The Applicability of Dodd-Frank Act Swap Regulations to Commercial Lenders

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For many commercial bankers, perhaps nothing has created more uncertainty and generated more questions than the Dodd-Frank Act's implementing regulations affecting swap transactions. This *Commercial Law Update* seeks to demystify the ***Dodd-Frank Act*** swap regulations applicable to commercial lenders, particularly community banks, and to reassure lenders that offering swap transactions to their customers gives them an opportunity to secure a competitive advantage.

A great deal of the complexity surrounding the Dodd-Frank Act swap regulations comes from the fact that that they are designed to cover all types of swap transactions, including currency swaps, commodity swaps, credit default swaps and others, in addition to the classic floating-to-fixed (or fixed-to-floating) interest rate swap with which most commercial lenders are most familiar.

The Regulatory Compliance Burden Depends on Whether a Commercial Lender is a "Swap Dealer," a "Major Swap Participant," or an "End-user"

The Dodd-Frank swap regulations impose varying levels of requirements depending on whether a party is a swap dealer, a major swap participant, or an end-user (a party that enters into swap transactions to hedge or mitigate commercial risk). Unlike end-users, swap dealers and major swap participants are subject to a comprehensive regulatory scheme regarding, for example, capital and margin, reporting, recordkeeping, daily trading records, business conduct standards, documentation standards, and trading duties. Therefore, as a threshold issue, it is necessary to identify whether a party (and its counterparty to a swap transaction) is a swap dealer, a major swap participant, or an end-user.

A swap dealer is a person that: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. Even if an entity engages in swap dealing, it is not required to register with the Commodity Futures Trading Commission (CFTC) as a swap dealer unless its swaps exceed a *de minimis* threshold of $8 billion in aggregate gross notional amount over a prior 12-month period. After the expiration of the phase-in period sometime in late 2015/early 2016, if not extended by the CFTC, this *de minimis* threshold will decrease to $3 billion. A much smaller $25 million threshold applies in the case of swaps with "special entities," which includes federal and state agencies, municipalities, and ERISA plans.

The other heavily regulated party, a major swap participant, is a person that does not meet the definition of a swap dealer but: (i) maintains a “substantial position” in any major category of swaps – excluding positions held for hedging or mitigating commercial risk and positions maintained by an employee benefit or governmental plan for the primary purpose of hedging or mitigating risks directly associated with the plan’s operation; (ii) its swaps create “substantial counterparty exposure”; or (iii) it is a private fund or other “financial entity” that is “highly leveraged,” is not subject to capital requirements established by an appropriate federal banking agency, and maintains a “substantial position” in a major category of swaps.

The thresholds for qualifying as a major swap participant are quite high:

- The “substantial position” thresholds are: (i) in the case of rate swaps, $3 billion or more in negative mark-to-market exposure or $6 billion or more in negative mark-to-market exposure taking potential future exposure into account; or (ii) in the case of credit, equity or other swaps, $1 billion or more in negative mark-to-market exposure or $2 billion or more in negative mark-to-market exposure, again inclusive of potential future exposure.

- “Substantial counterparty exposure” means $5 billion or more in negative mark-to-market exposure across all swaps or $8 billion or more in negative mark-to-market plus potential future exposure across all swaps.

- “Highly leveraged” refers to a ratio of total liabilities to equity in excess of 12-to-1.

An end-user is a swap transaction party that is neither a swap dealer nor a major swap participant. End-users are categorized into either financial end-users or non-financial end-users. A financial end-user is an end-user that is a commodity pool, a private fund, an employee benefit fund, or a person predominately engaged in activities that are banking or financial in nature. Financial institutions with $10 billion or less in total assets, however, are excluded from the definition, and therefore considered non-financial end-users. This exclusion for smaller financial institutions generally relaxes the compliance obligations applicable to community banks and enables them to take advantage of the end-user exception from the CFTC’s mandatory “clearing” requirements for certain swap transactions, including fixed-to-floating and floating-to-floating interest rate swaps. (“Clearing” refers to the process in which a third party is interjected into the swap transaction between, for example, a bank and its borrower – when a swap is cleared, the transaction is no longer a privately negotiated agreement between a bank and its borrower, and is generally subject to heightened regulatory requirements.) The end-user exception offers added flexibility to a community bank that offers interest rate swaps to mitigate their customers' interest rate risk to assess whether the costs and collateral requirements involved with clearing a swap or not is in the bank’s best interest.

Other regulatory compliance tasks for non-financial end-users (like community banks) include implementing policies and procedures to satisfy requirements related to recordkeeping, swap documentation, reporting (if applicable), and, as discussed below, ensuring that each counterparty to a swap transaction is an “eligible contract participant.

The “Eligible Contract Participant” Requirement for Counterparties and Their Guarantors

Pursuant to the Dodd-Frank Act, no party is permitted to enter into a swap transaction outside of a regulated futures exchange unless each party to the swap is considered an “eligible contract participant” (which includes swap dealers and major swap participants). A corporation, partnership, or other entity qualifies as an eligible contract participant if: (i) its assets exceed $10 million; (ii) its obligations are guaranteed by certain other eligible contract participants; or (iii) it is entering into the swap transaction to manage risk and its net worth exceeds $1 million.

Notably, a guarantee of obligations incurred in connection with a swap is also considered a swap transaction. Thus, any guarantor of a swap participant’s swap obligations must also qualify as an eligible contract participant. If not, the guarantee may not be enforceable even if both parties to the swap transaction are themselves eligible contract participants. Accordingly, it is imperative that commercial lenders exercise the necessary due diligence prior to effectuating a swap transaction to determine whether each borrower and each guarantor qualifies as an eligible contract participant. Modifications to a commercial lender’s existing loan documentation may be necessary to exclude from the scope of the guaranteed obligations those obligations arising under a swap.

Conclusion

Although the majority of the Dodd-Frank Act and its implementing regulations regarding swaps affect only swap dealers and major swap participants, an end-user must still consider what legal requirements are applicable to its prospective swap activities. Fortunately, the regulatory requirements imposed on end-users – particularly non-financial end-users (like most community banks) – are limited and much less burdensome than commonly believed. In many cases, the added flexibility swaps offer to a commercial lender and its borrower far outweighs the regulatory burden.

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