



Regulatory Update:

*Preliminary Impact of the Dodd – Frank Bill
on Derivatives for the Energy and Broader
Commodities Sector*

Financial Regulation: What to Expect

Key Provisions Relevant to Derivative Transactions

In a compromise of the “Volker Rule”, derivative transactions involving commodities, equities and un-cleared credit default swaps will need to be carried in a **separately capitalized affiliate** of the bank. Foreign exchange and interest rate derivatives which represent the vast majority of transactions among the major dealers would remain in-house.

Separately, the bill substantially limits the ability of banks to engage in derivatives for proprietary trading and invest in hedge funds and/or private equity.

The **clearing requirement for “standardized” swaps** through registered clearing and swap facilities remains substantially as outlined in the May ‘05 bill. There are **transitional rules that would allow counterparties that are not financial entities to be exempted from the clearing requirement** as long as: (i) legacy swaps are reported to a registered swap data repository; (ii) the swaps have been established to hedge or mitigate commercial risk; and (iii) the company notifies the regulator as to how it generally meets financial obligations associated with entering non-cleared swaps.

Although it was left out of the latest Dodd – Frank draft, based upon our understanding, **it is likely that an end-user exemption for mandatory clearing will be retained.**

Lawmakers have indicated that it will be reinserted upon further refinement of the bill.

To reiterate, exemptions from the clearing requirement will 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.

The regulation of swaps (participants and clearing organizations) will fall under the **dual jurisdiction of the CFTC and the SEC**. As noted in May, much of the compliance including margin requirements for un-cleared transactions, data reporting (see below) and oversight of activities (books and records) is to be determined. The bill suggests that most rules are to be in place within 180 days of enactment.

There is a **real time price reporting requirement** for counterparties to report data, including price and volume, as soon as “technologically practicable”, after the time at which the swap transaction has been executed. This reporting requirement effectively applies to all swaps including: (i) swaps that are subject to mandatory clearing; (ii) swaps not subject to mandatory clearing but cleared at a registered derivatives clearing organization; and (iii) swaps that are reported to a swap data repository but are not cleared at a registered derivatives clearing organization.

Other Relevant Provisions

There is a standard of conduct pertaining to swap dealers transacting with “special entities.” These special entities include municipalities, political subdivisions, and pension and endowment funds. This establishes a code of conduct for all registered swap dealers and major swap participants when advising these entities.

Under the general heading of corporate governance, stock exchanges would be required to delist companies that do not have a claw-back provision for excessive executive compensation tied to inaccurate financial statements. In other words, executive compensation is now to some degree dependent upon proper valuation from the perspective of accounting standards.

From the perspective of liability, ratings agency statements will be held to the same standard as those of public accountants and securities analysts.

Corporate Impacts: How to Prepare

Preliminary Conclusions: Ongoing Uncertainty, Higher Transaction Costs, and Decrease in Market Depth & Liquidity

Increased capital and margin requirements will affect banks, swap dealers, and major swap participants that are not banks. They are almost certain to increase the cost of transacting. 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)

With respect to the reporting requirement noted above, **many end users may not be prepared for meeting reporting needs related to market and transaction data requests.** Specifically, 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).

Regulation and compliance requirements are uncertain as subsequent to enactment the CFTC and SEC will embark on establishing rules for what is and is not "standardized" as well as which swaps that can be accepted by the derivatives clearing organizations. It

is anticipated that most of the rules will be in place within 180 days of enactment.

Separation of commodity and equity trading units may lead to fewer market participants.

Significant capitalization requirements for stand-alone derivative entities combined with the requirement to replace Trust Originated Preferreds for Tier 1 capital, may drive some incumbents to exit or substantially curtail certain activities.

Preparation: A two-step approach to mitigate risk stemming from rule changes

Step 1

In the near-term (pre rule-change), conduct a diagnosis on current operations:

- a) Inventory existing transaction portfolios 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.
- b) 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?).

- c) Determine required changes 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?).
- d) Assess how future liquidity requirements may change for overall derivative activity.
- e) Develop transition plan for how new deals will flow vis-à-vis the potential clearing requirement and exemptions.
- f) Initiate "no-regret" steps with regards to optimizing future counterparty paths: exchange platforms, technology, reporting, new contracts, and ISDAs.

Step 2

In the medium-term (post-rule change), implement complete risk mitigation steps once final rules are known:

- a) Enhance or increase liquidity facilities as appropriate.
- b) Make process changes to commercial/front-office and risk/mid-office activities.
- c) Implement reporting enhancements to support requirements and to facilitate internal management reporting.

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