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The Dodd-Frank Act: Hidden Risks

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The Dodd-Frank Act ("Act") was enacted to prevent another financial meltdown by regulating OTC products even though:

- The very nature of OTC products is inconsistent with the "one-size-fits" all approach;
- Energy products had nothing to do with the financial crisis of 2008;
- The liquidity and operational reliability in the energy markets will be negatively impacted; and
- The increased cost of hedging will be reflected in the higher cost for the U.S. energy providers and consumers.

The Act is intended to accomplish 3 primary goals:

- Require clearing for standardized swaps.
- Regulate the conduct of swap dealers and major swap participants.
- Increase swap market transparency via reporting.

Some key provisions in the Act:

- Prohibition against market manipulation.
- Business conduct standards for Swap Dealers and Major Swap Participants.
- Required swap reporting and recordkeeping including real-time public reporting.
- New position limits including a revised definition of bona-fide hedge.
- Credit rating agencies can be liable for their actions.

Market manipulation before the Act required the CFTC to meet the “4-Part” test:

1. Ability to influence prices;
2. Specific intent to create an artificial price;
3. Artificial price existed; and
4. Action caused the artificial price.

Anti-manipulation rule in Act does not require that any price was actually manipulated. Instead it is a fraud-based prohibition against:

- Use any manipulative or deceptive device, or material statement or omission;
- With "scienter" (intent or reckless disregard); and
- **In connection** with any swap, commodity, or futures.

The CFTC has indicated that it will interpret the words "in connection with" broadly and not technically or restrictively to reach any manipulative or deceptive conduct in connection with:

> purchase, sale, solicitation, execution, pendency, payment obligations, or termination of any swap, futures contract, or physical (forward) contract.

- Thus, the Rule covers conduct including, but not limited to, all of the payment and other obligations arising under a swap.

Not clear if a failure to comply with certain provisions of the ISDA Master Agreement (or any other master agreement) could constitute a market manipulation, or attempted market manipulation:

- Failure to comply with the terms of a CSA (to deliver CSA, to deliver collateral, to return collateral, to pay interest on collateral) in certain circumstances rise to a manipulative conduct;
- Failure to negotiate a master agreement after negotiating a long-form confirmation;
- Failure to provide certain customer documents under the ISDA Schedule;
- Failure to adequately calculate settlement amounts.

The anti-manipulation rule does not require proof that there was a market or price affect in order for the CFTC to commence an enforcement action:

- Many market participants believe that without affect or harm to the market, there should be no violation;
- Others have argued that only intentional conduct should be included in the anti-manipulation rule;
- Notwithstanding the numerous comments to the contrary, the final market-manipulation rule does not require intent as a requirement for enforcement action.
- According to the CFTC, the anti-manipulation rule should not affect market participants engaged in legitimate market activity undertaken in good faith.

When dealing with end-users, major swap participants and swap dealers are required by the Act to:

- Conform to all rules prohibiting any act, practice, or course that is fraudulent, deceptive, or manipulative;
- Diligently supervise trading business;
- Adhere to all applicable position limits;
- Verify the eligibility of their counterparties to enter into swaps (eligible contract participant);

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(continued: When dealing with end-users, major swap participants and swap dealers are required by the Act to:

- Disclose to their counterparties material information about swaps, including material risks, characteristics, incentives and conflicts of interests;
- Provide daily mark (upon counterparty's request – dealer only);

And…

- A swap dealer or major swap participant must have reasonable basis to believe that any swap or trading strategy recommended to a counterparty is suitable for the counterparty based on information obtained through reasonable due diligence (Institutional Suitability).

Factors that a swap dealer or major swap participant must consider in determining the institutional suitability:

- business objectives;
- tax status;
- ability to evaluate the recommendation;
- liquidity needs;
- risk tolerance;
- ability to absorb losses; and
- any other information known by the swap dealer or major swap participant.

A swap dealer or major swap participant will fulfill its obligations under the "institutional suitability" if the swap dealer (or a major swap participant):

- has a reasonable basis to believe that the counterparty is capable of evaluating, independently, the risks related to a particular swap or trading strategy involving swaps recommended to the counterparty;
- the counterparty affirmatively indicates that it is exercising independent judgment in evaluating the recommendations; and
- has a reasonable basis to believe that the counterparty has the capacity to absorb potential losses related to the recommended swap or trading strategy.

Implementation of these provisions will require one or more of the following:

- Amending the applicable policies and procedures – trading and/or risk management;
- Amending the standard trading documentation including:
  - Master agreements and applicable annexes;
  - Credit, margin, netting, or collateral agreements;
  - Long-form confirmations and stand-alone agreements;
- Training the front and middle office, compliance, and legal.

Swap Dealers and Major Swap Participants Acting as Counterparties to Special Entities must have a reasonable basis to believe that the Special Entity has a representative that:

- Has sufficient knowledge to evaluate the transaction and risks;
- Is not subject to statutory disqualification;
- Is independent of the swap dealer or major swap participant;
- Undertakes a duty to act in the best interest of the Special Entity it represents;
- Makes appropriate and timely disclosures; and
- Evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap;

In order to determine whether an independent representative has sufficient knowledge to evaluate the transaction and risks, the relevant considerations would include:

- The nature of the Special Entity/representative relationship;
- The representative's capability of making hedging or trading decisions;
- Use of consultant or qualified professional asset manager;

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(continued: the relevant considerations include…)

- The representative's general level of experience in the financial markets and particular experience with the type of product under consideration;
- The representative's ability to understand the economic features of the swap;
- The representative's ability to evaluate how market developments would affect the swap; and
- The complexity of the swap.

At minimum, the CFTC expects that the swap dealer or major swap participant would have a reasonable basis for believing that the representative could assess:

- How the proposed swap fits within the Special Entity's investment policy;
- What role the particular swap plays in the Special Entity's portfolio;
- The Special Entity's potential exposure to losses; and
- The appropriateness of the swap (prior to swap execution).

- What happens if a swap dealer or major swap participant does not believe that the independent representative meets the statutory qualifications?
- Would the CFTC be inundated with complaints from Special Entities about arbitrary or unreasonable determinations by the swap dealers or major swap participants?
- Could a Special Entity's bondholders go after a swap dealer or major swap participant for missing some red flags prior to entering into a swap that turns out to be deep-out-of-the-money to the Special Entity?

The business conduct rule creates significant risk for end-user and swap dealers (and major swap participants):

- Swap dealers and major swap participants face cost-prohibitive legal exposure;
- Liquidity could dry up if the dealers are unwilling to accommodate end-users;
- End-users face ongoing uncertainty about finding dealers willing to do business;
- End-users face possible inconsistent interpretation of the rule by different swap dealers or major swap participants;
- Some end-users will have to decide between investing in risk management infrastructure or foregoing hedging all together.

The final rule defines "Swap Dealer" as any person who:

- Holds itself out as a dealer in swaps;
- Makes a market in swaps;
- Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- Engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.

The final rule defining "Swap Dealer" excludes swaps that a person enters into for the purpose of offsetting or mitigating the person's price risks if:

- The price risks arise from the potential change in the value of assets that the person owns, produces, manufactures, processes, or merchandises; liabilities that the person owns or anticipates incurring, or services that the person provides or purchases;
- The swap represents a substitute for transactions or positions in a physical marketing channel;
- The swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise; and
- The swap is entered into in accordance with sound commercial practices and is not structured to evade designation as a swap dealer.

The (interim) final rule draws upon principles in the CFTC's interpretation of bona fide hedging:

- It excludes swap activity for the purpose of portfolio hedging and anticipatory hedging.
- The definition of "Bona-Fide Hedge" under the CFTC Rule 1.3(z) is not clear.
- Market participants face the risk of having their hedging strategies questioned after the fact.
- The CFTC is allowing for additional comments on the hedging exception.

The Dodd-Frank Act provides an exemption from "Swap Dealer" definition for a person who:

- Engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers.
- In order for a person to be exempt from the definition of swap dealer on the basis of *de minimis* activity, the aggregate gross notional amount of the swaps that the person enters into over the prior 12 months in connection with dealing activities must not exceed $3 ($8 billion in the interim period) billion; **AND**
- The aggregate gross notional amount of such swaps with "special entities" (public power and gas; municipal utilities) over the prior 12 months must not exceed $25 million.

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(continued: The Act provides an exemption from "Swap Dealer" definition…)

The impact of the rules could significantly affect the public utilities' hedging choices.

A large volume of unhedged physical portfolio could increase price volatility.

Definition of "Major Swap Participant" (MSP):

- A person that maintains 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.
- 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."
- 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 that maintains a "substantial position" in any of the major swap categories.

Definition of "Substantial Position:"

- The daily average current uncollateralized exposure of $1 billion in the applicable major category of swaps, except that the threshold for the rate swap category would be $3 billion; or
- $2 billion in daily average current uncollateralized exposure plus potential future exposure in the applicable major swap category, except that the threshold for the rate swap category would be $6 billion;
- The above definition of substantial position excludes positions held for "hedging or mitigating commercial risk; but the following does not:
- Total current swap exposure for all swaps (including hedges) of $5 billion, or a sum of current uncollateralized exposure and potential future exposure of $8 billion, across the entirety of a person's swap positions.

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Under the final (interim) rule, the CFTC clarified that:

- Commodity options will be permitted to transact subject to the same rules applicable to any other swap;
- "Trade Option Exemption" will be exempt from the general Dodd-Frank Act swaps regime, subject to certain ongoing conditions and compliance requirements;
- The option seller must fall into one of two categories: (1) option seller may be an ECP, or (b), option seller may be a producer, processor, or commercial user of, or a merchant offering or entering into the transaction solely for purposes related to its business as such;
- The option buyer must be a producer, processor, or commercial user of, or a merchant entering into the transaction solely for purposes related to its business as such. The option buyer does not have to be an ECP; and
- Both parties must intend that the commodity option be physically settled.

Credit rating agencies are subject to comprehensive Dodd-Frank Act regulation:

- Rating agencies must ensure that ratings are not unduly influenced by conflicts of interest.
- Must disclose information relating to assumptions and data relied upon to determine the rating.
- Investors can now sue rating agencies for a knowing or reckless failure to conduct a reasonable investigation during the rating process.
- The Dodd-Frank Act directs the CFTC to eliminate reference to credit ratings from all of their regulations.

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Questions? Comments?

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