A GUIDE TO DODD-FRANK FOR USERS OF SWAPS

Under Title VII of the Dodd-Frank Act, key participants in the swaps market are required to register and assume compliance obligations, and many other market participants must comply with clearing and execution mandates and meet new reporting and recordkeeping requirements. Focusing on the CFTC, the author summarizes the definitions of a “swap,” “swap dealer,” “major swap participant,” and “eligible contract participant.” She then turns to the processes for cleared vs. uncleared transactions, and concludes with a discussion of the end-user exception and required reporting and documentation.

By Willa Cohen Bruckner *

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) ¹ brings fundamental restructuring to the swap markets and will impact almost every aspect of swap transactions. Policy concerns underlying Dodd-Frank include regulation of significant market participants, transparency in trading, and stability of the financial system. Those policy objectives are addressed through the requirement for registration of key market participants (swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, central clearing entities, swap execution facilities, and swap data repositories), associated compliance obligations for registered entities, clearing and execution mandates for swaps, and swap reporting and recordkeeping. From a regulatory perspective, the majority of Dodd-Frank’s requirements are the responsibility of the registered entities. The implementation of those requirements, however, will spill over onto other market participants, who will have to take action if they intend to participate in swap transactions (swap market participants that are not required to register are referred to in this article as “users of swaps”). Market participants will have to become familiar with new procedures, changes in documentation, and new market practices. In addition, swap parties will have strategic decisions to make as they engage in the products to meet their business needs. This article discusses the most significant changes and the practical issues for users of swaps. The article does not address the registration and compliance obligations of registered entities, except to the extent they implicate action or decision-making on the part of users of swaps.

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A few words of caution are necessary. Dodd-Frank and the related regulations are lengthy and complex, with differences in treatment across a variety of categories of transactions and market participants. The regulatory landscape is changing as the regulators continue to finalize rules. In addition, timelines and implementation dates have been modified a number of times and are likely to be modified again. The discussion in this article is not intended as an exhaustive treatment of the issues under Dodd-Frank or as advice for any particular user of swaps, but rather presents a generalized summary and describes a framework to begin considering the issues. Each market participant should examine how the rules and the market practices, which have been and are being developed, will apply to its individual circumstances.

CFTC AND SEC JURISDICTION

Both the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) have a hand in regulating swaps. Broadly speaking, swaps based on interest rates, currency rates, commodities, and broad-based security indices are within the CFTC’s jurisdiction. Swap transactions under the SEC’s jurisdiction (referred to in Dodd-Frank as “security-based swaps”) include (i) swaps based on a single security or loan, or a narrow-based security index and (ii) credit default swaps on single reference entities or the issuers of securities in narrow-based indices.

Users of swaps will have to examine the nature of their swaps to determine which regulator is relevant for their business. If they are engaged in both swaps and security-based swaps, rules of both the CFTC and the SEC will be pertinent. Transactions with elements of both swaps and security-based swaps are referred to in Dodd-Frank as “mixed swaps.” A person may request the CFTC and SEC for a joint determination as to whether a contract is a swap, security-based swap, or mixed swap. Mixed swaps are subject to some CFTC regulations and some SEC regulations.

The statutory framework for regulating swaps is largely the same for the CFTC and the SEC, but the SEC lags behind the CFTC in its rulemaking. The remainder of this article focuses primarily on swaps under the jurisdiction of the CFTC and the rules promulgated by the CFTC, rather than security-based swaps and the SEC’s rules.

DEFINITION OF SWAP

The definition of “swap” is a cornerstone issue under Dodd-Frank, as the implementation of virtually every rule depends on the scope of that term. The statutory definition is broad, including both generic descriptions and specific types of contracts, as well as any “agreement, contract or transaction that is, or in the future becomes, commonly known to the trade as a swap.” Options are swaps, other than options on securities or foreign exchange that are subject to the securities laws. The CFTC has also been explicit that it interprets the term swap “to include a guarantee of [a] swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the swap.”

The swap definition encompasses some contracts not traditionally thought of as swaps and perhaps not intended by Congress to be regulated under Dodd-Frank, but that are swept into the broad language of the statutory definition. The CFTC’s and the SEC’s jointswap definition rule clarifies the treatment of some of those products and transactions, and imposes additional

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2 The banking regulators (referred to in Dodd-Frank as “Prudential Regulators”) are responsible for specific issues regarding banking entities as participants in the swap market but do not regulate swaps.

3 “Narrow-based security index” is defined at Securities Exchange Act §3(a)(55). For the remainder of this article, the term “swap” refers to CFTC regulated swap transactions.


5 Commodity Exchange Act §1a(47)(A)(iv).

analysis for other products and transactions. Users of swaps will have to look at each product and transaction to determine whether it is a swap (or a security-based swap) so they can determine whether the requirements of Dodd-Frank and its regulations are applicable. Market participants considering whether they have to register with the CFTC as a swap dealer or major swap participant (or with the SEC as a security-based swap dealer or major security-based swap participant) will need to know which of their contracts and transactions are swaps (or security-based swaps) in order to make the necessary calculations and judgments.

A number of products and transactions are excluded from the swap category either by statute, by regulation, or through interpretive guidance from the CFTC. The statute excludes futures contracts (already regulated under the Commodity Exchange Act) and various products and transactions subject to U.S. securities laws. In addition, a forward contract on a non-financial commodity is excluded under the statutory definition, as long as the parties intend to physically settle the transaction. No specific standards are provided for determining the parties’ intent. Instead, the CFTC leaves that determination to the facts and circumstances of each situation.

Foreign exchange swaps and forwards. Certain foreign exchange transactions are also carved out from most swap regulations. Dodd-Frank left it to the U.S. Treasury to determine whether foreign exchange swaps and foreign exchange forwards should be included as swaps. On November 20, 2012, the U.S. Treasury issued its determination that such instruments would not be considered swaps. The products excepted out by Treasury’s determination are specifically defined. Foreign exchange swaps involve an exchange of currencies at the start of the transaction and an exchange of currencies at the end of the transaction at a predetermined rate on a predetermined date. Foreign exchange forwards also involve an exchange of currencies at the end of the transaction at a predetermined rate on a predetermined date, but do not include an initial exchange of currencies. Unlike other excluded contracts and transactions, foreign exchange swaps and foreign exchange forwards are subject to the reporting requirements of Dodd-Frank discussed below, as well as business conduct rules applicable to swap dealers and major swap participants. All other currency based swap transactions, including non-deliverable forwards, currency swaps, and cross-currency swaps, are subject to the full range of Dodd-Frank swap regulation.

Insurance, consumer, and commercial contracts. In the swap definition rule, the CFTC carves out certain insurance contracts from the swap category. The exclusion covers contracts issued by a regulated insurance company or a U.S. or state governmental entity that require the beneficiary to have an insurable interest and to show proof of loss before recovery and that cannot be traded separately from the insured interest. Financial guaranty insurance must also permit acceleration of payments only at the discretion of the insurer in order to be excluded. Certain common insurance products (such as life insurance, health insurance, disability insurance, and property and casualty insurance) issued by a regulated insurance company or U.S. or state governmental entity are also carved out. With respect to consumer and commercial contracts, the CFTC enumerated common contracts that are excluded from the swap category. Among other contracts, the CFTC specifies the following consumer and commercial contracts: purchase of personal and real property, mortgages, purchase of personal products at fixed or capped prices, rate caps and locks on consumer and mortgage loans that become effective only if the loan is actually made, variable rate loans and mortgages, lease options, employment contracts, sales and servicing contracts, and warehouse lending in anticipation of asset securitization. The CFTC also indicated that the enumerated contracts are not exclusive. Other consumer and commercial contracts might be excepted from being a swap if their payment obligations cannot be severed from the remainder of the contract, they are not traded on an exchange or over-the-counter, they involve an asset owned by the consumer or a service to be purchased or provided by the consumer (for consumer contacts), and they are entered into for a business

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7 Id., 77 Fed. Reg. 48208.
8 Commodity Exchange Act §1a(47)(B).
9 Id. §1a(47)(E).
11 Commodity Exchange Act §1a(25).
12 Id. §1a(24).
13 Id. §1a(47)(E).
purpose other than hedging, speculation, or investment (for commercial contracts).  

Energy industry contracts. Many contracts common to the energy industry present unique issues in terms of their treatment under the swap definition because they are forwards on non-financial products but also include some optionality. As noted above, many options are treated as swaps for Dodd-Frank purposes, but forwards on non-financial commodities are not swaps if the parties intend to physically settle the contract. To distinguish forward contracts with embedded optionality that are regulated as swaps from those that are not regulated, the CFTC included two pieces of interpretive guidance in its release accompanying the swap definition rule. The first provides a three-prong test under which a forward with embedded optionality is not subject to Dodd-Frank if all of the following criteria are met: (i) the embedded option adjusts the price rather than the volume of the contract; (ii) the option does not target the delivery term of the contract; and (iii) the option cannot be severed from the contract and marketed separately. The second piece of interpretive guidance covers contracts with embedded volumetric optionality. For those contracts, the CFTC established a seven-prong test, all seven of which must be met if the contract is not to be considered a swap: (i) the option does not undermine the nature of the contract as a forward contract; (ii) the predominant feature of the contract is actual delivery; (iii) the optionality in the contract cannot be severed and marketed separately; (iv) the intent of the seller when it enters into the contract is to physically deliver the non-financial commodity; (v) the intent of the buyer when it enters into the contract is to take physical delivery of the non-financial commodity; (vi) both the buyer and the seller are commercial entities; and (vii) the exercise or non-exercise of the option is based on physical or regulatory requirements outside the parties’ control. The CFTC also provided extensive discussion regarding treatment of specific types of contracts in the energy industry, including full requirements contracts, capacity contracts, peaking contracts, natural gas storage contracts, and environmental commodities (such as renewable energy certificates).

Commodity option exemption. The CFTC has issued an additional exemption in the form of an interim final rule. The rule exempts certain commodity options from the application of most of the Dodd-Frank regulations. Commodity options are subject to the more limited regulatory treatment if (i) the underlying commodity is a non-financial, non-agricultural commodity that has a cash market; (ii) the party offering the option is an “eligible contract participant” (discussed below) or is a producer, processor, or commercial user of or merchant for the commodity and is entering into the option for purposes of its business; (iii) the party to which the option is offered is a producer, processor, or commercial user of or merchant for the commodity and is entering into the option for purposes of its business; and (iv) the parties intend to physically settle the option if it is exercised. Although exempt from most regulations, commodity options that fit the trade option exemption are subject to recordkeeping and reporting requirements.

SWAP DEALER AND MAJOR SWAP PARTICIPANT STATUS

A brief summary of the definition of swap dealer and major swap participant is provided so that users of swaps can investigate further if it appears their swap activities might put them in one of these categories requiring registration with the CFTC.

Swap Dealer

A swap dealer is defined in Dodd-Frank as an entity that (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties in the ordinary course of business for its own account; or (iv) engages in activities that cause it to be commonly known as a dealer or market maker in swaps. However, entities that enter into swaps for their own account, not as part of a regular business, are not swap dealers. The CFTC described some indicia of

16 Id., 77 Fed. Reg. at 48237.
17 Id., 77 Fed. Reg. at 48238. The energy industry has expressed uncertainty over the practicality of the seventh prong because the reason for the exercise or non-exercise of volumetric optionality and whether the reason will be outside the parties’ control may not be known at the time the contract is put in place.
19 Commodity Options, 77 Fed. Reg. 25320 (April 27, 2012). The relevant portion of the commodity option rule was issued in the form of an interim final rule with a request for comments, which means the CFTC could make changes to the rule.
20 Commodity Exchange Act §1a(49).
swap dealing activity in the release accompanying the final rule defining swap dealer.\(^{21}\)

Even if an entity engages in some swap dealing activity, the entity is not required to register as a swap dealer unless its swaps exceed a de minimis threshold. Initially, the de minimis threshold is $8 billion in aggregate gross notional amount over the prior 12-month period.\(^{22}\) Unless the CFTC takes affirmative action, the $8 billion threshold will reduce to $3 billion after an initial phase-in period. For transactions with governmental entities, employee benefit plans under ERISA, governmental plans under ERISA, and endowments, the de minimis threshold is only $25 million, and for transactions with publicly or government-owned utilities it is $800 million.

**Major Swap Participant**

Major swap participant status is based on the size of the entity’s swap activities and the potential impact of the entity’s failure on market stability. The CFTC does not anticipate many major swap participant registrations. An entity is a major swap participant if it is not a swap dealer and it fulfills any one of the following tests: \(^{23}\)

(1) **Substantial position test:** the entity maintains a “substantial position” in any one of the four major swap categories (rates, credit, equity, and all other swaps), excluding positions held solely for hedging or mitigating commercial risk. “Substantial position” means (x) the daily average uncollateralized mark-to-market value of out-of-the-money swaps in any category (“MtM”) exceeds the threshold noted below or (y) the daily average uncollateralized mark-to-market value of all swaps in any category plus the potential future exposure of all swaps (collateralized and uncollateralized) in that category (“MtM+PF”) exceeds the threshold noted below. Potential future exposure attempts to capture the size and direction of swap exposure in the future through a complex calculation based on the type, notional amount, and residual maturity of the swap. The thresholds are, by major swap category:

- Rate swaps: US$3 billion for MtM and US$6 billion for MtM+PF;
- Credit swaps: US$1 billion for MtM and US$2 billion for MtM+PF;
- Equity swaps: US$1 billion for MtM and US$2 billion for MtM+PF; and
- Other swaps: US$1 billion for MtM and US$2 billion for MtM+PF.

(2) **Substantial counterparty exposure test:** the entity has outstanding swaps creating substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. “Substantial counterparty exposure” is aggregated across the four categories of swaps and incorporates all swaps, including swaps used for hedging purposes. The thresholds for substantial counterparty exposure are: US$5 billion for the MtM and US$8 billion for the MtM+PF.

(3) **Highly leveraged financial entity test:** the entity is a financial entity that is highly leveraged and also maintains a “substantial position” in outstanding swaps in any of the four major swap categories. A financial institution is “highly leveraged” if the ratio of its total liabilities to its equity exceeds 12 to 1.

**Eligible Contract Participants**

Under Dodd-Frank, swaps must not be entered into outside a regulated exchange unless both parties to the swap are eligible contract participants. Eligible contract participants include both regulated and unregulated entities (and individuals). The following entities (or individuals), if acting for their own account, are eligible contract participants:

- commodity pools with assets in excess of $5,000,000 formed and operated by a person registered with the CFTC\(^{24}\);
• regulated insurance companies;
• investment companies registered with the SEC;
• financial institutions;
• corporations, partnerships, proprietorships, organizations, trusts, or other entities if (x) the entity’s assets exceed $10,000,000; (y) its obligations are guaranteed by specific types of eligible contract participants; or (z) its net worth exceeds $1,000,000 and it is engaging in the swap for hedging purposes;*
• employee benefit plans or governmental employee benefit plans with assets in excess of $5,000,000 for which the investment decisions are made by an SEC-registered investment adviser, a bank, or an insurance company;
• governmental entities, or divisions or agencies of governmental entities, that own and invest on a discretionary basis at least $50,000,000 or that engage in the swap with one of a specified type of regulated financial market participants;
• SEC-registered broker-dealers;
• CFTC-registered futures commission merchants (“FCM”); and
• individuals who have amounts invested on a discretionary basis, the aggregate of which is in excess of (x) $10,000,000 or (y) $5,000,000 if the swap is entered into for hedging purposes.

As noted earlier, guarantees of swaps are considered to be swaps under Dodd-Frank. As a result, the guarantor of a swap must also be an eligible contract participant. If it is not, the guarantee may be unenforceable even if both parties to the swap are eligible contract participants.

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**CLEARED VS. UNCLEARED SWAPS**

Under Dodd-Frank, the universe of swaps will be bifurcated into cleared and uncleared transactions. Any swap that the CFTC has mandated for clearing must be cleared unless the swap is subject to the end-user exception discussed in the next section. The more standardized a swap, the more likely it is to be subject to mandatory clearing. To date, the CFTC has only mandated clearing of certain interest rate swaps and credit default swaps.26

Processes and documentation for cleared and uncleared transactions are moving on two largely non-parallel paths. The structures and processes surrounding cleared swaps are based on the regulatory scheme and market conventions for futures products. Trading and documentation of uncleared swaps will be similar to the approach developed in the market over the past 25 years for bilateral over-the-counter swap transactions, with some additions reflecting rights and obligations under Dodd-Frank. Documentation is discussed in greater detail in a later section of this article.

Margin requirements and protection of customer margin are important business considerations for users of swaps. Margin must be provided for all cleared swap transactions and will include margin set by the clearing entity and any additional margin required by the FCM through which the clearing process is accessed. Customer margin for cleared swaps must be segregated from proprietary funds of the FCM. Whether margin will be required for uncleared swaps depends upon the outcome of rules proposed separately by the CFTC and the Prudential Regulators. The CFTC’s proposed rule, which covers swaps in which the swap dealer or major swap participant is not a banking entity, would not require margin from the end-user but would allow for the swap dealer or major swap participant to require credit support. By contrast, the Prudential Regulators’ proposed rule, applicable where the swap dealer or major swap participant is a banking entity, requires margin unless the counterparty’s swap activity is below specified thresholds. Protection of customer margin for uncleared swaps is at the customer’s election. A customer of a swap dealer or major swap participant has the right to require that margin or other credit support posted by it in excess of the market value of the swap must be segregated from the swap dealer’s or major swap participant’s property and held at a third-party

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25 The CFTC has issued interpretive guidance on eligible contract participant status and sole proprietorships, guarantees, and related issues. CFTC OGC Letter No. 12-17 (October 12, 2012).

26 Clearing Requirement Determination under Section 2(h) of the CEA, 77 Fed. Reg. 74284 (December 13, 2012).
custodian. The CFTC’s rule on segregation of margin or collateral for uncleared transactions has not yet been finalized.

**END-USER EXCEPTION**

Dodd-Frank permits end-users of swaps to avoid clearing in some circumstances. Four criteria must be met in order for a party to be eligible for the end-user exception to clearing.

1. **Nature of the party.** The end-user exception is not available to financial entities, defined under Dodd-Frank for this purpose to include swap dealers, major swap participants, security-based swap dealers, major security-based swap participants, commodity pools, funds exempt from Investment Company Act registration under Section 3(c)(1) or 3(c)(7) of that Act, employee benefit plans, and entities predominantly engaged in the business of banking or in financial activities. Captive finance companies meeting specified criteria are not considered to be financial entities for purposes of the end-user exception. In addition, banks with assets of $10 billion or less are exempt from the financial entity category for purposes of the end-user exception.

2. **Hedging or risk mitigation.** Each swap for which the end-user exception is claimed must be used to hedge or mitigate commercial risk and must not be used for a speculative, investing, or trading purposes. In addition, the swap must not be used to hedge another swap that does not itself fit the hedging requirement. The CFTC’s rule regarding the end-user exception sets out three definitions of hedging, at least one of which must be met for each swap. For purposes of the end-user exception, a swap is being used for hedging or risk mitigation purposes if:

- the swap is economically appropriate to the reduction of commercial risk arising from the potential change in value of the entity’s assets or liabilities or the products, services, or commodities it purchases or sells, or from changes in its exposure to interest rates, currencies, or foreign exchange rates;
- the swap qualifies for the bona fide hedging exemption from position limits; or
- the swap qualifies for hedging treatment under accounting standards (FASB Accounting Standards Codification Topic 815 or Governmental Accounting Standards Board Statement 53).

3. **Reporting requirement.** An entity claiming the end-user exception must report to the CFTC, either for each transaction under the end-user exception or on an annual basis. Information to be reported includes:
   (i) whether the entity is a financial entity; (ii) whether swaps for which the end-user exception is claimed are being used for hedging purposes; (iii) how the entity intends to meet its financial obligations in connection with uncleared swaps (for example, through a written credit support agreement, a pledge of collateral, a third-party guarantee, the entity’s available financial resources, and/or other means); and (iv) whether the entity is (or is controlled by) an SEC reporting company and, if so, the relevant SEC Central Index Key number and whether required board-level approval has been obtained.

4. **Board-level approval.** Companies that are issuers of securities registered under Section 12 of the Securities Exchange Act or required to file reports with the SEC under Section 15(d) of the Securities Exchange Act (a “Reporting Company”) must obtain board-level approval in order to engage in uncleared swaps and swaps that are not executed on an exchange or a swap execution facility (“off-facility swaps”). In addition, an entity that is controlled by a Reporting Company must also obtain board-level approval for uncleared swaps and off-facility swaps. Approval for a particular type of swap must be obtained by the time the clearing mandate becomes effective for users of that type of swap (or by the first time thereafter that the entity engages in that type of swap). Dodd-Frank requires uncleared and off-facility

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27 Commodity Exchange Act §4s(l).
28 Id. §§2(h)(7)(A), 2(j).
29 Id. §2(h)(7)(C)(i).
30 Id. §2(h)(7)(C)(iii).
31 Dodd-Frank authorized the CFTC to exempt small banks from the financial entity category. Id. §2(h)(7)(C)(ii). The CFTC made that determination in its rule regarding the end-user exception. End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42560, 42591 (July 19, 2012).
32 The detailed definition of hedging is included in the CFTC’s rule on the end-user exception. End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. at 42590-91.
33 Id.
34 Commodity Exchange Act §2(j).
35 For interest rate and credit swaps already subject to mandatory clearing, the board-level approval must be in place by September 9, 2013. Clearing Requirement Determination.
swaps to be approved by an “appropriate committee” of the board, meaning a committee that is “specifically authorized to review and approve the [company’s] decision to enter into swaps.” 36 For a Reporting Company, the “appropriate committee” should be a committee of the board. With respect to an entity controlled by a Reporting Company, the release accompanying the rule provides that the Reporting Company’s board would have “reasonable discretion” to determine the appropriate committee for its subsidiaries and affiliates. Each Reporting Company should take into account its corporate organization and the composition of the boards and committees of its affiliates that might engage in uncleared or off-facility swaps to assure that the committee making decisions regarding uncleared and off-facility swaps has sufficient information and experience to make reasoned decisions and that the Reporting Company is aware of the decisions. In addition to board committee approval, the board should set policies regarding use of swaps subject to the end-user exception and should review the policies at least annually, and more frequently if circumstances change (such as a new or modified hedging strategy).

Even if a swap is eligible for the end-user exception, the end-user does not have to take advantage of the exception and can instead elect to have the transaction cleared (if the other party to the swap is a swap dealer or major swap participant). 37 In considering that alternative, end-users can compare cleared and uncleared swaps on the basis of several factors, such as the terms of available cleared products, the costs associated with each product (including margin requirements), the relative security of the end-user’s funds posted as margin or collateral, and the relative convenience for the end-user of cleared swaps as compared to uncleared swaps.

EXECUTION OF SWAPS

Dodd-Frank requires that any swap that must be cleared must also be executed on a regulated trading platform, which may be either an exchange or a swap execution facility (“SEF”) as long as an exchange or a SEF makes the swap “available to trade.” 38 SEFs can use either a central limit order book mechanism, a transparent system in which bids and offers are matched, or a request-for-quote mechanism in which specific market participants are asked for quotes on a transaction.

As of this writing, the CFTC has yet to finalize its rules on SEFs, including when particular swaps are available to trade. 39 Although many entities are prepared to operate as SEFs, none are yet registered because they are awaiting finalization of the CFTC’s rules for such facilities.

REPORTING REQUIREMENTS

Dodd-Frank requires that all swaps be reported to a swap data repository or the CFTC. Reporting requirements apply both when the swap is entered into and on an ongoing basis. The information to be reported includes the key economic terms of the swap and information about the parties to the swap.

Three separate CFTC rules require reporting of swaps: 40

- 17 CFR Part 46 covers reporting of swaps entered into before July 21, 2010 (the date Dodd-Frank was enacted) (“Pre-Enactment Swaps”) and swaps entered into on or after July 21, 2010 and before April 10, 2013 (“Transition Swaps”) and includes an initial reporting requirement and ongoing reporting obligations; 41
- 17 CFR Part 45 covers reporting of all other swaps and includes an initial reporting requirement and ongoing reporting obligations; 42 and
- 17 CFR Part 43 addresses real-time reporting of swaps (reporting of pricing and related data as soon

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under Section 2(h) of the CEA, 77 Fed. Reg. 74289, n. 52 (December 13, 2012). In this publication, the CFTC also restated the end-user exception rule.

36 End-User Exception to the Clearing Requirement for Swaps, supra note 32.

37 Commodity Exchange Act §2(h)(7)(E).

38 Id. §2(h)(8).


40 Dodd-Frank also includes other types of reporting, for example, the reporting by swap parties making use of the end-user exception described previously.

41 Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 77 Fed. Reg. 35200 (June 12, 2012).

as technologically possible after a swap is executed). 45

In some cases, real-time and initial reporting of swaps will be handled by the exchange or SEF on which the swap is executed. Most of the remaining reporting requirements fall on swap dealers and major swap participants. However, users of swaps will be required to undertake reporting in a limited number of circumstances.

Other than reporting by exchanges and SEFs, the determination as to who must report is based on the nature of the parties. Dodd-Frank prioritizes parties for reporting purposes, as follows: (i) swap dealers; (ii) major swap participants; (iii) financial entities; and (iv) other users of swaps. As between parties at two different levels, the party higher in the priorities is responsible for reporting (for example, a swap dealer would be responsible for reporting a swap entered into with a major swap participant). If parties to a swap are at the same level, they must agree on who will report. Two exceptions to these general principles should be mentioned. First, for reporting under Parts 45 and 46, if a swap is between a U.S. party and a non-U.S. party and neither the U.S. party nor the foreign party is a swap dealer or a major swap participant, then the U.S. party must report. Second, Part 43 permits the parties to choose who will report, regardless of the nature of the parties. If the parties don’t make a choice, then the reporting party is determined according to the priority of parties noted above. Unlike Parts 45 and 46, however, Part 43 does not explicitly address swaps between a U.S. party and a non-U.S. party.

Based on these priorities and exceptions, a user of swaps may have to report if it is transacting with another user of swaps or, in some cases, if it is transacting with a foreign entity that is not a swap dealer or major swap participant. Reporting by users of swaps begins April 10, 2013.

Legal Entity Identifiers. Every party engaging in swaps, whether cleared or uncleared, must obtain a legal entity identifier number that will be reported along with other swap data. Legal entity identifiers, currently referred to as CFTC Interim Compliant Identifiers, or CICIs, can be obtained through a mechanism established by The Depository Trust & Clearing Corporation at https://www.ciciutility.org. A legal entity identifier is unique to each party. Affiliates must obtain separate numbers.

RECORDKEEPING REQUIREMENTS 44

Recordkeeping applies to all swap parties. In general, swap parties are required to retain records of each swap throughout the life of the swap and for five years after its termination. Records may be retained in electronic or paper form, but must be retrievable within five business days. The recordkeeping requirement has some bite to it because the CFTC, SEC, Department of Justice, or a Prudential Regulator may inspect swap records upon request.

Specific records to be retained depend upon when a swap was entered into and, in some cases, when it was terminated. For this purpose, swaps are grouped along a couple of different time lines, including Pre-Enactment Swaps and Transition Swaps (described above). For swaps terminated before April 25, 2011, documents and information in the hands of a user of swaps on or after October 14, 2010 must be retained if the swap is a Pre-Enactment Swap, and documents and information in the hands of a user of swaps on or after December 17, 2010 must be retained if the swap is a Transition Swap. If the swap (whether Pre-Enactment or Transition) is still in existence on or after April 25, 2011, the user of swaps must retain records of the minimum primary economic terms of the swap (which is generally the information in a confirmation), as well as information about the counterparty to the swap, but is not required to locate or recreate any records not already in its possession. In addition, any confirmation, master agreement, credit support document, and records created or available on or after April 10, 2013 must be retained. For each swap entered into after April 10, 2013, the user of swaps must retain full and complete records, with all relevant documents, in an organized system. Relevant documents include the master agreement, any credit support document, the confirmation, and any other documents and communication with respect to the swap.

DOCUMENTATION

Dodd-Frank will necessitate changes in documentation for both cleared and uncleared swaps. Industry trade associations have been working and continue to work on models to serve as new forms of standard documents or as the starting point for individually prepared agreements.


44 Recordkeeping requirements are detailed in the rules specified in the previous section on Reporting Requirements.
ISDA Protocol

Swap dealers must meet a large number of new compliance obligations for swap transactions, some of which are specific to the type of customer or the nature of the swap dealer’s relationship with the customer. Some of those obligations can be met or simplified through changes to documentation (including representations or disclosures by either party), and swap dealers prefer to implement the documentation changes through the ISDA protocol process, which permits multiple agreements to be modified efficiently without the need for separate bilateral amendments with every counterparty.\(^{46}\)

ISDA’s first Dodd-Frank protocol, the ISDA August 2012 DF Protocol, addresses swap dealers’ external business conduct requirements and reporting obligations.\(^{47}\) The protocol process starts with submission of an adherence letter to ISDA (and payment of a fee). The party then completes a questionnaire electronically and designates the counterparties to receive its questionnaire. Only the designated counterparties obtain the questionnaire, so as to keep each party’s proprietary information out of the public domain. When two entities have designated each other as recipients of their respective questionnaires, they are deemed to have supplemented their swap documentation in accordance with the terms of the protocol. Because the protocol process supplements the parties’ agreement, it is important for parties to read the protocol text carefully to assure they are comfortable with the new terms incorporated into their agreements. If a party wants to modify the terms of the protocol, it will be necessary to engage in bilateral negotiation and documentation between the party and each of its swap dealers. The protocol is designed to supplement all swap documentation, whether or not based on ISDA forms.

The timing of the protocol process is driven by the swap dealers’ deadline for meeting their external business conduct requirements. The deadline for some of the requirements, originally October 15, 2012, was pushed back to January 1, 2013. As that delayed deadline loomed, and it became clear that a significant majority of the swap market had not yet participated in the protocol or executed alternative bilateral documents, ISDA requested that the CFTC delay the deadline again. The CFTC has agreed to push the requirement back to May 1, 2013. Swap dealers will likely press customers to complete the protocol or alternative bilateral documentation by that date if the customers want to continue transacting swaps.\(^{48}\)

Clearing Documentation

The industry’s approach to documentation of cleared swap transactions will largely be based on documentation used for futures transactions. Customers of FCMs will be expected to enter into a futures account agreement along with an addendum for cleared swap transactions. No standard futures account agreement has been developed. As a result, the form and details of futures account agreements vary among FCMs, although much of the substance is consistent. Futures account agreements are generally more one-sided (in favor of the FCM) and less subject to negotiation than swap documentation developed before Dodd-Frank (often in the form of ISDA Master Agreements). A dealer’s willingness to consider changes to its futures account agreement will generally depend on the nature of the customer, its size, the dealer’s desire for the relationship, the perceived customer credit risk, and the particular changes requested by the customer. The cleared swaps addendum, developed jointly by the Futures Industry Association and ISDA with some buy-side input from the non-swap dealer community, is meant to address subjects on which futures and cleared swaps diverge. The addendum includes, among other points, representations and warranties, the customer’s right to have positions transferred to another dealer, provisions for liquidation upon default or other termination events, the consequences for the parties if a swap is not accepted for clearing, and a limitation of the FCM’s liability. As with the ISDA August 2012 DF protocol, customers should read the futures account agreement and cleared swaps addendum carefully, even if no changes will be requested or made, so as to assure that they do not inadvertently miss an operational deadline, violate a representation or covenant, or otherwise breach the agreement.

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\(^{45}\) “ISDA” refers to the International Swaps and Derivatives Association, Inc., a leading trade association for the swaps market.

\(^{46}\) Swap dealers and major swap participants have enhanced obligations with respect to governmental entities, ERISA plans, and endowments (“special entities”). Commodity Exchange Act §4s(b). The ISDA August 2012 Dodd-Frank protocol includes provisions particular to special entities and the related obligations.

\(^{47}\) Text of the ISDA August 2012 DF protocol can be obtained from ISDA’s website, www.isda.org.

\(^{48}\) ISDA has published a second Dodd-Frank protocol to address the CFTC’s rules regarding documentation requirements for swap dealers and the end-user exception.
Execution Documentation

In addition to the cleared swaps addendum, the Futures Industry Association and ISDA have developed a swaps execution agreement to address the process of submitting an executed swap for clearing, including who is responsible to submit the swap and the timing for submission. The agreement also sets out responsibilities and consequences if a swap is not accepted for clearing. Once a swap is cleared, the executed swap is superseded by two transactions (one between the customer and the clearing entity and a second between the dealer and the clearing entity) and the execution agreement is no longer relevant for that particular swap.

Users of swaps should review the execution agreement before signing and consider whether any changes are necessary. Although the time horizon over which the execution agreement is relevant for a particular swap will likely be short, the agreement will become most significant when the trade goes awry. Users of swaps would be better off understanding their rights and responsibilities before executing any swap transactions, rather than finding out that their rights are limited at the time they are most in need of protection.

One other point is worth noting with respect to execution documentation. Once trading through SEFs commences, parties may have to sign agreements required by SEFs for use of the SEFs’ execution platforms.

Documentation of uncleared trades

A number of documentation changes can be expected for uncleared swaps. Customers of swap dealers and major swap participants should expect to see provisions in ISDA agreements or confirmations regarding eligibility to use the end-user exception. With respect to reporting, if the swap parties choose between them who will report, that choice should be memorialized in the swap documentation. Customers of swap dealers or major swap participants that want margin or collateral segregated with a third-party custodian should expect to sign an agreement to document the custodial relationship, with provisions necessary to establish and protect the swap dealer’s or major swap participant’s security interest in the margin or collateral, and provisions outlining who bears the cost of the custodial arrangement.

CONCLUSION

Changes for swap transactions brought about by Dodd-Frank are extensive, requiring market participants to review virtually every aspect of their swap trading relationships. Although the majority of the changes affect swap dealer and major swap participants, parties that are users of swaps must also consider the impact of Dodd-Frank on their swap activities. Users of swaps should become familiar with the changes under Dodd-Frank so they can make necessary strategic decisions in their employment of swaps and are prepared to fulfill the related regulatory obligations.
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