

Changes Afoot For Derivatives Users

New regulations will transform the way companies use forwards, swaps, and other derivatives to manage risk – and increase the cost of doing so too

By Beckie Bown

Summary

Many companies use derivatives to manage their interest rate, market or foreign currency risks. These derivatives are often acquired in over-the-counter (“OTC”) transactions. This means that the company works directly with a bank to enter into a derivatives contract.

Because these transactions are privately negotiated between two parties, it was hard to know just how many derivative contracts had been written on a national or global basis, and whether there were concentrations of derivatives transactions with certain banks or hedge funds.

In the past few years, the U.S. and other jurisdictions have passed new laws to add transparency to OTC derivatives arrangements. These regulations primarily affect the banks that write derivatives contracts, but there are also some important implications for companies that use them to manage risk. Read on to learn more.

New regulation

Historically, the OTC derivatives market has been largely unregulated. It also has been criticized for being secretive and opaque, as well as for lacking competition – five big banks are thought to be responsible for over 90% of all OTC derivative trades.

As a consequence, there have been efforts to increase the regulation of derivatives both in the U.S. and worldwide, including the issuance of the Dodd Frank Wall Street Reform and Consumer Protection Act. The Dodd Frank Act provided a framework for derivatives regulation in the U.S., but left most of the responsibility for writing the detailed rules to the Commodity Futures and Trading Commission (“CFTC”).

The CFTC has recently released a spate of regulations governing the OTC derivatives markets; in fact, the Commission has issued 56 final rules and 13 final orders under the Dodd Frank Act so far.

In response, the CFTC has promulgated a series of new regulations, some of which are either already in effect or will affect companies shortly. The objective of these new rules is to increase



market stability and competition by bringing the majority of transactions onto regulated exchanges and providing pricing information to end users.

The rules are complex and wide ranging but, at a high-level, require that:

- Many types of derivatives trades be cleared through a derivatives clearing organization and/or carried out on exchanges, known as Swap Execution Facilities (“SEFs”).
- Post-trade data be reported to a central data repository and made available to the market.

In sum, the CFTC’s new rules don’t outright ban OTC trades, but they do make it more difficult and costly for companies to enter into them.

Similar proposals have also been introduced by the European Commission. The CFTC is also in the process of introducing further regulations to capture cross-border trading.

Impact on end-user companies

While these reforms will certainly impact large financial institutions, there are some important considerations for end-users of derivatives as well.

Although it was predominately credit derivatives which were viewed as being responsible for the financial crisis, most derivatives will now fall under the new CFTC regulations.

Compliance requirements

Companies will need to assess whether they use derivatives that fall within the scope of the new regulations. Certain derivatives, such as foreign currency exchange contracts have been excluded from many of the new CFTC rules. But other common derivatives, such as interest rate swaps and even some internal (inter-affiliate) swaps, are covered by the CFTC regulations.

Even if a company uses derivatives that are in scope, there are some exceptions which aim to reduce the burden on end-user companies. For instance, end-users are not required to use exchanges to acquire derivatives if:

- i) They are not financial entities,
- ii) They are using a swap to hedge or mitigate commercial risk and
- iii) They notify the CFTC of how they generally meet the financial obligations associated with entering into non-cleared swaps

In regards to the last requirement, the CFTC will require companies to provide certain disclosures on an annual basis. Additionally, SEC registrants will be obliged to obtain annual, documented approval by their boards or applicable committees to enter into non-cleared derivatives transactions (i.e., OTC contracts).

We note that many companies use central treasury entities to pool exposures and hedge risks. Somewhat surprisingly, these entities may not be eligible for the end-user exemption. While there may be other forms of potential relief available to central treasury entities, they apply on a rule-by-rule basis and it can be complex to determine which exceptions may or may not apply. For more details, we recommend this [comprehensive article](#) published by EY.

Reporting requirements

The CFTC rules require certain information on derivative transactions be reported to a Swap Data Repository. Much of that information ultimately will become publicly available.

In many cases, the data will be provided by the swap dealer or SEF. However, this may not be the case for all transactions. For example, cross-border transactions, transactions between end-users, or even certain transactions between affiliate entities (e.g., subsidiary “obtains” an interest rate swap from the parent company’s treasury center) must be reported by the end-user company. Thus, end-users need to be aware of the reporting requirements and determine, as applicable, which party is responsible for providing the data.

The regulations also require that companies remain responsible for appropriately recording transactions and that documentation is kept for minimum time periods.

Accounting consequences

It is expected that some existing derivative contracts may be novated from OTC transactions to exchange-based contracts. If companies have applied hedge accounting to these transactions, then they should consider whether there is any accounting impact of the change in counterparty.

Fortunately, the SEC has issued a letter indicating that in many cases, hedge accounting will not be impacted following a novation. However companies will need to consider the detailed SEC guidance to ensure that there is no impact. In any event, companies will need to consider whether their hedge documentation needs to be updated following a novation.

There may also be other accounting consequences. For instance, companies may not be able to claim a right of set-off if they centrally-clear more derivative transactions. This could result in a gross up of derivative activities on the financial statements.

Contract changes

The regulations will impose many new conditions on swap dealers and SEFs. Therefore, end-users can expect significant changes to the terms and conditions of the derivatives agreements with those parties.

Transaction costs

One aim of the CFTC regulations was to reduce transaction costs through increasing competition and transparency. However, swap dealers will incur additional costs from collecting and reporting data and utilizing central clearing organizations. Undoubtedly, these costs will be passed onto the end-users of derivative contracts.

Furthermore, end-user companies will likely see higher costs of performing uncleared, OTC trades (when they qualify to do so) due to higher collateral requirements and premiums for “customizability”, versus trades conducted through a SEF.



Many of the regulations issued by the CFTC are now final and in effect (or will be coming into effect soon). Companies are encouraged to assess their compliance and reporting responsibilities under these new rules and to quickly gain an understanding of wider business and accounting concerns. Mind the GAAP stands ready to help in performing these assessments – please contact one of our representatives for more information.