



Dodd-Frank Act OTC Derivatives Reform

**Supporting Materials for Panel Discussion
“*OTC Derivatives Reforms*”**

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**Part One:
End User Collateral Regulations**

End User Collateral Regulations

- Two proposed margin rules - CFTC and Prudential Regulators
- Futures Concepts - Initial Margin and Variation Margin
- Both margin rules requires counterparties to enter into collateral support agreements
 - Need not be an ISDA CSA
 - Must contain objective valuation methodology that uses objective inputs which permit regulators to determine the variation margin amounts

Proposed CFTC End User Margin Rules

- Apply to all CSEs subject to CFTC regulation, including subsidiaries of bank holding companies “pushed out” under Section 716 that trade commodities
- Credit support agreements **may, but are not required to**, mandate the posting of initial or variation margin
- Counterparties are permitted to use a collateral threshold for both initial margin and variation margin
- If variation margin is due, it would be collected on a weekly basis
- Permits the use of non-cash collateral as long as the value of the asset is “is reasonably ascertainable on a periodic basis”

Proposed Prudential Regulator End-User Margin Rules

- Two material differences from the CFTC's proposed margin rules
- Treatment of non-cash collateral
 - Under the prudential regulator's margin rules, the use of non-cash collateral that is not a cash equivalent is not permitted
 - This may be a major issue for parties that deliver letters of credit
- Margin requirements with non-financial end users
 - Under the prudential regulator's margin rules, credit support agreements between CSEs and non-financial end users must require the posting of initial and variation margin
 - Reasonable unsecured thresholds are permitted for both initial and variation margin

Technical Issues End-Users Should Understand

- Limited use of models to determine initial margin under CFTC Rules
 - The use of initial margin models is permitted, but the model must:
 - i. Not be proprietary
 - ii. Either be reviewed and approved by a prudential regulator
 - iii. Be used by a derivatives clearing organization, or
 - iv. Be made available by a third party vendor
 - To qualify, models must be subject to certain standards, including a requirement that the initial margin required by the model cover ninety-nine percent of possible price changes over a 10-day period
- Price reference to cleared swap (x2) or futures (x4.4) under CFTC Rules
 - If a CSE does not use an initial margin model, it must use the CFTC's non-model based approach
 - An initial margin amount is determined by multiplying the initial margin requirement for a comparable cleared swap by 2
 - If no comparable cleared swap exists, the initial margin amount is found by multiplying the initial margin requirement for a comparable future by 4.4

Technical Issues End-Users Should Understand

- Limited ability to net and offset initial margin amounts
 - Initial Margin Offset
 - Under the CFTC and Prudential Regulator model approach, initial margin may be offset as long as there is sound theoretical basis and significant empirical support
 - Under the CFTC non-model approach, initial margin may be offset up to 50% of the amount of initial margin required as long there is a sound theoretical basis and significant empirical support
 - Variation Margin Netting
 - Netting of variation margin is permitted as long as the swaps in question are subject to a qualified master netting agreement
- Thresholds have negative capital impacts for dealers
 - Swap dealers are permitted to reduce their capital requirements by the value of any collateral posted on a swap
 - In the event they allow the use of an unsecured credit threshold, they may incur increased regulatory capital cost

Technical Issues End-Users Should Understand

- Capital treatment of certain non-cash collateral
 - It is unclear whether traditional non-cash forms of collateral such as letters of credit and liens on physical assets will meet the requirements necessary to be considered acceptable collateral under the CFTC's proposed capital rules

- CFTC right to override margin determinations
 - The CFTC retained the right to override margin arrangements between a CSE and an end user if the CFTC finds them to be inadequate
 - It is unclear as to how and if the CFTC will exercise this right

Technical Issues End-Users Should Understand

- Right to initial margin segregation
 - End users will have the right to request the segregation of any initial margin posted on an swap with a CSE
 - Segregation would entail the use of an independent third party custodian
 - There is no limitation on the ability of a CSE to make this option cost prohibitive

Section 716 Implications

- Section 716 of Dodd-Frank will require banks to “push out” their physical commodities-based swap dealing activity into non-bank entities
- Those entities will be subject to the CFTC’s margin rules and the relevant Prudential Regulator’s capital rules
- Section 716 will force bank holding companies with affiliated swap dealers to choose between:
 - a) bifurcating their swap dealing business into two parts:
 - i. bank-eligible products and
 - ii. bank ineligible products, which includes energy swaps; or
 - b) locating *all* swap dealing activity in a “pushed out” entity

Section 716 Implications

- Under the first option:
 - A swap dealer transacting in bank-eligible products will have a lower cost of funds and likely will be more creditworthy than if it was a standalone entity
 - The swap dealer transacting in bank ineligible products will have to be separately capitalized and will be less creditworthy
 - This approach will reduce the ability to net and offset exposure across a portfolio of swaps with a given customer
 - This approach may be associated with increased costs because the two swap dealers must maintain separate, possibly duplicative, systems and personnel
- Under the second option:
 - The single swap dealer would have to be separately capitalized
 - Customers would be permitted to net and offset across an entire portfolio of trading transactions with that swap dealer
 - This paradigm likely comes a higher costs of funds for the swap dealer

Section 716 Implications

- Because many bank-affiliated swap dealers in commodity swap markets are already stand alone entities (e.g., J. Aron), Section 716 may not cause a wholesale structural shift in this market
- These stand alone bank-affiliated swap dealers often rely on guarantees from more creditworthy affiliates as credit support and as a substitute for adequate capitalization
- At the current time, it is unclear whether a bank holding company will be required to separately capitalize “pushed out” swap dealers by means of a true capital injection or if they can “capitalize” these entities using parental guarantees

**Part Two:
Physical Options as Swaps**

Forward Contract Exclusion

- The CFTC has stated it will interpret the exclusion from the definition of “swap” for “sales of non-financial commodities for deferred shipment, so long as the transaction *is intended to be physically settled*” in a manner that is consistent with its traditional forward contract exclusion, including the Brent Interpretation
- CFTC states that intent is a facts & circumstances test, but can infer intent from contractual binding delivery obligation and the fact that parties regularly make/take delivery

Treatment of Book Outs Under Forward Contract Exclusion

- Book-outs of forward contracts for all non-financial commodities will be subject to requirements of CFTC's existing "Brent Interpretation"
 - Contracts that do not contain express terms permitting financial settlement in lieu of physical settlement meet the Brent Interpretation
 - EEI Master Agreements, ISDA Master Agreement, NAESB Master Agreements, etc.
- In addition, market participants must enter into separately negotiated agreements to book-out a transaction
 - The form of such agreements not specified by the CFTC
 - Strong push by the energy and agriculture sectors that oral agreements satisfy this requirement
 - Requiring separate, written agreements to book-out transactions would disrupt the efficiency of physical commodity markets
 - Not clear where the CFTC will ultimately come out on this issue

NGX Issue

- CFTC might recharacterize standardized forward contracts that
 - Go to physical delivery less than 50% of the time; or
 - Is transacted in a market with one or more non-commercial market participants

Options and the Definition of Swap

- The definition of “swap” includes “a put, call cap, floor, collar, or similar option of any kind that is for the ***purchase or sale, or based on the value, of 1 or more...commodities***” (emphasis added)
- The definition captures options for the purchase or sale of a physical commodity
- Options for the purchase or sale of physical commodities are **not** covered by the exclusion from the definition of “swap” for forward contracts “intended to be physically settled”
- The CFTC **does** have the authority under both Section 4c(b) of the CEA (authority over options) and Section 4(c) of the CEA (general exemptive authority) to not treat options for the purchase or sale of physical commodities as swaps.

Treatment of Volumetric Options

- It is clear that an option as to the actual delivery of a physical commodity is a swap
- It is not clear as to whether an volumetric option will be treated as a swap
- A volumetric option can be characterized as a forward contract for the sale of a commodity (because delivery is obligated to be made and taken on the exercise date) with an embedded option as to volume
- A strong argument can be made that such a forward contract would be excluded from the definition of “swap” as it is *“intended to be physically settled”*

Forward Contracts with Embedded Options

- Forwards with embedded optionality are at risk of being regulated as swaps if such optionality goes to delivery terms, e.g., the obligation to make or take delivery
 - ***Embedded Options in Physical Contracts***—Options embedded in physical contracts are forward contracts, and **not swaps**, if the option:
 - (1) relates to **price**
 - (2) does not target delivery term—such that the primary feature of the contract is actual delivery, and
 - (3) cannot be separated and marketed separately from the forward contract in which they are embedded
 - In other words, if the option renders delivery “optional” it is a swap
 - Optionality with regard to pricing is not a concern
 - As noted above, not clear whether volumetric optionality will result in a forward contract being treated as a swap under Title VII

**Part Three:
Covered Swap Entity Issues**

CFTC's Proposed Capital Requirements

- The CFTC's proposed rules set minimum capital requirements for CSEs not affiliated with a bank (bank affiliated CSEs are subject to the relevant Prudential Regulator's rules) that are not FCMs or systemically important financial institutions (all of which trigger more onerous capital requirements)
- All other CSEs will be subject to the higher of (a) the National Futures Association's ("NFA") capital requirement and (b) the CFTC's tangible net equity ("TNE") capital requirement
- Generally, the CFTC's proposed capital requirements provide that a swap dealer or MSP must have "tangible net equity" in excess of \$20 million ***plus*** a market risk measure and a credit risk measure

CFTC Capital Rules - TNE

- Under the TNE paradigm, TNE is calculated under U.S. GAAP
- TNE cannot include credit support arrangements such as parental guarantees or subordinated debt
- Under the TNE paradigm, regulatory capital will be determined utilizing:
 - a capital model; or
 - the CFTC's proposed non-model approach

CFTC Capital Rules - TNE

- To use a capital model a CSE must first have CFTC approval
- However, the proposed capital rules currently limits models to those approved by the SEC or prudential regulators
- Therefore, CSEs regulated only by the CFTC will **not** be able to use capital models

CFTC Capital Rules-Covered Portfolio

- A swap dealer would calculate its capital requirement by considering the uncleared swaps and related hedge positions associated with its “swap dealing”
 - Related hedge positions includes physical positions
- A swap dealer would exclude swaps and related hedges that are part of the swap dealer’s commercial operations
 - For example, FX and IR swaps entered into by a treasury group would be excluded
- An MSP would include all of its swaps

CFTC Capital Rules-Non-Model Approach

- The CFTC's non-model based approach to capital will require a CSE to determine two separate amounts
 1. Market Risk Exposure Requirement
 2. Credit Risk Exposure Requirement
- Each exposure requirement is calculated based on the CFTC's proposed formulas

Non-Model Approach - Market Risk

- **The Market Risk Exposure Requirement is comprised of two requirements**
 - The specific risk requirement
 - The general market risk requirement
- **Specific Risk**
 - The specific risk requirements is only applicable to swap positions on debt or equity instruments
 - It is intended to capture idiosyncratic risks (e.g., probability of default on the underlying in a single name CDS)
- **General Market Risk Requirement**
 - The general market risk requirement for commodities is
 - 15% of the net open position in each class of commodity (a class of commodity includes all commodities that can delivered against each other) *plus*
 - 3% of the gross position in each commodity

Non-Model Approach - Market Risk

- To calculate net open and gross positions, positions are converted from their unit of measure for physical positions (e.g., MMbtu) and notional amount for derivatives into a notional dollar value
- Positions are converted to notional dollar amounts by multiplying the number of units by current spot rates
- Treatment of Options
 - Market risk for all options, including options on commodities, is determined using a “delta plus” methodology

Non-Model Approach - Credit Risk

- The Credit Risk Exposure Requirement is determined using a methodology similar to the MSP determination
- Credit risk exposure is determined for each counterparty
- Credit risk exposure is a function of
 - Current Exposure
 - Potential Future Exposure

Non-Model Approach - Credit Risk

- The credit risk equivalent amount may be reduced by the market value of any collateral
- Collateral value is subject to haircuts
- The collateral must:
 - Be in the CSE's **physical possession or control** or held by an independent third party custodian
 - Meet the requirements of the credit support agreement
 - Be subject to applicable haircuts

Open Issues - Capital Rules

- The following are the major open issues left unresolved under the proposed rules
 - What is the actual scope of the portfolio, physical and financial, required to be considered under the capital rules
 - Will IFRS be permitted for the TNE determination
 - How will inter-affiliate swaps be treated
 - Will the CFTC or NFA permit the use of capital models by non-financial CSEs
 - How does one convert a basis swap to a notional value
 - Why is and how is the spot price used to convert certain contracts to notional values

Legal Entity Registration

- Registration is undertaken through the filing of a Form 7- R with the National Futures Association (“NFA”) through its online registration system
 - A Form 8-R must be filed for each of a CSE’s principals to verify that the principal is not subject to a statutory disqualification
 - NFA will then conduct fitness reviews
- A CSE may choose to place any swap dealing activity into a separate legal entity, or it may be able to choose to register a division of the company as a swap dealer

Legal Entity Issues

- Generally, the CFTC’s proposed rules seem to apply on a “legal entity” basis
- In the NOPR further defining “swap dealer” CFTC Staff proposed **“limited purpose designation”** for non-financial swap dealers, but this idea is not well-grounded in the proposed rules
- Presumably, limited purpose designation would limit compliance obligations to the “limited purpose designation” portion of the legal entity—as opposed to applying such obligations to the entire legal entity

Legal Entity Registration - Limited Purpose Designation

- In recent meetings, the CFTC's staff and Commissioners, have indicated that the limited purpose designation may not be available under the final rules
- If limited purpose designation is available, it will likely only limit the application of activity-based rules such as business conduct standards and not prudential rules such as capital and margin requirements
 - *i.e.*, if a division of a legal entity registered as a swap dealer, then the entire entity would be subject to the CFTC's capital requirements, but only the limited designation division would be subject to applicable business conduct standards

Internal Business Conduct Standards

- Primarily relate to internal compliance and risk management obligations
- Internal business conduct standards include the obligation to:
 - Establish Title VIII risk management and compliance program
 - Monitor compliance with position limits, including intra-day compliance
 - Obtain information and disclose to CFTC
 - Address internal conflict of interest
 - Prevent potential antitrust violations

External Business Conduct Standards

- External business conduct standards relate to duties/obligations of CSEs to counterparties and include:
 - Duty to verify that counterparties are Eligible Contract Participants
 - Duty to disclose risks and conflicts of interests relating to a swap
 - Requirement that CSEs recommend swaps that are “suitable” for their counterparties (must have reasonable grounds to believe swap is suitable for counterparty)
 - The provision of a scenario analysis for high-risk, complex bilateral swaps
 - The provision of a daily mark to a counterparty on an uncleared swap, and the daily mark on a cleared swap, if requested by counterparty
 - Limited ability to trade ahead of executing a swap with a customer
- Special Entity (Government Entity) Requirements
 - If a CSE is advising a Special Entity, it must use reasonable efforts to obtain information necessary to determine that the swap is in the best interest of the Special Entity
 - If a CSE is merely a counterparty to a Special Entity, then it must have a reasonable basis to believe that the Special Entity has a qualified independent representative who can evaluate the appropriateness of the swap for the Special Entity

External Business Conduct Standards

- Special Entity Requirements
 - “Special Entity” is defined to include government agencies and municipalities
 - If a CSE is advising a Special Entity, it must use reasonable efforts to obtain information necessary to determine that the swap is in the **best interest** of the Special Entity
 - If a CSE is merely a counterparty to a Special Entity, then it must have a reasonable basis to believe that the Special Entity has a qualified independent representative who can evaluate the appropriateness of the swap for the Special Entity

Record Keeping and Daily Trading Records

- All records must be kept from the date of the creation of the swap through the life of the swap and for a period of at least five years from the final termination of the swap
- Records must be readily accessible via real time electronic access by the CSE throughout the life of the swap and for two years following the final termination of the swap and must be retrievable by CSE within three business days
- Records must be maintained in a manner that is identifiable and searchable by transaction and by counterparty
- A swap dealer must retain (i) records of each position held by it, identified by product and counterparty, (ii) records for transactions executed on a SEF or DCM or cleared by a DCO, (iii) business records, (iv) financial records, (v) records of information required to be submitted to a SDR, (vi) records of information required to be reported on a real-time public basis, and (vii) records of information relating to large notional swaps
- Recordkeeping requirements would require CSEs to preserve all information necessary to conduct a comprehensive trade reconstruction
- Would also extend to records of all oral and written communications that lead to the execution of a swap, whether communicated by telephone, voicemail, facsimile, instant message, chat rooms, e-mail, mobile device, or other digital or electronic media
- Requires CSEs to maintain recordings created in the normal course of its business, but does not impose an affirmative requirement to capture telephone recordings if the audit trail requirement can be met by other means (*i.e.*, e-mail)

General Reporting

- Counterparties to swaps are required to report certain swap creation and continuation data to SDRs
 - Swap dealers are deemed to be the reporting party for all transactions in which they engage
 - For a dealer-to-dealer transaction the parties may elect one party to be the reporting party
- MSPs are the reporting party for MSP-to-MSP and MSP-to-end user transactions
- For an end user to end user transaction the parties may elect one party to be the reporting party
- Timing and reporting obligations will vary depending on whether the swap is cleared through a DCO or executed on a SEF or DCM

Real-Time Reporting

- Counterparties to swap transactions are required to report swap transaction pricing data relating to “reportable swap transactions”
 - “Reportable swap transactions” is defined as any executed swap, novation, swap unwind, partial novation, partial swap unwind or such post-execution event that affects the price of a swap in real-time
- All swaps, whether cleared or uncleared and whether or not they are executed on a swap execution facility (“SEF”), designated contract market (“DCM”), or off-facility are required to be reported in real time
- Swap data must be reported to a “registered entity” **as soon as technologically practicable**, after which the registered entities must disseminate such information publicly
 - Parties that execute the transaction on a swap market are deemed to have satisfied their real-time reporting obligations
 - For off-facility swaps, the reporting party must report swap transaction and pricing data to a registered SDR as soon as technologically practicable

Swap Confirmation

- All terms of a swap must be provided for acknowledgment (a writing memorializing the terms of a swap) and confirmation (the signing of the acknowledgment by the receiving counterparty)
- For CSEs entering into a swap with another CSE, confirmation would be required for the following swaps:
 - swaps that are executed and processed electronically, within 15 minutes of execution
 - swaps that are not electronically executed, but are processed electronically, within 30 minutes of execution
 - swaps that cannot be processed electronically by the swap dealer/MSP, within the same calendar day as execution
- For CSEs entering into swaps with counterparties that are not CSEs, they must send an acknowledgment according to the timeframe set forth above for confirmation

Portfolio Reconciliation and Compression

- Both parties to one or more swaps must
 - Exchange the terms of all swaps in the portfolio between the parties
 - Exchange each party's valuation of each swap in the portfolio between the parties on the close of business of the immediately preceding business day; and
 - Resolve any discrepancy in material terms and valuations
- The schedule for reconciliation varies depending on the number of uncleared swaps and the entity classification of the counterparties
 - For a portfolio with another CSE, the schedule is
 - daily for portfolios consisting of 300 or more swaps
 - weekly for portfolios between 50 and 300 swaps, and
 - quarterly for portfolios of fewer than 50 swaps
 - For uncleared swap portfolios with a non-CSE, the schedule is
 - daily for portfolios of 500 or more swaps
 - weekly for portfolios between 100 and 500 swaps, and
 - quarterly for portfolios of less than 100 swaps
- CSEs must (a) cancel all offsetting swaps and (b) participate in mandatory portfolio compression exercises

Thank You

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