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Dodd-Frank Act: Are You Ready?

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Dodd-Frank Act: Are You Ready

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Purpose of Presentation

- Explore the CFTC's definitions of Swap, Swap Dealer, and Major Swap Participant;
- Provide guidance regarding how an entity can apply the CFTC's definitions;
- Analyze the implications of the Dodd-Frank Act on "end-users";
- Provide an overview of steps an end-user should take to comply with or prepare to comply with the Dodd-Frank Act; and
- Discuss open issues of relevance to energy market participants

Dodd-Frank Act: What is its purpose?

- Title VII of the Dodd-Frank Act is designed to establish a comprehensive framework regulating the United States swap markets. Title VII pursues this initiative by:
 - Amending the Commodity Exchange Act (“CEA”) in a number of ways; and
 - Directing the Commodity Futures Trading Commission (“CFTC”) to undertake a variety of rulemaking initiatives.
- Title VII is almost exclusively focused on swaps. If an entity engages in swap transactions, that entity will be impacted by the CFTC’s Title VII-related rulemakings.
 - Entities that do not engage in swap transactions, but engage in other trading activities, could be impacted by other provisions in the Act.



Definitions and Application

Dodd-Frank Act: What is a “Swap”?

- Section 721 of the Dodd-Frank Act defines a swap:
 - Any agreement, contract or transaction that is a “put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of one or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind.”
 - Any arrangement that provides for “any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.”
 - Any agreement known or in the future known as a “swap” unless the agreement is excluded or exempted.
- A swap is not:
 - The sale of a non-financial commodity for deferred shipment or delivery so long as the transaction is between commercial parties and is intended to be physically settled.
- The Dodd-Frank Act intends to define a swap broadly, and provides the CFTC authority to amend the definition to include instruments designed to evade the enacted definition.

Dodd-Frank Act: What is a “Swap”?

- On July 10, 2012, the CFTC issued its Final Rule further defining “swap”.
 - The CFTC’s Final Rule confirmed that options will be characterized as swaps.
- The CFTC expressly excluded non-financial forward contracts between commercial parties from the swap definition.
 - A forward contract is “any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.”
 - The CFTC defined the contours of the exclusion for non-financial forward contracts.
 - A contract may still be considered a forward contract even if it includes optionality, is later booked out, or is a physical exchange transaction.

Application: Swap

- Optionality:
 - Price optionality:
 - Cannot target the delivery term, so that the predominant feature of the contract is actual delivery; and
 - Cannot be severed and marketed separately from the overall forward contract in which they are embedded.
 - Volumetric optionality:
 - Cannot target the delivery term, so that the predominant feature of the contract is actual delivery;
 - Cannot be severed and marketed separately from the overall agreement;
 - Intends to deliver and take delivery of the commodity if the option is exercised;
 - Both parties are commercial parties; and
 - The exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors (e.g., weather, operational considerations), or regulatory requirements, that are outside the control of the parties.

Application: Swap

- Physical Exchange Transactions:
 - Straightforward physical exchange transactions are forward contracts excluded from the definition of “swap.”
- Book-outs:
 - In order for the original contract to avoid being included in the “swap” definition, the book-out transaction must meet the CFTC’s “Brent Interpretation” requirements.
 - A subsequent, independently negotiated transaction between commercial market participants that extinguishes the binding physical delivery obligation required by an earlier agreement; and
 - The book-out cannot have been provided for by the terms of the earlier agreement.
 - Physical netting agreements may qualify as a book-out transaction, provided that the parties had intended when entering into the transactions to make or take delivery of the commodity covered by the transaction.

Dodd-Frank Act: Impact on Entities Engaging in Swap Transactions

- The extent of the impact of the Dodd-Frank Act and CFTC regulations turns on whether an entity is a Swap Dealer or Major Swap Participant.
 - The Dodd-Frank Act defines:
 - A Swap Dealer as any person who holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps as an ordinary course of business, or engages in activities causing the person to be commonly known as a dealer or market maker.
 - A Major Swap Participant as any person who is not a swap dealer and maintains a substantial position in swaps whose positions create substantial counterparty exposure that could adversely affect the U.S. banking system or financial markets; or is a highly leveraged financial entity with substantial swap positions that is not subject to capital requirements.

Application: Swap Dealer

- The Swap Dealer definition is qualitative.
 - That is, it turns on whether an entity undertakes typical dealing activities or may be perceived as a dealer irrespective of the volume of trading activity.
- Some key questions to ask:
 - Do you contact potential parties to solicit interest in transacting in a swap or express availability to provide liquidity to counterparties regardless of the direction your business unit would take with respect to the transaction?
 - Do you enter into swaps with the primary purpose of satisfying the business or risk management needs of the counterparty?
 - Do you develop new types of swaps or customize swaps and inform potential counterparties that the swaps are available for trading?
 - Do you have an identifiable swap trading business or maintain a separate profit and loss statement for swap activity?
 - Do you quote on a commodity exchange or respond to requests made by potential counterparties for bid or offer prices or rates?

Application: Swap Dealer

- When considering whether an entity's activities would constitute dealing, the entity should separately identify:
 1. Swaps that are entered into for the purpose of hedging or mitigating commercial risk; and
 2. Swaps entered into between two majority-owned affiliates.
- In both instances, the swaps are to be excluded from any analysis into whether an entity is a Swap Dealer.
- A *de minimis* exception also exists.
 - Aggregate notional amount of swaps entered into over the prior 12 months in connection with dealing activities must not exceed \$8 billion.
 - Aggregate notional amount of swaps entered into just with "special entities" over the prior 12 months in connection with dealing activities must not exceed \$25 million.

Application: Major Swap Participant

- For commodity swaps:

	Substantial Position	Substantial Counterparty Exposure
Current Uncollateralized Exposure	\$1 billion	\$5 billion
Current Uncollateralized Exposure <u>plus</u> Aggregate Potential Outward Exposure	\$2 billion	\$8 billion



End-Users and the Dodd-Frank Act

Implications For End-Users

- The Dodd-Frank Act will impact end-users in four primary ways through new compliance requirements:
 - Mandatory clearing and trade execution;
 - Mandatory position limits;
 - Record retention; and
 - Reporting.

Implications For End-Users

- **Mandatory Clearing and Execution**
 - **General Rule:**
 - All swaps are required to be cleared if the CFTC determines that the type of swap must be cleared.
 - It is expected that most categories of swaps will be subject to the mandatory clearing requirement.
 - All swaps that are required to be cleared and are made available for trading on a SEF are required to be executed on a SEF.
 - **Exception:**
 - A non-financial end-user may elect to avoid the mandatory clearing and execution requirements of the Dodd-Frank Act (on a transaction-by transaction basis) for swaps entered into for the purpose of hedging.
 - To elect the exemption, the end-user must receive approval by a committee of its Board.

Implications For End-Users

- Position Limits
 - The spot month and non-spot month position limits established by the CFTC are applicable to all entities engaging in swap transactions, including end-users.
 - With respect to swaps relating to energy commodities, the position limits apply to futures, options, and linked contract in the following Core Referenced Futures Contracts:
 - NYMEX Henry Hub Natural Gas;
 - NYMEX Light Sweet Crude Oil;
 - NYMEX New York Harbor Gasoline; and
 - NYMEX New York Harbor Heating Oil.

Implications For End-Users

- Record Retention
 - Historical Swaps that expired before April 25, 2011:
 - For Pre-enactment Swaps, retain all information and documents possessed on October 14, 2010.
 - For Transition Swaps, retain all information and documents possessed on December 17, 2010.
 - Historical Swaps that were in effect on or after April 25, 2011:
 - Retain the following information and documents with respect to these swaps:
 - Identity and value
 - Date and time of execution
 - Price volume and payment provisions
 - Whether the swap was accepted for clearing, and if so by whom
 - Modifications of the terms of the swap
 - Confirmation terms and any amendments
 - Master agreement (and any modifications)
 - Credit support agreement (including modifications)

Implications For End-Users

- Record Retention

- Swaps entered into after the effective date of the Final Rules:
 - The rules require much of the same information that has been required for Historical Swaps, but the characterization, quantity and format of the information to be maintained is more specific.
 - Also, end-users electing the end-user exemption from mandatory clearing must retain all records demonstrating that they are entitled to the end-user exemption and the basis for their exemption.
- Records must be retained throughout the life of the swap and for at least five years afterwards.
- End-users are allowed to keep their records in paper or electronic form.

Implications For End-Users

- Reporting
 - **Swaps executed on a trading facility:**
 - All reporting requirements for trades executed on a trading facility are done by the swap execution facility or the designated contract market. End-users must report any errors or omissions to the SEF or DCM where the swap was executed.
 - **Reporting requirements for over-the-counter swaps:**
 - End-users have no reporting obligations for over-the-counter swaps that they enter into with swap dealers or major swap participants.
 - End-users that enter into a swap with another end-user, however, must determine which of the two end-users will be the “reporting party.”
 - End-users with reporting obligations can hire third-party service providers to submit required information to SDRs.

Implications For End-Users

- Reporting
 - If an end-user opts to become the “reporting party”, it must report to the Swap Data Repository (SDR) “as soon as technologically practicable”:
 - Swap transaction and pricing information, which includes the time and date of execution, whether the swap is cleared, effective and end dates, price information and timestamps;
 - Swap creation data, which include a swap’s primary economic terms; and
 - Confirmation data, which includes swap transaction and pricing information, a number of other terms, and all of the terms agreed to in the confirmation, including the identity of the counterparties.
 - If the swap is not cleared, the reporting party must report valuation data on a daily basis and on the day on which a “life cycle event” occurs.
 - Life cycle events include assignments, novations, partial terminations, changes in cash flows, changes in the rates or changes in business structure.
 - The reporting party must also report the primary economic terms, including all terms of a swap that are matched or affirmed by the counterparties in verifying the swap terms.

Preparing for Compliance as an End User

- Obtain a Legal Entity Identifier
 - Necessary for every market participant that enters into over-the-counter swaps in order to satisfy Part 45 of the CFTC's regulations relating to recordkeeping and reporting
 - For example, even though an end-user is not the Reporting Entity if its counterparty is a Swap Dealer, the end-user will need to provide its Legal Entity Identifier to its Swap Dealer counterparty
 - The Legal Entity Identifier may be obtained at: <https://www.ciciutility.org>

Preparing for Compliance as an End User

- Adhere to ISDA Protocol
 - For entities that:
 - Have an ISDA Master Agreement in place with a party that is likely to register with the CFTC as a Swap Dealer; and
 - Would like to continue to trade over-the counter derivatives under that ISDA Master Agreement
 - Under the Protocol, all market participants:
 - Will be giving representations;
 - Should become familiar with these representations; and
 - Should take any internal actions needed to give the representations.
 - Details regarding the Protocol may be found at:
<http://www2.isda.org/functional-areas/protocol-management/protocol/8>

Preparing for Compliance as an End User

- Obtain Board authority authorizing a committee to elect the end-user exemption from mandatory clearing and execution
 - The SEC Filer's Board is required to either approve the election of the end-user exemption on a swap-by-swap (or categorical) basis . Alternatively, the Board may delegate the responsible to an “appropriate committee”
 - End-users should receive Board approval of a resolution that delegates the authority to elect the end-user exemption to a committee.

Open Issues

- Inter-affiliate clearing exemption
 - The CFTC issued a proposed rule on August 16, 2012.
 - The proposed rule will have minimal (if any) impact on end-users because they may elect to use the end-user exemption for transactions undertaken for the purpose of hedging.
 - The proposed rule would greatly benefit Swap Dealers and Major Swap Participants because they may not elect to use the end-user exemption.

Open Issues

- Natural gas storage and transportation contracts
 - The 7th prong of the CFTC's volumetric optionality test has given rise to concern in the energy industry with respect to whether natural gas storage and transportation contracts would be considered swaps due to their embedded optionality.
 - On August 23, ConocoPhillips filed comments with the CFTC requesting that the CFTC eliminate the 7th prong of the volumetric optionality test in order to ensure that such contracts, which are widely-used in the energy industry, do not get characterized as swaps.

Open Issues

- Usage contracts
 - Language in the CFTC's swap definitional rule suggests that contracts containing both a reservation charge and an additional charge for the use of the service constitute swaps.
 - Contracts containing such a fee structure are widely-used in the energy industry.
 - Natural gas storage contracts
 - Electricity tolling agreements
 - LNG re-gasification contracts
 - The CFTC has been requested to reconsider the language of the swap definitional rule

Open Issues

- Transactions within RTOs and ISOs
 - On August 21, the CFTC issued a proposed rule that would exempt specifically defined FTRs, energy transactions, forward capacity transactions, and reserve or regulation transactions, that are offered or sold in a RTO or ISO from the provisions of the Commodity Exchange Act (“CEA”) and the CFTC’s regulations.
 - The transaction must have been entered into by persons who are “appropriate persons” or “eligible contract participants,” as defined in the CEA Act
 - The Tariff applicable to the transaction must have been approved or permitted to take effect by FERC or the PUCT
 - The CFTC’s general anti-fraud, anti-manipulation and enforcement authority would remain applicable.

Open Issues

- Aggregation of Position Limits
 - Presently, the CFTC's position limit rule requires swap positions to be aggregated for among entities that share a common ownership exceeding 10%
 - The CFTC has proposed a rule that would increase the aggregation threshold to over 50%. If adopted, entities that share a common ownership between 10.1% and 50% would not need to aggregate positions if certain conditions are met

Open Issues

- CFTC and FERC Coordination
 - Section 720 of the Dodd-Frank Act required FERC and the CFTC to enter into a MOU by the end of January 2011 delineating their respective authority and resolving conflicts concerning their jurisdiction.
 - This MOU is intended to resolve the issues raised in *Hunter v. FERC*, in which the D.C. Circuit addressed several arguments that FERC did not possess jurisdiction to investigate allegations of manipulation in the futures markets.
 - To date, FERC and the CFTC have not issued an MOU.

Questions?



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