

Dodd-Frank: The Impact on the Hedging Activities of the Corporate Treasurer

What if, on July 21, 2010, the treasurer of a corporate client had sat down with the Winston & Strawn Derivatives Team to discuss the impact to her of Title VII of the Dodd-Frank Act (“Dodd-Frank”), which was signed into law earlier that day. Set out below is one possible version of a transcript of that discussion.

Treasurer: I am the treasurer of a large manufacturing corporation based in the United States. To date the Company has regularly entered into over-the-counter derivatives to hedge its exposure to fluctuation in interest rates, foreign exchange rates and commodity prices. How will Dodd-Frank affect the Company’s day-to-day business practices?

Winston: From where we stand today, because so many details are going to be filled in as the CFTC promulgates regulations, it is difficult to know the full impact of Dodd-Frank on the Company’s day-to-day hedging activities. However, Dodd-Frank is specific enough in a few areas that we can advise you of certain changes to expect. Generally, Dodd-Frank changes the whole approach to OTC derivatives from one where few activities were regulated to one where most activities are. Did you say that the Company’s hedging activities are limited to interest rate, FX and commodity trades?

Treasurer: Almost exclusively, yes, and on a cash-settled basis. Although we did enter into some equity trades in connection with an accelerated share buy-back we did a few years ago.

Winston: Let’s set aside the equity trades for the moment. Let’s also set aside any commodity transactions in agricultural products.

The Company clearly satisfies the criteria to be an eligible contract participant and thus its derivatives activities are not limited to exchange traded products.

The types of trades into which the Company enters almost certainly will be characterized as “swaps” under Dodd-Frank and “swaps” will be regulated by the CFTC. The effect of this characterization is that, as a general matter, Dodd-Frank requires (i) clearing of all swaps that can be cleared, (ii) trading of all cleared swaps and (iii) reporting of all swaps to the CFTC or a registered swap data repository. On the first requirement, the CFTC will determine the types of swaps that are capable of being cleared. However, the interest rate, FX and commodity transactions that the Company traditionally has entered are the “poster children” for trades that can be cleared and almost certainly will be categorized as such, with the exception of spot FX transactions. In addition, the Treasury, after study, has the ability to exempt FX forwards and FX swaps from the requirements for swaps if it determines that such exemption is justified.

Treasurer: Isn’t “clearing” what happens with the exchange-traded futures the Company enters?

Winston: Yes, the clearing of a swap is similar to what happens to a futures contract in that a clearinghouse (a derivatives clearing organization or a DCO) would be interposed (through a legal process referred to as novation) between the Company and its counterparty so that

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all rights and obligations of the Company would be owed by and to the DCO, not the counterparty, and all rights and obligations of the counterparty would be owed by and to the DCO, not the Company. In addition, the Company (and the counterparty, for that matter) would be required to post initial and variation margin with the DCO, again much like the margin requirements for futures transactions.

However, I have some good news for you; it looks like the Company may not have to worry about the swap clearing process unless it wants to.

Treasurer: What do you mean?

Winston: Dodd-Frank exempts a swap from the clearing requirements if one of the counterparties to the swap: (i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the CFTC how it generally meets its financial obligations associated with entering non-cleared swaps. This is the so-called “end user exemption.” Dodd-Frank defines a financial entity to include a swap dealer, a major swap participant (MSP), a commodity pool, a private fund under the Investment Advisor’s Act, an employee benefit plan and a person predominantly engaged in a banking business or financial activities. With the possible exception of an MSP, the Company does not fit into any of these categories, so the Company ought not to be considered a financial entity. The Company enters into these transactions to hedge commercial risks so the second requirement should be met. Finally, the Company has never defaulted on a derivative transaction and has good credit standing so the Company should be able to demonstrate how it meets its financial obligations associated with entering these transactions. With respect to MSP, it is possible that the CFTC will set thresholds for an MSP so low as to ensnare the Company’s trading activities. However, with respect to the Company, we believe this would contravene the intent of the end user exemption. To avoid speculating on CFTC regulations that have yet to be written, we defer discussion of this topic to such date as it may become relevant to the Company.

Thus, overall the Company seems an excellent candidate for this exemption, meaning that the Company’s swaps should not be required to be cleared. If the Company prefers to have some or all of the swaps cleared, Dodd-Frank permits it to elect clearing and, if it so elects, it may select the DCO at which each swap is to be cleared.

Treasurer: So, assuming the Company qualifies for the end-user exemption, is Dodd-Frank a big non-event for the Company?

Winston: Unfortunately no. Even though the Company’s swaps are not required to be cleared, they will have to be reported first to the CFTC and then, when established, to a registered swaps data repository.

Treasurer: So the Company is going to have to disclose publicly its hedging strategy?

Winston: Not quite. The actual information that will be required to be disclosed will be set out in the CFTC regulations that are to be developed. However, Dodd-Frank does provide that, for swaps that are not cleared, the reporting will be in a manner that does not disclose the transactions and market positions of any person. Once the technology is there, the reporting will have to be in real time.

If the Company’s counterparty is a swap dealer or MSP, it will be required to report swaps on behalf of the Company. If the counterparty is another end user, the Company and the counterparty will need to select the party that is required to report. We would expect that, at a minimum, the notional size of each trade together with the term and pricing information will be required to be reported.

Treasurer: Are there are consequences beyond the reporting requirement?

Winston: Yes, both directly and indirectly. The CFTC is to develop minimum margin standards for non-cleared swaps. Thus, the Company may find itself required to post both initial and variation margin for these transactions. Indirectly, the swap dealers and MSPs that are the Company’s typical counterparties are themselves subject to a new regulatory regime in which, among others, they are required to meet minimum capital and margin requirements and to adhere to business conduct standards. These standards will require them to verify that the Company is an eligible contract participant, to provide detailed disclosures of the risks in the trades and to provide daily mark-to-market quotations. From the Company’s perspective many of these changes will provide more information to the Company and are not likely to be onerous. How the increased costs incurred by the counterparties in meeting these requirements will be borne remains to be seen.

Briefing

Treasurer: How does Dodd-Frank affect the Company's transactions that were outstanding when it was enacted earlier today?

Winston: Dodd-Frank is clear that swaps outstanding on the date of its enactment are not subject to the clearing requirements (as noted above, this may not be relevant to the Company in any event) but are subject to the reporting requirements. There is some question as to whether such swaps could be subject to minimum margin requirements imposed by the CFTC. Several prominent sponsors of the Act, including Senator Dodd, have gone on record stating that retroactive application of the margin requirements was not the legislative intent, but this remains an area of concern, particularly given the legal certainty provisions of Dodd-Frank that prohibit termination of any contract as a result of any provision of the Act, unless such termination right has been expressly reserved.

Treasurer: Will the Company still use ISDAs to document these transactions?

Winston: We see no reason why ISDAs will not continue to be used for these transactions, particularly non-cleared swaps. However, certain provisions will need to be modified or added to the Schedule to address changes brought on by Dodd-Frank.

Treasurer: Do all of these issues arise only when I am dealing with U.S. counterparties?

Winston: No. As a U.S. entity, the Company is subject to the jurisdiction of the CFTC and SEC and all the requirements of Dodd-Frank and the regulations to be issued that apply to U.S. entities.

Turning to those equity trades you did a few years ago, under Dodd-Frank they likely will be characterized as security-based swap agreements, in which case they will be regulated by the SEC, not the CFTC. However, the provisions of Dodd-Frank that deal with security-based swaps largely parallel the swap provisions. Thus, the advice above (e.g. regarding clearing, the exemption from clearing and reporting) generally would be the same for the equity trades, although the regulatory requirements will be set by the SEC.

Finally, to round out our discussion in the context of commodity transactions, we note that trades in agricultural commodities remain subject to a specific CFTC regulatory regime.

Please direct any questions concerning the above or, more broadly, concerning Title VII of Dodd-Frank to any of the below partners in our derivatives practice:

Chicago

Michael O'Brien mpobrien@winston.com (312) 558-8097

Michael Philipp mphilipp@winston.com (312) 558-5905

Washington, D.C.

Peter Malyshev pmalyshev@winston.com (202) 282-5691

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