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Clients&FriendsMemo

Regulation of End Users of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*

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The purpose of this memorandum is to provide an overview of the application of Title VII (the "**Derivatives Legislation**" or the "**Legislation**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**") to end users, particularly (i) operating corporations ("**Corporates**"), such as manufacturing companies, insurance companies and airlines (all of which may be impacted somewhat differently), (ii) state and other municipal entities ("**Munis**"), and (iii) public and private benefit plans ("**Plans**"; and collectively with Corporates and Munis, "**end users**").

In General, the Derivatives Legislation establishes a separate but parallel scheme of regulation for "security-based swaps" regulated by the Securities and Exchange Commission (the "**SEC**") and for "swaps" on non-securities such as interest rates, currencies, energy and agricultural products (and certain securities) regulated by the Commodity Futures Trading Commission (the "**CFTC**"; and together with the SEC, the "**Commissions**").[1]

The memorandum focuses on seven aspects of the Derivatives Legislation relevant to end users, as well as a number of topics that arise with respect to each of these issues.

- The **first issue** is the scope of the term "**swap**"; and the related topics include the application of that term to **forwards, commercial loans and insurance.**

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* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Appendix A links to the various topic-focused memoranda) or visit our website at http://www.cadwalader.com/list_client_friend.php.

[1] For purposes of simplicity, unless the distinction is particularly important, this memorandum refers to both "swaps" and "security-based swaps" as "swaps" and makes similar simplifying uses of terminology. For a more detailed description of the swap regulatory scheme, see our related memorandum titled "*The New Scheme for the Regulation of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*." That memorandum also contains additional Appendices relating to (i) the tax treatment of swaps, (ii) the retroactivity provisions of the Derivatives Legislation and (iii) certain additional obligations that apply to swap dealers in entering into transactions involving Munis and Plans.

- The **second issue** is the application of the "**major swap participant**" definition to each of Corporates, Munis and Plans.
- The **third issue** is the ability of these three types of entities to rely on the "**commercial user**" exemption from clearing and margin requirements.
- The **fourth issue** is the reporting requirements that apply to persons that enter into swaps.
- The **fifth issue** is the imposition of position limits on swaps and related assets and contracts.
- The **sixth issue** is the application of the "**legal certainty**" provision of the Derivatives Legislation as applied to **pre-existing swaps**.
- The **seventh issue** is the ability of end users to plan for compliance with the Derivatives Legislation so as to minimize the impact of the legislation.

Notwithstanding the length of the Derivatives Legislation, it is unclear (and there is no guidance in the legislative history) whether the number of end users required to register as a major swap participant, and thus be subject to the attendant regulatory burdens, will be 10,000 or 10: it is left to the regulators. Nonetheless, it is possible to identify issues of concern, and actions that end users may take to maximize flexibility once rules are implemented.

I. Definition of the Term "Swap"

The Derivatives Legislation provides a comprehensive scheme for regulating "swaps," including (i) mandatory registration of swaps dealers and certain large users of swaps (referred to as "major swap participants"[2]); (ii) capital and conduct requirements on entities required to register; (iii) mandatory central clearing of certain swaps and imposing margin requirements on many swaps not required to be cleared; (iv) trade reporting obligations; and (v) position limits. The impact of these requirements depends upon the definition of the term "swap" and how that term will ultimately be interpreted.

The Derivatives Legislation defines "swap" in an **extremely expansive** manner.[3] In this regard, the first part of the discussion below focuses on the application of the swap definition to "forward" transactions. In addition, in Sections I.C and D, we discuss the breadth of the definition, including the potential application to commercial loans and insurance contracts.

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[2] More precisely, larger users of swaps regulated by the CFTC are defined as "major swap participants" and large users of security based swaps regulated by the SEC are defined as "major security-based swap participants." This memo generally combines both terms under the rubric of "major swap participants."

[3] *See* Derivatives Legislation Sec. 721 (defining the term "swap").

A. Forwards.

"Swaps" generally include any contract that provides, on an executory basis, for the exchange of payments based on the value of one or more underlying rates or assets.[4] "Forwards" involving physical commodities are **excluded** from the definition of a "swap," **provided** the parties enter into the transaction with an **"intent" to make delivery.** Put differently, a transaction would not be a forward, even if the parties are hedging, if the parties do not intend delivery. Further, the term "forward" in the Derivatives Legislation is limited to transactions in physical commodities; *i.e,* it does not include transactions in financial commodities.[5]

Example of a Hedging Swap. Assume an airline holding company with various operating subsidiaries is concerned about the price of oil rising. The airline wishes to enter into purchase contracts to lock in the price of oil for the next three years. The first question for the airline is whether those purchase contracts are "forwards" (outside the scope of the Derivatives Legislation) or "swaps" (subject to the requirements of the Derivatives Legislation).

Assume that to support its fleet, the airline will require oil deliveries in various locations throughout the world (assume the United States and Europe by way of example). To rationalize its hedging, the airline only enters into purchase contracts in Houston, based on the assumption that (i) if the price of oil rises in Europe, (ii) the price of oil will also increase in Houston and (iii) the airline will close out the Houston oil contracts at a profit, offsetting its cost increases in Europe. In any case, the airline **does not intend all the oil it purchased in Houston to be delivered**, although the contracts are intended as hedges against rising oil prices.

Under the literal words of the Derivatives Legislation, the purchase contracts would be "swaps" inasmuch as they do not fit within the definition of "forwards" given the absence of intent to take delivery. (While this may not in and of itself be problematic, it does bring the trades within the scope of the Derivatives Legislation.) For purposes of this memorandum, we will refer to such contracts for hedging where delivery is not actually "intended," as "Hedging Swaps."

Intent and Forwards. Assume that the airline prefers that the oil purchase contracts be treated as forwards (outside the scope of the Derivatives Legislation), and not as swaps. It must then consider a difficult question raised by the forward contract definition: what is "intent" (*i.e.,* state of mind) to deliver?

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4 *See Id.*

5 Derivatives Legislation Sec. 721. One of exclusions for a "swap" includes "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."

Assume the airline's oil contracts were with three different oil producers in Houston and that, over time, the airline takes delivery of all of the oil contracts from one of the three producers, but not the other two. In that case, a question arises as to whether the airline had the requisite "intent" of taking delivery of the contracts, inasmuch as the airline took delivery of less than half of the oil.

Another difficult question is whether the intent of the airline is the same as the intent of the seller of the oil. That is, what if the seller of the oil has the "intent" to deliver, but the airline does not have the "intent" to receive, but rather expects to close out the contract by delivery. Whose intent governs? Can the parties agree on a mutual intent by contract? If an oil producer learns from experience that an airline consistently declines to take delivery, is that producer on notice that the airline does not have the requisite intent?

Litigation and Interpretation. Prior to the adoption of the Commodity Futures Modernization Act (the "**CFMA**"), whether parties to a forward had the requisite "intent" to make or take delivery in connection with forward contracts was the subject of both court disputes and regulatory actions.[6]

To eliminate these conflicts with respect to sophisticated institutional participants, the CFTC had begun to move away from an interpretation of the term "forward" that depended on whether the parties actually intended to settle by delivery. Rather, the CFTC moved (i) to a position that a contract would be deemed a forward based on a party's ability to make or take delivery, regardless of intent; and (ii) more generally to a sophistication standard, where so long as the parties were sophisticated, they would be deemed to have entered into a legal "forward" contract, regardless of intent or expectation of taking delivery.[7] These positions were controversial, since they were not

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[6] See, *e.g.*, CFTC v. Co Petro Mktg. Group, 680 F.2d 573 (9th Cir. 1982) ; In re Stovall, Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,775 (Dec. 6, 1979). The statutory exclusion for forward contracts in the Commodity Exchange Act ("CEA") reflects a judgment that notwithstanding the CEA's application to contracts involving delivery in the future, the regulatory scheme for futures trading "should simply not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity." Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39188, 39190 (Sep. 25, 1990).

In an opinion written by Judge Frank Easterbrook, the 7th Circuit held that the relevant inquiry was whether the transaction involved, on the one hand, "a sale **of the commodity**," in which case it would be deemed to be a forward; or the contract was, on the other hand, "a sale **of the contract**," in which case it would be considered a futures contract. *CFTC v. Zelener, 373 F.3d 861, 865 (7th Cir. 2004) reh'g and reh'g en banc denied, 387 F.3d 624 (7th Cir. 2004).* As a proxy for this inquiry, Judge Easterbrook focused on whether the contract was fungible or absent that, whether the seller promised to allow the buyer to enter into an offsetting contract on demand. If either condition applied, the contract would be regarded as a futures contract. *Id. at 868.*

[7] See, e.g, Regulation of Hybrid and Related Instruments ("Hybrids Interpretation"), Comm. Fut. L. Rep. (CCH) ¶ 23,995 at 34,491 (Dec. 11, 1987) (refraining from exercising regulatory jurisdiction over swap transactions "which contemplate cash settlement rather than delivery of the physical commodity"); Statutory Interpretation Concerning Forward Transactions ("Brent Interpretation"), Comm. Fut. L. Rep. (CCH) ¶ 24,925 at 37,368 (Sept. 25, 1990) (holding that 15-day Brent oil contracts were forward contracts notwithstanding the fact that such transactions "may ultimately result in performance through the payment of cash as an alternative to actual physical transfer or delivery of the commodity").

based on statutory interpretations, but on a view that sophisticated parties should be able to determine for themselves whether to trade or not.[8]

The issue of intent with respect to many transactions between institutional parties largely became moot after Congress adopted the CFMA, which provided that, so long as the parties met certain financial status requirements, such parties could enter into off-exchange forwards or swaps, regardless of their specific "intent."[9] The Derivatives Legislation undoes the CFMA and thus returns the law to the difficult issue of determining intent. The question then becomes how will the courts and the regulators, particularly the CFTC, interpret "intent."

For purposes of this memorandum, we assume that the courts and the CFTC will take the Derivatives Legislation at its plain meaning, and thus require intent (and not merely ability) to deliver as a prerequisite to a trade being a forward. Accordingly, parties need to consider how they can **demonstrate—both as to themselves and as to their counterparties—"intent,"** and what documentation can survive both potential litigation and regulatory challenge. At a minimum, market participants should be aware that the law in this area was unsettled prior to the adoption of the CFMA and this uncertainty will again return.[10]

B. Commodity Options.

Under the plain language of the Derivatives Legislation, it is possible that a commodity option will be treated as a "swap," rather than a forward, even if the option calls for settlement by physical delivery. As a practical matter, this question is left for determination by the CFTC.

C. Floating Rate Loans as Swaps.

As noted above, the definition of "swap" in the Derivatives Legislation is very broad. In addition to payment contracts based on the value of an underlying asset, the definition also includes "**any agreement, contract, or transaction . . . that provides for any . . . payment or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial,**

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8 *Mark D. Young, Should the Supreme Court Review Zelener? ABA Committee on Regulation of Futures and Derivative Instruments, Winter Meeting, Key West, Florida, February 5, 2005.*

9 Nevertheless, this issue of intent continued to create uncertainty in certain foreign currency and commercial agricultural transactions outside the scope of the CFMA. *See Robert Zwirb, The CFTC and Foreign Currency—From A to Zelener, Futures & Derivatives Law Report, Feb. 2009, Vol. 29, Issue 2.*

10 *See* Christina A. Barone, The Hedge-To-Arrive Controversy: Conflicting Outcomes in Administrative and Judicial Proceedings, 52 Admin. L. Rev. 1423, 1426 (2000) (noting that CFTC and federal courts analyzing HTA contracts according to the traditional case law multi-factor approach reach "opposing outcomes"). This dichotomy between the courts and the CFTC continues to this day.

economic, or commercial consequence."[11] While we read the definition of "swap" to carve out physically settled purchase contracts of nonfinancial commodities and securities (without regard to whether they are contingent contracts), the definition includes a wide variety of non-purchase contracts which include contingencies such as most credit agreements, success-fee contracts and similar arrangements, and most forms of insurance.

For example, this provision could be read to include, among other contracts, commercial loans having floating rates of interest, since these loans have payment terms dependent on the "occurrence of an event" (a rise or fall in interest rates) with a financial, economic or commercial consequence. Commercial loans having interest or payment triggers tied to other commodity prices (such as oil), currency values or the like could similarly be read to be included within the broad definition of "swap" set forth in the Derivatives Legislation, as could commercial loans with conditions precedent such as material adverse-change clauses.

We assume that Congress did not intend the term "swap" to cover commercial loans. Nonetheless, the scope of the definition of "swap" creates an interpretative problem. One potential solution is simply to conclude that the regulation of commercial loans is not what Congress intended. However, there are uncertainties associated with this position. *First*, being wrong could result in a violation of the law. *Second*, the CFTC has historically—pre-CFMA—asserted authority over private transactions linked to interest rates, currencies and other commodities. A body of regulatory practice developed at that time as to whether various loan and debt instruments were in fact disguised futures contracts subject to regulation under the Commodity Exchange Act.[12] *Third*, the Derivatives Legislation specifically excludes "securities" that have payment terms linked to commodity values, but it does not provide a similar carve-out for commercial loans.

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[11] Derivatives Legislation Sec. 721 (defining "Swap").

[12] For examples of pre-CFMA regulatory debates over the scope of the CEA's authority, see *e.g.*, (i) Advance Notice of Proposed Rulemaking, 52 Fed. Reg. 47022 (Dec. 11, 1987); (ii) Statutory Interpretation Concerning Certain Hybrid Instruments, 54 Fed. Reg. 1139 (Jan. 11, 1989) ; and (iii) Statutory Interpretation Concerning Hybrid Instruments, 55 Fed. Reg. 13582 (April 11, 1990) (the "Reissued Interpretation"). In the Reissued Interpretation, the CFTC expressed the view that "commercial loans, that is bank loans directly to a commercial customer for the purpose of providing funds for use by the customer in its business . . . as well as loans to foreign governments, or political subdivisions thereof, would be beyond the purview of the CEA. . . . " Assuming that the Reissued Interpretation would again become "good law," is it limited to loans by banks? And query why loans to foreign governments are carved out from the CFTC's jurisdiction, but not loans to municipalities?

It is unclear whether Congress or the CFTC considered these documents in the course of the debate over the Derivatives Legislation, as well as whether the old interpretations have any continuing authority in light of the adoption of the CMFA and now the impending repeal of the CFMA and adoption of the Derivatives Legislation. In short, how much of the old statutory interpretation survives?

D. Insurance Contracts as Swaps.

The definition of "swap" is also broad enough to include many, if not all, types of insurance contracts. Read literally, even contracts such as corporate life insurance, theft insurance, or fire insurance could be "swaps," since these contracts have payment terms linked to the occurrence of an event with a financial consequence.

Can we assume that Congress simply did not mean to include contracts that are commonly thought of as insurance as "swaps?" One possible "interpretation" is that Congress only intended to clarify that credit default swaps were not "insurance"—as the characterization of such swaps as insurance was publicly debated before the adoption of the Act. This approach raises not only the problem of the literal words of the Derivatives Legislation, but also the problem that Congress was explicitly considering the issue of insurance as it adopted the Derivatives Legislation. For example, sections of the Derivatives Legislation provide that no state insurance authority will have authority over any swap agreement[13]—which raises difficult questions given the broad definition of "swap." Further, the regulatory history of the CEA demonstrates that the CFTC has historically taken the position that it should have authority over certain classes of contracts sold as insurance. For example, in the Reissued Interpretation cited in footnote 12 above, the CFTC conceded that it would not have jurisdiction over "non-transferable life insurance contracts," but left open the question of its jurisdiction over other insurance contracts. The issue of the CFTC's authority over insurance is potentially more difficult now than it was in 1990 because the scope of CFTC jurisdiction under the Derivatives Legislation is much broader than it was in 1990.

In short, while Congress **likely did not intend** the words of the Derivatives Legislation to include all insurance, **it is not safe to assume** how the courts or regulators will determine this issue as to various types of insurance. As a practical matter, of course, insurance companies and buyers of insurance will likely have to reach a judgment as to the scope of the definition of the term "swap" before it is ultimately clarified.

E. Purposes of Swaps: Hedging and "Investment."

In the first section of this memorandum, we discussed the breadth of the term "swap." In the next parts of the memorandum, we discuss certain aspects of the regulation of swaps applicable to end users.

For end users, very significant aspects of the regulation under the Derivatives Legislation turn on the purpose for which swaps are entered. The purpose of a particular swap may determine, for

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[13] *See* Derivatives Legislation Sec. 722 (Jurisdiction); Sec. 767 (State Gaming and Bucket Shop Laws).

example, whether an end user (i) is required to register as a "major swap participant" or (ii) is eligible to use the "commercial user" exemption from clearing and margin requirements.

For purposes of the discussion below, we use the term "Hedging Swap" to mean a swap entered into "for hedging or mitigating commercial risk." This term is not defined in the Derivatives Legislation which gives the CFTC authority to define it.

For purposes of this memorandum, we use the term "Investment Swap" to mean any swap that does not qualify as a Hedging Swap; *e.g.,* a swap entered into to make a profit based on future price movements.[14]

II. Major Swap Participant Status

The Derivatives Legislation potentially subjects buy-side participants to regulation as strict as that applicable to sell-side firms. In particular, an end user which is deemed a "major swap participant" will be subject to largely the same rules that apply to swap dealers.

There are three major costs or risks (and various lesser ones) that flow from being deemed a "major swap participant." First, such an entity would be subject to capital regulation intended to be stricter than the capital regulation that applies to banks. Such capital regulation would likely be expensive and burdensome for most end users in the operation of their ordinary businesses. As a result, an end user so regulated would likely want to isolate its affected swaps activities in a separate subsidiary so that the Derivatives Legislation capital rules applicable to major swap participants did not burden all of the end user's activities.[15] Second, a major swap participant is generally required to clear and margin its swaps including Hedging Swaps. Thus, an end user regulated as a major swap participant would lose the benefit of statutory exemptions from mandatory clearing and margin. Third, a major swap participant is subject to a variety of requirements with regard to its counterparties, even if its counterparty is a swap dealer, raising the possibility of both private and civil liability for failing to fulfill these obligations.

Legal Entity Determination. The determination of whether an entity is a "major swap participant" is, under the words of the Derivatives Legislation, to be made **on a legal entity basis** and not by considering the activities of an entire corporate group. In short, the term "major swap participant" means a "person" who meets one of the three tests described below.

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[14] The Commodity Exchange Act generally uses the term "speculative" to refer to transactions entered into for such purposes, but this memorandum uses the term "investment" inasmuch as "speculative" has a pejorative meaning that distracts from the legal analysis.

[15] As a practical matter, this separate subsidiary is likely to require either a parent guarantee to make it creditworthy or else require the airline to isolate a very substantial amount of "cash" in the subsidiary.

The Three Tests. The Derivatives Legislation provides three alternative tests to determine whether an entity is a "major swap participant." End users must understand how these tests work to structure their business (i) to avoid falling within the "major swap participant" definition or (ii) to minimize the costs of being regulated. Note that each of the three tests requires detailed implementation and rulemaking by the Commissions, so end users will have to revisit their planning as the regulators specify what the three tests mean.

- The **first test** covers an entity that maintains a "**substantial position**" in swaps in any "**major swaps category.**"[16]
- The **second test** covers an entity whose "**swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.**"[17]
- The **third test** covers a "**financial entity**" (a term that specifically includes employee benefit plans and that would also include an insurance company[18]) that is "**highly leveraged relative to the amount of capital that it holds**," that is not an entity subject to U.S. bank capital requirements, and that maintains a "substantial position" in swaps in any "major swaps category."[19]

Two Exclusions From the First Test. **For purposes of the first test only**, swaps held "for hedging or mitigating commercial risk"; *i.e.,* Hedging Swaps, are not included in the determination of a substantial position.[20] The first test also excludes positions held by any employee benefit plan as defined in Section 3(3) and 3(32) of ERISA "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan."[21]

The scope of the Hedging Swap exemption is unclear. For example, can a Muni hedge "commercial risk" given that Munis are not generally regarded as being "in commerce." For

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16 Derivatives Legislation Sec. 721 (defining "Major Swap Participant").

17 *Id.*

18 The term "financial entity" includes an entity predominantly engaged in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act, which provision defines "insurance" as being "financial in nature." Derivatives Legislation Sec. 723 (Clearing).

19 *Id.*

20 The term "hedging or mitigating commercial risk" is not defined in the Derivatives Legislation. There is a somewhat similar term—bona fide hedge—which is used in the provisions regarding position limits, which are discussed in Section V of this memorandum.

21 Derivatives Legislation Sec. 721 (defining Major Swap Participant). It should be noted that the hedging exclusion for plans may not apply, absent clarification, to certain employee benefit plans that use swaps for more than just, for example, mitigating interest rate risk or currency risk of cash market investments made by the plan. In this regard, some employee benefit plans use swaps for what could be characterized as investment purposes; *e.g.,* to gain exposure to an asset class.

example, if a Muni enters into an energy swap to hedge the cost of its buying oil to heat police and fire stations, is that hedging a “commercial” risk? Similarly, if a Muni borrows money at a floating rate to pay outstanding debt used for general governmental purposes and enters into a fixed-rate swap to hedge that debt, is that the hedging of a “commercial” risk?

Definition of Substantial Position and Certain Considerations. For the first and third tests, the Derivatives Legislation provides that “substantial position” should be defined by the relevant swaps regulator (*i.e.*, the CFTC or the SEC) at the “threshold that the swaps regulator determines to be prudent for the effective monitoring, management or oversight of entities that are systemically important or can significantly impact the financial system of the United States.”[22] This is an unusual determination for the CFTC and the SEC to make as the two agencies do not monitor the financial system of the United States at a global level.

The Derivatives Legislation further provides that, in setting the “definition” of substantial position, the regulators (i) **shall** consider the person’s “relative position in uncleared as opposed to cleared swaps” and (ii) **may** take into consideration the value and quality of collateral held against counterparty exposure.[23] The purpose of these two provisions is uncertain. As to the first requirement, it is unclear why the “relative position” matters; if one entity has $400 of cleared exposure and $200 of uncleared exposure, is that entity less likely be a major swap participant than an entity which has $200 of each type of exposure? As to the second provision, it is unclear whether the regulators may only take into account collateral that is “held” by another party or if it is intended that the regulators should also take into account collateral that has been “posted” to another party (which would seem a more logical result).

“*Major Swap Category.”* The definition of a “substantial position” is dependent on the definition of a “major swap category”—a term left to the regulators to interpret. For example, a “major swap category” might be defined as (i) physical, non-agricultural commodities; (ii) energy; (iii) oil; or (iv) a particular type or grade of oil, since there is no guidance in the Derivatives Legislation. Further, it is not clear why the division of swaps into major categories is relevant to the purposes of the legislation. If the purpose of the Derivatives Legislation is to limit credit exposures relating to swaps, it is unclear why $200 of swaps relating to interest rates and $200 relating to gold should be treated differently from $400 of swaps relating wholly to gold?

Single Entity vs. Corporate Group: Matching the Swap to the Risk. While the first test for being a “major swap participant” includes the hedging exception noted above, **it appears that the risk**

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[22] As to the second test, there is no similar guidance, but the Commissions will need to develop criteria for determining what constitutes a systemically risky counterparty exposure.

[23] Derivatives Legislation Sec. 721.

being hedged must generally be in the same legal entity that is entering into the swap. The one exception is that the Hedging Swaps may be held in (i) "an entity whose primary business is providing financing," and (ii) uses derivatives to hedge commercial risks related to interest rates and foreign currencies, (iii) where 90% of the [rate and currency] exposures arise from financing the purchase or lease of products, (iv) 90% or more of which are "**manufactured**" [emphasis supplied] by the parent company directly or through a subsidiary.[24]

The above conditions are restrictive, even as to Corporates actually engaged in manufacturing. Thus, an automobile company would presumably have to calculate whether it met the required 90% tests. On the other hand, neither the airline nor the insurance company is commonly viewed as engaged in "manufacturing." These types of business entities would be required to conduct all of their Hedging Swaps (including any "forwards" that were deemed to be Hedging Swaps) in the same legal entity in which the related commercial risk arose or else risk having the legal entity that entered into the swaps being deemed a major swap participant.

III. Commercial User Status

A Hedging Swap is not subject to the Derivatives Legislation clearing requirements applicable to Investment Swaps; *provided* that several conditions are met. (This is the "commercial user" exemption from clearing.) The **first condition** is that the **legal entity** using the exemption can not be a "financial entity" (although there is an exception to this requirement). The **second condition** is that the relevant swap must be a Hedging Swap. The **third condition** is that the legal entity must notify the regulators how it generally meets its financial obligations with respect to non-cleared swaps.

Meeting the Three Conditions. As to the first condition, the term "financial entity" includes, among other things, (i) a major swap participant (which may cause an end user to isolate Investment Swaps in a separate entity from Hedging Swaps) or (ii) a person engaged in activities that are "financial in nature" as defined in the Bank Holding Company Act. Notably, an entity whose only business was entering into swaps would likely be deemed to be predominantly engaged in activities that are financial in nature. Thus, as a general matter, a separate swaps subsidiary could not be used for trading swaps that are not intended to be cleared and margined.[25]

The second requirement, that the swap be a Hedging Swap, is discussed above.

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[24] *Id.*

[25] There is a limited exception to the use of a separate entity, but this exception is only available with respect to "manufacturing," as above, and thus could not be used by many Corporates.

The third requirement, a statement as to how the entity will meet its obligations with respect to swaps, is unclear. On the one hand, this requirement may merely be a formality; *i.e.*, an airline would say that it meets its swap obligations, the same way that it meets its electricity bill or pays its employees, by flying passengers. On the other hand, it may be that a more substantial requirement is intended; *e.g.,* a certification by corporate officers that the airline will not become insolvent and thus that it will be able to pay its obligations arising with respect to swaps. In the latter cases, such a certification could be problematic: if the airline financial officers were required to certify as to ongoing ability to pay, and the airline were to become insolvent, the officers who signed the certificate might face liability for having given a false representation.

Unintended Contradiction? One of the principal purposes of exempting end users from mandatory clearing with respect to their Hedging Swaps was to allow end users to avoid margin requirements set by central clearing counterparties. However, in many cases, end users will trade with swaps dealers and the Derivatives Legislation requires the regulators for swap dealers to establish **both initial and variation margin requirements for all swaps that are not cleared**, with no exemption provided for Hedging Swaps with end users.

As of today, it is unclear how this contradiction between the exemption for end user Hedging Swaps and the margin rules applicable to swap dealers will be resolved. One possibility is to revise the margin provisions of the Derivatives Legislation in an amendment to be passed before the effective date for the new legislation. Another possibility is for the regulators to use their discretion to set very low initial margin requirements for swaps that are Hedging Swaps with end users. In this regard, the Derivatives Legislation gives the regulators discretion to set margin requirements for uncleared swaps at a level, "appropriate for the risk associated with the non-cleared swaps."[26] However, the Derivatives Legislation also provides a general presumption that the risk for uncleared swaps is greater than for cleared swaps. It would appear difficult for regulators required to be responsible for the safety and soundness of dealers to provide the effective equivalent of a blanket exception for trades with end users. Until this issue is resolved, end users will face uncertainty as to whether, and to what extent, the Derivatives Legislation will provide an effective exemption from the margin requirements.

[26] Derivatives Legislation Sec. 731 (Registration and Regulation of Swap Dealers and Major Swap Participants)

IV. Swap Reporting

All "swaps," including Hedging Swaps, are subject to reporting requirements. Swaps that are not accepted for clearing at a derivatives clearing organization must be reported to a registered swap data repository or, if no swap data repository will accept the report, to the regulators.[27]

To a large extent, swap reporting requirements will not apply directly to end users. For swaps where one of the parties is a swap dealer or major swap participant, the swap dealer or major swap participant (and not the end user) is required to report. However, where neither party is a swap dealer or major swap participant (or where both parties are major swap participants), then parties must decide between themselves which party will report.[28] Therefore, end users must develop and implement compliance procedures to satisfy potential reporting requirements and to provide for the timely submission of reports when they are required.

End users will need to consider several questions when developing these reporting procedures. First and foremost, end users will need to assess the scope of the reporting requirement and identify contracts to which it applies*; i.e.,* end users must determine which contracts are "swaps."

It seems unlikely that a swap data repository or the regulators have an interest in receiving a flood of reports for all manner of commercial contracts that include payment contingencies, so it is likely that the regulators will use their authority to further define the term "swap" to limit definitional overreach. Nevertheless, even in such a scenario, commercial end users must develop the capacity to identify contracts that may be deemed to be swaps and/or manage the risk of unintentional reporting failures.

Second, end users may be required to deal with difficult issues relating to what information is required to be reported and when. While both the timing and content of swap reports is largely in the discretion of the regulators, the Derivatives Legislation does **require** the CFTC to promulgate rules to provide for the "real time public reporting" of swap data, including for swaps that are exempt from clearing.[29] For this purpose, the Derivatives Legislation defines "real time public reporting" as public dissemination of swap data, including price and volume, "as soon as technologically practicable after the time at which the swap transaction has been executed."[30]

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[27] Security-based swaps that cannot be reported to a swap data repository will be reported to the SEC.

[28] The legislation does not make clear whether the parties are jointly liable for a failure to report under this circumstance, or whether the parties can rely on an agreement that one of the parties will report to limit potential liability for a compliance failure to one of the parties.

[29] Derivatives Legislation Sec. 727 (Public Reporting of Swap Transaction Data).

[30] *Id.*

Thus, it is likely that parties to uncleared swaps will be required to report more or less immediately upon "execution."

Lastly, end users must monitor for announcements as to start dates when swaps are to be reported. Transition rules in the Derivatives Legislation provide for the reporting of swaps (i) entered into before enactment of the Derivatives Legislation within 180 days of the general effective date of the legislation (*i.e.*, 540 days after enactment) and (ii) entered into after enactment but prior to the effective date within 90 days of the general effective date or by such other time as the CFTC prescribes by rule.[31] However, **another** provision of the Derivatives Legislation requires the CFTC to adopt a reporting rule for pre-enactment swaps within 90 days of enactment, and requires reporting of such swaps within 30 days of enacting the rule unless the CFTC determines another period to be appropriate.[32]

V. Position Limits

The CFTC is authorized to set position limits, other than "bona fide hedge positions," that may be held by "any person" with respect to swaps that are "economically equivalent" to futures traded on a U.S. futures exchange.[33]

The term "bona fide hedge" is defined in the Derivatives Legislation.[34] By contrast, the term "positions used to hedge or mitigate commercial risk" (which is the phrase used in the definition of major swap participant) is not a defined term. This could mean either that (i) the two terms are intended to be identical and the same language should have been used in both places or (ii) the term "bona fide hedge" is narrower—and that the CFTC could establish limits as to certain Hedging Swaps that are not considered to be "bona fide hedges."

The Derivatives Legislation is unusual in that it allows the CFTC to set position limits not only on a "person," and not only on a group of persons acting in concert, but on any "group or class of traders."[35] This CFTC power—to apply position limits to a "group or class" of entities—is something that has received very little attention or explanation. However, it implies that the CFTC could apply a position limit to, for example, all airlines in the aggregate, or all transportation companies, or all commercial companies, or all speculators.

[31] Derivatives Legislation Sec. 723 (Clearing).

[32] Derivatives Legislation Sec. 729 (Reporting and Recordkeeping).

[33] Derivatives Legislation Sec. 737 (Position Limits).

[34] *Id.*

[35] *Id.*

VI. Retroactivity

Another issue is the continued viability of swaps entered into before the date of the enactment of the Derivatives Legislation and whether such swaps can be terminated or modified by the parties? Section 739 of the Derivatives Legislation provides that "unless **specifically reserved**" [emphasis supplied] in the swap, the Derivatives Legislation and any rule adopted under the Derivatives Legislation can not constitute (i) a reason to terminate to the swap, (ii) an "illegality" under the swap; (iii) a reason to pass along any increased costs resulting from the swap; (iv) a "regulatory change" with respect to the swap; (v) or a reason to modify the swap.[36] (Note, however, that this Section only applies to those swaps that would be regulated by the CFTC; it does not apply to SEC-regulated swaps on securities. It is unclear if there is a reason for the difference in treatments.)

From a lawyer's perspective, Section 739 raises difficult questions. What does it mean for a right to be "specifically reserved"? Is a right that is included in the form of derivative contract (*e.g.*, the standard ISDA agreement) specifically reserved? Are there rights that are included in a contract, but are not deemed to be specifically reserved? Is the Derivatives Legislation over-riding contractual terms between parties? That may raise questions both from a Constitutional standpoint (is this a "takings"?) and from a general limits on the power of government standpoint (should the government be over-riding private agreements?).

What are the implications of Section 739 for a contract that relates to an Investment Swap but does not provide a "specific reservation" that such contract can be terminated because of an illegality (or indeed any provision that it can be terminated because of an illegality) where such contract does not allow for the collection of margin, but the Derivatives Legislation requires one of the parties to post margin. The contract is now possibly subject to an illegality, but the party that might be required to post margin cannot post it (perhaps does not have liquid assets to post). Can such a party rely on Section 739 for the proposition that the Derivatives Legislation does not allow for amendment of the terms of the contract? That is, (i) the Derivatives Legislation makes the contract "illegal," and (ii) the Derivatives Legislation does not allow a party to the contract to terminate the contract on the basis of the illegality. What happens in the face of these apparently contradictory provisions?

Finally, consider a contract that allows one party to pass along the costs of a change in law to the other party. The Derivatives Legislation is over 400 pages and clearly appears to constitute a change in law. But the Derivatives Legislation seems to say that it is not a change in law. Can one party nonetheless require the payment of increased costs? If the other party refuses to pay

[36] Derivatives Legislation Sec. 739 (Legal Certainty for Swaps).

increased costs, can the first party terminate? Is it safer to pay in the increased costs and litigate for their return? These questions also require resolution by the regulations.

VII. Planning and Corporate Structure

As we have said, notwithstanding the length of the Derivatives Legislation and the Act, there is a great lack of specificity in the Derivatives Legislation. For example, there is no way to know how broadly the regulators will define the term "major swap participant." As a practical matter, regulators will likely be forced to limit the scope of the defined term "swap," since, in its literal meaning in the Derivatives Legislation, it could include all insurance contracts, many commercial loans and numerous other contracts. In light of how much remains to be determined, the amount of real planning that can be done by end users is limited. Nonetheless, there are a few general items that should be considered.

A. Identify "Swaps."

End users should seek to identify contracts that might be considered swaps, being mindful that the statutory definition of the term is far broader than the plain meaning. As to transactions that might be considered swaps, end users should consider whether they are clearly swaps or they are in an area of legal uncertainty, and how the uncertainty may be resolved.

As to potential swaps, parties need to consider (i) which legal entity is the contracting party on the end user side; (ii) is the swap a "Hedging Swap" and, if so, is it being effected in the legal entity that actually requires the hedge; (iii) what type of entity is the counterparty; *e.g.,* U.S. or foreign, and how will the counterparty be affected by the Act; and (iv) are there terms of the swap that could be altered, or even made impermissible, by the Derivatives Legislation.

B. Corporate Structure and the Location of Hedging Swaps.

As the Derivatives Legislation is drafted, end users may effectively be required to book Hedging Swaps into the same legal entity that requires the hedge. Accordingly, end users should consider where swaps are current booked and where they may be required to be booked going forward.

C. Major Swap Participant Definition.

Forced registration as a major swap participant, and the related capital and other requirements, will likely be burdensome. Accordingly, end users should seek to arrange their activities so they do not fall within the definition. In this regard, one may wish to consider the following potential measures:

- Shift positions from swaps to futures, forwards, cash market positions and other non-swap contracts to the extent possible.
- Consider moving positions outside of the United States or away from U.S. counterparties, so as to minimize the potential affect of an entity's failure on the U.S. system (which is part of the second test of the major swap participant definition).
- Consider shortening the maturity of instruments so they mature prior to rule adoptions.
- Consider putting additional assets into a swaps entity so that it is not deemed to be highly leveraged. Similarly, separate swaps from borrowing activity so that the swaps entity does not become highly leveraged.
- Consider providing for posting margin on swaps that do not otherwise require margin if the provision of margin will make it less likely that an entity is deemed to hold substantial positions.

D. Monitor Developments.

As stated in this memorandum, major provisions of the Derivatives Legislation are either largely indeterminate or too broadly drafted to be implemented literally. Thus, there is necessarily much more to come.

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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