The Impact of Dodd-Frank on End-Users Hedging Commercial Risk in Over-the-Country Derivatives Markets

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I. INTRODUCTION

Derivatives have received their fair share of the blame for the 2008 financial crisis.\(^1\) American International Group, Inc. (AIG), the large insurance company that became the poster child of the financial meltdown required $180 billion in government bailout funds to cover losses from derivatives trading.\(^2\) Indeed, the now infamous credit derivative, the collateralized debt obligation (CDO),\(^3\) was responsible for ninety-four percent of that company’s losses in the crisis.\(^4\) Other large derivatives traders, including The Bear Stearns Companies, Inc. and Lehman Brothers Holdings Inc. (Lehman Brothers) were also casualties of the financial crisis, each falling prey to bankruptcy or takeover on account of their derivatives businesses.\(^5\)

Given the central role derivatives played in the financial crisis, it is unsurprising that derivatives regulation became a

\(^1\) Michael Sackheim et al., *Knocking on the Clearinghouse Door: A Lawyer’s Introduction to Cleared OTC Derivatives*, FUTURES & DERIVATIVES L. REP., July-Aug. 2010, at 1, 1.


\(^3\) CDOs are asset-backed securities that derive their value from a portfolio of underlying assets, such as mortgages. Frank D’Souza et al., *Illuminating the Need for Regulation in Dark Markets: Proposed Regulation of the OTC Derivatives Market*, 12 U. PA. J. BUS. L. 473, 485 (2010). A trust, often called a special purpose vehicle (SPV), issues securities based on the CDO and these securities receive cash flows from the underlying assets, e.g. mortgage payments. *Id.* The securities are typically broken into “tranches” that receive payments based on their level of risk; that is, the most senior tranches receive payments first and the lowest tranches, with the highest rates of return, bear the greatest default risk. *Id.*

\(^4\) *Id.* at 491.

\(^5\) *Id.* ("Some of the most prominent firms had traded in asset-backed securities, credit default swaps and other derivatives, and were the hardest hit by the subprime crisis. . . . Large losses from CDOs were implicated in both the AIG and Lehman Brothers failures.").
political target for reform. On July 21, 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)\textsuperscript{6} in an effort to rein in the U.S. portion of the $600 trillion over-the-counter (OTC) derivatives industry.\textsuperscript{7} In Title VII of Dodd-Frank, Congress aims to better regulate derivatives markets by requiring all derivatives to be exchange-traded and centrally cleared and giving regulatory agencies significant oversight authority over market participants and transactions.\textsuperscript{8}

The highly unpredictable impact of this new regulation of derivatives markets is worrisome for market participants, including nonfinancial corporate entities (referred to as nonfinancial “end-users”) that use derivatives to hedge commercial risk.\textsuperscript{9} While nonfinancial end-users secured an important exemption from Dodd-Frank’s regulatory requirements that will help ease the cost burden associated with new regulation, there remains a great deal

\begin{itemize}
\item \textsuperscript{6}Pub. L. No. 111-203, 124 Stat. 1376 (to be codified in scattered sections of U.S.C.).
\item \textsuperscript{7}According to data from the Bank for International Settlements, as of December 2009 there was $614,674 billion total notional amount outstanding of OTC derivatives in the G10 countries and Switzerland, which equaled $21,583 billion in gross market value. Bank for Int’l Settlements, Quarterly Review, A121 tbl.19 (June 2010), available at http://bis.org/statistics/otcder/dt1920a.pdf. Although the size of the OTC markets is often quoted at the $600 trillion notional value, Michael Chlistalla argues that gross market value—“the total value of all derivatives contracts globally if they had to be closed out and settled at market value on a specific date”—better represents the actual size of the market. MICHAEL CHLISTALLA, DEUTSCHE BANK, OTC DERIVATIVES: A NEW MARKET INFRASTRUCTURE IS TAKING SHAPE 4 (2010), available at http://www.dbresearch.com (follow “Research” hyperlink; then follow “Archive” hyperlink; article is number twelve on the list). He further argues that gross credit exposure, which is calculated after netting to reduce counterparty risk, is the best measure of real risk exposure. Id. According to the International Swaps and Derivatives Association (ISDA), this value was around $3.7 trillion, which is only fifteen percent of the gross market value. Id.
\item \textsuperscript{8}See Dodd-Frank Act §§ 701-774 (to be codified in scattered sections of 7 and 15 U.S.C.).
\item \textsuperscript{9}In a letter to Chairman Barney Frank and Rep. Collin Peterson describing the types of entities referred to as end-users in Dodd-Frank, Chairmen Blanche Lincoln and Chris Dodd expressed, “These entities could be anything ranging from car companies to airlines or energy companies who produce and distribute power to farm machinery manufacturers.” 156 CONG. REC. HS248 (daily ed. June 30, 2010) (letter from Chairmen Lincoln and Dodd entered into the record by Rep. Collin Peterson). Companies lobbying Congress for the end-user exemption included firms as diverse as Chicago utility Exelon Corporation, multinational conglomerate 3M Company, and aerospace and defense corporation The Boeing Company. See Randall Smith & Sarah N. Lynch, How Overhauling Derivatives Died, WALL ST. J., Dec. 28, 2009, at 24.
\end{itemize}
of uncertainty surrounding implementation of the regulation.\textsuperscript{10} How the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) define the parameters of the end-user exemption, and how these institutions respond to rapidly changing derivatives markets will drive both the effectiveness of the legislation and the ability of end-users to use derivatives to hedge commercial risk in the future.

The initial part of this note provides an overview of derivatives markets, including their role in the economy and how they have been regulated in the twentieth and twenty-first centuries.\textsuperscript{11} Part II considers the nature of current derivatives markets and the role these financial instruments played in the 2008 financial crisis.\textsuperscript{12} Part III explores the history of derivatives regulation under the Commodity Exchange Act (CEA)\textsuperscript{13} and the deregulatory impact of the Commodity Futures Modernization Act (CFMA) in 2000.\textsuperscript{14} Part IV then demonstrates how Dodd-Frank has fundamentally changed the future of derivatives markets through the imposition of trading and clearing requirements on derivatives trades.\textsuperscript{15}

The remainder of the note focuses on how Dodd-Frank applies to commercial end-users of derivatives. Part V considers the wisdom behind the end-user exemption in Dodd-Frank, outlines the CFTC's and the SEC's initial efforts to define the exemption, and highlights the uncertainty surrounding implementation of the regulation, including the potential for government agencies to directly regulate large commercial end-users as "Major Swap Participants" under Dodd-Frank.\textsuperscript{16} Finally, the note speculates about how Dodd-Frank will impact hedging transactions and the OTC derivatives landscape generally.\textsuperscript{17} Upon analyzing the costs and risks associated with hedging with derivatives, the note suggests that end-users must better protect

\textsuperscript{10} See Dodd-Frank Act, sec. 723(a), § 2 (codified as amended at 7 U.S.C. § 2).
\textsuperscript{11} See infra Parts II-IV.
\textsuperscript{12} See infra Part II.
\textsuperscript{13} 7 U.S.C. § 1 et seq. (1936).
\textsuperscript{14} See infra Part III.
\textsuperscript{15} See infra Part IV.
\textsuperscript{16} See infra Part V.
\textsuperscript{17} See infra Part V.
themselves in derivatives transactions and should carefully evaluate whether trading OTC contracts using the end-user exemption is more cost-effective and safer than trading less specialized exchange contracts.\(^{18}\)

II. RISKS POSED BY DERIVATIVES

A derivative is a financial contract under which parties agree to pay one another based on the value of an underlying asset.\(^ {19}\) A simple example is a forward contract under which parties agree to buy and sell an asset in the future for a predetermined price.\(^ {20}\) Corporations can use such a contract to hedge against foreign exchange rate fluctuations.\(^ {21}\) For example, if a U.S. corporation must pay a supplier £1 million in six months, it can enter into a forward contract to purchase £1 million in six months at a predetermined exchange rate.\(^ {22}\) If the pound appreciates relative to the U.S. dollar during that six-month period, this appreciation will have no impact on the amount the U.S. corporation must pay when its bill becomes due.\(^ {23}\) Consequently, derivatives have become a popular tool for companies to mitigate the risks associated with their businesses.\(^ {24}\)

Derivatives are also effective tools for investors who aim to speculate about future price movements.\(^ {25}\) Unlike in the example above, an investor can purchase a derivative without using it to offset underlying business risk.\(^ {26}\) To some extent, such speculation is necessary to create a market for companies using derivatives to hedge business risk since rarely would there be another company

\(^ {18}\) See infra Part V.


\(^ {20}\) Id. at 3.

\(^ {21}\) Id. at 4.

\(^ {22}\) Id.

\(^ {23}\) Id. at 4-5.

\(^ {24}\) D'Souza et al., supra note 3, at 487.


\(^ {26}\) Id.
hedging the exact opposite side of the trade. However, since speculators aim to take a position in the market rather than reduce exposure, speculation creates riskier markets, particularly when speculation is the reason behind both sides of the trade.

Rampant speculation in derivatives markets is dangerous for macroeconomic financial stability because of the "systemic risk" that arises from the interrelatedness of derivatives users. If a bank defaults on a derivatives contract, it could cause its transactional counterparty to default on its own outstanding derivatives contracts with third parties (assuming the counterparty was relying on income from the derivatives contract to meet its obligations to third parties). Within the small and interconnected group of institutions trading derivatives, massive derivatives losses at one firm leading to defaults could quickly lead to a chain reaction of defaults among other firms.

The 2008 global financial crisis is a recent example of the systemic risk associated with derivatives use. As homeowners defaulted on their subprime mortgages, this created a "ripple effect" through the burgeoning asset backed security market. Institutions that had purchased protection against mortgage

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29. Systemic risk can be defined as risk that "(i) an economic shock such as market or institutional failure triggers ... either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability ... ." Steven L. Schwarz, Systemic Risk, 97 GEO. L.J. 193, 204 (2008).

30. See D'Souza et al., supra note 3, at 487, 491.

31. See id. at 491 (noting that some observers speculated about the potential for a "derivatives tsunami," resulting in rampant bank failure and a global credit crisis).

32. See Lynn A. Stout, Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives, 48 DUKE L.J. 701, 770-71 (1999) [hereinafter Stout, Law Hates Speculators] (stating that regulators view systemic risk as more perilous than excessive speculation in derivatives trading because of the potential for "cataclysmic derivatives losses" at one institution to pass rapidly to other trading firms); D'Souza et al., supra note 3, at 491 (noting that the threat of systemic risk is heightened because derivatives trading is "concentrated in a small number of interconnected institutions ... ").

33. Stout, Deregulating Derivatives, supra note 25, at 7-8.

34. See D'Souza et al., supra note 3, at 490.
defaults in the form of credit default swaps (CDS)\textsuperscript{35} demanded more capital to back up their contracts, and the undercapitalized investment banks and insurers that had sold this protection were increasingly unable to meet collateral demands.\textsuperscript{36} Simultaneously, the CDO contracts in which these CDS sellers had heavily invested stopped making payments and plummeted in value.\textsuperscript{37} This crippled these institutions, including AIG and Lehman Brothers, and eventually led to their failure.\textsuperscript{38}

Further compounding the threat of systemic risk is the overall lack of transparency in derivatives markets.\textsuperscript{39} Some derivatives are traded on exchanges, which means there is a high level of price transparency, efficiency, and stability because of reporting and clearing requirements.\textsuperscript{40} However, exchange-traded derivatives make up a mere 3.4 percent of the $636,431 billion derivatives market.\textsuperscript{41} The overwhelming majority of derivatives are traded over-the-counter.\textsuperscript{42} This means that counterparties, typically a corporation and a large financial institution, privately enter into a highly specialized bilateral agreement to trade a derivative that is tailored to the parties’ hedging or speculating needs.\textsuperscript{43} These transactions have been largely invisible to

\begin{footnotesize}
\begin{enumerate}
\item A credit default swap is a derivative contract that functions like insurance against the default of a company. Hull, supra note 19, at 507-08. The buyer of the CDS makes payments to the seller until the CDS expires or the reference entity suffers a “credit event,” such as bankruptcy. Id. If the credit event occurs, the buyer is entitled to sell a bond for its face value to the seller. Id.
\item See D’Souza et al., supra note 3, at 490. For an explanation of how collateral operates in derivatives contracts, see infra pp. 184-185.
\item D’Souza et al., supra note 3, at 490-91.
\item Id.
\item See D’Souza et al., supra note 3, at 482.
\item D’Souza et al., supra note 3, at 483.
\item See id. at 474; Henry T.C. Hu, Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm, 138 U. Pa. L. Rev. 333, 364 (1989) [hereinafter Hu, Swaps Modern Process] (noting that financial institutions help companies hedge with swaps by “tailor[ing] the amount, type, and term of the swap to the precise needs of the customer”); Chlistalla, supra note 7, at 4 (distinguishing OTC contracts, which are “privately negotiated” between counterparties from derivatives traded on a “public venue”).
\end{enumerate}
\end{footnotesize}
regulators and other market participants because they have not had the same reporting requirements as those traded on exchanges.\textsuperscript{44}

Derivatives users prefer OTC trades because they can create highly specialized contracts at a lower cost. But as the 2008 financial crisis demonstrated, the combined threats of opaque markets and high systemic risk can be grave.\textsuperscript{45} Left unregulated, OTC market participants would continue to be able to take positions that could seriously endanger the economy as a whole.

III. DERIVATIVES DEREGULATION

Although the majority of financial derivatives were traded without regulation prior to Dodd-Frank, this has not always been the case.\textsuperscript{46} Both contract law cases at common law and the CEA, passed in the wake of the Great Depression, are anti-speculative in nature and outlaw speculative transactions that are not carried out on a public exchange.\textsuperscript{47} Yet this anti-speculation tide turned toward the end of the twentieth century as modern economic theory espoused the benefits of speculative trading, including the promotion of price efficiency and increased liquidity.\textsuperscript{48} In light of this, the CFTC began deregulating derivatives by exempting certain OTC contracts from regulation.\textsuperscript{49} Congress then passed the Commodity Futures Modernization Act (CFMA) in 2000, which permitted all OTC derivatives to trade without regulation, thereby

\textsuperscript{44} Greenberger, supra note 39, at 100.
\textsuperscript{45} Id. at 112.
\textsuperscript{46} See Stout, Law Hates Speculators, supra note 32, at 705-06.
\textsuperscript{47} See, e.g., Irwin v. Williar, 110 U.S. 499, 509 (1884) ("[I]f, under guise of such a [forward] contract, the real intent be merely to speculate in the rise or fall of prices . . . then the whole transaction constitutes nothing more than a wager, and is null and void."); State v. Stripling, 113 Ala. 120, 123-24 (1897) ("One of the most pernicious forms of gambling is 'speculating in futures,' on margins, and settling differences only."); Stout, Law Hates Speculators, supra note 32, at 703-04 (arguing that there are strong anti-speculative underpinnings both in common law and many state and federal statutes).
\textsuperscript{48} See Stout, Deregulating Derivatives, supra note 25, at 7.
\textsuperscript{49} See 7 U.S.C. § 1 et seq. (2006); Stout, Deregulating Derivatives, supra note 25, at 7 (noting that U.S. regulators passed "ad hoc regulatory exemptions" for certain derivatives, such as interest rate swaps, largely in response to the passage of the Financial Services Act of 1986 in the United Kingdom that mandated enforcement of all financial derivatives, regardless of their hedging or speculative nature).
completing what the CFTC had started.\textsuperscript{50} The CFMA removed derivatives from CFTC and SEC oversight and mandated the enforcement of derivatives contracts traded both on and off exchanges.\textsuperscript{51} This gave OTC derivatives contracts legal protection when they previously would not have been enforced in courts, but prevented any attempts by regulatory agencies to keep derivatives markets in check.\textsuperscript{52}

CFMA's complete deregulation of OTC markets corresponds directly to the massive proliferation of OTC contracts over the last decade.\textsuperscript{53} According to the Bank for International Settlements (BIS), derivatives contracts in the G10 countries and Switzerland totaled $636,431 billion in notional value at the end of 2009.\textsuperscript{54} Of that total, approximately $614,674 billion were privately arranged OTC derivatives contracts over which regulators had no authority.\textsuperscript{55} Some experts theorize that the deregulation, and the resulting dramatic growth in OTC derivatives, led directly to the financial crisis in 2008.\textsuperscript{56} Undeniably, the prominent role that derivatives played in the financial crisis made re-regulating

\begin{itemize}
\item 50. See Pub. L. No. 106-554, §§ 302(a), 303(a) (2000) (codified at 15 U.S.C. §§ 77b-1, 78c-1); Greenberger, supra note 39, at 99, 100 (noting that the CFMA, by exempting OTC derivatives from the exchange trading and clearing requirements of the CEA, “in one fell swoop . . . exempt[ed OTC derivatives] from capital adequacy requirements; reporting and disclosure; regulation of intermediaries; self regulation; any bars on fraud, manipulation and excessive speculation; and requirements for clearing”).
\item 51. See §§ 302(a), 303(a) (codified at 15 U.S.C. §§ 77b-1, 78c-1); Stout, Deregulating Derivatives, supra note 26, at 7 (arguing that the CFMA removed “legal constraint on derivatives speculation that dated back not just decades, but centuries”).
\item 52. See Stout, Deregulating Derivatives, supra note 25, at 7.
\item 53. See id.
\item 54. Van Duyn, supra note 41. The notional value of a derivatives contract is a hypothetical principal amount which parties use to calculate the payments made to one another under the contract. Hu, Swaps Modern Process, supra note 43, at 347. For example, in an interest rate swap, counterparties would pay each other the predetermined interest rate multiplied by the predetermined notional amount. Id. at 347-48. This notional amount, however, is never exchanged by the parties. Id. at 347.
\item 55. See Bank for Int’l Settlements, supra note 7.
\item 56. See Stout, Deregulating Derivatives, supra note 25, at 4 (arguing that the credit crisis resulted from the fear and uncertainty generated by the collapse of AIG in the complex and interconnected CDS market); Greenberger, supra note 37, at 100 (“It is now conventional wisdom that the unregulated multi-trillion dollar OTC CDS market fomented a mortgage crisis, then a credit crisis, and finally a ‘once-in-a-century’ systemic financial crisis . . . .”).
\end{itemize}
derivatives a prime target for Congress in Dodd-Frank. Politicians could no longer ignore the market failures and systemic risk associated with such an enormous and invisible market.

IV. RE-REGULATION UNDER DODD-FRANK

Title VII of Dodd-Frank tackles OTC derivatives regulation in three principal ways. With notable exceptions, for all derivatives trades Title VII of Dodd-Frank mandates: (1) data collection on dealers, participants, and transactions through registration and reporting; (2) central clearing; and (3) exchange trading. Through these requirements, Dodd-Frank aims to provide credit support for derivatives transactions to protect against default and provide more transparent pricing and trading information in derivatives markets.

A. Data Collection

Dodd-Frank aims to enhance the transparency of derivatives markets by implementing disclosure and conduct standards for large derivatives traders. It requires swap dealers and major swap participants to register under the Commodity Exchange Act and perform recordkeeping and reporting duties, thereby creating a comprehensive picture of derivatives

57. See D’Souza et al., supra note 3, at 477-78; Greenberger, supra note 39, at 100.
58. See generally CHLISTALLA, supra note 7, at 3 (describing the “structural improvements” regulators aim to achieve in financial markets following the financial crisis); Greenberger, supra note 39 (describing why the CFMA’s deregulation of derivatives led to unfortunate financial consequences and critiquing regulatory proposals to remedy the inherent problems derivatives pose to the financial system); Colleen M. Baker, Regulating the Invisible: The Case of Over-the-Counter Derivatives, 85 NOTRE DAME L. REV. 1287, 1314-21, 1338-76 (2010) (highlighting “regulatory gaps” that have arisen in derivatives regulation and suggesting improvements to the current regulatory framework).
61. See id., sec. 733, §7b-2(5h) (codified as amended at 7 U.S.C. § 7b-2(5h)).
63. Id.
participants and transactions. Nonfinancial end-users would only be subject to these requirements to the extent that they qualified as "Major Swap Participants," as defined by Dodd-Frank.

B. Central Clearing

Prior to Dodd-Frank, OTC contracts, unlike exchange-traded ones, had no mandated mechanism for providing credit support to trades. Each party to the bilateral OTC derivatives contract individually assumed the "credit risk" that its counterparty would default on payments under the contract. To protect against this credit risk, the parties posted collateral at the outset of the contract and continuously recalculated and exchanged collateral throughout the life of the contract as the value of the underlying asset changed. This is where OTC markets have often failed. Due to the operational inefficiency of managing collateral on many contracts, OTC market practice has been to revalue and exchange collateral on a weekly or monthly basis rather than a daily basis. Posting collateral is expensive, so the amount posted tends to be insufficient if parties negotiate individually. In OTC markets, collateral has typically covered

64. Dodd-Frank employs the same definition of “swap dealer” as the Commodity Exchange Act. A “swap dealer” is a person who (i) holds itself out as a dealer in swaps, or (ii) makes a market in swaps, or (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or (iv) engages in activity commonly known in the trade as a dealer or market maker in swaps. Dodd-Frank Act, sec. 721(a)(21), § 1a (codified as amended at 7 U.S.C. § 1a).


66. See supra Part III.

67. “Credit risk” is the risk a party bears when entering a derivatives transaction that the counterparty to the transaction will default. HULL, supra note 19, at 746.


69. CHLISTALLA, supra note 7, at 8.

70. Id.

71. See id.
only sixty-six percent of overall credit exposure, leaving more than one-third of all contracts without coverage.\footnote{72}

To overcome these issues, Dodd-Frank mandates that all derivatives transactions, including OTC derivatives, be centrally cleared.\footnote{73} Under central counterparty (CCP) clearing, market participants post a set amount of initial margin\footnote{74} to the CCP.\footnote{75} Depending on how the CCP is organized, in some cases it will convert the bilateral contracts cleared by members into two separate contracts – one with the CCP and another with each party involved.\footnote{76} Since the CCP takes the place of the counterparty, the market participant is no longer exposed to the credit risk of the counterparty, but instead that of the CCP, which is made up of many members that have all posted collateral to the CCP.\footnote{77}

In some instances, the CCP will not guarantee contract performance but will instead provide members with an important transfer mechanism for shifting a contract from an insolvent party to another clearing member.\footnote{78} Known as trade “portability,” this functionality enables the member to maintain the benefit of the contract even though the original counterparty cannot meet its obligations.\footnote{79} Further, since its collateral is segregated in the CCP, the member may easily transfer collateral to the new contract or recover its collateral in the event that the contract cannot be transferred.\footnote{80}

CCPs provide additional protection to members through mark-to-market collateralization and netting. Unlike OTC contracts, the CCP requires parties to post or recover collateral at
the end of each day based on the outcomes of their trades.\footnote{1} In this way, mark-to-market collateralization prevents contracts from having insufficient collateral.\footnote{2} CCPs also net a member’s position in the event of a default, meaning that if a party defaults on one contract, it automatically defaults on all outstanding contracts.\footnote{3} Gains from other contracts must be used to offset the losses on contracts on which it has defaulted.\footnote{4} This protects counterparties because a defaulting party cannot continue to reap the benefits of lucrative contracts while failing to make payments on unfavorable ones.\footnote{5} The lucrative contracts must instead cover the defaulter’s losses.\footnote{6}

The Intercontinental Exchange, the Chicago Mercantile Exchange, and the NASDAQ Stock Market have all established new clearinghouses to clear derivatives transactions.\footnote{7} In clearing many OTC contracts, however, they will face substantial challenges. Notably, CCPs can only handle standard derivatives contracts that have mark-to-market price discovery mechanisms in transparent and liquid markets.\footnote{8} This is because CCPs must be able to take on parties’ contracts, net positions across contracts, and value the risk of parties’ positions for collateral calls.\footnote{9} OTC derivatives contracts, however, tend to be highly customized due to the specific nature of each company’s business risk.\footnote{10} Therefore, without greater standardization of OTC contracts, CCPs will not

\footnote{17}{See Chлистала, supra note 7, at 12.}
\footnote{18}{See id. Had mark-to-market collateralization been in place prior to the financial crisis, the true risk positions of companies holding CDS contracts would have been apparent far earlier. Matthew Kerfoot, The Impact of Dodd-Frank on the Post-Crisis Derivatives Markets, Derivatives Week (Sept. 2, 2010), http://www.derivativesweek.com (search “Impact of Dodd-Frank on the Post-Crisis” to access article). This would have prevented CDS dealers from acquiring risky positions that had the potential to threaten the dealer’s solvency and overall health of financial markets. Id.}
\footnote{19}{See Chлистала, supra note 7, at 9, 10; Hull, supra note 19, at 493.}
\footnote{20}{Hull, supra note 19, at 493.}
\footnote{21}{See id.}
\footnote{22}{See id.}
\footnote{24}{Chлистала, supra note 7, at 9.}
\footnote{25}{Id. at 9, 11.}
\footnote{26}{See Baker, supra note 58, at 1299.}
be able to take on, net, and value these contracts, and thus, will be unable to clear these derivatives.\textsuperscript{91}

\textbf{C. Exchange Trading}

In addition to central clearing, Dodd-Frank mandates that all derivatives contracts be exchange-traded because a complete regulatory infrastructure, such as that employed in equity and futures markets, combines both central clearing and exchange trading.\textsuperscript{92} While central clearing plays a crucial role in assuring capital adequacy for derivatives transactions, exchange trading is important to facilitate public and transparent derivatives pricing.\textsuperscript{93} The exchange brings together buyers and sellers of a defined set of contracts, while the clearinghouse serves as an intermediary between these traders and the exchange to guarantee contract performance between parties.\textsuperscript{94}

Unlike OTC contracts, exchange-traded contracts have the benefit of pricing input from third parties to facilitate price discovery.\textsuperscript{95} This is essential for risky derivatives because the impact of counterparty default on contract price is difficult to effectively price.\textsuperscript{96} If contracts are exchange-traded, the market rather than individual parties to a transaction determines the price of risk.\textsuperscript{97} Had all CDSs been exchange-traded prior to the financial crisis, institutions becoming parties to CDS contracts would have been able to more accurately assess the risk of CDS dealer defaults and consequently would have been less likely to take such excessively risky positions.\textsuperscript{98}

Clearinghouses and exchanges deal with contracts differently, which has important implications for the level of standardization required for each to effectively handle a contract.\textsuperscript{99}

\textsuperscript{91} Chlistalla, \textit{supra} note 7, at 4, 9.
\textsuperscript{92} Greenberger, \textit{supra} note 39, at 105.
\textsuperscript{93} \textit{Id.}
\textsuperscript{94} See Hull, \textit{supra} note 19, at 1-2, 29.
\textsuperscript{95} See D'Souza et al., \textit{supra} note 3, at 481.
\textsuperscript{96} See \textit{id.} at 486.
\textsuperscript{97} Kerfoot, \textit{supra} note 82.
\textsuperscript{98} \textit{Id.}
\textsuperscript{99} See Chlistalla, \textit{supra} note 7, at 20.
For example, an interest rate contract is a different product from one day to the next in an exchange context because a key term – the contract’s maturity – changes. The contract would, therefore, not be considered standardized for purposes of an exchange, even though it would be considered standardized in a clearinghouse context (since day-to-day, the clearinghouse’s ability to value and manage the risk of the contract would be unchanged).

Overcoming the problem of contract standardization will prove to be an enormous challenge for the derivatives industry in adopting the central clearing and exchange trading of OTC derivatives. Such a transition, however, is likely to suffer less from impracticality than lack of political will from dealers. Price discovery through exchange trading enhances market transparency, but it also reduces dealer profits and available transactions. As a result, dealers are unlikely to be the frontrunners in standardizing OTC contracts, which is why nothing short of a regulatory mandate will result in a comprehensive framework for exchange trading and clearing derivatives.

100. See id. An interest rate swap is a derivative contract under which parties agree to exchange payments based on a notional principal amount multiplied by an interest rate for a set period of years. HULL, supra note 19, at 149. One party pays according to a fixed interest rate and receives interest from the counterparty at a floating rate on the same amount. Id.

101. CHLISTALLA, supra note 7, at 20.

102. See Smith & Lynch, supra note 9. Under the Securities Exchange Act, a dealer is “any person engaged in the business of buying and selling securities for his own account” but is referenced more specifically in this context as a large financial entity, such as an investment bank, that not only trades for its own account but also makes a market in derivatives. See Securities Exchange Act § 3(a)(5)(A), 15 U.S.C. § 78c. Examples of dealers registered with the SEC that trade derivatives include Credit Suisse Group AG, Barclays Capital, and Citigroup Inc. SEC. & EXCH. COMM’N, COMPANY INFORMATION ABOUT ACTIVE BROKER-DEALERS (2010), available at http://www.sec.gov/foia/bdreports/bd020111.txt.

103. See Smith & Lynch, supra note 9.

104. See id.
V. THE END-USER EXEMPTION UNDER DODD-FRANK

A. Rationale

For purposes of the Dodd-Frank end-user exemption, derivatives end-users are nonfinancial companies that use derivatives to hedge commercial risk.\(^{105}\) Given the extensive benefits of central clearing and exchange trading to macroeconomic stability, it may seem surprising that Congress exempted end-users from its legislative requirements. The congressional record reveals that Congress’ rationale centered on: (1) the potential negative impact to American consumers if firms suffered cost increases; and (2) the need for the flexibility of OTC contracts in hedging commercial risk.\(^{106}\)

Upon analysis, the logic behind the end-user exemption is sound. First of all, derivatives play an essential role in helping nonfinancial firms manage operations by reducing earnings volatility and inherent business risks.\(^{107}\) According to a survey by the International Swaps and Derivatives Association (ISDA), ninety-four percent of Fortune 500 firms use derivatives to mitigate risk.\(^{108}\) Global corporations rely on interest rate and foreign exchange swaps to shield exposure to currency and interest

\(^{105}\) See End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. 79,992, 79,993 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. pt. 240); cf. CHLISTALLA, supra note 7, at 7 (“End users, which can include financial institutions, have specific risk management concerns that can be mitigated (“hedged”) . . . .”) (emphasis added).

\(^{106}\) In a letter to Barney Frank, former Chairman of the H. Fin. Services Comm., and Collin Peterson, ranking member of the H. Agric. Comm., Blanche Lincoln, former Chairman of the S. Agric., Nutrition, and Forestry Comm., and Chris Dodd, former Chairman of the S. Banking Comm., express that the principal reason for including the end-user exemption was the “substantial public interest in keeping [transaction] costs low [for end-users] (i.e., to provide consumers with stable, low prices, promote investment, and create jobs.).” 156 CONG. REC. H5248 (daily ed. June 30, 2010) (letter from Chairmen Lincoln and Dodd entered into the record by Rep. Collin Peterson). Texas Sen. Kay Hutchinson feared end-users would be unable to hedge due to the unique nature of OTC contracts, leading them to “choose market volatility instead of risk-controlling derivatives altogether, exposing Americans to higher prices, slower economic growth, and more job losses.” 56 CONG. REC. S5881 (daily ed. July 15, 2010) (statement of Sen. Kay Hutchinson).

\(^{107}\) See CHLISTALLA, supra note 7, at 5.

\(^{108}\) Id.
rate fluctuations, while utilities and basic materials companies tend to employ commodity derivatives to hedge commercial exposure.  

By hedging, nonfinancial firms can ensure stable input prices in the face of unpredictable increases, and thereby avoid passing costs on to consumers or laying off workers. For example, on August 6, 2010, Russia announced an export ban on wheat due to a severe drought that diminished wheat yield by thirty to forty percent. The news led to a price jump of more than fifty percent for wheat for delivery in December from the June low. However, many major food companies, including Tyson Foods, Inc., Anheuser-Busch InBev N.V., General Mills, Inc., Kellogg Company, and Kraft Foods, Inc., had shielded themselves against the risk of rising wheat prices by buying wheat derivatives, which meant their operations were largely unaffected by the price moves.

Not only that, nonfinancial companies’ hedging contracts tend to be highly customized due to the unique nature of each firm’s business risk. Arguably, requiring these firms to trade the standardized contracts necessary for exchange trading and clearing would reduce their ability to effectively hedge through customized contracts. Indeed, the high demand for bespoke contracts in OTC markets indicates that firms highly value the ability to tailor derivatives products to their specific business needs.

An additional problem for nonfinancial firms is the cost associated with regulation, which could make hedging prohibitively expensive. Executives from utility, manufacturing, and technology companies lobbied for the end-user exemption

109. *Id.*
110. *See Baker, supra* note 58, at 1302.
112. *Id.*
114. D’Souza et al., *supra* note 3, at 504.
115. This is the view espoused by Sen. Kay Hutchinson in congressional debate of Dodd-Frank. *See supra* note 106.
116. *See Chistalla, supra* note 7, at 4 (“OTC derivatives markets are characterized by flexible and tailor-made products, satisfying the demand for bespoke contracts customized to the specific risks that a user wants to hedge.”).
based on the rationale that they would have to increase prices and lay off workers due to increased margin requirements.\textsuperscript{117} Presumably, this is because the firms would have to post more collateral to meet clearinghouse requirements than they currently do under OTC contracts.\textsuperscript{118} Capital tied up in collateral is expensive because firms cannot use it to generate a return. While hedging costs are likely to increase for end-users with or without the exemption due to overall changes in derivatives markets, requiring these firms to clear and exchange trade would further increase the cost burden associated with hedging.\textsuperscript{119}

Further, due to the small size of the nonfinancial derivatives hedging market and the types of derivatives end-users employ, the end-user exemption will not directly conflict with Congress' goal of improving macroeconomic stability. Of the $437.2 trillion market for interest rate derivatives, nonfinancial companies make up only nine percent.\textsuperscript{120} Of the $48.7 trillion market in foreign exchange derivatives, nonfinancial companies constitute seventeen percent, and of the $6.6 trillion market for commodities derivatives, nonfinancial companies make up only ten percent.\textsuperscript{121} Moreover, the types of derivatives nonfinancial firms principally use, namely interest rate and foreign exchange swaps, were not implicated in the financial crisis.\textsuperscript{122} Derivatives based on commodity prices also played a very minor role in the crisis.\textsuperscript{123} Nonfinancial firms rarely employ the equity and credit derivatives so popular with financial companies that contributed to the financial crisis.\textsuperscript{124} Given these considerations, if implemented effectively, the end-user exemption does not appear to substantially hamper Dodd-Frank's ability to rein in the riskiest behavior in OTC markets.

\textsuperscript{117} See Smith & Lynch, supra note 9.  
\textsuperscript{118} See id.  
\textsuperscript{119} See infra Part V.E.4 (arguing that costs of compliance with the end-user exemption in addition to dealers passing their increased costs from exchange trading and clearing on to customers will raise hedging costs in the remaining OTC market).  
\textsuperscript{120} Chlistalla, supra note 7, at 5.  
\textsuperscript{121} Id.  
\textsuperscript{122} Id.  
\textsuperscript{123} Id.  
\textsuperscript{124} Id.
B. Initial Regulatory Efforts to Define the End-User Exemption

A larger issue than whether Congress should have included an end-user exemption in Dodd-Frank is how the CFTC and SEC will define the exemption so that it effectively exempts legitimate hedging transactions but does not create a loophole for abuse.125 Dodd-Frank considers a party an "end-user," exempted from clearing and trading derivatives transactions – if it: (1) is not a financial entity,126 (2) is hedging its own commercial risk; and (3) notifies the Commission of how it meets financial obligations of swaps that are not cleared.127

This language gives the CFTC and SEC substantial discretion in establishing a framework for distinguishing end-user hedging transactions from speculative trades. However, ranking members of Congress, both immediately following Dodd-Frank's passage and since regulatory agencies have commenced rulemaking, have repeatedly admonished the CFTC and SEC to avoid creating an overly-narrow end-user exemption.128 Most


126. Dodd-Frank defines a "financial entity" as (i) a swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap participant; (v) a commodity pool as defined in section 1a(10) of the Commodity Exchange Act; (vi) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-2(a)); (vii) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. § 1002); (viii) a person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956. Dodd-Frank Act, sec. 723(a)(3), § 2 (codified as amended at 7 U.S.C. § 2). Dodd-Frank leaves it up to the discretion of the SEC whether to exempt small banks, savings associations, farm credit system institutions, and credit unions with total assets under $10 billion under the end-user exemption. Id. at 1680. Under Proposed Rule 3Cg-1, the SEC has proposed alternative language to include these institutions in the end-user exemption. End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. 79,992, 79,993 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. pt. 240); see infra Part V.D for Commission proposals on the definition of Major Swap Participant.


128. In a letter to Chairman Frank and Rep. Peterson, Chairmen Lincoln and Dodd expressed, "[Congress] created a robust end user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk. . . .
recently, in a comment letter in response to the SEC's proposed rule on the end-user exception, Representatives Spencer Bachus and Frank Lucas expressed “serious concerns” about the impact of Title VII of Dodd-Frank on American companies and emphasized that “[e]nd-users must be able to rely upon their exemption from the clearing and exchange trading requirements without having to overcome unnecessary bureaucratic obstacles.”

Consequently, the CFTC and SEC are in the difficult position of implementing a wide congressional mandate to regulate the vast and unregulated derivatives market, while still respecting stringent boundaries – namely, without “damag[ing] America’s economic engine – the manufacturers, technology companies, real estate developers, and companies that provide vital financing to consumers and American businesses.”

The SEC’s initial attempts to strike this balance address logistical matters – for example, the proposed rule on the end-user exemption designates mechanisms for end-users to notify regulators of how they are meeting the financial obligations of swaps that are not cleared. But more importantly, these initial proposals focus on the potential for abuse of the end-user exemption. Proposed Rule 3Cg-1 requires end-users to notify the SEC each time they invoke the exemption and provide the SEC with information to ensure that they qualify, including the identity

These entities did not get us into this crisis and should not be punished for Wall Street’s excesses. They help to finance jobs and provide lending for communities all across this nation. That is why Congress provided regulators the authority to exempt these institutions.” 156 CONG. REC. H5248 (daily ed. June 30, 2010) (letter from Chairmen Lincoln and Dodd entered into the record by Rep. Collin Peterson).


130. Id.

131. Specifically, Proposed Rule 3Cg-1 provides that an end-user may demonstrate how it will meet its financial obligations under the swap through a written credit support agreement, a written agreement to pledge or segregate assets, a written third-party guarantee, the counterparty’s available financial resources, or other means of meeting its financial obligations other than those described above. End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. at 79,994-95.
of the counterparty relying on the exemption and information regarding the party’s status as a nonfinancial entity.\textsuperscript{132}

C. \textit{The Persistent Problem of Distinguishing Hedging from Speculating}

Arguably, the most problematic part of policing the end-user exemption, however, is distinguishing when an end-user is “hedging or mitigating commercial risk” rather than taking a speculative position in derivatives markets. The changing nature of modern corporations further complicates this task.\textsuperscript{133} Many nonfinancial entities, such as companies dealing in commodity derivatives, use derivatives to speculate about commodities prices in addition to hedge business risks, while other companies operate similarly to hedge funds and pursue their own investment strategies.\textsuperscript{134} For example, in the first half of 2007, the luxury car manufacturer, Porsche Automobil Holding SE, earned three times more on derivatives trades than on car sales.\textsuperscript{135}

Initial agency attempts to distinguish transactions that are “hedging or mitigating commercial risk” for the end-user exemption use the “economically appropriate” standard established by rules for defining “bona fide hedging” positions in futures markets under the Commodities Exchange Act.\textsuperscript{136} Under proposed Rule 3a67-4, the SEC has proposed that a position be considered “hedging or mitigating commercial risk” under Dodd-Frank if:

\begin{quote}
[S]uch position is economically appropriate to the reduction of risks that are associated with the present conduct and management of a commercial enterprise, where such risks arise from: [t]he
\end{quote}

\textsuperscript{132} See id. at 79,998.
\textsuperscript{133} See Michelle Price, \textit{Hitting the Wrong Target}, \textit{Banker}, Oct. 1, 2010.
\textsuperscript{134} Id.
\textsuperscript{135} Id.
potential change in the value of assets . . . liabilities [or] . . . services . . . in the ordinary course of business of the enterprise.\textsuperscript{137}

This recently proposed definition mirrors CEA Rule 1.3(z), which the CFTC uses to distinguish hedging from speculating positions in the context of futures markets.\textsuperscript{138} Under the CEA, positions that qualify as bona fide hedges are exempt from mandated speculative position limits.\textsuperscript{139} According to commentary under proposed Rule 3a67-4, the CFTC and SEC may consider the existing interpretations of the language "economically appropriate" used by the CFTC in applying CEA Rule 1.3(z) if the interpretations apply in the swap context.\textsuperscript{140}

Looking to agency interpretations of Rule 1.3(z), however, gives little insight into how this standard may play out in modern transactions or positions in a contract for future delivery on any contract market, or in a commodity option, where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and where they arise from: (i) The potential change in the value of assets which a person owns, produces, manufactures, processes, or merchandises . . . (ii) The potential change in the value of liabilities . . . (iii) The potential change in the value of services . . .
derivatives markets. Historically, the CFTC has applied the Rule 1.3(z) definition of bona fide hedging both to exempt hedging transactions from futures position limits and to approve new futures contracts for exchange trading.\(^1\) For a futures contract to be approved for an exchange, a board of trade had to show that it could be used for bona fide hedging or price basing.\(^1\) Under CFTC Guideline 1, this meant that the contract had to pass the economic purpose test, which required dealers to show that a contract served an “economic purpose” beyond mere speculation and that its value superseded any negative impact from speculation.\(^1\) In this way, the economic purpose test aimed to ensure that proposed futures contracts facilitated pricing and hedging in the underlying asset.\(^1\)

The CFTC still maintains the economic purpose test as part of its policy, although it is not stringently enforced.\(^1\) In 1982, the CFTC stopped requiring exchanges to demonstrate a contract’s economic purpose and justify the contract terms.\(^1\) In 2000, the CFTC then eliminated the requirement of CFTC approval for the introduction of new contracts.\(^1\) Consequently, there is little modern agency interpretation of what has been labeled the “weak” economic purpose test, and therefore it is unclear how the

\(^1\) See Imel et al., *supra* note 139, at 273.

\(^2\) Id.

\(^3\) See Comm. Fut. L. Rep. (CCH) ¶ 20,041 (May 13, 1975). As CFTC regulation describes it, “The economic purpose test requires a board of trade to demonstrate that transactions for future delivery in a commodity are, or reasonably can be expected to be, quoted and disseminated for price basing, or utilized as a means of hedging against possible loss through fluctuations in price.” Economic and Public Interest Requirements for Contract Market Designation, 47 Fed. Reg. 49,832, 49,836 (Nov. 3, 1982) (to be codified at 17 C.F.R. pt. 5).


\(^5\) Id.

\(^6\) In an interpretive guideline, the CFTC stated, “The Commission has determined under the revised guideline, however, not to routinely require statements from, or reports of interviews with, potential market users concerning economic purpose.” Economic and Public Interest Requirements for Contract Market Designation, 47 Fed. Reg. 49,832, 49,837 (Nov. 3, 1982) (to be codified at 17 C.F.R. pt. 5); see also Peter H. Huang, *A Normative Analysis of New Financially Engineered Derivatives*, 73 S. CAL. L. REV. 471, 506 (2000) (describing the evolution of the CFTC’s process for approving new futures contracts for exchange trading).

\(^7\) Huang, *supra* note 146, at 506.
CFTC and SEC (the "Commissions") would apply the "economically appropriate" standard in the context of distinguishing end-user hedging transactions.\textsuperscript{148}

This lack of clarity on what constitutes an "economically appropriate" hedge position is troublesome in that it may not sufficiently limit what qualifies as a transaction "hedging or mitigating commercial risk." The Commissions have solicited comment on this point and even suggested limiting the qualified hedge transactions to nonfinancial commodities in order to limit their scope.\textsuperscript{149} The overall tone of the proposed rule commentary, however, is permissive. For example, whether a transaction qualifies as a hedge will "take into account the person's overall hedging and risk mitigation strategies."\textsuperscript{150} By employing complex "risk mitigating strategies," creative end-users could obscure whether their transactions are risk mitigating or speculation in disguise. In seemingly sweeping language, the Commissions state, "the proposal covers swaps hedging or mitigating any of a person's business risks, regardless of their status under accounting guidelines\textsuperscript{151} or the bona fide hedging exemption."\textsuperscript{152} This language, coupled with recent congressional admonishments,

\begin{itemize}
\item \textsuperscript{148} See id.
\item \textsuperscript{150} Id. at 80,195.
\item \textsuperscript{151} Hedge accounting is an accounting standard that reduces earnings volatility by permitting companies to recognize gains or losses from a hedging contract in the same period as the gains or losses from the item it is hedging. See Hull, supra note 19, at 39. Under standard accounting practices, an entity must recognize gains and losses from a futures contract when they occur. Id. Hedge accounting, however, allows companies to defer recognition of gains and losses on hedging contracts that otherwise would have to be recognized, thereby reducing swings in the value of either position. See Henry T.C. Hu, Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective, 73 Tex. L. Rev. 985, 1040 (1995). Limiting the end-user exemption to positions that qualify for hedge accounting would preclude many bona fide hedging transactions from receiving the exemption because often companies hedge with similar but more cost-effective proxy products that do not move directly in line with the product being hedged. See Price, supra note 133. As a result, the commercial hedge with a similar product would not meet hedge accounting requirements. Id.
\end{itemize}
suggests a broad interpretation of what will qualify as a transaction “hedging or mitigating commercial risk” that could lead to abuse, both by nonfinancial entities and the large investment banks that are counterparties to these trades.

D. End-Users as Major Swap Participants

Even if the hedging transactions of a large nonfinancial firm qualify under the end-user exemption, the exemption will prove unhelpful if the firm falls into the category of “Major Swap Participant” (MSP) and consequently is subject to additional regulation under Dodd-Frank. In Dodd-Frank, a MSP is defined as a party with a substantial non-hedging position in swaps that gives rise to systemic economic risk. Qualifying as a MSP will mean that a company must register with the CFTC or the SEC, perform recordkeeping duties, satisfy capital and margin requirements, and comply with regulatory business conduct standards.

The CFTC and SEC are responsible for defining the MSP category, and large commercial derivatives hedgers have expressed concern that if the category is broadly defined, they could be deemed MSPs. However, fears that nonfinancial firms qualifying for the end-user exemption will fall in the MSP category are likely


154. Id., sec. 721(a)(16), § 1a(33) (codified as amended at 7 U.S.C. § 1a(33)).


156. Orol, supra note 2; Price, supra note 133 (citing a memo from law firm Cadwalader, Wickersham & Taft LLP stating that it was “unclear whether the number of end-users required to register as a major swap participant will be 10,000 or 10: it is left to the regulators”).
exaggerated. CFTC Chairman Gary Gensler has stated that a company's derivatives trading would have to be "substantial enough to be relevant to the economy or the financial system as a whole" to qualify as a MSP and has emphasized that the majority of end-users are unlikely to fit this description.\textsuperscript{157} The congressional record is clear that Congress did not intend for firms hedging commercial risk to be regulated as MSPs.\textsuperscript{158}

Further, initial regulatory proposals rebut such a classification. In a joint proposal, the CFTC and SEC have outlined three tests for falling in the MSP category; only one potentially applies to hedging commercial end-users.\textsuperscript{159} If an end-user creates "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets," it would fall in the MSP category.\textsuperscript{160} This calculation includes hedging positions, but the proposed thresholds to qualify are high.\textsuperscript{161} Consequently, while

\begin{footnotesize}
\begin{enumerate}
\item[157.] Doering, \textit{supra} note 153.
\item[158.] In a letter to Chairman Barney Frank and Rep. Collin Peterson on the treatment of end-users, Chairmen Blanche Lincoln and Chris Dodd clarified that Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business. For example, the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business.
\item[156 CONG. REC. H5248 (daily ed. June 30, 2010)] (letter from Chairmen Lincoln and Dodd entered into the record by Rep. Collin Peterson).
\item[159.] The first test includes firms that maintain a "substantial position" in the major swap categories as defined by the CFTC and SEC, but excludes positions hedging or mitigating commercial risk. The Commissions propose adopting a definition of "hedging or mitigating commercial risk" identical to the definition of "hedging or mitigating commercial risk" for purposes of qualifying for the end-user exemption. See \textit{supra} Part V.C. The third test applies only to financial entities, and consequently would not apply to nonfinancial end-users. Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,147, 80,185-86 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. pt. 240).
\item[160.] \textit{Id.} at 80,186.
\item[161.] The CFTC has proposed that "substantial counterparty exposure" to qualify as a MSP would require current uncollateralized exposure of $5 billion, or a combined current uncollateralized exposure and potential future exposure of $8
\end{enumerate}
\end{footnotesize}
it is possible for a nonfinancial end-user to qualify as a MSP, such a classification appears highly unlikely.

E. Potential Impact on OTC Markets

Although many unknowns remain regarding how regulators will flesh out the specifics of the end-user exemption, hedging transactions and the OTC derivatives landscape are generally ripe for change in the wake of extensive regulation. The impact of the legislation’s costs and benefits will drive the landscape of the derivatives industry over the next ten years.

1. Impact of the Exemption

The success of Title VII in reining in OTC derivatives markets will turn in large part on how effectively regulatory agencies police the loopholes. The end-user exemption Congress enacted is fairly narrow, but agency implementation will ultimately drive its effect. Presuming the CFTC and SEC can distinguish transactions that are legitimately “hedging commercial risk,” there is likely to be a substantial reduction in OTC markets, given that nonfinancial hedgers currently constitute such a small percentage of the market.

The difficulty of distinguishing hedging and speculative trades – especially if obscured in complex “risk mitigation strategies” – could result in a blanket exemption for the derivatives activities of nonfinancial firms. Congress has persistently advocated for regulatory leniency with nonfinancial end-users, and initial rulemaking efforts by regulators are consistent with a broad exemption. Accordingly, it is fair to

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billion across the entirety of an entity’s swap positions. *Id.* at 80,198. The thresholds for “Major Security Based Swap Participants” (MSBSP) are lower. *Id.* To qualify as a MSBSP, the SEC has proposed that an entity maintain current uncollateralized exposure of $2 billion, or a combined current uncollateralized exposure and potential future exposure of $4 billion, across the entirety of an entity’s security-based swap positions. *Id.*

162. Sackheim et al., *supra* note 1, at 7.
163. *See supra* Part V.C.
164. *See supra* Part V.C.
conclude that large banks will feel the brunt of regulation under Dodd-Frank, while nonfinancial companies will escape relatively unscathed.\textsuperscript{165}

2. The Impending Transition

Despite a potentially lenient end-user exemption, the massive OTC market of the last decade will be fundamentally different as Dodd-Frank drives the majority of OTC trades to exchange trading and central clearing.\textsuperscript{166} Even before the CFTC had proposed initial rules, clearing organizations were already seeing significant increases in the clearing of what were previously OTC trades.\textsuperscript{167} For example, Eris Exchange, an organization that converts OTC contracts to futures and uses the CME Group to clear, transacted $3 billion worth of swaps between its opening in July, 2010 and October, 2010.\textsuperscript{168} LCH Clearnet – the largest derivatives clearing organization, handling around one-third of inter-dealer interest rate swaps – now offers dealer-to-customer swaps in addition to dealer-to-dealer transactions.\textsuperscript{169} The eagerness with which derivatives traders are beginning to use clearing facilities ahead of regulation indicates that the OTC derivatives landscape will transform quickly.\textsuperscript{170} Promising levels of initial volume at clearinghouses mean that traffic is likely to continue to increase at these venues, and OTC markets are on course for fundamental changes.\textsuperscript{171}

3. Commercial End-Users and the Need for Derivative Protection

Contrary to the general market trend, however, commercial end-users have been more reluctant to transition to

\textsuperscript{166} See Sackheim et al., \textit{ supra} note 1, at 7.
\textsuperscript{168} \textit{Id.}
\textsuperscript{169} Smith & Lynch, \textit{ supra} note 9.
\textsuperscript{170} See Saphir, \textit{ supra} note 167.
\textsuperscript{171} See \textit{id.}
central clearing. According to a survey by Greenwich Associates, less than twenty-five percent of companies that use commodities derivatives say they currently clear their derivatives trades with a central clearing party and only twenty-five percent expect to over the next year.\textsuperscript{172}

It would be imprudent, however, for nonfinancial firms hedging with derivatives to ignore the problems derivatives posed in the financial crisis and the changing nature of derivatives markets post Dodd-Frank. The ISDA agreements that have traditionally governed swaps transactions highly favor swaps dealers and provide little credit protection for end-users.\textsuperscript{173} Although both parties to the transaction can require the other to post additional collateral, typically end-users do not do this in practice.\textsuperscript{174} Therefore, if nonfinancial firms continue to avoid central clearing and exchange trading derivatives, they must protect themselves against bilateral credit risk by requiring more demanding terms in OTC agreements.\textsuperscript{175}

4. The Reality of Increased Hedging Costs

Regardless of whether end-users transition to central clearing and exchange trading or continue to use OTC contracts, the cost of hedging with derivatives for end-users will increase. If end-users transition to the exchanges, they will face increased margin requirements, thereby incurring the opportunity cost of having capital tied up.\textsuperscript{176} If firms employ a mix of centrally cleared and custom swaps, they will be unable to net exposure across the two types of contracts, which will demand higher margin requirements overall.\textsuperscript{177} Alternatively, if nonfinancial companies


\textsuperscript{173} Sackheim et al., supra note 1, at 1.

\textsuperscript{174} Id.

\textsuperscript{175} For example, Michael Sackheim suggests that nonfinancial end-users should contract for the ability to demand additional collateral and a right to terminate the agreements upon a ratings downgrade of the opposite party in OTC agreements. Id. at 10.

\textsuperscript{176} See id. at 18, 19.

\textsuperscript{177} See Mayer Brown, End-users and OTC Energy Derivatives:
rely solely on OTC contracts, they must provide the CFTC and SEC with the necessary documentation to comply with the exemption, which will require costly system development. Finally, as noted above, exchange trading and central clearing reduce dealer profit margins. Dealers will likely shift these increased costs to customers in both the exchange-traded and OTC contexts.

Due to the reality of increasing hedging costs after Dodd-Frank, end-users should evaluate whether the savings from failing to exchange trade and clear their derivatives trades is worth the additional credit risk in the post Dodd-Frank derivatives landscape. Firms have relied on complex OTC contracts to hedge commercial risk only in recent history and should thoughtfully evaluate whether trading such complex instruments is necessary when less risky exchange-traded hedging instruments are available to hedge most types of commercial risk.

VI. CONCLUSION

Hedging commercial risk is an increasingly important business practice for many large corporations, and Dodd-Frank has dramatically changed the landscape of derivatives markets on which these companies rely. Large banks will feel the greatest impact of new regulation, as they are subject to the most stringent directives of Dodd-Frank. However, the impact on nonfinancial end-users hedging commercial risk remains unclear due to the uncertainty surrounding the CFTC’s and SEC’s implementation of the legislation. The fact that initial regulatory proposals indicate that the end-user exemption will be broad should not lull nonfinancial firms into maintaining their current derivatives

178. See supra Part V.B.
179. See supra Part IV.B-C.
180. See Smith & Lynch, supra note 9; Sackheim et al., supra note 1, at 18, 22.
181. See supra Part V.
182. See supra Part V.D.1.
183. See supra Part V.D.1.
practices. OTC derivatives markets will be strikingly different after Dodd-Frank, as more transactions move to exchanges and dealers respond to regulatory demands. 184 In this changing environment, end-users should protect themselves from counterparty risk by demanding more favorable terms in ISDA agreements that notoriously favor dealers and using cleared derivatives contracts when possible. 185 Hedging commercial risk will be more expensive for end-users post Dodd-Frank, with or without an exemption; however, these costs are worthwhile if regulation enhances the financial stability of derivatives trading. 186 End-users should stay informed about market and regulatory developments to capitalize on a dramatically new environment for hedging commercial risk.

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184. See supra Part V.D.2.
185. See supra Part V.D.3.
186. See supra Part V.D.4.