

DODD-FRANK ACT HAS ITS FIRST BIRTHDAY, BUT DERIVATIVES END USERS HAVE LITTLE CAUSE TO CELEBRATE

*Michael Sackheim and Elizabeth M. Schubert**

A year has passed since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Title VII of the Dodd-Frank Act, entitled the Wall Street Transparency and Accountability Act of 2010 (“Title VII”) created a new transparent exchange-type trading marketplace for over-the-counter swaps subject to regulation by the Commodity Futures Trading Commission (“CFTC”) and security-based swaps subject to regulation by the Securities and Exchange Commission (“SEC”) (collectively, “OTC derivatives” or “swaps”). This article will discuss the significant impact Title VII has, and will continue to have, on the end user, or “buy” side, of the derivatives markets.¹

Background. Title VII repealed most of the exemptions for OTC derivatives created by the Commodity Futures Trading Modernization Act of 2000 (the “CFMA”). The new statute was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) providing for the registration and comprehensive regulation of swap dealers and large end users, termed “major swap participants;” (2) imposing clearing and trade execution requirements on standardized OTC derivative products; (3) creating recordkeeping and real-time reporting regimes; and (4) imposing margin, capital, and position limits requirements on market participants.

The CFMA opened the door for institutional traders having total assets exceeding \$10 million, termed “eligible contract participants” (“ECPs”), to enter into privately

* Michael Sackheim is a partner at Sidley Austin LLP, where he focuses on futures and derivatives regulatory, transactional and enforcement matters. Elizabeth M. Schubert is a partner at Sidley Austin LLP, where she focuses on futures and derivatives.

¹ Generally speaking, an end user is the party to a derivative contract that is a “customer” to a financial institution, or the non-dealer party to the transaction.

negotiated OTC derivatives for both hedging and speculative purposes, with credit terms tailored to the needs of the parties, free from burdensome government regulation. Since the passage of the CFMA, the volume of OTC derivatives transactions increased dramatically. Commercial end users who qualified as ECPs under the CFMA were able to use OTC derivatives as risk management tools and to negotiate the terms of bilateral equity, commodity, interest rate, and currency OTC derivatives, in most instances without being required to tie up capital as collateral. For derivatives end users who have grown accustomed to the liberal regulatory regime under the CFMA, compliance with Title VII will require major adjustments. These include possible registration as a major swap participant, central clearing of swaps transactions, complying with margin requirements, position limits, and recordkeeping and reporting requirements.

Registered Entities. Title VII creates two categories of regulated entities in the swaps markets, the swap dealer and the major swap participant.² Entities that fall under either of these definitions will have a significantly higher regulatory burden to meet than those that do not. Regulation will require, among other things, registration with either the CFTC or the SEC, business conduct standards, margin and capital requirements, recordkeeping and real time reporting of swap activity.

The majority of end users will not qualify as swap dealers.³ With respect to the major swap participant definition, the regulators' stated focus is to identify swap market participants that "do not cause them to be dealers, but could still pose a high degree of risk to the U.S. financial system."⁴ If the proposed rules on these definitions are adopted without major change, few end users will clear this high bar. The proposed definition is premised on whether the entity in question maintains a substantial position in major categories of swaps⁵ and whether its swaps create substantial counterparty exposure that could have serious adverse affects on the financial stability of the U. S. banking system or financial markets. An additional prong of the major swap participant test covers any financial entity that is highly leveraged relative to the amount of capital

² Section 731 of Dodd-Frank Act creates Section 4s of the Commodity Exchange Act, which requires registration and regulation of swap dealers and major swap participants. Section 764 of the Dodd-Frank Act creates Section 15F of the Securities Exchange Act of 1934, which requires registration and regulation of security-based swap dealers and major security-based swap participants.

³ Initially some commentators noted that a liberal interpretation of Title VII's definition of swap dealer could be construed to include a high volume end user of derivatives. In proposed rules on the definition of swap dealer, the CFTC and SEC have both clarified that most high volume end users will not be characterized as swap dealers.

⁴ See Definitions of "Major Swap Participant" and "Major Security-Based Swap Participant," 75 Fed. Reg. 80,174, 80,185 (proposed Dec. 21, 2010).

⁵ The "substantial position" prong of the definition expressly excludes positions held for hedging or mitigating commercial risk and positions maintained by or contracts held by any employee benefit plan for the primary purpose of hedging or mitigating risks directly associated with the person or plan. Categories of swaps subject to regulation by the CFTC are rate swaps, credit swaps, equity swaps and commodity swaps. Categories of swaps subject to regulation by the SEC are security-based credit derivatives and other security-based swaps. *Id.* at 80,186.

it holds and that is not subject to capital requirements established by the appropriate Federal Banking agency and that maintains a substantial position in swaps.⁶

Tests for what constitutes a “substantial position” are based on uncollateralized exposure or potential future exposure. Uncollateralized exposure is, simply put, mark-to-market exposure a counterparty may have to an end user, for which the end user has not posted collateral.⁷ Potential future exposure is measured by taking into account total notional principal amount of positions adjusted using a multiplier that takes into account the type of swap and remaining duration of the swap.⁸ The thresholds for what constitutes a substantial position are very high: a daily average of \$1 billion for most swap categories and \$3 billion for rate swaps.⁹ In all likelihood these thresholds will capture only the very largest of high volume end users. Similarly, the “substantial counterparty exposure” prong of the major swap participant test looks at uncollateralized exposure and potential future exposure, but across all categories of swaps. For swaps, thresholds are \$5 billion for uncollateralized exposure and \$8 billion for combined uncollateralized and potential future exposure.¹⁰ For security-based swaps, thresholds are \$2 billion for uncollateralized exposure and \$4 billion for combined uncollateralized and potential future exposure.¹¹ For the final prong, the definition of financial entity is broad and captures private investment funds.¹² The regulators have not yet given clarity on what constitutes “highly leveraged” and have proposed ratios of 8 to 1 and 15 to 1 with respect to an entity’s total liabilities to equity at the close of business on the last business day of the applicable fiscal quarter.¹³

The Clearing Requirement. Title VII requires swaps to be centrally cleared.¹⁴ The transition to central clearing marks a major change for end users who currently trade swaps over-the-counter (“OTC”). An end user to an OTC swap faces its counterparty directly. The documentation governing this relationship creates a bilateral credit relationship so both end user and dealer alike are able make demands for payments or collateral from the other and also to call one another in default if either party fails to perform its obligations. Central clearing creates one central counterparty to all swap transactions, the clearinghouse. Most end users do not face the clearinghouse directly, however, but through a clearing member that is typically a bank

⁶ *Id.*

⁷ *Id.* at 80,187.

⁸ *Id.* at 80,189.

⁹ *Id.* at 80,190.

¹⁰ *Id.* at 80,215.

¹¹ *Id.* at 80,213.

¹² *Id.* at 80,215.

¹³ *Id.*

¹⁴ Section 723 of the Dodd-Frank Act covers swaps while Section 763 covers security-based swaps. In both cases, the clearing requirement applies only to swaps that are *required to be cleared*. As of this writing, no regulatory guidance exists as to which products this will cover, although the market is assuming that any product currently eligible for clearing will be subject to the clearing requirement.

affiliate (a registered futures commission merchant, broker, dealer or security-based swap dealer).¹⁵ Unlike the OTC regime where an end user faces its counterparty directly, with a centrally cleared trade, the end user enters into a trade with an executing dealer, the trade is reported to the clearinghouse and if neither the end user or executing dealer has exceeded any clearinghouse imposed trading limits, the trade is accepted for clearing by the end user's clearing member. The clearing member then acts as the end user's agent facing the clearinghouse. To the extent the clearinghouse calls for margin on the end user's trade, the call will be made to the end user's clearing member and passed on to the end user. If the end user is owed margin on a trade, the margin will be paid out to the end user's clearing member who will in turn pass through the margin payment to the end user.

For most end users, the most fundamental component of the transition to central clearing is that the end user is no longer an "equal" party to the swap transaction.¹⁶ For OTC transactions, events of default and termination rights are negotiated bilaterally and apply equally to both end user and its counterparty. Under a centrally cleared trade, an end user typically has no right to call its clearing member in default, and if it does not negotiate its clearing agreements carefully, its clearing member may have the right to call an event of default or close out open transactions at any time if at any time it feels it needs to do so for its own protection.¹⁷ In addition, under the OTC model, end users have grown accustomed to negotiating the margin terms and any elective termination rights for their swap transactions at the time of the trade. Under a centrally cleared trade, a clearing member has the right to call for an unlimited amount of margin and also a liberal right to terminate the relationship and elect to terminate open positions. Finally, in managing an end user's counterparty risk, under the OTC model, an end user always has the right to call its counterparty in default. In addition, many end users have grown accustomed to negotiating for segregation of collateral so that if a counterparty becomes insolvent, the end user will be able to recover any posted collateral. At this point, the regulatory protections of customer collateral for cleared swaps are still unclear so end users do not yet have the knowledge required to prepare to manage counterparty risk in cleared swaps transactions.

¹⁵ Section 724 of the Dodd-Frank Act requires that any person accepting collateral for a cleared swap be a registered futures commission merchant. Section 763 of the Dodd-Frank Act requires that any person accepting collateral for a cleared security-based swap be a registered broker, dealer or security-based swap dealer.

¹⁶ In the bilateral swaps market, where swaps transactions are traded under the ISDA Master Agreement, the end user and bank counterparty come to the table as equals, however, the dealer typically has more bargaining power than the end user and will usually negotiate stronger terms for itself than it is willing to give to its end user client.

¹⁷ The operative agreement for most clearing arrangements is a futures customer agreement. A futures customer agreement is not a standardized contract like the ISDA Master Agreement, the operative document for most OTC swap transactions. A customary term in most futures customer agreements is that the client can be called in default at any time for any reason. In addition, open positions can be closed out at any time for any reason.

Margin Requirements. An additional burden on end users will be margin requirements for swap transactions. As Congress was concerned that non-cleared swaps pose counterparty and systemic risks, cleared swaps will be subject to the margin rules imposed by the applicable clearinghouse. For non-financial entity commercial end users that engage in swaps to hedge or mitigate commercial risk, section 723 of Title VII permits the avoidance of clearinghouse margin requirements by creating an exemption from mandatory clearing, allowing the commercial end user to instruct its dealer to not have its swaps cleared. The end user to a non-cleared swap may also require that its collateral be segregated with a third-party custodian, the additional costs of which will presumably be passed on by the dealer to the end user. To qualify for this non-clearing exemption, the end user must also notify the regulator how it generally satisfies its obligations with respect to non-cleared swaps and, if it is an SEC reporting company, an appropriate committee of its board or governing body must authorize the use of this exemption.

Sections 731 and 734 of Title VII require that the CFTC and the bank regulators impose margin requirements for non-cleared swaps on swap dealers. The CFTC has not proposed mandatory margin requirements for non-bank swap dealers. Instead, the CFTC requires non-bank swap dealers to enter into written credit support arrangements with their end user counterparties. For commercial end users, the CFTC will allow non-bank swap dealers to establish a threshold of unsecured exposure, but margin must be collected weekly. The CFTC also proposed that for non-cleared swaps with non-bank swap registrants, two-way bilateral margin should be required, resulting in dealers possibly passing on any related costs to the end users. The CFTC proposal does not require non-bank swap dealers to collect margin from their commercial end user counterparties, but parties must have a written credit support arrangement that (i) requires margin in the event the end user is out of the money above an agreed threshold, (ii) limits eligible collateral, (iii) imposes valuation haircuts and (iv) permits the commercial end user to require that its collateral be held in a segregated account with a third-party custodian, again, however, resulting in potential increased costs. By contrast to the CFTC, the bank regulators proposed mandatory margin collection rules for swap dealers that are insured depository institutions. Bank swap dealers will be required to collect initial and variation margin from both financial entities and commercial end users for non-cleared swaps, regardless of the end user's creditworthiness, as opposed to simply entering into a credit support arrangement as required by the CFTC for non-bank swap dealers.

Under the CFMA swaps safe harbor that has been repealed by Title VII, creditworthy commercial end users rarely entered into credit support arrangements or posted collateral, therefore they weren't required to tie up their capital as illiquid collateral. Because CFTC regulated non-bank swap dealers need only enter into credit support arrangements with commercial end users rather than collect mandatory margin as bank swap dealers must, this lack of harmonization may result in commercial end

users choosing to trade derivatives with swap dealers that are not banks.

Position Limits. Title VII imposes limits on the amount of swaps a trader can enter into. Position limits specify the maximum number of contracts in specified commodities that any one non-hedging market participant may hold. The CFTC has historically considered position limits in futures necessary to minimize market disruptions and price distortions resulting from excessive speculative trading. This has been a controversial issue and many market participants have argued that there is no evidence that speculative trading resulting in large positions causes these types of problems. Nevertheless, these objections have not had any traction. Section 737 of Title VII requires the CFTC to include swaps in addition to futures contracts under its position limits regime. In January 2011, the CFTC proposed new position limits for futures contracts and “economically equivalent” swaps involving energy, metals and agricultural products. Under the proposed rules, a swap is considered “economically equivalent” to a core futures contract if either (1) the price of the swap refers to a covered futures contract settlement price; or (2) the swap is priced on the same commodity delivered at the same location, or at locations with substantially the same supply and demand characteristics, as that of any of the core futures contracts.

The position limits regime has always included some form of hedging exemption. The rationale is that end users that use the futures markets to reduce the risks inherent in operating commercial enterprises are not speculators and should therefore not be constrained by position limits in their legitimate hedging activities. The CFTC also proposed a narrow bona fide hedging exemption from the position limits for physical hedging transactions that are economically appropriate for the reduction of risks by a commercial end user, and represents a substitute for transactions made or to be made on positions taken or to be taken at a later time in a physical marketing channel, or arises from the potential change in the value of assets that a commercial end user owns, produces, manufactures, processes or merchandises or anticipates doing so. The proposed bona fide exemption will be applicable only to physical commodity hedging, and will not be applicable to financial end user hedgers involving energy, metals and agricultural products.

The CFTC proposal would significantly narrow the availability of the bona fide hedging transaction compared to its pre-Dodd-Frank Act rules. Unlike the current definition, the proposal allows the exemption only for transactions that represent a substitute for a physical market transaction. The concern of many market participants is that this appears to exclude legitimate hedging strategies, such as portfolio hedging, that are currently used by mutual funds and other financial entities.

Commercial end users will be required to apply in advance to the CFTC to use the bona fide hedging exemption. Under the CFTC’s proposal, commercial end users that rely on the bona fide hedging exemption to acquire positions in excess of the limits must submit detailed information to the CFTC no later than 9 a.m. on the next business

day after the limits are exceeded. Commercial end users engaged in “anticipatory hedging” to hedge unsold anticipated commercial production or unfilled commercial requirements in an energy, metals or agricultural product must submit a request to the CFTC at least 10 days in advance of the date their positions will exceed the limits. These new filing requirements will impose a substantial administrative burden on commercial end users.

In enforcing the positions limits regime, the CFTC relies on a daily large trader reporting requirement to monitor positions of market participants. Violators of the CFTC’s position limits rules will be subject to enforcement remedies including fines and trading bans. End users of derivatives will need to put in place systems to assure compliance with the new position limits rules for futures and swaps, adding to their hedging costs.

Reporting and Recordkeeping. Title VII also imposes reporting and recordkeeping requirements on swaps markets participants. To date, the CFTC has been more explicit than the SEC about the recordkeeping requirements for non regulated swaps market participants and has proposed that all non regulated entities must keep a record for recorded swap information for the life of a swap transaction and for five years following termination.¹⁸ Such records must be retrievable within 3 business days and are subject to inspection by the Department of Justice, the SEC and the CFTC.¹⁹ Many swap end users currently keep similar records to comply with existing regulatory requirements so in many cases the new recordkeeping requirements will not be a substantial burden for end users.

Swaps data reporting requirements, however, may cause concern for certain end users. The CFTC and the SEC have both proposed that comprehensive information about every swap transaction, whether cleared or uncleared, be reported to a swaps data repository.²⁰ Such information will be accessible to foreign and domestic regulators. Two key areas of end user concern related to swaps data reporting are the timing of reporting and the public dissemination of reported information.

For swaps that are executed and confirmed electronically, swaps transaction data must be reported as soon as technologically practicable and in no event later than 15 minutes of execution.²¹ These short time frames for reporting will compress the time

¹⁸ Swap Data Recordkeeping and Reporting Requirements, 75 Fed. Reg. 765,574, 76,599 (proposed Dec. 8, 2010) (to be codified at 17 C.F.R. 45).

¹⁹ *Id.*

²⁰ *See id.*; Regulation SBSR--Reporting and Dissemination of Security-Based Swap Information, 75 Fed. Reg. 75,208, 75,284 (proposed Dec. 2, 2010) (to be codified at 75 C.F.R. 240, 242).

²¹ The regulators have proposed slightly longer timeframes for reporting swaps data if such transactions were not executed and confirmed electronically. Both the CFTC and the SEC allow up to 30 minutes to report a transaction that was executed but not confirmed electronically and 24 hours to report swaps transaction data for a transaction that has been neither executed or confirmed electronically. Regulation SBSR, *supra* note 20, at, 75, 242; Swap Data Recordkeeping and Reporting

periods during which swaps market participants are accustomed to negotiate the terms of their swap transaction confirmations.²² In addition, the reporting time frames leave little time for a swap dealer to enter into a hedge for a new swap transaction. If compliance with swaps data reporting requirements results in swaps dealers entering into unhedged swap transactions, end users will in all likelihood have to pay higher prices for these transactions.

Public dissemination of swaps data²³ raises additional concerns for end users, particularly those that do a high volume of swaps trading in connection with a proprietary trading strategy. A threshold concern for high volume end users is whether their identity will be publicly disclosed along with the material terms of their swap transactions. Such disclosure could result in other market participants either mimicking or trading against the end user, both of which will undermine the end user's strategy. The CFTC has made clear that identifying information shall not be publicly disseminated, however, the SEC has proposed that an identifying number for each swap transaction participant be publicly disclosed.²⁴ End users have grave concerns that it will be very easy to identify which end user is affiliated with which identifying number. For those end users that trade in high volumes and in large notional amounts, even absent identifying information, there is concern that publicly disseminated information about their trades will draw unwanted attention in the market place.

Conclusion. Many end users, particularly the high volume end user, face a significantly restricted environment for their over the counter derivatives transactions as a result of changes made by the Dodd-Frank Act. Central clearing of swaps transactions, complying with margin requirements, position limits and recordkeeping

Requirements, 75 Fed. Reg. 76,574, 76,599, 76,600 (proposed Dec. 8, 2010) (to be codified at 17 C.F.R. 45).

²² Section 5-701(b) of the New York General Obligations Law ("GOL") acknowledges creates the "qualified financial contract" exception to its general requirements that every agreement, promise or undertaking is void unless it or some note of memorandum thereof is in writing. The New York GOL defines "qualified financial contract" broadly and in a manner that would include most swap transactions. For a "qualified financial contract," there is sufficient evidence that a contract has been made if there is evidence of electronic communication (including the recording of a telephone call) sufficient to indicate that in such communication a contract was made between the parties; and a confirmation in writing sufficient to indicate that a contract has been made between the parties. Such evidence is sufficient against the sender if it is received by the party against whom enforcement is sought no later than the fifth business day after such confirmation is made and the sender does not receive on or before the third business day after such receipt written objection to a material term of the confirmation. Market practice has developed around these requirements. N.Y. GEN. OBLIG. § 5701(b) (2010).

²³ Both the CFTC and the SEC have proposed that all reported swaps transaction data be publicly disseminated immediately through the internet or some other electronic data feed. Real-Time Public Reporting of Swap Transaction Data, 75 Fed. Reg. 76,140, 76,172 (proposed Dec. 7, 2010) (to be codified at 17 C.F.R. pt. 43); Regulation SBSR, *supra* note 20, at 75,284.

²⁴ Regulation SBSR, *supra* note 20, at 75,285.

and reporting requirements are major changes for derivatives end users. As end users brace to comply with their new regulatory regime, what is especially frustrating is the lack of clarity they still have from regulators on the specifics of the many changes the Dodd-Frank Act seeks to implement.

Sidley Austin LLP, a Delaware limited liability partnership which operates at the firm's offices other than Chicago, London, Hong Kong, Singapore and Sydney, is affiliated with other partnerships, including Sidley Austin LLP, an Illinois limited liability partnership (Chicago); Sidley Austin LLP, a separate Delaware limited liability partnership (London); Sidley Austin LLP, a separate Delaware limited liability partnership (Singapore); Sidley Austin, a New York general partnership (Hong Kong); Sidley Austin, a Delaware general partnership of registered foreign lawyers restricted to practicing foreign law (Sydney); and Sidley Austin Nishikawa Foreign Law Joint Enterprise (Tokyo). The affiliated partnerships are referred to herein collectively as Sidley Austin, Sidley, or the firm.

Distributed with permission from Harvard Business Law Review.