

**Impacts of Financial Regulatory Reform - Hedging**  
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**FEI Summary**

While many of the provisions of the Dodd-Frank Act (HR 4173) will not take effect immediately, companies should be preparing now to understand potential impacts from the legislation. In general, the derivatives section of the legislation requires 100 percent of over-the-counter derivatives transactions to be reported to a central data repository, and with some exceptions, requires most transactions to be centrally cleared and/or executed on an exchange. Additional capital and margin requirements will be prescribed for most transactions.

Many companies will find that hedging business risks such as interest rates, commodities, and foreign exchange using derivatives may change as a result of passage of this legislation. The derivatives title of the bill will not take effect until July 2011. In the meantime, several federal entities including the Commodity Futures Trading Commission (CFTC), the Securities Exchange Commission (SEC) and the US Treasury will soon begin writing the detailed rules, which will govern the implementation of this new law. The following are some potential impacts of the legislation on corporate hedging practices.

**Available Swap Counterparties May Change Depending Upon Type of Derivative**

Banks can continue to serve as counterparties to over-the-counter derivatives hedges if they are related to interest rates, foreign exchange, centrally cleared credit default swaps, or gold and silver swaps. Banks can also continue to enter into derivatives contracts designed to hedge their own risk.

However, banks must spin off commodity, agriculture and energy swaps business into a separately capitalized affiliate. Uncleared credit default swaps must also be traded in the affiliate entity. Companies entering into these types of contracts may see changes in the number and names of the bank counterparties available.

**Margin and Collateral Requirements Left Up to Regulators**

There is some uncertainty in the law related to the ability for regulator to impose margin directly on corporate end-users. Thankfully, members of Congress have made it clear in letters and floor discussion that they did not intend to raise hedging costs for corporates. However, regulators, and possibly the courts will have the ultimate say on whether or not margin is charged directly or indirectly on end-user transactions.

Certainly, swap dealers will face higher capital requirements and margin requirements in their derivatives transactions, which could ultimately be passed on

to corporate end-users. The bill mandates, however, that capital and margin requirements for non-cleared trades be tied to actual risk of loss, and tied to ensuring 'safety and soundness' of the counterparties involved. Regulators are also required to permit the use of non-cash collateral.

### **Non-Financial Entities Have to Report, but not Centrally Clear Transactions**

Non-financial companies which enter into a derivatives contract for hedging or mitigating commercial risk are exempted from the central clearing requirement, but all transactions must be reported to a central data repository. However, companies must first get approval from their appropriate committee on their corporate board, and then must notify the CFTC of their ability to meet their financial obligations before the exemption will be allowed. Captive finance entities of non-financial companies will also enjoy the exemption, even though stand-alone financial entities will not.

### **It's Unclear If Existing Transactions Will Be Affected**

The retroactivity of the legislation is not clear and it will be left up to regulators to decide if any of the new margin requirements will be retroactively applied to outstanding contracts. However, the CFTC has stated that they do not believe the bill gives them the authority to apply the regulations retroactively.

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