

End-User Guide to CFTC Implementation of Dodd-Frank Act

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NAESB Board of Directors
Houston, Texas | June 23rd | 2011



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BACKGROUND

- Illustrative Impacts on Energy End-Users
 - *OTC Derivatives Reform: Energy Sector Impacts**
 - Energy commodities compose less than 1% of global OTC derivatives
 - Members focus on commercial risk and well-functioning energy markets
 - Specific example of impacts
 - Producer - \$700 MM less capital reducing new wells by 240 (SWE)
 - Public gas utility – need to obtain \$500 MM line of credit and raise rates by 10% (MGAG)
 - Large electric utility – immediate cost increases of 5-15% with pass through to customers (EEI & EPSA)
 - Competitive electric provider – need to provide \$1-2 billion in margin (EPSA)
 - Large natural gas producer – divert 25% of capital away from E&P development (NGSA)

* Edison Electric Institute published study for energy industry associations, January 2010.

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DEFINITIONS

- **Swap Dealer (SD)**
 - Holding oneself out as a dealer in swaps;
 - Making a market in swaps;
 - “Regularly” entering into swaps as an ordinary course of business for one’s own account; or
 - Engaging in activities causing oneself to be commonly known in the trade as a dealer or market maker in swaps.
- **Major Swap Participant (MSP)**
 - Not a SD; and Maintains “substantial positions” in category of swaps (energy commodity) excluding “positions held for hedging or mitigating commercial risk”, de minimus exception
 - Outstanding swaps create “substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets,” or
 - “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 outstanding swaps in major swap category.
- **End-User of Derivatives** (produce, manufacture, process, consumer or merchandize commodities)
 - CFTC has not proposed specific definition, but, generally, any entity who is not a SD or MSP and qualifies for elective exception to mandatory clearing requirements.
 - It appears entity can be SD/MSP in one category of swap and an end-user in another.
- **Product Definitions, Including Swap, Security-Based Swap, Mixed Swaps**
 - Comments due July 22, 2011. Swaps exclude “forward contracts” and adopt CFTC Brent Interpretation and 1985 Interpretation. CFTC request comments on variable delivery terms (Q35, 76 FR 29832)

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End-User Exception to Mandatory Clearing

- Party may “elect” to use exception to mandatory clearing of swaps if:
 - NOT a “financial entity” as defined in CEA Section 2(h)(7)(C)(i);
 - Using swap transaction to “hedge or mitigate commercial risk;” and
 - Notifies CFTC how it generally meets financial obligations for uncleared swap.
- Notification of election would be provided to CFTC by delivering information set forth in proposed §39.6 to Swap Data Repository (SDR):
 - Identification, whether financial entity, whether finance affiliate, whether swap used to hedge or mitigate commercial risk, how it meets financial obligations for swap, and Board of Director approval.
 - Financial obligation notification
 - Written credit support agreement, pledged or segregated assets, written third-party guarantee, reliance on credit ratings, or other method.
 - If issuer of securities, need confirmation that Board of Directors reviewed and approved use of exception to mandatory clearing.
- Industry comments suggested alternatives to CFTC proposed rule, including end-user notifying SDR of blanket end-user election or end-user register with CFTC.

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Reporting and Recordkeeping Requirements

- Pre-enactment (7/21/2010) Swap Transactions (NOPR - CEA Section 2(h)(5))
 - Retain current records (economic terms of Swap plus 5 years after expiration)
 - End-User to submit records to SDR (when established under CEA Section 21)
 - Reporting party same as Final Rule (third party service providers OK)
- Transition Swaps (Post-enactment and Prior to Final Rule Effective Date – CEA Section 2(h)(5)(B))
 - Retain records according to new Final Rule (different times for each swap class)
 - Counterparty/End-User to submit records to SDR (when established)
 - Reporting party same as Final Rule (third party service providers OK)
- Post-Final Rule Effective Date
 - Real-Time
 - “Anonymity”
 - Reporting party hierarchy - SD, MSP, or end-user counterparty (US Person for same level hierarchy)
 - Standards for Practice & Procedures for electronic communication among counterparties and SDR
- Comments – Inter-affiliate Swap exclusion for all reporting periods.

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Position Limits and Reporting

- Position Limits

- Spot-month, single-month and all-months-combined limits
- Bona fide hedging exemption
 - Comments: “workable” and consistent with “hedging or mitigating commercial risk” in other proposed rules
- Formula-based with periodic reevaluation
 - Comments: account for all sources of supply, e.g., for natural gas, include LNG and storage deliverability
- Comments
 - Inter-affiliate swaps should be excluded since they represent allocation of internal risks not risk to markets

- Bona Fide Hedging Exemption Reporting

- Comments: only when position first exceeds limits and when changes occur and electronic with industry input on form and method of submittal

- Position Visibility Reporting Levels and Requirements

- Includes Bona Fide Hedges



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Other Important Rules Relevant to End-Users

- **SD/MSP Rules (affects on counterparty liquidity)**
 - **Margin Requirements for non-bank SD/MSP counterparties**
 - Not imposed on non-financial entities including end-users
 - Credit support arrangements, which could include margin if end-user not creditworthy
 - Prudential Regulator's Margin and Capital Requirements Rulemaking April 11, 2011 (Banks, SDs and MSPs)
 - **Protection of Collateral of Counterparties to Uncleared Swaps**
 - New CEA 4s(l) – SD/MSP duties for margin posted by counterparties (portfolio separation)
 - **Antidisruptive Practices under CEA Section 4c(a)(5)**
 - Designated Contract Market (DCM) and Swap Execution Facility (SEF)
 - Violating Bid/Offers, Intentional or Reckless Disregard for Orderly Execution of Transactions During Closing Period, or “Spoofing”
 - **Business Conduct Rules (SD/MSP)**
 - Prohibition of front running and other trading practices
- **Whistleblower Provisions of CEA Section 23 & SEA Section 21F**
 - Eligibility for award does not require prior use of internal compliance program
- **Prohibition of Market Manipulation under CEA Sections 6(c)(1) & (3)**
 - Mirrors SEC 10b-5 “scienter” standards (similar to FERC and FTC)
- **FERC/CFTC MOU on Jurisdiction (due January 2011)**



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Estimated Timing of CFTC Implementation of Final Rules

- Final Rules
 - Three groups (early, middle & late)*
 - Early (by 7/21/2011) – Entity definitions, SD/MSP registration, end-user exception, mandatory clearing, submissions by clearinghouses and exchanges, large trader reporting, whistleblower, and market manipulation.
 - Middle (Aug/Sep 2011) – Designated Clearing Organizations (DCOs), business conduct for SD/MSP, SDRs, swap data recordkeeping and reporting, trading platforms such as DCMs and SEFs, agricultural swaps, and governance for DCMs, SEFs, and DCOs.
 - Late (Oct/Nov 2011) – Rules proposed after January 1, 2011.
 - CFTC-SEC held joint public roundtable on implementation of final rules on May 2-3, 2011
 - CFTC has requested comments on implementation schedules
- Technical Implementation
 - Key is Establishment of Swap Data Repositories (SDR)
 - Existing SDRs for credit swaps, interest rate swaps, equity swaps and currency rate swaps.
 - Existing SDR will need to update systems practices and procedures to conform to new rules. (CEA Section 45)
 - NO SDR for energy commodity swaps (and other commodity swaps), thus need new “other commodity” SDR (CEA Section 21)
 - After Final Rules need to establish communication standards, practices and procedures among counterparties, SDRs, SEFs, DCMs, SEC, CFTC and others. Existing practices and procedures for established SDRs? For new SDRs, NAESB experience indicates ~12 to 18 months after all applicable final rules.
 - Data Standardization Subcommittee of the CFTC Technical Advisory Committee (nominations - 5/14/2011)
- CFTC granted temporary exemptive relief until the earlier of final rule effective date or December 31, 2011
 - Apply to certain transactions in exempt or excluded commodities (primarily financial and energy commodities)
 - Does not apply to certain provisions that are self-effectuating that will be effective July 16, 2011
 - CFTC will post separate lists of the provisions in these two categories on its web site.
- Congressional Actions
 - CFTC available funding and resources (2012 Budget)
 - New CFTC Commissioner nominated (Mark Wetjen)
 - Extension of Dodd-Frank Implementation Timelines

* CFTC Chairman Gensler Remarks on March 16, 2011, Boca Raton, FL

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Conclusions and Lessons

- **GOOD NEWS and BAD NEWS is same**
- **GOOD NEWS** – *Final rules are not yet issued. There are opportunities to file comments on proposed rules.*
- **BAD NEWS** – *Final rules are not yet issued. All industry participants are unable to determine what actions they need to take to implement the new rules.*
- **Lessons Learned**
 - File comments in CFTC proceedings and include real life business experiences
 - Review comments filed by individuals and associations to determine possible impacts
 - Lobby congress for revisions (Grimm – Whistleblower Bill)



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Suggested Readings and Comments

- *OTC Derivatives Reform: Energy Sector Impacts*, by AGA, AE&PC, APGA, APPA, ANGA, EEI, EPSA, IPAA, NRECA, NGSA & PJM, published in 2010 by the Edison Electric Institute (EEI), www.eei.org
- *Comments on End-User Exception to Mandatory Clearing of Swaps*, by Coalition for Derivatives End-Users, Comment Number 27969 on 2/22/2011, www.cftc.gov
- *Comments on End-User Exception to Mandatory Clearing of Swaps*, by Coalition of Physical Energy Companies (COPE), Comment Number 27839 on 2/22/2011, www.cftc.gov
- *Comments on Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants*, by International Energy Credit Association (ICEA), Comment Number 35524 on 4/11/2011, www.cftc.gov



POTENTIAL KEY IMPACTS OF DODD-FRANK

	Swap Dealer	Major Swap Participant	End User	Physical Only
Origination	SEF (bilateral with EU)	SEF (bilateral with EU)	SEF/bilateral	N/A
Margining	DCO (bilateral with EU)	DCO (bilateral with EU)	DCO/bilateral	N/A
Reporting	Yes	Yes	Yes	N/A
Reporting time	Minutes	Minutes	Minutes	N/A
Hierarchy of reporting	Top	Mid	Bottom (Must decide if with another EU)	N/A
Archiving data	Life of swap +5	Life of swap +5	Life of swap +5	N/A
Settlement	DCO (bilateral with EU)	DCO (bilateral with EU)	DCO/bilateral	N/A
Position limits	Yes	Yes	Yes (bona fide hedger)	N/A

EU: End User

SEF: Swap Execution Facility

DCO: Derivatives Clearing Organization

*Source: PA Consulting

** The CFTC has not issued a Final Rule on these requirements