Futures & Derivatives Law Report

September 2012 ■ Volume 32 ■ Issue 8

Futures & Derivatives Law REPORT

The Journal on the Law of Investment & Risk Management Products

A Guide to "*Pari Passu* Swaps" under the Dodd-Frank Act

JULIA LU, TIMOTHY LIN, JOHN A. CLARK[1]

Introduction

Modern secured credit facilities often allow a lender to provide the borrower with a swap that shares the same collateral pledged to support the loans under the credit facility. These swaps are sometimes called "*pari passu* swaps" because they are secured to the same extent as, and on an equal priority with, loans advanced under the credit facility. Under this arrangement, a borrower can hedge risk efficiently without posting additional cash collateral to support the swap, and the lender providing the swap can generate additional business for its swap desk.

Part I of this article summarizes the unique and often overlooked business and legal issues that arise when negotiating a credit facility that permits a *pari passu* swap. For example, a swap provider must choose the counterparty for the swap carefully, the swap must be an "eligible swap" under the credit facility, the swap provider must meet certain eligibility requirements and, in some cases, notice of the swap and periodic updates must be provided to the agent for the lenders under the credit facility.

Part II of this article describes the expected impact of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Title VII") on the existing *pari passu* swap framework. In particular, it examines the array of new regulations affecting how swap providers — especially those that are U.S. insured depository institutions or major dealers of swaps — may hold *pari passu* swap positions, whether parties must clear such positions and how swap dealers' exposures to borrower losses must be collateralized.

I. *Pari Passu* Swaps Explained

A credit facility that permits *pari passu* swaps will invariably specify which entities may provide a *pari passu* swap, what types of swaps may be secured on a *pari passu* basis *vis-à-vis* the loans under the facility and whether swap execution and swap exposures must be reported to the administrative agent of the loan, as well as other details of concern to the lender group.

Choosing a Swap Counterparty

The providers of a *pari passu* swap must carefully choose the borrower or subsidiary it transacts with in order to maximize the available collateral coverage for the swap.

Under most credit facilities, the subsidiaries of the borrower will guarantee the borrower's obligations under the credit facility and, if applicable, *pari passu* swaps. Borrowers generally do not guarantee the obligations of their subsidiaries, and subsidiary guarantors may not cross-guarantee the obligations of other subsidiary guarantors. As a consequence of this arrangement, if the swap counterparty is the borrower, the *pari passu* swap provider will receive the benefit of the subsidiary guarantees. However, if the swap counterparty is a subsidiary guarantor, the swap provider will typically not have recourse to guarantees from the borrower or the other credit parties.

Similarly, if the swap provider executes a *pari passu* swap with a borrower subsidiary, it must carefully review the grant of security interest under the collateral documents. In most cases, the credit parties will grant liens to secure all of the "Secured Obligations," which typically is defined to include *all of the credit parties'* obligations under the credit facility and *pari passu* swaps. However, in some cases, each credit party will agree to grant a lien to secure *only its own* obligations — usually, its direct obligations under a *pari passu* swap (if any) and its guarantee of the borrower's obligations (assuming no cross-guarantees are applicable). In this situation, a *pari passu* swap with a borrower subsidiary would be secured only by the collateral of that subsidiary.

Where the credit parties include both U.S. and non-U.S. entities, the parties' respective obliga-

WEST®

REPRINT ARTICLE

tions may be secured by different pools of collateral. The obligations of domestic borrowers are often guaranteed and secured only by domestic subsidiaries and their assets[2] due to negative tax treatment resulting from foreign guarantees and wholesale pledges of foreign subsidiaries' assets. On the other hand, the obligations of foreign borrowers typically may be guaranteed and secured by both domestic and foreign subsidiaries and their assets. Swap providers should therefore carefully assess the value of domestic and foreign collateral and their implications on recoveries. In addition, if the swap provider chooses to transact with a foreign entity, it must also consider what effect a foreign insolvency proceeding would have on its ability to terminate and close out a swap in the event of a counterparty default.

Complying with Credit Facility Requirements

In a default scenario where secured creditors are under-collateralized, *pari passu* swaps are likely to be scrutinized and their secured status may be put at risk. Lenders (and other creditors) will be incentivized to exploit any drafting errors and to identify any non-compliance with the contractual requirements of the credit facility in an effort to argue that the swap obligations should not be supported by the credit facility's collateral package and, therefore, that such obligations should not share distributions from the proceeds of collateral on a *pari passu* basis with the loan obligations. With that type of challenge in mind, a swap provider should pay close attention to all the issues outlined below, thoroughly examine the wording of the facility documents and ensure the swap meets the various requirements under the facility documents in order for swap obligations to share in the collateral on a *pari passu* basis with the loan obligations.

A swap provider typically needs to satisfy several contractual requirements set forth in the terms of the credit facility in order for its swap to be secured on a *pari passu* basis. In one of the very few reported cases concerning a dispute over *pari passu* swaps, the Bankruptcy Court in the *Plastech* proceedings considered an objection by secured creditors challenging whether certain swaps provided by a lender to the debtor were secured on a *pari passu* basis under debtor's secured first-lien term loan facility.[3]

The facts in that dispute were not contested: The debtor was required to hedge the interest rate risk with respect to a certain amount of its debt and entered into a swap to satisfy its obligation. At the time the swap provider entered into the swap, it was neither a lender nor an affiliate of a lender under the credit facility. After the debtor filed for bankruptcy protection, the swap provider purchased term loans from another lender.

The Bankruptcy Court undertook a thorough review of the credit facility documentation and carefully parsed through a number of definitions to distill the *pari passu* requirements. In synthesizing a number of definitions and provisions in the facility documentation, the Bankruptcy Court found that in order for the swap to be secured, the swap provider must have been a "Lender Counterparty" (*i.e.*, a lender or an affiliate of a lender) on the date the swap obligation was incurred. Accordingly, the Bankruptcy Court held that because the swap provider was not a Lender Counterparty at the time the swap obligations were incurred (*i.e.*, the date the swap was executed), its swap was not secured. Notably, the Bankruptcy Court rejected as irrelevant e-mail correspondence between the debtor and the swap provider immediately prior to the execution of the swap, pursuant to which the debtor confirmed that it was the intent of the parties for the Wachovia swap to be secured on a *pari passu* basis under the credit facility.

The *Plastech* opinion underscores that it is crucial for a swap provider to adhere strictly to a credit facility's terms governing *pari passu* swaps, which often include requirements as to: (i) *who* may provide a *pari passu* swap (and, if applicable, *when* and *for how long* a swap provider must be a lender or an affiliate of a lender), (ii) *what types* of swaps are permitted to be secured on a *pari passu* basis and (iii) *notice or reporting* requirements applicable to *pari passu* swaps.

© 2012 THOMSON REUTERS

Confirming that a Lender Meets the Requirements of a Swap Provider

Typically, a permitted swap provider (often referred to as a "hedge bank" or "lender counterparty" in credit agreements) must be a lender or an affiliate at the time it enters into a *pari passu* swap.[4] Under some credit facilities, the swap provider may cease to be a lender or an affiliate of a lender after the execution of the *pari passu* swap without affecting its secured status. In other cases, the swap provider must continue to be a lender or an affiliate of a lender at all times during the term of the swap. Alternatively, the credit facility may provide that all lenders (and their affiliates) as of the facility closing date are permanently grandfathered as eligible *pari passu* swap providers, regardless of when they enter into swap trades with the borrower. So long as a swap provider qualifies as an eligible *pari passu* swap provider, credit agreements typically do not require that a *pari passu* swap be executed contemporaneously with the incurrence of the related indebtedness.

In cases where a credit facility requires a swap provider to be a lender or an affiliate at all times during the term of any swap contract, the swap provider must ensure that its loan trading desk or lending affiliate does not assign its required loan position during the term of the *pari passu* swap.

Confirming that the Swap is an Eligible Swap

Credit facilities typically require that only swaps used for hedging (as opposed to speculative) purposes may be *pari passu* swaps. Specifically, *pari passu* swaps usually must hedge actual interest rate or currency rate risk or, on occasion, commodity pricing risk borne by the borrower (or the borrower and its subsidiaries taken as a whole).[5] *Pari passu* swaps are also often required to be entered into "in the ordinary course of business" by a borrower (or subsidiary).

Some credit facilities may impose further limitations on the type of hedge that is permitted. For example, a credit facility may provide that a swap may be secured to the extent it hedges interest rate or currency risk associated with debt incurred under that particular facility. A credit facility may also require that a swap be on terms reasonably acceptable to the administrative agent. To the extent that a swap contains off-market terms, there is risk that the administrative agent may not permit it to be deemed a *pari passu* swap and share in the collateral.

Notifying the Agent that a Swap Has Been Executed

Credit facilities may require that written notice of execution of a *pari passu* swap be provided to the administrative agent or the collateral agent. The simplest formulation requires the swap provider to unilaterally give notice of the existence of the *pari passu* swap with the borrower or, if permitted, a subsidiary. In some cases, the borrower (or subsidiary) and swap provider must jointly execute the notice. In yet other cases, the borrower or subsidiary must execute and deliver the notice and formally designate the swap as a "secured swap agreement" (or other relevant defined term).

The notice requirement may also include a temporal element that requires delivery either on the date a swap is entered into or within some number of days thereafter. Alternatively, there may not be a timing requirement, but instead a swap will not be secured until notice is delivered to the relevant agent.

Some credit facilities may require that certain materials accompany the written notice, which may include a copy of the swap documentation, a summary of terms, an initial mark-to-market valuation or any documentation or information requested by the administrative agent.

Reporting Swap Exposure on a Continuing Basis or Upon a Default

Sometimes the swap provider may be required to periodically report its exposure under the swap, typically by calculating the mark-to-market value of the swap or the termination amount under the governing swap documentation. If ongoing reporting applies, the swap provider must be diligent in setting up an internal procedure to ensure that the relevant information is delivered in a timely manner.

© 2012 THOMSON REUTERS

Some credit facilities may specify that upon an event of default under the credit facility, it is incumbent on the swap provider to give notice to the administrative or collateral agent of its exposure under the *pari passu* swap. In other words, the relevant agent has no obligation to canvass the swap provider for its exposure prior to distributing payments in accordance with the collateral proceeds waterfall. Swap providers must be vigilant in providing timely notice to ensure they share ratably in the proceeds.

Avoiding Drafting and Negotiation Pitfalls

Perhaps because parties to credit facilities are primarily focused on their financing terms, borrower and lender counsel sometimes pay little attention to key provisions relating to securing *pari passu* swaps and erroneously treat them as boilerplate provisions. However, as defined terms and cross-references invariably evolve during the course of negotiations, errors and inconsistencies can be introduced across the credit documents. If the errors and definitional inconsistencies are material in a credit facility, a swap may not be *pari passu* and its provider may lose the benefit of collateral securing the swap.

Pari passu swap providers should be sure to carefully review the credit agreement, each collateral and guarantee document and, if applicable, the intercreditor agreement, to ensure that all the provisions work together to consistently provide that *pari passu* swaps will be secured. In particular, it is important to review definitions such as "secured parties," "secured obligations," "secured swap agreement," "hedge bank," "lender counterparty" and similar terms to ensure that obligations owing to eligible swap providers under eligible swap contracts are captured in each instance and in the same manner. Swap providers should confirm that any negative covenants restricting outstanding indebtedness and liens include carve-outs for *pari passu* swaps and do not otherwise conflict with the parties' intent to allow *pari passu* swaps. In addition, swap providers should carefully review the collateral proceeds waterfall to ensure that swap obligations are paid ratably with outstanding loans.

II. *Pari Passu* Swaps after Dodd-Frank

Providers of *pari passu* swaps not only must navigate the contractual terms of a credit facility, but now must also understand a variety of swap regulations promulgated under Title VII of the Dodd-Frank Act.[6] The remainder of this article explores several Title VII-related concerns, including: (i) how to evaluate the best entity to provide *pari passu* swaps to borrowers, given new registration requirements for "swap dealers" and "major swap participants" ("MSPs")[7] and swap holding restrictions for swap dealers subject to the "Swap Push-Out Rule," (ii) the impact of mandatory swap clearing and whether a swap will be exempt from clearing under the "Commercial End-User Exception" and (iii) if a swap is not cleared, what further documentation, internal procedures and additional margin will be required when writing a *pari passu* swap.

What Entity Should Provide a *Pari Passu* Swap?

Among its most significant changes, the Dodd-Frank Act includes provisions designed to regulate certain systemically important entities that transact frequently in the swaps market. Entities that fall within definitions of the terms "swap dealer" or "major swap participant" will be required to register with the U.S. Commodity Futures Trading Commission ("CFTC") and comply with extensive regulatory requirements such as reporting and recordkeeping rules, capital and margin requirements, business conduct rules and conflict of interest regulations.[8] A provider of *pari passu* swaps will not want to become a swap dealer or MSP inadvertently.[9] To make sure that it does not, a swap provider (that is not otherwise a swap dealer) will want to conform its *pari passu* swap activities to certain safe harbors under the "swap dealer" definition. If that is impractical, then a swap provider likely will want to consolidate its *pari passu* swap business within an entity

© 2012 THOMSON REUTERS

that must register as a swap dealer or MSP as a result of other swap activities conducted through that entity. In addition, any swap providers that are U.S. insured depository institutions ("IDIs") and *are* deemed to be swap dealers must ensure that all *pari passu* swaps activities are either permitted under the Swap Push-Out Rule or "pushed out" to a non-bank affiliate.[10]

Will *Pari Passu* Swaps Activities Trigger "Swap Dealer" Designation?

The Dodd-Frank Act defines a "swap dealer" as any entity that either: (i) holds itself out as a dealer in swaps, (ii) makes a market in swaps, (iii) regularly enters into swaps with counterparties in the ordinary course of its business for its own account, or (iv) engages in any activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.[11] If a *pari passu* swap provider does not otherwise engage in swap activity, it must ensure that the *pari passu* swap activities qualify under an exemption or else potentially become obligated to register as a "swap dealer." There are two exemptions relevant to a provider of *pari passu* swaps.

The Insured Depository Institution Exclusion

The first exemption is available to a swap provider that is an IDI. The Dodd-Frank Act expressly exempts from the term "swap dealer" any IDI "to the extent that it offers to enter into a swap with a customer in connection with originating a loan with that customer."[12] In May 2012, the CFTC (with the SEC) finalized rules describing the circumstances required for a given swap trade to fit within the IDI exclusion. The rules provide that two types of swaps will be recognized as potentially exempt: (i) swaps that are connected to and intended to hedge the financial terms of a loan,[13] such as the loan's duration, interest rate, currency or principal amount and (ii) swaps that are *required* under a loan's underwriting criteria to be in place as a condition of the loan in order to hedge commodity price risk.[14] While *pari passu* swaps generally are capable of fitting within these categories, the IDI exclusion includes several conditions, which may limit a swap provider's ability to rely on the exclusion for certain transactions.

The first regards timing: A qualifying swap must be executed no more than 90 days before or 180 days after the date of execution of a loan agreement or the date of any draw down of principal by the borrower.[15] This may be an issue for a swap provider that becomes a lender later than 180 days after the date of execution of the loan agreement or a draw down. It is unclear whether an amendment of the credit agreement (without new funding) restarts the qualifying period. It is also uncertain whether novation or amendment of a swap is considered an execution of a new swap, which would be subject to the 90/180-day timing requirement, or whether the parties to the modified swap can rely on the "original" agreement's qualifications.

Second, there are funding qualifications. In order to rely on the IDI exclusion, the swap provider must be the sole source of funds under the loans or have committed to provide at least 10% of the maximum principal amount under the loan.[16] If an IDI has less than a 10% loan commitment, the exclusion will only apply to a notional amount of its qualifying swaps up to the value amount it has lent to a borrower. It is unclear whether the funding percentage is based on all tranches and facilities under a single credit agreement, and whether an affiliate's loan position can be considered in this calculation.

Moreover, in all cases, the excluded notional amount of qualifying swaps between an IDI and a borrower counterparty may not exceed the aggregate principal amount outstanding under a facility at that time.[17] This could be an issue for a large lender that wants to provide hedging swaps in multiple product categories (*e.g.*, interest rate and currency) to a particular borrower if the swap notional amounts, in the aggregate, would exceed the outstanding principal amount of the loan to the borrower.

Lastly, as its name suggests, the IDI exclusion is *only* available to IDIs and is not available to non-insured affiliates of an IDI or lenders that are not banks. As a result, swap providers that technically are not IDIs may be designated as swap dealers even if their *pari passu* swaps are made in

© 2012 THOMSON REUTERS

connection with loan origination and would otherwise satisfy the criteria above.

The De Minimis Exemption

In addition to the IDI exclusion, the CFTC rules include a *de minimis* exemption allowing any type of entity to undertake a small amount of swap dealing activity. During a phase-in period (of between two to five years), any swap provider may enter into non-exempt swaps, over the course of any 12-month period, with an aggregate notional amount of up to $8 billion without triggering swap dealer status. That aggregate notional amount is calculated on a gross basis (*i.e.*, without netting or off-sets for collateral held) and includes notional amounts of swaps executed by affiliates under common control. After the phase-in period, the threshold amount will fall to $3 billion.[18]

Must *Pari Passu* Swap Activities Be "Pushed Out"?

Any U.S. banking entity that executes swaps and is designated a swap dealer (a likely result for large global financial services firms, given the narrowness of related exemptions) must consider the impact of the "Swap Push-Out Rule" under Section 716 of the Dodd-Frank Act. This section prohibits the giving of any "Federal assistance" (including access to the Federal Reserve discount window and Federal Deposit Insurance Corporation deposit insurance) to swap dealers and MSPs[19] subject to exceptions for only a few types of swap activities. Section 716's practical effect therefore will be to require IDIs to divest from (or "push out") certain disfavored OTC derivatives dealing and market-making businesses.[20] For IDIs under a bank or savings and loan holding company, this will likely mean pushing out substantial swap business to non-bank U.S. affiliates or overseas affiliates within the same bank holding company group.[21]

That said, most (but not all) types of *pari passu* swaps should be exempt from the push-out requirement. Section 716(d) allows any IDI to engage in swaps activities referencing rates or reference assets that are permissible for bank investment under a list promulgated by the U.S. Office of the Comptroller of the Currency.[22] Accordingly, swap providers that are IDIs will be permitted to execute and hold traditional *pari passu* swaps referencing interest rates and currency rates. However, *pari passu* swaps that reference commodities (except those based on bullion) will not satisfy the exemption and may need to be "pushed out."

Are *Pari Passu* Swaps Exempt from Mandatory Clearing?

In 2009, the leaders of the Group of 20 nations (G-20) resolved to clear standard, historically OTC swap contracts through central counterparties ideally by the end of 2012. In pursuit of that goal, Title VII includes a clearing mandate for all swaps that the CFTC determines must be cleared, subject to limited but important exceptions (discussed below). Mandatory clearing of previously uncleared OTC swap contracts entails the creation of new clearing infrastructure, including swaps clearing houses and swap execution facilities,[23] and extensive regulatory changes affecting, of particular note, margin treatment.

A cleared swap is, in essence, a contract between a customer and a dealer (a "futures commission merchant" or "FCM," in U.S. regulatory parlance) that has been novated to a clearing house (a "derivatives clearing organization," or "DCO") so that all rights, obligations and economic risks of the contract flow between the customer and DCO.[24] Since a DCO bears some risk of a counterparty default, every DCO collects initial margin and variation margin (usually cash) from customers to ensure that its exposure to customer credit risk is adequately collateralized.[25] A customer's collateral will be held in a segregated account securing various counterparties' obligations to the DCO. This collateralization regime for cleared swaps is fundamentally incompatible with the practice of securing *pari passu* swap obligations under a credit facility's typical grant of a security interest over borrower and credit parties' operational assets. As a result, if a given swap is subject to mandatory clearing, employing a *pari*

© 2012 THOMSON REUTERS

passu collateralization arrangement will not be viable.

In August 2012 the CFTC proposed rules which would subject certain "plain vanilla" interest rate swaps (among others) to the mandatory clearing requirements. These clearable swaps include rate swaps that (i) fall into one of four classes — *i.e.*, either the fixed-to-floating swap class, basis swap class, forward rate agreement class or overnight index swap class, (ii) are denominated in either U.S. dollars, euros, British pounds or (except for overnight index swaps) Japanese yen, (iii) have stated termination dates that fall within specified ranges and (iv) reference a specified often-quoted floating rate index (*e.g.*, LIBOR, in the case of a fixed-to-floating swap denominated in U.S. dollars).[26] The CFTC also has indicated that it may issue additional clearing determinations for other types of swaps in the future.

Fortunately, we expect that one statutory exemption — the so-called "Commercial End-User Exception" — should be available to many *pari passu* swaps executed with non-financial borrower counterparties.

The Commercial End-User Exception

Section 2(h)(7) of the Commodity Exchange Act (as amended by the Dodd-Frank Act) exempts any swap from any mandatory clearing obligations that would ordinarily apply so long as at least one party to the swap satisfies the so-called "Commercial End-User Exception." There are several requirements under the exception:

1. *The end-user party must <u>not</u> be a "financial entity."* The term "financial entity" includes banking institutions, swap dealers, major swap participants, pension plans and "private funds" as defined under the Investment Advisers Act of 1940 (which includes most hedge funds), though it excludes certain small banks and financial institutions (with less than $10 billion of total assets) and "captive finance entities" of otherwise qualifying end-users.[27] A *pari passu* swap only qualifies for the exception if the borrower counterparty is not one of these types of entities.

2. *The swap must "hedge or mitigate commercial risk" of the end-user.* A swap will qualify as being used to "hedge or mitigate commercial risk" under the Commercial End-User Exception if it: (i) "is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from…(D) the potential change in the value of assets or commodities that a person owns, produces, …processes… or reasonably anticipates owning, producing…processing…in the ordinary course of business of the enterprise [or] (E) any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities," and provided that such a swap is "not used for a purpose that is in the nature of speculation, investing or trading."[28] Although most credit facilities' expressly require that *pari passu* swaps hedge actual interest, currency or commodity price risk, the parties to a *pari passu* swap will have to evaluate whether it fits within CFTC's "economically appropriate" standard, which is a facts and circumstances test.[29]

3. *The CFTC must be notified that a party is taking advantage of the exception and that the party is qualified to do so.* The CFTC's rules require one of the counterparties to any exempt swap to report to the CFTC (or, more likely for standard swaps, one of its designated "swap data repositories") that an end-user has elected to use the exception. The obligation to file the report will almost always fall on a swap provider under the CFTC's swap reporting rules.[30] The reports will contain confirmation that the end-user is qualified to use the exception and information about the security arrangement.[31] Since only the end-user will have this information, it will be essential for *pari passu* swap providers as reporting counterparties to solicit this information prior to executing and reporting a *pari passu* swap. Furthermore, reporting counterparties must have a "reasonable basis to believe" that any end-user using the exemp-

© 2012 THOMSON REUTERS

tion meets the exemption's preconditions or else risk liability to the CFTC. Due diligence and reliance on an end-user's representations may be one way of establishing a "reasonable basis to believe" in an end-user's qualifications, but representations that are known to be false or lack credibility could ruin a swap provider's claim that it had such a reasonable basis to believe.[32]

4. Any end-user that files reports with the SEC must be authorized by the company's board of directors to enter into swaps that are subject to the clearing exemption.[33] A public reporting company seeking to use the exemption (or a "reporting counterparty" on its behalf) must provide notice to the CFTC regarding its governing board's decision to opt out of otherwise mandatory clearing. The board may delegate responsibility for the decision to a committee, so long as the committee is specifically authorized to make the decision concerning the clearing opt-out. If the board or committee does not want to approve trades on an individual basis, it must promulgate policies applying to the company's swap activities on a general basis. Any such policies must be reviewed at least annually and when relevant business circumstances substantially change (*e.g.*, when a new hedging strategy is to be implemented that was not contemplated in the original board approval).[34]

Swap providers should note that the Commercial End-User Exception from mandatory clearing only applies to qualifying swap contracts executed *with a commercial end-user* (or a qualifying affiliate thereof). There is no exception for swaps executed between swap providers and financial entities even if those swaps hedge or offset exempt, uncleared end-user swaps. This could lead to capital inefficiencies for swap providers seeking to lay off swap risk, where, for example, one uncleared *pari passu* swap position with a customer would not require the posting of cash collateral to the swap provider, while the swap provider's offsetting position is required to be cleared, thus subjecting the swap provider to margin collection by a clearing house.[35]

Are *Pari Passu* Swaps Subject to Regulatory Margin Requirements?

Under rules proposed by the CFTC and U.S. banking regulators (known as "Prudential Regulators")[36] many uncleared swaps will be subject to minimum margin collection and holding requirements.[37] The proposals are complex, and, due to the overlapping jurisdictions of U.S. regulators, the particular set of rules to be applied to a given swap transaction depends on the *type* of swap dealer or MSP executing such a swap. Specifically, if a swap dealer or MSP is regulated by a Prudential Regulator, then it will be subject to the Prudential Regulators' rules;[38] if it is not, then it will be subject to CFTC rules.[39] At a high level, both the Prudential Regulator and CFTC margin rules for uncleared swaps govern the calculation, collection and holding of mandatory initial margin amounts (if any) and the collection of variation margin (if any) as well as the types of property eligible to be accepted as collateral.

Prudential Regulator Regime

Under the Dodd-Frank Act, the Prudential Regulators will oversee and promulgate margin requirements for swap dealers and MSPs that are organized in the U.S. as national banks, federally and state-chartered banks, branches of foreign banks and bank or savings and loan holding companies (among other types of lending institutions).[40] A Prudentially Regulated entity must collect and hold collateral based on various proposed rules depending on whether its *counterparty* to a given swap transaction is (i) another swap dealer or MSP, (ii) a financial end-user (including, U.S. and non-U.S. commodity pools and private funds, pension plans and banking entities, among others) that is deemed "low risk,"[41] (iii) a financial end-user that is "high risk" (*i.e.*, all financial end-users that are not "low risk"), or (iv) a non-financial end-user. If a Prudentially Regulated swap provider executes a swap with either another swap dealer, MSP or high-risk financial entity, it is required to collect from its counterparty initial margin and daily variation margin generally in the form of cash or U.S. Treasury securities. Such a swap would not, therefore, be

eligible to be structured as a *pari passu* swap in which the borrower merely secures its obligations with collateral that is pledged, but not delivered, to the swap provider.

If a counterparty is a low-risk financial or non-financial end-user, the proposed rules allow a Prudentially Regulated swap provider to establish a credit exposure threshold (on a portfolio basis) with respect to that counterparty. The Prudentially Regulated entity is not required to collect collateral from a counterparty whose aggregate swap liabilities to the swap provider remained below the threshold amount. The proposed rules require that the risks of the swaps executed with a counterparty be reviewed, monitored and approved in accordance with the swap provider's credit processes in establishing such counterparty's credit threshold, but impose no cap on the maximum level of the exposure thresholds for transactions with non-financial end-users. For low-risk financial end-users, the rules do cap maximum exposure thresholds, which could make larger *pari passu* swap impractical.[42]

Even if a swap has not yet exceeded the credit exposure threshold for a particular end-user counterparty, the proposed rules require that the swap entity enter into contractual arrangements with the end-user counterparty which would entitle the swap entity to collect initial margin and variation margin as and when required. The trading documentation must specify the details of the margin requirements, including methods, procedures and inputs of calculation, and dispute resolution mechanisms. This would require parties to pre-negotiate collateral delivery documentation (such as a credit support annex to an ISDA master agreement), which is not currently used in traditional *pari passu* swap transactions.

CFTC Regime

The CFTC's proposed uncleared swap margin rules govern "CFTC covered swap entities" — namely entities that are swap dealers or MSPs except those regulated by a Prudential Regulator — which could include non-bank affiliates of a lender within the same bank holding company and potentially private funds and non-bank financial institutions acting as swap providers.[43] A CFTC covered swap entity must collect and hold collateral based on various rules depending on whether its counterparty to a given swap transaction is (i) another swap dealer or MSP, (ii) a "financial entity" (including U.S. and non-U.S. commodity pools and private funds, pension plans and banking entities, among others)[44] or (iii) any other entity (*i.e.,* a "non-financial entity").

These CFTC rules for uncleared swap margin effectively foreclose a swap provider's ability to secure a swap solely with a lien on non-delivered assets pledged by borrowers that are swap dealers, MSPs or other riskier financial entities. Like the Prudential Regulators' proposals, the CFTC would allow a swap provider to agree to a threshold below which initial margin and variation margin need not be posted by a financial entity counterparty that is considered low risk.[45]

Unlike the Prudential Regulators' rules, the CFTC proposal expressly notes that CFTC covered swap entities would *not* be required to collect margin from a non-financial counterparty.[46] Rather, the parties are permitted to agree to any privately negotiated credit support arrangements, provided that if margin is contractually required to be posted, the agreement's terms related to the calculation and eligibility of delivered margin must conform to the CFTC requirements. Even though margin may not be required to be posted, however, the CFTC proposed rules would require that covered swap entities calculate the hypothetical initial margin and variation margin (using methodology permitted in the rules) in connection with uncleared swap transactions with non-financial entities.[47] While these requirements are likely to be cumbersome to swap providers of *pari passu* swaps, the goal of the CFTC is to provide the covered swap entity with a risk management tool.

When Will Title VII Requirements Take Effect?

The CFTC's definitions of "swap dealer" and "major swap participant" generally became effective on July 23, 2012. Rules requiring the registration of such swap dealers and MSPs are already

© 2012 THOMSON REUTERS

final and effective,[48] however registration is not mandatory until October 12, 2012 (the date on which regulators' definitions for the term "swap" become effective).

The Swap Push-Out Rule technically becomes effective July 16, 2013. However, IDIs that are designated as swap dealers will have up to two additional years to push out non-exempt trading activities to an affiliate — or three years in the case of those receiving a special allowance for more time from relevant U.S. regulators.[49] The Dodd-Frank Act also grandfathers non-exempt swaps executed by an IDI prior to the end of its transition period. Grandfathered swaps may be retained by the institution through their maturity.

The G-20 commitment to require mandatory clearing of standard derivatives had aimed to become effective by the end of 2012. At this time, mandatory clearing of swaps in the U.S. remains predicated only on: (i) a final determination by the CFTC of which swaps must be cleared and (ii) registration of DCOs able to clear such swaps subject to mandatory clearing and the acceptance (or deemed acceptance) by such DCOs of such swaps for clearing.[50] In any event, the CFTC's established timelines for clearing compliance provide *non*-financial end-users with a 270-day grace period (following final determination of which swaps must be cleared) and *financial* end-users with a 180-day grace period in which to prepare for compliance with the mandatory clearing requirements.[51]

The Prudential Regulators' rules and CFTC's rules governing margin collection and segregation for uncleared swaps currently exist in proposed form only.

Conclusion

For borrowers seeking to hedge their interest rate, currency or commodity risks associated with their business or credit facilities, *pari passu* swaps are a popular and efficient option. Despite their common use in the market, however, swap providers should be aware that *pari passu* swaps present a number of documentation issues and must, as always, conduct thorough reviews of relevant credit and security documents to confirm their status as a secured party sharing the collateral with facility lenders on a *pari passu* basis.

With the implementation of Dodd-Frank, providers of *pari passu* swaps should also begin to evaluate their overall swap activities to ensure compliance with new derivatives regulations. As an initial matter, some swap providers may note that it would be difficult to confine their *pari passu* swap activities to those that would fit within an exemption from registration as a swap dealer and therefore would conduct *pari passu* swap activities from a registered swap dealer entity. If any such swap dealer entity is also an IDI, it must determine whether, going forward, *pari passu* swap transactions may be held by it or must be "pushed out" to a non-bank affiliate. *Pari passu* swaps referencing commodities may indeed be required to be pushed out.

The Dodd-Frank Act will require new considerations of swap activities at the transaction level as well. *Pari passu* swaps that would otherwise be subject to the clearing mandate must be executed with qualifying counterparties under the "Commercial End-User Exception." Borrowers will have to determine their eligibility and establish new policies and procedures to comply with regulatory requirements in order to preserve *pari passu* swaps' eligibility to be executed and settled over the counter. From the swap provider's perspective, these requirements may necessitate obtaining representations from the borrower counterparty as to its eligibility and compliance with the exemption. Swap providers will also need to comply with the relevant margin collection and holding requirements for uncleared swaps mandated by their regulator. The extent of these requirements turns on the status of their counterparty, and therefore appropriate representations will also be necessary.

The issues raised in this article by no means exhaust all the concerns presented to swap providers transacting in *pari passu* swaps in the Dodd-Frank landscape. Rather, these issues represent the most immediately impactful regulatory risks known at the present. Swap providers should think about how to best manage their *pari passu* swap business and how to structure and document new *pari passu* swap transactions in order

© 2012 THOMSON REUTERS

to ensure the continued viability of *pari passu* swaps in light of these and other looming regulatory constraints under the new Dodd-Frank Act regime. While the conclusion to rulemaking may still seem far away, the process for evaluating and responding to the new rules' effects on swap execution also will be time-consuming. Swap providers should begin considering the potential impact of Title VII on their *pari passu* swaps activities now to avoid being caught off-guard.

NOTES

1. Julia Lu and Timothy Lin are partners and John A. Clark is an associate in Richards Kibbe & Orbe LLP's New York office.
 Using her background in securities offerings, Ms. Lu currently focuses her practice on distressed debt and derivatives markets. She advises clients in transactional and regulatory aspects of their trading businesses, drawing on her previous experience as the acting chief operating officer of the loan trading desk at Goldman Sachs. Ms. Lu is a potential pool member for external reviews of determinations made by the ISDA Credit Derivatives Determinations Committees.
 Mr. Lin advises investment banks, hedge funds and other financial institutions on special situations and distressed investments, including the purchase and sale of claims against bankrupt companies. Mr. Lin also has extensive experience in lending and restructuring transactions and distressed acquisitions.
 Mr. Clark primarily advises on derivatives, secured transactions, bankruptcy claims trading and related regulatory developments within the firm's corporate department.
 The views expressed in this article are those of the authors at this time, and neither represent the views of the firm, nor limit the positions the firm or the authors may take presently or in the future, in the representation of clients or otherwise.
2. One caveat is that a domestic entity typically will be limited to pledging 65% of the total shares of a foreign subsidiary to avoid negative tax treatment.
3. *In Re Plastech Engineered Products, Inc.*, 399 B.R. 1 (Bankr. E.D. Mich. 2008).
4. In addition, sometimes an agent or arranger or their respective affiliates may also be permitted swap providers.
5. Though uncommon, some credit facilities will only allow collateralization of those swaps *required* by the terms of the facility to be entered into by the borrower (or its affiliate) (see, *e.g.*, the *Plastech* opinion referenced in this memorandum). In these cases, the credit facility may permit the borrower and its affiliates to incur an unlimited amount of non-speculative swaps; however, the borrower (or its affiliate) may be required to hedge only a certain percentage of its debt for a specific period after the closing date. Under this formulation, swaps in excess of the minimum notional amount or that extend beyond the specified period may not be secured.
6. Due to the complexity of the Dodd-Frank Act and new Title VII-related regulations, this article focuses only on aspects of the new federal laws and rules that will directly affect swap providers who offer *pari passu* swaps or their execution of these swaps. The reader should note that all market participants, including lenders, swap providers and borrowers, may be affected by other parts of Title VII and other titles of the Dodd-Frank Act that are beyond the scope of this article.
7. The Dodd-Frank Act also contains extensive requirements for "security-based swaps" (as opposed to "swaps") and their dealers, which are overseen by the U.S. Securities and Exchange Commission (SEC). However, the legislation grants the CFTC sole jurisdiction over "swaps" constituting the types of interest rate, currency rate and commodity swap contracts that are most commonly used by borrowers for hedging purposes as *pari passu* swaps under a credit facility. Therefore, in this article, we discuss exclusively regulations applicable to "swaps" and to dealers and end-users of "swaps."
8. The CFTC estimates that roughly 120-125 entities will need to register either as swap dealers or MSPs, although as many as 450 entities likely will need to analyze their business activities to determine whether they will trigger swap dealer or MSP recognition. Further Definition of "Swap Dealer," "Security-Based Swap Dealer," Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 77 Fed. Reg. 30596, 30713 (May 23, 2012).
9. The CFTC has stated that it expects very few entities ("six or fewer") to be deemed to be a "major swap participant" under its finalized definition of that term. *Id.* at 30713 n. 1351. Absent unusual circumstances, entities engaged in ordinary lending and provision of pari passu swaps likely will not fall within the definition of an MSP as a result of such activities. The MSP definition focuses on large uncollateralized open swap positions (therefore excluding *pari passu* swaps) and high internal leveraging of the entity in question (therefore excluding most bank entities). This article, therefore, focuses on the "swap dealer" designation.
10. We expect designation as a swap dealer or MSP and application of the Swap Push-Out Rule will mainly be of concern U.S. persons (including, potentially, U.S. branches of foreign banks). The precise scope of extraterritorial application of Title VII, however, remains subject to regulatory consideration and is in any event beyond the scope of this article.
11. Commodity Exchange Act Section 1a(49)(A).
12. Commodity Exchange Act Section 1a(49). We refer to this exclusion, as further detailed by related CFTC regulations, as the "IDI exclusion."

© 2012 THOMSON REUTERS

Technically, the exclusion does not apply exclusively to swaps executed with borrower counterparties. Rather, a back-to-back swap that an IDI enters into for the purpose of hedging the risk of another *swap* that is covered by the IDI exclusion will not be considered under the swap dealer definitional tests, either. However, the exclusion does not cover swaps used by a depository to hedge or lay off risk arising from a loan position (such as a credit default swap referencing the loan itself). 77 Fed. Reg. 30596, 30623.

13. The CFTC has declined to define the term "loan." Its rules provide, however, that the IDI exclusion will not cover swaps executed in connection with "sham" loans (a term that also is not defined) or synthetic loan positions (such as loan credit default swaps or loan total return swaps). 17 C.F.R. § 1.3(ggg)(5)(iii).
14. 17 C.F.R. § 1.3(ggg)(5)(i)(B).
15. 17 C.F.R. § 1.3(ggg)(5)(i)(A).
16. *See* 17 C.F.R. § 1.3(ggg)(5)(i)(D).
17. *See* 17 C.F.R. § 1.3(ggg)(5)(i)(E).
18. *See* 17 C.F.R. § 1.3(ggg)(4).
19. Although Section 716 generally bars federal assistance to MSPs, MSPs that are IDIs are not affected. Section 716(b)(2)(B).
20. Many of the largest swap providers in the U.S. historically have executed and held most of their OTC swap positions (on a notional basis) through U.S. bank subsidiaries of their bank holding company groups. Such bank entities generally have been regarded as better credit risks than their group as a whole and are viewed by most swap customers as more attractive counterparties. U.S. banks also typically have low costs of funding (by virtue of accepting deposits), can access the Federal Reserve discount window in an emergency and incur much lower capital charges for exposures on uncleared swaps as compared to their U.S. broker-dealer affiliates.
21. Section 716(c) of the Dodd-Frank Act expressly allows IDIs to push out swaps to a swap dealer or MSP affiliate provided that the affiliate is commonly controlled by a Federal Reserve-regulated bank or savings and loan holding company. Insured institutions that push out swaps trades to such an affiliate must comply with long-established sections 23A and 23B of the Federal Reserve Act, which govern inter-affiliate transactions and are designed to insulate insured institutions from non-insured affiliates' risk.

    It is not yet clear how an insured institution organized *outside* of a bank or savings and loan holding company (such as an insured U.S. branch of a foreign bank) will be able to comply with Section 716 other than by ceasing prohibited swap trading activity altogether. After the Dodd-Frank Act's passage, however, U.S. Senators Blanche Lincoln and Christopher Dodd indicated that the technical exclusion of foreign banks with U.S. branches from the 716(c) safe harbor was unintended and should be remedied by future legislation. *See* 156 Cong. Rec. S5903-04 (daily ed. July 15, 2010). At least one piece of corrective legislation has since been proposed by the U.S. House Committee on Financial Services. H.R. 1838, 112th Cong. (2012).
22. *See* 12 U.S.C. § 24 (Seventh) (2009) (including currency, bullion, loans on personal security, corporate bonds and U.S. government and agency debt securities among the list of permissible assets for bank investments).
23. Any swap subject to mandatory clearing requirements will also be subject to mandatory trade execution on a "designated contract market" (an exchange for derivative contracts) or on a "swap execution facility" ("SEF") provided that any such swap has been made "available to trade" on an exchange or SEF. *See* Commodity Exchange Act Section 2(h)(8) (as amended by the Dodd-Frank Act). SEFs are facilities that allow multiple parties to show trade bids or offers to multiple potential counterparties simultaneously. Under the mandatory trading requirement, bilateral execution in the way that *pari passu* swaps are traditionally traded will not be permitted.
24. This is a highly simplified description of the typical U.S. clearing relationship between end-users and DCOs. Among other features, one or more FCMs will act as intermediaries between a customer and a DCO so that customer information and margin operationally flow through the FCM. An FCM that is a clearing member of a DCO must also agree to guarantee, for the DCO's benefit, a customer's swap obligations in order for a customer's contract to be accepted by a DCO for clearing. See Julia Lu and Charles D. Thompson, II, Prepare for the Clearing Environment (Dec. 3, 2010), http://www.rkollp.com/newsroom-publications-139.html.
25. For a more detailed explanation of the segregation of posted collateral under the U.S. regime for cleared swaps, see Julia Lu and John A. Clark, CFTC Adopts "Legal Segregation with Operational Commingling" Model for Treatment of Cleared Swaps Collateral (Feb 1., 2012), http://www.rkollp.com/newsroom-publications-214.html.
26. *See generally* Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 47170 (proposed Aug. 7, 2012).
27. For a more specific list of financial entities, see CEA Section 2(h)(7)(C)(i). The CFTC also has exempted banks, savings associations, farm credit system institutions and credit unions from the definition of "financial entity." End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42559, 42591 (July 19, 2012) (to be codified at 17 C.F.R. § 39.6(d)).
28. 77 Fed. Reg. 42559, 42590 (to be codified at 17 C.F.R. § 39.6(c)). This condition generally will also be satisfied if a swap qualifies for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133). *See id.*
29. *Id.* at 42572.

© 2012 THOMSON REUTERS

30. *See generally* 17 C.F.R. Part 45. CFTC rules also require that any IDI taking advantage of the IDI exclusion under the swap dealer definition (discussed above) to be the "reporting counterparty" for such swaps. *See* 17 C.F.R. 1.3(ggg)(5)(i)(F). The CFTC believes this is consistent with prevailing practice that the lenders handle the documentation of loans made to borrowers.
31. 77 Fed. Reg. 42559, 42590 (to be codified at 17 C.F.R. § 39.6(b)).
32. *See* 77 Fed. Reg. 42559, 42570 (regarding "Liability for Reporting").
33. In particular, this rule applies to entities that are issues of securities registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") or that are required to file reports pursuant to Section 15(d) of the Exchange Act. *See* Commodity Exchange Act Section 2(j).
34. *See* 77 Fed. Reg. 42559, 42568-70 (regarding "Board Approval for SEC Filers").
35. An exempt end-user, on the other hand, is permitted to rely on the clearing exception for a swap that hedges another swap position, if the latter itself qualifies under the clearing exception. *See id.* at 42574 (to be codified at 17 C.F.R. § 39.6(c)(2(ii)).
36. The term "Prudential Regulators" refers to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Farm Credit Administration and the Federal Housing Finance Agency, collectively. *See* Commodity Exchange Act Section 1a(39).
37. The CFTC and Prudential Regulators (and SEC) view the Dodd-Frank Act as authorizing them to prescribe mandatory margin collection and holding rules for uncleared swaps. The Commercial End-User Exception discussed above does *not* exempt a customer from the regulators' proposed uncleared margin rules. There is, however, federal legislation pending that would exempt commercial end-users from the rules. [\As of the publication date of this article, the relevant bill had passed the U.S. House of Representatives but had not yet been scheduled for a vote in the Senate. *See* H.R. 2682, 112th Cong. (2011).
38. *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 (proposed May 11, 2011).
39. *See* Margin Requirements for Uncleared Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (proposed Apr. 28, 2011).
40. However, non-bank subsidiaries of bank or savings and loan holding companies fall under CFTC jurisdiction if they are required to register as swap dealers or MSPs. *Id.*
41. A "low-risk" financial end-user must not have any "significant swaps exposure," must predominantly use swaps to "hedge or mitigate the risks of its business activities" and must be subject to capital requirements established by a Prudential Regulator or state insurance regulator. *See* 76 Fed. Reg. 27564, 27587.
42. *See* 76 Fed. Reg. 27564, 27857 (to be codified at § __.2(m)). Precise cap amounts (within the figures bracketed here) will be set forth in the Prudential Regulators' final rules. As proposed, these caps are equal to the lesser of (i) [$15 to $45] million and (ii) [0.1% to 0.3%] of the Prudentially Regulated entity's regulatory capital.
43. *See* Commodity Exchange Act Section 1a(39) (defining Prudential Regulator jurisdiction).
44. *See* 76 Fed. Reg. 23732 (to be codified at 17 C.F.R. § 23.150).
45. The CFTC does not use the term "low-risk financial entity," but acknowledges that the criteria of financial entity eligible for a threshold were developed in consultation with the Prudential Regulators.
46. *See, e.g.*, 76 Fed. Reg. 23732, 23736.
47. *See id.* at 23737
48. *See* Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613 (Jan. 19, 2012).
49. *See* Guidance on the Effective Date of Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Fed. Reg. 27456 (May 10, 2012).
50. As discussed above, CFTC rules for mandatory clearing of certain interest rate swaps (and credit default swaps) are still in proposed form. Other regulatory prerequisites for mandatory clearing — such as rules governing DCO membership criteria, the review process for mandatory swap clearing and the Commercial End-User Exemption — have already been finalized.
51. *See* Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA, 77 Fed. Reg. 44441 (July 30, 2012) (to be codified at 17 C.F.R. § 50.25).

Article REPRINT

(#74810) Reprinted with permission from the September 2012 issue of Futures & Derivatives Law Report.
© 2012 West Services Inc., a Thomson Reuters company. All rights reserved. For more information about Futures & Derivatives Law Report, please visit www.store.westlaw.com.
For more information about reprints, please visit PARS International Corp. at www.reutersreprints.com.

© 2012 THOMSON REUTERS