

# Dodd-Frank Financial Reform:

## Impact on the Commodity Derivatives Brokerage Industry

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# Find Out About....

- New requirements for swap transactions,
- Brokers and swap execution facilities (SEF),
- Costs and challenges of creating and operating a SEF,
- Estimated timeline for new clearing and execution requirements,
- What will become of non-SEF voice brokerages after Dodd-Frank.



# Speakers

- Lou Pellathy, Co-Founder, VP Brokerage
- Sara Lesch, JD, Counsel
- Brad Flaster, VP Operations

**About Parity Energy:** OTC Markets Modernized - Parity Energy (Parity) matches institutional buyers and sellers of energy and precious metals options. Unique in its category, Parity delivers the combined benefits of electronic trading and high-quality voice service through the Parity Energy Platform (PEP). PEP is Parity's award-winning electronic trader-to-trader marketplace for off-exchange cleared options. PEP combines an electronic order book, request for quote (RFQ) capability, system connectivity and full support from Parity's own voice brokerage. Parity operates as an exempt commercial market and expects to transition to a swap execution facility. Learn more at [www.parityenergy.com](http://www.parityenergy.com).



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# Dodd Frank Act = Big Changes for OTC Brokers

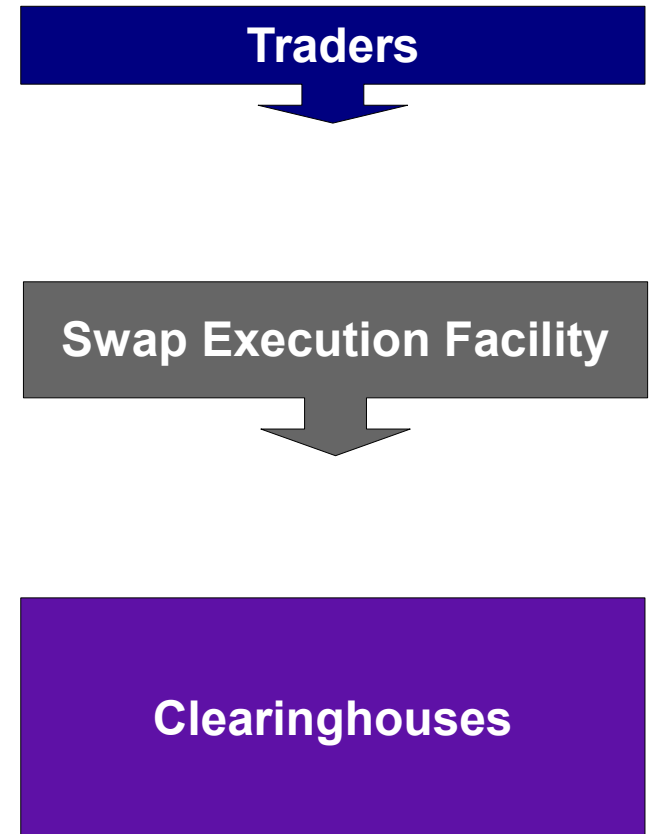
- No more “Business as usual”
- Profound impact on the market structure and economics of OTC derivatives trading
- Role of voice brokerage to be significantly limited



# Why Dodd-Frank Matters

For most swap trading, the Dodd-Frank Act will establish:

- 1) Mandatory clearing
- 2) Mandatory execution on regulated marketplaces  
(Swap Execution Facility- **SEF** - or Designated Contract Market - **DCM**)
- 3) Mandatory reporting



# What is a SEF?

The Dodd Frank Act defines a SEF as:

A trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that -

(A) facilitates the execution of swaps between persons; and

(B) is not a designated contract market



# Execution on a SEF (Per Current CFTC Draft Rule)

- Order Book
  - Permits multiple market participants to trade by accepting bids and offers made by other multiple participants, and -
- Optional RFQ
  - Requests must go out to no fewer than five market participants



# The 15 Second Rule

According to the CFTC's proposed SEF rule:

*“Swap execution facilities must require that traders who have the ability to execute against a customer’s order or to execute against a customer’s order or to execute two customers against each other be subject to a 15 second timing delay between the entry of those two orders, such that one side of the potential transaction is disclosed and made available to the other market participants before the second side of the potential transaction (whether for the trader’s own account or for a second customer), is submitted for execution.”*



# Exceptions to the Rule

Under the DFA and enabling regulations, a swap transaction will NOT need to be executed on a SEF under the following circumstances:

- If the swap is not required to be cleared;
- If a swap is not made available for trading on a SEF or DCM;
- If a swap trade qualifies as a block trade;
- If the End-User Exception applies to the trade.



# The End User Exception

To qualify for the End User Exception, a swap trade must satisfy three requirements:

- First: at least one of the parties to the swap must not be a financial entity;
- Second: the non-financial entity must be using the swap transaction to hedge or mitigate financial risk;
- Third: the non-financial entity must notify the CFTC as to how generally it meets the financial obligations associated with entering into non-cleared swaps.



# Projected Timeline for DFA

## Clearing & Execution Requirements:

- The following time line is a rough estimate drawn from regulator projections as well as deadlines listed in the DFA and in finalized and proposed regulations.
- If the CFTC issues relevant final rules by April 2012, and if no further extensions are granted, the DFA clearing and execution requirements might phase in as follows:
  - April 2012: CFTC publishes final rules relating to SEFs and other entities; end user exemptions and capital and margin requirements;
  - October 2012: First SEF applications are submitted to the CFTC;
  - Fall 2012: First SEF applications provisionally approved by the CFTC;
  - Early 2013: CFTC approves first SEF determinations of swaps available to trade and finds some swaps currently cleared to be required to be cleared;
  - April 2013: Phase in of the first clearing and execution requirements begins for Category 1 entities, including major swap participants and swap dealers.
  - July 2013: Phase in of clearing and execution requirements for Category 2 entities, including commodity pools, employee benefit funds and entities predominately engaged in the business of banking;
  - October 2013: All entities not eligible for and opting to use the end user exemption must comply with DFA clearing and execution requirements.



# What does it take to become a SEF?

Under the CFTC's proposed SEF rule, among other things, a SEF must:

Register with the CFTC by filing a Form SEF and attaching documentation that details, among other things:

- The SEF's business organization;
- The SEF's financial resources;
- The SEF's compliance program;
- The SEF's technological and operational capabilities; and
- How the SEF will comply with the 15 core SEF principles.



# Costs & Financial Impacts of Becoming a SEF

Major Operational Costs can be Separated into  
Three Basic Categories:

- 1) Technology
- 2) Compliance
- 3) Capital Requirements



# Costs & Financial Impacts of Becoming a SEF

## Technology

- Development or Licensing of Trading Software
- Deployment of an Electronic Monitoring System
- Connections to Clearing Houses
- Connections to Swap Data Repositories
  - Real-time Reporting Requirements
- Fully Redundant Hardware and Disaster Recovery Processes



# Costs & Financial Impacts of Becoming a SEF

## Compliance

- Legal Resources
  - Creation and Maintenance of Rulebooks, Client Documentation, Full Compliance Program
- Staffing
  - Chief Compliance Officer (mandatory)
  - Monitoring and Enforcement Staff
- Outsourcing Compliance Burden is an Option but Still Very Costly



# Costs & Financial Impacts of Becoming a SEF

## Capital Requirements

- Maintenance of “adequate” financial resources to support operating costs of the SEF for at least twelve (12) months, on a rolling basis
- At least six (6) months of the “adequate” financial resources must also be in unencumbered, liquid financial assets



# Costs & Financial Impacts of Becoming a SEF

## Dollars and Cents

- Estimated SEF establishment costs = \$7.4million\*
- Estimated SEF operation costs = \$12 million/year\*
- Capital requirements = \$12 million (must be equal to 12 months of operational costs)

*\*(ISDA, "Costs and Benefits of Mandatory Electronic Execution Requirements for Interest Rate Products Dealers", Nov. 2011)*



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# Example of SEF Technology: Parity Energy Platform (PEP)

- Designed for institutional option traders: minimum size, RFQ, multi-leg strategies – live, firm prices
- 165+ customers (E&P, refiners, utilities, banks, hedge funds, locals)
- Clearinghouse-neutral: CME ClearPort or ICE Clear
- Automated quoting via FIX API, Excel, certified vendors
- Robust & Scalable: 12,000 transactions, 1 million contracts

***Here's where YOU come in:***  
**Embedded broker support**

Quotes   Logs   System   My Account   Help   New!   Logout									
Instrument	Delta	Bid			Offer			Last	
		Size	Ind.	Price	Price	Ind.	Size		
+Put +Call More ▾ <input type="checkbox"/> <input type="checkbox"/> NG LAL - European Option									
G12 2.25 Put Live	-0.01	50	-	0.0010	0.0040	0.0120	50		
G12 2.50 Put Live	-0.10	50	0.0070	0.0150	0.0190	0.0270	50		
G12 2.70 Put Live	-0.34	50	0.0510	0.0580	0.0640	0.0760	50		
G12 2.75 Put Live	-0.42	50	0.0710	0.0780	0.0840	0.0960	50		
G12 2.80 Put Live	-0.50	50	0.0960	0.1030	0.1090	0.1210	50		
G12 2.75 Call Live	0.58	50	0.0990	0.1090	0.1160	0.1240	50		
G12 2.80 Call Live	0.50	50	0.0740	0.0830	0.0890	0.0990	50		
G12 3.00 Call Live	0.20	50	0.0140	0.0220	0.0270	0.0340	50	(H) 0.0180 (13:21) ▾	
G12 3.25 Call Live	0.03	50	-	0.0020	0.0050	0.0140	50		
G12 3.50 Call Live	0.01		-	---	0.0020	0.0110	50		
G12 2.75/2.50 Put Spread vs 2.82 29d	-0.31		0.0450	---	---	0.0650		(B) 0.0550 (09:47) ▾	
H12 2.75 Put vs 2.84 38d	-0.39		0.1190	---	---	0.1440		(B) 0.1300 (09:20) ▾	
H12 3.00/3.50 Call Spread Live	0.30	100	0.0630	0.0740	0.0840	0.0930	100		
J12 3.00/3.50 Call Spread Live	0.31	100	0.1060	0.1210	0.1310	0.1410	100	(L) 0.1220 (14:19) ▾	
N12 3.25 Call vs 3.12 48d	0.46		0.2510	---	---	0.2810		(B) 0.2600 (08:06) ▾	
Q12 2.00 Put Live	-0.05	250	0.0175	0.0270	0.0360	0.0475	250		
Q12 2.50 Put Live	-0.16	250	0.0975	0.1080	0.1200	0.1275	250		
U12 3.50 Put Live	-0.57		0.6170	---	---	0.6520		(H) 0.6375 (12:17) ▾	
U12 3.00/3.50 Call Spread Live	0.19	100	0.1775	0.1910	0.1990	0.2075	100	(L) 0.1920 (11:40) ▾	
V12 2.50 Put vs 3.17 18d	-0.16		0.1300	---	---	0.1600		(L) 0.1425 (08:55) ▾	
V12 3.50 Put Live	-0.52		0.6175	---	---	0.6525		(H) 0.6400 (12:11) ▾	
V12 5.00 Call vs 3.10 9d	0.08	50	0.0190	0.0325	0.0390	0.0490	50		
V12 5.50 Call vs 3.12 3d	0.04	50	0.0090	0.0180	---	0.0390			
V12 3.00/3.50 Call Spread Live	0.17	100	0.1920	0.2025	0.2125	0.2220	100	(L) 0.2075 (11:31) ▾	



# Don't Want to Become a SEF? Our Plan for OTC Brokers...

- Use PEP to place customer orders
- Maintain your revenue stream
- Lower compliance costs & headaches
- Reduce back-office burden

- Gain access to existing liquidity on PEP
- Submit RFQs
- Cross trades (15-sec rule)
- Block large trades
- No cost to access

**USE PEP AS YOUR SEF SOLUTION !**



# Contact Info & Sources

- Web Sources
  - Search keywords: “CFTC SEF Rules”
  - <http://www.cftc.gov/>

- Questions?

- Reach out:

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