

## Impact of Treasury's OTC Derivatives Legislation on End-Users: Clearing, Capital, Margin and Reporting Requirements

The Administration's proposal (the "Proposal") would restructure many aspects of how market participants, including corporate end-users, would access the OTC derivatives market. Among other things, the Proposal would:

- require all "standardized" derivative contracts of a swaps dealer or a major swap participant ("regulated entities") be cleared through a registered derivatives clearing organization ("DCO") and traded on an exchange or a registered alternative swap execution facility ("ASEF") unless one counterparty to the trade is not a regulated entity<sup>1</sup> and does not meet the eligibility requirements of a DCO;
- create a presumption that any contract accepted by any DCO is standardized;
- require reporting of non-cleared trades by both counterparties to a swap trade repository or to the SEC or CFTC;
- impose capital requirements on all cleared and non-cleared contracts with the requirements for non-cleared contracts set at a higher level than those for cleared contracts;
- impose margin requirements on all non-cleared contracts with certain limited exceptions; and
- explicitly limit the exemptive authority of the SEC and CFTC over swaps provisions to those areas in which the regulators are specifically authorized to grant exemptions.

As a result, the Proposal will significantly limit the availability of swaps and other important risk management tools for American companies either as a result of such companies' designation as Major Swap Participants (as defined below) or the resulting increased costs their counterparties will face, which will likely be passed on to end users. Below is a non-exhaustive list of issues raised in the Proposal:

- **Mandatory Clearing:** The Proposal requires the CFTC and SEC to jointly adopt rules to define the term "standardized" as broadly as possible and provides that any swap accepted for clearing by any DCO be presumed "standardized". The Proposal requires all "standardized" swaps to be centrally cleared and traded on a regulated exchange or ASEF unless (i) no DCO accepts such swap for clearing or (ii) one of the counterparties to the contract is not a regulated entity and such counterparty does not meet the eligibility requirements of any DCO that clears such contract.
  - Regulatory-directed standardization and mandatory central clearing could actually increase risk by limiting the use of OTC derivative markets and the ability of these markets to develop new risk management products. This can lead to ineffective hedging and incomplete

---

<sup>1</sup> For purposes of this note, the term swap dealer shall include security-based swap dealer and the term major swap participant shall include major security-based swap participant.

transfer of risk, leaving end users with basis risks<sup>2</sup> they don't want and can not manage effectively. The Proposal sets up a trade-off between arguably reducing counterparty credit risk in certain standardized contracts and increasing basis risk by encouraging the use of those standardized contracts to cover underlying risks on a mismatched basis.

- The limited scope of the exemption from mandatory clearing also raises concerns. For instance, an end user that is not deemed to be a regulated entity may nonetheless be subject to mandatory clearing if such end user meets the eligibility requirements of any DCO. Requiring smaller market participants, who deal in lower volumes and transact contracts less frequently, to develop and operate complex processes in this context would impose a heavy compliance burden, with little benefit in terms of mitigation of systemic risk.
- Basing this exemption on a DCO's self-imposed eligibility requirements, along with the provision that creates a presumption that any swap accepted by any registered DCO is standardized, places a great deal of authority in the hands of DCOs. Is this the proper role for for-profit DCOs? Eligibility being decided according to whether or not the DCO will clear the swap or whether the market participant meets self-directed eligibility requirements could raise conflicts of interest within the DCO and for its membership.
- *Major Swap Participant:* "Major swap participant" is vaguely defined as any person who is not a "swap dealer" who maintains a substantial net position in outstanding swaps, other than to create and maintain an effective hedge under GAAP subject to further SEC/CFTC jointly defined rules or regulations. Persons determined to have met this vague definition will be designated as Major Swap Participants and will face costly barriers to entering into OTC derivative transactions, including but not limited to, mandatory clearing of all "standardized" OTC swaps, capital and margin requirements and undefined reporting, recordkeeping and other corporate governance responsibilities. Some of the key questions and concerns raised by the Proposal's language include:
  - How will a person's "substantial net position" be determined generally?
  - How, if at all, will changes in the "net position" over the life of a portfolio be addressed? Can a company float in and out of regulation based on its exposures?
  - The Proposal seeks to carve out "hedgers" from the designation of Major Swap Participant. However, it precisely ties this carve out to a narrow GAAP accounting standard for "hedging". As a result, many end users that use derivatives for risk mitigation purposes, but

---

<sup>2</sup> Basis Risk is generally defined as the risk that offsetting investments in a hedging strategy will not be affected by price changes in entirely opposite directions from each other. This imperfect correlation between the two investments creates the potential for excess gains or losses in a hedging strategy.

- that may not otherwise qualify for GAAP "hedge" accounting treatment, may unintentionally be swept into the Major Swap Participant category.
- How will a company that utilizes derivatives for different purposes be treated? Consider a commodities company that uses derivatives both to manage interest rate risk and commodities price risk. The company may be considered a major swap participant with respect to its commodities activities, but may use interest rate swaps only infrequently to hedge its funding costs. Would the company be considered a major swaps participant with respect to its use of interest rate derivatives? If so, such a designation could hamper seriously the ability of some non-financial companies to hedge financial risks.
  - *Capital Requirements:* The Proposal would impose capital requirements on regulated entities for both cleared and non-cleared swaps with the requirements for non-cleared swaps set at a higher level than those for cleared swaps. Capital levels will be determined by either a regulated entity's Prudential Regulator or, for entities not subject to a Prudential Regulator, by the SEC/CFTC under joint rulemaking authority with the caveat that the SEC/CFTC capital levels may not be lower than the levels imposed by the Prudential Regulators.
    - To the extent that end users are swept into the broad definition of Major Swap Participant, they will face these capital requirements. As an initial matter, imposing capital requirements on non-financial companies would seem to be very difficult and may result in significant unintended consequences such as causing liquidity or working capital contractions or incentivizing firms to abandon otherwise beneficial hedging transactions.
      - Most nonfinancial companies are not highly leveraged and the majority of assets on their balance sheets are primarily non-financial assets. It would be fruitless to impose capital requirements on a subset of assets or off-balance sheet exposures in isolation. Capital requirements need to be firm-wide to be effective. Is the intention of the Proposal to establish limits on borrowing and leverage for all non-financial companies that are frequent users of derivatives, which would include over 90 percent of all large companies in the United States?
    - A significant number of participants in these markets are not financial firms, but commercial producers and manufacturers hedging their risks. Therefore, legislation designed for the financial sector may not be adequately tailored to their activity and risk profile. The Proposal precludes regulators from considering the nature of different OTC derivative market participants and the nature of the risks they incur (or don't incur), and the nature of different OTC derivative markets in considering whether to require capital charges.

- *Margin Requirements:* The Proposal provides regulators with broad discretion to impose both initial and variation margin requirements on counterparties that enter into transactions with a regulated entity. As a result, end users will be subject to regulator-set margin requirements on their OTC derivative contracts regardless of potential mitigating factors such as counterparty credit risk assessment. It is also unclear whether margin will be determined on a notional or net basis. While there is an exception to the margin requirements, the exception is based on the narrow GAAP definition of "hedge" and requires that one of the counterparties not be a regulated entity and not be predominantly engaged in non-financial activities.
  - Currently, many small and mid-sized companies that are only occasional users of derivatives choose to use OTC swaps because of the costs and demands of managing margin requirements on a daily basis. Significantly increasing the costs associated with using derivatives will hamper the ability of small- and mid-sized companies to manage their risks.
  - Some companies will be forced to use bank letters of credit to post margin with their counterparties thereby incurring high costs while still leaving banks effectively exposed to counterparty credit risk. If this is the outcome, the Proposal will have substantially raised costs on end users without reducing the exposure of banks to counterparty credit risk.
  - Why should regulated entities, in effect, be forbidden from extending credit to counterparties since this is conceptually no different from their core credit-risk business? Imposing mandatory margin amounts restricts their ability to extend credit.
- *Registration, Reporting and other Administrative Requirements:* An end user characterized as a Major Swap Participant would be subject to registration with the CFTC, SEC or both, required to join a DCO (or make other arrangements to have access to clearing), and subject to rules regarding reporting and recordkeeping, daily trading records, business conduct standards and documentation and back office standards. In addition, it would be required to monitor trading to prevent violation of applicable position limits, have the ability to disclose information as necessary to the regulators and implement conflict-of-interest systems and procedures.
  - Even if an end user is not a regulated entity, such end user will still be subject to reporting requirements regarding any swap that is not cleared. More importantly, since these registration, reporting and administrative requirements will be imposed on regulated entities that will likely serve as an end user's counterparty, it is likely the associated costs will be passed on to end users.
- *Limited Exemptive Relief:* The Proposal explicitly limits the exemptive authority of the agencies to those areas in which the regulators are specifically authorized by the Proposal to grant exemptions.

In light of the broad delegation of interpretive authority granted to the agencies, this explicit limit on exemptive authority seems counterintuitive. Problematically, many of the key exemptions (see Market Swap Participant and Margin Requirement provisions) are premised on the narrow GAAP definition of "hedge". Without broad exemptive authority, the agencies will have limited ability to interpret the regulations in the most prudent and efficient manner.

- For instance, current CFTC regulation provides a "risk management" exemption for certain of its regulations, which would presumably not be available under the Proposal. Currently, this exemption is used by companies that provide vital investment services and utilize OTC derivatives to hedge risks but where such use may not meet the narrow GAAP definition of "hedge". Therefore, under the Proposal these companies may be considered Major Swap Participants thereby inhibiting or possibly even precluding them from providing these services and risk management tools.
- *Additional Considerations:* The SEC and CFTC, via joint rulemaking on an expedited basis with a limited notice and comment period, are tasked with interpreting the specific details of the Proposal. Given the high degree of coordination that would be required, the expedited timeframe (which will limit industry participation) and explicit limit on agency exemptive authority, the resulting rules may pose significant challenges for end users.
  - OTC derivatives vary substantially among different market segments. The current Proposal calls for identical treatment of all derivative markets. Given the wide breadth and depth of OTC derivatives, a more narrowly tailored approach that reflects the realities of the market should be considered.