

## Overview and Implications of the Regulatory Reform of OTC Derivatives

July 21, 2010

### I. Background

On July 21, 2010, the President signed into law watershed financial reform legislation titled the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Title VII of the Dodd-Frank Act, the Wall Street Transparency and Accountability Act of 2010 (the "Act") accomplishes a sweeping reform of the previously largely unregulated derivatives market. Even once enacted, however, the full scope of the Act and its effect on the derivatives marketplace will not be known for some time. The Act provides broad authority to the Commodity Futures Trading Commission (the "CFTC") or the Securities and Exchange Commission (the "SEC") (either the CFTC or the SEC, as applicable, the "Commission") to define terms, implement regulations and, with respect to certain key provisions, determine which types of swaps and entities will be required to comply with its provisions. The Commissions generally have up to one year to implement the provisions of the Act, and certain provisions of the Act, such as the derivatives "push-out" provision (see below), have an even longer phase-in period.

The effects of the Act on the derivatives marketplace will be profound, but they will not be immediately felt. This client alert provides a summary of the derivatives-related provisions of the Act and an analysis of potential implications for the various sectors of the derivatives marketplace. We will continue to monitor the progress of the derivatives reforms and will provide you with updates of any significant developments.

## **II. Summary of Act**

### **A. Scope of Act – What is a Swap?**

The Act divides the swap universe into two types of swaps: “Swaps” regulated by the CFTC and “Security-Based Swaps” regulated by the SEC, and two corresponding sets of actors: “Swap Dealers” and “Major Swap Participants” with respect to Swaps, and “Security-Based Swap Dealers” and “Major Security-Based Swap Participants” with respect to Security-Based Swaps.<sup>1</sup>

The definition of “Swap” is fairly broad and does not change significantly from the House or Senate bill and includes many of the transactions that are currently included within the definition of “swap agreement” contained in the Gramm-Leach-Bliley Act of 1999 (the “GLBA”). The definition of “Security-Based Swap” has not changed significantly from the House bill and means swaps that are based on a narrow-based security index, a single security or loan and on the occurrence or non-occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-base security index, which event directly affects the financial statements, financial condition or financial obligations of the issuer or issuers. The last type of Security-Based Swaps appears to be targeted at single name credit default swaps or credit default swaps on a narrow-based security index. Credit default swaps on broad-based indices or baskets would likely be excluded under this definition, but would be included under the definition of “Swap.” Swaps based on government securities are also excluded from the definition of “Security-Based Swap.”

The Act also retains the exclusion of “identified banking products” (as defined in the GLBA), including bank deposits and loan participations, from regulation by the CFTC and the SEC, unless such product meets the definition of “Swap” or “Security-Based Swap” and has become known in the trade as a Swap or a Security-Based Swap or the product has been structured for purposes of avoiding the Act’s requirements.

One area that generated much attention was the treatment of foreign exchange products. Unlike the House bill, however, foreign exchange swaps and forwards (unlike spot transactions) are not specifically excluded from the definition of “Swap” unless the Secretary of the Treasury determines that either foreign exchange forwards or foreign exchange swaps or both should not be regulated and are not structured to

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<sup>1</sup> Where the provisions relating to the different types of swaps and actors are similar, we use the terms “swaps,” “swap dealers” and “major swap participants” to refer to both types of swaps and actors.

evade the Act. Even if the Secretary determines that foreign exchange swaps and foreign exchange forwards are not included within the definition of "Swap," these transactions will still have to be reported to a swap data repository or to the CFTC.

In addition to the treatment of foreign exchange products, another definitional question that needs to be addressed is the treatment of physically settled forwards. The forward contract exclusion from the definition of a "Swap" is ambiguous, as the exclusion is for "any sale of a nonfinancial commodity for deferred delivery or shipment so long as the transaction is intended to be physically settled." It still remains to be clarified as to whether or not a transaction is a Swap if a transaction was intended to be deferred but is later financially settled.

### ***B. Geographic Reach of Act***

As in the House and Senate bills, the geographical reach of the Act is determined by an "effects test." The Act provides that it will not apply to activities outside the United States unless those activities:

- have a direct and significant connection with activities in or effect on US commerce; or
- contravene such rules or regulations as the CFTC may prescribe as necessary or appropriate to prevent any evasion of the Act.

Presumably, this test will give the CFTC discretion to determine under what circumstances Swaps conducted through a non-US subsidiary of a US entity have a direct and significant connection with activities in or effect on US commerce. Instead of imposing US regulatory standards on non-US activities, the goal of the Act is that the CFTC coordinate with foreign regulatory authorities to establish international standards and information sharing.

### ***C. Derivatives Push-Out Provision***

The Act prohibits federal assistance to registered swap dealers and major swap participants, including in the form of FDIC insurance and access to the Federal Reserve discount window. Insured depository institutions are exempt from this prohibition so long as they are only engaged in permissible activities. As a result, the Act will cause insured depository institutions to divest themselves of a substantial portion of their swap dealer activities. In a last minute compromise reached in the conference committee, depository institutions are permitted to continue to act as swap

dealers with respect to hedges of their own activities and to enter into rate swaps and swaps referencing assets permitted for investment by a national bank. These reference assets include foreign exchange, currency, gold and silver, US government and agency securities, state general obligation bonds, and “investment securities” (marketable securities that are not predominately speculative in nature, with investment grade debt deemed to be not predominately speculative in nature), but would generally exclude equity as well as debt securities and commodities other than those mentioned. In addition, swap dealer activity in credit default swaps would be permitted only for cleared swaps referencing the permissible assets described in the previous sentence. The Act specifically authorizes the spin-off by depository institutions of impermissible swap dealer activities to affiliates controlled by the same bank or savings and loan holding company. Insured depository institutions will have up to 24 months from the effective date of the Act (extendible in special circumstances for an additional year) to divest themselves of impermissible swap dealer activities. Swaps entered into prior to the end of the transition period for a particular depository institution will not be affected by the push-out provision.

#### ***D. Limitation on Proprietary Trading***

The provisions of the Act requiring push-out should be read in conjunction with the so-called “Volcker Rule” (the “Rule”), which prohibits banking entities from engaging in proprietary trading, subject to exceptions for certain permitted activities. Certain nonbank financial companies supervised by the Federal Reserve Board that engage in proprietary trading are not prohibited from such trading, but are subject to additional capital requirements and quantitative limits with respect to proprietary trading, subject to exceptions for certain permitted activities.

For the purpose of the Rule, “banking entity” means any of the following:

- an insured depository institution,
- a company that controls an insured depository institution,
- a company that is treated as a bank holding company, and
- an affiliate of any of the foregoing entities.

“Proprietary trading” means engaging as a principal for the trading account of the banking entity or nonbank financial company in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any

derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative or contract, or any other security or financial instrument that may become subject to the Rule by future rulemaking.

“Trading account” means any account used for acquiring or taking positions in the securities or instruments described in the definition of “proprietary trading,” principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements) or any other account that may become subject to the Rule by future rulemaking.

Relevant permitted activities include:

- purchase or sale of derivatives in connection with underwriting or market-making activities, to the extent designed not to exceed the reasonably expected near term demands of clients, customers or counterparties;
- risk-mitigating hedging activities in connection with contracts, positions or other holdings of the banking entity or nonbank financial entity;
- purchase and sale of derivatives on behalf of customers;
- purchase and sale of derivatives by a regulated insurance company or any of its affiliates for the general account of the insurance company;
- trading solely outside the US so long as the banking entity is not controlled by a banking entity organized in the US; and
- such other activities as are permitted in the future.

The Rule has a particularly long and complicated implementation process. Within six months of enactment of the Dodd-Frank Act, the Financial Stability Oversight Council is to conduct a study and make recommendations on implementation. Within nine months of completion of the study, the applicable regulators are to adopt rules. The Rule is to become effective on the earlier of (i) twelve months after the issuance of the final rules and (ii) two years after enactment of the Dodd-Frank Act. Banking entities and nonbank financial companies subject to the Rule are required to bring their activities into compliance with the Rule generally

within two years after effectiveness, but such two year period may be extended one year at a time for up to an additional three years.

## ***E. Clearance and Trading***

### *1. Clearing Requirement*

The Act makes it unlawful for any person to “engage” in a swap if the swap is required to be cleared unless the swap is submitted to a clearing organization (“CO”). The determination as to whether a swap or any group, category, type or class of swaps is required to be cleared is to be made by the Commission based either on its own initiative or the submission of a CO, which is required to submit each type of swap it plans to accept for clearing. In the latter case, the applicable regulator is required to make its determination as to whether clearance is required within 90 days (or such longer period as agreed by the CO), and in each case it is required to provide at least a 30-day public comment period about the clearance requirement. The applicable regulator has one year after the enactment of the Act to implement regulations for reviewing submissions.

### *2. Grandfathering*

Swaps entered into before the effectiveness of the Act or after the effectiveness of the Act but before such swaps are required to be cleared are exempt from clearing, if reported to a registered swap data repository (as discussed below) or the applicable regulator.

### *3. Clearing Exemptions*

Notwithstanding the clearance requirement, there exists an exemption available on an individual basis to an entity which:

- is not a financial entity;
- uses swaps to hedge commercial risks; and
- notifies the Commission regarding how it generally meets its financial obligations under non-cleared swaps (the “financial compliance test”).

If an exempt entity has securities registered under Section 12 of the Securities Exchange Act of 1934 or reports under Section 15(d) of the Securities Exchange Act of 1934, it is also required to obtain approval of the appropriate board committee in order to take advantage of this exemption.

Included within the definition of “financial entity” are swap dealers, major swap participants, commodity pools, private funds, employee benefit plans and entities predominantly engaged in activities that involve banking or are financial in nature (as defined in Section 4(k) of the Bank Holding Company Act).<sup>2</sup> The Act clarifies that “financial entity” does not include any captive finance facilities that use derivatives to hedge interest rate or foreign currency exposures if 90 percent or more of the exposures arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by its parent or another subsidiary of its parent (“Captive Finance Facilities”).

In limiting the scope of the exemption to non-financial entities, the Act narrowed the exemption from the House bill, which exempted entities that were not major swap participants or swap dealers, as long as they used swaps for hedging purposes and met the financial compliance test. The Act is also different from the Senate bill exemption, which exempted non-financial entities which, as a primary business activity, own, use, produce, process, manufacture, distribute, merchandise or market goods, services, or commodities.

In addition to the non-financial entity exemption, the Act also directs the CFTC to consider whether to exempt small banks, savings associations, farm credit system institutions and credit unions with total assets of \$10 billion or less.

#### *4. Execution Requirements*

The Act requires that each swap that is required to be cleared also be traded on an exchange or a swap execution facility, unless no such entity accepts the swap.

#### *5. Swap Reporting*

If a swap is not required to be cleared and/or was entered into before the effectiveness of the Act, it must be reported to a swap data repository. If a swap is cleared, the CO is required to provide the applicable regulator all information the regulator needs to perform its responsibilities. Swaps entered into before the enactment of the Act must be reported within 180 days of the effectiveness of the Act. Swaps entered into on or after the enactment of the Act must be reported within 90 days of the effectiveness of the Act, or such later date as the Commission may prescribe. The applicable regulator is authorized to provide for the public availability of “real-time” data, including transactional price and volume information for both cleared and non-cleared swaps.

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<sup>2</sup> This includes insurance companies. See Part III.A.2.b for a further discussion.

## ***F. Regulation of Swap Dealers and Major Swap Participants***

### *1. Definitions*

A “Swap Dealer” or a “Security-Based Swap Dealer” (collectively, “swap dealers”) is a person who:

- holds itself out as a dealer in Swaps/Security-Based Swaps;
- makes a market in Swaps/Security-Based Swaps;
- regularly enters into Swaps/Security-Based Swaps in the ordinary course of business for its own account; or
- engages in any activity causing that person to be commonly known in the trade as a dealer or market maker in Swaps/Security-Based Swaps.

The third criterion was the result of a last minute change from the language in the Senate bill of “regularly engages in the purchase and sale” to “regularly enters into,” thereby blurring the distinction between swap dealers and major swap participants.

The Act explicitly exempts anyone who enters into swaps for its own account, either individually or in a fiduciary capacity, but not as part of a regular business. It also exempts from the definition of “Swap Dealer” any insured depository institution to the extent it offers to enter into a Swap with a customer in connection with a loan to that customer. In addition, the Commission may exempt an entity if its swap dealing is *de minimis*.

A “Major Swap Participant” or a “Major Security-Based Swap Participant” (collectively, “major swap participant”) is a person who is not a swap dealer and:

- who maintains “a substantial position” in Swap/Security-Based Swap for any of the major categories (as determined by the Commission), excluding (a) positions held for hedging or mitigating commercial risk and (b) positions maintained by any employee benefit plan for the primary purpose of hedging or mitigating any risks directly associated with the operation of the plan;
- whose outstanding Swaps/Security-Based Swaps create substantial counterparty exposure that could have serious

adverse effects on the financial stability of the US banking system or financial markets; or

- who is a financial entity that (a) is highly leveraged relatively to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency and (b) maintains a “substantial position” in outstanding swaps in any major category (as determined by the Commission).

Similar to the definition of “financial entity” (see Part II.E.3 above), the Act explicitly exempts from the definition of “Major Swap Participant” Captive Finance Facilities.

The CFTC and the SEC are required to define “substantial position” by rule or regulation at prudent thresholds, taking into consideration an entity’s position in non-cleared swaps and, at the Commission’s option, the value and quality of collateral held against counterparty exposures. Such thresholds are to be set at levels that the Commission determines prudent to regulate those entities that are systemically important or can significantly impact the US financial system.

The definitions of “Major Swap Participant” and “Major Security-Based Swap Participant” are closer to the Senate bill definitions, which were broader than those in the House bill. They appear to exempt most end-users whose derivatives activities are incidental to their commercial enterprises.

In each case, a person may be a swap dealer or major swap participant for just one or more type, class or category of swaps and not for other types, classes or categories. These definitions are subject to further rulemaking by the CFTC and the SEC, including for the purpose of bringing in transactions and entities that have been structured to evade the Act’s requirements.

### ***G. Registration and Margin Requirements***

All swap dealers and major swap participants are required to register with the Commission within a year after the enactment of the Act. All registered swap dealers and major swap participants are subject to capital and margin, reporting and recordkeeping, business conduct, documentation standards and internal systems and procedures requirements. In addition, each swap dealer and major swap participant is required to designate a chief compliance officer, who will be required to certify annually as to the

compliance of such swap dealer or major swap participant, as applicable, with the Act, including the code of ethics and conflict of interest policies.

Swap dealers and major swap participants are subject to minimum capital requirements and minimum initial and variation margin requirements prescribed by the applicable regulators on non-cleared swaps. Regulators have the discretion to permit the use of non-cash collateral when prescribing margin requirements. But unlike the Senate bill, there is no express exemption if one of the counterparties is not a swap dealer, major swap participant or financial entity (i.e., an end-user), and such counterparty is eligible for, and using the exemption from, clearing available to non-financial entities.<sup>3</sup> The Act does not include explicit language prohibiting the retroactive application of margin requirements to existing Swaps/Security-Based Swaps.

#### ***H. Segregation of Collateral***

In response to difficulties counterparties experienced in the aftermath of the Lehman bankruptcy in retrieving collateral that may have been rehypothecated and/or commingled with other assets of the failed institution, the Act addresses the segregation of collateral pledged for swaps. For swaps cleared through a CO, the Act provides that it is unlawful for any person to accept margin property unless that person is also registered as (1) for Swaps, a futures commission merchant and (2) for Security-Based Swaps, a broker, dealer or Security-Based Swap Dealer. The Act also provides that (with certain exceptions) futures commission merchants, brokers, dealers and Security-Based Swap Dealers must segregate such property and may not commingle it with their own property or use it to margin, secure, or guarantee trades or contracts of another customer. With respect to non-cleared swaps, a swap dealer or major swap participant must notify the counterparty at the beginning of the transaction that the counterparty has the right to require segregation of initial margin property (but not variation margin) and, if the counterparty so requests, must segregate the property.<sup>4</sup>

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<sup>3</sup> However, Chairmen Dodd and Lincoln clarify, in their letter to Chairmen Frank and Peterson dated June 30, 2010, that the intent of Congress is that margin and capital requirements are not imposed on end-users. For non-cleared swaps between swap dealers and end-users, margin should not be imposed on the end-user, and instead margin on the dealer side of the swap should reflect the counterparty risk of the transaction.

<sup>4</sup> In addition to the statutory requirements, market participants should also look to industry guidance as to the treatment and identification of collateral (whether rehypothecated or not), which is contained in the recently published "Best Practices for the OTC Derivatives Collateral Process" issued by the International Swaps and Derivatives Association ("[ISDA](#)").

## ***I. Duty of Care for Swap Dealers and Major Swap Participants***

The Act imposes a new duty of care on swap dealers and major swap participants in dealing with customers and counterparties and, in particular, in dealing with a newly defined class of customers or counterparties called “Special Entities.” “Special Entities” include federal agencies, states, state agencies, political subdivisions, municipalities, employee benefit plans, retirement plans and endowments. The Act empowers the applicable regulator to adopt business conduct standards for transactions with Special Entities.

When entering into a swap with a counterparty who is not a swap dealer or major swap participant, swap dealers and major swap participants must disclose the material risks and characteristics of the swap and material incentives or conflicts of interest. In addition, swap dealers and major swap participants are required to provide daily marks to their counterparties (upon request of the counterparty in the case of cleared swaps).

If a swap dealer or major swap participant proposes to enter into a swap with a Special Entity (or depending upon some conflicting language in the provision, Special Entities that are governmental entities), it is required to comply with any duty established by the applicable regulator that requires such entity to have a reasonable basis to believe that the Special Entity has a representative, independent of the swap dealer or major swap participant, capable of evaluating the transaction and acting in the best interests of the counterparty, who will provide written representations to the Special Entity regarding the fairness of the pricing and the appropriateness of the transaction.

If a swap dealer or major swap participant proposes to act as an advisor to a Special Entity, it is required to act in the best interests of the Special Entity and is required to make reasonable efforts to ensure that it has information necessary to determine what is in the best efforts of the Special Entity. In addition, under the caption dealing with action as advisor, the Act contains a general anti-fraud provision applicable to transactions with Special Entities, the language of which is broad enough to cover dealings by swap dealers and major swap participants, whether or not acting as advisor.

## ***J. Regulation of Clearing Organizations***

### *1. Registration*

Each CO clearing Swaps/Security-Based Swaps is required to be registered with the Commission. Exemptions exist for CO's subject to comparable, comprehensive supervision (in the view of the Commission) by a foreign governmental authority or the other Commission.

### *2. Core Principles*

Each registered CO is required to comply with core principles and standards established by the Commission. The Act sets forth core principles for CO's that clear Swaps relating to its financial, operational and managerial resources, its membership standards, risk management controls, margin requirements, settlement procedures, treatment of member and participant funds, procedures in the event of a member default, rule enforcement and system safeguards, reporting and recordkeeping, information sharing, antitrust considerations, governance fitness standards, conflicts of interest, composition of governing boards and legal risk. The SEC is given the authority to establish standards for CO's that clear Security-Based Swaps and to conform such standards to reflect evolving US and international standards.

### *3. Conflicts of Interest*

Within 180 days after the enactment of the Act, the CFTC and the SEC are each required to adopt rules that mitigate conflicts of interest. The rules may include numerical limits on the control of, or the voting rights with respect to, any CO that clears Swaps/Security-Based Swaps, by a bank holding company with total consolidated assets of at least \$50 billion, a nonbank financial company supervised by the Board of Governors of the Federal Reserve System, an affiliate of such a bank holding company or non-bank financial company, a swap dealer, a major swap participant, or associated person of a swap dealer or major swap participant. In adopting rules, the Commission is to take into consideration any conflicts of interest arising from the amount of equity owned by a single investor, voting rights, and governance arrangements of any CO that clears Swaps.<sup>5</sup> In addition, the CFTC is charged with adopting rules to mitigate conflicts of interest between a swap dealer or major swap participant with a CO that clears or trades Swaps in which that swap dealer or major swap participant has a material debt or material equity investment.

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<sup>5</sup> Presumably, for the SEC this applies to any CO that clears or trades Security-Based Swaps.

#### *4. Annual Compliance Certification*

Similar to swap dealers and major swap participants, each registered CO is required to designate a chief compliance officer, who will be required to certify annually as to the compliance of such CO with the Act, including the code of ethics and conflict of interest policies.

In addition, each swap dealer and major swap participant is required to designate a chief compliance officer, who will be required to certify annually as to the compliance of such swap dealer or major swap participant, as applicable, with the Act, including the code of ethics and conflict of interest policies.

#### ***K. Enhanced Enforcement Authority***

The Act grants the CFTC and the SEC enhanced enforcement authority in connection with Swaps and Security-Based Swaps, respectively. For example, it introduces Rule 10b-5 type language to the Commodity Exchange Act, which broadens the CFTC's anti-fraud and anti-manipulation authority. The SEC has similar authority under Rule 10b-5 with the amendment of the definition of "security" under the Securities Exchange Act of 1934 to include Security-Based Swaps. The Act also introduces whistleblower protection and monetary awards for whistleblowers. It requires the CFTC to award whistleblowers who voluntarily provide "original information" that leads to a successful enforcement of the covered judicial or administrative action, or related action, in an amount determined by the Commission at its discretion, subject to certain guidelines.

#### ***L. Preemption of State Law***

The Act appears to treat the state regulation of Swaps differently from the state regulation of Security-Based Swaps. For the former, the Act repeals federal preemption of state and local laws prohibiting gaming and bucket shop laws (other than anti-fraud provisions of general applicability). For the latter, the Act generally preserves federal preemption of state regulation of Security-Based Swaps, but state gaming and bucket shop laws may apply unless such swaps are traded on a regulated exchange or swap execution facility.

The Act explicitly clarifies that swaps will not be considered to be insurance and that they may not be regulated as an insurance contract under any state law. As a result, the Credit Default Insurance Model Legislation adopted last November by the National Conference of

Insurance Legislators (“NCOIL”)<sup>6</sup> which regulated credit default swaps as insurance, will be preempted by the Act.<sup>7</sup> The model legislation proposed to require sellers of credit default swaps to be licensed by the state insurance department and banned naked credit default swaps.

### ***M. Timing and Phase-In***

After the Act is enacted, the CFTC and the SEC are required to promulgate rules and regulations within 360 days, except as otherwise specified in the Act. The effective date of the Act is the later of (1) 360 days from its enactment and (2) if rulemaking is required, 60 days after the publication of the final rules or regulations, except as otherwise specified in the Act. The derivatives push-out provision is effective starting two years after the effective date of the Act.

## **III. Possible Implications of Act**

While, as mentioned above, much of the scope of the legislation will have to be filled in by the rulemaking process, its provisions could have significant direct effects on key derivatives actors as well as existing documentation between parties. In addition, even if the Act does not directly impose requirements on a particular counterparty, its indirect effects, such as reduced liquidity and enhanced margin requirements, could be significant. Any entity that uses or has used over-the-counter (“OTC”) derivatives can be affected and, if it falls within one of the categories below, should consider the following when evaluating its compliance obligations:

### ***A. Implications for Key Derivatives Actors***

#### ***1. Financial Institutions***

As a group, financial institutions will be the most affected by the Act. Financial institutions that are insured depository institutions and/or banking entities will undergo major changes under the derivatives push-out provision and the Rule (see Parts II.C and II.D above). Most large financial institutions will be required to register with the Commission as swap dealers and major swap participants within a year of the enactment of the Act. As such, they will be subject to the corresponding capital and margin, reporting and recordkeeping, business conduct (including the new duty of

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<sup>6</sup> NCOIL is an organization of state legislators whose main area of public policy concern is insurance legislation and regulation. None of the states have adopted the model legislation.

<sup>7</sup> See Dewey & LeBoeuf’s Client Alert, “NCOIL Adopts Model Law Regulating Credit Default Swaps as Insurance,” dated December 9, 2009, for a description of NCOIL’s model legislation.

care for Special Entities) and other requirements (see Parts II.G and II.I). As financial entities, they will be subject to the clearing and reporting requirements, unless the Commission decides to expand the exemption from clearing to small banks, savings associations, farm credit system institutions and credit unions with total assets of \$10 billion or less (see Part II.E above). Financial institutions are expected to pass along some of the costs associated with complying with the Act to their customers. In some cases, they may reduce or eliminate certain divisions of their derivatives business (perhaps spinning them off to an affiliate), which will likely lead to reduced liquidity and increased hedging costs.

## *2. Insurance Companies*

### *a. Insurance Companies May Not be Subject to Regulation under Act*

It would appear that US property and casualty and life insurance companies, the swap activities of which are largely confined to hedging or mitigating the risk of their insurance business, will not be subject to registration and regulation under the Act in connection with their derivatives activities.<sup>8</sup> This evaluation must, however, remain uncertain until the CFTC and the SEC make their respective determinations as to what constitutes a “substantial position” for the purpose of the definition of “major swap participant.” In addition, the lack of definition of the term “commercial risk”<sup>9</sup> creates further uncertainty, and situations may differ on a case-by-case basis.

As discussed above, characterization as a major swap participant generally<sup>10</sup> requires that there be either a “substantial position” in swaps other than positions for hedging or mitigating commercial risk, or swaps positions that create “significant counterparty exposure” with potentially serious adverse effects on the financial stability of the US banking system or financial markets. In making a determination as to these issues, the Commission is required to consider a party’s position in non-cleared as opposed to cleared swaps, and may take into consideration the value and quality of collateral held against counterparty exposure. These considerations should be helpful to insurers. US property and casualty and life insurance companies are currently restricted by state insurance laws to

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<sup>8</sup> This discussion is limited to the traditional hedging and investment activities of US property and casualty and life insurance companies. The analysis with respect to financial guaranty insurance companies having portfolios of leveraged credit default swaps, and other specialty insurance companies is beyond the scope of this client alert.

<sup>9</sup> The SEC and the CFTC may, by rule, further define “commercial risk.”

<sup>10</sup> A financial entity (which, as discussed below, includes insurance companies) which is highly leveraged and not subject to federal banking agency established capital requirement, and which maintains a “substantial position” in any major swap category as determined by the relevant Commission may also be a major swap participant.

the use of derivatives for hedging purposes -- interest rate, foreign exchange and, to a lesser extent, hedges of equity and credit exposure. Assuming that such hedges are hedges of commercial risk, insurance companies should be able to escape characterization as major swap participants. Life insurance companies whose products include cash value life insurance and annuity policies may pose additional issues.<sup>11</sup>

Presumably questions of what types of swap positions are considered to “hedge or mitigate commercial risk” will be determined by the Commission by rulemaking and in conjunction with the examination of insurance derivatives portfolios over time. Insurance companies may elect to divest themselves of those positions which are not found to constitute hedges of commercial risk and which may cause them to have a “substantial position” in swaps.

Although it is not free from doubt, the most reasonable reading of the definition of “swap dealer” would imply that most insurance companies should not be treated as swap dealers.<sup>12</sup> As discussed above, the definition of “swap dealer” goes beyond activity typically thought of as dealing and includes a person “who regularly enters into swaps in the ordinary course of business.” At the same time, an exception to the definition of “swap dealer” exists for a person that enters into swaps for such person’s own account, but not as a part of a regular business. One reasonable reading of these provisions taken together is that, if the swap activity is incidental to a company’s principal business and not a business in and of itself, the company should not be a swap dealer.

*b. Insurance Companies Are Not Entitled to Non-Financial Entity Exemption from Clearing*

As discussed above, if a type of swap must be cleared, it will be unlawful to enter into a swap of that type without clearing it. An exemption to this requirement is available only for entities that are not financial entities.

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<sup>11</sup> To the extent that swaps are entered into by an insurance company in connection with investment options offered under cash value life insurance and annuity policies in order to protect or enhance the investment return passed through directly or indirectly to the owners of such policies, such swaps may not be found to hedge or mitigate the commercial risk of the business of the insurance company.

<sup>12</sup> Section 719(d) of the Act requires the SEC and the CFTC jointly to determine within fifteen months after the enactment of the Act if stable value contracts (as defined in Section 719(d)(2), which are stable value contracts available as investments in ERISA plans) fall within the definition of “swaps,” and if so, if an exemption from such definition is appropriate. If such stable value contracts are determined to be swaps, and an exemption is not granted for the purposes of the Act, insurance companies who engage in a business of entering into or selling such stable value contracts might be designated as swap dealers in this product. Section 719(d) also raises questions about the status as swaps of stable value contracts, other than as defined in Section in 719(d)(2), and the status as dealers of insurance companies who engage in a business of entering into or selling such stable value contracts.

Financial entities include persons predominantly engaged in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act, which definition includes “insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing in any state.” Hence, insurance companies are financial entities for the purposes of the Act and therefore not eligible for the non-financial entity exemption.

The unavailability of the end-user exemption may make it more expensive for insurance companies to hedge commercial risk. Certain relatively customized hedges entered into by insurance companies, such as long-dated rate swaps, may become subject to clearing. Such swaps, because of their relatively one-off nature, may attract prohibitively high levels of margin from a CO, while they may have been economically feasible in the OTC market.

#### *c. Application of Volcker Rule to Insurance Companies*

If an insurance company is a banking entity or an affiliate of a banking entity, it will be subject to the limitation on proprietary trading described in Part II.D. However, as described above, regulated insurance companies and their affiliates are permitted to purchase and sell derivatives to the extent such activities are conducted in connection with the general account of the insurance company. The reason for the limitation of this provision to activities conducted in connection with the general account is not clear, but it may be the case that activities conducted in connection with a separate account are not proprietary trading, because such activities are perhaps thought to benefit/create risk for policy holders and not the insurance company.

In addition, such activities must be conducted in compliance with state insurance company investment laws, regulations and written guidance. Moreover, federal banking agencies, after consultation with the Financial Stability Oversight Council and relevant insurance commissioners, may determine that a particular state insurance investment law, regulation or written guidance is insufficient to protect the safety and soundness of the banking entity. Such restrictions could cause insurance companies to divest themselves of their depository institution affiliates.

#### *d. Certain Provisions of Act Provide Flexibility*

In addition to potentially providing some relief from the regulations imposed on other kinds of companies, the Act is relatively favorable to

certain positions advocated by the insurance industry.<sup>13</sup> The Act recognizes at least tacitly that there will remain an OTC market in non-standardized, non-cleared swaps. This recognition is important because customized OTC products may offer more effective hedges for certain product types in certain circumstances, permitting hedge accounting which might not be available if only less effective, non-customized swaps were used. An example would be the use of long-dated rate swaps in connection with long-duration life products instead of short-dated futures products.

The insurance industry advocated that margin property held for swaps cleared through a CO be permitted to be other than US treasuries or cash. Currently in the OTC market, insurance companies post corporate bonds and other investment securities (subject to appropriate haircuts). It would significantly increase hedging costs if insurance companies are not permitted to use such types of collateral in connection with cleared swaps. The Act potentially provides for the use of such collateral, by permitting investments which are state government obligation bonds and such other obligations as may be permitted by rulemaking.

*e. Indirect Effects of Act on Insurance Companies*

Although the direct regulatory impact of the Act on many insurance companies may be limited to reporting obligations, as a practical matter, insurance companies' derivatives business will be impacted by regulatory changes affecting their counterparties and general market changes arising from the regulation.

As more products become subject to clearing, insurance companies can expect to conduct a substantial part of their derivatives business through CO's. Because insurance companies will have books of cleared and non-cleared swaps, the net amount of collateral required to be posted may increase because of the inability to net cleared and non-cleared swap positions.

Finally, insurance companies are likely to find that the cost of hedging is increased because their major swap participant and swap dealer counterparties are required to post more collateral on their books of business and hold more capital (including in the case of insured depository institutions, increased capital in newly formed non-depository, separately capitalized affiliates) and are passing these increased costs on to their customers.

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<sup>13</sup> The American Council of Life Insurers presented its positions on certain provisions of the Act to legislators on behalf of its members.

### *3. Industrial End-Users*

The potential scope of the Act can directly reach industrial end-users such as car companies, steel manufacturers and any other non-financial entity whose primary business activity is producing and marketing goods and services. It is anticipated that most industrial end-users will not fall within the category of swaps dealers or major swap participants because they either will not fall within the category of "financial entities" or use swaps only for hedging purposes. Nonetheless, it is possible that large industrial end-users who are using swaps only for hedging purposes may fall within the definition of "major swap participants" if their swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets. This will depend on how narrowly or broadly the CFTC defines "substantial counterparty exposure." End-users may consider trading with many different counterparties, instead of one, so as to reduce the possibility that its trades can affect a key participant in the financial sector. The issues discussed in Parts III.A.2.d and III.A.2.e above also apply to industrial end-users.

### *4. Energy Companies*

Many energy-related companies may be in the same category as industrial end-users and face issues similar to those set forth in the section above. Other types of energy companies, in particular, power marketers, face unique issues and the Act may have more an impact on them. Large power marketers who have net long or short positions may be deemed major swap participants or even swap dealers if they regularly enter into swaps for their own account or are deemed to make a market in swaps. In addition, while the Act clarifies that nothing in the Act limits or affects the authority of the Federal Energy Regulatory Commission (the "FERC") or a state regulatory authority with respect to an agreement entered into in connection with a tariff or rate schedule that FERC or the state regulatory authority approves,<sup>14</sup> the Act does not contain a clear cut exemption for any electricity product or service subject to a FERC tariff. While the Act directs the FERC and the CFTC to negotiate a memorandum of understanding to establish procedures to avoid conflicting or duplicative regulation, the absence of this clear exemption could result in situations of overlapping regulation for the energy sector. The issues discussed in Parts III.A.2.d and III.A.2.e above also apply to energy companies.

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<sup>14</sup> In addition, the agreement, contract or transition must (1) not be executed, traded or cleared on a registered entity or trading facility; or (2) be executed, traded, or cleared on a registered entity or trading facility owned or operated by a regional transmission organization or independent system operator.

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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## *5. Hedge Funds*

Hedge funds will have to examine several provisions of the Act to determine whether they are required to register and/or clear their swaps. Large funds whose dominant trading strategy is to hold net short synthetic swap positions may qualify as swap dealers or as major swap participants if their outstanding swaps are deemed to create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets. Even if their positions in terms of the overall swap markets do not create substantial counterparty exposure, the open-ended nature of the definition of "financial entity" (entities that are engaged in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act) may require their trades to be cleared at a minimum and may put them within the definition of "major swap participant" (with corresponding margin, capital, business conduct and recordkeeping requirements) if they are a highly leveraged fund and have a substantial position in outstanding swaps in a major category (as opposed to swaps in general). Finally, hedge funds entering into swaps may be treated as commodity pools, and fund managers and advisors may be treated as commodity pool operators and commodity pool advisors. These characterizations impose regulatory requirements, including disclosure, periodic reporting and audit requirements. The issues discussed in Parts III.A.2.d and III.A.2.e and possibly III.A.2.b above also apply to hedge funds.

### *B. Implications for Documentation*

The Act provides for legal certainty for swap agreements entered into prior to the date of enactment of the Act by stating that the enactment of the Act shall not constitute a termination event, illegality, a regulatory change or similar event under a swap agreement that permits termination of that agreement. The Act does not specify precisely what documentation should be used (ISDA forms<sup>15</sup> or otherwise); however, the Act requires the CFTC to adopt rules governing documentation standards for swap dealers and major swap participants and requires each swap dealer and major swap participant to conform to such standards. Once the rules are issued by the CFTC, parties should examine their existing documentation to determine what, if any, changes are required. In addition, for cleared swaps, parties will have to follow any guidelines issued by the applicable CO. For the time being, until the Act is enacted, rules are promulgated and provisions become effective (such as the clearing requirement), parties negotiating a new swap agreement should consider including bridging or transition provisions that contemplate mechanisms to have certain transactions

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<sup>15</sup> ISDA publishes documentation for derivatives that are widely used in the industry.

cleared and others executed bilaterally and to have a flexible process for incorporating relevant rule-making provisions of the CFTC without having to amend the swap agreement in the future.

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