

The Impact of Dodd Frank on Companies in the Energy Industry

Presentation to the Board of Directors of the North American
Energy Standards Board (NAESB)

Houston, TX

March 22, 2012

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Presenter's Background

- Over 30 years of commodities and securities market experience – C-level executive at 3 exchanges
 - Founder and CEO of Wolkoff Consulting Services LLC - providing independent advice and business services on regulatory and exchange matters
 - www.wolkoffconsulting.com
 - CEO of ELX Futures, LP
 - Chairman and CEO, American Stock Exchange
 - *On the Cover of Forbes, October 2006, for efforts to solve the regulatory problems at Amex – Subtitled “Mr. Clean”*
 - EVP and Chief Operating Officer, NYMEX
 - *Also served as Chief Regulatory Officer, and Acting President*
 - *Designed and Implemented Clearport for clearing energy OTC products*
 - *CFTC – Honors Program Trial Attorney, Division of Enforcement*
- Education:
 - BA, Columbia University
 - JD, Boston University School of Law



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Swap Regulation: Background

- In the late 1980s, transactions in Brent crude oil swaps inaugurated the world of off-exchange derivatives transactions.
 - Brent swaps were unregulated, negotiated between private parties away from exchanges as a means of hedging price risk or speculating on oil prices for profit.
 - *A derivative, basically, is a promise between two counterparties to pay or receive from each other the difference in value between the purchase price of the derivative (say, oil at \$100) and a reference price of an actual product at a date in the future (say the price of oil 3 months from now)*
 - When a federal court in 1990 (the Transnor Decision) found that Brent forward contracts were “gambling instruments,” and failed to enforce their terms (the party on the losing side refused to pay, and was allowed to avoid payment on his contract), the CFTC adopted the first policy to expressly state that such Brent contracts would in the future be legal.



Swaps Regulation: Background

- The CFTC's policy statement was not as binding as a change in the statute in which Congress acts definitively to make off-exchange derivatives transactions legal
 - A series of CFTC policy statements and regulations followed the first Brent policy. Although the regulatory underpinning for off-exchange derivatives was still shaky, the oil industry and banks accepted the legal uncertainty, and the market grew.
 - Off-exchange derivatives became popular in areas other than oil such as interest rate and foreign exchange swaps.



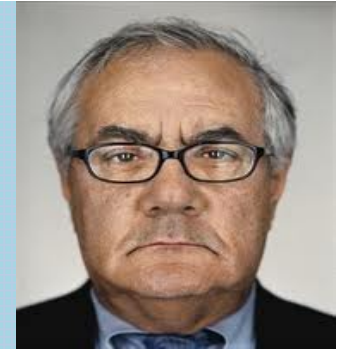
Swap Regulation Background

- Fast forward to the later years of the Clinton administration, and financial deregulation became a large topic of concern. The U.S. Congress and the administration were afraid the U.S. would fall behind London and Singapore as global financial centers if we did not deregulate the financial industry.
 - The Glass-Steagall Act, a depression era law, which prohibited commercial and investment banking activities to occur within the same company, was repealed, giving rise to the first financial “supermarkets.”
- The Commodity Futures Modernization Act of 2000, (the CFMA), was passed to explicitly authorize off-exchange “swaps” trading with full legal protection.
 - Legal Certainty - The risk that the losing counterparty to the trade could walk away without recourse from his debt disappeared.
 - Also, many different types of products were now allowed to be traded privately, off-exchange, without regulatory oversight, so long as small, retail investors were not allowed to participate.





The Wall Street Reform and Consumer Protection Act



- **“Dodd Frank” was signed into law on July 21, 2010 following:**
 - The near-failure of Bear Stearns in March 2008
 - The bankruptcy of Lehman Brothers in September 2008
 - Massive TARP payments funded by taxpayers to AIG, Fannie Mae, Freddie Mac, banks and the auto industry
 - Conversion of 3 remaining investment banks into commercial banks with access to the Fed Funds Window (Morgan Stanley, Goldman and Merrill – acquired by BofA)
 - **Basic Causes of the Crisis:**
 - Use of derivatives to expand investment supply of subprime mortgages, which were highly rated but subject to default with eroding valuations in housing prices
 - Poor ratings practices, and likely mortgage marketing fraud, affecting the veracity of the valuation of the underlying assets
 - Insurance-like derivatives (Credit Default Swaps or “CDS”) to insure against losses in mortgage investments – and default by the companies which invested in them – lacking adequate capital reserves or oversight in the case of loss
 - Rapidly falling real estate prices – the bubble popped
- Greed and Mismanagement with poor governmental oversight



Title VII of Dodd Frank: Wall Street Transparency and Accountability

- DF affects businesses that use swaps in different ways
 - Most non-financial businesses that use swaps will, under DF, avoid most new regulations by executing swaps on exchanges (DCMs or SEFs), and clearing them on Designated Clearing Organizations (DCOs).
- Some non-financial businesses that use swaps will fall into new regulated categories:
 - *Swap Dealers (SDs)*
 - *Major Swap Participants (MSPs)*
 - *End Users – exempt from certain trading and clearing requirements but subject to new reporting and recordkeeping requirements*



SDs and MSPs

- There is a well-justified fear that non-financial companies in the energy industry will fall under one of the highly regulated new categories by surprise.
 - Swap Dealers (SDs) and Major Swap Participants (MSPs) will have to register with the CFTC, and meet stringent reporting requirements, business conduct standards, disclosure requirements, and face unforeseen operational and audit demands.
 - *Neither SD nor MSP has yet been defined in final form, and firms may need to prepare to register before having certainty.*
 - *SOX §404 will also force public SDs and MSPs to document all internal controls associated with the new rules*



Swap Dealers

- **§721(b) of the Dodd-Frank Act defines the term “swap dealer” as any person who:**
 - *(i) holds itself out as a dealer in swaps,*
 - *(ii) makes a market in swaps,*
 - *(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or*
 - *(iv) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.*
- **The Commission “preliminarily believes” that the distinguishing characteristics of swap dealers are that:**
 - *swap dealers tend to accommodate demand for swaps from other parties;*
 - *swap dealers are generally available to enter into swaps to facilitate other parties’ interest in entering into swaps;*
 - *swap dealers tend not to request that other parties propose the terms of swaps; rather, they tend to enter into swaps on their own standard terms or on terms they arrange in response to other parties’ interest; and*
 - *swap dealers tend to be able to arrange customized terms for swaps upon request, or to create new types of swaps at their own initiative.*



Swap Dealers – Other Specific Indicators

- **As stated by the CFTC:**

- **contacting potential counterparties to solicit interest in swaps,**
- **developing new types of swaps and informing potential counterparties of their availability,**
- **membership in a swap association in a category reserved for dealers,**
- **providing marketing materials (such as a web site) that describe the types of swaps one is willing to enter into with other parties, and**
- **generally expressing a willingness to offer or provide a range of financial products that would include swaps.**



SD Regulatory Coverage

- **Obvious targets of the definition are the dealer banks**
 - *Captures their swap businesses in the CFTC's scheme of registration, reporting, and business conduct standards*
- **Less clear is which non-bank, non-financial companies will be covered.**
 - *as of today, the rules are not final*
- **In the Energy industry, there may be several (or more) companies caught within the SD definition. Others will be caught in the MSP definition.**
 - ***De minimis exemption standards are as yet unknown***
 - Originally, notional value of \$100mm/year; fewer than 15 counterparties; no more than 20 swaps/year as a dealer; and less than \$25 million against “Special Entities” like municipalities
 - Reports are circulating that the notional value threshold is increasing to \$3 billion, but that is uncertain



Major Swap Participants

- **A MSP is an entity that meets one of the following 3 tests (not a final rule):**
 1. Maintaining a “substantial position” in any of the major swap categories, excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan; or
 2. A person whose outstanding swaps create “substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets,” or
 3. Any “financial entity” that is “highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency” and maintains a “substantial position” in any of the major swap categories.
- **The “substantial position” test is the only one applicable to most energy industry participants that are not banks or hedge funds**



What Is a “Substantial Position?”

- **Two tests define “substantial position,” excluding swaps held for “Hedging or Mitigating Commercial Risk:”**
 - *Position is within the major asset category of “other commodity swaps.”*
 - (1) focuses on an entity’s current uncollateralized exposure;
 - *Currently a daily average current uncollateralized exposure of \$1 billion in the major asset category*
 - (2) supplements a current uncollateralized exposure measure with an additional measure that estimates potential future exposure.
 - *Currently \$2 billion total in daily average current uncollateralized exposure plus potential future exposure in the major swap category*
- **A position that satisfies either test would be a “substantial position.”**



Requirements for SDs and MSPs

- **Other than registration, most special requirements of SDs and MSPs come into play when swap trades are done off of an exchange (DCM) or Swap Execution Facility (SEF).**
- **In the original CFTC release defining SDs and MSPs, the CFTC expressed the intent to treat both categories similarly:**
 - “Persons that meet the major participant definitions in large part must follow the same statutory requirements that apply to swap dealers.”
- **Following a comment period, several requirements were made unique to Swap Dealers and did not affect Major Swap Participants.**
- **Requirements Affecting SDs Only:**
 - Required to implement a Large Trader Reporting System on the date the SD definition becomes effective;
 - Determine Suitability of Counterparty;
 - Know Your Counterparty;
 - Scenario Analysis;
 - Possible registration as a Commodity Trading Adviser where advice to a counterparty is more than “solely incidental;”Unique requirements prohibiting campaign contributions when dealing with a Special Entity



Requirements for both SDs and MSPs

- **Registration with the CFTC as a SD or MSP**
 - Registration of employees who trade with counterparties as Associated Persons
 - *Must determine that employee does not have a statutory disqualification – background checks to be conducted*
 - *No “safe harbor” if background checks are outsourced to a third party like the NFA, and something is missed*
- **Reporting and Recordkeeping Duties**
 - Trades to be reported as soon as “technologically practicable.”
 - *As between SDs or MSPs and non-registrants, the duty to report will fall on the SD or MSP*
 - *Use of DCMs or SEFs satisfies the reporting responsibility*



Requirements for both SDs and MSPs

- **Policies to monitor trading to avoid position limit violations**
 - Swaps that serve a significant price discovery function will be subject to position limits
 - There will be a 2-Phase implementation of new limits
 - *Phase 1 – current DCM limits on spot and all month positions apply*
 - *Phase 2 – spot limits will be based on the CFTC’s target of 25% of deliverable supply*
 - Swaps that pre-exist the Phase 2 limits will not count toward limits
 - Aggregation of swaps, futures and options in Phase 2
 - DCM rules for all-month limits appear likely to govern
 - Exemptions will be under the CFTC’s authority – process is unclear



Requirements for both SDs and MSPs

- **Business Conduct Standards**

- Must inform the counterparty that it:
 - *Has the right to select the clearinghouse*
 - Since cross margining benefits of swaps and futures/listed options will not be available across clearing houses, the costs of transferring positions or lost opportunities will be borne by the SD or MSP
 - *Has the right to clear a swap that is not required to be cleared (not “available for trading”)*
 - Duty to verify that the counterparty is an Eligible Contract Participant (ECP)
 - Policies and procedures must be in place to assure that the daily mark is reliable and timely, and that the methodology to determine the mark is explained
 - Must have written policies and procedures reasonably designed to protect material confidential information of a counterparty
 - Must have documented policies and procedures to avoid fraud and manipulation
 - Duty to communicate with counterparties in a “fair and balanced” manner based on principles of fair dealing and good faith
 - Duty to disclose material information to counterparty
- Required to keep all documentation available for inspection by regulator



Requirements for both SDs and MSPs

- **Risk Management Program**
 - Must have a documented program of risk management policies and procedures
 - *Able to identify risks and risk tolerance limits*
 - *Inclusive of risks posed by affiliates*
- **Business continuity and disaster recovery policies**
- **Documented Policies for diligent supervision of swap activities**
- **Capital Requirements**
 - Appear to be imposed only on financial firms; not applicable to energy industry firms



DCM and SEF Execution and DCO Clearing Requirement

- Clearing Requirement
 - A swap is required to be cleared if the CFTC determines it is subject to mandatory clearing
 - *Upon application of a DCO*
 - *Upon the CFTC's own initiative*
- Trading Requirement
 - If a swap is required to be cleared, and if it is “made available to trade” on a SEF or DCM, then it must be traded and cleared
 - *subject to the “end-user” exemption from both the trading and clearing requirements*
 - *Swaps “not available to trade” may still be subject to mandatory clearing or can be voluntary cleared if offered by a DCO*
 - *Swaps can still be offered for trading by a DCM or SEF without being “available to trade”*



DCM and SEF Execution and DCO Clearing Requirement

- If a swap is made “available to trade” on a Designated Contract Market (DCM – a traditional exchange) or Swap Execution Facility (SEF) then it must be traded there, and cleared at a designated clearing organization (DCO or clearing house)
 - Assumes that a swap that meets the standards for mandatory trading will have a willing and able DCO to clear it
 - subject to the “end-user” exemption from both the trading and clearing requirements
 - Execution of a swap on a DCM or SEF satisfies the requirements for an SD or MSP to:
 - *report the trade to a Swap Data Repository (SDR);*
 - *know its counterparty;*
 - *disclose information;*
 - *verify eligibility of the counterparty as a ECP;*
 - *provide a scenario analysis; or*
 - *to determine the counterparty’s suitability for the trade*



The “End User” Exemption

- **Currently, (pre-DF implementation) end-users transacting a swap can avoid the collateral and daily mark-to market requirements associated with listed products;**
- **In order to maintain a semblance of that status quo, DF and the CFTC regulations have carved out an exemption from the exchange trading and clearing of swaps where one or both parties is an “end-user”**
 - The end-user exemption is complex and carries significant reporting and record-keeping requirements, so it is not a full-scale exemption to all new rules



The “End User” Exemption

- **Limited to hedging or risk mitigating transactions**
 - The end-user exemption to trading and clearing cannot be used for speculative trades
- **The exemption must be elected at the time of the trade**
 - **The CFTC must be notified of the election at time of trade**
- **Reporting of price and terms to a Swap Data Depository (SDR)**
 - Where both parties are using the exemption, they must decide on the responsible one for reporting
 - *If an SD or MSP is a counterparty, the SD or MSP will report the trade*
 - The report to a SDR includes price, terms of the swap, and the credit arrangements for the trade.



Prudent Steps for an Energy Company To Take Now

- **Analyze swap activity to determine whether the firm falls within the levels to register as a SD or MSP**
 - Review web site, promotional materials, and client communications to determine how the firm describes itself. Much of what determines whether a non-financial firm is an SD will be its own self-description.
 - How much of the firm's current swap activity can be transacted in listed futures as an alternative?
 - *Will not count toward requirement to register as a SD or MSP*
 - Clearing requirements will require collateral management that is different and from the current bilateral arrangements of swap transactions
 - *How will the firm meet its collateral management needs?*



Prudent Steps

- **If the firm may be required to register as a SD or MSP (and the level of swap business that triggers registration will likely cover many more firms than anticipate the requirements):**
 - Must prepare documentation and systems to meet the new requirements for reporting, business conduct standards, duty of supervision and risk management responsibilities under the new rules. The requirements are extensive
 - Now is a good time to examine whether the firm can avoid possible registration through a change in trading and risk management practices



Determine if you can qualify for an end-user exemption

- **Do you qualify for the end user exemption?**
 - Allows the firm to avoid exchange trading and clearing of swaps used for hedging and risk mitigation
- **What level of swap trading is done for speculation as opposed to hedging or risk mitigation?**
 - Speculative trades will be limited to exchange or SEF execution, if a swap is available to trade, and must be cleared.
- **Prepare to implement the policies and procedures to report the election of a trade as an end-user to the CFTC, and to report trades against an end-user to a Swap Data Repository.**



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