



NORTH CAROLINA
BANKING INSTITUTE

Volume 15 | Issue 1

Article 10

2011

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Recommended Citation

Laurin C. Ariail, *The Impact of Dodd-Frank on End-Users Hedging Commercial Risk in Over-the-Country Derivatives Markets*, 15 N.C. BANKING INST. 175 (2011).

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

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.

2. Ronald D. Orol, *CFTC, Businesses Clash on Derivatives Rules*, MARKETWATCH (Sept. 21, 2010, 3:22 PM), <http://www.marketwatch.com/story/cftc-business-community-clash-on-derivatives-2010-09-21>.

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)⁶ in an effort to rein in the U.S. portion of the \$600 trillion over-the-counter (OTC) derivatives industry.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.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.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

6. Pub. L. No. 111-203, 124 Stat. 1376 (to be codified in scattered sections of U.S.C.).

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.*

8. See Dodd-Frank Act §§ 701-774 (to be codified in scattered sections of 7 and 15 U.S.C.).

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. H5248 (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.

of uncertainty surrounding implementation of the regulation.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.¹¹ Part II considers the nature of current derivatives markets and the role these financial instruments played in the 2008 financial crisis.¹² Part III explores the history of derivatives regulation under the Commodity Exchange Act (CEA)¹³ and the deregulatory impact of the Commodity Futures Modernization Act (CFMA) in 2000.¹⁴ 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.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.¹⁶ Finally, the note speculates about how Dodd-Frank will impact hedging transactions and the OTC derivatives landscape generally.¹⁷ Upon analyzing the costs and risks associated with hedging with derivatives, the note suggests that end-users must better protect

10. See Dodd-Frank Act, sec. 723(a), § 2 (codified as amended at 7 U.S.C. § 2).

11. See *infra* Parts II-IV.

12. See *infra* Part II.

13. 7 U.S.C. § 1 *et seq.* (1936).

14. See *infra* Part III.

15. See *infra* Part IV.

16. See *infra* Part V.

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.

19. JOHN C. HULL, *OPTIONS, FUTURES, AND OTHER DERIVATIVES* 1 (David Alexander ed., Prentice Hall 6th ed. 2006) (1993).

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.

25. *See* Lynn A. Stout, *How Deregulating Derivatives Led to Disaster, and Why Re-Regulating Them Can Prevent Another*, LOMBARD STREET, 7 (July 6, 2009) [hereinafter Stout, *Deregulating Derivatives*], <http://www.finreg21.com/download-lombard-street> (follow "Lombard Street - Volume 1 Issue 7.pdf" hyperlink).

26. *Id.*

hedging the exact opposite side of the trade.²⁷ 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.²⁸

Rampant speculation in derivatives markets is dangerous for macroeconomic financial stability because of the “systemic risk”²⁹ that arises from the interrelatedness of derivatives users.³⁰ 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).³¹ 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.³²

The 2008 global financial crisis is a recent example of the systemic risk associated with derivatives use.³³ As homeowners defaulted on their subprime mortgages, this created a “ripple effect” through the burgeoning asset backed security market.³⁴ Institutions that had purchased protection against mortgage

27. See Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 429 (2005).

28. See Stout, *Deregulating Derivatives*, *supra* note 25, at 7-8.

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. Schwarcz, *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)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.³⁶ Simultaneously, the CDO contracts in which these CDS sellers had heavily invested stopped making payments and plummeted in value.³⁷ This crippled these institutions, including AIG and Lehman Brothers, and eventually led to their failure.³⁸

Further compounding the threat of systemic risk is the overall lack of transparency in derivatives markets.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.⁴⁰ However, exchange-traded derivatives make up a mere 3.4 percent of the \$636,431 billion derivatives market.⁴¹ The overwhelming majority of derivatives are traded over-the-counter.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.⁴³ These transactions have been largely invisible to

35. 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.*

36. 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.

37. D'Souza et al., *supra* note 3, at 490-91.

38. *Id.*

39. See Michael Greenberger, *Make Markets be Markets: Out of the Black Hole: Regulatory Reform of the Over-the-Counter-Derivatives Market*, ROOSEVELT INSTITUTE 99, 99 (Mar. 3, 2010), <http://www.makemarketsbemarkets.org> (follow "Read the Report" hyperlink to download PDF).

40. See D'Souza et al., *supra* note 3, at 482.

41. Aline van Duyn, *Financial Markets: Derivative Dilemmas*, FIN. TIMES (Aug. 11, 2010), <http://www.ft.com> (search "Derivative Dilemmas").

42. D'Souza et al., *supra* note 3, at 483.

43. 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").

regulators and other market participants because they have not had the same reporting requirements as those traded on exchanges.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.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.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.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.⁴⁸ In light of this, the CFTC began deregulating derivatives by exempting certain OTC contracts from regulation.⁴⁹ Congress then passed the Commodity Futures Modernization Act (CFMA) in 2000, which permitted all OTC derivatives to trade without regulation, thereby

44. Greenberger, *supra* note 39, at 100.

45. *Id.* at 112.

46. See Stout, *Law Hates Speculators*, *supra* note 32, at 705-06.

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).

48. See Stout, *Deregulating Derivatives*, *supra* note 25, at 7.

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.⁵⁰ The CFMA removed derivatives from CFTC and SEC oversight and mandated the enforcement of derivatives contracts traded both on and off exchanges.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.⁵²

CFMA's complete deregulation of OTC markets corresponds directly to the massive proliferation of OTC contracts over the last decade.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 2009.⁵⁴ Of that total, approximately \$614,674 billion were privately arranged OTC derivatives contracts over which regulators had no authority.⁵⁵ Some experts theorize that the deregulation, and the resulting dramatic growth in OTC derivatives, led directly to the financial crisis in 2008.⁵⁶ Undeniably, the prominent role that derivatives played in the financial crisis made re-regulating

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").

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").

52. See Stout, *Deregulating Derivatives*, *supra* note 25, at 7.

53. See *id.*

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.

55. See Bank for Int'l Settlements, *supra* note 7.

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 . . .").

derivatives a prime target for Congress in Dodd-Frank.⁵⁷ Politicians could no longer ignore the market failures and systemic risk associated with such an enormous and invisible market.⁵⁸

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;⁵⁹ (2) central clearing;⁶⁰ and (3) exchange trading.⁶¹ 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.⁶²

A. *Data Collection*

Dodd-Frank aims to enhance the transparency of derivatives markets by implementing disclosure and conduct standards for large derivatives traders.⁶³ 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).

59. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 727, § 2(a), 124 Stat. 1376, 1696-97 (2010) (codified as amended at 7 U.S.C. § 2(a)).

60. See *id.*, sec. 723(a)(3), § 2 (codified as amended at 7 U.S.C. § 2).

61. See *id.*, sec. 733, § 7b-2(5h) (codified as amended at 7 U.S.C. § 7b-2(5h)).

62. PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, *DERIVATIVES REGULATION* §1.02[12A][2] (3d ed. 2004 & Supp. 2010) (forthcoming 2011).

63. *Id.*

participants and transactions.⁶⁴ 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.⁶⁵

B. Central Clearing

Prior to Dodd-Frank, OTC contracts, unlike exchange-traded ones, had no mandated mechanism for providing credit support to trades.⁶⁶ Each party to the bilateral OTC derivatives contract individually assumed the “credit risk”⁶⁷ that its counterparty would default on payments under the contract.⁶⁸ 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.⁶⁹ 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.⁷⁰ Posting collateral is expensive, so the amount posted tends to be insufficient if parties negotiate individually.⁷¹ 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).

65. The CFTC and SEC have proposed a joint rule defining what constitutes a Major Swap Participant. Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 75 Fed. Reg. 80,174 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. pt. 240). Under Dodd-Frank, a Major Swap Participant is a party with a substantial non-hedging position in swaps that gives rise to systemic economic risk. Dodd-Frank Act, sec. 721(a)(16), § 1a(33) (codified as amended at 7 U.S.C. § 1a(33)). For a discussion of the impact of the Major Swap Participant category on end-users, see *infra* Part V.D.

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.

68. See Hu, *Swaps Modern Process*, *supra* note 43, at 347.

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.⁷²

To overcome these issues, Dodd-Frank mandates that all derivatives transactions, including OTC derivatives, be centrally cleared.⁷³ Under central counterparty (CCP) clearing, market participants post a set amount of initial margin⁷⁴ to the CCP.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.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.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.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.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.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

72. *Id.*

73. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 723(a)(3), § 2(h), 124 Stat. 1376, 1675 (2010) (codified as amended at 7 U.S.C. § 2(h)).

74. Margin is the cash balance in a trader’s account with a clearinghouse. HULL, *supra* note 19, at 27, 29. If the balance falls below a certain point, called a maintenance margin, the member must post additional collateral so that it maintains its balance at a level determined by the clearinghouse. *Id.*

75. CHLISTALLA, *supra* note 7, at 8.

76. *Id.* at 9.

77. See Baker, *supra* note 58, at 1296-98.

78. Sackheim et al., *supra* note 1, at 10.

79. *Id.* at 8.

80. *Id.* at 10.

the end of each day based on the outcomes of their trades.⁸¹ In this way, mark-to-market collateralization prevents contracts from having insufficient collateral.⁸² 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.⁸³ Gains from other contracts must be used to offset the losses on contracts on which it has defaulted.⁸⁴ This protects counterparties because a defaulting party cannot continue to reap the benefits of lucrative contracts while failing to make payments on unfavorable ones.⁸⁵ The lucrative contracts must instead cover the defaulter's losses.⁸⁶

The IntercontinentalExchange, the Chicago Mercantile Exchange, and the NASDAQ Stock Market have all established new clearinghouses to clear derivatives transactions.⁸⁷ 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.⁸⁸ 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.⁸⁹ OTC derivatives contracts, however, tend to be highly customized due to the specific nature of each company's business risk.⁹⁰ Therefore, without greater standardization of OTC contracts, CCPs will not

81. See CHLISTALLA, *supra* note 7, at 12.

82. 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.*

83. See CHLISTALLA, *supra* note 7, at 9, 10; HULL, *supra* note 19, at 493.

84. HULL, *supra* note 19, at 493.

85. See *id.*

86. See *id.*

87. Louise Story, *A Secretive Banking Elite Rules Derivatives Trading*, N.Y. TIMES, Dec. 12, 2010, at A1.

88. CHLISTALLA, *supra* note 7, at 9.

89. *Id.* at 9, 11.

90. 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.⁹¹

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.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.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.⁹⁴

Unlike OTC contracts, exchange-traded contracts have the benefit of pricing input from third parties to facilitate price discovery.⁹⁵ This is essential for risky derivatives because the impact of counterparty default on contract price is difficult to effectively price.⁹⁶ If contracts are exchange-traded, the market rather than individual parties to a transaction determines the price of risk.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.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.⁹⁹

91. CHLISTALLA, *supra* note 7, at 4, 9.

92. Greenberger, *supra* note 39, at 105.

93. *Id.*

94. See HULL, *supra* note 19, at 1-2, 29.

95. See D'Souza et al., *supra* note 3, at 481.

96. See *id.* at 486.

97. Kerfoot, *supra* note 82.

98. *Id.*

99. See CHLISTALLA, *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.¹⁰⁰ 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).¹⁰¹

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.¹⁰² Price discovery through exchange trading enhances market transparency, but it also reduces dealer profits and available transactions.¹⁰³ 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.¹⁰⁴

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.¹⁰⁹

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.¹¹⁰ 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.¹¹¹ The news led to a price jump of more than fifty percent for wheat for delivery in December from the June low.¹¹² 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.¹¹³

Not only that, nonfinancial companies' hedging contracts tend to be highly customized due to the unique nature of each firm's business risk.¹¹⁴ 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.¹¹⁵ 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.¹¹⁶

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.

111. *See Andrew E. Kramer, Drought in Russia Ripples Beyond the Wheat Fields, N.Y. TIMES, Aug. 27, 2010, at B3.*

112. *Id.*

113. Javier Blas & Greg Farrell, *Hedging Helps Food Producers to Weather Uncertainty, FIN. TIMES, Aug. 13, 2010, at 19.*

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 CHLISTALLA, 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.¹¹⁷ Presumably, this is because the firms would have to post more collateral to meet clearinghouse requirements than they currently do under OTC contracts.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.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.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.¹²¹ Moreover, the types of derivatives nonfinancial firms principally use, namely interest rate and foreign exchange swaps, were not implicated in the financial crisis.¹²² Derivatives based on commodity prices also played a very minor role in the crisis.¹²³ Nonfinancial firms rarely employ the equity and credit derivatives so popular with financial companies that contributed to the financial crisis.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.

117. See Smith & Lynch, *supra* note 9.

118. See *id.*

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).

120. CHLISTALLA, *supra* note 7, at 5.

121. *Id.*

122. *Id.*

123. *Id.*

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

125. The CFTC and SEC share jurisdiction over the issue since Dodd-Frank continues the distinction in the Securities Exchange Act between swaps, regulated by the CFTC, and security-based swaps, regulated by the SEC. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 711, 124 Stat. 1376, 1641 (2010) (to be codified at 7 U.S.C. § 1a).

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.

127. Dodd-Frank Act, sec. 723(a)(3), § 2 (codified as amended at 7 U.S.C. § 2).

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."¹²⁹ 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."¹³⁰

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.¹³¹ 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).

129. Letter from Rep. Spencer Bachus and Rep. Frank Lucas to Treasury Sec. Timothy Geithner, CFTC Chairman Gary Gensler, SEC Chairman Mary Shapiro, and Fed. Reserve Chairman Ben Bernanke (Dec. 16, 2010) (on file with the SEC), available at <http://sec.gov/comments/s7-39-10/s73910-5.pdf>.

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.¹³²

C. *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.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.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.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.¹³⁶ Under proposed Rule 3a67-4, the SEC has proposed that a position be considered "hedging or mitigating commercial risk" under Dodd-Frank if:

[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

132. *See id.* at 79,998.

133. *See* Michelle Price, *Hitting the Wrong Target*, *BANKER*, Oct. 1, 2010.

134. *Id.*

135. *Id.*

136. Commodity Exchange Act, 17 C.F.R. § 1.3(z) (2010); Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,174, 80,217 (proposed Dec. 21, 2010) (to be codified 17 C.F.R. 240).

potential change in the value of assets . . . liabilities [or] . . . services . . . in the ordinary course of business of the enterprise.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.¹³⁸ Under the CEA, positions that qualify as bona fide hedges are exempt from mandated speculative position limits.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.¹⁴⁰

Looking to agency interpretations of Rule 1.3(z), however, gives little insight into how this standard may play out in modern

137. Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 75 Fed. Reg. at 80,217. The CFTC and SEC proposed to use this standard of “hedging or mitigating commercial risk” both for purposes of determining which transactions qualify for the end-user exemption and which positions are exempted from calculating an entity’s position for purposes of determining if it qualifies as a Major Swap Participant. *Id.* at 80,195. The SEC adopts this proposal into Proposed Rule 3Cg-1(a)(4). End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. at 80,000. For a discussion of the impact of Major Swap Participant classification, *see infra* Part V.D.

138. Rule 1.3(z)(1) defines bona fide hedging transactions and positions as

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 . . .

Commodity Exchange Act, 17 C.F.R. § 1.3(z) (2010).

139. 7 U.S.C. § 6a(c)(1) (2006); Blake Imel et al., *CFTC’s Hedging Definition-Development and Contemporary Issues*, in PRACTISING LAW INSTITUTE, THE COMMODITY FUTURES TRADING COMMISSION: CURRENT ISSUES 269, 273 (1985).

140. *See* Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 75 Fed. Reg. at 80,195.

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.¹⁴¹ 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.¹⁴² 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.¹⁴³ In this way, the economic purpose test aimed to ensure that proposed futures contracts facilitated pricing and hedging in the underlying asset.¹⁴⁴

The CFTC still maintains the economic purpose test as part of its policy, although it is not stringently enforced.¹⁴⁵ In 1982, the CFTC stopped requiring exchanges to demonstrate a contract’s economic purpose and justify the contract terms.¹⁴⁶ In 2000, the CFTC then eliminated the requirement of CFTC approval for the introduction of new contracts.¹⁴⁷ Consequently, there is little modern agency interpretation of what has been labeled the “weak” economic purpose test, and therefore it is unclear how the

141. See Imel et al., *supra* note 139, at 273.

142. *Id.*

143. 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).

144. Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 1029-31 (1992).

145. *Id.*

146. 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).

147. 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.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.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.”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 guidelines¹⁵¹ or the bona fide hedging exemption.”¹⁵² This language, coupled with recent congressional admonishments,

148. *See id.*

149. *See* Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 75 Fed. Reg. 80,174, 80,195-96 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. pt. 240).

150. *Id.* at 80,195.

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.*

152. Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 75 Fed. Reg. at 80,195.

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.¹⁵³ 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.¹⁵⁴ 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.¹⁵⁵

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.¹⁵⁶ However, fears that nonfinancial firms qualifying for the end-user exemption will fall in the MSP category are likely

153. Dodd-Frank defines “Major Swap Participant” and “Major Security Based Swap Participant.” The categories are functionally the same, requiring enhanced reporting requirements, but are distinguishable regarding the type of swaps the entity trades and the regulatory agency with jurisdiction over the regulation. The categories continue the distinction under the Securities Exchange Act between swaps and security-based swaps with the former under CFTC jurisdiction and the latter under SEC jurisdiction. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, secs. 721(a)(16), 731, 761a(6), 124 Stat. 1376, 1663, 1703, 1755 (2010), § 3(a)(68) (codified as amended at 15 U.S.C. § 78c(a)(68)); Securities Exchange Act § 3(a)(68), 15 U.S.C. § 78c(a)(68); *see also*, Christopher Doering, *CFTC Roll-out of Swaps Reform Begins to Take Shape*, REUTERS, Sept. 21, 2010, <http://www.reuters.com/article/idUSN2116959420100921> (documenting the concerns of nonfinancial companies hedging commercial risk that they may be labeled “Major Swap Participants” under Dodd-Frank).

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

155. *See id.*, sec. 731, § 4s (codified as amended at 7 U.S.C. § 4s).

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.¹⁵⁷ The congressional record is clear that Congress did not intend for firms hedging commercial risk to be regulated as MSPs.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.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.¹⁶⁰ This calculation includes hedging positions, but the proposed thresholds to qualify are high.¹⁶¹ Consequently, while

157. Doering, *supra* note 153.

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.

156 CONG. REC. H5248 (daily ed. June 30, 2010) (letter from Chairmen Lincoln and Dodd entered into the record by Rep. Collin Peterson).

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 *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).

160. *Id.* at 80,186.

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

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.¹⁶² 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.¹⁶³

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.¹⁶⁴ Accordingly, it is fair to

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.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.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.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, 2010.¹⁶⁸ 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.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.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.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

165. See Cheyenne Hopkins, *Carve-Outs Abound in Reform Law*, AM. BANKER, Aug. 10, 2010.

166. See Sackheim et al., *supra* note 1, at 7.

167. Ann Saphir, *Swaps Clearing Wins Converts After Crisis*, REUTERS, Oct. 10, 2010, available at <http://www.reuters.com/article/idUSTRE68R5I220100928>.

168. *Id.*

169. Smith & Lynch, *supra* note 9.

170. See Saphir, *supra* note 167.

171. See *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.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.¹⁷³ Although both parties to the transaction can require the other to post additional collateral, typically end-users do not do this in practice.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.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.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.¹⁷⁷ Alternatively, if nonfinancial companies

172. *Derivative Rules to Increase Commodity Hedging Costs: Study*, FUTURES MAG., Sept. 20, 2010, <http://www.futuresmag.com/News/2010/9/Pages/Derivative-rules-will-increase-commodity-hedging-costs-Study.aspx>.

173. Sackheim et al., *supra* note 1, at 1.

174. *Id.*

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.

176. *See id.* at 18, 19.

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.¹⁷⁸ Finally, as noted above, exchange trading and central clearing reduce dealer profit margins.¹⁷⁹ Dealers will likely shift these increased costs to customers in both the exchange-traded and OTC contexts.¹⁸⁰

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.¹⁸¹ Large banks will feel the greatest impact of new regulation, as they are subject to the most stringent directives of Dodd-Frank.¹⁸² 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.¹⁸³ 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

POTENTIAL IMPACTS UNDER THE WALL STREET TRANSPARENCY AND ACCOUNTABILITY ACT OF 2010, at 2 (Aug. 27, 2010), available at http://www.mayerbrown.com/dodd_frank_act/article.asp?id=9540&nid=13007.

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.