules, during which time such branches may be permitted to apply to the CFTC to permit substituted compliance for other transaction-level requirements where the requirements of the home jurisdiction are "comparable and comprehensive to the applicable requirements under the CEA."

[54] *Id.*

[55] For transactions between such a non-U.S. subsidiary or affiliate and a non-U.S. person guaranteed by a U.S. person, the non-U.S. subsidiary or affiliate would be granted a one-year extension of the deadline for compliance with the external business conduct rules, during which time such subsidiary or affiliate may be permitted to apply to the CFTC for substituted compliance for other transaction-level requirements, which if granted, would allow the SD to comply with home country rules in lieu of certain CFTC rules.

END-USER COUNTERPARTIES—EFFECTS OF TRANSACTING WITH REGISTERED SDS AND MSPS

For end-users who transact with registered SDs or MSPs, the initial impact of SD/MSP registration will be that SDs and MSPs are likely to require their end-user counterparties to provide additional representations, consents and acknowledgments in order to facilitate compliance by SDs and MSPs with requirements applicable to their dealings with counterparties. The International Swaps and Derivatives Association ("ISDA") has published the ISDA August 2012 DF Protocol which seeks to assist SDs and MSPs in obtaining from counterparties certain of these additional representations, consents and disclosures. The most significant provisions of the ISDA August 2012 DF Protocol that will affect end-users are:

- "Eligible Contract Participant" category: an end-user will be required to specify the category of "eligible contract participant" that applies to them. It is already a requirement for all parties to swaps to be "eligible contract participants." This change adds a requirement for each party to specify how it qualifies;

- Material Confidential Information: absent an existing non-disclosure agreement, the parties agree that material confidential information may be disclosed in accordance with the CFTC's external business conduct rules and to (i) certain other parties to comply with the risk management policies of the parties and (ii) "front office" employees for pricing and hedging purposes;

- Daily Marks: under Title VII of the Dodd-Frank Act, the SD/MSP must provide to its counterparty, on a daily basis, the mid-market mark of the swap. In the ISDA August 2012 DF Protocol, the parties agree that such daily mark will be calculated by the SD/MSP as of the close of business on the prior business day;[56]

- Scenario Analysis: under Title VII of the Dodd-Frank Act, an end-user counterparty has the right to receive a scenario analysis for a given transaction indicating how that transaction would be affected by changes to particular market conditions, such as an increase in interest rates. The ISDA August 2012 DF Protocol specifies that the end-user must request such scenario analysis, confirmed in writing, from the SD/MSP prior to the execution, amendment, unwinding or novation of the swap in order to be entitled to receive such scenario analysis (unless otherwise agreed by the SD/MSP); and

- Optional institutional suitability safe harbor: under Title VII of the Dodd-Frank Act, an SD or MSP must undertake reasonable diligence to ensure a transaction meets general and counterparty-specific suitability requirements. The CFTC rules provide SDs and MSPs with a safe harbor from the suitability requirement with respect to certain institutional counterparties. The ISDA August 2012 DF Protocol facilitates reliance by SDs and MSPs on this safe harbor by permitting an end-user to provide certain representations, covenants and disclosures that will allow the SD/MSP to forego certain diligence requirements in determining whether a transaction is suitable for that specific end-user counterparty. By agreeing to incorporate the optional institutional suitability safe harbor schedule (Schedule 3 to the ISDA August 2012 DF Protocol Supplement) into its ISDA agreement, the end-user represents that it is exercising its independent judgment in evaluating recommendations and that it, or its agent, is capable of independently evaluating the investment risks of a swap. The end-user must also represent that it has complied in good faith with written policies and procedures reasonably designed to ensure that the persons responsible for evaluating recommendations and making trading decisions on its behalf are capable of doing so. Electing this safe harbor reduces the level of responsibility and potential liability of the SD or MSP toward its end-user counterparty. Each end-user should carefully consider whether to incorporate the optional institutional suitability safe harbor into its ISDA agreements.

SDs will generally need to comply with external business conduct rules beginning December 31, 2012. However, the CFTC has deferred the compliance date for certain external business conduct rules until May 1, 2013.[57]

[56] The CFTC will not take enforcement action against an SD or MSP for failure to disclose pre-trade mid-market marks to a counterparty to certain credit and rate derivative transactions prior to the issuance of final CFTC regulations governing the registration of SEFs, provided that (i) real-time tradeable bid and offer prices are available electronically to the counterparty and (ii) the counterparty agrees in writing that the SD or MSP does not need to disclose a pre-trade mid-market mark. *See* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-58.pdf.

[57] The CFTC has decided to defer the compliance dates for §§ 23.201(b)(3)(ii), 23.402; 23.410(c); 23.430; 23.431(a)-(c); 23.432; 23.434(a)(2), (b), and (c); 23.440; 23.450; and 23.505 of subpart F, subpart H, and subpart I of part 23 until May 1, 2013. Compliance dates for all other provisions of subpart F, subpart H and subpart I of part 23 remain unchanged. *See* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister121812.pdf.

COMMODITY POOLS

Title VII of the Dodd-Frank Act effectively expanded the scope of the term "commodity pool operator" to include certain persons that invest in swaps. Persons or entities deemed to operate a commodity pool are required to register with the CFTC, become a member of and make various filings with the National Futures Association (a self-regulatory organization subject to CFTC oversight) and comply with certain CFTC regulatory requirements, including the requirement to make various annual and periodic financial filings.

Broadly, a commodity pool is an enterprise, such as an investment fund, special purpose vehicle or trust, in which funds contributed by a number of persons are combined "for the purpose of trading" in commodity interests, such as futures contracts, options on futures, retail off-exchange foreign exchange contracts or swaps, or to invest in another commodity pool. The CFTC has historically interpreted the term "commodity pool" broadly such that an entity that holds a single commodity interest, even for hedging purposes and even if the entity does not actively "trade" commodity interests, would be covered by the definition. A commodity pool entity that is not based in the U.S. may still be subject to CFTC regulation if it is operating in the U.S. (such as a commodity pool entity which solicits U.S. investor business with U.S. persons, has U.S. persons as directors or has a management company operating in the U.S.) or has a single U.S. investor.

Although the CFTC has declined to apply a *de minimis* standard to determine the degree of swap activity that would confer commodity pool status on an entity and has construed the term "trading" broadly, certain CFTC releases, decisions and interpretations maintain that a non-financial company that uses commodity interests to hedge the price risks associated with its business is not a commodity pool within the meaning and intent of the rule.[58]

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[58] *See* Commodity Futures Releases, Decisions and Interpretations, Commodity Futures Trading Commission, CFTC Staff Letter No. 00-89. (Re: Rule 4.10(d)(1): Request for Interpretation that Limited Partnership Engaged in Pork Production is Not a Commodity Pool), ¶28,248, (Sept. 11, 2000). *See* also http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-13.pdf.