



Dodd-Frank's Title VII – OTC derivatives reform

Important answers for board members
as companies begin the road to reform

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Introduction

Thousands of companies hedge business risks by entering into derivatives with banks or other derivative dealers that are executed bilaterally over the counter (OTC) (i.e., one counterparty faces another counterparty). Examples include interest rate, foreign exchange, energy and other commodity derivatives. Historically, such OTC derivatives have not been subject to government regulation, but Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Title VII) changes that. Under Title VII, all OTC derivatives – even hedges executed by non-financial end users – are subject to regulatory oversight and new requirements. Boards and the appropriate designated committees (which might include Audit Committees or finance committees) should focus on the impact of Title VII at the companies they oversee; compliance with some of the new regulations mandates direct board involvement.

The questions in this document are designed to help members of the boards of directors at companies understand the potential impacts of the new regulation on non-financial companies that use OTC derivatives. Many of these questions are appropriate to ask of management (e.g., treasury, legal and/or accounting) as they prepare to comply with the new regulations.

The questions are organized into three main groups:

- ▶ Overview of OTC derivatives reform
- ▶ Key business impacts
- ▶ Key questions board members should be asking

What you need to know:

- ▶ Any organization that transacts in the OTC derivatives market will be impacted.
- ▶ Market changes driven by the regulation may impact hedging strategy, cost to hedge, working capital and liquidity in addition to various business processes.
- ▶ Multiple business functions will be impacted, including treasury, compliance, risk, legal and technology.
- ▶ The Commodity Futures Trading Commission (CFTC) has broad enforcement authority and may impose stiff civil and criminal penalties for non-compliance.
- ▶ Compliance deadlines have been set throughout 2013 - board members should monitor their companies' progress to prepare now.

Overview of OTC derivatives reform

1. Why is reform of the OTC derivatives market included as part of Title VII?

Congress viewed the lack of regulation of OTC derivatives transactions as exacerbating the 2008 financial crisis, with the government "bailout" of AIG loss positions on its credit derivatives most often cited as the prime example. Prior to the crisis, many large financial institutions accumulated sizable unrealized losses from highly leveraged speculative positions in OTC derivatives. Since the trades were not regulated, the amount of market participants' exposures throughout the financial system could not be quantified.

The two primary goals of Title VII of the Dodd-Frank Act are to reduce risk to the US financial system and American taxpayers and to increase transparency in the OTC derivatives market. Title VII aims to reduce systemic risk through mandating central clearing of previously unregulated derivative instruments, and by requiring more capital and liquid collateral to back derivative trades. Title VII aims to give regulators transparency into market participants' trading activities and exposures by mandating comprehensive reporting of OTC derivative trades. In addition, Title VII includes provisions that require many market participants to execute trades on regulated exchanges or trading platforms and that require the public dissemination of the prices at which the vast majority of derivatives are executed.

2. Which provisions of the Dodd-Frank Act's OTC derivatives regulations are the most important for end users?

OTC derivatives will be subject to important new clearing, trading, margin and reporting requirements. The majority of OTC derivative contracts will now need to be cleared post-execution at a regulated clearinghouse. Clearing is a process by which a third party, the clearinghouse, steps in between the original counterparties and guarantees the performance of both, by requiring that each post substantial amounts of liquid collateral (i.e., "initial and variation margin"). Limited exceptions to clearing do exist for certain market participants, including many non-financial end users of OTC derivatives, but the exceptions are not automatic and are subject to certain conditions and qualifications. In addition to clearing, Title VII requires robust reporting on all derivatives (both cleared and non-cleared) to enhance transparency and monitoring by the Commodity Futures Trading Commission (CFTC).

3. Why would the board of directors of a company be involved in compliance with this regulation?

Non-financial entities that are Securities and Exchange Commission (SEC) filers and enter into OTC swaps may avoid the central clearing mandate for OTC derivatives if those derivatives qualify for the so-called "commercial end-user exception," an exception that requires explicit review and approval of management's decision not to clear by an "appropriate committee" of the board of directors (at least annually). In a somewhat unusual move, Congress wanted the responsibility for the decision to opt out of Title VII's clearing requirement to be placed at a level higher than senior management of a company. Further, the CFTC has broad enforcement authority and may impose civil and criminal penalties for non-compliance and improper election of the end-user exception from clearing, and boards of directors will need to be aware of the steps required to remain in compliance.

The "appropriate committee" of the board of directors is the one that is permitted to review and approve decisions to enter into swaps and set policies governing these types of transactions. This committee would also be responsible for revisiting the review and approval process upon a change to the company's hedging program. Depending on the organization, the "appropriate committee" could be the audit committee based on its experience with derivatives and risk mitigation practices.



4. What are some of the key deadlines for compliance with the OTC derivatives regulations?

The most relevant rule for non-financial companies, the commercial end-user exception, became final and effective September 17, 2012. Compliance is not required until 270 days after a mandatory clearing determination is final. But because the compliance deadlines are staggered by the OTC derivative asset class, there is not a single pinpointed date by which all end-user exceptions must be in place. The first expected clearing mandate was set in the fourth quarter 2012. Therefore, end-users would be expected to be required to clear the instruments mandated by the third quarter 2013. Accordingly, most companies are scheduling their board resolutions to claim the exception from clearing to occur by September 9, 2013.

While the CFTC has already finalized many rules under Title VII, there are still some important issues that have yet to be finalized or are otherwise subject to change (e.g., rules concerning margin requirements, product-level exemptions, inter-affiliate swaps and foreign subsidiary transactions). Monitoring the finalization of these proposals will be important to many companies with more complex, cross-border Treasury functions.

Swap dealer counterparties (i.e., many large banks and other swap dealers) face earlier compliance deadlines than end users. They will not be able to trade with end users after May 1, 2013, unless derivative contracts are amended to conform to Title VII's requirements regarding business conduct standards. The swap dealers and the International Swaps and Derivatives Association are taking the lead in working with "end user" customers to negotiate/enact the necessary contractual changes prior to year-end.

Key business impacts

Title VII: Where do you fit?

Any entity that intends to continue to trade various OTC interest-rate, FX or commodity derivatives now must comply with Title VII. Your entity's classification determines the level of impact and effort necessary for compliance:

- ▶ Swap dealers (SD) – Entities that deal in swaps or make markets in swaps
- ▶ Major swap participants (MSP) – Non-SDs with swap exposures significant enough to pose a risk to the financial system
- ▶ Financial entities – Banks, insurers, private funds, commodity pools, pension plans and all other entities "predominantly engaged" in financial activities
- ▶ Non-financial or commercial end users – Entities that are not SDs, MSPs, or other financial entities, but that generally engage in derivatives trades to hedge or mitigate commercial risk
- ▶ Any company entering into OTC swap agreements will fall into at least one of these designations, and the volume and type of swap activity they are engaged in also helps to determine the appropriate designation

5. Which products meet the CFTC's "swap" definition?

What is my company's market participant designation?

The CFTC's definition of a "swap" encompasses most every OTC derivative common in the marketplace, including interest-rate swaps, forwards and options; many types of commodity swaps, forwards and options; and many types of foreign currency forwards, swaps and options. While the definition is complex, it is atypical for an OTC derivative not to be scoped in under Title VII.

While nearly every OTC derivative is scoped in, the extent to which the new regulatory requirements impact an entity will vary depending on how a particular entity is classified under Title VII (see "Where do you fit?" box at left). This classification will be determined by the type of OTC activity and exposures associated with that entity. For instance, companies that generally enter into OTC derivatives to hedge or mitigate commercial risk will be impacted to a lesser extent than large financial institutions that engage in a substantial amount of derivative activity or are market makers. However, all market participants are affected in some way by the new rules.

6. Are there any exceptions to the regulations? What are the requirements for qualifying for these limited exceptions and exclusions from the general rules?

The commercial end-user exception is the most broadly applicable exemption for OTC derivatives users that Title VII defines as "non-financial" companies. It provides an exception to the mandatory clearing and trading requirements for trades that the non-financial entity executes for the purpose of hedging or mitigating commercial risk. Trades that qualify for hedge accounting under US Generally Accepted Accounting Principles automatically meet this standard, but other trades may as well.

Non-financial entities must provide information about how they will generally meet their financial obligations and, if public, obtain approval from an appropriate committee of their board of directors to claim the exception. It is possible that entities within a corporation that provide financing or extend credit to customers could be considered "financial entities" under Title VII, as could stand-alone centralized treasury or "in-house bank" entities, and could fail to qualify for the end-user exception. In addition, employee benefit or

pension plans are defined as "financial entities" and are not privy to the end-user exception from clearing and trading requirements.

There are other exceptions that should help decrease the compliance burden for certain types of OTC derivative transactions. Forward contracts on non-financial commodities that are intended to be physically delivered are excluded from the swap definition. Also, on November 16, 2012, the U.S. Treasury Department finalized a limited exemption for certain foreign exchange swaps and forwards from the definition of "swap" used by the CFTC. On April 1, 2013, the CFTC approved a final rule that would exempt certain inter-affiliate transactions from mandatory clearing requirements. The CFTC released proposed guidance on the impact of Title VII on transactions outside the US that do not have a direct or significant effect on commerce in the US. Many of these exceptions and exclusions are still subject to change and would not completely exempt a company from compliance with Title VII.

7. Assuming we decide to opt out of clearing, what would be our continuing responsibility under the law?

Apart from following the other Title VII requirements and ensuring continued compliance with the qualifications for any exception, a company must renew the end-user exception from clearing at least annually and perhaps more frequently if it enters into new, previously unused types of derivatives and risk mitigation programs.

From a more strategic perspective, a company should be prepared to monitor the changes in the derivatives markets, as more companies clear derivatives either by choice or by law to see how the increased costs to banks get distributed throughout the financial system. Accordingly, the company should continue to challenge whether the cost of continuing to use uncleared OTC derivatives justifies electing the exemption from clearing.



8. What modifications might we need to make to existing infrastructure, systems and transaction processes, and what will they cost?

New regulatory requirements will have a substantial impact on the front-to-back transaction work flow for many market participants. The exceptions that may apply to non-financial companies are not free passes. Companies must determine not only what is necessary to qualify for the exceptions, they must also determine what is necessary to comply with the regulations from which they are not exempted. While end users may be exempted from clearing and trading requirements for certain transactions, Title VII's provisions will require modifications to their derivative-related policies and procedures and may have an impact on their working capital and liquidity. A key proposed rule would require that end users post collateral under a "credit support arrangement" for their uncleared trades, which would require new documentation and new operational procedures for many end users. New record-keeping requirements still apply and some end users may need to report the terms of certain trades to "swap data repositories" on a trade-by-trade basis.

Additionally, companies must meet certain criteria in order to qualify for available exemptions and will need to be aware of the activities that could prevent them from qualifying for the exceptions in the future. Policies and procedures will need to be updated to reflect compliance with the new regulatory requirements and new tasks will have to be completed on an ongoing, periodic basis. Depending on the extent to which a company engages in OTC derivatives, the costs associated with preparing for Title VII could be significant.

9. What are the relevant factors in making the decision to exercise any available exception from the clearing mandate for OTC derivatives?

Any end user who chooses to "clear" will be required to post substantial amounts of liquid collateral, both at the outset of a trade and on a daily basis, which could amount to a significant drain on working capital. In addition, getting set up for clearing requires a substantial amount of work at the outset and on a daily basis going forward in order to meet the operational demands attendant to clearing. Many treasurers at end-user companies do not have to factor these working capital and operational demands into their daily business decisions. In addition, treasurers may not be able to find a cleared derivative product that matches the unique characteristics of the underlying risk they are seeking to hedge. Cleared derivatives do not often include the customized, bespoke features of uncleared, OTC derivatives that are often important to the design of highly effective hedging strategies. It is equally important to remember that clearing can also work in the company's favor when the derivatives are in an unrealized gain position, as the company is protected from any non-performance risk otherwise associated with the swap dealer.

However, many observers believe that the costs of uncleared trades will inevitably increase because new regulations will force swap dealers, such as regulated financial institutions, to reserve significantly more capital against uncleared swaps than cleared swaps. In addition, uncleared swaps are still subject to the direct and indirect impacts of new regulations.

Bank regulators empowered by Title VII have proposed a rule that would impose collateral requirements on all parties to non-cleared trades, including non-financial end users that use derivatives for hedging. While such proposed requirements would require non-financial hedgers to post collateral only after exceeding "credit exposure limits," and thus would not be as onerous as clearing-related collateral requirements, companies need to be aware that opting out of the clearing mandate does not mean a return to the status quo.

End users also need to be mindful of the indirect effect of the clearing and collateral requirements that swap dealers are still subject to on the offsetting trades that they enter into with other swap dealers to lay off the risk from their end-user trades. These capital and margin costs could be passed on to end users, which would have the effect of making customized, bilateral (uncleared) swaps much more expensive than cleared and exchange-traded swaps. Non-financial companies that have never considered cleared or exchange-traded derivatives may want to consider these alternatives in the future.

Despite some of the less-than-attractive aspects of the decision to opt out of clearing, nearly all companies that we are speaking with believe that claiming the end-user exception from the clearing mandate is in the best interest of their companies in this first year of compliance, and they intend to present that recommendation to their boards or appropriate board committees.

Key questions boards of directors or audit committees should ask

10. Can our organization elect the “end-user exception”? If so, does the audit committee (or other appropriate committee of the board of directors) have enough information to review and approve this decision, while still upholding our fiduciary responsibility to shareholders?

Audit committees and boards of directors should be familiar with all of the exceptions, the qualifications for those exceptions, and the compliance required for companies that do meet the exceptions. As previously mentioned, the commercial end-user exception specifically requires approval by an “appropriate committee” of the board of directors for companies that register with the SEC. This committee should review supporting documentation of corporate risk management policies that describe the permitted uses of derivatives, financial statement disclosures regarding the use of derivatives, hedge accounting documentation and other narratives that explain how derivatives mitigate commercial risk. The committee should be familiar enough with the company’s derivative transactions, purposes and policies to evaluate whether taking advantage of the exception from clearing represents the decision that is the most appropriate from a financial and risk perspective.

11. Do we have a road map for complying with all of the requirements and for managing a compliance effort on multiple tracks?

A plan or road map is essential to ensuring timely and effective compliance with Title VII. This effort begins with understanding the CFTC regulations under Title VII and how the regulations apply given the volume and type of a company’s OTC derivative transactions. This requires understanding how the company uses OTC derivatives and whether taking advantage of any exceptions to the clearing requirements would be advantageous. It also requires putting into place procedures to comply with the collateral, reporting and record-keeping requirements of Title VII.

As previously mentioned, some exact dates on the time line for compliance are still not clear, as certain rules still need to be finalized. Companies, however, need to determine what type of entity they are (i.e., SD, MSP, financial entity or end-user) and which of their transactions meet the definition of a “swap.” For most companies, these determinations will be obvious now that the rules have been finalized, but it could be more complicated for companies that use derivatives extensively. After that, the company can start analyzing the clearing exceptions and other compliance implications.

Management and the board (or appropriate committee) should begin dialogue now about whether or not to pursue the “end-user exception” from the clearing mandate. Management and the board should agree on the evidence that should be gathered and prepared for the board to feel comfortable with the eligibility for claiming the exception as well as the business justification for doing so. Given the explicit responsibilities of the board of directors related to reviewing and approving the use of the end-user exception, some companies’ boards are asking internal audit to conduct a review of preparations for initial compliance with Title VII and to develop a process for a periodic compliance assessment going forward.

12. When should we begin our compliance efforts?

Now. Because so many of the regulations became final during 2012, companies are devoting the early part of 2013 to preparing to adjust to the post-Title VII world of OTC derivatives. Dodd-Frank compliance is being added to the discussion agendas for board meetings scheduled in the spring and summer. Treasurers and legal counsel are working together to establish compliance plans and calendars, and decisions on seeking assistance from external advisors are being made. In addition to taking steps to prepare for compliance with near-term deadlines, some companies with sophisticated cross-border trading and/or treasury centers are monitoring developments in Washington related to key rules that have not been finalized.

How we can help

Title VII compliance team in our Financial Accounting Advisory Services (FAAS)

Our team has deep knowledge of OTC derivatives markets, products, commercial risk mitigation practices and hedging strategies. We have a strong understanding of Title VII and the complex web of related rules and regulations such that we can identify the implications on hedging programs, policies and procedures, and corporate governance. We have insight into the steps being taken by hundreds of companies across virtually all industries as they prepare for compliance with Title VII. Our team has a solid track record working with boards of directors on key issues that impact business such as Title VII.

Our FAAS team can customize our services to any organization's particular circumstances:

- ▶ **End-user training suite** - Two distinct modules to educate treasury departments and boards of directors on the regulations and potential impacts
- ▶ **End-user compliance toolkit** - A package of training, documentation templates and hands-on assistance from our professionals
- ▶ **End-user readiness assessment** - An analysis of the potential gaps between your company's compliance preparations thus far and the applicable new requirements, along with a fixed amount of assistance from our professionals
- ▶ **End-user assessment and compliance plan** - A comprehensive Title VII readiness assessment and implementation, with assistance from our specialists throughout the project, including:
 - Assessing Title VII's impact, reviewing your hedging portfolio, helping you establish which trading entity designation is applicable to relevant business units, and helping you classify derivatives contracts
 - Advising on what changes must be made to processes, infrastructure and systems to achieve compliance and adapt to the evolving derivatives market
 - Reviewing alternative systems and platforms for executing and capturing trades, modeling and risk management
 - Documenting functional and reporting requirements to determine what technology changes may be needed
 - Recommending appropriate implementation plans and a project road map, in line with expected mandates for compliance
 - Helping educate the board of directors regarding their accountability for reviewing and approving management's decision to enter into non-cleared swaps
 - Providing an in-depth analysis of your organization's systems, policies, processes, risk models and controls as impacted by Title VII regulatory changes, and working alongside you to design and implement necessary improvements

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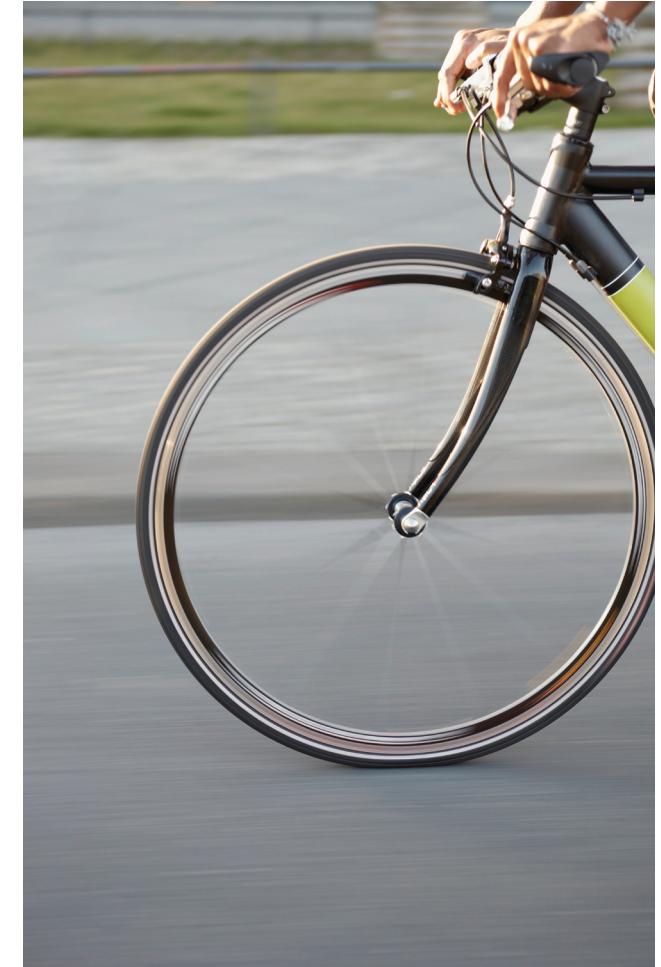
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