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The Dodd-Frank Act: Implications for Insurance and Energy Companies

Eileen Bannon and Evan M. Koster

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), perhaps the most far-reaching overhaul of the US financial oversight regime since the 1930's. 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. A significant amount of attention has been directed to the effect of legislation on financial institutions and on "commercial" end-users in general. This Learning Curve will address the implications of the Act on two key industries often considered to be end-users of derivatives, the insurance and energy industries. Much of the Act remains to be implemented by regulations to be issued by 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") and its full effect is difficult to predict, but nonetheless, certain general conclusions can be made.

Regulation as a Swap Dealer or Major Swap Participant

The Act establishes two categories of entities, swap dealers, and major swap participants, that are required to register with the Commission. In general, a person is a swap dealer if that person holds itself out as a swap dealer, makes a market in swaps,¹ regularly enters into swaps in the ordinary course of business or engages in an activity causing it to be commonly known as a dealer. A major swap participant is a person who is not a swap dealer and (a) maintains a "substantial position" in swaps in a major category excluding positions hedging or mitigating commercial risk and positions maintained by an employee benefit plan hedging or mitigating the risks associated with the plan; (b) whose swaps create substantial counterparty exposure that could have serious systemic risks; or (c) a highly leveraged financial entity that is not subject to federal banking capital requirements that maintains a "substantial position" in swaps in a major category.

1. The Act addresses both "swaps" and "security-based swaps." Where the provisions relating to the different types of swaps and actors are similar, we use the term "swaps," "swap dealers" and "major swap participants" to refer to both types of swaps and actors.

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In addition to the registration requirements, swap dealers and major swap participants will be subject to capital, margin, recordkeeping and business conduct requirements to be further defined by the Commission.

Insurance Companies

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.² 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 risk³ creates further uncertainty, and situations may differ on a case-by-case basis.

As discussed above, characterization as a major swap participant generally requires that there be either a “substantial position” in swaps other than positions for hedging or mitigating commercial risk, or swaps positions that create “substantial counterparty exposure” with potentially serious systemic risks. 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 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. This is because the benefit or risk of the swaps in connection with such products may be deemed to be passed through directly or indirectly to the owners of the policies, and as a result the swaps may not be found to hedge or mitigate the commercial risk of the insurance company.

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 (especially those who do not have a stable value contract business) should not be treated as swap dealers. 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 who enters into swaps for such person’s own account, but not as

2. 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 Learning Curve.

3. The SEC and the CFTC may, by rule, further define “commercial risk.”

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.

Energy Companies

Many energy-related companies may be situated similarly to insurance companies, i.e., their activities are confined to hedging or mitigating the commercial risk of their energy business and are not likely to qualify as major swap participants as long as their positions in swaps held other than for hedging or mitigating commercial risk are not "substantial." For example, utilities which enter into swaps solely to hedge their power purchase requirements should be able to escape characterization as major swap participants, assuming their positions other than for hedging or mitigating commercial risk are not "substantial." A similar conclusion can be reached with respect to generating companies whose swaps consist of positions to hedge their fuel requirements.

Other types of energy companies, in particular, power marketers, face unique issues and the Act may have more of an impact on them. Large power marketers who have net long or short positions which are substantial may be deemed major swap participants, or may be deemed to be swap dealers if they regularly enter into swaps for their own account or are deemed to make a market in swaps.

In addition, those energy-related companies whose swap transactions consist primarily of physically settled forwards are not likely to be swept in as swap dealers or major swap participants since these transactions are not "swaps" within the meaning of the Act.

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. The determination of whether a swap or class of swaps is required to be cleared is to be made by the Commission. If the swap is required to be cleared it must also be traded on an exchange or a swap execution facility. An exemption from the clearing requirement exists for an entity which is not a financial entity, uses swaps to hedge commercial risks and notifies the Commission as to how it generally meets its financial obligations under non-cleared swaps. 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).

Insurance Companies

Insurance companies are financial entities because they 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." Therefore insurance companies are not eligible for the non-financial entity exemption from clearing.

This article 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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The unavailability of this 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 clearing organization, while they may have been economically feasible in the OTC market.

In addition, if an insurance company is a banking entity or an affiliate of a banking entity, it will be subject to limitations on its “proprietary trading” in derivatives under the so-called “Volcker Rule.” However, the purchase and sale of derivatives in connection with the insurance company’s general account will be exempt from such limitations.

Energy Companies

Many energy companies should be able to rely upon the non-financial entity exemption since, as mentioned above, they should escape characterization as major swap participants or swap dealers. Power marketers, if they are considered major swap participants or swap dealers, would not be able to rely upon this exemption. In addition, even if power marketers are not swap dealers or major swap participants, such entities may be limited in relying upon this exemption in situations where they have speculative positions which are not tied to hedging commercial risks. Energy related funds that use swaps may also be limited in using this non-financial entity exemption as they could be considered “private funds” or “commodity pools” and therefore financial entities.

Recordkeeping Requirements and Indirect Effects

All swaps regardless of the status of the counterparties, are required to be reported under the Act. 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.

Finally, insurance and energy 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.