Dodd-Frank and Real Estate: Preparing for New Derivatives Regulations

November 7, 2012

Pam Brown
Agenda

- The Regulatory Journey
- Determining Impact
- Impact on Financial End Users
- Impact on Nonfinancial End Users
- Putting It All Together: how hedge transactions will change
- Next Steps: Getting Ready
The Regulatory Journey
Where are we and how did we get here?
The Dodd-Frank Act: A Complex Piece of Legislation

Financial Legislation (increasing complexity)

<table>
<thead>
<tr>
<th>Act</th>
<th>Number of Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve Act (1913)</td>
<td>31</td>
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<tr>
<td>Glass-Steagall Act (1933)</td>
<td>37</td>
</tr>
<tr>
<td>Sarbanes-Oxley Act (2002)</td>
<td>66</td>
</tr>
<tr>
<td>Gramm-Leach-Bliley Act (1999)</td>
<td>145</td>
</tr>
<tr>
<td>Dodd-Frank Act (2010)</td>
<td>848</td>
</tr>
</tbody>
</table>
Rulemaking: An Extraordinary Undertaking

After a 2½ year regulatory journey, regulators are not yet finished.

Source: Davis Polk 10/1/12
Compliance Begins

You are here

- **Q4 2012**
  - External Business Conduct Standards & Dodd-Frank Protocol

- **Q1 2013**
  - Final Clearing Determination for Interest Rate & Credit Derivatives

- **Q2 2013**
  - Clearing for Financial Entities

- **Q3 2013**
  - Reporting
  - End-User Exception/Board Resolution
Determining Impact

Which requirements apply?
Key Features of US Derivatives Reform
Title VII of Dodd-Frank seeks to contain systemic risk and increase transparency in the over-the-counter ("OTC") derivatives market
US Entity Classifications
4 key entity classifications determine scope of regulatory impact

End user exception
- Non-financial hedgers are exempt from clearing and trading requirements
- Speculators and financial end users are not exempt from clearing/trading

Financial Entities
- Commodity pools
- Private funds
- Entities predominantly engaged in the business of banking or in activities that are financial in nature

Companies that are unsure of whether their hedging entities are financial should begin confirming their status with legal counsel now
## US Requirements By Entity Type

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Swap Dealer</th>
<th>Major Swap Participant</th>
<th>Financial Entity</th>
<th>Nonfinancial End User</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Capital Requirements</td>
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<td>Business Conduct Standards</td>
<td>✔</td>
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<tr>
<td>Conflict of Interest Rules</td>
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<td>✔</td>
<td>✔</td>
<td></td>
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<tr>
<td>Central Clearing</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>Exempt from clearing &amp; trading requirements if certain conditions are met</td>
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<tr>
<td>Exchange/SEF Trading</td>
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<td>✔</td>
<td>✔</td>
<td></td>
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<tr>
<td>Confirmation and Portfolio</td>
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<tr>
<td>Reconciliation/Compression</td>
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<tr>
<td>Reporting and Recordkeeping</td>
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<td>✔</td>
<td>✔</td>
<td>*</td>
</tr>
<tr>
<td>Margin for Non-Cleared Swaps</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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*Trades between two non-swap dealers/non-major swap participants

**Only for trades executed with swap dealers and major swap participants
Key Question: What is a Financial Entity?

“Financial entity” is:

- A swap dealer
- A security-based swap dealer
- A major swap participant
- A security-based major swap participant
- A commodity pool
- A private fund as defined in section 202(a) of the Investment Advisers Act of 1940
- An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974
- A person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956

*Section 723 of the Dodd-Frank Act*
Example #1: Equity REIT

- On October 12, CFTC issued interpretative guidance stating that equity REITs are NOT “commodity pools” (and, as a result, NOT financial entities)
  - Commodity pool is “any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading commodity interests” (CEA section 1a(10))
  - There was concern among equity REITs that they would be captured by new commodity pool definition, which expanded “commodity interests” to include swaps
  - Interpretation provides relief to an equity REIT that satisfies the following conditions:
    - Primarily derives its income from the ownership and management of real estate and uses derivatives for hedging interest rate or FX risk
    - Is operated so as to comply with all of the requirements of a REIT election under the IRC, including the “75 percent test” and the “95 percent test”
    - Has identified (or has stated its intention to identify) itself as an equity REIT in Item G of its last US income tax return on Form 1120-REIT and continues to qualify as such
Example #2: Private Real Estate Fund

**Fund:**
- Most likely a financial entity
  - 3(c)(1) and 3(c)(7) funds are financial entities
  - Commodity pools are financial entities

**Holding Company**
- Possibly nonfinancial*

**Property-holding entities**
- Most likely nonfinancial*

*Note that if the fund engages in any derivatives activity and is a commodity pool, then there is a small possibility that – in addition to the fund – the holding company and/or property-holding entities could also be deemed commodity pools/financial entities.
Impact on Financial End Users
Key Requirements on Financial End Users

<table>
<thead>
<tr>
<th>Key Requirements</th>
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<tr>
<td>Central Clearing</td>
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<tr>
<td>Trading</td>
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<tr>
<td>Amending Swap Relationship Documentation</td>
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<tr>
<td>Recordkeeping</td>
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</table>
OTC Derivatives Central Clearing Paradigm

Central clearing reduces risk by reducing interconnectedness of large swap dealers and other major market players and by removing credit risk through initial & variation margin.
Central Clearing Requires Daily Posting of Margin

Initial Margin (IM) and Variation Margin (VM)

End User → FCM (for end user) → DCO (clearing house) → FCM (for dealer) → Executing Broker (dealer)

End user posts variation margin (VM) when the MTM value of its derivative positions is negative.

Only initial margin is held at the DCO.

EB posts variation margin (VM) when the MTM value of its derivative positions is negative.
Swaps Required to Be Cleared

- First categories of swaps proposed for mandatory clearing:
  - Fixed-to-floating swaps
  - Basis swaps (floating-to-floating)
  - Forward rate agreements
  - OIS swaps
  - IR swaps with amortizing/ accreting/ roller coaster notional amounts
  - IR swaps with optionality
  - IR swaps that reference more than one currency

- Clearing determination anticipated to be finalized in November

- Finalized determination triggers implementation schedule
  - + 90 days for swap dealers, major swap participants and active funds
  - + 180 days for other financial entities
  - + 270 days for end users and third party accounts
Trading Requirement: Exchanges/Swap Execution Facilities

- If a trade that is subject to the clearing requirement is also “made available for trading” on a regulated exchange or swap execution facility (SEF), then swap dealers, MSPs and financial entities must execute the trade on the exchange or SEF.

- Swap execution facilities are third party trading platforms that accept bids/offers from multiple participants.

- Two models:
  - Central Limit Order Book (CLOB)
  - Request for Quote (RFQ)

- Final rule expected by end of 2012.

Selected Exchange and Likely SEF Participants:

- Tradeweb
- FXall
- ICAP
- GFI
- CME Group
- Bloomberg
- Eris Exchange
Amending Swap Relationship Documentation

- Background
  - SDs and MSPs are required to comply with external business conduct standards under Title VII and the CFTC’s regulations
  - Requires SDs and MSPs to provide and receive representations, agreements and notices to/from counterparties
  - CFTC’s recent documentation rules extended the compliance date for many of the external business conduct standards to January 1, 2013

- End-User Impact
  - If end-users wish to continue trading after January 1, 2013, they will be required to amend current swap relationship documentation to reflect the new rules
  - ISDAs may be amended bilaterally or through the ISDA August 2012 Dodd-Frank Protocol
  - Additional Protocol(s) are in the works to address other requirements under Title VII
Recordkeeping Requirements

- Recordkeeping Rules for New Swaps (“Part 45”)
  - End users are required to “keep full, complete, and systematic records, together with all pertinent data and memoranda” of each swap transaction in which they are a counterparty until the swap has been fully terminated for five years
  - Among data required to be kept is a Legal Entity Identifier (LEI)
  - Records may be kept in either electronic or paper format, but must be retrievable within five business days
  - Compliance date: April 10, 2013

- Recordkeeping Rules for Historical Swap Data (“Part 46”)
  - Parties must retain data for all historical swaps in existence after July 21, 2010 (even if such swap is currently terminated or otherwise extinguished)
Impact on Nonfinancial End Users
Key Requirements on Nonfinancial End Users

<table>
<thead>
<tr>
<th>Key Requirements</th>
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</thead>
<tbody>
<tr>
<td>End-User Exception to Mandatory Clearing</td>
</tr>
<tr>
<td>Margin</td>
</tr>
<tr>
<td>Amending Swap Relationship Documentation (same as for financial end users)</td>
</tr>
<tr>
<td>Recordkeeping (same as for financial end users)</td>
</tr>
</tbody>
</table>
End-User Exception to Mandatory Clearing

End-user exception is available for a swap if one of the counterparties:

- Is not a financial entity
- Is using swaps to hedge or mitigate commercial risk; and
- Notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps

Final End-User Exception Rule creates CFTC Regulation § 39.6 which describes the requirements for electing this statutory exception by:

- Establishing the criteria for determining whether a swap hedges or mitigates commercial risk;
- Specifying the information that counterparties must report to satisfy the notification requirement; and
- Specifying how SEC filers will evidence the board committee’s approval to elect the end user exception
Margin Requirements: Non-Cleared Trades

• G20 committed to develop global margin standards for consultation in June 2012

• Working Group on Margining Requirements (WGMR)

• Regulators globally are likely to substantially adopt WGMR’s recommendations

• Consultation closed Sept 28

G20 Cannes Declaration:

“We call on the Basel Committee on Banking Supervision (BCBS) & the International Organization for Securities Commission (IOSCO), together with other relevant organizations, to develop for consultation standards on margining for non-centrally cleared OTC derivatives by June 2012”
WGMR Proposal on Margin for Uncleared Trades

- No margin requirements for nonfinancial end users
- All asset classes covered, including FX

Various possibilities for financial entities, including:
- Initial margin thresholds
- Varying initial margin thresholds by entity type
- Reasonably broad eligible collateral, including cash, sovereigns, high quality corporate bonds, equities included in major equity indices, gold
- Variation margin applies to interaffiliate trades
- Initial margin calculated at levels intended to create incentive to clear
## Margin Requirements: US Proposed Rules

<table>
<thead>
<tr>
<th></th>
<th>CFTC Rule</th>
<th>Prudential Regulator Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Applies to...</strong></td>
<td>Non-bank swap dealers including certain bank affiliates</td>
<td>Bank swap dealers</td>
</tr>
</tbody>
</table>
| **Requirements for Financial Entities** | • Full initial margin (IM) and variation margin (VM) for “high risk financial entities”  
  • Small threshold (< $30mm) permitted for “low risk financial entities” |                                                                                                |
| **Requirements for Non-Financial Entities** | No margin requirement                                                      | Margin required when portfolio exceeds credit exposure limit |
| **Eligible collateral** | Limited to cash, treasuries, and certain GSEs                               |                                                  |
| **Pre-existing trades** | Not subject to requirements if under separate ISDA                         |                                                  |

**Key question for end users:**

*Will bank regulators conform to CFTC & WGMR approach for nonfinancial end users?*
Putting It Together

How hedge transactions will change
### Current Transaction Workflow (for financial and nonfinancial entities)

<table>
<thead>
<tr>
<th></th>
<th>Pre Dodd-Frank Transaction Workflow</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Pre-execution set-up with dealer banks</td>
</tr>
<tr>
<td>2</td>
<td>Trade execution</td>
</tr>
<tr>
<td>3</td>
<td>Post-execution trade confirmation</td>
</tr>
<tr>
<td>4</td>
<td>Valuations &amp; accounting</td>
</tr>
</tbody>
</table>
Future Transaction Workflow (for a financial entity)

**Post Dodd-Frank Dealer-Facing Transaction Workflow**

1. **Pre-execution set-up with dealer banks and others**
   - Documentation
     - Changes to ISDAs with dealer banks
   - Trading/Clearing prep
     - Establish relationships with FCMs, DCOs, SEFs & DCMs (potentially)

2. **Trade execution**
   - Trading
     - Phone execution may be prohibited for some trades; may have to execute on SEF/DCM

3. **Post-execution confirmation**
   - Confirmation
     - Electronic confirmation for some trades

4. **Central clearing/bilateral margin**
   - Clearing
     - Dealer-facing trade may have to be cleared
     - Bilateral margin
       - Thresholds set for dealer-facing bilateral (i.e., non-cleared) swaps?

5. **Recordkeeping**
   - Recordkeeping
     - Maintain “full, complete, and systematic records”

6. **Valuations & accounting**
   - Valuations
     - Market move toward using OIS to value (i.e., discount factors) all swaps
Future Transaction Workflow
(for a nonfinancial entity)

1. **SEC Filers only:** obtain Board committee approval
2. Pre-execution set-up with dealer banks
3. Trade execution
4. Post-execution confirmation
5. Bilateral margin
6. Recordkeeping
7. Valuations & accounting

**Documentation**
- Changes to ISDAs with dealer banks

**Confirmation**
- Electronic confirmation by market convention?

**End-User Exception**
- Provide information for the election of end-user exception

**Bilateral margin**
- Potential posting of margin to dealer counterparty

**Recordkeeping**
- Maintain “full, complete, and systematic records”

**Valuations**
- Market move toward using OIS to value (i.e., discount factors) all swaps
Next Steps: Getting Ready

What should I do now?
## Compliance Timeline

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Action Step</th>
<th>Compliance Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>N/A</td>
<td>Determine financial entity status</td>
<td>now</td>
</tr>
<tr>
<td>ISDA August 2012 DF Protocol</td>
<td>If your entity plans on executing trades after January 1, 2013, determine whether you would like to complete the adherence process</td>
<td>January 1, 2013</td>
</tr>
<tr>
<td>Swap Data Recordkeeping</td>
<td>Prepare to keep records of information relating to swaps</td>
<td>April 10, 2013</td>
</tr>
<tr>
<td>Central clearing (financials only)</td>
<td>Evaluate/select clearing partner (FCM); negotiate documentation; complete onboarding process</td>
<td>May 2013**</td>
</tr>
<tr>
<td>End-user Exception Election (nonfinancials only)</td>
<td>If you are a public company, prepare to obtain approval (i.e., resolution) from an appropriate board committee in order to elect the end-user exception for trades that are otherwise subject to the clearing requirement</td>
<td>August 2013**</td>
</tr>
</tbody>
</table>

*The CFTC is expected to issue its first clearing determination requirement in November 2012. Once it does, financial entities will have 180 days to comply and nonfinancial end users will have 270 days to comply/elect the end-user exception.*
Contact Information

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