ORRICK

Derivatives Month in Review

February 24, 2011

Dodd-Frank Implementation Update

Under Title VII of the Dodd-Frank financial reform, titled the "Wall Street Transparency and Accountability Act of 2010" (the "Act"), which is generally intended to bring the $600 trillion over-the-counter derivatives market under greater regulation, the Commodity Futures Trading Commission ("CFTC") will have primary responsibility for the regulation of "swaps" and the Securities Exchange Commission ("SEC" and, together with the CFTC, the "Commissions") will have primary responsibility for the regulation of "security-based swaps."

The Commissions continue to meet with market participants and industry groups and to publish proposed rules and requests for comment related to the implementation of the Act. The implementation timeline mandated by Congress is extremely compressed for such an expansive undertaking and, as a result, the pace of the publication of notices and marketplace responses has been simply torrid. In fact, as of February 10th, the CFTC had held nine roundtables and over 500 meetings with market participants and had approved 39 notices of proposed rulemaking, two interim final rules, four advanced notices of proposed rulemaking and one final rule. As of the same date, the CFTC had received over 2,800 submissions from the public and over 1,100 official comments in response to its proposed rulemakings under the Act. This pace has led to concern over whether the appropriate deliberation was taking place before the finalization of rules that could result in unintended consequences.[1]

Each market participant is necessarily concerned with the impact proposed regulations (and their interpretation) will have on that participant's use of swaps in connection with its specific business. Of course, market participants and their use of swaps are necessarily diverse, and include everything from a governmental agency hedging interest rate risk on its variable rate bonds to an airline hedging the future cost of jet fuel to a hedge fund speculating on the value of equity securities. Consequently, the areas of concern in the derivatives market relating to implementation of the Act are similarly diverse. A few of these areas of concern—primarily relating to regulations proposed by the CFTC—are discussed below.

Contacts

Nikiforos Mathews
Of Counsel
nmathews@orrick.com
(212) 506-5257

Al Sawyers
Partner
asawyers@orrick.com
(212) 506-5041

William Haft
Partner
whaft@orrick.com
(212) 506-3740

Julie Eum
Managing Associate
jeum@orrick.com
(212) 506-5039

---

[1] In a February 8th letter to the CFTC, SEC and other regulators, several Senators cautioned as follows:

> "[W]e hope that your agencies will take the time to implement [the Act] thoughtfully and to pay particularly close attention to the array of unintended consequences that may arise. If the major overhaul of our derivatives market is implemented hastily, agency rulemakings could have negative effects on our economy at a time when we can least afford it."

Similarly, in a January 26th letter to the CFTC, two Congressmen expressed their concern with the rapid publication of proposed regulations, arguing that "by prioritizing speed over deliberation in writing rules, the CFTC has created an irrational sequence of rule proposals that prevents stakeholders and the public from providing meaningful comments after rules are proposed." The Congressmen urged that the CFTC elect to voluntarily adhere to Executive Order 12866, issued by President Barack Obama on January 18th, which, among other things, requires that government agencies "propose or adopt a regulation only upon a reasonable determination that its benefits justify its costs." The executive order does not apply to independent agencies such as the CFTC.

Special Entities

Significant market concerns exist over the business conduct standards proposed by the CFTC that would govern the relationship between swap dealers and major swap participants and their "special entity" counterparties, such as employee benefit plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), endowments and state and local governmental entities. In accordance with the Act, each swap dealer or major swap participant that enters into or offers to enter into a swap with a special entity must comply with certain specified requirements.[2] However, in the drafting stages of the Act, Congress considered—but ultimately rejected—imposing a fiduciary standard on swap dealers transacting with special entities.

The proposed rules nevertheless take an expansive approach, providing that swap dealers act as "advisers" to a special entity (and, as such, must act in the entity's "best interests") by recommending a swap or a trading strategy that involves the use of a swap. On February 17th, the Securities Industry and Financial Markets Association and the International Swaps and Derivatives Association, Inc. jointly submitted a comment letter that, *inter alia*, argued that the proposed approach could effectively preclude the participation of special entities from the swap market. Among numerous other points, the groups noted that it is common for swap dealers to provide state and local governments and their advisors with valuable information identifying swap opportunities, proposing structures and products and presenting possibilities to restructure existing transactions. Preventing them from doing so would alter the face of this market and could ultimately involve additional costs for special entities. As a potential solution, the groups suggested that the CFTC instead treat swap dealers as advisors only where they provide advice to a special entity pursuant to a written agreement and the advice (i) will serve as the primary basis for the special entity's investment decision and (ii) will be individualized based on the particular needs of the special entity.

With respect to ERISA plans, more specifically, the concerns fall into two main areas: (i) resurrection of the possibility that swap dealers engaging in typical business activities with special entities could be treated as ERISA fiduciaries (and, therefore, that the swaps entered into with such entities would be prohibited and, possibly, subject to rescission and excise taxes); and (ii) whether investment vehicles into which employee benefit plans invest (such as a fund in which 25% or more of its equity interests are held by "benefit plan investors," a term that includes ERISA-subject plans and investment vehicles) constitute special entities in the same way as employee benefit plans themselves.[3]

Position Limits

The Act requires that the CFTC establish position limits for certain commodity derivatives to prevent market manipulation and curb speculation in these critical markets, but at the same time ensure that sufficient market liquidity exists for *bona fide* hedgers and that the price discovery function of the underlying market is not disrupted.[4] The CFTC was required to impose such limits within 180 days of enactment for "exempt" commodities (generally, metals and energy) and within 270 days of enactment for agricultural commodities.[5] The Commission has been unable to strictly comply with this timing due to the lack of certain market data at its disposal. Nevertheless, it proposed rules that would establish position limits in two phases: (i) initially, "spot-month" (generally, the nearest delivery month on a futures contract) limits at the levels currently imposed by designated contract markets ("DCMs") and (ii) once sufficient data is gathered, non-spot-month limits, as well as CFTC-determined spot-month limits.

---

[2] These requirements include: (i) having a reasonable basis to believe that the special entity has an independent representative that, *inter alia*, has sufficient knowledge to evaluate each transaction and its risks and (ii) before the initiation of any transaction, disclosing to the special entity in writing the capacity in which the swap dealer or major swap participant is acting.

[3] For additional information regarding swaps with ERISA plans under the relevant proposed rules, please click here.

[4] This portion of the Act was driven, at least in part, by claims that excessive speculation in the oil market resulted in a precipitous spike in the price of crude oil to almost $150 per barrel in July 2008.

[5] The proposed regulations cover nine exempt commodities (i.e., gold, silver, copper, platinum, palladium, crude oil, natural gas, heating oil and gasoline) and 19 agricultural commodities (including, but not limited to, corn, oats, rice, soybeans, wheat, milk, cocoa, coffee, sugar and cotton).

DCMs currently set spot-month position limits based on their own estimates of deliverable supply. The CFTC will adopt these estimates of deliverable supply in the first phase. However, most non-spot-month position limits are based on “open interest” levels, for which the CFTC does not have sufficient information. As such, the Commission decided to defer establishing non-spot-month position limits until the implementation of a comprehensive system for gathering such information. Generally, for physically-delivered contracts, the proposed rules would impose a spot-month limit of 25% of estimated deliverable supply (to be adjusted annually) and, for cash-settled contracts, a conditional limit of five times the corresponding physical delivery limit where the relevant positions are all cash-settled and the trader holds physical commodity positions that are no more than 25% of the estimated deliverable supply. In the second phase, the proposed rules would impose a non-spot-month limit for each trader of 10% of open interest in a market up to the first 25,000 contracts and 2.5% for additional contracts. Positions of all accounts in which a trader holds an ownership interest of at least 10% would be aggregated for purposes of the rules. The proposed rules also provide for exemptions for *bona fide* hedging transactions and for positions established in good faith prior to the effective date of specific limits adopted.

Opponents of the proposed rules argue that, as written, they will constrain legitimate trading activity, harm liquidity and, potentially, drive markets overseas where regulation is lagging. Chairman Gensler has acknowledged that the CFTC would likely be revising its proposed position limit rules based on the comments it continues to receive from interested market participants.

End-Users

Another area of proposed regulation that has received substantial attention is the applicability of the Act to end-users of swaps, particularly corporate entities (such as airlines and manufacturers) which use derivatives to hedge market risks relating to volatility in interest rates, foreign exchange rates and commodity prices. Individual and groups of end-users have asked the CFTC for either an exemption or other accommodation from certain aspects of regulation. For example, at least one industry group has asked that end-users be exempt from the real-time reporting[6] of uncleared swaps to a swap data repository (“SDR”) where one end-user faces another end-user, because (i) such swaps constitute an insignificant portion of the derivatives market and, therefore, do not present systemic risk and (ii) requiring such reporting would result in prohibitive costs for end-users to develop the necessary technologic and other infrastructure necessary for compliance.[7] Alternatively, this industry group suggests that, in such a case, the reporting end-user be able to satisfy its reporting obligations by submitting a weekly report to an SDR.

Market participants have also expressed concerns about the implementation of the end-user clearing exemption in the Act. Among other things, this exemption requires that the end-user relying on it notify the CFTC how it generally meets its financial obligations associated with uncleared swaps.[8] Some market participants have asked the CFTC to permit end-users to use a one-time (or periodic) report to satisfy the requirement to notify the CFTC of its election and to clarify that public companies need not receive explicit board approval to enter into each individual swap. Other market concerns relating to the end-user clearing exemption include whether to allow the exemption for small banks and other financial entities having less than $10 billion in assets and the appropriate level of swap dealer responsibility in confirming that its counterparty qualifies for the exemption.

[6] Under the Act, “real-time public reporting” is defined to mean to report data relating to a swap, including price and volume, as soon as technologically practicable after the time at which the swap has been executed.

[7] Response of the International Energy Credit Association to the Commodity Futures Trading Commission Notice or Proposed Rule respecting Real-Time Public Reporting of Swap Transaction Data (17 CFR Part 43, RIN 3038-AD08, Federal Register Dec. 7, 2010) pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, dated February 7, 2010.

[8] Generally, the Act makes it unlawful for any person to engage in a swap that the CFTC determines should be required to be cleared unless that person submits the swap for clearing to a registered or exempt derivatives clearing organization ("DCO"). However, an important exemption to this requirement exists if one counterparty to a swap (i) is not a financial entity, (ii) is using the swap to hedge or mitigate “commercial risk” (as such term will be defined by the CFTC) and (iii) notifies the CFTC how it generally meets its financial obligations associated with uncleared swaps. Notwithstanding this exemption, a party that satisfies these requirements and enters into a swap with a swap dealer or major swap participant may elect to require clearing of the swap and, in any such case, will have the sole right to select the DCO at which the swap will be cleared.

Possibly the most significant point of concern for end-users involves the margin rules that regulators will ultimately propose for uncleared swaps. Under the Act, the capital and margin requirements imposed in connection with uncleared swaps are to reflect the greater risk to the swap dealer or major swap participant and the financial system as a whole arising from such swaps. Corporate end-users and lobbying groups have long argued that they should be exempt from these margin requirements, as such market participants were unrelated to the root cause of the financial crisis.[9] End-user anxiety persists over this issue, as the immediate liquidity drain of corporate end-users to satisfy even modest margin requirements would be measured in the billions of dollars and could lead to a profound loss of jobs from the United States economy.[10]

Although the relevant margin rules have not yet been proposed, it appears that regulators are largely in agreement with the corporate end-users on this point. In particular, the Board of Governors of the Federal Reserve (the "Federal Reserve") (which, as a prudential regulator of bank swap dealers, shares responsibility for drafting the rules) recently indicated that it plans to strongly consider the systemic risk an institution poses in establishing margin rules. Specifically, Federal Reserve Governor Daniel Tarullo testified on February 15th that the Federal Reserve planned to establish exposure thresholds for margin from non-financial end-users that would be "substantially higher than those for financial market participants." This would result in a *de facto* exemption for many non-financial companies, although certain larger end-users would be required to post margin. CFTC Chairman Gensler took an even more accommodating approach, stating that the CFTC view was that the Act's margin requirements clearly "do not cover nonfinancial end users" and that legislation was not necessary to further clarify the point.

Continuing Regulatory Supervision and Swap Usage Fees

The CFTC's operating budget for fiscal year 2011 was $169 million. On February 14th, President Obama requested that this budget be increased to $308 million, primarily due to increased personnel and technology costs relating to the implementation of the Act and the CFTC's expanded supervisory and enforcement role.[11] In a statement released that same day, Commissioner Bart Chilton emphasized the importance of these additional funds, noting that "[w]ithout adequate funding of our financial market regulatory apparatus, the new legislation won't mean much in the real world." The final CFTC budget will depend on numerous factors, including whether the Commission is allowed to assess swap user fees.

Weeks before the President's budget was proposed, Commissioner Chilton stated that opponents of reform have attempted to "deny resources to regulators—starving us on the vine if you will—and thereby denying us the ability to enforce the new law and oversee these markets."[12] In the event that sufficient funding is not provided to support the CFTC's expanded role, Commissioner Chilton suggested that the CFTC be permitted to impose swap transaction fees, possibly on a per-transaction basis. The President's proposed budget ultimately included $117 million in user fees for the upcoming fiscal year (and some $588 million through 2016) to help pay for the CFTC's non-enforcement activities. Opponents of this fee, including Commissioner Scott O'Malia, have labeled it a "transaction tax" on the financial industry which, they argue, can ill-afford an additional tax burden in a time of tepid economic recovery during which it must absorb numerous additional costs relating to the implementation of financial reform. The assessment of swap user fees remains open for debate and ultimately will require Congressional approval.

---

[9] Indeed, when the Act was still in draft form, Senators Blanche Lincoln and Christopher Dodd clarified in a June 30, 2010 letter that "[t]he [proposed Act] does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk."

[10] The Coalition for Derivatives End-Users issued a study on February 14th which concluded that the imposition of a three percent (3%) margin requirement on swaps used by Standard & Poor's 500 companies could cut capital spending by $5.1 to $6.7 billion and result in the loss of between 100,000 to 130,000 jobs. Congressional testimony from corporate end-users also focused on the risk of increased prices of goods and services that could result if margin rules applied to them. In an interesting discourse, following testimony by a representative of MillerCoors LLC in support of a broad end-users exemption from margin rules, one Congressman warned regulators that their rules could affect the price of a six-pack of beer, stating "I think you just got the attention of the American people." In his sobering response, CFTC Chairman Gary Gensler acknowledged that the CFTC had met with representatives of the brewing company and had reassured them that the CFTC had no intention of imposing margin rules on the company, stating "We're aware and focused on the cost of a six-pack."

[11] Note that the President also proposed a budget of $1.4 billion for the SEC, which represents a $300 million increase over its fiscal year 2011 budget.

[12] Keynote Address of Commissioner Bart Chilton to the Institutional Investor TraderForum, New York, NY (Jan. 26, 2010).