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Proposed Rules for End-User Exception to Clearing of Swaps

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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. The Dodd-Frank Act provides that the Commodity Futures Trading Commission (the "CFTC") will regulate swaps, the Securities and Exchange Commission (the "SEC," together with the CFTC, the "Commissions") will regulate security-based swaps, and the Commissions will jointly regulate "mixed swaps."[1]

As discussed in our memo of July 22, 2010,[2] Title VII contains a broad requirement for the clearing and exchange trading of swaps.[3] However, the Dodd-Frank Act provides for an exception to mandatory clearing of swaps, often referred to as the "end-user" exception, which applies where one of the counterparties to the swap:

- is not a financial entity,
- is using swaps to hedge or mitigate commercial risk, and
- notifies the relevant Commission that it meets the financial obligations of entering into a non-cleared swap transaction.

In addition, in the case of SEC reporting companies (referred to below as "SEC Filers"), if the company wishes to avail itself of the end-user exception, the end user must have appropriate board or committee procedures in place pursuant to which it entered into the non-cleared swap.

Earlier this month, the CFTC and the SEC issued proposed rules governing the application of the end-user exception (individually, the "Proposed Rule," and together, the "Proposed Rules"). The Proposed Rules are open for public comment until February 22, 2011 for the CFTC's Proposed Rule and February 4, 2011 for the SEC's Proposed Rule. Based on the Commissions' published schedules of their anticipated regulatory actions under the Dodd-Frank Act, we expect that final rules will be adopted between April and July 2011. The final rules, when issued, may differ in significant ways from the Proposed Rules.

In general, we expect that most operating companies that are not financial institutions will qualify for the end-user exception for most of the swaps that they routinely enter into to hedge, for example, interest rate and commodity risks in their business. Notably, one important exception appears to be a swap relating to a company's own stock.[4] As outlined below, the Proposed Rules would require companies seeking to use the end-user exception to (i) determine their eligibility for the exception and (ii) allow for a notice to be filed setting

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[1] Title VII generally defines swaps and security-based swaps to include a broad array of derivatives transactions.

[2] *See* "Reform of the Swaps Market Under the Dodd-Frank Act," July 22, 2010, *available at* http://www.cravath.com/files/Uploads/Documents/Publications/Dodd-Frank%20(Reform%20of%20the%20Swaps%20Market).pdf.

[3] This requirement is not applicable to swaps if the relevant Commission makes a determination that a swap is not required to be cleared.

[4] While transactions by a company to hedge its own stock may not qualify for the end-user exception, such transactions may not be swaps because they are essentially securities purchase agreements, and others may be found by the Commissions to be so customized that they are not capable of being cleared.

out the basis for eligibility, including the form of any credit support for the company's obligations. It is difficult to predict at this time how extensively this exception will be used. However, we expect that the decision to use the end-user exception will be driven significantly by consideration of the increased liquidity that should be provided by cleared swaps over non-cleared swaps, the greater ability to customize non-cleared swaps, when compared to cleared swaps, and the relative costs of cleared swaps versus non-cleared swaps, including margining or collateral costs.

END-USER EXCEPTION TO MANDATORY CLEARING OF SWAPS

Non-Financial Entity

The Dodd-Frank Act limits availability of the end-user exception to circumstances when one of the counterparties to the swap is not a financial entity. The term financial entity means:

- a swap dealer,
- a security-based swap dealer,
- a major swap participant,
- a major 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
- 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.[5]

Hedging or Mitigating Commercial Risk

The definitions of "hedging or mitigating commercial risk" under the Proposed Rules are outlined below. Importantly, the determination of whether a swap is used to hedge or mitigate commercial risk would be made on a swap-by-swap basis. In making this determination, the CFTC suggests that the entity's overall hedging and risk mitigation strategy should be a factor. Also, the SEC's Proposed Rule includes a specific documentation requirement relating to the effectiveness of the hedge position of a security-based swap. Accordingly, it may be advisable for companies to review their overall hedging and risk mitigation policies, and related internal documentation policies, to ensure they support any necessary determination.

The CFTC's Proposed Rule and the SEC's Proposed Rule both generally provide that a swap position would be deemed to be held for the purpose of hedging or mitigating commercial risk when:

- such position is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where such risks arise from:
  - the potential change in the value of assets that a person does, or reasonably expects to, own, produce, manufacture, process or merchandise,
  - 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, or

[5] The terms "swap dealer," "security-based swap dealer," "major swap participant" and "major security-based swap participant" are currently the subject of a proposed joint rulemaking by the Commissions. The proposed definitions of these terms can be found in Exchange Act Release No. 63452 (Dec. 7, 2010).

- the potential change in the value of services that a person does, or reasonably expects to, provide or purchase in the ordinary course of business of the enterprise, and

- such position is:

  - not held for a purpose that is in the nature of speculation or trading (the CFTC also provides that the position must not be held for a purpose in the nature of investing), and

  - not held to hedge or mitigate the risk under another swap, unless that other swap is held for the purpose of hedging or mitigating commercial risk.

The CFTC's Proposed Rule additionally provides that a swap would be deemed to be used to hedge or mitigate commercial risk:

- where the risks arise from:

  - the potential change in the value of assets, services, inputs, products or commodities that a person does, or reasonably expects to, own, produce, manufacture, process, merchandise, lease or sell,

  - any potential change in value related to any of the commercial risks mentioned above from foreign exchange rate movements associated with such assets, liabilities, services, inputs, products or commodities, or

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

- when the swap qualifies as bona fide hedging for purposes of an exemption from position limits under the CEA,[6] or

- when the swap qualifies for hedge accounting treatment under the Financial Accounting Standards Board hedge accounting standards.

The SEC's Proposed Rule also would require that a person holding a security-based swap position and intending to take advantage of the end-user exception:

- identify and document the risks that are being reduced by the swap position, and

- establish and document a method of assessing the effectiveness of the swap as a hedge.[7]

Notification to the Relevant Commission

The Dodd-Frank Act requires all transactions in swaps, whether cleared or non-cleared, to be reported to a registered swap data repository ("SDR") or, if no registered SDR is available, the appropriate Commission. The Commissions have issued proposed rules governing such reporting and the manner in which the notice is to be provided to the SDR (the "Proposed Reporting Rules").[8] Under the Proposed Rules, in order to satisfy the notice requirement under the Dodd-Frank Act, the "reporting party" would be required to provide specified information described below to a registered SDR or the relevant Commission in the same manner as provided under the Proposed Reporting Rules.

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[6] These exemptions are set forth in Section 737(c) of the Dodd-Frank Act.

[7] The SEC notes that its Proposed Rule adopts the definition of "hedging or mitigating commercial risk" that the CFTC and SEC proposed in a recent joint proposed rulemaking for purposes of defining a major swap participant under the Dodd-Frank Act, and therefore certain portions of the SEC's Proposed Rule would be either inapplicable to, or would need to be interpreted in light of, the circumstances surrounding the end-user exception. For example, the definition of "hedging or mitigating commercial risk" used in the SEC's Proposed Rule would require a person holding a security-based swap position to regularly assess the effectiveness of the swap as a hedge. However, given that persons must determine whether the end-user exception is available at the time the swap is first confirmed, this requirement would be inapplicable for purposes of the end-user exception.

[8] *See* "Swap Data Recordkeeping and Reporting Requirements," 75 FR 76573 (Dec. 8, 2010), "Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information," 75 FR 75208 (Dec. 2, 2010).

- Where only one counterparty to a swap is a U.S. person, the U.S. person shall be the reporting party.

- Where both counterparties to a swap are U.S. persons and only one counterparty is a swap dealer or major swap participant, the swap dealer or major swap participant shall be the reporting party.[9]

- If neither counterparty is a U.S. person, the counterparties to the swap would select a counterparty to be the reporting party.

- With respect to any other swap, including where both counterparties are U.S. persons and neither party is a swap dealer or major swap participant, the counterparties to the swap would select a counterparty to be the reporting party.

The Proposed Reporting Rules provide that the required information about a non-cleared swap would need to be reported promptly after the transaction, but in no event later than (i) 15 minutes after the time of execution for a swap that is executed and confirmed electronically, (ii) 30 minutes after the time of execution for a swap that is confirmed electronically but not executed electronically, or (iii) 24 hours after the time of execution for a swap that is not executed or confirmed electronically.[10]

Under the Proposed Rules, the notice would need to specify the following:

- which of the parties to the swap is invoking the end-user exception,[11]

- whether the counterparty invoking the end-user exception is a financial entity,

- whether the counterparty invoking the end-user exception is an affiliate of another person qualifying for the exception under the Dodd-Frank Act and satisfies the additional requirements for such affiliates under the Dodd-Frank Act,[12]

- whether the counterparty invoking the end-user exception uses the swap being reported to hedge or mitigate commercial risk,

- whether the non-financial entity intends to meet its financial obligations associated with the non-cleared swap:

  - by using a written credit support agreement,

  - by collateral that has been pledged under a written security arrangement not requiring the transfer of possession of collateral to either of the swap counterparties,

  - by a guarantee by a person or entity other than the non-financial entity or entities that are party to the swap,[13]

  - solely by utilizing available financial resources, or

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[9] Thus, in many cases where an end user is invoking the exception, the end user will not be the reporting party. With respect to a swap in which one counterparty is a swap dealer and the other a major swap participant, the Proposed Reporting Rules would make the swap dealer the reporting party.

[10] Under the Proposed Reporting Rules, the time at which the swap transaction has been executed is the point at which the counterparties to a swap become irrevocably bound under applicable law. For example, in the event of an oral agreement over the phone, the time of execution would be deemed to be the time that the parties to the telephone call agreed to the material terms. The time a transaction is confirmed means the production of a confirmation that is agreed to by the parties to be definitive and complete and that has been manually, electronically or by some other legally equivalent means signed, where the term confirmation refers to the specific documentation that evidences the legally binding agreement. An ISDA confirmation or executed term sheet that is intended to be binding should each likely qualify under this standard.

[11] The Proposed Rules provide that both parties would be able to use the exception and provide the specified information to the SDR when both are non-financial entities and otherwise meet the requirements of the end-user exception.

[12] Specifically, the affiliate, acting on behalf of the person that qualifies for the exception and as an agent, must use the swap to hedge or mitigate the commercial risk of the person qualifying for the exception under the Dodd-Frank Act or other affiliate of such person that is not a financial entity, provided that the affiliate is not a swap dealer, a security-based swap dealer, a major swap participant, a major security-based swap participant, an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940 but for paragraph (1) or (7) of subsection (c) of that Act, a commodity pool or a bank holding company with over $50,000,000,000 in consolidated assets.

[13] The CFTC's Proposed Rule specifies that the indication must be made as to a guarantee of all, or any portion, of the financial obligations associated with the non-cleared swap.

- by means other than those described above, and

- whether the counterparty invoking the end-user exception is an issuer of securities registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") or required to file reports under Section 15(d) of the Exchange Act (an "SEC Filer"), and if so, the additional information set out below.[14]

SEC Filers—Board Committee Review and Approval

The end-user exception would be available to SEC Filers only if a committee of the issuer's board of directors or governing body specifically authorized to review and approve the issuer's decision to enter into swaps that are subject to the exception has done so. When the counterparty invoking the end-user exception is an SEC Filer, the Proposed Rules require the following additional information:

- confirmation that an appropriately authorized committee of the board of directors or equivalent governing body of the SEC Filer invoking the end-user exception has reviewed and approved the decision not to clear the swap being reported, and

- the SEC Filer's Central Index Key (CIK) number.

The Proposed Rules suggest that one way a company could comply with the requirement that an appropriate committee review and approve non-cleared swaps would be through a board resolution or an amendment to a board committee's charter that expressly authorizes such committee to review and approve decisions of the company not to clear reported swaps. And although the language of the Proposed Rules suggests that the chosen board committee must approve swaps on an individual basis, the Commissions have indicated in their rulemaking releases that a committee could adopt policies and procedures to review and approve decisions not to clear swaps, either on a periodic basis or subject to other conditions determined to be satisfactory to the board committee, and once those procedures are in place and followed, a company's management could make the determination with regard to individual swaps. Clearly, the costs and benefits of the end-user exception vary considerably if a board committee must pre-approve individual swaps and we anticipate that this confusion in the proposed regulatory text will be resolved in any final rulemaking.

It is important to note that the foregoing discussion of the end-user exception is based on the Proposed Rules and it is likely that the final rules will differ in some respects from the proposals.

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[14] For these purposes, the Commissions consider a counterparty invoking the end-user exception to be an SEC Filer if it is controlled by a person that is an SEC Filer.