

Coming Changes For Derivatives Users

Law360, New York (July 6, 2011) -- The Dodd-Frank law means many things to many people, but for energy companies, it universally will mean increased costs of compliance. While swap dealers and major swap participants have been projected to face tens of millions of dollars in capital costs to comply with the Dodd-Frank regime, the burden may fall more disproportionately on end users. In no area is that compliance burden more evident than the law's requirements concerning security and margining.

Mandatory Clearing

One hallmark of Dodd-Frank's treatment of the financial and commodity trading industries is the mandatory clearing of swaps. All contracts subject to mandatory clearing will be executed on a designated contract market (DCM) or swap execution facility (SEF), if either is available for trading those contracts. In most cases, a contract that is required to be cleared will be entered into on either a DCM or a SEF and then submitted to a derivatives clearing organization (DCO) for clearing. That submission will take place through futures commission merchants that are clearing members of a DCO.

As detailed below, this elaborate process leads to many of the increased costs that will be placed upon market participants. All cleared swap transactions will be subject to initial and variation margin requirements, which are intended to secure the market and credit exposure associated with such swaps. Further, even uncleared swaps will be subject to increased collateral requirements and potentially higher costs.

Dodd-Frank does provide an end-user exception to the mandatory clearing of swaps.

In practice, however, obtaining the exception may be prohibitively costly. The [CFTC](#) has indicated that an end-user must qualify for the exception on a trade-by-trade basis. In light of the processing and information technology requirements necessary to continually request and obtain the end-user exception, it is possible that smaller end-users will forego the exception altogether. Moreover, the proposition of clearing only a portion of a company's trades may be unrealistic from economic and operational perspectives.

Initial Margin and Credit Support Arrangements

Some market participants may be accustomed to posting something similar to initial margin in the form of an independent amount, which is sometimes required under trading agreements. An independent amount may be required in the Collateral Support Annex (CSA) to the ISDA Master Agreement, or in similar sections concerning collateral rights of other trading agreements. While there are many differences between the concepts of initial margin and independent amount, each is intended to mitigate the fundamental counterparty credit risk in the trading relationship. Neither attempts to address market risk.

The amount of initial margin will generally be set by a party's futures commission merchant, and governed by the contractual documentation between that FCM and the end user. The amount of initial margin required by the FCM will be influenced by the DCO's own requirements. DCOs generally require initial margin and variation margin in cash, and in an amount sufficient to cover 100 percent of the risk of an entity's failure to pay any amount due under a cleared swap. Further, it is worth emphasizing that an FCM is free to require greater initial margin than the amount set by the DCO.

The regime is slightly different for uncleared swaps. On April 12, 2011, the CFTC and the "prudential regulators" (i.e., the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency) proposed rules concerning margin requirements for uncleared swaps. For trades between Swap Dealers or Major Swap Participants and end users, neither party is required to post margin — but they are required to enter into credit support arrangements like the CSA. Presumably, the Swap Dealers and Major Swap Participants will generally demand an Independent Amount as part of their CSAs with end users.

Some observers have expressed concern that the amount of capital necessary to post initial margin will be significant enough to divert end users' resources from other needed capital expenditures. They argue that there are more productive uses for the capital, particularly in a fragile economy, than to force it into segregated margin accounts. On the other hand, supporters of the law respond that increasing the stability of the financial system is of paramount importance.

Variation Margin

Variation margin is intended to address a party's exposure due to market fluctuations. It aims to be collateral that covers an in-the-money party's exposure if its counterparty becomes insolvent. Like initial margin, variation margin will be required by the FCM. The details concerning the posting of variation margin — e.g., the frequency of posting, the return of excess margin, etc. — will be governed by the contract between the FCM and the end user. Dodd-Frank requires that all margin posted to the FCM must be segregated, so that it can never be treated as property of the FCM.

In the over-the-counter market, many participants are given some unsecured credit exposure (or credit thresholds) based on their creditworthiness. Companies will not have such thresholds with their FCMs. That factor alone leads to the conclusion that collateral requirements will be greater.

Some end users, such as hedge funds, are accustomed to posting large sums of collateral. For them, the changes to a cleared swaps framework may be less onerous. They may even find countervailing benefits, such as a broader range of potential counterparties, that outweigh the burdens. Many others, however, will find the Dodd-Frank model very burdensome in its imposition of substantial margin requirements. Among those likely to see significantly higher costs are energy companies that have historically boasted relatively strong credit ratings.

Other Related Costs

In addition to margin, Dodd-Frank also requires all market participants to record, retain and report data. For reporting, the statute requires traders to share price and volume data “as soon as technologically practicable” — i.e., in real time. Larger parties will likely be able to implement the technology and systems needed to comply with such requirements (albeit at significant cost). On the other hand, end users, which often use off-the-shelf software to capture trading data, may not be able to easily meet the requirements. Their costs in developing compliant systems may be quite substantial.

With regard to the recording of information, the CFTC has indicated that “all pertinent data and memoranda” must be retained. The requirement may cause considerable concern to market participants. Smaller players’ existing systems may be inadequate to meet the necessary record-keeping requirements. Those players can eventually develop the systems to allow for their compliance, but only with even more outlay of money and other resources.

Finally, much of the discussion above has focused on the costs to the end user in future swaps. On the other side of most swaps will be a swap dealer or a major swap participant, which will also be incurred added costs. It is foreseeable, however, that as the ultimate customer, an end user may have the costs of the swap dealer or major swap participant passed along to it.

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