A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act

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Part of an ongoing series

Implications of

Derivatives Regulation and Changing Market Infrastructure for Nonfinancial Companies

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Regulators have been actively working toward finalizing the complicated and controversial mosaic of proposals intended to reform the derivatives (swaps) markets as envisioned in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank or the Act). Companies that use swaps will face new regulatory, business and operational challenges as dealers, counterparties and other swap market participants become subject to new clearing, margin and collateral requirements, recordkeeping and reporting duties, and new trade execution alternatives. This *A Closer Look* focuses on the potential impact of the new derivatives market reform for companies outside the financial services industry (nonfinancial companies).

Dodd-Frank subjects swaps, swap markets, and certain swap market participants to new, comprehensive regulation aimed at increasing transparency, reducing systemic risk, and ensuring orderly markets. A swap, as broadly defined by the Act, includes traditional swaps such as plain vanilla interest rate swaps, but could also include other derivative financial instruments such as puts, calls, collars and caps, and potentially certain derivatives embedded in other contracts. A key objective of the Act is to move a significant portion of Over-the-Counter (OTC) swap transactions onto regulated exchanges with clearing required through central clearinghouses.[1] Companies with significant swap activities could face enhanced registration requirements and ongoing regulation. New recordkeeping and reporting requirements are intended to increase transparency for all participants and allow regulators to better monitor risks and potential market manipulation.

The impact on all companies using the derivatives markets is expected to be significant. Once a company identifies the applicable regulations governing its swap activities, it will need to understand the relative cost components associated with execution, credit and reporting for its swap transactions. Each time a nonfinancial company contemplates entering into a swap, management will need to consider:

- Applicability of the commercial end-user exemption
- Various alternatives for execution and clearing
- Potential liquidity needed to support the swap
- Recordkeeping and reporting requirements and Commodity Futures Trading Commission (CFTC)/ Securities Exchange Commission (SEC) notifications
- Operational infrastructure needed to comply with new requirements
- Potential accounting implications associated with the financial instrument

Regulators and rule-making

The CFTC and the SEC (together the Regulators) have bifurcated responsibility for interpreting and implementing the derivatives provisions in Title VII of Dodd-Frank. The CFTC regulates swaps, which it has described as “notional contracts requiring the performance of agreed terms by each party” (e.g., an interest rate swap). The SEC regulates “security-based swaps,” which are a narrower category of swap based on a single, underlying corporate security or narrow index of corporate securities (e.g., puts and calls on equity securities). The CFTC and SEC are tasked with implementing coordinated, but not identical, swap regulatory regimes. To accomplish this, to date the CFTC and the SEC have proposed, separately or jointly, more than 60 sets of regulations.

What should companies do now?

Dodd-Frank will have a significant impact on all swap users. As the rulemaking process is open to public comment, companies should assess the potential impact of the Act on their business and operational activities, and consider providing feedback to the CFTC and SEC prior to the release of their implementation plan. The following items outline the key points of focus and action steps nonfinancial companies should consider when assessing the Act’s potential impact, and when drafting their comments to the Regulators.

Identify the types of transactions potentially in scope

Prior to Dodd-Frank, OTC swaps were predominantly unregulated. Once effective, Dodd-Frank reverses that status, bringing all swaps within its scope. As a result, all swap parties will be affected, and companies will need to assess the business and operational costs associated with compliance. To evaluate these costs, companies first need to understand the breadth of their swap activities subject to the regulation.

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[1] Use of central clearinghouses mutualizes risk among clearing members and accordingly reduces counterparty credit risk.

The Act contains a broad definition of a swap that could capture derivative financial instruments beyond those traditionally considered to be a swap, such as certain derivatives embedded in purchase and sale contracts. To complicate matters further, the regulators have proposed exempting certain instruments from regulation.

For example, the US Treasury department recently proposed excluding foreign exchange swaps and forwards from treatment as swaps, except with respect to reporting, recordkeeping and swap dealer business conduct rules. This exemption appears fairly narrow, capturing only "plain vanilla" foreign exchange (FX) swaps and forwards.[2]

The Act also excludes "forward contracts in nonfinancial commodities" as historically interpreted by the CFTC. Furthermore, the proposed rules stipulate certain instruments that would not qualify as swaps under the Act, increasing the challenges and importance of correctly classifying instruments that could qualify as swaps. Companies therefore need to be diligent and methodical in identifying their areas of potential exposure.

Reasonable action step: *Create an inventory of swaps potentially subject to the regulation. Most swaps are centrally managed by the corporate treasury function, and will therefore be fairly easy to identify. Other swaps may be embedded in vendor or customer contracts managed by procurement, sales, or other departments, and likely will be more difficult to identify. Companies should consider where in their organization swap activities exist so they can gather key data before the final rules emerge.*

Evaluate entity classification

Dodd-Frank regulates both entities that engage in swap activities as well as swap transactions themselves. If an entity is determined to be a swap dealer (SD), major swap participant (MSP), or other type of regulated swap market participant, it will have to register as such, and it will have to observe specific regulations that drive how it functions in this capacity.[3] This may give rise to additional duties for swap market participants, such as becoming the designated reporter of swap data from OTC swaps.[4]

Timely identification and analysis of an entity's swap activities is a critical step to determine whether a company must register, or could avoid registration in the future. Nonfinancial companies that are not active swap market participants are unlikely to face entity regulation, but should monitor this risk. We expect nonfinancial companies are more likely to be concerned with regulation of their particular swap transactions, rather than entity regulation with the CFTC or SEC.

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[2] For example, FX swaps and forwards that include any optionality would not be exempt. This exemption proposed by the U.S. Treasury would also not apply to foreign currency options, non-deliverable forward contracts involving foreign exchange, currency swaps and cross-currency swaps.

[3] Depending on a company's activities, the addition of "swaps" to existing regulations could lead to registration requirements in a pre-Dodd-Frank capacity, e.g. as a commodity pool operator, commodity trading adviser, introducing broker, or futures commission merchant. New categories of market intermediaries (e.g., SEF, DCO) would require registration as well.

[4] The economic terms of the swap required to be reported to a Swap Data Repository (SDR) include the notional amount, effective date, maturity date, counterparty, swap price, swap optionality features, payment date, and the periodic reporting of the valuation of the swap through its life cycle.

Reasonable action step: *Based on a functional and quantitative analysis as prescribed by the CFTC and SEC, assess whether the entity's level of swap (or securities-based swap) activities and counterparty exposure could trigger classification as an SD or MSP. While most nonfinancial companies assume they will be "commercial end-users" (CEUs) for their swap transactions, companies in certain industries have been surprised to find that the proposed rules place them in the highly regulated SD or MSP categories.*

Consider execution and credit cost components

Even if a company does not have to register as a regulated entity, it must consider how to comply with any transaction-based swap regulation governing, among other things, the execution and clearing alternatives available, and the recordkeeping and reporting requirements.

The Act permits the CFTC or SEC to *require* centralized execution and clearing of swaps through regulated facilities such as Swap Execution Facilities (SEF), Designated Contract Markets (DCM), registered exchanges or Designated Clearing Organizations (DCO), *unless* a swap counterparty qualifies for the commercial end-user exemption. The regulators must follow a process for mandating clearing for particular swaps or categories of swaps that requires evaluating factors such as liquidity, infrastructure, ability to clear, risk mitigation and competitive effect. While companies should not expect all swaps to be subject to the mandatory clearing requirement, broad categories of swaps will be drawn in. We expect that highly standardized, liquid swaps will be subject to mandatory clearing first, with other similarly clearable instruments to follow over time. Certain swaps, such as highly customized products, are unlikely to be drawn into mandatory clearing.

There are limited paths that a company may take to bypass the mandatory execution or clearing requirements. A company may execute a swap transaction off-exchange if it is an Eligible Contract Participant (ECP) and if the swap is either exempt from, or not subject to, a mandatory clearing requirement. An ECP generally is a person or entity with a level of financial resources deemed sufficient to enter swaps or securities-based swaps bilaterally or off-exchange.[5]

The Commercial End User (CEU) exemption is the only route that a company can take to opt out of mandatory clearing for a swap. Under the CEU exemption, a company must use the swap to "hedge or mitigate commercial risk," and cannot be an SD, MSP or a "financial entity" as defined in the Act. All companies that wish to use the CEU exemption would be required to obtain board approval and notify the regulators as to how they plan to meet their financial obligations for the swap transactions they will not be clearing through a DCO.

For clearing exempt CEU swap transactions, companies may choose between the various trade execution and clearing alternatives. For example, in the new marketplace CEUs who are using swaps to hedge or mitigate commercial risk will have the option to voluntarily elect to transact their swaps using:

- An exchange and clearing organization

[5] An ECP would include SDs, MSPs, regulated persons, entities that qualify as ECPs based on a total assets test (i.e., total assets exceeding $10 million) and entities that qualify based on a total assets and business activity test (i.e., net worth exceeds $1 million and engages in business-related hedging).

- A clearing organization, but no exchange
- An exchange, but no clearing organization
- Their current OTC transaction method

When deciding how to execute and clear their swap transactions, companies will need to consider the relative cost components associated with each execution and clearing option. Included in this analysis will be costs associated with any widening bid-ask spreads, cost of capital associated with margin requirements, or increased costs on other banking transactions including liquidity facilities that can be used as a backstop for a company's swap transactions.

These cost components could be greatly impacted by the new regulatory requirements imposed on bank and other dealer counterparties. Pre-Dodd-Frank, bank counterparties in the derivatives markets have been subject to few if any regulatory capital charges embedded in the pricing of a swap, and most transactions have been executed bilaterally to closely match the exposure being hedged. After financial reform from Dodd-Frank and elsewhere, bank swap dealers could face new capital and margin requirements, reporting duties, and documentation standards, all of which will come at a cost and can be expected to impact the pricing of swaps with CEUs. For example, if bank dealer counterparties have to take significant capital charges for uncollateralized swaps, then the question remains how much of this capital charge will be passed onto companies through a widening bid-ask spread or through the pricing of other banking products offered to the CEU (such as liquidity facilities backstopping the company's swaps).

Dodd-Frank may provide benefits to companies that elect to transact a clearing-exempt swap through a new SEF, swap exchange, or DCM, because these execution options may offer the best price due to impartial access to the market and dealer competition. This contrasts with an OTC transaction wherein a counterparty is largely unaware of best pricing other than from direct dealer outreach. A company may continue to trade swaps OTC because the OTC market facilitates the creation of tailored swaps that accommodate the company's specific business needs and closely match its exposure. However, those customized, tailored swaps could come at a higher cost under the new regime, with the dealer's own increased costs embedded in the swap bid-ask spread. Companies will need to weigh the availability and benefits of greater transparency and competitive pricing of a swap on an exchange against the cost of obtaining a customized swap with terms that are more closely matched to the risk being managed.

Clearing an otherwise CEU exempt transaction may provide benefits for certain companies. A company may determine that the costs of capital associated with margin requirements may be outweighed by some of the advantages of clearing and posting margin for certain swaps—e.g., legal certainty for swap terms, early resolution of valuation disputes, and effective management of counterparty non-performance.

Other considerations in deciding how to execute and clear a swap transaction include:

- The ability of the counterparties to provide the swap data reporting mandated by the Act
- The operational costs associated with collateral movements
- The actual costs associated with posting collateral

The CFTC has consistently expressed concern about evasion of the Act, and the compliance stakes are high for companies planning to rely on the CEU exception from clearing for any of their swaps. Dodd-Frank makes it a felony for "any person to abuse the end-user exception" as determined by the CFTC. This felony is punishable by a maximum fine of $1,000,000 and/or imprisonment for ten years.

Reasonable action step: *Identify the execution and clearing choices available as a CEU. The vast majority of nonfinancial companies use swaps to hedge or mitigate their commercial risks and should be exempt from mandatory clearing and exchange trading requirements. However, the CEU exemption does not preclude companies from voluntarily trading on a DCM, SEF or exchange, or from clearing through a DCO. Companies should be aware of:*

- *How new execution and clearing alternatives can affect the cost of swap transactions and company liquidity*
- *The regulatory status of their counterparties and whether, and to what extent, their counterparties status will create new margin requirements, or effect the recordkeeping and reporting requirements (by giving one party the duty to report swap data to an SDR)*
- *The impact of swap standardization and the availability of "customized" swap instruments*
- *How the use of standardized swaps executed on DCMs, SEFs, exchanges or through intermediaries may affect the ability to apply hedge accounting - in particular the shortcut and critical terms match methods.*

Evaluate the application of hedge accounting to standardized swaps

Under certain circumstances taking advantage of the different options for trade execution could lead to unintended challenges in the application of the hedge accounting rules. The use of standardized exchange-traded swaps may affect a company's ability to exactly match the terms of the hedged exposure, and accordingly there may be circumstances in which certain swaps would not qualify for the shortcut or critical-terms-match hedge accounting methods under the Financial Accounting Standards Board's Accounting Standards Codification 815 (ASC 815). As a result, a company wishing to apply hedge accounting to an exchange-traded swap may have to consider implementing a "long haul" hedge effectiveness methodology that requires the use of a quantitative calculation, and may potentially result in some level of ineffectiveness and earnings volatility.

Reasonable action step: *A company needs to evaluate its existing hedge accounting and recordkeeping practices in light of the new swaps regulatory regime in order to identify any potential accounting and recordkeeping gaps that may exist going forward. Companies should assess the benefits associated with exchange-traded swaps against the increased operational requirements of applying long-haul hedge accounting.*

Consider and prepare for the new reporting and recordkeeping requirements

Every swap transaction executed on or after July 21, 2010 is subject to new data reporting and recordkeeping requirements under either a current transitional reporting requirement or the pending final reporting system.

All swap counterparties need to consider these new requirements and whether the duty to report lies with them or with a separate market intermediary (e.g., an exchange, SEF, DCM or DCO). Once the permanent reporting regime is operational, companies that execute a swap on an exchange, SEF or DCM, or clear the swap through a DCO, should be able to rely on those intermediaries to minimize their reporting obligations. Under the proposed rules, the reporting burden falls first to the exchanges and clearing organizations and then to the SDs and MSPs (if the swap is not executed on an exchange or centrally cleared). If a company executes an OTC swap with a dealer not registered as a SD, it will need to agree-upon with the dealer as to who will fulfill the reporting requirements.

The company may need to maintain detailed records of swap activity through a five-year post-termination period. Companies also may be asked to provide certain records to their counterparties so that those counterparties can fulfill their reporting obligations.

Rulemaking timeline and effective dates

Swap regulation will phase in over time. The Act contains some provisions that become effective on July 16, 2011. Other provisions require the regulators to promulgate rulemakings before becoming effective, some of which are required by that same date. The regulators are not fully synchronized in this effort, but they are cooperating, with the CFTC substantially done with *proposing* a swap regulatory regime, while the SEC still needs to propose some important interpretive rules (such as capital and margin rules) for security-based swaps. All of these proposed regulations need to be issued in final form with effective dates and compliance dates.

To provide clarity for the market place, the CFTC and SEC have offered temporary exemptions that shelter market participants from swap regulation until final rules become effective. The CFTC granted this relief until December 31, 2011, to keep the rulemaking process brisk, while the SEC''s exemption extends until final security-based swap rulemakings are issued and effective.

Both the CFTC and SEC have turned their attention to how to put final rules in place to implement a swap regulatory regime. Although they have not announced a sequence for adopting final rules, they have indicated that effective dates for the various rules will be staggered.

There has been much public debate about the volume and speed of rulemaking and the risk of unintended consequences, balanced against the need for timely reform to close regulatory gaps. A short timeframe and limited resources are key constraints in the regulators' efforts to build and implement a cohesive and comprehensive framework that provides a practical basis for achieving the legislative goals of greater transparency, accountability and risk management for derivative use by all types of entities.

While final rules still need to be adopted, and the implementation sequence still needs to be set, some aspects of the new swap market regulation could be in place by year-end 2011, with full implementation roll-out continuing into 2012.

Conclusion: Keeping an eye on the big picture

This edition of *A Closer Look* seeks to identify and explain some of the most significant areas of impact that Dodd-Frank's regulation of swaps, swap markets and swap market participants will have on nonfinancial companies. Observant, agile companies will be better able to leverage the changing swap market dynamics to manage risks in a cost-effective, capital-efficient manner.

Additional information

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