

## SWAPS AND OTHER ENERGY TRANSACTIONS UNDER DODD FRANK

PRESENTED TO THE  
INTERNATIONAL ENERGY CREDIT ASSOCIATION

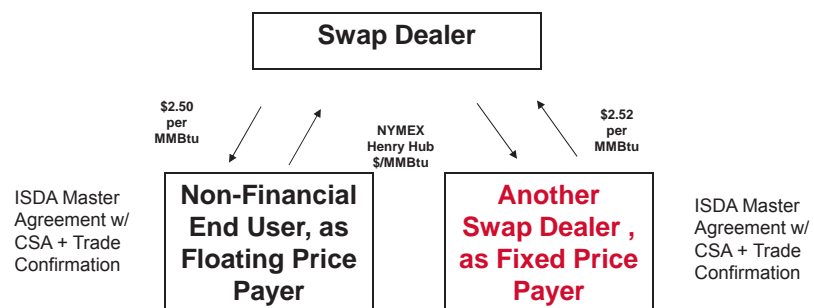
October 15, 2012

### PART I: A PICTURE OF A TRANSACTION

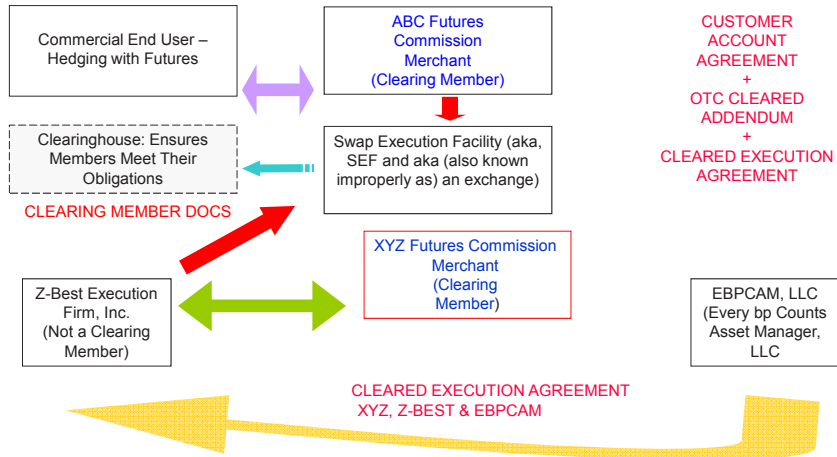
## What's Still Here and What's New

- What's still here?
  - ISDA Based Trading for Bi-Lateral OTCs
  - Futures for exchange-traded futures and swaps
- What's new?
  - OTC Trade Flow that looks like futures

## Before: Bi-Lateral Commodity Hedge



## After: OTC Execution & Clearing



## PART II: WHAT IS A SWAP?

*Let's start at the beginning. (Where the CFTC should have begun the story...)*

## Swap Definition

- The term “swap” has the meaning set forth in Section 1(a)(47) of the Commodity Exchange Act (“CEA”)
- Plus – interest rate, currency, CDS, equity, and commodity swaps
- A commodity option is a swap under the CEA
- Physical sales of commodities in the spot market are not subject to the CFTC’s jurisdiction under the CEA
- Final Rule - Effective October 12, 2012

## What Isn’t A Swap?

- A forward contract
  - CEA § 1a(47)(B)(ii) excludes “Any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled”
- Nonfinancial commodity
  - Physically delivered
  - Exempt commodity (or ag commodity)
  - Intangible commodities (e.g., emission allowances, carbon offsets)

## Forward Contract Exclusion

- Statutory exclusion, substantially interpreted through CFTC interpretive guidance
- Primary purpose: transfer ownership of the commodity between commercial entities and not to transfer solely its price risk
- “Facts and circumstances” test for whether parties intended physical delivery
- Does not apply to speculative transactions
  - Delivery obligations can be extinguished for reasons other than commercial convenience or necessity

## Book-Outs Under Forward Contract Exclusion

- Based on Brent Interpretation
- Applies to all non-financials
- Between two commercial market participants that regularly make or take delivery of the reference commodity in the ordinary course of their business
- Subsequent, separately negotiated agreement to book-out is required
- Requires confirmation of oral book-outs

## Book-Outs (continued)

- No optionality as to delivery
  - Other than as permitted by the Brent Interpretation
- Optionality converts a forward into a swap
- Commodity Options are swaps
- Trade Option Exemption provides for a lighter form of swap regulation
  - Discussed below

## Embedded Optionality Tests - Price

- Price optionality embedded in forward contract will not disqualify contract from “safe harbor”<sup>\*</sup> if option:
  1. Is used to adjust contract price without undermining contract’s overall nature;
  2. Does not target delivery term, so contract’s predominant feature is actual delivery; and
  3. Cannot be severed and marketed separately from the contract

*<sup>\*</sup>Don't confuse with US Bankruptcy Code “safe harbor” for counterparties to derivative transactions!*

## Embedded Volumetric Optionality – Seven Part Test

1. Optionality does not undermine the overall nature of the transaction as a forward contract (*i.e.*, actual physical delivery)
2. Predominant feature is actual delivery
3. Embedded option cannot be severed and marketed separately
4. When entered into, seller intends to deliver commodity upon exercise
5. When entered into, buyer intends to take delivery upon exercise

## Embedded Volumetric Optionality (continued)

6. Both parties must be commercial parties
  - By comparison, only offeree must be commercial participant in TOE
7. Exercise or non-exercise of option based primarily on physical factors or regulatory requirements that are:
  - Outside control of parties; and
  - Influencing demand or supply for the non-financial commodity

## Contracts Discussed in CFTC Interpretation

- Full Requirements Contracts; Output Contracts; Capacity Contracts; Transmission or Transportation Service Contracts; and Tolling Agreements
- Such contracts may have features that will satisfy “forwards with embedded volumetric optionality” interpretation or may not contain embedded volumetric options (like FRCs) and may satisfy other parts of forward interpretation.

## Physical Commercial Contracts for Supply/Consumption of Energy that Provide Flexibility (Lease-like)

- Tolls on power plants; transportation on natural gas pipelines, natural gas storage, and other contracts, analogous to leases, that have option-like features.
- Flexible physical agreements (such as those listed above) meeting the following 3-step test should qualify for forward exclusion from definition of swap



### Lease-like Optionality: 3-Step Test

1. Subject of the transaction is usage of a specific facility, rather than purchase or sale of the commodity created, transported, processed or stored
2. Contract grants buyer the exclusive use of the specified facility (or part) and provides unconditional obligation on seller to grant buyer the exclusive use
3. Payment for use of the specified facility represents payment for its use rather than the option to use it

### BUT...

- “However, in the alternative, if the right to use the specified facility is only obtained via the payment of a demand charge or reservation fee, and the exercise of the right ... entails the further payment of actual storage fees, usage fees, rents, or other analogous service charges...such agreement ... is a commodity option subject to the swap definition.”
- 77 Fed Reg 48242 (Aug 13, 2012)

## Trade Option Exemption

- Although swaps, CFTC provides for lighter regulatory treatment for Commodity Options if:
  1. Option is intended to be physically settled;
  2. Offeror is an ECP or commercial market participant; and
  3. Offeree is a commercial market participant
- See CFTC Rule 32.3

## Trade Option Regulatory Obligations

- Part 45 recordkeeping requirements apply
- Requires annual notice filing on Form TO, if neither party is otherwise subject to Part 45 reporting for non-trade option swap trading activity

## Swap – What's In, What's Out

Swaps	Not Swaps
Forwards in Non-Financials - Unacceptable Optionality	Forwards in Non-Financials - Acceptable Optionality
Commodity Options - But see Trade Options Exemption	Trade Options Exemption - Swap-lite
Deliverable FX Forwards / Swaps - Unless Exempted by Treasury	Spot Transactions - FX + Physical Commodities
FX Options & NDFs	Security-Based Swaps
Cash-settled physical commodity derivatives	Anything that is a security
Interest Rate Derivatives (IRS, FRA)	Consumer and Commercial Agreements, Contracts & Transactions
Credit Derivatives on an Index	Insurance Products
	Loan Participations

PART III:  
OKAY, SOME OF MY TRANSACTIONS  
ARE SWAPS;  
WHAT DOES THAT MEAN FOR ME?

## Key Documentation Issues

- Obtain a Legal Entity Identifier\*
- Adhere to ISDA Dodd-Frank Protocol or amend your ISDAs to reflect new business conduct standards\*
- Timing – Clearing Documentation
  - Category 1: 90 days after determination
  - Category 2: 180 days after determination
  - **Category 3: 270 days after determination**

*\*Recommended by 12/31*

## A Typical Derivatives Trading Relationship

- Pre-Trade
- Execution
- Clearing
- Reporting

## Pre-Trade Regulatory Issues

- What trades will be subject to regulations?
- Who is a swap dealer and who is a MSP?
- When will swap dealers be required to register with the CFTC?
- What are the final internal and external business conduct standards?

## Swap Dealer: The Definition

- Holds itself out as a dealer in swaps
- Makes a market in swaps
- Enters into swaps for own account as ordinary course of business
- Engages in activity that causes person to be commonly known as a dealer

## Swap Dealer: The Exemptions

- Insured Depository Institution Making Loan
- De Minimis Activity
  - \$8 billion over 12 months (temporary transition)
  - \$3 billion threshold beginning in 2017
  - **Threshold for Swaps with Special Entities:**
    - \$800 million for “utility commodity swaps” with “Utility Special Entities”; requires data to be reported to CFTC by 12/31/12, then quarterly
    - **\$25 million** for all other swaps with special entities

## MSP: The Definition

- Substantial position in major category of swaps
- Outstanding swaps created substantial counterparty exposure
- Highly leveraged financial entity that maintains substantial position in outstanding swaps in major category of swaps
- Safe harbor in final rule
- Discussed below in context of end-user exception

## SD/MSP Registration

- SD/MSP definitions and definition of swap effective October 12, 2012; start counting transactions on October 12, 2012:
  - SD registration due 60 days after month in which entity first exceeds *de minimis* level for SD registration;
  - MSP registration due 60 days after quarter in which entity passes MSP exposure thresholds
- Filing not required until January 1, 2013
- Recordkeeping and reporting for SDs/MSPs becomes a reality upon registration

## External Business Conduct Standards

- Prohibition on Fraud, Manipulation and Other Abusive Practices
- Verification of Counterparty Eligibility
- Disclose Material Risks and Conflicts
  - Scenario Analysis
- Notification re: Right to Select CCP
- Fair Dealing & Institutional Suitability
- ISDA Dodd-Frank Protocol

## Stricter Standards for SD/MSP if Counterparty is a Special Entity

- Swap Dealers and MSPs entering into swaps with Special Entities (governmental agencies, municipalities, etc.) have stricter responsibilities (some call them fiduciary obligations) for such swaps
- Schedules 4, 5 and 6 to ISDA Dodd-Frank Protocol Are Helpful Summary of Standards
- \$25 Million - A “*De Minimis*” De Minimis Level; BEWARE!!!

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## Internal Business Conduct Standards

- Reporting, Recordkeeping and Daily Trading Record Requirements
- Duty to Have a Risk Management Program
- Duty to Have a Business Continuity and Disaster Recovery Plan
- Position Limits, Supervise, Conflicts, Consider Antitrust
- Chief Compliance Officer



## Other Standards From 09/2012 Final Rule

- Confirmation
- Portfolio Reconciliation
- Portfolio Compression
- Swap Trading Relationship Documentation

## Extraterritoriality

- Variety of Situations (nexus to U.S.): i.e., U.S. customer, U.S. office of foreign entity, foreign sub of U.S. entity, foreign customer, etc.
- Variety of Definitions: What is a U.S. Person? Why does it matter?
- Variety of Requirements for Non-US Person SD/MSP: Entity level vs transaction level?
- Variety of Regulatory Approaches: What about inconsistency between jurisdictions?
- Timing of Registration by Non-US entity

## Execution Regulatory Issues

- Is bi-lateral execution a thing of the past?
- What is a SEF?
- What capital and margin requirements will apply to commercial counterparties?
- How will capital and margin requirements apply to non-bank swap dealers and MSPs?

## Execution: What We Know and Don't Know

- Bi-lateral execution
- Execution through swap execution facility
- Execution through designated contract market
- Documentation likely to be a Cleared Derivatives Execution Agreement
- Still much to be learned

## Margin & Capital Requirements

- All OTC derivatives likely to face initial and variation margin requirements
- Non-cleared trades will face higher margin and capital requirements than cleared trades
- As *proposed*, in non-cleared swap context
  - Commercial counterparties will NOT be required to provide margin
  - Swap dealers will NOT be required to post under any circumstances
- Capital requirements affect, but do not directly apply, to non-SD counterparties
  - IECA Comments: Give credit for credit (*i.e.*, guarantees, liens and lines)

## Clearing Regulatory Issues

- What is the central clearing mandate and why was it proposed?
- What are the different central clearing models and why should I care about them?
- When will trades start to centrally clear?
- What do we know about the end user exception to central clearing?

## Central Clearing and Trading Mandate

- A clearinghouse must act as an intermediary between two parties to a standardized swap
  - CFTC determines whether swap is sufficiently standardized
- Any standardized swap subject to clearing must be executed on a futures exchange or over a swap execution facility
- Exception to mandate for end-users using swaps to hedge or mitigate commercial risk

## Clearing: Segregation & Portability

- Segregation: The Clearing Models
  - Baseline Futures Model
  - Legal Segregation w/ Recourse
  - **Complete Legal Segregation**
  - Full Physical Segregation
- Portability: “Prompt and Efficient Transfer” of Positions and Collateral

## Non-Cleared Swaps

- Customer has right to keep its initial margin at its custodian
  - Tri-party control agreement
- Increased margin and capital
- Heightened business conduct standards

## End-User Exception

- Enters into “swaps” to hedge or mitigate commercial risks of a commercial enterprise
- Risk related to potential change in the value of assets, services, inputs, products or commodities that a person owns, produces, manufactures, processes, merchandises, leases or sells
- Filing required to qualify
- See discussion in Part IV below

## Recordkeeping and Reporting Regulatory Issues

- Will commercial participants face any new recordkeeping and reporting obligations?
- What “R&R” obligations of dealers / MSPs may be of interest to end users?
- What is “real time reporting” all about?
- What about the position limits / aggregation?
- Any news on portfolio margining?
- What is status of anti-manipulation?

## Recordkeeping: SD, MSP, SEF, DCM, DCO

- General – Full, Complete, and Systematic Business Records
- Retention Period – Life of the Swap + 5 Years After Termination
- Retention Form – Electronic, if Available, or Paper
- Retrievability – Readily Accessible for Life of Swap + 2 Years
- Inspection – Records Open to Inspection Upon Request

## Recordkeeping: SDR

- General– Full, Complete, Systematic and Accessible Business Records
- Retention Period – Life of the Swap + 15 Years After Termination
- Retention Form – Electronic
- Retrievability – Readily Accessible for Life of Swap + 5 Years
- Inspection – Records Open to Inspection Upon Request

## Recordkeeping: All Other Market Participants

- General– Full, Complete, and Systematic Business Records
- Retention Period – Life of the Swap + 5 Years After Termination
- Retention Form – Electronic or Paper
- Retrievability – Retrievable within 5 Business Days for Life of Swap + 5 Years
- Inspection – Records Open to Inspection Upon Request
- Compliance Date – April 10, 2013

## Reporting: Creation and Continuation

- Swap Creation Data
  - Primary Economic Data
  - Confirmation Data
- Swap Continuation Data
  - Life Cycle Event Data
  - State Data
  - Valuation Data

## Reporting: Identifiers

- Unique Swap Identifiers
  - Name Space Method
  - Allocation Issues
- Legal Entity Identifiers
  - Level One Data
  - Level Two Data
- Unique Product Identifiers



## Who is Responsible for Reporting?

<u>Types of Counterparties</u>	<u>Reporting Counterparty</u>
Only one counterparty is an SD or MSP	SD or MSP
One counterparty is an SD and the other is an MSP	SD
Two non-SD/MSP counterparties, but only one is a "financial entity"	Financial entity
Two counterparties at same hierarchical level	As per agreement of two counterparties
One counterparty is SD/MSP and non-U.S. person, the other counterparty is a non-SD/MSP and U.S. person	Non-U.S. person SD/MSP
Both counterparties non-SD/MSPs, but only one is a U.S. person	U.S. person
Both Non-U.S. persons, swap executed on a SEF or DCM, or cleared through a DCO	As per agreement

## Reporting

- Use of Data Reporting Vendors
  - Third-Party Service Provider
- Reporting to a Single SDR
  - On-Facility Swaps
  - Off-Facility Swaps
  - Off-Facility Swaps Excused from Reporting
- Data Reporting for Swap in Asset Class not Accepted by SDR
  - Reporting counterparty must report all swap data to CFTC
- Required Data Standards
  - Use facilities, methods or data standards required by SDR

## Reporting

- Voluntary Supplemental Reporting By Non-reporting Counterparty
  - USI for swap subject to voluntary supplemental reporting
  - Identification of SDR, if VSR made to different SDR
  - LEI of counterparty submitting VSR
  - If applicable, indication that VSR is made pursuant to law of non-U.S. jurisdiction
- Reporting Errors and Omissions in Previously Reported Data
  - Reporting Counterparty – Report errors or omissions in data as soon as possible after discovery
  - Non-Reporting Counterparty – Must notify reporting counterparty
  - Liability for Errors or Omissions – No safe harbor for good-faith mistakes; CFTC will carry out oversight in “reasonable and appropriate manner”

## SD Reporting Requirements

- Part 43
  - Real-Time Public Reporting of Swap Transaction and Pricing Data
- Part 45
  - Swap Data Reporting and Recordkeeping Requirements

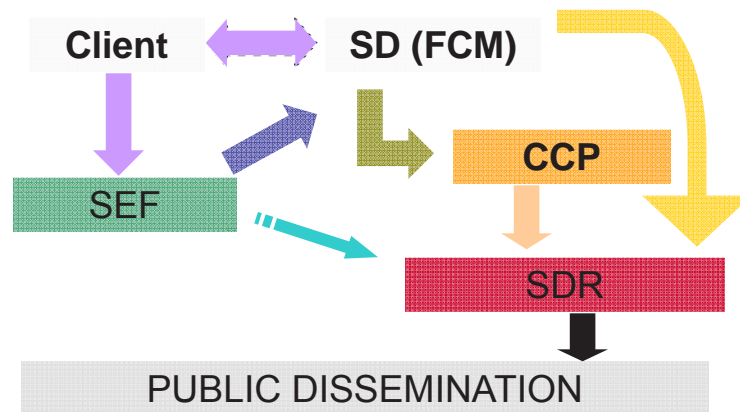
## Real Time Reporting

- Support fairness and efficiency of markets and increase transparency, so as to improve price discovery and reduce risk
- Reporting: SEF/DCM vs. Off-Facility means via execution vs. by reporting party
- Dissemination: SEF/DCM to SDR; SDR to public
- Sensitivities: Anonymity and Size of Trade

## Position Limits

- Final Rule: CFTC will impose position limits as appropriate to prevent excessive speculation that distorts prices on certain commodities
- Independent account controller exemption
- Certain aspects operating on basis of a proposal until CFTC makes determination
- District Court Vacated CFTC's Position Limits rule- Discuss Impacts...

## OTC: Central Execution and Clearing



PART IV  
HOW DO I KNOW IF I AM  
AN END-USER?

## Overview of Topics Covered

- An Overview of the End-User Exception
  - Final CFTC Rule 39.6
  - Proposed Inter-affiliate Clearing Exemption
- Pictures That Are Worth 1,000 Words
  - Exhibits
- A Detailed Look At the MSP Definition

## THE END-USER EXCEPTION

## Central Clearing and Trading Mandate

- A clearinghouse must act as an intermediary between two parties to a standardized swap
  - CFTC determines whether swap is sufficiently standardized
- Any standardized swap subject to clearing must be executed on a futures exchange or over a swap execution facility
- Exception to mandate for end-users using swaps to hedge or mitigate commercial risk

## Primary Statutory Elements

- Electing counterparty may not be a financial entity unless it is one of the following
  - Captive finance affiliate (or captive finance company)
  - Acting as agent and on behalf of an affiliate that is not a financial entity
  - A small financial institution
- Electing counterparty must use swaps to “hedge or mitigate commercial risk”
- Notification to CFTC, as to how electing counterparty meets its obligations
- Board approval for SEC filer

## CFTC Rule 39.6

- Structure
  - General requirements
  - Reporting obligations
  - “Hedging or Mitigating Commercial Risk” defined
- CFTC Guidance “amplifies” certain statutory elements
  - Financial entity definition
  - Inter-affiliate transactions
  - “Hedging or Mitigating Commercial Risk”

## Financial Entity Definition

- SD / SBSD
- ✓ **MSP / MSBSP**
  - ✓ **Discussed later**
- Commodity pool
- Hedge fund
- Employee benefit plan (as defined in § 3(3) and (32) of ERISA)
- ✓ **“Predominantly engaged in activities...that are financial in nature, as defined in section 4(k) of BHCA of 1956**
  - ✓ **Stand-alone Treasury sub**

## Exceptions: Certain Financial Entities

- Acting *as agent and on behalf of* a non-financial entity affiliate
  - Swap must HMCR of NFE affiliate
- Captive finance affiliate
  - Primary business is provision of financing
  - Using derivatives to hedge interest rate and FX risks
  - 90% of risks arise from financing purchase and lease of “products” & 90% of products “manufactured” by parent or another affiliate of parent
  - Product & manufacture broadly defined
- Small financial institution
  - \$10 billion in assets

## Inter-affiliate Swaps Under Final Rule

- Swap between 2 affiliates eligible for end-user exception, even if one party is a financial entity (*i.e.*, stand-alone Treasury sub)\*
- Back-to-back “Street-facing swap” eligible, if end-user is a captive finance affiliate
- “Street-facing swap” also eligible if entered into by a financial entity end-user “acting on behalf of and as an agent” for its non-financial end-user affiliate using the swap to HMCR

\*See Exhibit B at end of presentation for diagrams



## Hedge or Mitigate Commercial Risks

- Swap must satisfy any 1 of these 3 tests
  - Hedge Accounting Test
  - Bona Fide Hedging Test (note - in now vacated Position Limits Rule)
  - Economically Appropriate Test
- Swap may not be used
  - For speculation, investing, or trading
  - To hedge or mitigate the risk of another swap unless that other swap is use to HMCR
- Financial risks can be commercial risks
  - Interest rate risk
  - Currency risk

## Hedge Accounting Test

- Qualifies for hedging treatment
  - FASB Accounting Standards Codification Topic 815
  - GASB Statement 53
- Determined at time of election
  - No need to demonstrate hedge effectiveness or engage in periodic hedge effectiveness testing
- Does not require electing counterparty to apply hedge accounting
  - Transaction must qualify

## Bona Fide Hedging Test

- Substitute for positions taken / transactions made in physical marketing channel
- Economically appropriate to reduction of risks in conduct and management of commercial enterprise
- Arises from potential change in value of assets, liabilities or services involved with the person
- If a swap of another swap, then the other swap must be a bona fide hedge

## Economically Appropriate Test

- Potential change in value of
  - Assets owned, produced, manufactured, processed or merchandised
  - Liabilities incurred in ordinary course of business (OCoB)
  - Services provided or purchased in OCoB
  - Assets, services, inputs products, or commodities owned, produced, manufactured, processed, merchandised, leased or sold in the OCoB
  - Changes in interest, currency, or FX rate exposures related to any of the foregoing
- Fluctuation in interest, currency, or FX rate exposures arising from a person's current or anticipated assets or liabilities

## Reporting Requirements

- Annual by Electing Counterparty
  - Whether a financial entity
  - Whether swaps used to HMCR
  - How counterparty meets its financial obligations associated with non-cleared swaps
  - If SEC issuer/filer, then CIK # and confirm board approval
- Trade-by-trade
  - Notice of election of exception
  - Identity of the electing counterparty
  - The information that would be included in an annual report by an electing counterparty (unless that report has already been filed)
  - Reporting counterparty determined under Rule 45.8

## Board Approval

- Board or appropriate board committee must review and approve the decision not to clear swap, if counterparty
  - Issues securities registered under § 12 of Exchange Act
  - Is required to fill reports under § 15(d) of Exchange Act
- An entity under control of an SEC issuer/filer is considered to be an SEC issuer/filer
- Renew on annual, or more appropriate, basis

## Inter-affiliate Swaps: Proposal

- Proposed under Section 4(c)(1)
  - Both entities can be financial entities
  - Swap does not need to hedge or mitigate commercial risk
- Conditions
  - Majority-owned affiliates reported on consolidated basis
  - Centralized risk management & documentation required
  - Variation margin required if 2 financial entities, **unless** 100% commonly-owned, commonly guaranteed affiliates with 100% commonly-owned guarantor
  - Both affiliates must make election

## Inter-affiliate Swaps: Proposal *continued*

- Election and reporting
  - Both parties elect
  - One party does reporting
    - General SDR reporting under Part 45
    - Board approval requirement, if SEC filer
- If one affiliate is Non-U.S. Affiliate
  - Located in jurisdiction with comparable clearing regime
  - Required to clear swaps
- See exhibits

## THE MAJOR SWAP PARTICIPANT DEFINITION

### The MSP Definition Is Important...

- Because you may not claim the end-user exception from central clearing under Rule 39.6 if you are a major swap participant, *and*
- An MSP is a “financial entity”

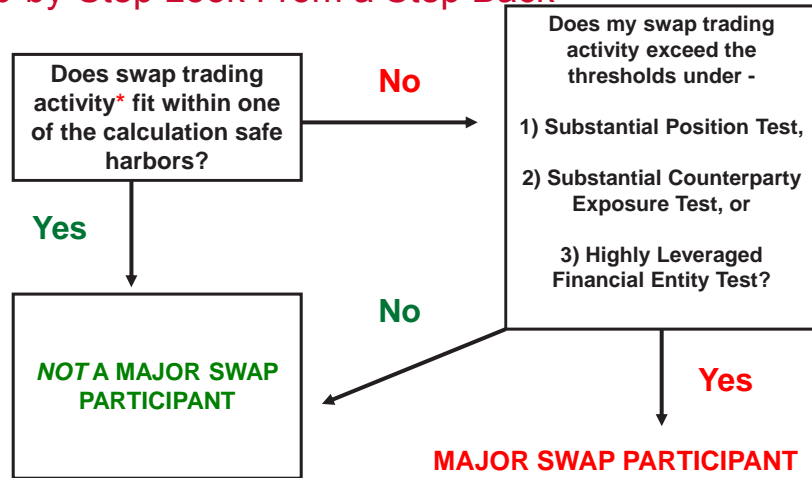
## MSP: The Statutory Definition

- **Substantial position** in major category of swaps, excluding –
  - Positions held for HMCR
  - Positions maintained by ERISA plan for primary purposes of hedging or mitigating the plan's operational risks
- Outstanding swaps create **substantial counterparty exposure**
- **Highly leveraged** financial entity that maintains substantial position in outstanding swaps in major category of swaps

## MSP: The Regulatory Definitions

RULE 1.3	DEFINED TERM
(hhh)	Major swap participant
(iii)	Category of swap; Major swap category
(jjj)	Substantial position
(kkk)	Hedging or mitigating commercial risk
(lll)	Substantial counterparty exposure
(mmm)	Financial entity; Highly leveraged

## A Step-by-Step Look From a Step Back



\*Include swaps of any other entity guaranteed by your entity

## The Calculation Safe Harbors

#1	#2	#3	#3 Alternate
<ul style="list-style-type: none"> <li>\$100 million cap uncollateralized exposure to all CPs</li> <li>\$2 billion cap notional in any major category</li> <li>\$4 billion cap notional across all major categories</li> </ul> <p>Hedges included under all calculations</p>	<ul style="list-style-type: none"> <li>\$200 million cap uncollateralized exposure to all CPs</li> <li>\$1 billion month-end limit on <math>\sum</math> AUOE and APOE in any major category (only include hedges, if highly leveraged financial entity)</li> <li>\$2 billion month-end limit on <math>\sum</math> AUOE and APOE across all categories (includes hedges)</li> </ul>	<ul style="list-style-type: none"> <li>\$1.5 billion month-end limit AUOE* in rate category (\$500 million for each of the other categories)</li> <li>\$3 billion month-end limit <math>\sum</math> AUOE* and notional multiplied by applicable PFE risk multipliers* for rate category (\$1 billion for each of the other categories)</li> </ul> <p>* Citation in final rule to be revised</p>	<ul style="list-style-type: none"> <li>\$500 million month-end limit AUOE* (includes hedges) across all categories of swaps</li> <li>\$1 billion month-end limit <math>\sum</math> AUOE* of swaps and 15% of notional for all categories of swaps</li> </ul>

\*Based on exposure on statements from swap dealers

## Calculating Aggregate Uncollateralized Outward Exposure

- 1: Inventory all swap positions by category
- 2: Calculate Uncollateralized Outward Exposure (UOE) by category for each counterparty\*
  - Out of the money (based on “industry standard mark-to-market”) less collateral
- 3: Add together UOE across all counterparties

\*May give effect to netting agreements

## Master Netting Agreement – Allocation of AUOE

$$E_{s(mc)} = E_{\text{net total}} * \frac{OTM_{s(mc)}}{OTM_{s(mc)} + OTM_{s(o)} + OTM_{\text{non-s}}}$$

$$E_{\text{net total}} = \text{Exposure} = 120$$

$$OTM_{s(mc)} = \text{Out-of-Money in Rates} = 40$$

$$OTM_{s(o)} = \text{Out-of-Money all other categories} = 90$$

$$OTM_{\text{non-s}} = \text{Out-of-Money Non-Swaps Subject to Netting (so, e.g., FX if exempt)} = 120$$

$$E_{s(mc)} = 120 * \frac{40}{40+90+120} = 19.20$$



## Calculating Aggregate POE for Non-cleared Swaps or No Daily Margin

- 1: Identify excluded transactions
  - All obligations paid (i.e., option bought)
  - Must be covered under law
- 2: Determine effective notional amount
  - Give effect to multipliers or leverage
- 3: Calculate Potential Outward Exposure
  - Effective Notional x Risk Multiplier
  - Further reduction for netting agreement

## Netting Adjustment – APOE

$$P_{\text{net}} = (.4 * P_{\text{gross}}) + (.6 * \text{NGR} * P_{\text{gross}})$$

$$P_{\text{net}} = \text{Potential Outward Exposure}$$

$$P_{\text{gross}} = \text{Notional} * \text{Risk Multiplier}$$

$$\text{NGR} = \frac{ES_{mc}}{OTM_{s(mc)}} = \frac{19.20}{40} = .48$$

So, if Notional is 800 and Risk Multiplier is .005, then  $P_{\text{gross}} = 4$  and

$$P_{\text{net}} = (.4 * 4) + (.6 * .48 * 4) = 2.752$$

## Risk Multipliers

RISK MULTIPLIER BY TYPE OF SWAP OR SBS								
Residual Maturity	Interest Rate Swap	FX and Gold Swaps	Precious Metals Swaps (ex-Gold)	Other Commodities Swap	Credit Swap*	Equity Swap (not SBS)	Debt SBS*	Other SBS
1 Year or Less	0.00	0.01	0.07	0.10	0.10	0.06	0.10	0.06
Over 1 to 5 Years	0.005	0.05	0.07	0.12	0.10	0.08	0.10	0.08
Over 5 Years	0.015	0.075	0.08	0.15	0.10	0.10	0.10	0.10

\*The POE is capped at the NPV of any unpaid premiums owed by the person in respect of 1) a credit derivative in which the person is the protection buyer or 2) any other option purchased by the person.

## Calculating Aggregate POE for Cleared Swaps or Daily Margin

- Same as Non-cleared swaps
- Additional 90% haircut, if cleared
- Additional 80% haircut, if non-cleared and subject to daily mark-to-market margining
  - If subject to master netting, then considered to be subject to MTM margining
  - Must give effect to MTA in excess of \$1 million or Threshold (net of any Ind't Amt's posted)

## Substantial Position Test

CATEGORY OF SWAP OR SBS	AOUE THRESHOLD* (Applied per Category)	AUE +PFE THRESHOLD (Applied per Category)
Rate Swap	\$3 billion	\$6 billion
Credit Swap	\$1 billion	\$2 billion
Equity Swap	\$1 billion	\$2 billion
Other Commodity Swap	\$1 billion	\$2 billion
Debt SBS	\$1 billion	\$2 billion
Other SBS	\$1 billion	\$2 billion

Excludes positions that hedge or mitigate commercial risk and positions maintained by ERISA plan for primary purposes of hedging or mitigating the plan's operational risks.

\*Based on the mean of an entity's AOUE measure at the close of each business day, beginning on the first business day of each calendar quarter and continuing through the last business day of that quarter (i.e., a daily average test measure as of the close of business over each calendar quarter).

## Substantial Counterparty Exposure Test

- Calculate as Substantial Position but
  - Across all categories
  - Does not exclude hedging or ERISA positions

SWAP OR SBS	AUE THRESHOLD* (Applied across categories)	AUE +PFE THRESHOLD (Applied across categories)
Swap	\$5 billion	\$8 billion
SBS	\$2 billion	\$4 billion

\*Based on the mean of an entity's AUE measure at the close of each business day, beginning on the first business day of each calendar quarter and continuing through the last business day of that quarter (i.e., a daily average test measure as of the close of business over each calendar quarter).

## Highly Leveraged Financial Entity Test

- Financial entity
  - Not a swap dealer
  - Not a bank
- Highly leveraged
  - 12:1 debt-to-equity ratio
- Substantial Position Test – By Category
  - Does **not** exclude hedges

BONUS TOPICS

## “Orderly Liquidation Authority” - New Insolvency Regime

- OLA - Similar to FDIA’s Treatment of Banks, Including FDIC Receivership; Replaces Bankruptcy Code
- Systemically Important, Nonbank “Financial Companies” in Default or in Danger of Default, “Predominantly Engaged” in Financial Activities - 85% Test (Regulations TBD)
- Applicability Determined Only When Company is in Default or in the Zone – Multi-step Process: FDIC+ FRB > Treasury Secretary + President > Voluntary or Court-ordered Receivership
- Incorporates Bankruptcy Code Provisions but Limits Contractual Termination, Suspension of Obligations, and Setoff Rights

## Whistleblower

- WB need not follow regular corporate controls
- WB incentivized to not follow corporate controls because penalties higher if not self-reported
- Penalties: No < 10% or > 30%
- CFTC proposal “trumps” attorney-client privilege

## Manipulation and Disruptive Trading Prohibitions

- Disruptive Trading Practices, per CFTC interpretive order only applies to SEF/DCM executed futures & swaps
- Market manipulation prohibition applicable to all
  - Trading to change prices independent of supply / demand view

## EXHIBIT A

*List of CFTC Final Rules and Proposed Rules as of 11 October 2012*

## Final Rules – 2010

FINAL RULE	DATE
Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries	9/10/2010
Interim Final Rule: Reporting Pre-Enactment Swap Transactions	10/14/2010
Interim Final Rule: Reporting Certain Post-Enactment Swap Transactions	12/17/2010

## Final Rules – 2011

FINAL RULE	DATE
Agricultural Commodity Definition	7/13/2011
Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices - Prohibition on Price Manipulation	7/14/2011
Privacy of Consumer Financial Information; Conforming Amendments under Dodd-Frank Act	7/22/2011
Large Trader Reporting for Physical Commodity Swaps	7/22/2011
Removing Any Reference to or Reliance on Credit Ratings in Commission Regulations	7/25/2011
Process for Review of Swaps for Mandatory Clearing	7/26/2011
Provisions Common to Registered Entities	7/27/2011 amended 8/1/2011
Agricultural Swaps	8/10/2011
Whistleblower Incentives and Protection	8/25/2011
Swap Data Repositories: Registration Standards, Duties and Core Principles	9/1/2011
Retail Foreign Exchange Transactions; Conforming Changes to Existing Regulations	9/12/2011
Part 30 Foreign Futures and Options Contracts on a Non-Narrow-Based Security Index; Commission Certification Procedures	9/26/2011
Reporting by Investment Advisers to Private Funds and Certain CPOs and CTAs on Form PF	11/16/2011
Position Limits for Futures and Swaps	11/18/2011
Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions	12/19/2011
Registration of Foreign Boards of Trade	12/23/2011
Chapter 1 Amendment to July 14, 2011 Order for Swap Regulation	12/23/2011 amended 7/13/2012

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## Final Rules – 2012

FINAL RULE	DATE
Real-Time Public Reporting of Swap Transaction Data	1/9/2012 amended 1/20/2012, 8/13/2012
Swap Data Recordkeeping and Reporting Requirements	1/13/2012
Registration of Swap Dealers and Major Swap Participants	1/19/2012 amended 1/25/2012
Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions	2/7/2012
Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties	2/17/2012
Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations	2/24/2012 amended 3/26/2012
SD and MSP Recordkeeping, Reporting, and Duties Rules; FCM and IB Conflicts of Interest Rules; and CCO Rules for SDs, MSPs, and FCMs	4/3/2012
Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management	4/9/2012 amended 6/25/2012
Commodity Options (Parts 3, 32, and 33)	4/27/2012
Further Definition of SD, SBSB, MSP, MSB and ECP	5/23/2012 amended 7/5/2012
Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps	6/12/2012
Core Principles and Other Requirements for Designated Contract Markets	6/19/2012
End-User Exception to the Clearing Requirement for Swaps	7/19/2012
Part 50 Swap Transaction Compliance and Implementation Schedule: Clearing Requirement under Section 2(h) of the CEA	7/30/2012
Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping	8/13/2012
Registration of Intermediaries	8/28/2012
Amendments to CPO and CTA Regulations Resulting From the Dodd-Frank Act	9/5/2012
Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants	9/11/2012

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## What Needs to be Finalized

PROPOSED RULE	DATE
Requirements for DCOs, DCMs, and SEFs Regarding the Mitigation of Conflicts of Interest	10/18/2010
Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions	11/3/2010
Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy	12/3/2010
Governance Requirements for DCOs, DCMs, and SEFs; Additional Requirements Re: the Mitigation of Conflicts	1/6/2011
Margin Requirements for Uncleared Swaps for SDs and MSPs	4/28/2011
Capital Requirements of SDs and MSPs	5/12/2011
Adaptation of Regulations to Incorporate Swaps	6/7/2011
Process for a DCM or SEF to Make a Swap Available to Trade under Section 2(h)(8) of the CEA	12/14/2011
Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Covered Funds	2/14/2012
Harmonization of Compliance Obligations for Mutual Funds Required to Register as CPOs	2/24/2012
Identity Theft Red Flags Rules	3/6/2012
Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades	3/15/2012
Aggregation, Position Limits for Futures and Swaps	5/30/2012
Dual and Multiple Associations of Persons Associated With SDs, MSPs, and Other Commission Registrants	6/15/2012
Rules Prohibiting the Aggregation of Orders To Satisfy Minimum Block Sizes or Cap Size Requirements, and Establishing Eligibility Requirements for Parties to Block Trades	6/27/2012
Cross-Border Application of Certain Swaps Provisions of the CEA	7/12/2012
Clearing Exemption for Certain Swaps Entered Into by Cooperatives	7/17/2012
Clearing Requirement Determination Under Section 2(h) of the CEA	8/7/2012
Clearing Exemption for Swaps Between Certain Affiliated Entities	8/21/2012

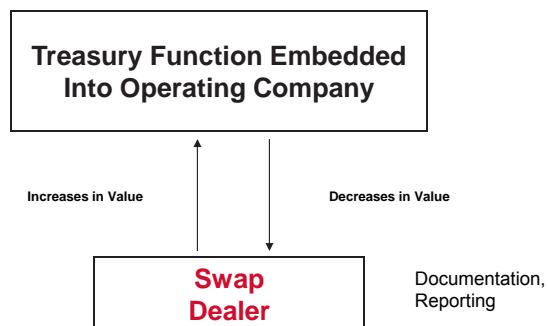
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## EXHIBIT B

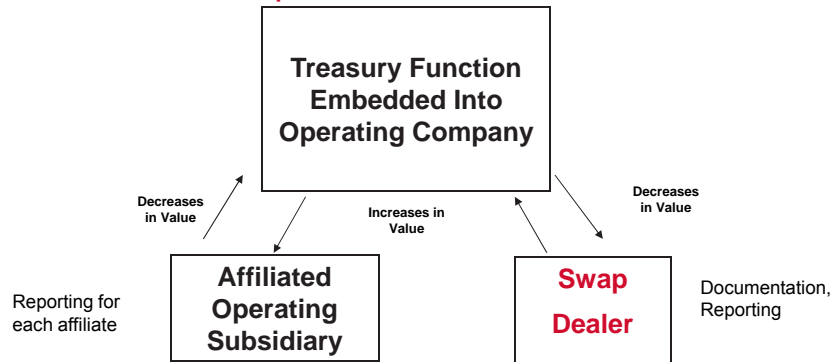
*End-User Exception Diagrams*

### Embedded Treasury Function – Direct Swaps



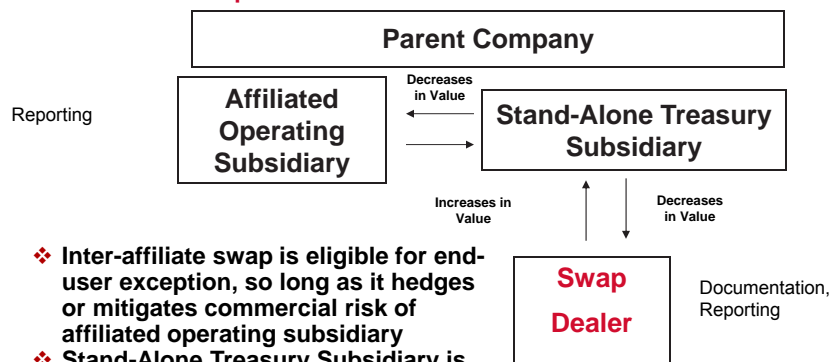
- ❖ Operating Company may not be a “financial entity” (**not** an MSP)
- ❖ Each swap must be used to hedge or mitigate commercial risk
- ❖ Annual Reporting by Operating Company or Swap Dealer
- ❖ Trade-by-trade Reporting by Swap Dealer

## Embedded Treasury Function – Back-to-Back Swaps



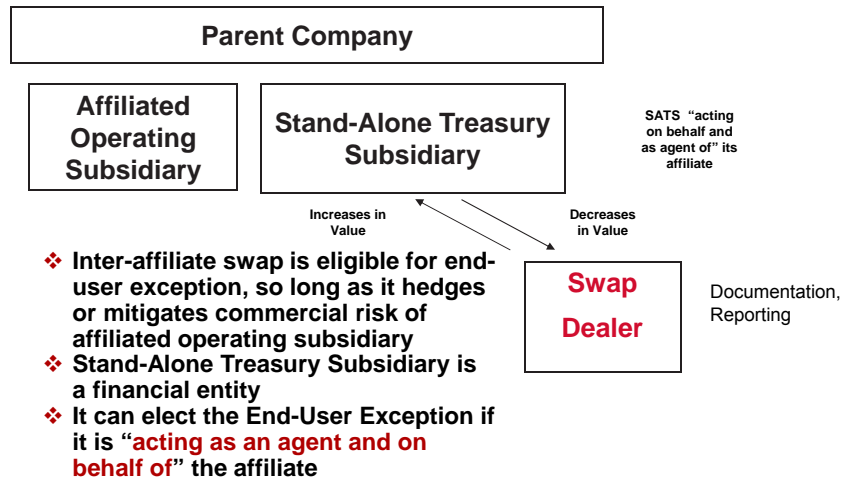
- ❖ Inter-affiliate swap is eligible for end-user exception, so long as it hedges or mitigates commercial risk of affiliate
- ❖ Swap between Operating Company and Swap Dealer can fit within the End-User Exception under CFTC Rule 39.6(c)(2)(ii), but only if Operating Company is not a “financial entity”

## Stand-Alone Treasury Subsidiary – Back-to-Back Swaps

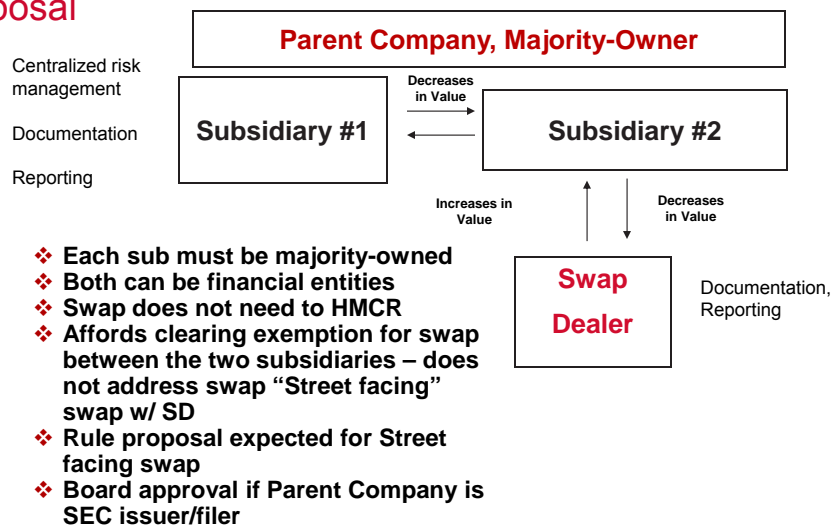


- ❖ Inter-affiliate swap is eligible for end-user exception, so long as it hedges or mitigates commercial risk of affiliated operating subsidiary
- ❖ Stand-Alone Treasury Subsidiary is a financial entity – so, it can only elect the End-User Exception for “Street facing swap” with SD if it is a “**Captive Finance Company**”
- ❖ Rule proposal likely for swap w/ SD

## Stand-Alone Treasury Subsidiary – Acting As Agent and On Behalf Of



## Inter-affiliate Clearing Exemption – Proposal



## Thank You

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  - Commercial Restructuring & Bankruptcy
  - Investing and Trading Strategies
  - Disputes Concerning Breach of Contract, Structured Debt, Derivatives Transactions, and Cross Border issues
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  - Financial Industry
  - Energy and Commodities
  - Secured and Unsecured Creditors
  - Ad Hoc and Official Committees



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  - Derivatives Regulation by CFTC
- Industries Served
  - Energy Trading Companies
  - Power Project Developers/Owners and Equity Funds
  - Various End-Users of Physical and Financial Energy Commodities



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