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A Corporate End-User's Handbook for Dodd-Frank Title VII Compliance (Version 2.0)

Almost four years after the financial crisis and over two years after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the overhaul of the US derivatives market is rapidly shifting into the implementation phase. Many of the key elements of Dodd-Frank relating to OTC derivatives have begun to take effect on October 12, 2012, although the CFTC has delayed implementation of some requirements until the beginning of 2013.

This handbook provides an overview of the key requirements and issues that End-Users need to consider as they enter the implementation phase of Dodd-Frank. As a reference tool, we have provided a table summarizing the required compliance timeline for the various elements of Dodd-Frank that End-Users may need to comply with, including recordkeeping and reporting requirements, adopting board resolutions to take advantage of the clearing exception offered to End-Users and amending swap documentation as appropriate.

I. Introduction

Almost four years after the financial crisis and over two years after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"), the overhaul of the US derivatives market is rapidly shifting into the implementation phase. Many of the key elements of Dodd-Frank relating to OTC derivatives have begun to take effect on October 12, 2012, although the CFTC has delayed implementation of some requirements until the beginning of 2013.[1]

Under Dodd-Frank, Swap Dealers, Security-Based Swap Dealers, Major Swap Participants ("**MSPs**") and Major Security-Based Swap Participants must register with the CFTC or SEC, as appropriate, and thereafter will be subject to strict regulation. Swap Dealers and MSPs will be required to comply with, among other things, regulations governing minimum margin and capital requirements, mandatory clearing and exchange trading of swaps and security-based swaps, swap reporting and recordkeeping requirements, internal and external business conduct standards and position limits. Even for companies that are not Swap Dealers or MSPs, are predominantly engaged in non-financial activity, and are using swaps or security-based swaps to hedge or mitigate commercial risk ("**End-Users**"), compliance with Dodd-Frank presents a significant challenge.

Dodd-Frank divided the OTC derivatives market into swaps and security-based swaps, to be regulated by the CFTC and SEC, respectively. Generally, swaps are defined to 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 index, a single security or loan or the occurrence, nonoccurrence of an event relating to a single issuer of a security, among other things. The regulation of mixed swaps falls under the joint jurisdiction of both Commissions.

Notably, the Secretary of the Treasury has issued a determination excluding foreign exchange swaps and forwards from the definition of swap. Only physically settled transactions involving the physical exchange of two different currencies are excluded and as a result, many commonly used foreign exchange derivatives, including foreign currency options, currency swaps and non-deliverable forwards, are still considered swaps.[2][3] 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 trade reporting (but not real-time reporting) requirements, enhanced anti-evasion authority, and strengthened

[1] The October effective date resulted from the adoption of the joint final rule by the CFTC and SEC defining the terms "swap," "security-based swap," and "mixed swap." "Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208 (August 13, 2012).

The CFTC has on several occasions delayed the effectiveness of certain provisions of Dodd-Frank and related regulations because these definitions were not yet final. On July 3, 2012, the CFTC adopted an order to further extend temporary relief from the effective dates of many new requirements for swaps under Dodd-Frank that otherwise would have taken effect on July 16, 2012. The CFTC first granted temporary relief from the effectiveness of these requirements in a final order issued on July 14, 2011 and this relief was extended until the earlier of December 31, 2012, or such other compliance date determined by the CFTC.

[2] 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] The CFTC granted no-action relief from the requirement to include FX swaps and forwards in calculating the *de minimis* amount for the swap dealer exception and "substantial position in swaps" or "substantial counterparty exposure for determining whether a person is an MSP. Time Limited No-action Relief: Foreign Exchange Swaps and Foreign Exchange Forwards Not to be Considered in Calculating Aggregate Gross Notional Amount for Purposes of Swap Dealer De Minimis Exception or in Calculating Substantial Position in Swaps or Substantial Counterparty Exposure for Purposes of the Major Swap Participant Definition; Time-Limited No-action Relief for persons that meet the definitions of Commodity Pool Operators and Commodity Trading Advisors Solely as a Result of their Foreign Exchange Swap and Foreign Exchange Forward Activities, CFTC No-Action Letter No. 12-21 (October 12, 2012).

business conduct standards applicable to registered swap dealers and major swap participants.[4] These business conduct rules include all of the CFTC's regulations promulgated pursuant to §4s of the Commodity Exchange Act, including recordkeeping, reporting, external business conduct, swap trading relationship documentation requirements and portfolio reconciliation requirements.[5]

This handbook provides an overview of the key requirements and issues that End-Users need to consider as they enter the implementation phase of Dodd Frank. As a reference tool, we have provided a table summarizing the required compliance timeline for the various elements of Dodd-Frank that End-Users may need to comply with, including recordkeeping and reporting requirements, adopting board resolutions to take advantage of the clearing exception offered to End-Users and amending swap documentation as appropriate.

II. Commercial End-User Exception from Clearing

(a) Mandatory Clearing

Dodd-Frank's key aim is to reduce risk, increase transparency and promote market integrity by, among other things, mandating clearing and exchange trading of certain swaps and security-based swaps. However, there are substantial costs associated with clearing and Congress recognized that these costs create disincentives for End-Users to hedge their commercial risk. As a result, Dodd-Frank contains an exception from the clearing requirement that is intended to be available to End-Users. End-Users using swaps to hedge or mitigate commercial risk will generally not be required to clear their swaps. 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 Derivatives Clearing Organization ("**DCO**") in accordance with its rules.[6]

Mandatory clearing determinations for swaps, security-based swaps and mixed swaps are made by the CFTC and/or the SEC, as appropriate. Clearing determinations will be made following submissions from DCOs or by the CFTC following a review on its own initiative. The CFTC has finalized a phased-in compliance timeline for complying with the clearing requirements. Generally, the phased-in compliance schedule 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). The CFTC's phased-in compliance schedule provides that End-Users that are subject to the clearing requirement will be required to clear a

[4] 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/.

[5] Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg 9734 (Feb. 17, 2012); Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 Fed. Reg. 20128 (Apr. 3, 2012); 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).

[6] 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 IX for more detail.

particular product within 270 days following publication of the final clearing determination in the Federal Register unless an election to use the End-User Exception is made.[7]

The CFTC has issued its first determination for "plain vanilla" fixed-for-floating interest rate swaps, forward rate agreements and basis swaps in US dollars, Euro, Sterling or Yen, and CDX and iTraxx index credit default swaps.[8] The CFTC's adopting release provides that the standard phased in compliance schedule is not applicable for this clearing determination. Instead, End-Users that are subject to the clearing requirement will be required to clear swaps beginning on Monday, September 9, 2013, for swaps entered into on or after that date.

(b) Commercial End-User Exception from Clearing

The requirement to clear and the attendant obligation to exchange trade and post margin 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) End-User is not a Financial Entity;

(ii) Swap is hedging or mitigating commercial risk; and

(iii) End-User satisfies its reporting obligations to the CFTC, including how it generally meets its financial obligations for non-cleared swaps.[9]

The draft November 2012 Dodd-Frank Protocol includes representations to this effect.[10] 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 these activities could preclude use of an affiliate or captive finance subsidiary from claiming the End-User 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's recently adopted definition of "swap" defines the term to include guarantees of swaps.

(c) What Does it Mean to "Hedge or Mitigate Commercial Risk"?

The CFTC has adopted an expansive definition of hedging or mitigating commercial risk that is substantially similar to the guidance it provided for the same phrase as used within the MSP definition.[11] Generally, the definition requires that the swap

[7] "Swap Transaction Compliance and Implementation Schedule: Clearing Requirement Under Section 2(h) of the CEA" 77 Fed. Reg. 44441 (July 30, 2012) (to be codified at 17 C.F.R. pt. 50).

[8] "Clearing Requirement Determination under Section 2(h) of CEA" 77 Fed. Reg. 74284 (December 13, 2012) (to be codified at 17 C.F.R. pts. 39 and 50).

[9] End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42560 (July 19, 2012) (to be codified at 17 C.F.R. pt. 39).

[10] See draft November 2012 Dodd-Frank Protocol, http://www2.isda.org/dodd-frank-documentation-initiative/ (last accessed November 14, 2012.)

[11] 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) (to be codified at 17 C.F.R. pts. 1 and 240). 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/.

be economically appropriate to the reduction or mitigation of a commercial risk.[12] 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.[13] The CFTC emphasized that determining whether a swap hedges or mitigates a commercial risk will require a facts and circumstances analysis, to be performed at the time the swap is entered into and 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 welcome flexibility in designing their hedging operations.

(d) Who Is a Financial Entity?

The definition of Financial Entity is sufficiently narrow and precise that most End-Users will not meet that definition, provided that their level and type of swap activity does not qualify them as a Swap Dealer or MSP.[14] "**Financial Entities**" 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, except depositary institutions with less than $10 billion in total assets. Financial Entities are generally not entitled to the End-User Exception, except when the Financial Entity is a captive finance subsidiary or is an affiliate entering into the swaps as agent on behalf of an End-User hedging a commercial risk of that End-User. Financial Entities may however be eligible for the inter-affiliate exemption, discussed below.

(e) 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 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:

[12] 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.

[13] The swap must also not be used to hedge or mitigate the risk of another swap (except swaps that offset swaps originally used to hedge or mitigate commercial risk).

[14] See discussion in section VIII below.

(i) primary business is providing financing;

(ii) use 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 "products"[15] and "facilitates"[16] when performing both 90% calculations.

(f) Affiliated Agents

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. Dodd-Frank allows affiliates of an End-User (including captive finance subsidiaries) to rely on the End-User Exception when entering into the swap as agent on behalf of the End-User if an End-User could enter into the same swap and rely on the End-User Exception, unless the affiliate is a type of entity that is specifically not permitted to rely on this provision.[17] Entities that are predominantly engaged in activities that are financial in nature are not prohibited from acting as agent on behalf of End-Users, even though such entities would otherwise be unable to rely on the exception for hedging their own commercial risk.

The CFTC declined to exempt swaps entered into by End-User hedging affiliates on a principal basis from the clearing requirement where the hedging affiliates are Financial Entities, even if the hedging affiliate is hedging or mitigating the commercial risk of the End-User. The CFTC states that the statute leaves no room for them to provide relief on this point. This position will disproportionally affect certain hedging structures. For example, the End-User Exception would be available if the treasury function of an entire corporate group is undertaken by the parent or other corporate entity that engages in non-financial activity. However, for those End-Users with a treasury affiliate that operates as a separate legal entity, because the treasury affiliate would likely be a Financial Entity, the End-User could not take advantage of the End-User Exception if it acts as principal in conducting hedging. As a result, many End-Users who do not qualify for the End-User Exception or the inter-affiliate exemption may need to restructure their business and risk management techniques, thereby potentially losing many benefits of their current centralized hedging operations.

[15] 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.

[16] 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.

[17] The list of entities that are not allowed to act as agent include Swap Dealers, MSPs, investment companies, commodity pools and bank holding companies with more than $50 billion in assets.

(g) Eligible Contract Participant

Dodd-Frank makes it unlawful for a person that is not an eligible contract participant ("**ECP**") to (1) enter into a swap other than on a designated contract market ("**DCM**") or subject to the rules of a DCM, or (2) enter into a security-based swap other than on a registered national securities exchange.[18] Generally, End-Users will be able to trade swaps off-exchange by meeting 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.[19] The hedging entity prong of the ECP definition also applies to corporations, partnerships, proprietorships, organizations, trusts or similar entities, but lowers the asset threshold test to $1,000,000, but requires that the swap be entered into in the conduct of the business or to hedge risks associated with the business.[20] In a recent interpretation, the CFTC has clarified that swap guarantors must also be ECPs and granted temporary no action relief until March 31, 2013 for non-ECP guarantors of a swap and beneficiaries of the non-ECP guarantor so long as the beneficiary's swap counterparty is a an ECP.[21] Counterparties of End-Users that meet certain requirements will have until December 31, 2012 to determine whether the End-User is an ECP or otherwise come into compliance with the CFTC regulations.

(h) Reporting Requirement for End-User Exception

Dodd-Frank imposes a reporting requirement when an End-User relies on the End-User Exception. The required information must be reported to a Swap Data Repository ("**SDR**"). The CFTC has responded to commenters' concerns regarding the amount of information that the proposed rulemaking required by allowing End-Users to comply with most of the reporting requirements with a single annual filing that will primarily employ a check-the-box approach. However, for each swap for which the End-User elects to rely on the End-User Exception, the reporting counterparty, as determined by CFTC's swap data reporting rules (see discussion in section IV below), is required to provide notice of the election and the identity of the electing counterparty. The annual filing contains basic information about the entity and the basis for relying on the End-User Exception and requires the End-User to inform the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps.[22] There is an ongoing reporting obligation, which requires that the filing be updated with any material changes. There is no exception from the requirement to report use of the End-User Exception for inter-affiliate swaps and consequently End-Users with centralized hedging arrangements will need to develop policies and procedures designed to ensure that such reporting requirements are complied with.

The reporting counterparty, as determined by the CFTC's swap data reporting rules, will typically be a Swap Dealer.[23] The CFTC is requiring that the reporting counterparty have a "reasonable basis to believe" that the End-User that is electing to

[18] 7 U.S.C. § 2(e) (2012).

[19] 7 U.S.C. § 1a(18)(A)(v)(I) -(II) (2012).

[20] 7 U.S.C. § 1a(18)(A)(v)(III) (2012).

[21] Staff Interpretations and No-Action Relief Regarding ECP Status: Swap Guarantee Arrangements; Jointly and Severally Liable Counterparties; Amounts Invested on a Discretionary Basis; and "Anticipatory ECPs", CFTC No-Action Letter No. 12-17 (October 12, 2012).

[22] 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 provide a catch all "other" category for those who meet their financial obligations in other ways.

[23] The CFTC's Part 45 rules establish the reporting requirements for all swap data.

rely on the End-User Exception meets the requirements necessary to make such election. As a result, the Swap Dealer will likely require the End-User to provide certain representations regarding its eligibility to make the election.[24]

If an End-User is a publicly-traded company, then that End-User's board or an "appropriate committee" thereof must approve the End-User's election to rely on the End-User Exception.[25] The annual filing requires the End-Users relying on the End-User Exception 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. Both the SEC and CFTC have 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. For End-Users that will require board approval to make use of 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 (*e.g.*, a new hedging strategy is to be implemented that was not contemplated in the original board approval).

(i) 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 certain 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 their dealers in connection with their OTC swaps, but this may change going forward. For cleared swaps, End-Users will be required to post initial and variation margin, as determined by the clearinghouse, together with any additional margin required by the clearing broker above clearinghouse minimums. It is also expected that additional margin requirements will be imposed for uncleared swaps entered into with a Swap Dealer if the End-User meets certain criteria discussed in greater detail below. After the CFTC and banking regulators finalize rules relating to margin requirements for uncleared swaps, 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 oft-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

[24] This provision is not addressed by the August 2012 Dodd-Frank Protocol (as defined below).

[25] 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.

will face certain risks associated with their clearing brokers. A discussion of some of these risks, including the limitations of the customer asset protections offered by the central clearing model, follows below in section III.

(j) Cleared OTC Derivatives Alternatives

Recently, several major platforms that have been providing OTC markets for cleared swaps in exempt commodities have announced their intention to transition the cleared swap activities offered on those markets to cleared futures contracts. For example, IntercontinentalExchange ("**ICE**") is transitioning cleared OTC energy swaps and options to futures as of October 15, 2012, such that cleared North American natural gas, electric power, and environmental products will be listed as futures on ICE Futures U.S. energy division, while cleared oil products, freight, iron ore, and natural gas liquid swaps will be listed as futures on ICE Futures Europe. Similarly, the CME Group will list its ClearPort products as futures contracts and options on futures for trading on Globex and on the trading floor. [26] In response to these developments, the CFTC has offered time-limited no-action relief in order to provide participants in the market for cleared swaps and swaps exchanged for futures referencing exempt commodities and agricultural commodities sufficient time to determine whether and in what manner to transition those swap activities to similar products in the futures markets that will become available in the near future, and to enable any such transition to proceed in an orderly manner. End-Users and other participants in the market for these swaps would have until December 31, 2012 to determine whether and in what manner to transition their current business practices to the new regulatory environment.

(k) Inter-Affiliate Exemption

The CFTC has proposed the inter-affiliate exemption proposal as an alternative to the End-User Exception.[27] 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. The CFTC expects that the inter-affiliate exception will only be used where the End-User Exception cannot be used, i.e. between two financial entities or for swaps that do not hedge or mitigate commercial risk.

In order to take advantage of this proposed exemption, one party 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, and the financial statements of both counterparties must be reported on a consolidated basis.[28] In addition, the following conditions must be met in order to use the inter-affiliate exception:

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

(ii) if neither eligible affiliate counterparty is a swap dealer or major swap participant, the swap is documented in a swap trading relationship document that shall be in writing and shall include all terms governing the trading

[26] See Time-Limited No-Action Relief: Swaps in Agricultural and Exempt Commodities Not to be Considered in Calculating Aggregate Gross Notional Amount for Purposes of Swap Dealer De Minimis Exception and Calculation of Whether a Person is a Major Swap Participant, CFTC No-Action Letter No. 12-20 (October 12, 2012). See also Time-Limited No-Action Relief: Cleared Swaps in Agricultural and Exempt Commodities and Swaps Exchanged for Futures Not to be Considered in Calculating Aggregate Gross Notional Amount for Purposes of Swap Dealer De Minimis Exception , CFTC N0-Action Letter No. 12-16 (October 12, 2012).

[27] Clearing Exemption for Swaps Between Affiliated Entities, 77 Fed. Reg. 50425 (August 21, 2012).

[28] 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.

relationship between the affiliates, including, without limitation, 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 procedures;

(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) With the exception of 100% commonly-owned and commonly-guaranteed affiliates where the common guarantor is also 100% commonly-owned, for a swap for which both counterparties are financial entities[29], both parties shall pay and collect variation margin;

(v) Each counterparty either:

(A) Is located in the United States;

(B) Is located in a jurisdiction that has a clearing requirement that is comparable and comprehensive to the clearing requirement in the United States;

(C) Is required to clear swaps with non-affiliated parties in compliance with United States law; or

(D) Does not enter into swaps with non-affiliated parties; and

(vi) The reporting counterparty for the swap, complies with the reporting requirements, including the requirement to acknowledge that board approval has been obtained.

As with the End-User Exception, the reporting requirements can be satisfied on an annual basis.

Because this proposed exemption is not available and may not be final when clearing of credit default swaps and interest rate swaps becomes mandatory for certain market participants, the CFTC's Division of Clearing and Risk has provided time limited no-action relief for failure to clear swaps. The no-action relief has fewer conditions than the proposed exemption and requires only that (i) one party directly or indirectly holds a majority ownership interest in the other, or a third party directly or indirectly holds a majority ownership interest in both counterparties, [30] (ii) the financial statements of both counterparties are reported on a consolidated basis, and (iii) both counterparties elect not to clear the swap.

III. Initial Margin for Swaps

(a) Non-Cleared Swaps

Market practice has been that End-Users are generally not required to post initial margin to their dealer counterparties. As risk management procedures at the dealers change in response to the new Dodd-Frank regulatory environment, End-Users may be subject to margin requirements depending on the outcome of the margin rules and whether Swap Dealers will decide

[29] The term "financial entity" has the meaning given such term in section 2(h)(7)(C), the End-User Exception .

[30] 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.

to begin collection such margin from their End-User clients even though they may not be required to do so.[31] According to the CFTC's proposed rule addressing margin requirements for uncleared swaps, Swap Dealers and MSPs will not be required to collect initial and variation margin from their End-User clients, unless such End-Users qualify as financial entities. Margin requirements, if any, will be agreed between the parties and documented with a credit support arrangement.

Several prudential regulators proposed rules on the same topic applicable to Swap Dealers and Major Swap Participants that are banking entities.[32] These proposed rules are substantially similar to the CFTC's proposal with several exceptions. The prudential regulators' rules would require Swap Dealers and MSPs to determine a credit exposure limit for End-Users and collect initial and variation margin to the extent that the End-User's credit exposure exceeds the calculated limit. Such collection would likewise be subject to a minimum transfer amount of $100,000. Variation margin amounts would only have to be collected from End-Users on a weekly basis as opposed to a daily basis once the credit limit is reached. Since both the CFTC and banking regulators' proposals are not yet final, there remains uncertainty surrounding the margin requirements that End-Users will be subject to for uncleared swaps.

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 the initial margin with an independent third party custodian. This right is limited to initial margin and does not extend to variation margin.

(b) Cleared Swaps

When entering into cleared swaps, End-Users will be required to post initial and variation margin, as determined by the clearinghouse, together with any additional margin required by the clearing broker. The CFTC adopted a new client margin segregation model for cleared swaps intended to provide greater protection than the existing futures segregation model.[33] The new 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.

[31] For further information regarding these rules you may wish to refer to our publication on this topic, available at: http://www.shearman.com/Dodd-Frank-CFTC-and-Prudential-Regulators-Release-Proposed-Margin-Requirements-for-Uncleared-Swaps-04-27-2011/.

[32] The prudential regulators include the Department of the Treasury, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

[33] 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/.

IV. Swaps Reporting and Recordkeeping

Reporting. Dodd-Frank imposes significant real time price and regulatory reporting and recordkeeping obligations on market participants. End-Users, however, will rarely be required to act as the reporting party.[34] When the End-User's counterparty is a Swap Dealer, MSP or financial entity,[35] almost all of the reporting burden for execution data is shifted to the End-User's counterparty, although when the swap is cleared and exchange traded, most of the reporting requirements are satisfied by the DCO and/or SEF itself.[36] 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 or MSP counterparty will be the responsible party for reporting this information. The reporting requirements are subject to phase-in and regulatory reporting of inter-affiliate swaps will not be required until mid-April 2013. For swaps in existence after July 21, 2010, but before the reporting obligations become effective, Dodd-Frank imposes less stringent reporting requirements[37] and if these swaps were entered into with entities that now meet the definition of Swap Dealers or MSPs, then the counterparty, not the End-User, bears the reporting obligation. This still requires that End-Users undertake a review of their swap activity over approximately the past two years to ensure that they are in compliance with all of their reporting requirements.

In addition to the foregoing regulatory reporting, Dodd-Frank's real time reporting requirements demand reporting of price and transaction volume data as soon as technologically practicable, but again the reporting burden is shifted to the swap dealing counterparty.[38] Notably, the obligation to report real time swap data does not apply to inter-affiliate swaps, but other regulatory reporting has not received the same exemption. The CFTC has adopted a phased in schedule for complying with this requirement, so that in circumstances where End-Users are the reporting party (*e.g.* inter-affiliate swaps) they will not have to report until mid-April 2013.

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.[39] For swaps entered into before April 25, 2011, but after July 21, 2010, End-Users are required to comply with a separate set of recordkeeping requirements.[40] Generally End-Users must retain the information about the transaction in their possession, but may involve gathering primary economic terms of the transaction.

[34] Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136 (January 13, 2012) (to be codified at 17 C.F.R. pt. 45).

[35] 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.

[36] 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 US Person or a Financial Entity). The August 2012 Dodd-Frank Protocol addressed this by providing that End-Users will give Swap Dealers notice of corporate Life-Cycle events within one business day.

[37] Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 77 Fed. Reg. 2136 (June 12, 2012) (to be codified at 17 C.F.R. pt. 46).

[38] Real-Time Public Reporting of Swap Transaction Data, 77 Fed. Reg. 1182 (January 9, 2012) (to be codified at 17 C.F.R. pt. 43).

[39] The CFTC's Part 45 rules establish the reporting requirements for all swap data.

[40] Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 77 Fed. Reg. 2136 (June 12, 2012) (to be codified at 17 C.F.R. pt. 46).

V. External Business Conduct Rules

The CFTC's external business conduct rules[41] establish business conduct standards under CEA section 4s(h) governing the conduct of Swap Dealers and MSPs when entering swaps with other market participants. These rules represent a significant change in the manner in which swap market participants have dealt with counterparties, which historically has been on a "non-reliance" basis in which a market participant undertakes few, if any, specific duties with respect to a counterparty. Swap Dealers and MSPs will be 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;
- provide disclosure of material information about the swap to their counterparties;
- provide a daily mid-market mark for uncleared swaps; and
- 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 swap execution facility or DCO, upon request Swap Dealers must provide a scenario analysis that is developed in consultation with the counterparty;
- 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 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 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 need End-Users to address these issues if Swap Dealers are to continue trading with the End-Users. Swap Dealers intend to 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 VII below. This protocol is unlike previous protocol processes that ISDA has employed and End-Users will want to carefully review the documentation associated with the protocol to understand its implications. There may also be follow-on protocols to address CFTC rulemakings that were not final at the time of publication.

[41] 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/.

VI. Position Limits

The CFTC has established limits on positions in 28 commodity contracts and "economically equivalent" futures, options, and swaps.[42] However, a recent ruling by a federal district court vacated and remanded the regulations back to the CFTC for additional rulemaking action on the grounds that the CFTC did not comply with Dodd-Frank's statutory instruction to demonstrate the necessity of position limits before imposing them.[43] Generally the position limit regulations would have restricted the positions an entity could control or own, net long and short, of these contracts. The CFTC established separate rules for spot-months and non-spot-months. The rules required contract positions owned by related entities to be aggregated for the calculation of position limits and while certain positions were exempted from the calculation, these are generally limited to physical commodity hedging and will not include financial hedging or risk management transactions. End-Users are subject to these requirements, but there are exceptions for "bona fide hedging." Assuming an End-User's positions are within the exemptions, the rules would have required additional compliance and reporting. The rules would have required end users to closely monitor compliance with the new limits and have systems in place to comply with the new reporting requirements. Preexisting positions would have been largely exempted from the position limit requirements with a notable exception for spot-month limits.

VII. Documentation

Swap Dealers will need to amend their swap documentation to comply with their obligations under Dodd-Frank pursuant to, among others, the external business conduct rules and reporting requirements. In an effort to streamline this process, ISDA's Dodd-Frank Documentation Working Group has published the August 2012 Dodd-Frank Protocol.[44] The August 2012 Dodd-Frank Protocol is designed to amend any specified agreement that governs swap transactions to allow the relevant Swap Dealers to meet many of these regulatory requirements.[45] It remains to be seen how market participants ultimately elect to proceed, but Swap Dealers may suspend trading with counterparties that are not adherents to the August 2012 Dodd-Frank Protocol process or those that do not otherwise negotiate a bilateral amendment to bring existing documentation into compliance. End-Users entitled to use the End-User Exception can expect their Swap Dealers to approach them with the August 2012 Dodd-Frank Protocol questionnaire forms well before December 31, 2012 (the date by which Swap Dealer registration requirements will become effective).[46] Unlike past ISDA protocols, where signing an adherence letter was the only necessary step, for the August 2012 Dodd-Frank Protocol, after signing the adherence letter, adherents will need to complete and exchange questionnaires with all of their counterparties, which will allow Swap Dealers to satisfy their KYC requirements.

[42] Position Limits for Futures and Swaps, 76 Fed. Reg. 71626 (November 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).

[43] *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).

[44] See http://www2.isda.org/dodd-frank-documentation-initiative/ (last accessed November 14, 2012.)

[45] See discussion in section V above.

[46] The CFTC has offered clarifying guidance that swap dealer registration will not be required until this December 31, 2012 at the earliest. Press Release, CFTC, *CFTC Staff Responds to Questions on Timing of Swap Dealer Registration Rules*, (September 10, 2012), http://www.cftc.gov/PressRoom/PressReleases/pr6348-12.

Future protocols are being developed by ISDA to address additional rule makings.[47] For example, the CFTC recently imposed an obligation on Swap Dealers to have trading documentation in place with all counterparties, including a credit support arrangement, for all uncleared swaps.[48] Trading documentation must contain all terms governing the trading relationship between 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. While the swap trading documentation rules may not require parties to execute a credit support agreement until the CFTC has finalized its margin rules, Swap Dealers may demand to have such an agreement in place in order to continue trading.

Credit support arrangements must include, in accordance with applicable CFTC or prudential regulator requirements, when finalized: (i) initial and variation margin requirements, if any; (ii) types of assets that may be used as margin and asset valuation haircuts, if any; (iii) investment and rehypothecation terms for assets used as margin for uncleared swaps, if any; and (iv) custodial arrangements for margin assets, including whether margin assets are to be segregated with an independent third party, if any. End-Users who then elect to segregate this independent amount with a third-party custodian will need to enter into an agreement to govern that tri-party relationship, as well.

If requested by End-Users, such documentation shall include provisions on valuation of swaps, with valuation method to be based on objective criteria, such as recently-executed transactions, to the maximum extent possible. 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. Trades under existing trading documentation can still be entered into orally, but confirmations of trades between Swap Dealers and End-Users must be signed within two business days after the trade is entered into.

In addition to the August 2012 Dodd-Frank Protocol, 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 elect to clear a transaction, will need to establish the documentation infrastructure to facilitate clearing. For End-Users that will need to clear swaps through an FCM, 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 (i) a Cleared OTC Derivatives Addendum to their futures agreements and (ii) a Cleared Derivatives Execution Agreement, both of which have been published by ISDA-FIA working groups. The Cleared OTC Derivatives Addendum will supplement a futures account agreement to facilitate the clearing of OTC transactions.

The Cleared Derivatives Execution Agreement 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. 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 the necessity for different agreements with each DCO, as was previously the case.

[47] See draft November 2012 Dodd-Frank Protocol, addressing CFTC rulemakings relating to portfolio reconciliation, swap trading relationship documentation and the end-user clearing exception, http://www2.isda.org/dodd-frank-documentation-initiative/ (last accessed November 14, 2012.)

[48] Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904 (September 11, 2012) (to be codified at 17 C.F.R. pt. 23).

VIII. Major Swap Participant and Swap Dealer

Although it is unlikely that many End-Users will qualify as MSPs or Major Security-Based Swap Participants, it is not an impossibility.[49] MSPs are market participants that are not Swap Dealers, but (i) maintain a substantial position in swaps in any of the major categories, excluding hedging; (ii) have a level of outstanding swaps that create substantial counterparty exposure that could have a serious adverse 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.[50] The substantial position tests in (i) both exclude positions held for hedging or mitigating commercial risk and certain inter-affiliate activities. In addition, the tests generally look at uncollateralized exposure. Consequently for most End-Users, the swap activity taken into consideration for the substantial position analysis will be minimal.[51] Nevertheless, End-Users who wish to be assured that they are not an MSP as a result of the substantial position test may wish to confirm that they fall within one of the safe-harbors adopted by the agencies.[52]

A market participant can also become an MSP by having substantial counterparty 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 meet one of the statutory safe-harbors. Again, only a handful of market participants are expected to exceed the thresholds.[53]

The third and final way in which a market participant can qualify as an MSP is by being a "financial entity"[54] that is "highly leveraged"[55] relative to the amount of capital such entity holds and 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 Test but does not exclude hedging or employee plan positions. Some End-Users may be surprised to learn that they 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. This is not an intuitive definition

[49] 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) (to be codified at 17 C.F.R. pts. 1 and 240). 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/.

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

[51] See section II(c) for a further explanation of the term "hedging or mitigating commercial risk."

[52] 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) (to be codified at 17 C.F.R. pts. 1 and 240). 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/.

[53] 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.

[54] "Financial entity" is defined to include (i) swap dealers; (ii) MSPs; (iii) commodity pools as defined in the Commodity Exchange Act; (iv) private funds as defined in the Investment Advisers Act of 1940; (v) employee benefit plans as defined in the Employee Retirement Income Security Act of 1974; and (vi) persons predominantly engaged in activities that are in the business of banking or financial in nature, as defined in the Bank Holding Company Act of 1956.

[55] "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 SEC would determine their total liabilities and equity based on the financial statements included with such filings. All other entities would calculate the value of total liabilities and equity consistent with the proper application of GAAP.

and captures many activities that would not ordinarily be considered the business of banking. End-Users will 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 meet one of the statutory safe-harbors.

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 have significant swap trading operations and may need to analyze further whether they may 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. The so-called "dealer-trader" distinction, which has long been used in the context of securities dealer registration requirements, provides a basis for interpreting the term swap dealer. Under this analysis, evidence of dealing activity includes (i) 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; (ii) advising a counterparty as to how to use Swaps to meet the counterparty's hedging goals, or structuring Swaps on behalf of a counterparty; (iii) having a regular clientele and actively advertising or soliciting clients in connection with Swaps; (iv) acting in a market maker capacity on an organized exchange or trading system for Swaps; and (v) 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.

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. In any event, the SEC and CFTC have provided for a de minimis exception from the dealer definitions, 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. The CFTC has also adopted an interim final rule that provides 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.

IX. 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.[56] The CFTC has proposed interpretive guidance regarding this provision and the applicability of Dodd-Frank to transactions and persons outside of the US.

For Swap Dealers and MSPs, the CFTC has proposed bifurcating compliance with Dodd-Frank into compliance with 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, chief compliance officer, risk management, swap data recordkeeping and

[56] For further information regarding this rule you may wish to refer to our publication on this topic, available at: http://www.shearman.com/cross-border-application-of-the-swaps-provisions-of-the-dodd-frank-act-07-18-2012/.

reporting and large trader reporting. The transaction-level requirements encompass mandatory clearing and swap processing, margin for uncleared swaps, trade execution requirements, relationship documentation, portfolio reconciliation and compression, real-time public reporting, trade confirmation, daily trading records and external business conduct standards. For certain requirements, including entity-level requirements and certain transaction-level requirements applicable to transactions with non-US persons, Swap Dealers and MSPs may be able to rely on substituted compliance with home country requirements. Registered Swap Dealers and MSPs (with US or non-US) will generally have to comply with transaction-level requirements in transactions with US persons.

This guidance must also be viewed against the backdrop of ongoing regulatory developments at the SEC and in other jurisdictions. Although the SEC is expected to issue its own rules or guidance for security-based swaps, it has not yet done so, and it is not clear that the two agencies will take the same approach. Inconsistencies may lead to additional compliance complications for market participants who trade both swaps and security-based swaps. Other major swap market jurisdictions, including in Europe and Asia, are at various stages of implementation of their own reforms of their own OTC derivatives markets pursuant to their G20 commitments. Many of these reforms are expected to be broadly similar, but not identical, to the rules of the CFTC.

Where neither counterparty is an MSP or Swap Dealer, transactions outside of the US where one party is a US 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. The guidance defines "US Person" to include any corporation, partnership or other entity that is organized or incorporated under the laws of the United States or a state thereof or having its principal place of business in the United States. Under the proposed interpretation, affiliates and subsidiaries are not deemed US persons merely by virtue of the fact that a parent or affiliate is a US person or by virtue of the fact that the US parent has provided a guarantee (although certain substantive Dodd-Frank requirements may apply to transactions with non-US persons guaranteed by US persons).

The guidance creates a potential problem by not permitting substituted compliance for the clearing, trade-execution and real-time public reporting requirements, or for the large trader reporting requirements otherwise applicable to non-US persons. However, the CFTC would allow substituted compliance with respect to SDR reporting and recordkeeping requirements for transactions subject to them, provided that the CFTC has direct access to the swap data for these transactions that is stored at the foreign trade repository. This aspect of the CFTC's guidance does little to resolve many of the concerns raised by market participants about the potential extraterritorial application of the Dodd-Frank derivatives amendments. As the CFTC acknowledges in the CFTC's guidance, it is possible, and perhaps even likely, that a transaction between a non-US person and a US person could be subject to multiple regulatory requirements, which may be inconsistent or conflicting. This could, for example, include the requirement to clear the trade in multiple jurisdictions. In addition, given the timing of upcoming requirements, market participants will likely need to begin to determine their potential obligations before final cross-border guidance is adopted.

X. Conclusion

Dodd-Frank and certain subsequent rulemakings have sought to minimize and mitigate some of the more onerous regulatory obligations placed upon other market participants by exempting or excluding End-Users from the applicability of these provisions or by shifting the burden to the End-Users' Swap Dealer counterparties. Nevertheless, these new rules may significantly change the way End-Users access and use the derivatives markets, and End-Users will need to expend significant resources complying with and adapting to the new regulatory regime. End-Users will need to continue to track regulatory developments, especially in light of the fact that the SEC and foreign regulators have yet to address many of the

issues that the CFTC has addressed. Also the CFTC's proposed extraterritoriality guidance leaves open many questions for End-Users with multinational operations. At a minimum, End-Users should begin the process of reviewing trading documentation and internal policies relating to swap activity in light of the End-User Exception. We will continue to monitor these developments and provide updates as these events unfold.

Exhibit 1: Timeline for End-User Dodd-Frank Compliance[57]

DODD-FRANK REQUIREMENT	COMPLIANCE DATE	COMPLIANCE OBLIGATION
Segregation for Cleared Swaps	11/2012	FCMs and DCOs must comply with rules on treatment of cleared swaps customer contracts and collateral.
Clearing Requirement	270 days from each CFTC determination	After the CFTC makes a clearing requirement determination, clearing is required by non-SD/MSP and non-financial entities 270 days after this determination is published in the Federal Register, unless otherwise provided.
Real-time Reporting of Credit and Interest Rate Swaps	12/31/2012	SDs and MSPs must report credit and interest rate swaps to SDRs and comply with applicable recordkeeping requirements.
Swap Data Reporting	12/31/2012	Trades with SDs must be reported, but trades with non-SD/MSPs only need to be reported beginning on 4/10/12
Internal CFTC Business Conduct Rules	12/31/2012	SDs and MSPs are required to comply with reporting and recordkeeping requirements.
External CFTC Business Conduct Rules	1/1/2012[58]	SDs and MSPs must comply with the external business conduct rules. End-User Note: Expect DF Protocol document in advance.
Internal CFTC Business Conduct Rules	1/2013	Under proposed exemptive order, US SDs and MSPs may defer compliance with entity-level requirements (including risk management requirements and CCO requirements) until this date.
Real-time Reporting for all Swaps for other Market Participants	4/10/2013	All other market participants (if required) must commence reporting swaps to SDRs.

[57] Assuming that Swap Dealers forego registration until December 31, 2012.

[58] "Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants" 77 Fed. Reg. 55904 (September 11, 2012) (to be codified at 17 C.F.R. pt. 23). In this rulemaking action, the CFTC clarified that regardless of registration status, many of the External Business Conduct rules would not apply to Swap Dealers until January 1, 2013.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Patrick Clancy
London
+1.44.20.7655.5878
patrick.clancy@shearman.com

Thomas Donegan
London
+1.44.20.7655.5566
thomas.donegan@shearman.com

Geoffrey B. Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

Ian Harvey-Samuel
London
+1.44.20.7655.5000
ian.harvey-samuel@shearman.com

Donna M. Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Barnabas W.B. Reynolds
London
+1.44.20.7655.5528
barney.reynolds@shearman.com

Bradley K. Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Donald N. Lamson
Washington, DC
+1.202.508.8130
donald.lamson@shearman.com

Gregg L. Rozansky
New York
+1.212.848.4055
gregg.rozansky@shearman.com

Jared R. Gianatasio
New York
+1.212.848.4384
jared.gianatasio@shearman.com

James Larsen
New York
+1.212.848.5343
james.larsen@shearman.com