

Client Alert

August 2012

In This Issue:

[Recent Developments](#)

[Implications for Corporate End-Users](#)

[What the New Rules Say](#)

[Timing](#)

The New Rules for Swaps - Implications for Corporate End-Users

Recent Developments

In another step to complete the regulatory puzzle of the financial reform legislation under the Dodd-Frank Act, the Commodity Futures Trading Commission (“CFTC”) released final rules regarding certain exceptions for end-users from the sweeping new rules for swaps mandated by the Dodd-Frank Act.

Implications for Corporate End-Users

While most provisions of the Dodd-Frank Act are directed at “swap dealers” and “major swap participants”, some rules affect companies that don’t deal in or speculate with swaps but use swaps merely to hedge exposures in their business, and some provisions are specifically directed at such swap end-users.

The new rules will take effect over the next several months, and corporate end-users may want use the remaining time to understand the key issues and prepare for the required actions on their part.

What the New Rules Say

The Dodd-Frank Act seeks to transform the historically unregulated “over-the-counter swap market” into a more regulated market with standardized terms and daily “mark-to-market” cash collateral posting requirements.

Among the myriad of proposed and final rules, the following will have the most immediate impact on corporate end-users of swaps:

- *The End-User Exception.* Generally, all parties to swaps must go through mandatory clearing and exchange trading. Most corporate end-users may be able to use this exception of the swaps they commonly enter into.
- *The FX Exemption.* The Treasury Secretary may make use of its authorization to exclude certain FX hedging products from most of the new swaps rules.
- *The Board Approval Requirement.* Corporate end-users that are reporting companies must obtain board approval before using the end-user exception.
- *Recordkeeping and Reporting Requirements.* Corporate end-users must keep certain records and report certain data relating to their swap transactions.

This client alert is meant to give a brief overview of the most important practical implications for commercial end-users of common types of swaps. For further information or to access source material, please go to the CFTC’s website at www.cftc.gov/lawregulation/doddfrankact/index.htm which contains status information as well as a compilation of the proposed and final rules and regulations, or contact the author of this client alert.

- *The External Business Conduct Rules.* These rules require swap dealers and major swap participants to collect certain information about the counterparties, including commercial end-users.
- *Margin Requirements for Non-Cleared Swaps.* These proposed rules would require swap dealers and major swap participants to collect cash collateral from end-users.
- *Cross-Border Application of US Swaps Rules.* This proposed guidance seeks to clarify to what extent cross-border transactions fall under the new US swaps rules.

The End-User Exception

The new swap rules are based on the principle that

“it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization ... if the swap is required to be cleared”

unless an exception applies.

A “swap” is broadly defined and includes, for example, any interest rate swaps, commodity swaps, currency swaps, equity swaps and credit default swaps.

Clearing means that swaps will not be entered bilaterally between the two counterparties, but that each counterparty will face a clearing organization which will act as an intermediary. In addition, execution would occur “exchange-style” on a swap execution facility or a designated contract market.

As a practical matter for a corporate end-user, clearing would require, among other things, establishing a relationship with an appropriate clearing organization.

In the coming months, the CFTC will specify which categories of swaps are required to be cleared. The initial categories proposed by the CFTC focus on types of swaps that are already being cleared and exchange traded on a voluntary basis.

However, the new swap rules contain an end-user exception from the clearing requirement. Under this exception, a company that hedges the exposures in its business, e.g. through interest rate, currency exchange rate or commodities swaps, can elect to enter into swaps without clearing if it meets the following specific requirements:

- It is a nonfinancial entity;
- It uses the swap in question to hedge or mitigate commercial risk; and
- It notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps

Nonfinancial entity: A corporate end-user would typically qualify unless it is a “financial entity” which includes, among others, swap dealers, major swap participants, commodity pools, private funds and employee benefit plans.

Hedging or mitigating commercial risk: A swap is considered to hedge or mitigate commercial risk if it

- is “economically appropriate” to reduce, in the ordinary course of business of a commercial enterprise, risks arising from a change in the value of assets that the entity owns, produces, manufactures, processes or merchandises, the value of liabilities that the entity incurs, the value of services that the entity provides or purchases, the value of assets, services or liabilities due to fluctuations in interest, currency or foreign exchange rates, or the interest, currency or foreign exchange rate exposures arising from a person’s assets, services or liabilities; or qualifies for hedging treatment under FASB or GASB accounting rules; or qualifies as bona fide hedging under the position limit rules of the Commodity Exchange Act;

and

- is not used for a purposes that is in the nature of speculation, investing or trading and not be used to hedge or mitigate the risk of another swap, unless the other swap itself is used to hedge or mitigate commercial risk.

These requirements apply on a trade-by-trade basis. A nonfinancial entity is therefore required to clear any swap that is not used to hedge or mitigate commercial risk, even if it uses the end-user exception for other trades.

Notification of the CFTC. The notification needs to specify in a “check-the box” format how the end-user generally meets its financial obligations, which may be through a written credit support document, pledged or segregated assets (including posting or receiving margin), a written third party guarantee, its own financial resources, or by other means.

Invoking the end-user exception is optional for the end-user. In deciding whether to have a swap cleared and executed on a trading platform, or instead to use the end-user exception and to enter into a swap on a bilateral basis with the counterparty, corporate end-users may want to consider the cost (including the cost of the respective margin or other credit support arrangements), the liquidity of the market for the particular type of swap and the creditworthiness of the respective counterparty.

The FX Exemption

The Treasury Secretary is expected to use its ability under the Dodd-Frank Act to exclude “foreign exchange swaps” and “foreign exchange forwards” from the definition of swaps and thereby exclude them from the scope of the new swaps regulations for most purposes. However, these types of foreign exchange derivatives would still be subject to reporting requirements. The exclusion would also not apply to a number of other foreign exchange derivatives, such as non-deliverable forwards, currency swaps and foreign exchange options, which would still be subject to the general swaps rules. However, spot foreign exchange transactions are not subject to the swaps rules.

The Board Approval Requirement

This requirement applies only to Exchange Act reporting companies. For these end-users, the decision to use the end-user exception must be reviewed and approved by its board or an “appropriate committee” of the board. The CFTC expects that the board would set appropriate policies regarding the company’s

use of swaps and to review these policies at least annually or whenever appropriate, e.g. upon the change of the company's hedging strategy.

The board approval needs to be reported to the CFTC, either on an annual basis or on a trade-by-trade basis.

Recordkeeping and Reporting Requirements

Recordkeeping. All parties to swaps will be required to keep full, complete and systematic records relating to its swap transactions, together with all pertinent data and memoranda, including all records demonstrating that the end-user was entitled to rely on the end-user exception. These records can be kept in paper or in electronic form, must be retained for five years following the end date of the related trade, and must be retrievable within five business days. The CFTC did not specify the particular documents that need to be retained, but would most likely expect that end-users retain at least all written agreements relating to each of their trades as. Each swap will also be assigned a swap identification number (in the case of end-users most likely handled by the swap dealer) which needs to be included in the records. In addition, certain historical information about swaps entered in the past need to be retained.

Reporting. The Dodd-Frank Act requires certain data about each swap transaction, whether cleared or un-cleared, to be provided to a swap data repository.

The responsibility for such reporting lies with the "reporting counterparty" for each swap transaction. If a swap dealer or major swap participant is a party to a swap with a corporate end-user, the swap dealer or major swap participant would have this responsibility. End-users will therefore not have the obligation to notify the CFTC, unless they enter into a swap with another end-user, e.g. one of their affiliates. In that case, the two end-users need to agree which party will be the reporting party. The notifications can be given on a trade-by-trade basis or on an annual basis.

With respect to a swap counterparty electing to use the end-user exception, the report must include the following information:

- how the electing counterparty is eligible to use the end-user exception;
- if the electing counterparty uses the swap to hedge or mitigate commercial risk;
- how the electing counterparty intends to meet its financial obligations under the swap;
- whether the electing counterparty is an SEC Filer or a subsidiary of an SEC Filer; and
- if it is an SEC Filer, whether its board or board committee has reviewed and approved the decision generally to enter into swaps exempt from the clearing and exchange trading requirements.

The reporting party must have a reasonable basis to believe that the electing counterparty qualifies as an end-user under the end-user exception. This means that a reporting party may need to conduct a certain degree of due diligence

investigation to form that belief, which may be lower if there has been a long and well established relationship with the electing counterparty.

External Business Conduct Rules

Among other things, these rules require swap dealers and major swap participants to apply a new "know-your-counterparty" process and collect certain information about their counterparties. As a result, commercial end-users should expect changes in the swap documentation and requests for additional information and representations by the commercial end-user.

In particular, swap dealers and major swap participants are required to ascertain that their counterparties qualify as "eligible contract participants" as defined in the Commodity Exchange Act, and under which prong of the definition the counterparty falls.

In addition, swap dealers and major swap participants are required to provide certain risk disclosure relating to each swap to their counterparties.

Swap dealers and major swap participants must be in compliance with this rules by mid-October 2012 and end-users should therefore expect inquiries soon.

Margin Requirements for Non-Cleared Swaps

The Dodd-Frank Act mandates that the CFTC and banking regulators enact margin regulations requiring swap dealers and major swap participants to collect margin from their counterparties. To date, no regulations have been adopted and therefore no requirement for swap dealers to request margin from end-users exists. There are various proposals by the relevant regulators which, however, don't contemplate specific margin requirements but rather seem to give swap dealers and major swap participants certain flexibility to enter into negotiated margin arrangements with end-users.

Cross-Border Application of the US Swap Rules

The CFTC also released a proposal for interpretive guidance on how the new US swaps regulations will apply in a cross-border context and requested comments from market participants. The release of final interpretive guidance is expected for early 2013. The SEC is also expected to issue additional guidance for derivatives products regulated by it but has not put forward a proposal at this time.

Under the CFTC proposal, US swap rules would generally apply to any swap to which at least one US person is a party.

A "US person" includes, among others,

- any natural person who is a resident of the United States,
- any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund, or any form of enterprise similar to any of the foregoing, in each case that is either organized or incorporated under the laws of the United States or having its principal place of business in the United States
- any entity in which the direct or indirect owners are responsible for the liabilities of such entity and one or more of such owners is a US person, and

For further information please contact

Hans Montag
+1 212 626 4625
hans.montag@bakermckenzie.com

Baker & McKenzie LLP
1114 Avenue of the Americas
New York, New York 10036
United States

- any pension plan for the employees, officers, or principals of a legal entity with its principal place of business inside the United States.

In addition, the CFTC proposes to include branches and agencies of US persons within the definition of US person, but to exclude affiliates and subsidiaries of US persons even if their obligations are guaranteed by a US person.

Timing

- *End-User Exception.* This rule will technically become effective on September 17, 2012. However, the CFTC recognizes that compliance with only be necessary (or even possible) when specific categories of swaps become subject to the clearing requirement. The CFTC is expected to designate the first set of these swaps soon. Upon such designation, end-users will have 270 days to comply with the rules by either having swaps cleared or invoking the end-user exception. However, swap dealers will have to report swap activities much sooner and will probably begin to collect the requisite information from their counterparties in the coming months.
- *The FX Exemption.* At this time, there is no definite date scheduled for the implementation of this exemption.
- *The Board Approval Requirement.* This requirement is part of the rules governing the end-user exception and will take effect at the same time.
- *Recordkeeping and Reporting Requirements.* Corporate end-users will be required to be in compliance by early 2013.
- *External Business Conduct Rules.* These rules became effective on February 17, 2012 and swap dealers and major swap participants must be in compliance by October 14, 2012.
- *Margin Requirements for Non-Cleared Swaps.* At this time, there is no definite date scheduled for the implementation of this rule.

Cross-Border Application of US Swaps Rules. The CFTC has proposed an exemptive order that would delay compliance with the cross-border application rules until at least July 2013.