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Calm Before the Regulatory Reform

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Dodd-Frank: What Does it Really Do?

Sean Cota, President, Cota & Cota Inc

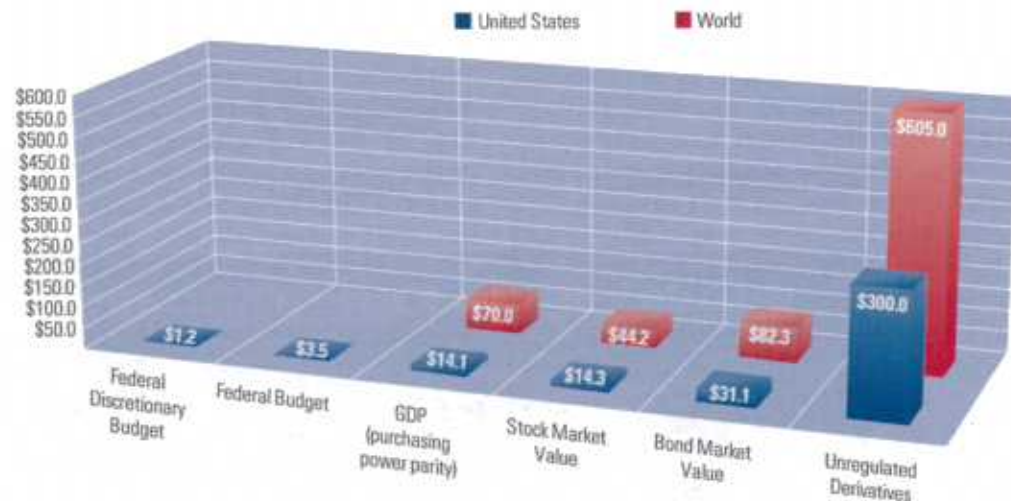
The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L.111-203) and its 16 Titles of law, touch on nearly every aspect of banking, investment, and consumer credit protection. Energy regulation is generally impacted under the derivatives title which regulates over-the-counter (OTC) trading rules.

Derivatives: Why Do We Care?

Willie Sutton, the famous depression era bank robber, when asked why he robbed banks said, "That's where the money is." Derivatives make up the vast majority of the financials. The 2009 US federal discretionary budget is approximately \$1.2 trillion dollars, the total budget is \$3.5 trillion, total US GDP is \$14 trillion, and world GDP is \$70 trillion. The scale of derivatives dwarfs

these numbers. The total worldwide stock market capital value is \$44 trillion and the world bond market is \$82 trillion, but in 2009 the unregulated "Dark Market" of derivatives was \$605 trillion, where the US portion was \$300 trillion (Figure 1). These derivative markets were opaque, and highly leveraged at an average leverage rate of 35 to 1. In some of these markets, like currency trading, it is common to have 200 times leverage. In energy trading, these derivatives allowed infinite leverage. For example, you, as a small business, go down to your local bank loan officer, explain that you are pretty good in Vegas, you've got \$1,000 dollars, and ask if they will front you \$200,000, and the loan officer agrees. Furthermore, you take that loan and begin a cycle of buying and selling a

1. 2009 world financial perspective.



Note: 2009 figures adjusted to US dollars. All figures in trillions. GDP is from CIA World Book. Derivatives are from the Bank of International Settlements and is their educated guess as the market is unregulated.

Source: Sean Cota

commodity that contributes to the run-up in pricing of the commodity. The impact of large, leveraged, deals trading in Dark Markets created most of the bubble that resulted in the economic collapse at the end of 2008.

The 2005 Commodity Market Takeover

Although derivatives have been around for decades, they made a significant impact in 2005 when financial speculation in energy trading began to increase. The classic economic principle of "supply and demand" became less important to the pricing in energy markets. Today's energy markets have often seen huge amounts of demand destruction, inventory builds and excess capacity builds, without significant impacts on price. Enron was one of the first large players in energy derivatives, but the trading patterns that began in 2005, and remain with us today, pale by comparison. Today, commodity markets are valued more by the flows of capital into these markets where many large, passive investors believe that they are diversifying their investments into a new "asset class." In reality, they are distorting the traditional markets by artificially raising price contango over the outer months, while not realizing that these contango value charges are coming out of their rates of return.

What Does Dodd-Frank Do in Derivatives?

Exchange Trading and Clearing

The first significant changes are in exchange trading and clearing. In the world of OTC derivatives, there is no systemic risk guarantor except sometimes the US taxpayer. The first clue that a party to a bilateral derivative is going to go bad, is when they go bad. There are no ratings, no guaranteeing parties, and due to the standard ISDA contract, few if any remedies. With the new Dodd-Frank requirements, the vast majority of OTC derivatives will need to be exchange traded and exchange cleared. If one of the two parties in an exchange traded contract defaults, the exchange functions as the guarantor. If a market becomes too volatile, or the underlying

commodity becomes too risky, margin for the contract parties is increased to cover the additional risk. If these margins are not enough to cover the defaults, the clearing members of the exchange also function as guarantors.

Trading on exchanges creates a transparent trading venue, and a "mark-to-market" valuation. Many traditional OTC market derivatives were not valued on company's balance sheets. Derivatives, much like a lease, show up on income statements as either income or expense. The true asset or liability would show up as a footnote on the balance sheet with an undetermined value. In this way many companies were able to move profits or losses to different financial periods without penalty to their financial ratios. Depending on how the Financial Accounting Standards Board (FASB) interprets the new law, the "mark to market" function of exchange trading may provide real value to financial statements.

Leverage and margin requirements are crucial functions of exchanges. For those buying US equities on margin, leverage was limited to 2 times or 50% of the stock value. The traditional margin requirements of commodities is 5% or 20 times leverage and another speculative "carrying" margin of generally 5% if held the next month. In addition, if the market moves against your position, you will need to post additional margin for the exchange to handle the increased risk of the exchange to your contract. This will have positive effects. First, volatility will decrease over time, and market trading ranges will give a clearer signal to producers and buyers of commodities, so they can rely on supply and demand again to make their long term capital planning in a more predictable way. Second, large "out of the money" bets which have a tendency to pull the market in their direction, will need to spend more capital to make these trades.

Transparency: Dark Markets Will See the Light of Day

While the Dodd-Frank law allows for existing grandfathered derivatives to continue until maturity, they will, for the first time, be recorded. This report-

ing requirement will extend to non-cleared and traded contracts, including "end user" exempted transactions, and overnight held positions where the detailed trading data tracked by CFTC were reported daily. Under the new law, most transaction types, amounts and parties, will be reported with new information feeds.

Aggregate Position Limits

The CFTC had authority before the Dodd-Frank law to impose aggregate position limits, but under the new law they will be required. An example of the problem of a lack of transparency and position limits was the trading of the now defunct Amaranth Advisors that drove their position at one point in 2006 natural gas contracts to 80% of all US natural gas production. Therefore, aggregate limits are particularly important in finite commodities like food and energy where the physical market can be overwhelmed by financial trades. Aggregate limits will also impact many of the commodity index funds, as their trading volumes are huge, and their speculative trading caused much of the artificial contango in recent years.

What Dodd-Frank Fin-Reg Won't Do Overseas Trading Venues

Of the US OTC derivative market volume, 50% to 70% of the trading will be touched by the new law. Foreign venues for trading like London, Dubai, and Singapore are not covered, and will be largely able to do what they have traditionally done. However, overseas governments are now drafting laws to follow on the lead of the US. The United Kingdom is scaling down and perhaps eliminating the FSA and returning financial regulation to the Bank of England. The French and German governments are considering creating a European Union institution like the CFTC with our new model as a base.

End Users Exemption

Traditional physical players in the US commodity markets will be exempted, except for reporting. While this will save many players the margin cost that they may have otherwise needed to provide, if these participants do not use

exchange clearing they will not be protected if a trade goes bad. If your counterparty in an OTC derivative was Bear Stearns at the time of its collapse, your swap contract would have gone bad with little timely recourse.

Short and Long Term Impacts

CFTC Rulemaking: Who's on First?

The Dodd-Frank law gives the CFTC approximately one year to write the administrative rules. Energy is first in the pecking order. By March 2011, energy regulations should be written and implementation begun. If the unregulated trading markets are captured in the way Congress intends, there should be greatly reduced volatility. If the limits on leverage reduces the speculative longs, we could see a decline in the markets. In the following 180 day period, the CFTC will focus on agriculture products, and lastly, the pure financial instruments like interest rate swaps.

Deleveraging of Markets

A not often reported point is the impact of moving to exchanges as a mechanism for deleveraging. As these swaps move to exchanges there is no way to avoid the deleveraging. This will cause downward pressure on commodity markets, and for the consuming parts of these markets, a resurgence of demand.

Truth in Financial Reporting and a World With Reduced Leverage

As derivatives emerge on balance sheets of public companies in the next year, financial ratios will change. In the case of companies that have used derivatives to move profits and losses from one year to another, those acts will become transparent. This will generate regained trust, and the large amounts of cash sitting on the sidelines, or in commodities, will be reapplied to the better disclosed companies, and our economy will begin a real stock market recovery.

The gambling that has occurred in our markets is nothing new, and not always bad. The industries that rely on these markets will, for the first time in many years, be able to play at an honest gambling table. This is good for physical markets, and it will be the beginning of a sustained and resurgent recovery. ■