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Corporate and Futures and Derivatives Alert

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The New Swaps Regime: A Primer for Nonfinancial Companies

More than two years after enactment, the Dodd-Frank Act's sweeping new derivatives provisions are beginning to be implemented. Many of the Dodd-Frank Act's requirements apply to nonfinancial public and private companies that use derivatives. This guide explains what those requirements are, how they affect nonfinancial corporate end users of derivatives, and how your company should prepare to become compliant as these rules are phased in during 2013.

Background

In August 2012, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) jointly finalized their definitions of those derivative instruments that come within the scope of the Dodd-Frank Act (Covered Derivatives).[1] Covered Derivatives include a variety of instruments—including currency swaps, interest rate swaps, and credit default swaps—that many nonfinancial companies use to manage a range of risks to which they are exposed in the ordinary course of business.

Under the new rules, if your company uses Covered Derivatives, it may be required to have these instruments submitted to a central clearing house and executed on a regulated exchange or exchange-equivalent. Your company can elect out of the clearing process if it satisfies the requirements for the "nonfinancial end user" exception. These requirements include that the company not be a swap dealer, major swap participant (MSP) or other "financial entity";[2] that the Covered Derivatives be used for commercial purposes, not investment, trading or speculation; and that, if your company is publicly traded, you obtain approval from your board of directors to enter into these instruments and to rely on the end user exception. Companies that use Covered Derivatives will be responsible for significant new recordkeeping requirements and may have reporting obligations as well. In any event, the new derivatives regulations could result in additional costs associated with entering into and maintaining Covered Derivatives.[3]

This guide, in question and answer format, is designed to provide public and private companies that are not financial institutions, but that use Covered Derivatives, with a framework for approaching compliance with the new Dodd-Frank Act regime. We have included an action plan at the end of the guide to address the issues discussed.

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[1] The Dodd-Frank Act requires the CFTC and the SEC to adopt some Dodd-Frank Act rules separately and others jointly. The CFTC is significantly further along in its mandatory rulemaking than the SEC.

[2] As discussed below, certain financial institutions will nonetheless be able to rely on the nonfinancial end user exception.

[3] The CFTC and SEC have both proposed but not yet adopted rules that will require mandatory margin and capital charges for uncleared Covered Derivatives. The extent to which nonfinancial end users electing not to clear their Covered Derivatives may be exempt from these requirements is still unclear.

What is a Covered Derivative and does your company use any?

A derivative is a contract whose value is based on (i.e., derived from) the value of something else. That "something else" is usually referred to as an "underlying," which is typically (but not always) a security, a commodity (e.g., fuel), an index or portfolio, or a reference rate. Derivatives may be traded on an exchange or over-the-counter (OTC). Exchange-traded derivatives (e.g., futures, options on futures, and exchange-listed equity options) were regulated before the Dodd-Frank Act. OTC derivatives, on the other hand, which are bilateral contracts typically negotiated between principals, were largely unregulated prior to implementation of the Dodd-Frank Act provisions, but most will now be regulated under the Dodd-Frank Act.

OTC derivatives that are now regulated, i.e., Covered Derivatives, include three categories of instruments: "swaps," "security-based swaps," and "mixed swaps." Examples of swaps include interest rate swaps, foreign currency and cross-currency swaps and options, forward rate agreements, non-deliverable forward foreign exchange transactions, credit default swaps and total return swaps on broad-based security indexes or on more than one loan, and commodity swaps. Swaps are regulated by the CFTC. Derivatives based on a single security, loan, or issuer, or on a narrow-based security index, are security-based swaps. Examples of security-based swaps include instruments based on yields; credit default swaps and total return swaps on a single security or loan or on a narrow-based security index; and combinations, permutations, or options on a security-based swap.[4] Security-based swaps are regulated by the SEC. "Mixed swaps" contain elements of both swaps and security-based swaps and are subject to regulation by both the CFTC and the SEC.

The threshold inquiry for public and private companies is whether your company uses Covered Derivatives and, if so, whether they are swaps or security-based swaps. Because swaps regulations are now beginning to be implemented by the CFTC, the remainder of this guide focuses on what your company needs to know to become compliant with CFTC regulation.

Are certain foreign exchange swaps exempt from CFTC rules?

The Secretary of the Treasury has exempted certain foreign exchange derivatives from the definition of "swap" pursuant to explicit authority granted by the Dodd-Frank Act.[5] However, the definition of which instruments are exempt is narrow. The exempted instruments are foreign exchange swaps and forwards that are "deliverable," i.e., physically settled through the exchange of currencies. The Commodity Exchange Act defines a foreign exchange swap narrowly as a transaction that solely involves (i) an exchange of two different currencies on a specific date at a fixed rate agreed to at the start of the contract; and (ii) a reverse exchange of the two currencies at a later date at a fixed rate that is agreed to at the start of the contract. Similarly, a foreign exchange forward is narrowly defined as a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed to at the start of the contract.

Even these exempt instruments remain subject to certain reporting, recordkeeping, business conduct, and anti-evasion requirements.

All other types of OTC foreign exchange and currency transactions are subject to regulation as swaps, including foreign exchange options, currency swaps, and non-deliverable foreign exchange forwards.

Is your company a swap dealer or major swap participant?

If your company enters into swaps as a regular part of its business, makes a market in swaps, or maintains a substantial position in swaps or has significant swaps counterparty exposure, it might be deemed a swap dealer or major swap participant (MSP) and have to register as such, if it exceeds specified *de minimis* thresholds. There are two *de minimis* thresholds for a swap dealer determination—

[4] For a discussion of the final rules on the definitions of Covered Derivatives, *see* WilmerHale Client Alert, SEC and CFTC Finally Define Swaps: Regulators Issue Final Rules and Interpretations Further Defining Swap-Related Terms (Aug. 14, 2012).
[5] Dept. of the Treasury, Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act (Nov. 20, 2012), 77 FR 69694 (Nov. 20, 2012).

$8 billion in unhedged exposures with all counterparties and $25 million in swaps with "special entity" counterparties.[6] The *de minimis* thresholds for an MSP determination are similarly quite high (current uncollateralized exposure of $5 billion, or a sum of current uncollateralized exposure and potential future exposure of $8 billion). Although most nonfinancial companies are unlikely to reach any of the applicable activity levels for registration, nonfinancial companies should be aware of and make the threshold determination of whether registration could be required.[7]

Is your company a financial entity?

Nonfinancial end users may be excepted from many of the Dodd-Frank Act requirements. A nonfinancial end user is an entity that is not a "financial entity," the definition of which includes a swap dealer or MSP, a commodity pool, a private fund, an employee benefit plan (such as a 401(k) plan), or a person predominantly engaged in financial activities, as broadly defined in Section 4(k) of the Bank Holding Company Act of 1956. Even if your company is not a financial entity, its affiliates may be financial entities and, if so, would generally be regulated as such.[8]

What are the implications of being a swap dealer, MSP, or other financial entity?

Swap dealers and MSPs are subject to substantial registration, business conduct, and capital requirements. In addition, swap dealers, MSPs, and most other financial entities are also subject to mandatory clearing of their swaps (and execution on a registered trading platform), as well as margin, reporting, and recordkeeping requirements.

What are the implications of *not* being a swap dealer, MSP, or other financial entity?

Nonfinancial end users (and certain financial end users, as discussed separately below), may elect not to clear their swaps, which will also then be excepted from mandatory trading of the swaps on a regulated exchange or exchange equivalent. In order to claim this exception, the nonfinancial end user will be required to make an annual filing with the CFTC. Moreover, nonfinancial end users will have significant recordkeeping requirements and may also be responsible for reporting some of their swaps, regardless of whether they choose the exception from mandatory clearing. In addition, in order to rely on the exception, public company end users will need to have certain actions taken by their boards of directors. And companies that are "special entities" will be required to comply with additional requirements in connection with their swaps transactions.

Does your company qualify for the nonfinancial end user exception?

If your company is a nonfinancial entity, it may elect to use the end user exception from mandatory clearing for swaps that it uses to hedge or mitigate its commercial risk and not for speculative trading

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[6] "Special entities" are defined in Section 4s of the Commodity Exchange Act to include federal agencies; states, state agencies, cities, counties, municipalities, or other political subdivisions of any of the foregoing; certain private and public pension plans; and endowments.

[7] Because of the Treasury Secretary's exemption, deliverable foreign exchange swaps and forwards need not be counted for purposes of the initial swap dealer and MSP calculations.

[8] Under the Dodd-Frank Act and CFTC rules, certain financial institutions have been exempted or excluded from the definition of "financial entity," including:

- Banks, savings associations, credit unions, and farm credit system institutions with no more than $10 billion in assets, but only if they are not also swap dealers, MSPs, or private funds.

- Captive finance companies, if their primary business is to provide financing to their parent and they use swaps to hedge commercial risk related to interest rate and foreign currency exposures. The bulk of the exposures (at least 90 percent) must arise from financing that facilitates the purchase or lease of products; and the bulk of the products (at least 90 percent) must be manufactured by the parent company or another subsidiary of the parent company.

We include these types of institutions when we refer to "nonfinancial entities" in this guide.

purposes. The purpose determination is made on a transaction-by-transaction basis. A company will not be allowed to use the exception for non-hedging swaps even if it otherwise qualifies for the exception.[9]

Is your company using your swaps to hedge or mitigate commercial risk?

Your company will need to assess whether its swaps have been entered into *for the purpose of* hedging or mitigating commercial risk.

Whether a risk will be considered commercial is based on the underlying activity creating the risk, not on the nature of the business that your company generally conducts. Commercial risk may thus include financial risk if it is related to your company's commercial activities. The CFTC has construed the concept of hedging commercial risk broadly for purposes of the end user exception. It is not necessary for the hedge to qualify as *bona fide* hedging for purposes of the Commodity Exchange Act or for hedging treatment under applicable accounting standards,[10] although satisfying either of those tests will also satisfy the end user requirement. Even if neither of those tests can be met, however, if the particular swap is economically appropriate to the reduction of certain risks in the management of your company's business, it should qualify for the end user exception.[11]

Can your company's affiliates claim the end user exception?

Affiliates that are themselves nonfinancial entities may claim the end user exception for their own swaps if they are used for hedging or mitigating commercial risk.

In some instances, even certain financial affiliates will be allowed to rely on the end user exception. For example, your company may centralize its risk management or treasury function in the parent company or in a separate hedging affiliate or subsidiary that is a financial entity. Whether the financial entity entering into the swaps may rely on the end user exception is a complex question and depends on where in the corporate structure the hedging activity is done and whether the entity is entering into the swaps as agent of the nonfinancial end user or as principal.[12]

If your company conducts centralized hedging within the corporate organizations, you will need to analyze whether the end user exception will be available for swaps entered into by the legal unit engaging in the hedging activity.

If your company qualifies, how does it elect the exception from clearing?

All end users (public and nonpublic) that rely on the end user exception to elect not to clear qualifying swaps must provide the following information to a swap data repository (SDR), if available, or to the CFTC:

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[9] *See* CFTC, End-User Exception to the Clearing Requirement for Swaps; Final Rule (CFTC Final Rule), 77 FR 42560 (July 19, 2012). For a detailed discussion on the end user exception, *see* WilmerHale Client Alert, CFTC's Final Rule on the End-User Exception to the Mandatory Clearing of Swaps (July 20, 2012).

[10] Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging, formerly known as Statement of Financial Accounting Standards No. 133.

[11] The risks recognized as commercial by the CFTC include risks arising from: (i) the potential change in the value of assets that the company owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of its business; (ii) the potential change in the value of liabilities that the company has incurred or reasonably anticipates incurring in the ordinary course of its business; (iii) the potential change in the value of services that the company provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of its business; (iv) the potential change in the value of assets, services, inputs, products, or commodities that the company owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of its business; (v) a 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 the company's current or anticipated assets or liabilities.

[12] Many companies also enter into inter-affiliate swaps. The CFTC has proposed, but not yet adopted, a clearing exception for certain inter-affiliate swaps. Proposed Rule, Clearing Exemption for Swaps Between Certain Affiliated Entities, 77 FR 50425 (Aug. 21, 2012).

- Whether your company is a financial entity and, if so, which exception to the definition of "financial entity" it is using (e.g., is it a small bank or a captive finance company?);

- Whether the swap for which the election is being made hedges or mitigates commercial risk. To satisfy this requirement, the company need only state that it will only elect the end user exception for swaps that meet the hedging or risk mitigation standard;

- How the company generally expects to meet its financial obligations with respect to entering into uncleared swaps. The company will need to indicate (in a check-the-box format) all the following that apply:

    - 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;

    - its available financial resources; or

    - other means; and

- Whether it is a public company[13] and, if so, confirmation that it has obtained appropriate approvals from its board of directors. Nonpublic companies are not required to obtain board approval.

These items may be reported on an annual basis (in anticipation of making the election and valid for 365 days from the report) rather than at the time a swap is entered into. However, the election of the exception and the identity of the end user must be reported on a swap-by-swap basis at the time the swap is entered into. While *all* swaps will ultimately need to be reported, the obligation to report will largely be borne by swap dealers, MSPs, and larger private funds and not by nonfinancial end users. These requirements only apply to swaps entered into on or after the compliance date.

What board approvals are required for public companies to elect the end user exception?

A public company must obtain approval from its board of directors or an appropriate committee of the board of directors before it may enter into swaps that are eligible for the end user exception. An appropriate committee is one that the board of directors has *expressly* authorized to review and approve decisions to enter into swaps for the company. Your company's existing governing documents may specify the appropriate board committee, but if not, the board of directors will be able to select the committee it considers the most appropriate. This could be the audit, finance, or risk committee, or it could be a new board committee constituted for this purpose.

Approval to elect the end user exception will require the board to consider the company's policies and procedures generally with respect to swaps trading. Factors the board should consider in making the designation include the number and types of swaps entered into by the company and whether all the swaps should be overseen by the same committee. Ultimately, the board of directors should make its selection with the overall risk management of the company in mind. The board of directors or designated committee must have written procedures relating to the determination of whether or not to clear, including, for example, procedures relating to whether the determination will be made on a swap-by-swap, type of swap, or other basis. The procedures should be reviewed at least annually and updated as necessary

[13] As used herein, "public company" means: an entity with securities registered under Section 12 of the Exchange Act or that is required to file reports under Section 15(d) of the Exchange Act; and an entity controlled by such an entity. Thus, a nonpublic subsidiary of a public company would be an issuer of securities for purposes of the end user exception and would be a "public company" as used in this guide even though it is not itself an issuer. The SEC has proposed using the same definition in its end user exception proposal. *See* CFTC Final Rule, at 42570.

and appropriate.

Where a public company has controlled affiliates and/or subsidiaries that enter into swaps, the board of directors of the parent has "reasonable discretion" to determine the appropriate committee, either at the parent level or at the affiliate or subsidiary level. If the affiliate or subsidiary will make its own decisions about clearing, we recommend that the board of directors of the public company parent consider making a formal delegation of this authority to the affiliate or subsidiary.

Is it better to clear or not to clear?

All end users permitted to make an election not to clear will need to weigh the pros and cons of their decisions, many of which are still unknown. There are advantages and disadvantages to both alternatives and these should be considered in the context of the company's overall risk management. For example, companies should consider the needs of their particular hedging programs as well as the relative costs involved in clearing or not clearing particular instruments, including how margin and capital requirements will apply and the costs of any new compliance requirements. Moreover, this determination may change over time as clearing arrangements are implemented and the full panoply of regulations, including capital and margin requirements, are applied to non-cleared contracts. Accordingly, the relative costs and benefits of each arrangement may need to be reassessed periodically.

Assuming your company elects not to clear, who is responsible for reporting that election?

Your company's counterparty must report your company's election not to clear, on a swap-by-swap basis, unless your company enters into a swap with another nonfinancial end user.[14] End users' counterparties typically would be swap dealers and, as such, they would be required to do the swap-by-swap reporting, as well as the required swap data reporting for new and existing swaps.

In order to have a reasonable basis for making its report on your company's election of the clearing exception, your company's swap dealer counterparty will need to collect information and obtain certain representations from your company. Your company's counterparty's additional swap dealer obligations (e.g., under the new business conduct standards) will also entail providing to your company and obtaining from your company additional information and disclosures, which will require amendments to your company's current swap trading agreements.[15]

Is your company required to obtain a Legal Entity Identifier?

The swap reporting rules also require that every swap counterparty (whether or not the swap is cleared) must have a Legal Entity Identifier (LEI) in place before reporting begins. It is generally your company's responsibility to obtain an LEI. The CFTC has designated DTCC-SWIFT the sole LEI provider for now. That body's CFTC Interim Compliant Identifier (CICI) is to be used as the LEI for all swaps recordkeeping and reporting purposes. If your company does not yet have a CICI, it will have to register with DTCC-SWIFT to obtain one. In some cases, your swap dealer counterparty may be willing to obtain a CICI on your company's behalf.

What recordkeeping and reporting requirements will your company have?

(a) Recordkeeping

Your company will be required to keep complete records of all of its swaps. These records, which must be made available to the CFTC for inspection, must be maintained for at least five years after termination of a swap and be retrievable within five business days. Records must be kept, either in electronic or paper

[14] Your company may have the reporting obligation for historical and new inter-affiliate swaps and swaps with other nonfinancial end users as counterparties. This obligation is addressed below in the Q&A on recordkeeping and reporting.

[15] As discussed in previous WilmerHale Client Alerts, your company, if it has not already done so, may need to adhere to the ISDA August 2012 Dodd Frank Protocol to facilitate its swap dealer counterparties' compliance with CFTC rules, including those relating to the new business conduct standards. The compliance deadline was extended to May 1, 2013. *See* CFTC to Extend Compliance Date for ISDA August 2012 Dodd-Frank Protocol (Dec. 20, 2012), and Reminder, Compliance Deadline Approaching for ISDA August 2012 Dodd-Frank Protocol (Dec. 7, 2012).

form, both for existing and new swaps. These obligations will require your company to establish swap recordkeeping policies and procedures and may require investment in new recordkeeping systems. Recordkeeping obligations differ depending on whether a swap is a new swap (governed by Part 45 of the CFTC's regulations) or a "historical" swap (governed by Part 46 of those regulations). Historical swaps include "pre-enactment" and "transition" swaps. Pre-enactment swaps are swaps entered into before and still in existence on July 21, 2010, the date of enactment of the Dodd-Frank Act. Transition swaps are swaps entered into on or after that date. The recordkeeping requirements also differ depending on whether a pre-enactment or transition swap was in existence on or after April 25, 2011, the day the CFTC proposed its recordkeeping and reporting rules.

In general, counterparties to historical swaps that terminated before April 25, 2011 are required to keep all information and documents relating to the terms of the transactions that they possessed as of October 14, 2010 (for pre-enactment swaps) or December 17, 2010 (for transition swaps), when the CFTC published interim final rules ordering that all such information be preserved.[16] Counterparties to these swaps are not required to recreate documentation or to alter the method by which the information they have is organized and stored.

Counterparties to historical swaps in existence on or after April 25, 2011, however, must keep records of certain minimum primary economic terms as well as additional documentation, to the extent it has been in a counterparty's possession at any time after April 25, 2011. The additional documentation includes, for example, confirmations, master agreements, and credit support agreements. Additional documentation for historical swaps must be kept for any historical swap that remains in existence after the applicable reporting compliance date (discussed in the next Q&A) to the extent such records are created by or become available to the counterparty on or after the compliance date.

All information relevant to new swaps (those entered into on or after the applicable compliance date) must be retained, including all records demonstrating that your company is entitled to elect the end user exception with respect to any particular swap.

(b) Reporting

A nonfinancial company that enters into a swap with a swap dealer, MSP, or other financial entity counterparty will have no reporting obligations because its counterparty has been designated the reporting counterparty by the CFTC. Your company will need to provide its swap dealer/MSP/financial entity counterparty with all the information it needs to meet its reporting obligation on a timely basis, although most of the required information will already be available to that counterparty.

If a nonfinancial company enters into a swap with another nonfinancial company (including inter-affiliate swaps), generally the counterparties may elect which one of them will report the swap data. If the swap is cleared, neither of the counterparties will have reporting obligations. If the swap is uncleared, however, the reporting party will have a variety of reporting obligations, depending on whether the swap is executed on a registered trading platform. The information that must be reported could include data on the primary economic terms of the swap, as well as confirmation, valuation, and continuation (i.e., over the life of the swap) data.

What is the timing of these new requirements?

Although nonfinancial end users will not need to begin clearing or electing not to clear their swaps until September 9, 2013, at the earliest,[17] reporting obligations start sooner. As discussed above, however, if one of the counterparties to a swap is a swap dealer or MSP, the nonfinancial counterparty will not be required to do the reporting. Reporting for swap dealer and MSP counterparties is as follows:

[16] CFTC Interim Final Rule for Reporting Pre-Enactment Swap Transactions, 75 FR 63080 (Oct. 14, 2010); CFTC Interim Final Rule for Reporting Post-Enactment Swap Transactions, 75 FR 78892 (Dec. 17, 2010).
[17] The CFTC has approved clearing of certain credit default swaps and interest rate swaps. The September 9 date applies to a clearing election in connection with these swaps. The CFTC has yet to approve clearing of other types of swaps.

- Interest rate and credit swaps entered into on or after December 31, 2012 with swap dealer counterparties began to be reported as of that date.

- New equity swaps, foreign exchange swaps, and other commodity swaps entered into on or after February 28, 2013 with swap dealer or MSP counterparties will need to be reported beginning on that date.

Historical swaps (i.e., pre-existing and transition swaps) will need to be reported beginning on March 31, 2013.

All swaps (including those between nonfinancial counterparties) will need to be reported by no later than April 10, 2013.

Your company will need to ensure that it has systems in place to provide its counterparties with all required information in time to meet this schedule.

What should your company's action plan be?

Many of these deadlines are fast approaching and counterparties that are swap dealers, MSPs, and financial entities are already reaching out to their nonfinancial counterparties to ensure compliance. So what does your company need to do?

1. Assess whether your company has any Covered Derivatives and, if so, whether they are subject to the rules of the CFTC or the SEC or both.

2. Determine whether your company is a swap dealer, MSP, or financial entity.

3. If not, assess whether your company qualifies for the nonfinancial end user exception.

4. If your company conducts its risk management through a centralized hedging unit, assess whether that unit will qualify for the end user exception.

5. Assuming your company qualifies, determine whether it uses swaps to hedge or mitigate risk.

6. Determine whether the company's board of directors or a board committee will oversee matters relating to swaps and whether or not to elect to use the nonfinancial end user exception; if necessary, establish a new committee of the board or delegate authority to an existing board committee; and identify the board or committee meeting at which the decision will be made.

7. Implement procedures for the board or committee to follow in connection with its approval of swaps.

8. Analyze the pros and cons of electing to use the nonfinancial end user exception.

9. If your company elects to use the nonfinancial end user exception, make the election by reporting to the SDR. Your company's swap dealer counterparty may do this on its behalf.

10. Obtain an LEI.

11. Implement procedures and processes for swaps trading, recordkeeping, and, if applicable, reporting.

Even companies that have never used derivatives or do not currently use them should consider implementing internal procedures to ensure that the company not enter into derivatives in the future without ensuring compliance with the Dodd-Frank Act rules.

FOR MORE INFORMATION ON THIS OR OTHER FUTURES AND DERIVATIVES MATTERS, CONTACT:

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