Basel III and Derivatives Exposures:
Understanding the Regulatory Capital Effects

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3. The CFTC’s Interpretive Letters Regarding Securitizations, REITs and the Definition of “Commodity Pool”
4. Dodd-Frank Considerations for End-Users of Derivatives
Understanding the Regulatory Capital Effects of Derivatives and Related Exposures under the Federal Banking Agencies’ Proposed Capital Rules

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Today’s Topics

- Background
- Risk-Based Capital – a Refresher
- The Standardized Approach Proposal
- Risk Weighted Asset Amounts for Derivatives
- Risk Weights for OTC Transactions
- Treatment of Collateralized Transactions and Guarantees
- Cleared Transactions
Background

• In June 2012, the Federal banking agencies (the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation) (the “Agencies”) proposed for comment, in a series of three separate but related proposals, substantial revisions to the U.S. regulatory capital regimen for banking organizations (the “Capital Proposals”).

• If adopted, the Capital Proposals will have a significant impact on the U.S. banking industry.
Background

• One of the proposals, “Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements” (the “Standardized Approach Proposal”), details the extent to which banks would, upon its adoption, be required to hold risk-based capital for counterparty risk for, among other things, derivatives transactions and related exposures.

• The Standardized Approach Proposal is based in significant part on the “standardized approach” for the weighting and calculation of risk-based capital requirements under the 2004-2006 Basel 2 Accord.
Risk-Based Capital – A Refresher

• A bank’s risk-based capital ratio is calculated by dividing its qualifying total capital base (the numerator) by its risk-weighted assets (the denominator):

  Qualifying Total Capital Base
  Risk-Weighted Assets

• The qualifying total capital base consists of Tier 1 (primary) and Tier 2 (supplemental) capital.

• Risk-weighted assets consist of on-balance-sheet assets, and off-balance-sheet commitments and contingencies.

• Under current rules, the general risk-based capital ratio must be no lower than 8%. Tier 1 (equity and substantive equivalents) must represent at least 50% of a bank’s total capital. Under the Capital Proposals, the components and amounts of required risk-based capital will be significantly fortified.
Risk-Based Capital – A Refresher

• The Several Faces of the Basel Accord
  • Basel 1 – General risk-based capital requirements (since 1988).
    • Currently applies to all U.S. banks.
  • Basel 2 – Advanced risk based capital requirements (since 2004).
    • The “three pillars” of Basel 2: capital; supervision; disclosure.
    • Basel 2 requires capital for credit and operational risk.
    • Applies to internationally active banks. In the U.S., only those banks with $250 billion or more of assets, or $10 billion or more in on-balance-sheet foreign exposures, are subject to Basel 2.
    • Basel 2 is not yet fully effective in the U.S.
  • Basel “2.5” – Market Risk Rules (since 1996; revised 2012).
Risk-Based Capital – A Refresher

• Basel 2 – the “denominator”
  • Introduced in 2004, revised in 2006.
  • Two advanced approaches for credit risk: Standardized and Internal Ratings-Based (“IRB”) approaches
  • Standardized approach: risk weights imposed by regulators.
    • More carefully calibrated risk weights.
  • IRB approach.
    • Risk weights determined internally.
    • Available only with supervisory approval.
    • Before full adoption, bank must engage in parallel run of IRB approach and Basel I requirements.
Standardized Approach Proposal

• Applicability of the Standardized Approach Proposal
  • All U.S. banks that are subject to minimum capital requirements, including Federal and state savings banks.
  • Bank and savings and loan holding companies other than “small bank holding companies” (generally bank holding companies with consolidated assets of less than $500 million).
  • Top-tier domestic bank and savings and loan holding companies of foreign banking organizations, but not FBOs themselves.
  • Large banks that are subject to the Basel 2 advanced (IRB) requirements will have to use this approach to calculate their capital floors under the Dodd-Frank Act “Collins Amendment.”
  • Generally excludes “covered positions” under Basel 2.5 (Market Risk Rules).
Standardized Approach Proposal

• As noted above, the Standardized Approach Proposal draws heavily from the Basel 2 standardized approach.
• The rules are still in proposal form and have not been finalized.
• The original comment period initially expired on September 7, 2012 but was extended until October 22, 2012.
• Spirited commentary on the Capital Proposals includes detailed comment letters from major financial services advocacy groups.
• The Agencies have suggested that final action on the Standardized Approach Proposal and other Capital Proposals will be taken later this year, possibly with significant changes to the proposed rules.
• Standardized Approach Proposal rules generally would go into effect no later than January 1, 2015.
Standardized Approach Proposal

• Critiques of the Standardized Approach Proposal
  • Lack of empirical studies supporting new proposed risk weights.
  • Fighting the last war.
  • Overly complex.
  • Encourages arbitrage and asset misallocation.
  • Too great a regulatory burden for smaller institutions.

• Regulatory Responses to the Critiques
  • Because final rules have not yet been adopted, specific banking agency responses are not yet known.
  • The Agencies, however, have acknowledged these concerns and have suggested that changes to the proposed rules may be made, particularly to accommodate the concerns of smaller banks.
Risk-Weights for Derivatives

• A risk weighted asset amount equals the product of:
  • (i) relevant risk weight and
  • (ii) relevant exposure amount

• Total risk-weighted assets equal the sum of the risk-weighted asset amounts.

• Risk weights – vary according to type of counterparty.

• Exposure amounts:
  • Equal (i) current exposure plus (ii) potential future exposure ("PFE").
Risk Weights for OTC Transactions

• Generally a function of the counterparty that the bank is facing.
• Under the Standardized Approach Proposal, the highest risk weight applicable to OTC derivatives, 50 percent, would no longer apply.
• Numerous different categories of counterparties.
Risk Weights for OTC Transactions

• Risk weights for different counterparty types are set out in Section __ 32 of the Standardized Approach Proposal, which is referenced herein as the “General Risk Weight Provision.”
• United States and its agencies – generally, zero risk weights (conditionally guaranteed obligations have risk weights of 20 percent).
• Supranationals (Bank for International Settlements, International Monetary Fund and others) – zero risk weight.
Risk Weights for OTC Transactions

• Sovereigns – depending on the country, risk weights range from zero to 150 percent (determined by reliance on Organization for Economic Cooperation and Development (OECD) Country Risk Classifications (CRCs) for relevant country, rather than credit ratings, as in original Basel 2 framework).

• Domestic banks (generally, risk weight of 20 percent).

• Foreign banks – similar to sovereigns; depending on the country, risk weights range from 20 percent to 150 percent, determined by reliance on the relevant OECD CRC.

• Corporate exposures (risk weight of 100 percent).
Exposure Amounts (Single OTC Transactions)

• The “current credit exposure” for a single derivative transaction is the greater of the transaction’s mark-to-market value or zero.
  • When a bank’s position under the transaction is flat or in-the-money, the “current credit exposure” component counts as zero.
• The PFE component of a single swap transaction equals the product of:
  • (i) the swap’s notional amount and
  • (ii) a “conversion factor” contained in a matrix in the proposed regulations (based on both the perceived volatility of the transaction type and the transaction’s remaining maturity).
• The conversion factors range from zero, in the case of interest rate swaps with a remaining maturity of less than one year, to 15 percent, in the case of transactions of non-standard types with remaining maturities of more than five years.
Exposure Amounts (Multiple OTC Transactions)

• Qualifying Master Netting Agreement (“QMNA”)
  • Key determinant of whether multiple transactions can be treated together as a “netting set” is whether they are subject to such a qualifying agreement.
  • A QMNA will, upon an event of default, reliably permit a party to terminate, apply close-out netting and promptly liquidate or set-off collateral, with full two-way payments at termination.
  • Bank is required to conduct sufficient legal review to conclude with a well founded basis that an agreement constitutes a QMNA.
Exposure Amounts (Multiple OTC Transactions) (Cont.)

- For multiple transactions under a QMNA, the “net current credit exposure” is the greater of the sum of all mark-to-market values (both positive and negative) of the individual transactions subject to such agreement or zero.
  - When the bank’s aggregate net position under all such transactions is flat or in-the-money, then the net current exposure amount will be zero.
- For multiple transactions subject to a QMNA, the relevant PFE amount is not calculated by simply adding the PFE amounts for each individual transaction.
- Instead, a formula determines an “adjusted sum of the PFE amounts” in which a portion of the sum of the PFE amounts is multiplied by a fraction (equal to the ratio of the net current exposure to the gross current exposure) that should often be far less than one when there are numerous transactions under the same QMNA.
Exposure Amounts (Multiple OTC Transactions) (Cont.)

• The use of this fraction as a factor in the formula ensures what should in most cases be a significant benefit of using a QMNA.

• The formula is as follows:
  • Adjusted Sum of PFE Amounts = \((0.4 \times Agross) + (0.6 \times NGR \times Agross)\)

  Where:
  Agross = the sum of the PFE amounts for each individual derivative contract; and
  NGR = the Net-to-Gross Ratio (the ratio of the net current credit exposure to the gross current credit exposure, with “gross current credit exposure” being equal to the sum of the positive current credit exposures of all individual derivative contracts subject to the QMNA).
Critiques of Approach to OTC Transactions

• The Standardized Approach Proposal carries forward an outdated approach to OTC derivatives first introduced in 1988.
  • The approach to PFE incorporates gross exposure, which fails to recognize offsetting positions that reduce actual counterparty credit risk.
  • Similarly, the approach looks at each individual position without regard to portfolio diversification, which reduces risks.
  • The approach fails to fully recognize the risk mitigating benefits of posted collateral and of haircuts to posted collateral.
Critiques of Approach to OTC Transactions

• The Agencies should permit the internal models methodology (“IMM”) as an alternative to the methodologies proposed in the Standardized Approach Proposal, which overstate true exposure amounts.
  • Under the IMM, risk weights are calculated using internal estimates of risks.
  • Data, processes and methods to determine inputs are subject to regulatory supervision.
• The Agencies should recognize netting benefits to a greater degree (raise the percentage to be multiplied by NGR) and apply a 15 percent haircut to exposure amounts.
• The 50 percent risk weight ceiling for OTC derivatives should be reinstated.
Collateralized Transactions

• There are two distinct options for banks that wish to recognize the credit risk mitigating effects of financial collateral:
  • The “simple approach” and
  • The “collateralized haircut approach”.

• Eligible financial collateral has been expanded beyond the current eligibility requirements to include specified assets (gold bullion, investment grade debt securities, publicly-traded equity securities, and money market and daily value mutual funds):
  • in which the bank has a perfected first-priority security interest, and
  • where the bank has adopted and implemented suitable (specified) risk management requirements (such as a sufficient legal review, risk correlation review, consideration of timing and costs of collateral realization, maintenance of security interest enforceability, and regular collateral valuation).
Collateralized Transactions

• Simple Approach
  • Under the simple approach, to the extent a derivatives exposure is collateralized, a bank may substitute for the risk weight of the derivatives exposure an alternative risk weight relating to the collateral.
  • The value of the collateral for this purpose is its current market value.
  • As a general rule, the risk weight assigned to the collateralized portion of the relevant exposure must be at least 20 percent.
Collateralized Transactions

• Simple Approach
  • However, there are exceptions to the 20 percent floor.
    • A risk weight of zero may apply when the collateral consists of “cash on deposit”, or when the collateral is an exposure to a sovereign that qualifies for a zero risk weight under the General Risk Weight Provision and the bank discounts by 20 percent the market value of the collateral.
    • In addition, a 10 percent risk weight may apply when there is a daily margin maintenance requirement and the collateral is an exposure to a sovereign that qualifies for a zero risk weight under the General Risk Weight Provision.
  • Other requirements: collateral agreement covering the life of the exposure; revaluation of collateral at least every 6 months; collateral other than gold must be in the same currency.
Collateralized Transactions

• Collateralized Haircut Approach
  • Under the new collateralized haircut approach, the original risk-weighting of the underlying asset is not changed, but the risk-weighting charge is applied to the asset’s calculated “exposure amount” instead of the full value of the asset.
  • In turn, the exposure amount of an asset is determined by means of a mathematical formula under which the value of the collateral is subtracted from the exposure amount for the relevant transactions, and then upward adjustments are made for both the market price volatility for the collateral and mismatches between a settlement currency and the currency in which posted collateral is denominated.
Collateralized Transactions

• Collateralized Haircut Approach
  • With respect to these adjustments, a bank may use either haircuts set out in the Standardized Approach Proposal or, with regulatory approval, its own internal estimates for haircuts.
  • There are two types of financial collateral that are eligible under this approach:
    • Financial collateral securing eligible margin loans, repo-style transactions, collateralized derivatives, or a single netting set of such products.
    • For banks subject to the Market Risk Rules, collateral securing a repo-style transaction included in a bank’s VaR (value at risk) measure thereunder.
  • The collateralized haircut approach requires sophisticated mathematics to determine its effect and is expected to be employed only by larger banks.
Guarantees

• Similar to the “simple approach” for collateral, the Standardized Approach Proposal provides for a “substitution approach” that permits a bank to substitute for the risk weight associated with an exposure the risk weight associated with an eligible guarantor.

• The Standardized Approach Proposal would expand the types of eligible guarantors (sovereigns; OECD public sector enterprises; U.S. GSEs, U.S. depository institutions and their holding companies; foreign banks; and qualifying OECD securities firms) to include:
  • Investment grade-rated corporations, other than monoline insurers or similar entities, whose credit is not positively correlated with the credit risk of the exposures that it is guaranteeing.
  • To qualify as eligible, a guarantee must satisfy nine requirements generally designed to ensure that the guarantee is unconditional (with one limited exception for certain conditional guarantees by the U.S. government), readily accessible, and legally enforceable.
Guarantees

• Qualifying credit derivatives are treated as eligible credit risk mitigants.
  • These instruments not only must satisfy the criteria for an eligible guarantee noted above, but also must satisfy additional criteria governing terms and conditions, payment and settlement.
• Partial substitutions of the risk weight associated with an eligible guarantor are permitted when an eligible guarantee is limited in amount or has a remaining maturity shorter than that of the underlying obligation.
• The credit-protected amount is calculated as the effective notional amount of the protection, with required adjustments for maturity mismatches, credit derivatives that do not treat a restructuring of the hedged exposure as a credit event, and currency mismatches.
• Multiple guarantees or credit derivatives covering single exposures, and single credit protection of multiple exposures with different notional maturities, are conditionally allowed.
Critiques of Collateral/Guarantees

• Collateralized Transactions
  • Simple approach – 20% risk-weighting floor should be removed.
  • Collateralized haircut approach – overly conservative and overstate risks of many transactions.
• Solutions:
  • Market-based haircut approach
  • Exclude overcollateralized transactions or transactions collateralized with high-quality liquid sovereign debt;
  • Use simple VaR approach.

• Guarantees
  • Narrowing of “eligible guarantors” under the Advanced Approaches Proposal.
  • Financial insurance exclusion from “eligible guarantors.”
Cleared Transactions

• The Standardized Approach Proposal establishes risk weightings that, in comparison with those for OTC transactions, are highly favorable for transactions that are cleared through central counterparties (“CCPs”) that are qualifying CCPs, or “QCCPs.”

• In comparison with the risk weight of at least 20 percent generally applicable to counterparties (other than the United States and its agencies, the highest rated sovereigns and certain supranational entities and multilateral development banks), the risk weights generally applicable in relation to QCCPs are 2 percent and 4 percent.
Cleared Transactions

• Generally, QCCPs are defined as CCPs that are (i) designated financial market utilities under Title VIII of the Dodd-Frank Act, (ii) if located outside the United States, similarly regulated and supervised, or (iii) otherwise demonstrated to the satisfaction of the relevant agency to be in sound financial condition and subject to effective regulatory oversight and risk management standards, with full collateralization on a daily basis.

• In practice, most CCPs would likely qualify under (iii); a Title VIII designation will be limited to a small handful of clearing entities (currently 8) that have been deemed “systemically important.”
Cleared Transactions

• Bank as Clearing Member Client
  • The basic formula is the same as for OTC transactions -- a risk weighted asset amount for a cleared transaction with the bank as a clearing member client equals the product of:
    • the relevant risk weight and
    • the relevant exposure amount.
  • A couple of significant differences from OTC derivatives, however:
    • Risk weightings.
    • Inclusion of value of collateral posted by in trade exposure amount.
Cleared Transactions

• Bank as Clearing Member Client
  • Risk weighting for transactions cleared through QCCPs are generally significantly lower than for OTC transactions.
  • The risk weight will be 2 percent, if, among other things, “the collateral posted by the [bank] to the QCCP or clearing member is subject to an arrangement that prevents any losses to the clearing member client due to the joint default or a concurrent insolvency, liquidation, or receivership proceeding of the clearing member and any other clearing member clients of the clearing member.”
    • CFTC’s LSOC (Legally Segregated Operationally Commingled) Model for protection of cleared swaps customer contracts is intended to implement such an arrangement to protect customer property from fellow customer defaults.
  • If the CCP is a QCCP but no such arrangement is in place, then the risk weight will be 4 percent.
Cleared Transactions

• Bank as Clearing Member Client
  • If the central counterparty does not qualify as a QCCP, the relevant risk weight will be determined as the risk weight appropriate for such central counterparty; this would likely be considered as a corporate-type exposure with a risk weight of 100 percent.
  • Exposure amounts for a bank that is a clearing member client are generally calculated in the same manner as exposure amounts for OTC derivatives (current exposure amount plus PFE amount).
Cleared Transactions

• Bank as Clearing Member Client
  • However, when the collateral posted by the clearing member client bank is held in a manner that is not bankruptcy remote, then the trade exposure amount also includes the value of that collateral.
  • If the collateral is bankruptcy remote from each of the CCP, the clearing member and other clearing member clients of that clearing member, then no risk weight applies to such collateral.
  • The General Risk Weight Provision will determine the risk weight in relation to collateral posted by a bank in an arrangement that is not bankruptcy remote (based on obligor under the collateral).
Cleared Transactions

• Bank as Clearing Member
  • Trade exposure amounts for cleared transactions are generally calculated in the same manner as exposure amounts for OTC derivatives transactions.
    • However, when the collateral posted by the clearing member bank is held in a manner that is not bankruptcy remote, then the trade exposure amount also includes the fair value of that collateral.
    • If the collateral is bankruptcy remote from each of the CCP, the clearing member and other clearing member clients of that clearing member, then no risk weight applies to such collateral.
  • The General Risk Weight Provision will determine the risk weight in relation to collateral posted by a bank in an arrangement that is not bankruptcy remote (based on obligor under the collateral).
Cleared Transactions

• Bank as Clearing Member
  • There are only two risk weights that may apply to cleared transactions for a bank acting as a clearing member in relation to cleared transactions.
    • If the CCP is a QCCP, then the risk weight will be 2 percent.
    • If the CCP is not a QCCP, then the risk weight will be determined in accordance with the General Risk Weight Provision, which will also determine the risk weight for collateral that is not held in a bankruptcy remote manner.
Cleared Transactions

• Bank as Clearing Member – Default Funds
  • For a bank that is a clearing member of a CCP, a risk weighting also applies to its required contributions to that CCP’s default fund.
  • In relation to default fund contributions to QCCPs, the Standardized Approach Proposal contains complex formulae intended to:
    • First, calculate the amount of capital that a QCCP would, if it were a bank, be required to maintain.
    • Second, compare that hypothetical capital requirement with the amount of the QCCP’s default fund that is funded by the QCCP itself and
    • Third, allocate back to each clearing member its portion of the capital requirement.
Cleared Transactions

• Bank as Clearing Member – Default Funds
  • A risk weight of 1,250% applies only to the amount equaling the clearing member’s portion of the QCCP’s hypothetical capital requirement; much lower risk weights apply to any contributions in excess of this amount.
  • The entire amount of a default fund contribution to a CCP that is not a QCCP is subject to a risk weight of 1,250% – in effect, capital must be held on a dollar-for-dollar basis.
Cleared Transactions

• Unsettled Transactions
  • DvP and PvP transactions:
    • Exposure: difference between settlement and current market prices.
      • Exposure arises when counterparty fails to make payment or delivery 5 business days after contractual settlement date (subject to the “normal settlement period” for that exposure).
      • Risk weighting: tiered weightings on positive current exposures according to number of days late: 100% beginning on day 5 up to 1,250% on day 46.
      • If extended contractual settlement, treated as an OTC derivative.
  • Non-DvP and non-PvP transactions:
    • Exposure is current market value of deliverables owed to bank.
    • Risk weight: Counterparty risk weight up to day 5, and 1,250% beginning on day 5.
Critiques of Approach to Cleared Transactions

• Definition of Cleared Transactions

  • A cleared transaction excludes an exposure of a bank that is a clearing member to its clearing member client if either (i) the banking organization is acting as a financial intermediary and enters into an offsetting transactions with a CCP or (ii) the banking organization provides a guarantee to the CCP on client performance.

  • Typically clearing members do guarantee the performance of their clients to CCPs.

  • This definition means that most exposures of clearing member banks to their customers would in fact be treated as OTC transactions.

  • Disincentive to clear transactions because, with capital charge for CCP default fund contributions, capital charges for clearing member banks are actually higher on a per transaction basis than for OTC transactions.
Critiques of Approach to Cleared Transactions

• Definition of QCCPs:
  • Rather than requiring individual banking organizations to demonstrate that a particular CCP satisfies criteria (in sound financial condition and subject to effective regulatory oversight and risk management standards), the Agencies should assemble a list of QCCPs (which should include all registered derivatives clearing organizations registered with CFTC or the SEC).

• Calculation of QCCP’s hypothetical capital requirement:
  • The basic model used (CEM) was not developed with central clearing in mind and is not sufficiently sensitive to the actual risk for sophisticated organizations such as CCPs, which have well-hedged portfolios and effectively engage in riskless principal activities.
  • Should incorporate internal models methodology.
Critiques of Approach to Cleared Transactions

• Eligibility Criteria for 2 Percent Risk Weight
  • Agencies should clarify that client accounts set up by clearing members for non-clearing members satisfy the criteria for 2 percent weighting (collateral posted by bank to the Q CCP or clearing member is subject to an arrangement that prevents any losses to the clearing member client due to the joint default or a concurrent insolvency, liquidation, or receivership proceeding of the clearing member and any other clearing member clients of the clearing member).
Conclusion

• Questions
On June 12, 2012, the federal banking agencies (the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation) formally proposed for comment, in a series of three separate but related proposals, substantial revisions to the U.S. regulatory capital regimen for banking organizations that, if adopted, will have a significant impact on the U.S. banking industry. One of these proposals, “Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements” (the “Proposal”),¹ details the extent to which banking organizations would, upon the Proposal’s adoption, be required to hold risk-based capital for counterparty risk for derivatives transactions. The Proposal is based in significant part on the “standardized approach” for the weighting and calculation of risk-based capital requirements under the 2004-2006 Basel II Accord (“Basel II”).² The method for determining risk-weighted assets for derivatives transactions, as for on-balance sheet exposures generally, is to multiply (i) the relevant risk weight by (ii) the relevant exposure amount.

The regime for risk-weighted assets contained in the Proposal is complex. However, the regulators’ policy preference for cleared derivatives over non-cleared transactions is clear. In requiring significantly higher risk weights for non-cleared OTC transactions than for cleared transactions—indeed, the risk weight for a non-cleared transaction may be 50 times the risk weight for a cleared transaction—the Proposal implements the regulators’ stated preference for cleared transactions.³

I. OTC Transactions

A. Risk Weights for OTC Transactions

Risk weights for OTC derivatives are generally a function of the counterparty the bank is facing.⁴ Under the Proposal, the highest risk weight currently applicable to OTC derivatives, 50 percent, would no longer apply. OTC derivatives would generally be subject to the general risk weights contained in Subpart D – Risk Weighted Assets – Standardized Approach, §_.32, General Risk Weights (the “General Risk Weight Provision”). Containing many more categories than the four categories contained in the current general risk-based capital requirements, the

¹ The other two proposals are (i) Implementation of Basel III; Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Periods and Prompt Corrective Action; and (ii) Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule.
³ “In general, [central counterparties] help improve the safety and soundness of the derivatives market through the multilateral netting of exposures, establishment and enforcement of collateral requirements, and promoting market transparency.” Proposal, Supplementary Information, II.E.1 at 45.
⁴ However, special treatment applies to certain credit derivatives and equity derivatives. It appears that when banks use certain credit derivatives for purposes of credit mitigation, they will have the option to choose either the risk weight associated with the counterparty or the risk weight associated with the underlying exposure, so long as the treatment is consistent for all such transactions under the particular master agreement. See Subpart D – Risk Weighted Assets – Standardized Approach, §§_.34(c) and 36(c). In addition, banks must treat OTC equity derivatives as equity exposures and calculate a risk-weighted asset amount accordingly. Subpart D, §34(d).
General Risk Weight Provision introduces new complexity to the determination of risk weights. By way of example, the risk weight categories include the United States and its agencies (risk weight of zero), domestic banks (generally, risk weight of 20 percent) and corporate exposures (risk weight of 100 percent). Sovereigns and foreign banks are subject to risk weights that range as high as 150 percent and are determined by reliance on the Organization for Economic Co-operation and Development (OECD) Country Risk Classification for the relevant country (rather than based on credit ratings, as in the original Basel II framework). 5

B. Exposure Amounts for OTC Transactions

The exposure amount attributable to a derivatives transaction, or a set of derivatives transactions, is the sum of two components: first, a current exposure component and, second, a potential future exposure (“PFE”) component.

1. Single Swaps

The “current credit exposure” for a single derivatives transaction is the greater of the transaction’s mark-to-market value or zero. 6 In other words, when a bank’s position under the transaction is flat or in-the-money to it, then the “current credit exposure” component counts as zero.

The PFE component of a single swap transaction equals the swap’s notional amount multiplied by a “Conversion Factor Matrix” contained in Subpart D, §_.34(a). The new proposed matrix has been updated from the one currently in effect to include additional categories of transactions. The conversion factors contained in the matrix are based on both the perceived volatility of the transaction type and the transaction’s remaining maturity. The factors range from zero, in the case of interest rate swaps with a remaining maturity of less than one year, to 15 percent, in the case of transactions of non-standard types with remaining maturities of more than five years.

2. Multiple OTC Derivatives Contracts

With regard to both current credit exposure and PFE, whether swap transactions that are subject to a single master agreement can be treated together as a “netting set” depends largely on whether the agreement is a “qualifying master netting agreement.” The essence of a “qualifying master netting agreement” is that the agreement will, upon an event of default, reliably permit a party to terminate, apply close-out netting, and promptly liquidate or set-off collateral, with the assurance that a party’s own default will not disqualify it from receiving a full termination payment. 7

For multiple transactions under a qualified master netting agreement, the “net current credit exposure” is the greater of the sum of all mark-to-market values (both positive and negative) of the individual transactions subject to such agreement or zero. 8 In other words, when the bank’s aggregate net position under all of such transactions is flat or in-the-money to it, then the net current exposure amount will be zero.

For multiple transactions subject to a qualifying master netting agreement, the relevant PFE amount is not calculated by simply adding the PFE amounts for each individual transaction. Instead, a formula determines an “adjusted sum of the PFE amounts” in which a portion of the sum of the PFE amounts is multiplied by a fraction (equal to the ratio of the net current exposure to the gross current exposure) that should equal less than one in a great many cases and should often be far less than one when there are numerous transactions under the same

5 The other categories of risk weights contained in the General Risk Weight Provision that are most relevant to the derivatives market relate to supranational entities, U.S. public sector entities and foreign public sector entities.
6 Subpart D, §_.34(a)(1)(i).
7 See Proposal, Addendum 2: Definitions Used in the Proposal, at 177.
8 Subpart D, §_.34(a)(2)(i).
qualifying master netting agreement. The use of this fraction as a factor in the formula ensures what should in most cases be a significant benefit of using a qualifying master netting agreement.

II. Cleared Transactions

The Proposal establishes risk weightings that, in comparison with those for OTC transactions, are highly favorable for transactions that are cleared through qualifying central counterparties, or QCCPs. The General Risk Weight Provision generally applies risk weights of at least 20 percent to counterparties other than the United States and its agencies, the highest rated sovereigns, and certain supranational entities and multilateral development banks. In contrast, the risk weights generally applicable in relation to QCCPs are 2 percent and 4 percent.

Broadly, QCCPs are defined as central counterparties that are (i) designated financial market utilities under Title VIII of the Dodd-Frank Act, (ii) if located outside the United States, similarly regulated and supervised, or (iii) otherwise demonstrated to the satisfaction of the relevant agency to be in sound financial condition and subject to effective regulatory oversight and risk management standards, with full collateralization on a daily basis. In practice, most central counterparties would likely qualify under (iii); a Title VIII designation will be limited to a small handful of clearing entities that have been deemed “systemically important.”

A. Bank as Clearing Member Client

When a bank is a clearing member client, exposure amounts for its cleared transactions are generally calculated in the same manner as exposure amounts for OTC derivatives, except that when the collateral posted by the clearing member client bank is held in a manner that is not bankruptcy remote, then the trade exposure amount also includes the value of that collateral.

The risk weightings for transactions cleared through QCCPs are generally significantly lower than for OTC transactions. The risk weight will be 2 percent if, among other things, “the collateral posted by the [bank] to the Q CCP or clearing member is subject to an arrangement that prevents any losses to the clearing member client due to the joint default or a concurrent insolvency, liquidation, or receivership proceeding of the clearing member and any other clearing member clients of the clearing member.” If the central counterparty is a Q CCP but no such arrangement is in place, then the risk weight will be 4 percent.

If the central counterparty does not qualify as a Q CCP, the relevant risk weight will be determined in accordance with the General Risk Weight Provision as the risk weight appropriate for such central counterparty; this would likely be considered as a corporate-type exposure with a risk weight of 100 percent. The General Risk Weight Provision will also determine the risk weight in relation to collateral posted by a bank in an arrangement that is not bankruptcy remote. If the collateral is bankruptcy remote from each of the central counterparty, the clearing member and other clearing member clients of that clearing member, then no risk weight applies to such collateral.

B. Bank as Clearing Member

The risk weight rules for banks as clearing members are similar to those for banks as clearing member clients. Trade exposure amounts for cleared transactions are generally calculated in the same manner as are exposure amounts for OTC derivatives transactions, except that, when the collateral posted by the clearing member bank is

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9 See Subpart D, § _34(a)(2)(ii).
10 See Proposal, Addendum 2: Definitions Used in the Proposal, at 176.
11 See Subpart D, § _35(b)(2).
14 Subpart D, § _35(b)(3)(ii).
15 Subpart D, §§ _35(b)(4).
held in a manner that is not bankruptcy remote, then the trade exposure amount also includes the fair value of that collateral.  

There are only two risk weights that may apply to cleared transactions for a bank acting as a clearing member. If the central counterparty is a QCCP, then the risk weight will be 2 percent. If the central counterparty is not a QCCP, then the risk weight will be determined in accordance with the General Risk Weight Provision, which will also determine the risk weight for collateral that is not held in a bankruptcy remote manner. 

Where a bank is a clearing member of a central counterparty, a risk weighting will also apply to its contributions to that central counterparty’s default fund. The entire amount of a default fund contribution to a central counterparty that is not a QCCP is subject to a risk weight of 1,250 percent—capital must be held essentially on a dollar-for-dollar basis. In relation to default fund contributions to QCCPs, the Proposal contains complex formulae aimed at, first, calculating the amount of capital that a QCCP would, if it were a bank, be required to maintain; second, comparing that hypothetical capital requirement with the amount of the QCCP’s default fund that is funded by the QCCP itself; and third, allocating back to each clearing member its portion of the capital requirement. A risk weight of 1,250 percent applies only to the amount equaling the clearing member’s portion of the QCCP’s hypothetical capital requirement; much lower risk weights apply to any contributions in excess of this amount.

III. Treatment of Credit Risk Mitigants

A. Financial Collateral

There are two distinct options for banks who wish to recognize the credit risk mitigating effects of financial collateral posted under qualifying master netting agreements, the “simple approach” and the “collateralized haircut approach.”

Under the simple approach, to the extent a derivatives exposure is collateralized, a bank may substitute for the risk weight of the derivatives exposure an alternative risk weight relating instead to the collateral. As a general rule, the risk weight assigned to the collateralized portion of the relevant exposure must be at least 20 percent. However, there are exceptions to the 20 percent floor. A risk weight of zero may apply when the collateral consists of “cash on deposit,” or when the collateral is an exposure to a sovereign that qualifies for a zero risk weight under the General Risk Weight Provision and the bank discounts by 20 percent the market value of the collateral. In addition, a 10 percent risk weight may apply when there is a daily margin maintenance requirement and the collateral is an exposure to a sovereign that qualifies for a zero risk weight under the General Risk Weight Provision.

Under the collateralized haircut approach, the exposure amount is determined by means of a mathematical formula under which the value of the collateral is subtracted from the exposure amount for the relevant transactions, and then upward adjustments are made for both the market price volatility for the collateral and mismatches between a settlement currency and the currency in which posted collateral is denominated. With respect to these adjustments, a bank may use either haircuts set out in the Proposal or, with regulatory approval, its own internal estimates for haircuts.

The collateralized haircut approach requires sophisticated mathematics to determine its effect and is expected to be employed only by complex banks.

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16 Subpart D, § .35(c)(2)(i).
17 Subpart D, §§ .35(c)(3) and (4).
18 Subpart D, § .35(d); see also discussion at Proposal, Supplementary Information, II.E.3 at 50-51.
19 Subpart D, § .37(b)(2).
20 Subpart D, § .37(b)(3).
21 Subpart D, § .37(c).
B. Guarantees

Similar to the “simple approach” for collateral, the Proposal permits a bank to substitute for the risk weight associated with an exposure the risk weight associated with an eligible guarantor.22 The Proposal would significantly expand the types of eligible guarantors beyond those currently permitted. Such guarantors would include sovereigns, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, Federal Home Loan Banks, Farmer Mac, multilateral development banks, depository institutions, bank holding companies, savings and loan holding companies, credit unions, foreign banks, and investment grade rated corporations (other than monoline insurers or similar entities) whose credit is not positively correlated with the credit risk of the exposures that it is guaranteeing.23 In order to qualify as eligible, a guarantee must satisfy several requirements designed to ensure that the guarantee is unconditional (there is one limited exception for certain conditional guarantees by the U.S. government), readily accessible, and enforceable.24 Partial substitutions of the risk weight associated with an eligible guarantor are permitted when an eligible guarantee is limited in amount or has a remaining maturity shorter than that of the underlying obligation.


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22 Subpart D, § _.36(a).
The CFTC’s Interpretive Letters Regarding Securitizations, REITs and the Definition of “Commodity Pool”

In two interpretive letters issued on October 11, 2012 (collectively, the “Interpretive Letters”), the Division of Swap Dealers and Intermediary Oversight (the “Division”) of the Commodity Futures Trading Commission (the “CFTC”) gave guidance as to which securitization vehicles (each hereinafter, an “SV”) and which real estate investment trusts (each hereinafter, a “REIT”) may enter into swaps and yet fall outside of the definition of “commodity pool” under the Commodity Exchange Act (the “CEA”) as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).

The possibility that REITs and SVs might be characterized as commodity pools arises primarily because Dodd-Frank amended the definition of “commodity pool” to include enterprises that are operated for the purpose of trading in swaps. Historical guidance as to what constitutes a “commodity pool” is somewhat sparse. However, whether or not an enterprise may constitute a commodity pool by reason of its entering into derivatives may matter a great deal to the enterprise and persons associated with it because, among other things:

- commodity pools and the persons operating them are subject to regulation by the CFTC including, without limitation, the requirement that such persons register as commodity pool operators; and

- an entity that is not a commodity pool may, subject to certain requirements, avail itself of the end-user exception from the mandatory clearing of swap transactions; a commodity pool may not.

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1 CFTC Letter No. 12-14, Interpretation, October 11, 2012, Division of Swap Dealers and Intermediary Oversight, “Request for Exclusion from Commodity Pool Regulation for Securitization Vehicles” (the “Securitization Letter”); and CFTC Letter No. 12-13, Interpretation, October 11, 2012, Division of Swap Dealers and Intermediary Oversight, “Request for Interpretation of the Definition of ‘Commodity Pool’ under Section 1a(10) of the Commodity Exchange Act” (the “REIT Letter”).

2 The CFTC’s interpretations relate to swaps and not to the security-based swaps that are subject to regulation by the Securities and Exchange Commission. This is generally the case with the CFTC’s guidance.

3 The Interpretive Letters also address the same question with respect to “pool,” as defined in CFTC regulation 4.10(d), a term the CFTC considers to be substantially identical to “commodity pool” under the CEA. See Securitization Letter at 2; REIT Letter at 3.

4 7 U.S.C. 1, et seq.

5 The definition of “commodity pool,” contained in § 1a(10) of the CEA, includes any “investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests,” which now include, among other things, any swap. Under CEA § 1a(10)(B), the CFTC, “by rule or regulation, may include within, or exclude from, the term ‘commodity pool’ any investment trust, syndicate, or similar form of enterprise if the Commission determines that the rule or regulation will effectuate the purposes” of the CEA.

Market participants may find the narrowness of the relief afforded by the Interpretive Letters concerning; the letters appear to leave open the possibility that many SVs and REITs not typically considered heretofore to constitute commodity pools may be subject to regulation as such. The Interpretive Letters are significant not only because of their specific determinations but because they indicate the fact-intensive nature of the inquiry that the CFTC will likely make in future determinations as to whether entities entering into swaps (including SVs and REITs not expressly covered in the Interpretive Letters) constitute “commodity pools.”

Taken together, the Interpretive Letters may be understood to indicate that the CFTC will be less likely to determine an entity is operated for the purpose of trading in swaps, and therefore less likely to find that an entity constitutes a commodity pool, to the extent that:

- the entity enters into swaps not in order to take a market view but rather to hedge or mitigate risks from its primary business and, in the case of a securitization, to alter the payment characteristics of the SV’s cash flows;
- the entity is operated in accordance with regulations that limit the nature of the swaps that the entity may transact; and
- there is no reasonable basis to expect that swaps will contribute materially to the profits or income (or loss) of the entity or of its stakeholders.

I. The Securitization Letter

In the Securitization Letter, addressing requests for interpretation made by the American Securitization Forum and the Securities Industry and Financial Markets Association, the Division rejected the premise that an entity could constitute a commodity pool only if its “principal purpose” is to trade in commodity interests. The Division likewise rejected the assertion that the factors set out in a leading case interpreting the term “commodity pool,” Lopez v. Dean Witter Reynolds, Inc., 805 F.2d 880 (9th Cir. 1986), should be dispositive. Rather, the Division found, whether or not an entity constitutes a commodity pool depends on an evaluation of “the facts and circumstances presented in their entirety.”

The Division “tend[ed] to agree that certain entities that meet certain of the criteria you identify are likely not commodity pools.” These include SVs that:

- do not have multiple equity participants;
- do not make allocations of accrued profits or losses; and

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7 Under § 2(b)(7)(C)(i) of the CEA, a commodity pool constitutes a “financial entity.” Only an entity that is not a “financial entity” may take advantage of the exceptions for end-users (provided by § 39.6 of the CFTC's regulations) from the requirement that swaps be cleared. See End-User Exception to the Clearing Requirement for Swaps; Final Rule, 77 Fed. Reg. 42560, 42590 (July 19, 2012).
8 Securitization Letter at 3.
9 See Securitization Letter at 4. The Lopez court found that the following factors indicated the existence of a commodity pool: an investment organization in which the funds of various investors are solicited and combined into a single account for the purpose of investing in commodity interests; common funds used to execute transactions on behalf of the entire account; participants sharing pro rata in accrued profits or losses from commodity trading; and transactions being traded by a commodity pool operator in the name of the pool rather than in the name of any individual investor. See Lopez v. Dean Witter Reynolds, Inc., 805 F.2d at 884.
10 Securitization Letter at 4.
- only issue interests in the form of debt or debt-like interests with a stated interest rate or yield and principal balance and a specific maturity date.\(^{11}\)

At the same time, the Division found “overly broad” the request for “relief for entities operating to some extent under any covered bond statute, entities involved in collateralized debt obligations, entities involved in collateralized loan obligations, any insurance-related issuances, and any other synthetic securitizations.” The descriptions provided to the Division of such entities “do not preclude the issuer or, in the case of a covered bond, the related covered pool from being a commodity pool.”\(^{12}\)

The Division went on to find that an SV is “substantively distinguishable”\(^{13}\) from, and will not constitute, a commodity pool if it conforms to the following criteria:

- the issuer of the asset-backed securities is operated consistent with the conditions set forth in Regulation AB,\(^{14}\) or Rule 3a-7,\(^{15}\) whether or not the issuer’s security offerings are in fact regulated pursuant to either regulation, such that the issuer, pool assets, and issued securities satisfy the requirements of either regulation;

- the entity’s activities are limited to passively owning or holding a pool of receivables or other financial assets (either fixed or revolving) that by their terms convert to cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders;

- the entity’s use of derivatives is limited to the uses of derivatives permitted under the terms of Regulation AB, which include credit enhancement and the use of derivatives such as interest rate and currency swap agreements to alter the payment characteristics of the cash flows from the issuing entity;

- the issuer makes payments to securities holders only from cash flow generated by its pool assets and other permitted rights and assets, and not from or otherwise based upon changes in the value of the entity’s assets; and

- the issuer is not permitted to acquire additional assets or dispose of assets for the primary purpose of realizing gain or minimizing loss due to changes in market value of the vehicle’s assets.\(^{16}\)

The Securitization Letter notes that the Division remains “open to discussions with securitization sponsors to consider the facts and circumstances of their securitization structures with a view to determining whether or not they might not be properly considered a commodity pool.”\(^{17}\)

II. The REIT Letter

In the REIT Letter, addressing a request for interpretation made by the National Association of Real Estate Investment Trusts (“NAREIT”), the Division determined that certain REITS, known as equity REITS, fall outside the definition of “commodity pool.”

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\(^{11}\) Securitization Letter at 4.

\(^{12}\) Securitization Letter at 4.

\(^{13}\) Securitization Letter at 5.

\(^{14}\) 70 Fed. Reg. 1506 (January 7, 2005). Regulation AB sets out detailed rules addressing registration, disclosure and reporting requirements for asset-backed securities.

\(^{15}\) 17 CFR 270.3a-7. Rule 3a-7 sets out the requirements for issuers of asset-backed securities not to constitute investment companies for purposes of the Investment Company Act of 1940.

\(^{16}\) Securitization Letter at 4-5.

\(^{17}\) Securitization Letter at 5-6.
In the REIT Letter, as in the Securitization Letter, the Division stated that the term “commodity pool” may apply to entities other than those whose “principal purpose” is to trade in commodity interests: “there may be entities whose primary business focus may be outside the commodity interest sphere, yet may still have a significant exposure to those markets, which may implicate the Commission’s concerns regarding both customer and market protection.”

The Division determined that an equity REIT does not constitute a commodity pool if the REIT:

- primarily derives its income from the ownership and management of real estate and uses derivatives for the limited purpose of mitigating exposure to interest rate or currency fluctuation risk;

- is operated so as to comply with all of the requirements of a REIT election under the Internal Revenue Code, including the requirements that
  - at least 75 percent of the equity REIT’s annual gross income must be derived from qualifying real estate related sources (the “75 Percent Test”); and
  - at least 95 percent of an equity REIT’s annual gross income must consist of items that would satisfy the 75 Percent Test plus other passive income such as interest and dividends (the “95 Percent Test”); and

- has identified itself as an equity REIT in its last U.S. income tax return and continues to qualify as such, or, if the REIT has not yet filed its first tax filing with the Internal Revenue Service, the REIT has stated its intention to do so and effectuates its stated intention.

The Division’s determination was based, in part, on the representations by NAREIT that, among other things:

- equity REITs are understood by market participants to constitute operating companies rather than investment pools;

- the use of derivatives by equity REITs is limited to activities supporting the primary focus of real estate ownership and operation through a reduction in the cost of capital;

- the limited use of derivatives by equity REITs is further enforced through the Internal Revenue Code, under which a “qualified REIT hedging transaction” is limited to those transactions entered into:
  - in the normal course of business primarily to manage the risk of interest rate, price, or currency fluctuations related to the carrying of qualifying real estate assets; or
  - primarily to manage the risk of currency fluctuations with respect to any qualifying income under the 75 Percent Test and the 95 Percent Test; and

- if income is derived from a transaction that is not a “qualified REIT hedging transaction” under the Internal Revenue Code, it is “nonqualifying income,” which, in order for an entity to maintain its status as a REIT, cannot exceed 5% of the REIT’s annual gross income.

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18 REIT Letter at 4.
19 REIT Letter at 4-5.
20 REIT Letter at 5.
21 REIT Letter at 2-3.
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Dodd-Frank Considerations for End-Users of Derivatives

More than two years after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), regulations under Title VII of that legislation have reached a sufficiently advanced point that end-users of derivatives will soon be required to take action to ensure their compliance with the regulatory scheme and their continued access to the derivatives market. In this article, we review the current state of play for end-users, the actions they must take or should consider taking, and the likely timeframe for the relevant regulations’ implementation.

The considerations highlighted in this article relate to interest rate swaps, foreign exchange transactions, commodity swaps and certain credit swaps, all of which are regulated by the Commodity Futures Trading Commission (the “CFTC”). They do not generally relate to “security-based swaps” subject to the jurisdiction of the Securities and Exchange Commission, whose rule-making process has lagged behind that of the CFTC.

I. Dodd-Frank Protocol

End-users will need to adhere to ISDA’s August 2012 DF Protocol (the “Protocol”) or enter into alternative documentation offered by some swap dealers. The Protocol, an industry-designed mechanism to amend swap agreements to comply with numerous CFTC regulations, addresses, among other regulations, certain of the CFTC’s external business conduct standards1 that impose on swap dealers and major swap participants additional pre-transaction know-your-customer and due diligence requirements as well as heightened standards for dealing with “Special Entities” such as municipalities and pension plans.

The external business conduct standards are scheduled to go into effect on January 1, 2013, when most swap dealers are expected to be required to register as such. Starting on that date, it is unlikely that any swap dealer will agree to enter into any swap with an end-user who has not yet adhered to the Protocol or entered into alternative documentation with comparable effect.

Similar to other ISDA protocols, the Protocol is a multilateral contractual amendment mechanism through which any two adhering parties may amend the relevant agreements between them. Adhering to the Protocol requires, among other things, the submission of an adherence letter, the payment of an adherence fee, and the completion of a detailed questionnaire. Adherence instructions are posted on ISDA’s website (at www.isda.org).

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II. Election of End-User Exemption

CFTC regulations mandate that certain swaps will be required to be cleared by clearinghouses. While the regulators’ preference for centrally cleared swaps is evident, however, the extent to which cleared swaps will be priced competitively with traditional bilateral swaps remains to be seen. In addition, clearing relationships will require end-users to negotiate additional documentation (discussed in Part III below).

The CFTC has, however, provided an exemption for mandatory clearing (the “End-User Exemption”) that applies to certain transactions entered into by certain end-users.2 Although there is still some time before any end-user swaps will be required to be cleared,3 end-users should determine the extent to which they and their transactions are likely to qualify for the End-User Exemption and, to the extent practicable, take the required steps to affirmatively elect that exemption. In particular, end-users that are public companies and thus subject to the requirement of a board resolution, as set out below, should move expeditiously to take the steps required to elect the End-User Exemption.

The End-User Exemption is available to end-users who (i) fulfill reporting requirements by providing to a swap data repository (“SDR”) information as to applicability of the End-User Exemption, (ii) do not constitute “financial entities” and (iii) use the applicable swap or swaps “to hedge or mitigate commercial risk.”4

A. Reporting for Purposes of the End-User Exemption

CFTC regulations require end-users to report information to SDRs indicating that the requirements of the End-User Exemption have been met. This information can be reported on a swap-by-swap basis, in the ordinary course of swap data reporting under the CFTC’s recordkeeping and reporting requirements. However, much of this information can instead be reported on a yearly basis by an end-user electing the End-User Exemption.5 End-users should lay the groundwork for making the first yearly report.

For public companies, that groundwork includes convening a meeting of “an appropriate committee” of the “board of directors (or equivalent body)” to review and approve “the decision to enter into swaps that are exempt” from mandatory clearing requirements.6 As a practical matter, public company end-users should consider taking this action as soon as practicable, given meeting schedules, the need to provide board and committee members with appropriate background materials, and the necessity to timely file the required information with an SDR. The other information permitted to be reported on a yearly basis includes confirmation that the relevant swaps will be used to hedge or mitigate commercial risk and the means by which the party electing the End-User Exemption generally meets its obligations associated with swaps that are not cleared.7

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3 CFTC regulations make clear that no swap with any non-financial end-user eligible to elect the End-User Exemption (see Part II(B) below) will be required to be cleared earlier than 270 days after the date on which the CFTC determines that swaps of the relevant type must be cleared. See Swap Transaction Compliance and Implementation Schedule; Clearing Requirement Under Section 2(h) of the CEA, 77 Fed. Reg. 44441 (July 30, 2012). To date, the CFTC has made no such determination that any swap must be cleared.
4 17 C.F.R. § 39.6(a).
6 17 C.F.R. § 39.6(b)(1)(iii)(D)(2).
7 17 C.F.R. § 39.6(b)(1)(iii).
The yearly report must be filed before an end-user’s electing to use the exemption from mandatory clearing. Swap dealers, which are required to document their reasonable basis to believe that the requirements of the End-User Exemption have been met, will likely require proof that end-users have made required filings.

B. Entities Eligible to Elect the End-User Exemption

Only end-users that are not “financial entities” may elect the End-User Exemption. In order to qualify as a non-financial entity, an entity must not be:

- a swap dealer or major swap participant;
- a security-based swap dealer or a major security-based swap participant;
- a commodity pool;
- a private fund (a subset of investment companies as defined in the Investment Company Act of 1940);
- an employee benefit plan or governmental plan (as defined under the Employee Retirement Income Security Act of 1974); or
- a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature (as defined under the Bank Holding Company Act of 1956).

An affiliate of an entity that qualifies for the End-User Exemption may itself qualify for the End-User Exemption, but “only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity” and the affiliate is not a swap dealer, major swap participant, commodity pool, investment company of a specified type, or a bank holding company with more than $50 billion in consolidated assets. Further, certain financing subsidiaries using derivatives to hedge interest rate and foreign currency exposures relating to facilitating the purchase or lease of products manufactured by an affiliate are expressly excluded from the definition of “financial entity.” Also excluded from the definition of “financial entity” are banks and certain similar entities with total assets of $10 billion or less.

C. Hedging or Mitigating Commercial Risk

There are three ways in which a swap is deemed to hedge or mitigate commercial risk and therefore falls within the End-User Exemption.

First, a swap is deemed to hedge or mitigate commercial risk when it is “economically appropriate,” in the context of the management of a commercial enterprise, to reduce risks arising from such factors as the potential change in the value of the assets, liabilities, services, inputs, products, or commodities of the business, including any such change relating to interest rate or foreign exchange movements.

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10 CEA §§ 2(h)(7)(D)(i) and (ii); see also 77 Fed. Reg. at 42563-64.
11 CEA § 2(h)(7)(C)(iii).
12 17 C.F.R. § 39.6(d).
13 17 C.F.R. § 39.6(c)(1)(I).
Second, a swap is deemed to hedge or mitigate commercial risk when it qualifies for hedging treatment under certain specified accounting standards, and such swap is not used for a purpose that is in the nature of speculation, investing or trading.\(^\text{14}\)

Finally, a swap falls within the End-User Exemption if it qualifies as bona fide hedging for purposes of an exemption from position limits under the CEA.\(^\text{15}\)

### III. Swap Clearing Documentation

If an end-user wishes to enter into cleared swaps, or is not certain that all of its swaps will meet the requirements of the End-User Exemption, that end-user should negotiate documentation to facilitate the clearing of swaps. It would be prudent for end-users to commence these negotiations in the near future if they have not yet started them.

There are three forms of documentation that end-users are likely to have to negotiate. The first of these is the customer agreement for clearing transactions, which typically varies from dealer to dealer. In many cases, this will be the standard futures account agreement offered by a futures commission merchant and some end-users may already be party to such an agreement if they are active in the futures markets. The other two have been jointly published by ISDA and Futures Industry Association (“FIA”). These are the FIA-ISDA Cleared Derivatives Addendum, which supplements the terms of customer agreements in relation to cleared swaps, and the FIA-ISDA Cleared Derivatives Execution Agreement, which addresses contingencies that may arise if a swap is rejected for clearing.

### IV. Swap Data Reporting Requirements

CFTC regulations impose an extensive swap data reporting regime, under which market participants are required to report detailed swap transaction data (including with respect to existing swaps) to SDRs.\(^\text{16}\) For many non-end-users, including swap dealers and major swap participants, reporting requirements are scheduled to go into effect by January 10, 2013.\(^\text{17}\) Non-financial end-users, however, will not have any reporting responsibilities until April 10, 2013, and even then, their reporting responsibilities will be modest, arising primarily in limited circumstances when they face other end-users and agree to be the reporting party for the swap.\(^\text{18}\)

#### A. Legal Entity Identifiers

There is, however, one reporting-related requirement that end-users would be prudent to attend to in the near future. One piece of data that will be generally reportable for each swap when the reporting requirements go into effect will be each transacting party’s Legal Entity Identifier (“LEI”). Although the relevant CFTC releases appear to contemplate that not all parties will have obtained LEIs at the time when swap data reporting commences,\(^\text{19}\) LEIs are requested as part of the Protocol adherence process and end-users would be well-advised to obtain one in the near future. LEIs are available from DTCC-SWIFT (go to http://www.ciciutility.org/).

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\(^\text{14}\) 17 C.F.R. § 39.6(c)(1)(iii).
\(^\text{15}\) 17 C.F.R. § 39.6(c)(1)(ii). However, on September 28, 2012, the United States District Court for the District of Columbia vacated the CFTC’s positions limit rule, which by its terms applied to end-users, and remanded it to the CFTC. See International Swaps and Derivatives Association, et al. v. United States Commodity Futures Trading Commission, No. 1:11-cv-02146-RLW, 2012 WL 4466311 (D.D.C. Sept. 28, 2012). The Court’s decision appears to leave open the possibility that the CFTC will be able to impose position limits at a later time. See generally Position Limits for Futures and Swaps, 76 Fed. Reg. 71626 (Nov. 18, 2011), 17 C.F.R. § 150.2.
\(^\text{17}\) See 77 Fed. Reg. at 1228, 2136 and 35200.
\(^\text{18}\) 17 C.F.R. §§ 43.3, 45.8 and 46.5.
\(^\text{19}\) See, e.g., 77 Fed. Reg. at 2211, 35231.
B. Other Reporting Considerations

In preparation for the end-user reporting requirements to go into effect in April of next year, end-users should determine for which existing swaps, if any, they will be responsible to report data. In addition, end-users should consider implementing procedures to assure that any reporting obligations are met (or, to the extent practicable, that they will have no reporting obligations).

V. Recordkeeping Requirements

Like the CFTC’s reporting requirements, the CFTC’s recordkeeping requirements are scheduled to go into effect for end-users on April 10, 2013. Under the recordkeeping requirements, end-users are required to keep “full, complete and systematic records” for all new swaps and to retain such records for at least five years following final termination of each new swap. There are separate recordkeeping requirements for existing swaps.

Given the recordkeeping requirements for existing swaps, end-users should retain all records relating to existing swaps. In addition, end-users should consider implementing procedures to assure that recordkeeping requirements are met.

VI. OTC Margining and Custodial Documentation

Margin requirements for uncleared swaps are not yet finalized. Under proposed rules that the CFTC released in April 2011, parties facing swap dealers would be required, subject to applicable thresholds, to post both initial and variation margin. After final margin requirements are established, end-users will need to evaluate their credit support arrangements with their dealer counterparties in light of those requirements and determine whether any adjustments or modifications are necessary or appropriate.

Further, Dodd-Frank gives end-users the right to require that any initial margin they post in relation to OTC swaps be held by a third party custodian. If an end-user intends to require a custodial arrangement, it will need to negotiate documentation that achieves this goal and otherwise complies with Dodd-Frank and the regulations thereunder.

VII. Large Trader Reporting

Although they are likely to be applicable to only a small subset of end-users, end-users should be aware of books and records requirements in relation to “large traders” of swaps relating to physical commodities.

The books and records requirements apply to every person who trades in swaps which, when converted into futures equivalent positions in specified futures contracts in accordance with the CFTC’s methodology, exceed a specified amount. All such traders in such swaps are required to keep books and records showing all records for the swap and swaption transactions resulting in such positions, transactions in the cash commodity underlying such positions, and all commercial activities that are hedged by such positions. The books and records requirements are currently in effect.

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20 77 Fed. Reg. at 2136, 35200.
21 17 C.F.R. §§ 45.2(b), 45.2(c).
22 17 C.F.R. § 46.2.
24 CEA § 4s(l).
26 17 C.F.R. § 20.6(c).
VIII. Potential Benefits to End-Users

Given the extent and complexity of the CFTC's regulations, it is possible to lose sight of the fact that the regulations are motivated, in part, by a desire to level the playing field between swap dealers and end-users and better allow end-users to mitigate their risks in relation to dealers. The CFTC’s regulations include requirements that a swap dealer:

- prior to entering into a swap, disclose to its counterparty material information to allow the counterparty to assess the dealer’s incentives, including a mid-market mark of the relevant swap;27
- in certain circumstances, provide its counterparty with a scenario analysis that covers a range of assumptions, including severe downside stress scenarios;28 and
- upon a request by a counterparty prior to entering into any swap, provide to such counterparty a written statement of all terms of the swap, other than pricing and other terms to be agreed upon entering into the swap.29

End-users should also take some comfort from the added protections afforded by the cleared swap environment and from the possibility that final CFTC regulations may require swap dealers to post collateral to end-users. End-users should also be aware, however, that the additional costs and burdens of complying with the new Dodd-Frank regime, particularly the increased margin and capital costs associated with swaps activities, may negatively affect liquidity and pricing in the swaps market and thus to some degree offset these benefits.

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27 17 C.F.R. §§ 23.431(a), 23.431(d).
28 17 C.F.R. §§ 23.431(b).