

Eco Risk Markets LLC is a private firm which specializes in the outsourcing of risk management activities, covering energy, commodities, interest rates and foreign exchange

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Perspectives on the Impact of Derivatives Regulation

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Background on derivatives related legislation

After the financial crisis of 2008, congressional work resulted in several financial reform bills generated out of the House and Senate¹

- **Wall Street Reform and Consumer Protection Act of 2009 (HR 4173).** Passed in December 2009, this House bill originated in the House Financial Services Committee and contains language in section 3001 regulating derivatives. In addition to derivatives changes, this bill represents the broad financial reform effort to attempt to prevent systemic risks to the financial system

- **Restoring American Financial Stability Act of 2010 (S 3271).** This is the Senate's version of the financial reform bill that is being actively debated between two groups – the Senate Banking Committee and the Senate Agriculture Committee (due to commodities) – and will likely result in a merged Senate approved version which then has to be reconciled with HR 4173. S 3271 is also a broad financial reform bill

- **Latest activity is focused on developing a merged version of the Senate bill which, once passed, would need to be reconciled with the House bill and then approved again by the House and then signed by the President**
 - The Wall Street Transparency and Accountability Act of 2010 is the amendment (substitute) by Dodd/Lincoln to S 3271

¹ Bills include The Derivative Trading Accountability and Disclosure Act (HR 3300), The Over-The-Counter Derivative Markets Act of 2009 (HR 3795), and The Derivatives Markets Transparency and Accountability Act of 2009 (HR 977).

The Dodd/Lincoln proposal has a key “end-user” impact...

- **Requirement to Exchange Clear Transactions.** Any swap that has characteristics that are substantially similar to other swaps (economically equivalent in term, index and volume), and therefore could be offset against other swaps, must be cleared if they are acceptable to a registered clearing agency (or if the CFTC or SEC determines that the swaps must be cleared)
 - Interpretation of what constitutes “standard, clear-able” transactions is still evolving
 - Confirmation needed that existing non-cleared swaps are grandfathered from this provision
 - Definition of a registered clearing agency may need to be clarified
 - Frequency and/or likelihood of CFTC/SEC impositions are unclear at this time
 - Uncertainty around whether registered clearing agencies are required to accept all counterparties

- **Commercial End User Exemption.** Exemptions from the clearing requirement exist for "commercial end users" who can elect either cleared or "not cleared" swap execution when hedging its own commercial risk. This exemption applies to entities that, individually or as a fiduciary, own, produce, manufacture, and distribute goods and services or commodities which shall include, but are not limited to, coal, natural gas, electricity, ethanol, crude oil, gasoline, propane, distillates, and other hydrocarbons
 - This provision applies to physical asset participants (upstream, midstream/transport, and downstream/retail)
 - Companies may need to separate transactions used to hedge native/commercial risks from those used for trading activities
 - To transact outside of a clearing agency or qualified swap execution facility, public companies would need to certify that this course of action has been approved by the Board's Audit committee

...While other provisions may increase the cost of doing business...

- **Regulators to Set Capital/Margin Requirements.** Regulators may be granted powers to set capital/margin requirements for banks. As banks comprise the majority of the exchange clearing agents, increased requirements could likely trickle down to counterparties using exchanges to clear trades
 - Potential for increased cost of doing business - particularly through increased initial margin levels
 - Uncertainty around degree of capital/margin requirement change (if any) for various classes of credit ratings

- **Segregation of Collateral.** There is a requirement to segregate collateral with a third party custodian when securing swap transactions that are not cleared; it appears this requirement is triggered at the request of the non-bank counterparty who is not providing collateral (to ensure that banks have sufficient funding to meet obligations)
 - Financial institutions would need additional capital set aside to support deals; this may be reflected in higher transaction costs and bid/ask spreads
 - Unclear whether there is a carry-over for commercial end users to segregate or restrict collateral use under an ISDA

- **Reporting Requirement.** The proposal imposes a reporting requirement for transactions and pricing data – even for non-cleared transactions; further, real-time reporting is required as soon as "technologically practicable"
 - End users may not be prepared for meeting reporting needs related to market and transaction data requests
 - As envisioned, advanced reporting would reflect a major change to how many market risk and credit risk systems work today (i.e., most risk systems are refreshed once a day after all deals have been entered and confirmed with counterparties)

...Or decrease market depth and participation

- **Position Limits for Large Traders.** With respect to overall position limits for "physical delivery", the CFTC and/or SEC would be authorized to establish rules for "large traders"
 - Market-making entities may have less flexibility and thus market depth may decrease

- **Carve-out of proprietary/speculative trading units.** To emphasize Congress' intent to stop "*too big to fail*" and the implicit support to the financial sector, certain institutions may be required to spin-off or carve-out their derivative activities. Without separation, these institutions risk access to the Fed window or FDIC support
 - Significant capitalization requirements for stand-alone market-making/trading entities may force trading operations to scale back degree of activity
 - Among non-bank entities, the incremental capital costs may drive out certain legacy participants including hedge funds and other proprietary trading interests.
 - This could result in less liquidity for key energy risk products including: gas basis or financial transmission rights (FTR's)

Eco+Risk suggests a two-step approach to mitigate risk stemming from rule changes

- In the near-term, conduct a diagnosis on current operations:
 - Inventory existing transaction portfolio into key sub-categories including commodity type, financial vs. physical, exchange cleared vs. OTC, asset management vs. trading, simple vs. complex products, standard vs. non-standard collateral terms, etc.
 - Evaluate forecast contract and transaction portfolio to determine potential issues and opportunities (i.e., are there enough exchange clearing relationships and do they support the type of transactions typically executed?)
 - Determine changes needed to current portfolio of over-the-counter ISDAs (i.e., will these ISDAs primarily be supporting physical deals in the future and are credit terms appropriate as-is?)
 - Assess how future liquidity requirements may change for overall derivative activity
 - Develop transition plan for how new deals will flow vis-à-vis the potential clearing requirement and exemptions
 - Initiate “no-regret” steps with regards to optimizing future counterparty paths: exchange platforms, technology/reporting, new contracts/ISDAs

- In the medium-term (post-rule change), implement complete risk mitigation steps once final rules are known:
 - Enhance or increase liquidity facilities as appropriate
 - Make process changes to commercial/front-office and risk/mid-office activities
 - Implement reporting enhancements to support requirements and to facilitate internal management reporting

Company Overview

Eco Risk Markets LLC is a private firm which specializes in helping companies manage their commodity expenditures.

Our team has worked with leading companies to establish a practical approach to managing the risks surrounding commodity price volatility through the execution of consistent, efficient, and well-communicated hedge programs.

Eco+Risk has taken this approach to the next logical step and integrated overall energy price management with our client's renewable fuels and sustainability initiatives.

We believe an integrated approach to managing overall commodity risk is imperative as new energy legislation is enacted, new markets continue to develop, and derivative regulations become increasingly burdensome.

Our Mission

Our mission is to help our clients manage commodity price risks in a manner consistent with shareholder expectations, sustainability initiatives, and transparency needs



Company Overview

Eco Risk Markets has offices in the Southwest and the Northeast. Our primary office is in Houston:

808 Travis Street, Suite 100
Houston, TX 77019

For further information, please contact us:

Brian O'Neal | Managing Director – Risk Management
832.725.0314 | brian.oneal@ecoriskmarkets.com

Randy Wilson | Managing Director – Renewables
713.582.5763 | randy.wilson@ecoriskmarkets.com

Evan Zuckert | Managing Director – Capital Markets
203. 505.4126 | evan.zuckert@ecoriskmarkets.com

Dung Tran | Managing Director – Utilities
214.605.1116 | dung.tran@ecoriskmarkets.com