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From our Task Force on Modernizing Financial Services Regulation

Swap Clearing Proposals Leave Uncertainties for Financial Firms

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December 27, 2010 -- Financial firms have expressed concerns about provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") that are designed to promote central clearing of swaps, including both swaps that are "security-based" and those that are not.

> NOTE: Dodd-Frank gives primary responsibility to the SEC for regulating security-based swaps and to the CFTC for regulating non-security-based swaps. In most respects relevant to this Alert, however, the SEC and the CFTC (the "Commissions") propose to treat both types of swap similarly. *For simplicity, this Alert generally uses the term "swap" to include both security-based and non-security-based swaps.*

Such firms, including mutual funds, hedge funds, and insurance companies, frequently enter into swaps, either to generate returns or to mitigate risks. Central clearing would make it more costly or burdensome for such firms to use many types of swaps.

Although Dodd-Frank gives the Commissions considerable latitude to respond to such concerns, recent Commission proposals, discussed below, leave in doubt how satisfactory those responses ultimately will be from the standpoint of financial firms.

I. The "End-User" Exception from Mandatory Clearing

The SEC issued a release on December 15, 2010 (available here[1]) that proposes a new rule prescribing the steps that a party to a security-based swap must follow in order to rely on the so-called "end-user" exception to any mandatory clearing requirements that otherwise would apply pursuant to Dodd-Frank. The SEC release followed a similar December 9, 2010 CFTC release (available here[2]) concerning the corresponding end-user exception that Dodd-Frank prescribes in the context of swaps that are not security-based.

Consistent with language in Dodd-Frank, the Commissions' proposals would generally limit the availability of the end-user exception to persons who are not "financial entities." Moreover, the term "financial entity" would be defined sufficiently broadly that, for example, most insurance companies, mutual funds, hedge funds and broker-dealers could not rely on the end-user exception.

Specifically, the term "financial entity" would include any (i) swap dealer; (ii) major swap participant; (iii) commodity pool; (iv) fund that relies on the exclusions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940; (v) employee benefit plan as defined in paragraphs (3) and (32) of ERISA Section 3; or (vi) person predominantly engaged in activities that are in the business of banking or are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956. Section 4(k)'s definition, in turn, is very broad, potentially encompassing the following types of activities: (a) lending, exchanging, transferring, investing for others, or safeguarding money or securities; (b) insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing or issuing annuities, and acting as principal, agent or broker for such activities; (c) providing financial, investment, or economic advisory services, including advising an investment company; and (d) underwriting, dealing in, or making a market in securities.

Thus, the Commissions are not proposing to allow even limited categories of financial firms (such as mutual funds or insurance companies) to rely on the end-user exception.

II. The Mandatory Central Clearing Requirement

Assuming the end-user exception is not available, a swap transaction may be required to be centrally cleared. As further discussed below, Dodd-Frank gives to the Commissions the authority and responsibility to determine whether such clearing is mandatory for a given type of swap.

Such a requirement could have adverse effects for financial entities that use swaps, regardless of whether those swaps are used for purposes of hedging or mitigating risks or for generating investment returns. Among other things, if swaps are centrally cleared, the clearing organization may impose fees and require the posting of amounts of collateral or margin that would not be required if two parties entered into the swap directly, without any intervening clearing organization. Thus, central clearing may increase the capital and other costs to the parties.

Such increased costs are especially likely to the extent that (i) the terms of the swap are customized or otherwise unusual or (ii) the swap or its components are difficult to value, volatile, or illiquid. Thus, for example, it is foreseeable that insurance companies would incur substantial additional costs if central clearing were required for certain customized swaps that they use to hedge and mitigate risks arising out of their insurance obligations.

However, if the Commissions believe that the costs and practical difficulties exceed the benefits of central clearing for a given type of swap, they presumably will not require central clearing for such swaps. Both Commissions have proposed rules governing the procedures they will follow in exercising their responsibilities to determine whether a particular type of swap must be centrally cleared. Although the Commissions recognize that Dodd-Frank aims generally to promote central clearing of swap transactions, the proposals provide little insight as to exactly where the Commissions will draw the line between swaps that are and swaps that are not subject to such clearing.

The CFTC's proposal for determining whether a given type of non-security-based swap must be cleared (available here[3]) was issued in late October 2010 and is largely procedural in nature. Although it sets forth many of the factors that would be relevant to the CFTC's determination about mandatory clearing for a given type of swap, it does not give much indication of how the CFTC would weigh those factors in a close case. The same is generally true of the analogous proposal of the SEC (available here [4]), which was issued December 15, 2010.

The CFTC, in its proposing release, noted that one of Dodd-Frank's purposes was to impose clearing and trade execution requirements on "standardized derivative products." However, it is unclear how the CFTC would actually implement this principle, including what would qualify as "standardized" for this purpose.

The SEC, in its proposing release, stated as follows:

> [A]n overly broad or narrow application of the mandatory clearing requirement could undermine the policy objectives of the Dodd-Frank Act. For example, a premature determination that a security-based swap is subject to mandatory clearing may, in certain circumstances, limit the ability of certain market participants to utilize that product (including for risk management purposes), which in turn could ultimately result in less clearing and more limited use of the security-based swap than might otherwise have been the case if it had been permitted to trade without being subject to a mandatory clearing requirement for a longer period of time.
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> On the other hand, an overly narrow application of the mandatory clearing requirement would undermine the potential benefits of central clearing for counterparties and the marketplace generally that [Dodd-Frank] was intended to provide. Moreover, because security-based swaps that are subject to the clearing requirement also are required to be executed on a national securities exchange or a swap execution facility if such exchange or facility makes the security-based swap available to trade, imposing a clearing requirement could have a substantial impact generally on the trading environment of the relevant instruments, which in turn could affect the relative transparency and liquidity of those instruments in ways that may promote, or detract from, the overall goals of the Dodd-Frank Act.

The SEC also quotes with apparent approval the following language from Senate Report 111-176[5]:

> Some parts of the OTC market may not be suitable for clearing and exchange trading due to individual business needs of certain users. Those users should retain the ability to engage in customized, uncleared contracts while bringing in as much of the OTC market under the centrally cleared and exchange-traded framework as possible. Also, OTC (contracts not cleared centrally) should still be subject to reporting, capital, and margin requirements so that regulators have the tools to monitor and discourage potentially risky activities, except in very narrow circumstances. These exceptions should be crafted very

narrowly with an understanding that every company, regardless of the type of business they are engaged in, has a strong commercial incentive to evade regulatory requirements.

To summarize, it is unclear where the Commissions will draw the line between those swaps that must be centrally cleared and those that need not. Moreover, the Commissions may see fit to impose potentially costly and burdensome requirements even as to swaps that are not subject to such clearing. For example, if no clearing organization accepts a swap for clearing, the Commissions will have the power under Dodd-Frank to take such other actions as they deem necessary and in the public interest with respect to that swap, which may include imposition of margin or capital requirements on the parties to the transaction.

Accordingly, financial firms that use swaps can have little assurance at this point that they will be able to continue to use all of such swaps without significant additional costs or burdens. Although the Commissions would have considerable discretion in these regards, the manner in which the Commissions would exercise that discretion remains in many respects unclear.

This Alert does not constitute legal or other professional advice or service by Jorden Burt LLP and/or its attorneys.

For additional information:

Jorden Burt has formed a special Task Force to monitor Dodd-Frank and other developments relating to reform of financial services regulation. To obtain additional information about particular developments that might have an impact on the insurance or reinsurance industries, you may contact Roland Goss (rcg@jordenusa.com or (202) 965-8148). To obtain additional information about particular developments that might have an impact on the investment adviser and fund industries, you may contact Tom Lauerman (tcl@jordenusa.com or (202) 965-8156). Or you may contact any of Jorden Burt's other regulatory attorneys.

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[1] Comments on this proposal are due February 4, 2011.

[2] Comments on this proposal are due February 22, 2011.

[3] Comments on this proposal are due January 3, 2011.

[4] Comments on this proposal are due 45 days after publication in the Federal Register.

[5] This Senate committee report pertained to S. 3127, the substance of which was ultimately incorporated in Dodd-Frank, after considerable amendment.

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