SHEARMAN & STERLING

31 JANUARY 2018

DERIVATIVES & STRUCTURED PRODUCTS

A Corporate End User's Handbook for Dodd-Frank Derivatives Compliance

IN THIS ISSUE:

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), signed into law on July 21, 2010, was the largest overhaul of the U.S. derivatives market in history. While there are still a few parts of Dodd-Frank not yet implemented, the majority of the rules and regulations related to Dodd-Frank have been put into effect: many of the largest market makers in swaps are now registered as swap dealers (Swap Dealers); mandatory clearing and exchange trading is in effect for certain types of swaps; reporting requirements apply to almost all swap transactions; and margin requirements for swaps between financial entities are being phased in. At the same time, with the change of U.S. administration, new consideration (both at a legislative and regulatory level) is being given to modifications to the derivatives regulatory landscape.

Although many of the U.S. derivatives requirements are directed primarily at financial institutions, there have been, and remain, significant implications for end users of derivatives, both financial and non-financial (**End Users**). This handbook provides an overview of the key requirements and issues that End Users need to consider as they navigate through the U.S. regulatory requirements. In light of the current regulatory environment, End Users will also need to remain alert to the prospect of future changes in U.S. regulation of derivatives.

I. Introduction

At the seven-year mark following the passage of Dodd-Frank, the overhaul of the U.S. derivatives market has largely been implemented (with a few significant exceptions). At this time:

- Many of the largest dealers and market-makers in swaps are registered as Swap Dealers, and are subject to comprehensive regulation, including in terms of business conduct standards and documentation requirements.
- Significant categories of interest rate swaps and index credit default swaps are required to be cleared at a derivatives clearing organization (**DCO**) and

traded on a swap execution facility (**SEF**) or similar platform. Other categories of swaps are not subject to these requirements, however, and can be executed and maintained bilaterally.

- Most swaps are required to be reported to a swap data repository (**SDR**) and are subject to recordkeeping requirements.
- Swaps between financial entities are subject to mandatory variation margin requirements and, for certain transactions among dealers and large financial market participants, mandatory initial margin requirements.
- With limited exceptions, these requirements will apply to transactions on a cross-border basis, where at least one of the parties is a U.S. person or has certain other U.S. connections.
- Most of these requirements do not, however, currently apply to security-based swaps, as described in further detail below.

By imposing these requirements, Dodd-Frank divided the over-the-counter (**OTC**) derivatives market into "swaps" and "security-based swaps," regulated by the U.S. Commodity Futures Trading Commission (**CFTC**) and U.S. Securities and Exchange Commission (**SEC**), respectively. Generally, swaps include contracts based upon interest rates, foreign exchange rates, commodities, and broad-based security or credit indices, among other financial instruments. Security-based swaps, on the other hand, include transactions based on a narrow-based security index, a narrow-based credit index, a single security or loan or the occurrence or non-occurrence of an event relating to a single issuer of a security, among other things. The regulation of transactions that are both swaps and security-based swaps, so-called "mixed swaps," falls under the joint jurisdiction of both Commissions.

Certain transactions are excluded from the definition of both swaps and security-based swaps. This is true of most spot transactions. In addition, the Secretary of the Treasury has issued a determination excluding foreign exchange swaps and forwards from the definition of a swap.[1] However, only physically-settled transactions involving the physical exchange of two different currencies are excluded and many commonly used foreign exchange

1 Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 20, 2012).

derivatives, including foreign currency options, currency swaps and non-deliverable forwards, are still considered swaps.[2]

Although many of the requirements for swaps and security-based swaps are directed principally at Swap Dealers and other financial entities, compliance may present a challenge even for End Users. This handbook provides an overview of the key requirements and issues that End Users need to consider as they navigate through Dodd-Frank in its current state.

The change of U.S. administration has not, as of the date of publication, resulted in significant changes in the Dodd-Frank regulations applicable to derivatives. However, it remains possible that certain aspects of Dodd-Frank, including those affecting End Users, will be modified. In this regard, and as noted below, the U.S. Treasury Report on Capital Markets[3] suggests a number of reforms of the derivatives regulatory framework, and others may be considered by Congress and/or the CFTC and SEC. The CFTC has also sought input from market participants generally as to ways in which the regulatory burden from existing rules can be reduced.[4] In general, these proposals may provide more flexibility to End Users, although the prospects for adoption of any such changes are not certain.

II. Eligible Contract Participant Requirement

Dodd-Frank makes it unlawful for a person that is not an eligible contract participant (**ECP**)[5] to (1) enter into a swap other than on or subject to the rules of a designated contract market (**DCM**), or (2) enter into a security based swap other than on a registered national securities exchange.[6] Generally, End Users will be able to qualify as ECPs, and thus trade swaps off-exchange, by meeting

2 Though exempt from many of the requirements of Dodd-Frank, including clearing, exchange trading and margin requirements, FX swaps and forwards are still subject to the CFTC's swap trade data reporting (but not real-time reporting) requirements, enhanced anti-evasion authority, and business conduct standards applicable to registered Swap Dealers and MSPs. For further information regarding this rule, you may wish to refer to our publication on this topic, available at: http://www.shearman.com/dodd-frank--treasury-exempts-fx-swaps-and-fx-forwards-12-06-2012/.

3 United States Department of the Treasury, A Financial System that Creates Economic Opportunities: Capital Markets (Oct. 2017) (the **Treasury Capital Markets Report**), available at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf. For further information regarding the Treasury Capital Markets Report, you may wish to refer to our publication on this topic, available at: https://www.shearman.com/perspectives/2017/10/treasury-issues-recommendations-capital-markets.

4 Project KISS, 82 Fed. Reg. 23765 (May 24, 2017). The CFTC requested public input on simplifying and modernizing Commission rules through its Project KISS initiative. The comment period closed on September 30, 2017. The comment letters are available at: https://comments.cftc.gov/KISS/KissInitiative.aspx.

5 CEA Section 1a(18).

6 CEA Section 2(e).

either the large entity or hedging entity prongs of the ECP definition. The large entity prong of the definition states that "a corporation, partnership, proprietorship, organization, trust or similar entity . . . that has total assets exceeding $10,000,000" is an ECP, and it also picks up entities guaranteed by such persons.[7] The hedging entity prong of the ECP definition also applies to corporations, partnerships, proprietorships, organizations, trusts or similar entities, but lowers the financial threshold test to a net worth exceeding $1,000,000 and requires that the swap be entered into in the conduct of the business or to hedge risks associated with the business.[8]

Significantly for End Users, the CFTC has taken the position that guarantors of swaps must themselves also be ECPs. This requirement has raised certain issues in broader financing structures that use guarantees of affiliates. The CFTC has stated that it intends to address certain practical considerations regarding its interpretation of the term "swap" to include a guarantee of a swap in a separate rule release (although it has not yet done so).[9]

III. Mandatory Clearing and Trading and the End-User Exceptions

(a) Mandatory Clearing Requirement

Some of the key aims of Dodd-Frank are to reduce risk, increase transparency and promote market integrity by, among other things, mandating clearing of certain swaps and security based swaps. Despite its benefits, there are also substantial costs associated with clearing. Congress recognized that these costs create disincentives for End Users to hedge their commercial risk, and, as a result, Dodd-Frank contains an exception from the clearing requirement that is intended to be available to End Users using swaps to hedge or mitigate commercial risk. End Users may, however, elect to clear if they wish, and may in fact be required to clear under certain circumstances. If an End User is going to clear a swap, then the trade must be submitted for clearing by or through a registered futures commission merchant (**FCM**) to a registered DCO in accordance with the Commodity Exchange Act (**CEA**) and CFTC rules.[10]

7 CEA Section 1a(18)(A)(v)(I)-(II).

8 CEA Section 1a(18)(A)(v)(III).

9 *See* CFTC Interpretive Letter No. 12-17 (Oct. 12, 2012). As a result of the CFTC's position, End Users must consider carefully certain financing structures involving swaps where the package of obligations under the debt are supported by guarantees of non-ECPs. In such cases it may be necessary to exclude swaps from being guaranteed by the non-ECPs.

10 This requirement is applicable to the extent that the End User is subject to Dodd-Frank. Please see our discussion on extraterritorial application of the rules in part XI for more detail.

Mandatory clearing determinations for swaps, security based swaps and mixed swaps are made by the CFTC and/or the SEC, as appropriate. Clearing determinations can be made following submissions from DCOs or by the CFTC following a review on its own initiative.

The CFTC issued its first clearing determination for "plain vanilla" fixed to floating interest rate swaps, forward rate agreements and basis swaps in U.S. dollars, Euro, Sterling or Yen, overnight index swaps in U.S. dollars, Euro or Sterling, and CDX and iTraxx index credit default swaps.[11] The CFTC has additionally issued a clearing determination for (i) fixed-to-floating interest rate swaps denominated in Australian dollars, Canadian dollars, Hong Kong dollars, Mexican pesos, Norwegian kroner, Polish zlotys, Singapore dollars, Swedish kronor, and Swiss francs, (ii) basis swaps denominated in Australian dollars, (iii) forward rate agreements denominated in Norwegian kroner, Polish zlotys, and Swedish kronor, and (iv) overnight index swaps denominated in Australian dollars, Canadian dollars, U.S. dollars, Euro or Sterling up to certain termination dates.[12] Trades that do not fully comply with the specifications of the determination are not subject to mandatory clearing. The compliance schedule for the second determination is designed to match the timetable for implementation of similar mandatory clearing requirements in the relevant currencies in other jurisdictions, with a two-year time limit on such phase-in schedule.[13] End Users that are subject to the clearing requirements are required to clear such swaps or avail themselves of an exception.

(b) Mandatory Exchange Trading

Dodd-Frank provides that certain swaps that are required to be cleared must also be executed on or through the facilities of a DCM or SEF that is registered with the CFTC.[14] At present, the mandatory trading requirement applies only to

11 CFTC Rule 50.4; Clearing Requirement Determination under Section 2(h) of CEA, 77 Fed. Reg. 74284 (Dec. 13, 2012).

12 Clearing Requirement Determination Under Section 2(h) of CEA, 81 Fed. Reg. 71202 (Oct. 14, 2016).

13 *See id*. at 71227-71230. For the prior clearing determination, the CFTC had used a phased-in compliance timeline that generally grants End Users more time than active market participants, such as hedge funds, to come into compliance with the clearing requirement (to the extent it applies). At the time of publication, the compliance dates for all Australian dollar-, Canadian dollar-, Hong Kong dollar-, Mexican peso-, Norwegian krone-, Polish zloty- and Swedish krona-denominated swaps have passed. The compliance dates for Swiss franc- and Singapore dollar-denominated fixed-to-floating interest rate swaps will take place on the earlier of: (i) 60 days after the first clearing requirement compliance date for such swaps, or (ii) October 15, 2018, which is two years following publication of the expanded clearing requirement. *See* 17 C.F.R. 50.25.

14 CEA Section 2(h)(8); 17 C.F.R. 37.9-10. Swaps traded on a foreign board of trade may also satisfy the mandatory execution requirement. The CFTC has also indicated that it intends to recognize certain other EU authorized trading venues for purposes of this requirement

a subset of the interest rate and credit default swaps that are subject to the mandatory clearing requirement.[15] Swaps subject to the mandatory trading requirement must be executed through the order book or a qualifying request-for-quote system of a DCM or SEF. Exceptions exist for block transactions.[16] The CFTC has also provided temporary relief for certain "package transactions" that constitute a combination of a swap subject to the mandatory trading requirement and certain other types of swaps, derivatives or securities transactions.[17]

The mandatory trading requirement applies where a SEF or DCM has made the relevant swap "available to trade" on its facility, within the meaning of CFTC regulations.[18] The facility must file a certification with the CFTC as to such determination, based on a number of specified factors, including the size and liquidity of trading in the relevant contract. Once a facility has made a swap available to trade, the mandatory trading requirement applies to trading on any facility that lists the swap.

End Users transacting in swaps that are subject to the mandatory trading requirement must have arrangements to execute through a SEF or DCM, unless an exemption from the requirement is available.

(c) Commercial End-User Exception from Clearing and Trading

The requirement to clear and to trade on a DCM or SEF, along with the attendant requirements to post margin to a DCO for cleared transactions, presents a significant cost and operational challenge for End Users. In recognition of these significant burdens, Congress provided End Users with an optional exception from the mandatory clearing and trading requirement (**End-User Exception**) when the following conditions are satisfied:

(i) The End User is not a Financial Entity;

---

without requiring SEF registration. *See* United States Commodity Futures Trading Commission and the European Commission: A Common Approach on Certain Derivatives Trading Venues (Oct. 13, 2017).

15 The CFTC publishes a list of swaps "made available to trade" on its website from time to time. *See, e.g.*, https://sirt.cftc.gov/sirt/sirt.aspx?Topic=SwapsMadeAvailableToTradeDetermination and http://www.cftc.gov/idc/groups/public/@otherif/documents/file/swapsmadeavailablechart.pdf.

16 17 C.F.R. 37.9. Block transactions are defined in 17 C.F.R. 43.2 and are subject to certain minimum size and other requirements. *See* also CFTC Staff Letter No. 17-60 (Nov. 14, 2017).

17 *See* CFTC Staff Letter No. 17-55 (Oct. 31, 2017).

18 17 C.F.R. 37.10.

(ii) The swap is being used to hedge or mitigate commercial risk; and

(iii) The End User satisfies certain reporting obligations, including as to how it generally meets its financial obligations for non-cleared swaps.[19]

End Users will want to perform a thorough analysis of their hedging operations, including a review of any inter-affiliate swap activity and any activity undertaken by a captive finance subsidiary, in order to determine if their activities permit use of the exception. End Users will also want to carefully analyze and monitor which entities are ultimately liable for swaps entered into by affiliates or captive finance subsidiaries, because the CFTC interprets the definition of "swap" to include guarantees of swaps.

The March 2013 ISDA Dodd-Frank Protocol was published in part to facilitate use of the End-User Exception.[20] The protocol allows Swap Dealers to obtain representations from End Users to confirm that the swap is not required to be cleared and to ensure that the reporting obligations are properly satisfied. The protocol offers End Users the ability to make a standing election to use the End-User Exception, unless it instructs a Swap Dealer to the contrary. Regardless of whether the standing election is made, the Protocol allows any party electing to use the End-User Exception to represent that they have satisfied their reporting requirement under the exception by using an annual filing (rather than on a trade-by-trade basis), unless it notifies the Swap Dealer that this is not the case. End Users can use the protocol to inform Swap Dealer counterparties that the annual filing will not be made, in which case the End User will have to provide the Swap Dealer with the information necessary to satisfy the reporting requirement on a trade by trade basis. Swap Dealers, in turn, agree to report this information to a swap data repository on a trade by trade basis.

(i) What Does It Mean to 'Hedge or Mitigate Commercial Risk'?

The CFTC has adopted an expansive definition of hedging or mitigating commercial risk.[21] Generally, the definition requires that the swap be

19 CEA Section 2(h)(7); 17 C.F.R. 50.50; End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42560 (July 19, 2012).

20 *See* http://www2.isda.org/functional-areas/protocol-management/protocol/12. For further information regarding the protocol, you may wish to refer to our publication on this topic, available at: http://www.shearman.com/isda-march-2013-dodd-frank-protocol-aka-dodd-frank-protocol-20-05-31-2013/.

21 17 C.F.R. 50.50(c); 77 Fed. Reg. 42560 (July 19, 2012). The approach is substantially similar to the guidance the CFTC provided for the same phrase as used within the MSP definition. *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012). For further

economically appropriate to the reduction or mitigation of a commercial risk.[22] Commercial risk has been interpreted broadly by the CFTC, which acknowledges that commercial risks can arise from financial activities such as interest rate risk on a non-Financial Entity's debt incurred for commercial business operations. However, the use of the End-User Exception by non-Financial Entities for financial risk hedging or mitigation must be an incidental part of (i.e., not central to) the electing counterparty's business. In addition, the swap must not be entered into for speculative purposes.[23] The CFTC emphasized that determining whether a swap hedges or mitigates a commercial risk will require a facts-and-circumstances analysis which is to be performed at the time the swap is entered into, and that the overall purpose of the swap is the driving factor in what will determine whether it is eligible for the End-User Exception. As part of their recordkeeping requirements, End Users are required to maintain records justifying their reliance on the End-User Exception and will need to develop (or update existing) policies and procedures for making and documenting this determination.

Several commenters raised concerns over dynamic and portfolio hedging and whether these more sophisticated hedging techniques could still meet the test for hedging or mitigating commercial risk. The CFTC determined that a swap that facilitates this type of hedging program may be eligible for the End-User Exception if it hedges or mitigates a commercial risk. Commenters also raised concerns over hedge effectiveness testing, but the CFTC determined that parties will not be required to demonstrate hedge effectiveness or engage in periodic hedge effectiveness testing, nor will parties be required to document and report the risk being hedged. These clarifications from the CFTC should offer End Users flexibility in designing their hedging operations.

---

information regarding these definitions, you may wish to refer to our publication on this topic, available at: http://www.shearman.com/swap-dealer-major-swap-participant-and-eligible-contract-participant-sec-and-cftc-adopt-entity-definition-rules-07-13-2012/.

22 The swap must be economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise, where the risks arise from potential changes in value of assets, liabilities, services, inputs, products or commodities or any fluctuation in interest, currency or foreign exchange exposures. Alternatively, the swap will meet the definition if the swap is exempt from position limits by virtue of qualifying as a bona fide hedge under CFTC rules or qualifies for hedging treatment under FASB or GASB accounting rules. 17 C.F.R. 50.50(c)(1).

23 The swap must also not be used to hedge or mitigate the risk of another swap (except swaps that offset swaps themselves used to hedge or mitigate commercial risk). 17 C.F.R. 50.50(c)(2).

(ii) Who Is a Financial Entity?

"**Financial Entities**" include Swap Dealers, major swap participants (**MSPs**), private funds, commodity pools, certain employee benefit plans and persons predominately engaged in the business of banking or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956, except depositary institutions with less than $10 billion in total assets. While this definition will exclude most commercial End Users, one note of caution is that Section 4(k) of the Bank Holding Company Act of 1956 includes a broad list of financial activities that could cover the business activities of some End Users.[24] Consequently, it is important for End Users to review this list of activities to determine if they are engaged in activities that are financial in nature. The impact of this broad definition is mitigated somewhat by the requirement that the person be "predominantly engaged" in such activities. However, the CFTC has provided only limited guidance on the meaning of "predominantly engaged" in this context. Specifically, in the context of certain no-action relief, the CFTC has indicated that parties may look to the Federal Reserve's rules regarding the definition of "predominantly engaged in financial activities."[25]

Financial Entities are generally not entitled to the End-User Exception, except when the Financial Entity is a captive finance subsidiary, eligible treasury affiliate or an affiliate entering into the swap as an agent on behalf of a non-Financial Entity End User hedging a commercial risk of that End User. Financial Entities may also be eligible for the Inter-Affiliate Exemption, discussed below, in relevant circumstances.

(iii) Exception: Captive Finance Subsidiary – '90/90 Test'

A captive finance entity or subsidiary generally refers to an entity that provides purchase or lease financing to customers for the purchase or lease of products

24 The list of 4(k) activities includes, but is not limited to (i) lending, exchanging, transferring, investing for others, or safeguarding money and securities, (ii) underwriting, (iii) engaging in certain activities related to extending credit, (iv) leasing personal or real property under certain circumstances, (v) certain financial and investment advisory activities and (vi) certain management consulting and counseling activities, among other activities.

25 The CFTC has indicated in two separate No-Action Relief Letters that, for purposes of those letters (relating to treasury affiliates), entities may look towards the Federal Reserve final rule regarding the definition of "predominantly engaged in financial activities" for purposes of Title I of Dodd-Frank, which states that when at least 85% of the company's consolidated total annual gross revenues is derived from financial activities or at least 85% of the company's consolidated total assets are attributable to financial activities, the entity shall be deemed to be "predominantly engaged" in such activities. *See* CFTC No-Action Letters 14-44 (Nov. 26, 2014), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/14-144.pdf, and 13-22 (June 4, 2013), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/13-22.pdf.

or other goods manufactured or assembled by a parent or affiliate. Dodd-Frank provides that captive finance companies are not Financial Entities if they satisfy the following requirements:

(i) the primary business is providing financing;

(ii) the entity uses derivatives for hedging commercial risks related to foreign currency (F/X) and interest rate exposures;

(iii) at least 90% of exposures arise from financing that facilitates the purchase or lease of products; and

(iv) at least 90% of such products are manufactured by the parent company or a parent's subsidiary.

The two 90% calculations are interpreted separately, so that in order to be a captive finance company, first, at least 90% of the interest rate and F/X exposure that is being hedged must arise from financing that facilitates the purchase or lease of products (as calculated on a consolidated basis that includes the entity's consolidated subsidiaries), and second, of the products that are being purchased or leased using financing, at least 90% must be manufactured by the parent company or parent's subsidiary. Captive finance companies can take an expansive view of "facilitates"[26] and "products"[27] when performing both 90% calculations.

(iv) Exception: Eligible Treasury Affiliates

The hedging activities engaged in by End Users can vary significantly as can the corporate structures that End Users employ to enter into these hedging transactions. Many End Users are part of a larger corporate organization that employs centralized hedging and may make use of, among other strategies, a central booking entity, which may use a series of inter-affiliate risk transfers completed by back to back transactions.

As a result of amendments enacted by Congress in 2015, Dodd-Frank allows affiliates of a Non-Financial End User (including captive finance subsidiaries), acting as principal or agent, to rely on the End-User Exception when entering

[26] Also in response to comments provided to the proposed rule, the CFTC clarified that "facilitates" should be interpreted broadly to include financing that may indirectly help to facilitate the purchase or lease of products, such as, for example, providing working capital to a dealer that sells the End User's products or financing the sale of a product that contains the End User's product as a component. *See id*.

[27] In response to comments provided to the proposed rule, the CFTC clarified that "products" should be interpreted broadly to include service, labor, component parts and attachments that are related to the products. *See* 77 Fed. Reg. 42560, 42564 (July 19, 2012).

into the swap to hedge the risk of the End User, subject to certain conditions.[28] We refer to such an affiliate of an End User as an "Eligible Treasury Affiliate." The conditions for the use of the exemption are as follows:

(i) the Eligible Treasury Affiliate enters into the swap to hedge or mitigate the commercial risk of the End User, and the commercial risk being hedged has been transferred to the Eligible Treasury Affiliate;

(ii) the Eligible Treasury Affiliate is (a) directly, wholly-owned by a non-Financial Entity or another Eligible Treasury Affiliate and (b) is not indirectly majority-owned by a Financial Entity;

(iii) the entity's ultimate parent is not a Financial Entity;

(iv) the entity is not, and is not affiliated with, a swap dealer, major swap participant, security based swap dealer, or major security based swap participant;

(v) the entity is not a private fund,[29] a commodity pool, an employee benefit plan,[30] a bank holding company, an insured depository institution, a farm credit system institution, a credit union, a nonbank financial company that has been designated as "systemically important" by the Financial Stability Oversight Council (a **Nonbank SIFI**), or an entity engaged in insurance that is subject to regulatory capital requirements; and

(vi) the entity does not provide any services to any affiliate that is a Nonbank SIFI.

In addition to the requirements set forth above, there are a number of general conditions and limitations to the swap activity permitted under the Eligible Treasury Affiliate exception, as follows:

(i) the Eligible Treasury Affiliate cannot enter into swaps other than for the purpose of hedging or mitigating commercial risk;

(ii) neither the Eligible Treasury Affiliate nor any person affiliated with the Eligible Treasury Affiliate that is not a Financial Entity may (a) enter into swaps with or on behalf of any affiliate that is a Financial Entity or (b) otherwise assume, net, combine, or consolidate the risk of swaps

[28] CEA Section 2(h)(7)(D) (adopted by Consolidated Appropriations Act, 2016, Pub. L. 114-113 (2015)).

[29] As defined in section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. § 80-b-2(a)).

[30] As defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. § 1002).

entered into by any Financial Entity, except in the event such Financial Entity qualifies as an Eligible Treasury Affiliate; and

(iii) each swap entered into by the Eligible Treasury Affiliate must be subject to a centralized risk management program that is reasonably designed to monitor and manage the risks associated with such swap and identifies the related affiliate on whose behalf each exempted swap has been entered into by the Eligible Treasury Affiliate.

Finally, in order to utilize the Eligible Treasury Affiliate exception, the Eligible Treasury Affiliate must report certain information to an SDR, consistent with the End-User Exception generally. The requirements are detailed in section (v) below.

(v) Reporting Requirement for the End-User Exception

CFTC regulations require that for an End User to rely on the End-User Exception, certain required information must be reported to an SDR.[31] In response to commenters' concerns about the amount of information that the proposed rulemaking required, the CFTC allows End Users to comply with most of the reporting requirements with a single annual filing that primarily employs a check-the-box approach. However, for each swap where the End User elects to rely on the End-User Exception, the reporting counterparty, as determined by the CFTC's swap data reporting rules (see discussion in Section IV below), is required to provide notice to the SDR of the election and the identity of the electing counterparty. The annual filing contains basic information about the End User and its basis for relying on the End-User Exception and requires the End User to state how it generally meets its financial obligations associated with entering into non-cleared swaps.[32] There is an ongoing reporting obligation, which requires that the filing be updated annually and at times when there are material changes.[33]

The reporting counterparty, as determined by the CFTC's swap data reporting rules, will typically be a Swap Dealer or other Financial Entity.[34] The CFTC

31 17 C.F.R. 50.50(b).

32 The CFTC specified several options for an End User to select when reporting how it meets its financial obligations, namely (i) a written credit support agreement; (ii) pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise); (iii) a written third-party guarantee; or (iv) the electing counterparty's available financial resources. The CFTC also provides a catch-all "other" category for those who meet their financial obligations in other ways.

33 The CFTC has provided no-action relief from the obligation to report use of the End-User Exception in connection with certain intra-group swaps among wholly owned affiliates. *See* CFTC No-Action Letter No. 13-09 (April 5, 2013).

34 17 C.F.R. 45.8.

requires that the reporting counterparty have a "reasonable basis to believe" that the End User that is electing to rely on the End-User Exception meets the requirements necessary to make such election.[35] As a result, the Swap Dealer will likely require the End User to complete the relevant ISDA protocol, which includes certain representations about the End User's eligibility to elect the End-User Exception.[36]

If an End User is a publicly traded company, its board or an "appropriate committee" thereof must approve the election to rely on the End-User Exception.[37] The annual filing requires the End User to confirm that board approval has been obtained within the last year. The CFTC noted that board approval must be obtained from an appropriate committee with sufficient authority and may be required more frequently than annually if there is a triggering event such as implementation of a new hedging strategy. The CFTC has determined that End Users controlled by public companies will also be required to obtain such approval before they can rely on the End-User Exception. The board or committee must maintain policies and procedures governing the use of swaps subject to the End-User Exception and review those policies at least annually and, as appropriate, more often upon a triggering event.

(d) Inter-Affiliate Exemption

The CFTC has adopted a separate exemption from the mandatory clearing requirement for swaps between certain affiliated entities within a corporate group (**Inter-Affiliate Exemption**) as an alternative to the End-User Exception.[38] A counterparty to an inter-affiliate swap that qualifies for both the End-User Exception and the Inter-Affiliate Exemption may elect not to clear the swap under either form of relief. Since the relief granted under the Inter-Affiliate Exemption is subject to a greater number of conditions than those under the End-User Exception, End Users will likely rely on the Inter-Affiliate Exemption only in situations where the End-User Exception is unavailable, i.e., where a swap is entered into by a Financial Entity or if the swap is being used for speculative, non-hedging purposes. This relief may be relevant for Financial

35 17 C.F.R. 50.50(b)(3).

36 *See* http://www2.isda.org/functional-areas/protocol-management/protocol/12.

37 Section 2(j) of the CEA and §3C(i) of the Exchange Act require board approval for use of the End-User Exception by issuers of securities registered under Section 12 of the Securities Exchange Act of 1934 or issuers that are required to file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934. Board approval may be obtained on a general basis and need not be obtained for each swap.

38 17 C.F.R. 50.52; *See* Clearing Exemption for Swaps between Certain Affiliated Entities; Final Rule, 78 Fed. Reg. 21750 (April 11, 2013).

End Users that utilize a central booking entity, which may be a Financial Entity under the CEA's expansive definition. As with the End-User Exception, End Users that are public companies will need to obtain board approval of the decision to engage in swaps transactions exempt from mandatory clearing pursuant to the Inter-Affiliate Exemption.

(i) Requirements for Inter-Affiliate Exemption

In order to take advantage of the Inter-Affiliate Exemption, one party to the swap must directly or indirectly hold a majority ownership interest in the other, or a third party must directly or indirectly hold a majority ownership interest in both counterparties. Additionally, the financial statements of the majority interest holder (whether third party or not) must be reported on a consolidated basis and must include the financial results of the majority owned affiliate(s).[39] Further, the following conditions must be met:

(i) Both counterparties elect not to clear the swap;

(ii) If neither eligible affiliate counterparty is a Swap Dealer or MSP, the swap is documented under a swap trading relationship document that shall be in writing and shall include all terms governing the trading relationship between the affiliates;[40]

(iii) The swap is subject to a centralized risk management program that is reasonably designed to monitor and manage the risks associated with the swap;

(iv) Each affiliate counterparty that enters into a swap with an unaffiliated counterparty (i.e., outward facing swaps) must comply with the clearing requirements (including any exception or exemption therefrom) under Section 2(h) of the CEA, or under a foreign jurisdiction's clearing mandate that is comparable and comprehensive, as determined by the CFTC (this condition, the **Outward Facing Swaps Condition**);[41] and

39 A counterparty or third party directly or indirectly holds a majority ownership interest if it directly or indirectly holds a majority of the equity securities of an entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership.

40 Swap Dealers or MSPs and their affiliates may satisfy the swap trading documentation requirement for purposes of the Inter-Affiliate Exemption by complying with existing swap trading relationship documentation requirements under 17 C.F.R. 23.504.

41 An eligible affiliate counterparty that is not located in the United States or in a comparable foreign jurisdiction may elect the Inter-Affiliate Exemption if it clears any outward-facing swap through a registered DCO or clearing organization that is subject to supervision in its home country and has been assessed to be in compliance with the CPMI/IOSCO Principles for Financial Market Infrastructures (PFMIs). 17 C.F.R. 50.52(b)(4)(E).

(v) The reporting counterparty for the swap complies with the reporting requirements applicable to inter-affiliate swaps, including the requirement to acknowledge that board approval has been obtained.

The CFTC also provided a transitional compliance framework with respect to the Outward Facing Swaps Condition until other jurisdictions have adopted or finalized their swap clearing regimes. This transitional compliance framework has been extended by the CFTC several times, with the current no-action letter in effect until the earlier of December 31, 2020 or 60 days after the CFTC announces a comparability determination for the relevant jurisdiction. The transitional compliance framework available to eligible parties seeking relief under the Inter-Affiliate Exemption will depend on the jurisdiction in which a non U.S. eligible affiliate counterparty is organized.[42]

In addition to the conditions relating to outward facing swaps, affiliate counterparties will also be subject to the general authority of the CFTC regarding evasion of the clearing requirement.[43]

(ii) Reporting Requirement for the Inter-Affiliate Clearing Exemption

The general reporting and recordkeeping requirements of the CEA and CFTC rules, including Part 45, will apply to uncleared inter-affiliate swaps. Real time reporting under Part 43, however, will only apply if the swap is a "publicly reportable swap transaction"- a category that does not include transactions

[42] No-Action Relief from Certain Provisions of the Outward-Facing Swaps Condition in the Inter-Affiliate Exemption from the Clearing Requirement, CFTC No-Action Letter No. 17-66 (Dec. 14, 2017). Under the relief,

(1) If one of the eligible affiliate counterparties is domiciled in a jurisdiction that has adopted a swap clearing regime and is currently in the process of implementation (i.e., Japan, the European Union, Australia and Mexico), the parties are not required to satisfy, or will be deemed to satisfy, the Outward Facing Swaps Condition if:
   (a) the majority interest holder (whether third party or not) is not a "Financial Entity" as defined in Section 2(h)(7)(C)(i) of the CEA and neither eligible affiliate counterparty is affiliated with a Swap Dealer or MSP; or
   (b) if the majority interest holder (whether third party or not) is a "Financial Entity" as defined in Section 2(h)(7)(C)(i) of the CEA or either eligible affiliate counterparty is affiliated with a Swap Dealer or MSP, the affiliate counterparties or a majority interest holder on their behalf pays and collects full variation margin daily on either all inter-affiliate swaps or all third-party swaps.

(2) For eligible affiliate counterparties domiciled in other jurisdictions, the parties are not required to satisfy the outward facing swaps condition if:
   (a) the aggregate notional value of the inter-affiliate swaps does not exceed 5% of the aggregate notional value of all swaps subject to the clearing requirement (the notional value must be measured in U.S. dollar equivalents and calculated for each calendar quarter); and
   (b) the affiliate counterparties or a majority interest holder on their behalf pays and collects full variation margin daily on either all inter-affiliate swaps or all third party swaps executed in such other jurisdictions.

[43] CEA Section 2(h)(4)(A).

between wholly owned affiliates.[44] As a further condition for electing the Inter-Affiliate Exemption, affiliate counterparties must provide certain information to a registered SDR. Information to be reported includes:

(1) For each inter-affiliate swap, the reporting counterparty must confirm that both affiliate counterparties are electing not to clear the swap and meet the exemption's requirements.

(2) The reporting counterparty must also submit annual information regarding how the affiliate counterparties will satisfy their financial obligations with respect to uncleared swaps.

(3) For public companies, an appropriate committee of the electing affiliate's board or governing body must review and approve its decision to enter into swaps subject to the Inter-Affiliate Exemption.[45]

As with the End-User Exception, the reporting requirements may be fulfilled by one affiliate counterparty on behalf of both counterparties, pursuant to the general reporting party hierarchy under Part 45 of the CFTC rules.

IV. OTC Clearing Considerations

(a) Costs and Benefits of Clearing OTC Derivatives

Even if an End User is entitled to rely on the End-User Exception, it may still elect to clear swap transactions. There are a multitude of factors that may impact this decision for any given swap, but three principal considerations will be cost, liquidity and counterparty risk.

Cost. Without the End-User Exception, an End User may be subject to substantial additional costs in connection with their cleared derivatives by way of margin requirements set by a particular DCO. Historically, many End Users have avoided posting initial and variation margin in cash or liquid securities to

44 A "publicly reportable swap transaction" is a transaction that is executed at arm's length between two parties that results in a change in the market risk positions between the two parties. Although the adopting release for Part 43 makes clear that inter-affiliate swaps between 100% commonly-owned affiliates are not included in this definition, there is no express carve-out for swaps between majority-owned (but not 100% commonly-owned) affiliates. Assessing whether these swaps constitute "publicly reportable swap transactions", therefore, requires an analysis of whether the transaction is at arm's length. The CFTC has generally stated that transactions that (A) cause one affiliate to have credit exposure to another affiliate and (B) are on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable, as those prevailing at the time for comparable transactions with or involving nonaffiliated entities, or, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would apply to, transactions between nonaffiliated entities are "publicly reportable swap transactions".

45 17 C.F.R. 50.52(c).

their dealers in connection with their OTC swaps, but this may change going forward. For cleared swaps, End Users are required to post initial and variation margin, as determined by the clearinghouse, together with any additional margin required by the FCM above clearinghouse minimums. At the same time, although End Users may not be directly subject to the margin requirements for uncleared swaps, as discussed below, such requirements applicable to their dealers or other counterparties may affect the costs of such transactions, and further may affect the willingness of such counterparties to transact with End Users without similar initial and variation margin. A complete cost-benefit analysis of trading a cleared or uncleared product will include the amount of margin, if any, that End Users will need to post in connection with each transaction type.

Liquidity. Two of the frequently touted benefits of OTC clearing are enhanced liquidity and transparency, both of which may enhance an End User's ability to enter into transactions and may also have the potential to lower the costs associated with cleared swaps. In particular, a more liquid and transparent market may result in a narrowing of bid-offer spreads. As the cleared OTC markets deepen and liquidity increases, End Users may develop a preference for clearing certain products. On the other hand, splitting the market between cleared and uncleared swaps may have an adverse effect on liquidity, particularly in the short run as clearing (and particularly mandatory clearing) is implemented.

Counterparty Risk. A key benefit of central clearing is the reduction of counterparty credit risk. With the DCO standing in the middle of each cleared transaction, there is a reduced likelihood of loss from a counterparty default. However, End Users will face certain risks associated with their FCMs. In addition, central clearing may concentrate certain risks in the DCO itself. A discussion of some of these risks, including the limitations of the customer asset protections offered by the central clearing model follows.

(b) Margin Protections for Cleared Swaps

When entering into cleared swaps, End Users are required to post initial and variation margin, as determined by the clearinghouse, together with any additional margin required by the FCM. The CFTC adopted a new client margin segregation model for cleared swaps intended to provide greater protection than the existing futures segregation model.[46] The swap model is called legal segregation with operational commingling (the **LSOC Rules**) and is intended to reduce so-called "fellow customer risk," that is, the risk that margin posted by one customer of an FCM will be used to cover a loss caused by a different customer of that FCM in the event of the failure of the FCM. When End Users clear their swap trades, each FCM is to (i) hold cleared swaps customer collateral in an account (or location) that is separate from the property belonging to the FCM, and (ii) not use the collateral of one cleared swaps customer to cover the obligations of another cleared swaps customer or the obligations of the FCM. The LSOC Rules also limit the ability of a DCO to use customer margin posted by non-defaulting customers of a failed FCM to satisfy losses caused by defaulting customers. The LSOC Rules nonetheless permit the commingling of margin of different cleared swaps customers at the DCO, and the rules do not limit the mutualization of customer losses from investment losses, custodial failures, fraud, malfeasance or other causes.[47]

(c) Other Exchange Traded Alternatives to Cleared OTC Derivatives

In response to Dodd-Frank, several major platforms that previously provided OTC markets for cleared swaps in exempt commodities transitioned the cleared swap activities offered on those markets to cleared futures contracts. For example, Intercontinental Exchange (**ICE**) transitioned cleared OTC energy swaps and options to futures in 2012. Similarly, the CME Group lists its ClearPort products as futures contracts and options on futures for trading on Globex and on the trading floor.

V. Margin for Uncleared Swaps

Historically, market practice has been that End Users are generally not required to post initial margin, or in some cases, variation margin, to their dealer counterparties. For some End Users, the final margin rules for both the CFTC and the Prudential Regulators[48] (the CFTC and Prudential Regulators

46 For further information regarding these rules, you may wish to refer to our publication on this topic, available at: http://www.shearman.com/cftc-adopts-final-rules-on-protection-of-cleared-swaps-customer-collateral-02-01-2012/.

47 The LSOC Rules do not apply to exchange-traded futures. As a result, customer margin posted in connection with futures transactions may be subject to greater fellow customer risk than with cleared swaps.

48 "Prudential Regulators" refers collectively to the Department of the Treasury, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

margin rules, collectively, the **U.S. Margin Rules**)[49] may change that practice. In general, the U.S. Margin Rules require the exchange of variation margin and, in some cases, initial margin between certain types of financial entities. For End Users, the U.S. Margin Rules have further bifurcated the End User concept into Financial End Users and End Users who do not qualify as Financial End Users (such End Users, **Non-Financial End Users**). As discussed herein, the U.S. Margin rules require the exchange of margin between Swap Dealers (and MSPs) and Financial End Users, but not Non-Financial End Users.

Although Non-Financial End Users may not be required to post margin under the U.S. Margin Rules, it remains to be seen how the U.S. Margin Rules applicable to their counterparties may affect the cost of uncleared transactions for such End Users, or the willingness of Swap Dealers to continue to enter into uncleared transactions with End Users without collecting margin, even though they may not be legally required to collect margin.

Margin rules for uncleared swaps will generally apply to any Financial End User who enters into swap transactions with a "Covered Swap Entity," which is defined as a Swap Dealer or MSP. A Covered Swap Entity is required to both provide and collect variation margin to and from its Financial End User counterparties, in an amount sufficient to fully collateralize the mark-to-market of non-centrally cleared derivatives transactions on a daily basis for transactions entered into on or after March 1, 2017. In addition, in cases where Financial End Users have material swaps exposure, as defined in the U.S. Margin Rules, Covered Swap Entities will be required to both provide and collect initial margin to and from its Financial End User counterparties. Initial margin requirements are being phased in on a yearly basis until 2020, based on the aggregate notional amount of the parties' positions, as discussed below.

The U.S. Margin Rules permit, among other prescribed terms, that margin transfers may be subject to a de minimis minimum transfer amount not to exceed $500,000 and require margin transfers to occur on a same day/next day basis. Regarding eligible collateral, the U.S. Margin Rules permit cash, high-quality government and central bank securities, high-quality corporate or covered bonds, equities included in major stock indices, and gold, each with their own prescribed minimum haircut.

Initial margin, where required, must be exchanged on a gross basis, segregated from proprietary assets, and held with a third party custodian.

49 Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 229 (Nov. 30, 2015) (prudential regulator rules); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 3 (Jan. 6, 2016) (CFTC rules).

Variation margin requirements came into effect on March 1, 2017 (but full compliance was delayed until September 1, 2017 in some cases). The following chart illustrates the compliance schedule for initial margin requirements.

Compliance Schedule for Initial Margin

Both the Covered Swap Entity combined with all its margin affiliates and its Counterparty combined with all its margin affiliates have an average daily aggregate notional amount for March, April and May of such year that:	**Compliance Date (on or before)**
Exceeds $3 trillion	September 1, 2016
Exceeds 2.25 trillion	September 1, 2017
Exceeds 1.5 trillion	September 1, 2018
Exceeds 0.75 trillion	September 1, 2019
N/A (see below)	September 1, 2020

At this time, because of these notional limitations, the initial margin requirement is largely limited to transactions between major financial institutions. After September 1, 2020, the initial margin requirement will apply to any transaction between (i) Covered Swap Entities, without a notional threshold and (ii) a Covered Swap Entity and a Financial End User with "material swaps exposure." Material swaps exposure is defined as an entity and its margin affiliates having an average daily aggregate notional amount of uncleared swaps, uncleared security based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds $8 billion.

Under the U.S. Margin Rules, Covered Swap Entities are not required to collect initial and variation margin from (or post such margin to) their End User clients who do not qualify as Financial End Users. Nothing in the U.S. Margin Rules, however, precludes a Covered Swap Entity and Non-Financial End User from agreeing to collect or post initial or variation margin as between them as a commercial or risk management matter.

In general, an End User that qualifies for the End-User Exception will be treated as a Non-Financial End User for purposes of the U.S. Margin Rules.[50] Other

50 17 C.F.R. 23.150(b).

entities that may be subject to the mandatory clearing requirement will not necessarily be treated as Financial End Users[51] for purposes of the U.S. Margin

[51] **Financial End User** means:

(1) A counterparty that is not a Swap Entity and that is:
- (i) A bank holding company or a margin affiliate thereof; a savings and loan holding company; a U.S. intermediate holding company established or designated for purposes of compliance with 12 C.F.R. 252.153; or a nonbank financial institution supervised by the Board of Governors of the Federal Reserve System under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5323);
- (ii) A depository institution; a foreign bank; a Federal credit union or State credit union as defined in section 2 of the Federal Credit Union Act (12 U.S.C. 1752(1) and (6)); an institution that functions solely in a trust or fiduciary capacity as described in section 2(c)(2)(D) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(D)); an industrial loan company, an industrial bank, or other similar institution described in section 2(c)(2)(H) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(H));
- (iii) An entity that is state-licensed or registered as:
  - (A) A credit or lending entity, including a finance company; money lender; installment lender; consumer lender or lending company; mortgage lender, broker, or bank; motor vehicle title pledge lender; payday or deferred deposit lender; premium finance company; commercial finance or lending company; or commercial mortgage company; except entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers;
  - (B) A money services business, including a check casher; money transmitter; currency dealer or exchange; or money order or traveler's check issuer;
- (iv) A regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)) or any entity for which the Federal Housing Finance Agency or its successor is the primary federal regulator;
- (v) Any institution chartered in accordance with the Farm Credit Act of 1971, as amended, 12 U.S.C. 2001 *et seq.* that is regulated by the Farm Credit Administration;
- (vi) A securities holding company; a broker or dealer; an investment adviser as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)); an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*); a company that has elected to be regulated as a business development company pursuant to section 54(a) of the investment Company Act of 1940 915 U.S.C.80a-53(a)); or a person that is registered with the U.S. Securities and Exchange Commission as a security-based swap dealer or a major security-based swap participant pursuant to the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*);
- (vii) A private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80-b-2(a)); an entity that would be an investment company under section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3) but for section 3(c)(5)(C); or an entity that is deemed not to be an investment company under section 3 of the Investment Company Act of 1940 pursuant to Investment Company Act Rule 3a-7 (17 C.F.R. 270.3a-7) of the Securities and Exchange Commission;
- (viii) A commodity pool, a commodity pool operator, a commodity trading advisor, a floor broker, a floor trader, an introducing broker or a futures commission merchant;
- (ix) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002);
- (x) An entity that is organized as an insurance company, primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies, or is subject to supervision as such by a State insurance regulator or foreign insurance regulator;
- (xi) An entity, person, or arrangement that is, or holds itself out as being, an entity, person, or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for investing or trading or facilitating the investing or trading in loans, securities, swaps, funds, or other assets; or

Rules, however. The definition of Financial End User is limited to enumerated categories of regulated financial institutions, including banks, broker-dealers, insurance companies and other lending institutions, and various types of private funds (*e.g.*, hedge funds) and commodity pools.[52] End Users that do not fall within the End-User Exception will need to consider their status under the specific terms of the Financial End User definition.

When swaps are not cleared, Dodd-Frank requires that Swap Dealers and MSPs notify End Users of their right to request segregation of initial margin and, if this election is made, segregate their initial margin (including initial margin that is not required under the U.S. Margin Rules) with an independent third party custodian. This right is limited to initial margin and does not extend to variation margin.

VI. Swap Reporting and Recordkeeping

(a) Reporting Requirements

Dodd-Frank imposes significant real-time price[53] and regulatory reporting[54] and recordkeeping obligations on market participants. End Users, however, will rarely be required to act as the reporting party. When the End User's counterparty is a Swap Dealer, almost all of the reporting burden for execution data is shifted to the End User's counterparty, although when the swap is cleared and/or exchange traded, most of the reporting requirements are

---

(xii) An entity that would be a Financial End User described in paragraph (1) of this definition or a Swap Entity if it were organized under the laws of the United States or any State thereof.

(2) The term "Financial End User" does not include any counterparty that is:

(i) A sovereign entity;

(ii) A multilateral development bank;

(iii) The Bank for International Settlements;

(iv) An entity that is exempt from the definition of Financial Entity pursuant to section 2(h)(7)(C)(iii) of the Act and implementing regulations;

(v) An affiliate that qualifies for the exemption from clearing pursuant to section 2(h)(7)(D) of the Act; or

(vi) An eligible treasury affiliate that the Commission exempts from the requirements of § 23.150 through § 23.161 by rule.

52 *See* 17 C.F.R. 23.151.

53 17 C.F.R. Part 43.

54 17 C.F.R. Part 45. Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136 (Jan.13, 2012).

satisfied by the DCO and/or SEF itself.[55] Certain swap data needs to be reported throughout the life of the swap, including all changes to the primary economic terms of the swap and a daily mark. Similarly, an End User's Swap Dealer counterparty will be the responsible party for reporting this information.

When End Users enter into swaps with a party that is not a Swap Dealer or MSP, they must take care to determine which one of the parties to a swap transaction will be the reporting party. If neither counterparty is a Swap Dealer or MSP and only one counterparty is a Financial Entity as defined in CEA Section 2(h)(7)(C), the Financial Entity would be the reporting counterparty. Notwithstanding the foregoing, if neither counterparty to a swap is a Swap Dealer or MSP and only one counterparty is a U.S. person, the U.S. person would be the reporting counterparty. Neither the reporting rules nor the CEA defines U.S. person, but the CFTC has provided a "U.S. person" definition in its Cross Border Guidance (see discussion of "U.S. person" definition in Section XI below). If a U.S. End User transacts with a non-U.S. swap counterparty that is not a Swap Dealer (as is the case with some non-U.S. financial institutions), then the U.S. End User will be the reporting party and will be responsible for all of the associated reporting requirements. (In some such cases, the counterparty may agree to perform the reporting, although the U.S. End User would still be responsible.) End Users may also be the reporting party when engaging in inter-affiliate swaps, to the extent such swaps are not exempt from reporting under the no-action relief discussed below. When an End User enters into a swap with a party that is not a Swap Dealer or MSP, but both parties are U.S. persons and both parties are Financial Entities, then the parties are responsible for allocating the reporting obligation amongst themselves.[56] It is also the case that when a non-U.S. End User enters into a swap subject to the jurisdiction of the CFTC with a party that is also a non U.S. person, the parties are responsible for allocating the reporting obligation amongst themselves (unless the other party is a Swap Dealer).

In addition to the foregoing regulatory reporting requirements, Dodd-Frank's real time reporting requirements demand reporting of price and transaction

55 Even where an End User is trading with a Swap Dealer, the End User is required to report corporate life-cycle events (*e.g.*, change in status with respect to being a U.S. person or a Financial Entity). The August 2012 Dodd-Frank Protocol addresses this by providing that End Users will give Swap Dealers notice of corporate life-cycle events within one business day.

56 End Users that employ centralized hedging and make use of a central booking entity may find that that entity meets the definition of Financial Entity. Financial Entities in the reporting context include Swap Dealers, MSPs, private funds, commodity pools, certain employee benefit plans and persons predominately engaged in the business of banking or in activities that are financial in nature. *See* II(d) for a further explanation of the term "activities that are financial in nature."

volume data as soon as technologically practicable, but again the reporting burden is shifted to the swap dealing counterparty.[57] Notably, the obligation to report real time swap data does not apply to inter-affiliate swaps between entities that are 100% owned by the same parent entity.

The CFTC permits the reporting party to outsource the reporting function to another party (including the swap counterparty), but ultimate responsibility remains with the reporting party.

The CFTC staff has announced that it intends to conduct a comprehensive review of the swap data reporting requirements.[58]

(b) Inter-Affiliate Swap Reporting No Action Relief

In response to requests from market participants, the CFTC has issued no action relief from the requirement to report certain inter-affiliate swaps under Part 45.[59] The relief is conditioned on both parties to an unreported inter-affiliate swap reporting all of their swap activity with unaffiliated counterparties. The relief is not available where the parties have elected the Inter-Affiliate Exemption from clearing.[60]

Under the no action letter, swaps between affiliates do not need to be reported where one of the parties, directly or indirectly, holds a 100% ownership interest in the other party or they are both owned by a third party that, directly or indirectly, holds a 100% ownership interest in them both.[61] Swaps between affiliates where one of the parties, directly or indirectly, holds a majority ownership interest in the other party or they are both owned by a third party that, directly or indirectly, holds a majority ownership interest in them both only need to be reported on a quarterly basis within 30 days following the end of each quarter after June 30, 2013.[62] To be eligible for the majority ownership

57 17 C.F.R. 43.3(a); Real-Time Public Reporting of Swap Transaction Data, 77 Fed. Reg. 1182 (Jan. 9, 2012).

58 Division of Market Oversight Announces Review of Swap Reporting Rules in Parts 43, 45, and 49 of Commission Regulations, CFTC No-Action Letter No. 17-33 (July 10, 2017).

59 No-Action Relief for Swaps Between Affiliated Counterparties That Are Neither Swap Dealers Nor Major Swap Participants from Certain Swap Data Reporting Requirements Under Parts 45, 46, and Regulation 50.50(b) of the Commission's Regulations, CFTC No-Action Letter No. 13-09 (April 5, 2013).

60 The inter-affiliate swap reporting no-action relief only applies to non-exchange traded, uncleared swaps between affiliates that are not Swap Dealers or MSPs or their affiliates or systemically important financial companies.

61 An affiliated counterparty or third party directly or indirectly holds a 100% ownership interest if it directly or indirectly holds 100% of the equity securities of an entity, or the right to receive upon dissolution, or the contribution of, 100% of the capital of a partnership.

62 An affiliated counterparty or third party directly or indirectly holds a majority ownership interest if it directly or indirectly holds a majority of the equity securities of an entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership.

reporting relief under Part 45, the swap must also be exempt from the Part 43 reporting requirement, which only applies to arm's length transactions.[63]

In both cases, however, the no-action relief for inter-affiliate swap reporting only applies if the affiliates report their financial statements on a consolidated basis and if certain other conditions are satisfied, including the requirement for both affiliates to report any swap with any unaffiliated counterparty.[64]

(c) Recordkeeping

End Users subject to the jurisdiction of the CFTC must also retain records of every swap until five years after the swap has terminated. These records may be kept in either paper or electronic form, but must be retrievable within five business days for the entire period. These records must include all pertinent data with respect to each swap, including, without limitation, all records demonstrating entitlement to the End-User Exception or the Inter-Affiliate Exemption.[65]

VII. External Business Conduct Rules

The CFTC's external business conduct rules[66] establish business conduct standards under CEA Section 4s(h) governing the conduct of Swap Dealers and MSPs when entering swaps with other market participants, including End Users. These rules marked a significant change in the manner in which swap market participants had dealt with counterparties, which historically had been on a "non-reliance" basis where a market participant undertakes few, if any, specific duties with respect to a counterparty. Swap Dealers and MSPs are subject to strict and detailed business conduct standards in dealing with End Users, obligating them to, in addition to other requirements, undertake the following actions:

- conduct due diligence on their counterparties to verify eligibility to trade (including eligible contract participant status);
- refrain from engaging in abusive market practices;

63 *See supra* note 44.

64 The recordkeeping requirements must still be satisfied and the reporting party must internally generate swap identifiers.

65 For swaps entered into before April 25, 2011, but after July 21, 2010, End Users must comply with a separate set of recordkeeping requirements that will generally require End Users to retain the swap information already in their possession. *See* 17 C.F.R. Part 46.

66 17 C.F.R. 23.400 *et seq*. For further information regarding this rule, you may wish to refer to our publication on this topic, available at: http://www.shearman.com/cftc-adopts-registration-rules-and-external-business-conduct-standards-for-swap-dealers-and-major-swap-participants-02-06-2012/.

- provide disclosure of material information about the swap to their counterparties;
- provide a daily mid-market mark for uncleared swaps;
- inform their counterparties of their right to:
  - clear a swap that is not required to be cleared;
  - select the DCO through which a cleared swap is cleared; and
  - request a scenario analysis and a daily mid-market mark for cleared swaps;
- provide material information sufficient to allow the counterparty to assess the swap's material risks, characteristics, incentives and conflicts of interests;
  - For swaps that are not made available for trading on a SEF or a DCM, upon request Swap Dealers must provide a scenario analysis that is developed in consultation with the counterparty; and
- when recommending a swap to a counterparty, make a determination as to the suitability of the swap for the counterparty based on reasonable diligence concerning the counterparty.
  - A safe harbor is available where the Swap Dealer reasonably determines that the counterparty (or its agent) is capable of independently evaluating the recommendation, the counterparty (or such agent) represents that it is doing so, and the Swap Dealer discloses in writing that it is not evaluating the suitability of the recommendation and is acting in its capacity as a counterparty, rather than as an advisor.

These requirements do not apply directly to the End User, but Swap Dealers will require End Users to take certain steps to facilitate Swap Dealer compliance if the parties are to continue trading. In practice, Swap Dealers satisfy many of their external business conduct requirements and meet the safe harbors using ISDA's August 2012 Dodd-Frank Protocol (discussed in greater detail in Section VIII below). End Users will want to carefully review the documentation associated with the protocol to understand its implications.

VIII. Documentation

Swap Dealers are required to comply with a number of rules affecting their documentation with End Users and other counterparties, including the external business conduct rules, the swap trading relationship documentation rules and the reporting requirements. Swap Dealers have in effect been required to amend documentation (or otherwise enter into compliant documentation) prior to entering into any new swaps with their counterparties. To facilitate compliance by Swap Dealers with these requirements, ISDA's Dodd-Frank Documentation Working Group published the August 2012 Dodd-Frank

Protocol and the March 2013 Dodd-Frank Protocol.[67] Unlike other ISDA protocols, where signing an adherence letter is the only necessary step, after signing the adherence letter, adherents will need to complete and exchange questionnaires with all of their counterparties.

In addition to the business conduct rules discussed above, the protocols address certain aspects of clearing and the CFTC's swap trading documentation rules. The CFTC's swap trading documentation rules require Swap Dealers to have trading documentation in place with all counterparties for all uncleared swaps.[68] Trading documentation must contain all terms governing the trading relationship between a Swap Dealer and its counterparty, including, without limitation, terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution. The protocols also provide parties lacking the required documentation the option to elect to enter into a deemed 2002 ISDA Master Agreement to govern swaps (defined to also include excluded FX swaps and forwards) that are <u>not</u> (i) governed by an existing master agreement or (ii) agreed by the parties to be cleared through a DCO. The deemed 2002 ISDA Master Agreement has certain predetermined elections made to its schedule. The ISDA will be governed by New York law, multiple payment transaction netting will be applicable for FX Transactions and Currency Option Transactions only, and if the parties have completed the August 2012 Dodd-Frank Protocol, then this agreement will be supplemented per the terms of that protocol. However, because ISDA Master Agreements tend to be highly customized and heavily negotiated, many market participants that do not currently have an ISDA Master Agreement in place may prefer to negotiate their own agreement rather than enter into this deemed 2002 ISDA Master Agreement.

Long form confirmations may still be used, but must contain all of the required information and must be finished and signed before the trade is executed.

67 *See* http://www2.isda.org/functional-areas/protocol-management/protocol/8 and http://www2.isda.org/functional-areas/protocol-management/protocol/12.

68 Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904 (Sept. 11, 2012) (to be codified at 17 C.F.R. pt. 23). Significant portions of this rulemaking were delayed until July 1, 2013. For further information regarding this delay, you may wish to refer to our publication on this topic, available at: http://www.shearman.com/cftc-defers-compliance-dates-for-business-conduct-and-documentation-requirements-until-mid-2013-12-19-2012/.

Trades under existing trading documentation can still be entered into orally, but swap dealers must have policies to ensure that confirmations of trades between Swap Dealers and End Users are signed within two business days after the trade is entered into.

In addition to the ISDA protocol documentation, which can be used to update ISDA Master Agreements, End Users who elect to clear, either because they cannot rely on the End-User Exception in all circumstances (*e.g.*, entering into swaps for purposes other than hedging or mitigating commercial risk) or because they choose to clear a transaction for risk management or other purposes, will need to put in place appropriate clearing documentation. Dodd-Frank requires that a cleared swap be submitted and cleared with an FCM. As a result, End Users will need to select one or more FCMs and enter into futures account agreements with those FCMs to the extent an agreement is not already in place. In addition to a futures agreement, the End User will also likely need to enter into a Cleared OTC Derivatives Addendum to their futures agreements, which has been published by the ISDA FIA working group. The Cleared OTC Derivatives Addendum supplements a futures account agreement to facilitate the clearing of OTC transactions, and addresses issues particular to the close-out of OTC contracts, as opposed to exchange traded ones.

End Users may need additional documentation for the execution of swaps intended to be submitted for clearing. Some counterparties may require a Cleared Derivatives Execution Agreement (a form published by ISDA FIA working groups), which acts as a "give up" arrangement in which parties can execute swap transactions with an executing party for clearing by that same or a different clearing agent. This agreement also addresses concerns unique to clearing, such as trade submission for clearing and certain fallback procedures if the trade fails to be accepted for clearing. If the transaction is to be executed on a SEF, it will be necessary to have access to the SEF for that purpose (either directly through an arrangement with the SEF itself, or through an FCM or other broker). While there is no legal requirement for an End User to have more than one FCM, End Users may wish to do so to diversify FCM exposures and for pricing competitiveness. Both the Cleared Derivatives Execution Agreement and the Cleared OTC Derivatives Addendum are product and DCO neutral, eliminating any necessity for different agreements with respect to each DCO.

Starting January 1, 2019, certain financial institutions must amend certain qualified financial contracts (**QFCs**) in order to restrict their counterparties' ability to immediately terminate such contracts in the event that the financial institution or its affiliate enters into bankruptcy or resolution proceedings. The Federal Reserve, the Federal Deposit Insurance Corporation (**FDIC**) and the Office of the Comptroller of the Currency (**OCC**) have all published substantively identical rules requiring such amendments,[69] with each rule covering entities under their respective jurisdictions. As a result, End Users that either plan on entering into new QFCs or have existing QFCs with such entities may be asked to amend their in-scope QFCs through adherence to an ISDA Protocol. Currently, the ISDA 2015 Universal Resolution Stay Protocol[70] is available for adherence, but it is anticipated that ISDA will develop a U.S.-specific version of the Resolution Stay Jurisdictional Modular Protocol, which as of the time of publication has yet to be released.

IX. Position Limits

The CFTC has long imposed position limits on certain futures contracts, and futures exchanges have imposed separate limits and position accountability standards for contracts not subject to CFTC rules. The CFTC has, for a number of years, been attempting to revise and expand its position limits, including to cover certain swaps. In 2011, the CFTC adopted rules that would have established new or revised limits on positions in 28 commodity contracts and "economically equivalent" futures, options, and swaps.[71] However, a federal district court vacated the regulations and remanded them to the CFTC for additional rulemaking on the grounds that the CFTC did not demonstrate the necessity of position limits before imposing them.[72] In addition to the new limits, the rules would have expanded the requirements that contract positions owned by related entities be aggregated for the calculation of position limits and limited exemptions from the aggregation requirement. End Users would have been subject to these requirements, but there were exceptions for "bona fide hedging." Assuming an End User's positions were within the exemptions, the rules would have required End Users to closely monitor compliance with the

69 82 Fed. Reg 42882 (Sept. 12, 2017) (Federal Reserve); 82 Fed. Reg. 50228 (Oct. 30, 2017) (FDIC); 82 Fed. Reg. 56630 (Nov. 29, 2017) (OCC). For further information regarding these rules, you may wish to refer to our publication on this topic, available at: https://www.shearman.com/perspectives/2017/11/final-rule-issued-on-qualified-financial.

70 *See* https://www.isda.org/protocol/isda-2015-universal-resolution-stay-protocol/.

71 Position Limits for Futures and Swaps, 76 Fed. Reg. 71626 (Nov. 18, 2011) (to be codified at 17 C.F.R. pts. 1, 150 and 151) and Aggregation, Position Limits for Futures and Swaps, 77 Fed. Reg. 31767 (May 30, 2012) (to be codified at 17 C.F.R. pt. 151).

72 *International Swaps and Derivatives Association, et al. v. United States Commodity Futures Trading Commission*, No. 11-cv-2146 (RLW) (D.D.C. Sept. 28, 2012) (order granting summary judgment).

new limits and have systems in place to comply with new reporting requirements.

In December 2016, the CFTC re-proposed position limit rules regarding 25 commodity contracts and "economically equivalent" futures, options and swaps while deferring action on three cash-settled commodities.[73] These rules were amended in accordance with the prior federal district court ruling and, among other items, revised and relaxed the "bona fide hedging" and other exceptions. The CFTC has also adopted revised aggregation rules, which apply to its current position limits and are intended to apply to any additional position limits adopted.[74] In light of the changes in CFTC leadership, the prospects for adoption of additional position limits are uncertain. We note, however, that the Treasury Capital Markets Report recommends that the CFTC complete its position limit rulemaking, in a manner that ensures the availability of appropriate exemptions for End Users, calibrates limits based on the risk of manipulation and considers the deliverable supply on a global basis where appropriate.[75] At the time of publication, it remains to be seen if or how the CFTC will implement Treasury's suggestions, and we will continue to monitor and provide updates on any changes going forward.

X. MSP and Swap Dealer Registration

(a) MSP Registration

Although it is unlikely, in rare circumstances End Users may need to consider whether they qualify as MSPs or Major Security-Based Swap Participants.[76] MSPs are market participants that are not Swap Dealers, but (i) maintain a substantial position in swaps in any of the major categories, excluding swaps entered into for hedging purposes; (ii) have a level of outstanding swaps that create substantial counterparty exposure that could have a serious adverse

73 Position Limits for Derivatives, 81 Fed. Reg. 96704 (Dec. 30, 2016) (to be codified at 17 C.F.R. pts. 1, 15, 17, 19, 37, 38, 140, 150, and 151).

74 Aggregation of Positions, 81 Fed. Reg. 91454 (Dec. 16, 2016).

75 Treasury Capital Markets Report, at 143.

76 17 C.F.R. 1.3(hhh); 17 C.F.R. 240.3a67-1; Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012). As of the date of this publication, registration requirements for Major Security-Based Swap Participants are not yet in effect, even though the relevant definitional rules have been adopted. For further information regarding these definitions, you may wish to refer to our publication on this topic, available at: http://www.shearman.com/swap-dealer-major-swap-participant-and-eligible-contract-participant-sec-and-cftc-adopt-entity-definition-rules-07-13-2012/.

effect on the financial stability of financial markets; or (iii) are highly leveraged, unregulated Financial Entities that maintain a substantial position in swaps in any of the major categories.[77] In practice, it is unlikely for End Users to fall within this category, as the tests are based on uncollateralized outward exposure (which most End Users do not have in any significant amount) and have substantial thresholds before registration is required. (It is instructive in this regard that to date there are only two entities that have registered as MSPs.)

The substantial position tests in (i) above exclude both positions held for hedging or mitigating commercial risk and certain inter-affiliate activities. In addition, because the tests generally look at uncollateralized exposure, for most End Users the swap activity taken into consideration for the substantial position analysis will be minimal.[78] Nevertheless, End Users who wish to be assured that they are not an MSP as a result of the substantial position tests may wish to confirm that they fall within one of the safe harbors adopted by the agencies.[79]

A market participant can also become an MSP by having substantial counterparty exposure (again, determined based on uncollateralized outward exposure) such that a default by the market participant would have a serious adverse effect on the stability of financial markets. Hedging positions are not excluded from the "substantial counterparty exposure" calculations and therefore End Users may need to verify that their swap activity falls below the relevant thresholds or meets one of the safe harbors. Nonetheless, it is unlikely that an End User would exceed these thresholds.[80]

The third and final way in which a market participant can qualify as an MSP is by being a "Financial Entity"[81] that is "highly leveraged"[82] relative to the

77 As discussed above, Dodd-Frank specifically excludes "90/90" captive finance subsidiaries from the MSP definition.

78 *See* Section II(c) for a further explanation of the term "hedging or mitigating commercial risk."

79 17 C.F.R. 1.3(hhh)(6); 17 C.F.R. 240.3a67-9; Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012). For further information regarding these definitions, you may wish to refer to our publication on this topic, available at: http://www.shearman.com/swap-dealer-major-swap-participant-and-eligible-contract-participant-sec-and-cftc-adopt-entity-definition-rules-07-13-2012/.

80 Thresholds have been set at $5 billion in daily average aggregate uncollateralized outward exposure or $8 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure.

81 Financial Entity for this purpose has the same definition discussed above in the context of the End-User Clearing Exception.

82 "Highly leveraged" generally means a ratio of liabilities to equity in excess of 12 to 1, as measured at the close of business on the last business day of the applicable fiscal quarter. Entities that file quarterly reports on Form 10-Q and annual reports on Form 10-K with the

amount of capital such entity holds, that is not subject to capital requirements established by an appropriate Federal banking agency and that maintains a substantial position in any of the major swap categories. The "substantial position" calculation in the Financial Entity Test uses the same method used to calculate "substantial position" in the substantial position tests but does not exclude hedging or employee plan positions. Some End Users may fall within the expansive definition of Financial Entity because they are engaged in the business of banking or activity that is financial in nature, as defined in the Bank Holding Company Act of 1956. End Users with substantial uncollateralized outward exposure may thus need to undertake a review of the definition to make such a determination or, alternatively, they can verify that their swap activity falls below the relevant thresholds or meets one of the safe harbors noted above.

(b) Swap Dealer Registration

While very few End Users will meet the definition of Swap Dealers or Security-Based Swap Dealers, in certain markets (*e.g.*, energy), End Users may have significant swap trading operations and may need to analyze further whether they satisfy the definition. The SEC and CFTC generally consider dealers to include persons who (i) hold themselves out as a dealer in swaps, (ii) make a market in swaps, (iii) regularly enter into swaps with counterparties as an ordinary course of business for their own account, or (iv) engage in activity causing them to be commonly known in the trade as a dealer or market maker in swaps. However, a person that enters into swaps for its own account, either individually or in a fiduciary capacity, but not as a part of regular business, is not a dealer. The so-called "dealer/trader" distinction, which has long been used in the context of securities dealer registration requirements, provides a basis for interpreting this distinction for purposes of Swap Dealer registration. Under this analysis, evidence of dealing activity includes (1) providing liquidity by accommodating demand for or facilitating interest in the instrument (swaps, in this case), holding oneself out as willing to enter into swaps (independent of whether another party has already expressed interest), or being known in the industry as being available to accommodate demand for swaps; (2) advising a counterparty as to how to use swaps to meet the counterparty's hedging goals, or structuring swaps on behalf of a counterparty; (3) having a regular clientele

SEC would determine their total liabilities and equity based on the financial statements included with such filings. All other entities would and actively advertising or soliciting clients in connection with swaps; (4) acting in a market maker capacity on an organized exchange or trading system for swaps; and (5) helping to set the prices offered in the market (such as by acting as a market maker) rather than taking those prices, although the fact that a person regularly takes the market price for its swaps does not foreclose the possibility that the person may be a Swap Dealer.

In any event, the SEC and CFTC have provided for a *de minimis* exception from the dealer definitions for limited dealing activity, with the initial thresholds set at $8 billion gross notional for swaps and credit default swaps that are security based swaps and for all other security based swaps, $400 million aggregate gross notional amount.[83]

The CFTC has also adopted a safe harbor from the dealer definition for swaps entered into for the purpose of hedging a physical commodity position. In order to qualify for the exclusion, the swap must hedge price risks from either (1) assets the person does or anticipates owning, producing, manufacturing, processing or merchandising, (2) liabilities that the person owns or anticipates incurring, or (3) services that the person provides, purchases or anticipates providing or purchasing.[84] Other types of commercial hedging activity will likely also not be viewed as dealing, depending on the circumstances and the factors noted above.

XI. Extraterritoriality

Dodd-Frank provides that provisions of the CEA relating to swaps "shall not apply to activities outside the United States unless those activities (1) have a direct and significant connection with activities in, or effect on, commerce of the United States or (2) contravene such rules or regulations" as the CFTC may adopt to prevent the evasion of the CEA swap provisions. The CFTC has issued interpretive guidance as to the applicability of Dodd-Frank to transactions and persons outside of the United States (the **Cross-Border Guidance**).[85]

calculate the value of total liabilities and equity consistent with the proper application of GAAP.

83 17 C.F.R. 1.3(ggg)(4). Although under the CEA the *de minimis* threshold for swaps will drop to $3 billion unless the CFTC adopts rules to maintain or change it, the CFTC has delayed any change in the threshold until at least December 2019 as it continues to study the issue. *See* 82 Fed. Reg. 50309 (Oct. 31, 2017).

84 17 C.F.R. 1.3(ggg)(6)(iii).

85 Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013).

For Swap Dealers and MSPs, the Cross-Border Guidance bifurcates regulatory requirements into entity-level requirements and transaction-level requirements. Entity-level requirements apply to a Swap Dealer or MSP as a whole and encompass requirements as to capital adequacy, chief compliance officer, risk management, swap data recordkeeping and reporting and large trader reporting. The transaction-level requirements are specific to a particular transaction and encompass mandatory clearing and swap processing, margining (and segregation) for uncleared swaps, mandatory trade execution, swap trading relationship documentation, portfolio reconciliation and compression, real time public reporting, trade confirmation, daily trading records and external business conduct standards.

The Cross-Border Guidance details how the Dodd-Frank requirements will apply to certain cross-border transactions, based in part on the U.S. person status of parties to the swap transaction. The CFTC's interpretation of the term "U.S. person" generally includes, but is not limited to:[86]

(i) a natural person who is a U.S. resident;

(ii) the estate of a decedent who was a U.S. resident at the time of death;

(iii) a corporation, partnership, limited liability company, business or other trust, association, joint stock company, fund or any form of enterprise similar to any of the foregoing (other than an entity described in prongs (iv) or (v), below), that is organized or incorporated in the United States or has its principal place of business in the United States;[87]

(iv) a pension plan for the employees, officers or principals of a legal entity described in prong (iii), unless the pension plan is primarily for foreign employees of such entity;

86 The CFTC has added "but is not limited to" as it expects that there may be circumstances that are not fully addressed by the Cross-Border Guidance, or other situations where it does not appropriately resolve whether a person should be included in the interpretation of the term "U.S. person."

87 The CFTC adopted the test set forth by the Supreme Court in *Hertz Corp. v. Friend*, 599 U.S. 77 (2010), which identifies a corporation's "principal place of business" as the place where the corporation's high level officers direct, control, and coordinate the corporation's activities (i.e., the corporation's "nerve center"). In practice, this should normally be the place where the corporation maintains its headquarters; provided that the headquarters is the actual center of direction, control and coordination, and not simply an office where the corporation holds its board meetings. With respect to collective investment vehicles, the CFTC will generally consider the principal place of business to be in the United States if the senior personnel responsible for either (1) the formation and promotion of the collective investment vehicle or (2) the implementation of the vehicle's investment strategy are located in the United States, depending on the facts and circumstances that are relevant to determining the center of direction, control and coordination of the vehicle.

(v) a trust governed by U.S. law, if a court within the United States is able to exercise primary supervision over the administration of the trust;

(vi) a commodity pool, pooled account, investment fund, or other collective investment vehicle[88] that is not described in prong (iii) and that is majority owned by one or more U.S. persons described in prong (i), (ii), (iii), (iv), or (v), except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non U.S. persons and not offered to U.S. persons;[89]

(vii) an entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority owned by one or more U.S. persons described in prong (i), (ii), (iii), (iv), or (v) and in which such U.S. person(s) bears unlimited responsibility for the obligations and liabilities of the entity; and

(viii) an individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a U.S. person described above.

Foreign branches of U.S. Swap Dealers are also considered U.S. persons.

In the context of the U.S. Margin Rules, however, the CFTC has adopted a slightly different definition of U.S. person.[90] Significantly, in the context of the U.S. Margin Rules, the U.S. person definition does not have prong (vi) above, and so does not require looking through a non-U.S. fund to the U.S. person status of its investors. The CFTC has also proposed a rule that would adopt this

88 The CFTC defines a "collective investment vehicle" as an entity or group of related entities created for the purpose of pooling assets of one or more investors and channeling these assets to trade or invest to achieve the investment objectives of the investor(s), rather than being a separate, active operating business. Typically, investors do not have day-to-day control over the management or operation of the vehicle and are essentially passive, beneficial owners of the vehicle's assets. Prior to participating in a collective investment vehicle, an investor enters into an arrangement with the vehicle which governs the fees collected by the manager of the vehicle and the investor's payout from the vehicle, which may include periodic payments. Typically, a limited liability entity such as a corporation, limited partnership or limited liability company is used as part of the arrangement so that investor liability is limited to the investor's beneficial interest in the vehicle's assets.

89 This prong applies irrespective of whether the collective investment vehicle is organized or incorporated in the United States.

90 17 C.F.R. 23.160(a)(10). Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71946 (Oct. 18, 2016). The U.S. Margin Rules make certain other clarifications in the cross-border context, including the addition of a "Foreign Consolidated Subsidiary" definition, clarifications regarding guarantees and guaranteed entities, and the application of certain rules and regulations in the event a swap transaction is "arranged, negotiated, or executed using personnel located in the United States.

revised definition more broadly in the context of the swap dealer registration requirements and application of certain other swap dealer regulations.[91]

For certain requirements, including entity-level requirements and certain transaction-level requirements applicable to transactions with non-U.S. persons, non-U.S. Swap Dealers and MSPs may be able to rely on substituted compliance with home country requirements, as discussed below. Registered Swap Dealers and MSPs (whether U.S. or non-U.S.) will generally have to comply with transaction level requirements in their transactions with U.S. persons. Where neither counterparty is a Swap Dealer or MSP, transactions where one party is a U.S. person or a non-U.S. person that is guaranteed by, or an "affiliate conduit"[92] of, a U.S. person will be subject to a subset of the Dodd-Frank regulations, specifically the regulations relating to clearing, trade execution, real time public reporting, large trader reporting, SDR reporting and recordkeeping. These requirements will normally not apply in a transaction between two non-U.S. persons that are not Swap Dealers or MSPs and are not guaranteed by, or affiliate conduits of, U.S. persons.

The CFTC has made limited determinations that a non-U.S. Swap Dealer may comply with comparable regulations in its home jurisdiction, in lieu of complying strictly with U.S. requirements, a process referred to as "substituted compliance." In particular, the CFTC has adopted comparability determinations with respect to certain internal business conduct requirements applicable to Swap Dealers located in the European Union, Australia, Hong Kong, Japan, Switzerland and Canada.[93] The CFTC has also adopted comparability determinations with respect to certain other business conduct and transaction documentation requirements for Swap Dealers located in the EU and Japan.[94]

91 Cross Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71946 (Oct. 18, 2016) (proposed rule).

92 Factors that are relevant to the consideration of whether a non-U.S. person is an "affiliate conduit" include whether:(i) the non-U.S. person is majority owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. person controls, is controlled by, or is under common control with the U.S. person; (iii) the non-U.S. person, in the regular course of business, engages in swaps with non-U.S. third party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with such U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with third party(ies) to its U.S. affiliates; and (iv) the financial results of the non-U.S. person are included in the consolidated financial statements of the U.S. person. Other facts and circumstances also may be relevant.

93 *See* 78 Fed. Reg. 78864 (Dec. 27, 2013) (Australia); 78 Fed. Reg. 78852 (Dec. 27, 2013) (Hong Kong); 78 Fed. Reg. 78910 (Dec. 27, 2013) (Japan); 78 Fed. Reg. 78899 (Dec. 27, 2013) (Switzerland); 78 Fed. Reg. 78839 (Dec. 27, 2013) (Canada); 78 Fed. Reg. 78923 (Dec. 27, 2013) (EU).

94 78 Fed. Reg. 78878 (Dec. 27, 2013) (EU); 78 Fed. Reg. 78890 (Dec. 27, 2013) (Japan).

A slightly different set of cross-border standards applies to the U.S. Margin Rules.[95] In general, U.S. Swap Dealers will need to comply with the U.S. Margin Rules when transacting with U.S. persons and non-U.S. persons. Conversely, a non-U.S. Swap Dealer will generally only need to comply with the U.S. Margin Rules when transacting with U.S. persons and non-U.S. persons that are guaranteed by U.S. persons or are foreign consolidated subsidiaries of US. persons. In certain scenarios, substituted compliance with a non-U.S. margin regime may be available. In particular, substituted compliance determinations have been made for the EU and Japan in the context of certain margin requirements.[96]

Aspects of the Cross-Border Guidance have continued to be controversial, and the CFTC's approach must be viewed against the backdrop of ongoing regulatory developments at the SEC and in other jurisdictions. Notably, the CFTC has continued to delay implementation of a controversial staff interpretation that, in the cross-border context, U.S. requirements should generally apply where U.S.-based personnel are involved in the arrangement, negotiation or execution of the transaction, notwithstanding that the transaction is otherwise between two non-U.S. persons to which the requirements would not otherwise apply.[97] Although the SEC's requirements for security-based swap activities are largely not yet in effect, the SEC has adopted its own regulations governing the cross-border treatment of security-based swap activities, which differs in some respects from that of the CFTC, including in the definition of U.S. person used.[98] Inconsistencies between the CFTC's approach and the SEC's approach may lead to additional compliance complications for market participants who trade both swaps and security based swaps. Other major swap market jurisdictions have implemented their own reforms of their derivatives markets pursuant to their G20 commitments, including most notably the European Market Infrastructure Regulation (**EMIR**)[99] and Markets in Financial Instruments Directive (**MiFID II**) in the EU.[100]

95 17 C.F.R. 23.160.

96 *See* 82 Fed. Reg. 48394 (Oct. 18, 2017) (EU); 81 Fed. Reg. 63376 (Sept. 15, 2016) (Japan); *see also* 17 C.F.R. 23.160 (addressing permitted scope of substituted compliance for margin in cross-border transactions).

97 CFTC Staff Letter No. 17-36 (July 25, 2017).

98 Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. 47278 (Aug. 12, 2014).

99 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

100 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

Differences in approach among these regulations, and inconsistencies even where regulations are broadly similar, will lead to ongoing compliance challenges for End Users that engage in derivatives activities, or trade with counterparties, in multiple jurisdictions.

XII. Conclusion

Dodd-Frank and related rulemakings have significantly altered the U.S. derivatives regulatory framework. Although End Users are exempt or excluded from the application of some of the more onerous of these requirements, the Dodd-Frank regulations have nonetheless changed, and continue to change, the ways in which End Users may access and use the derivatives markets. As a result, End Users active in the derivatives markets will likely need to continue to expend significant resources complying with the U.S. derivatives regulatory regime. End Users will in particular need to review trading documentation and internal policies relating to swap activity, in light of clearing, margin, mandatory trading and similar requirements. End Users will need to track potential developments for security-based swaps, as the SEC has yet to implement many of its regulatory requirements for this product category. Market participants will also need to follow potential legislative and regulatory amendments following the change in administration, including those outlined in the Treasury Capital Markets Report. We will continue to monitor developments in these areas and provide updates as regulatory changes occur.

AZAM H. AZIZ
Partner
New York
aaziz
@shearman.com

GEOFFREY B. GOLDMAN
Partner
New York
geoffrey.goldman
@shearman.com

DONNA M. PARISI
Partner
New York
dparisi
@shearman.com

REENA SAHNI
Partner
New York
reena.sahni
@shearman.com

KERRI DURSO
Associate
New York
kerri.durso
@shearman.com

NICHOLAS D. EMGUSCHOWA
Associate
New York
nicholas.emguschowa
@shearman.com