

Dodd-Frank

Am I Too Big to Fail?

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October 7, 2010

The materials included herein provide a general description of certain legal and business matters and should not be construed as providing specific legal advice or establishing an attorney-client relationship.

Overview

- Over the counter (OTC) derivatives subject to central clearing and trading.
- Private Investment Funds (i.e., hedge funds) required to register.
- New Federal Office of Insurance.

What does Dodd-Frank Mean?

- Ask Senator Dodd
- “No one will know until this is actually in place how it works.”
- Significant regulatory uncertainty due to significant rulemakings yet to come.
- One conservative estimate* found that Dodd-Frank has 243 separate rulemakings, 67 studies and 22 periodic reports.

*Memorandum of Davis Polk & Wardell, July 21, 2010

OTC Derivatives Overview

- \$615 trillion market
- All types of end users of derivatives, such as energy companies and manufacturing companies, will be affected.
- Dodd-Frank intends to create more transparency and oversight for derivatives.

What is a Swap?

Examples of swaps include:

- interest rate swap
- cross-currency rate swap
- foreign exchange swap
- energy swap
- credit default swap

Exclusions from Swaps

- A swap does not include a commodity that is “intended” to be physically settled.
- A forward for the delivery of gas is not a swap. A hedge against the price of gas with no physical delivery is a swap.
- A swap is not an option traded on an exchange.

What is a Security-Based Swap?

- A swap that is based on a narrow security based index or a single security or a loan.
- A credit default swap
- Security-based swaps are regulated by the SEC. Swaps are regulated by the CFTC. “Mixed Swaps” are subject to dual regulation.

Trading Rules for Swaps

- Must be settled through a central clearing system.
- Must be traded on an exchange.
- Exceptions: No clearing if (i) one counterparty is not a financial entity, (ii) such counterparty is using the swap to hedge or mitigate commercial risk and (iii) such counterparty notifies the applicable regulator how it generally meets its financial obligations with entering into non-cleared swaps.
- A financial entity is a swap dealer, a major swap participant, a private fund, an employee benefit plan and a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature.

What is a Swap Dealer?

- A Swap Dealer is a “dealer” or “market maker” in swaps such as a swap trading desk.
- A Swap Dealer is also anyone who regularly enters into swaps with counterparties as an ordinary course of business.
- A hedge fund regularly trades in swaps.
- Any company that regularly hedges risks could be a swap dealer.

Who is a Major Swap Participant?

- Any person who holds a substantial position in swaps or whose swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States.
- Substantial position determined by applicable regulators.
- Regulators will look to the amount of cleared swaps versus uncleared swaps and the amount and quality of collateral held against counterparty exposure.

Key Exclusions

- In determining whether a person is a major swap participant, you do not count towards substantial position the following:
 - positions held for hedging or mitigating commercial risk; and
 - positions maintained by any employee benefit plan for the primary purpose of hedging or mitigating any risk directly associated with operating the plan.
- Swap must be entered into by party who has the need for the hedge.

Am I a Major Swap Participant?

- Do I have significant counterparty exposure?
- Do I enter into swaps for hedging purposes (and in the correct legal entity)?
- Do I have a substantial position?
- Am I overleveraged?
- Regulatory uncertainty (interim final rule expected later this year).

Rules for Swap Dealers and Major Swap Participants

- Registration
- Capital Requirements
- Margin Requirements
- Books and Records Requirements (daily tracking records and all related records and recorded communications, a complete audit trail for trade reconstructions and certain counterparty records).
- Establish business conduct standards to prevent fraud and supervise the business.
- Hire Chief Compliance Officer, have a compliance program and submit an annual compliance report.

End Users: In or Out?

- There is no express “end user” exemption. See letter from Senators Dodd and Lincoln and SEC website.
- If not a swap dealer, could be a major swap participant.
- Even if neither a swap dealer nor a major swap participant, still have reporting obligations to avoid clearing.
- Counterparties are important. They can impose margin costs on you.

Position Limits

- SEC and CFTC have authority to adopt position limits in commodities and swaps.
- Persons subject to position limits will have additional reporting responsibilities.
- Rules for position limits are pending.
- Pre-enactment positions are exempt.

Do the New Rules Apply to Existing Swaps?

- No, for swaps entered into prior to July 21, 2010, if reported to the appropriate agency.
- No, for swaps entered into on or after July 21, 2010, but prior to the effective date (generally July, 2011) and reported to the appropriate agency.
- New rule issued this week by the CFTC exempts “pre-enactment swaps” that are reported to a registered swap data repository or the CFTC by the date established by pending rules or 60 days after a swap data repository becomes registered with the CFTC and commences operations, whichever occurs first.
- SEC likely to adopt similar rules this month for security-based swaps.

Do the New Rules Apply to Existing Swaps? (Part II)

- Reporting of pre-enactments swaps must include:
 - a copy of the transaction confirmation, in electronic form if available, or in written form if not available;
 - the time, if available, when the transaction was executed; and
 - report to the CFTC any information relating to the swap requested by the CFTC.
- Reporting to be done by the swap dealer, if any, then the major swap participant, if any, and then one of the counterparties.

Do the New Rules Apply to Existing Swaps? (Part III)

- Each counterparty to a pre-enactment swap shall retain all information and documents relating to the swap, including:
 - any information necessary to identify and value the transaction;
 - the date and time of execution of the transaction;
 - information relevant to the price of the transaction;
 - whether the transaction was accepted for clearing and, if so, the identity of the clearing organization;
 - any modifications to the terms of the transaction; and
 - the final confirmation of the transaction.

Lincoln Rule

- Federal insured institutions (i.e., banks) must transfer their trading desks to a separately capitalized affiliate.
- Exception for interest rate and currency swaps.
- Will increase the cost of doing business for your swap counterparty.
- Two-year transition.

Volcker Rule

- Ban on “proprietary trading” for financial institutions.
- Broader than only banks.
- Impacts trading in swaps for investment purposes.
- Long transition.
- Ultimately your counterparties may be changing.

When will this matter?

- Interim Final Rule required later this month.
- Pre-enactment swaps exempt if reported.
- Post-enactment/pre-effective date swaps also exempt if reported.
- Clearing and Trading will be up by July 2011.

What can I do now?

- Identify existing swap business. Can your swaps be moved from “swaps” to “forwards” that are intended to be settled?
- Identify existing swaps and swaps entered into later this year that will need to be reported to avoid clearing.
- Consider posting margin to reduce “substantial position” and reducing leverage in your swaps entity or entities.
- If you are likely to be a swap dealer or major swap participant, consider isolating swaps into a single entity that will be subject to the capital requirements.

What can I do now? (Part II)

- Carefully review ISDA and other swap documentation to anticipate new rules, such as reporting requirements.
- Monitor new rules as they develop.
- Monitor your counterparties.
- Consider aggregating data about swaps that could be subject to position limits.

Private Fund Registration

- Applies to all types of private investment funds, including hedge funds, private equity funds and real estate funds.
- All advisers to private funds, other than venture capital funds, with assets under management equal to or in excess of \$150 million.
- Real estate funds affected if they trade in “securities.”

Modified Registration

- Advisers to venture capital funds not required to register, but subject to books and records and reporting requirements.
- Advisers to funds with assets under management equal to or in excess of \$100 million but less than \$150 million not required to register, but subject to books and records and reporting requirements.
- Mid-sized funds subject to streamlined registration, books and records and reporting requirements.

What does Registration Mean?

- File Form ADV with the SEC and deliver a part of the Form ADV to your investors.
- If registered, each manager will need to (i) appoint a chief compliance officer, (ii) establish a compliance program and (iii) adopt a code of ethics.
- Each investment adviser will also need to comply with existing custody requirements.

What does Reporting Mean?

- Each adviser to a private fund will need to keep books and records for each “private fund” with respect to the following:
 - assets under management;
 - leverage;
 - credit counterparty risks;
 - trading positions;
 - valuation policies and practices;
 - assets held;
 - side letters with investors; and
 - trading positions.

State Regulation

- Advisers to hedge funds in Texas will generally register with the State if they have assets under management of less than \$100 million.
- Some advisers may need to move from federal to state registration.
- Principals at the fund may be subject to state licensing requirements.

Regulatory Uncertainty

- Regulators need to define:
 - “venture capital fund”
 - streamlined reporting/registration requirements
 - assets under management
- Generally, rules become effective in July.

What can Advisers do now?

- Determine expected assets under management.
- Review your compliance program.
- Monitor regulatory developments.
- Review state licensing requirements.
- Review asset base to determine what type of fund you might qualify as, and consider whether the asset base will/should change.

Other Concerns for Funds

- Volcker rule—banks cannot invest in funds except on a limited basis. Banks will be moving funds off their books.
- Large funds will be subject to authority of new Financial Stability Oversight Committee (FSOC) and will be subject to the Orderly Liquidation Authority. If you pose a systemic risk, your fund could be subject to capital requirements, and insolvency will run through the FDIC rather than the courts.
- New Proxy Access rule: Ability to propose directors for inclusion in proxy.

Insurance

- Dodd-Frank creates the Federal Insurance Office (FIO).
- Regulatory authority over all insurance other than health care and long term care insurance (but includes life insurance as part of long term care insurance) and crop insurance.

Responsibilities of FIO

- Monitor insurance industry to determine gaps in regulations.
- Monitor the extent to which underserved consumers and communities, minorities and low- and moderate-income persons have access to affordable insurance products.
- Recommend to the FSOC treating any insurance company as systemically important.
- Conduct a study on federal regulation of insurance.

Preemption

- FIO has the power to preempt any state insurance regulation that results in less favorable treatment of a non-U.S. insurer as compared to a U.S. insurer admitted in the state and is consistent with international agreements governing prudential standards.
- Preemption must be limited to the subject matter of the covered agreement.
- FIO must consult with state regulator before making a preemption determination.
- Preemption does not apply to state insurance measures governing rates, premiums, underwriting, sales practices, coverage practices, the application of antitrust law or measures governing capital or solvency unless such measures treat non-U.S. insurers less favorably than U.S. insurers.

Closing Thoughts

- Dodd-Frank is more than “too big to fail.”
- Rules of the road will be set in next 12-24 months.
- Rules need to be monitored.
- Discussion/questions.

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