



Dodd-Frank And The Impact On Internal Audit

The Path Forward For Energy Companies

The Institute Of Internal Auditors – Houston Chapter

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Paul is a leader in Deloitte's Energy Risk practice, providing services to the energy industry and the federal government. With more than 20 years of experience, he also leads specialists from a group of approximately 200 professionals solely dedicated to providing services related to risk strategy, regulatory compliance, credit, climate change, quantitative analytics, technology, business process and operations and risk accounting to energy companies.

Paul has worked with some of the largest companies in North America on transformation efforts related to the underlying infrastructure, systems, processes and technologies for new organizations as well mature organizations focused on significantly changing operations with thorough programs of change or responding to regulatory directives. This includes helping to design, develop, select and implement energy trading and risk management systems, as well as those to support compliance with derivative accounting guidance. This includes leading all energy related efforts for regulatory compliance and Dodd-Frank.

He has led numerous risk assessments of front, middle and back office operations and worked extensively on risk management issues related to new business strategies; including the resulting process, technology and accounting change implementations. These assessments have often then led to the development of a program of activities related improvements in the risk and trading processes.

His client service work also includes developing of end user energy management strategies, due diligence analyses, bankruptcy work, and significant litigation support efforts regarding portfolio valuation, internal investigations and support to external counsel in trading and risk management matters. Paul also has significant experience speaking and providing training to both internal and external audiences. Prior to joining Deloitte, Paul worked for 4 years as a regulatory economist for the Maryland Public Service Commission and then worked for several energy trading companies moving to Houston.

- BS, Physics – The George Washington University
- BA, Political Communications – The George Washington University

Overview of Dodd-Frank Act Title VII

Glossary of terms and acronyms

API	Application Programming Interface	LTR	Large Trader Reporting
BCS	Business Conduct Standards	MSP	Major Swap Participant
CFR	Code of Federal Regulations	NFA	National Futures Association
CFTC	Commodity Futures Trading Commission	Nons	Non SD / Non MSP
CPO	Commodity Pool Operators	OTC	Over the Counter
CRFC	Core Reference Futures Contract	PLR	Position Limits Reporting
DRR	Data, Recordkeeping and Reporting	RTO	Regional Transmission Organization
DCM	Designated Contract Market	RTR	Real Time Reporting
DCO	Derivative Clearing Organization	SD	Swap Dealer
ECP	Eligible Contract Participant	SDR	Swap Data Repository
ETRM	Energy Trading Risk Management	SEF	Swap Execution Facility
FAS	Financial Accounting Standard	SPV	Special Purpose Vehicle
FTR	Financial Transmission Rights	UCI	Unique Counterparty Identifier
ISO	Independent System Operator	UPI	Universal Product Identifier
LEI	Legal Entity Identifier	USI	Unique Swap Identifier

Dodd-Frank Act¹: Background and perspective

Systemic Risk
in Financial
Markets
associated
with
derivatives
trading

Dodd-Frank Act

Title VII includes key provisions for the energy industry with clear consideration of the Commodity Futures Modernization Act of 2000 that exempt many over-the-counter energy trades from federal regulation.

1. Legislative Phase

- Act signed into law July 2010
- Many rule making responsibilities delegated to the SEC and the CFTC
- Law passed as response to concerns over inadequate oversight of financial and commodity markets

2. Regulatory Phase

- CFTC aimed for Dec 2011 for final rules (numerous delays have occurred)
- 30+ rule making processes initiated
- Rule making activities address new market structures and functions, changing definitions, new processes and more oversight
- Ongoing advocacy process

3. Commercial Phase

- Dealing with uncertainty over final rules and implementation timelines
- Evaluating readiness to handle proposed rules
- Evaluating financial impacts related to credit and collateral as well as potential capital investment needs
- Implementing changes to people, processes, technology, and governance

Controls

CFTC (Commodity Futures Trading Commission)

Swap Data Repositories, Swap Execution Facilities
Major Swap Participants, Swap Dealers, End Users

Reporting requirements (execution and record keeping)

Compliance (Chief Compliance Officer)

Transparency

Portfolio valuations and reconciliations

Push from OTC to Derivative Clearing Organizations

From un-cleared to cleared transactions

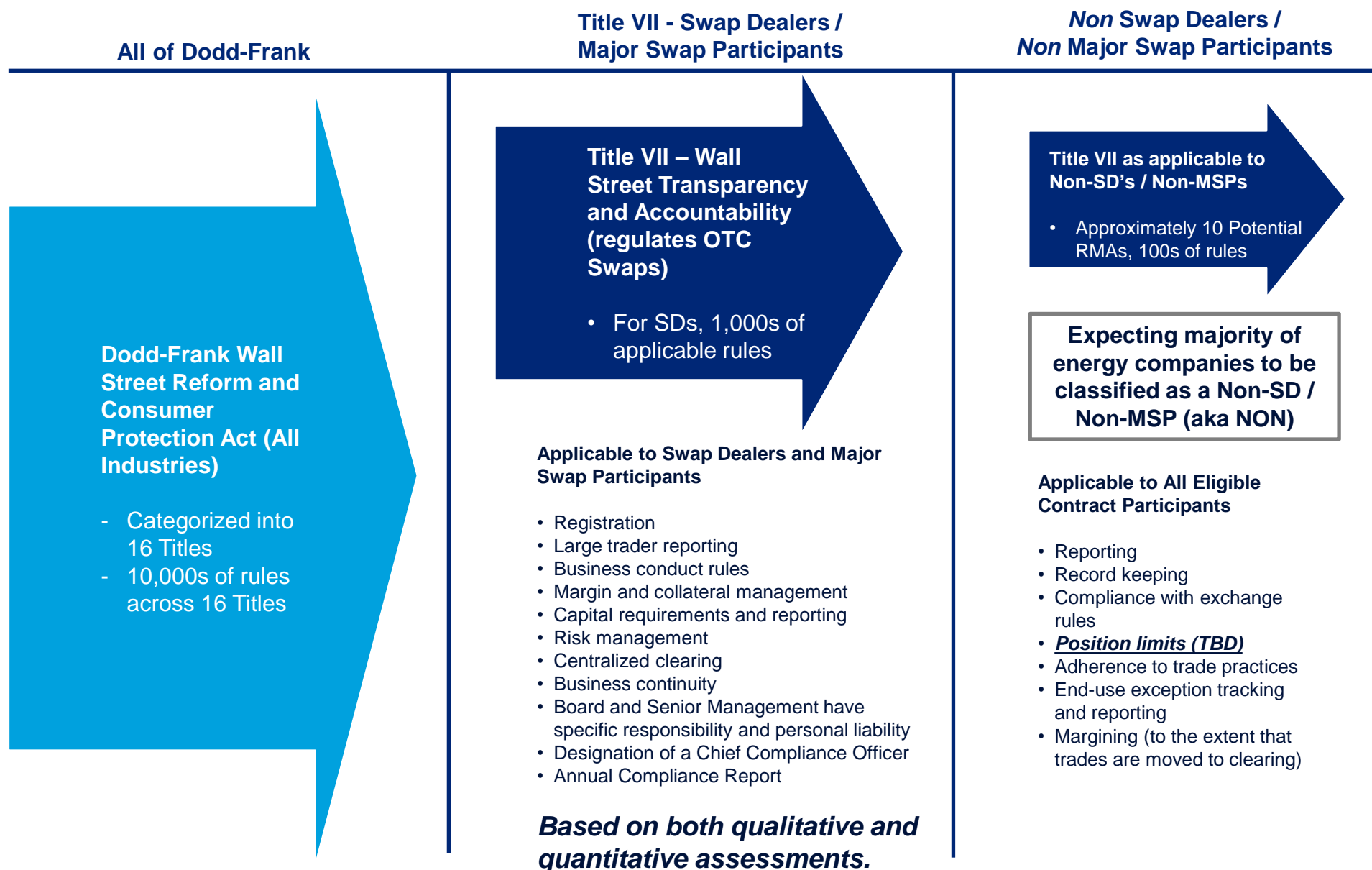
Counterparty Risk
Management

Position limits (TBD)

Capital requirements

¹ <http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm>

Energy industry and Non-SD application



Important points for energy companies

- The CFTC is working to finalize the rule-writing across the more than 30 different rule categories and is implementing a process balancing market disruption, cost and desired compliance status. The rules are generally comprehensive in nature across all commodities, IR and FX.
- Final rules yet to be published include:
 1. Margin and clearing requirements, including risk capital for Swap Dealers and MSP
 2. Position limits – unclear on regulatory path following Sep 22
- The CFTC has finalized most rules for compliance so the time to comply may vary depending on the category of company or asset. A staged approach is underway, in which effective dates for compliance vary by rule and become known as final rules are published. Current compliance timelines have ranged from 30 to 270 days.
- Most companies in the energy industry would describe themselves as having an internal group “maintaining awareness” of the rules, but often struggling with governance issues and how to plan or commit resources in the face of regulatory uncertainty
- **Most companies have not addressed Sec. 1502 or 1504 as part of integrated planning.**
- **There are significant compliance requirements for almost any entity using swaps.**
- **There are specific concerns related to “special entities”.**
- **There is some chance for further delays or altering of regulations, but a clear desire by regulators to finalize rules quickly.**
- **Further uncertainty is likely.**

Beyond Title VII - Other non-swap related provisions (Title XV) ¹

Conflict Minerals Provision (Sec. 1502)

- Finalized on August 22, 2012
- Companies that use conflict minerals from the Democratic Republic of the Congo and adjoining countries (“DRC”) that are “necessary to the functionality or production of a product manufactured by such person” must disclose annually public on their website, file a conflict mineral report to the SEC and annual report.
- The report will include description of measures of due diligence on the minerals source and chain of custody. Even if the minerals did not originate in the DRC the company would be required to maintain all documentation and issue the report.
- The SEC requires this report go through an independent private sector audit.
- The SEC realizes that there is some ambiguity as to whom the conflict mineral provision applies to. This would include many companies that do not have to report today.
- The SEC proposed rule would make amendments to Form 10-K, Form 20-F, and Form 40-F to add this information.
- Issuers must comply with the final rule for the calendar year beginning January 1, 2013 with the first reports due May 31, 2014

Mine Safety (Sec. 1503)

- Finalized on December 21, 2011
- Already in effect

¹ <http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm>

Beyond Title VII - Other non-swap related provisions (Title XV) ¹

Disclosure of Payments to Governments by Resource Extraction Issuers (Sec. 1504)

- Finalized on August 22, 2012
- Companies that extract or commercial development related to oil, natural gas, or minerals will need to file an annual report with SEC containing all the payment information to foreign governments at the project level. This report will include:
 - the total amount of payments, by category;
 - the currency used to make the payments;
 - the financial period in which the payments were made;
 - the business segment of the resource extraction issuer that made the payments;
 - the government that received the payments and the country in which the government is located;
and
 - the project of the resource extraction issuer to which the payments relate
- The SEC proposed rule would make amendments to Form 10-K, Form 20-F, and Form 40-F to add this information.
- According to the rules the companies will need to include this information starting with an issuer's annual report relating to any fiscal year beginning on or after September 30, 2013.

¹ <http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm>

Whistleblower Regulations - Section 748¹

The CFTC has issued final rules to provide whistleblower incentives and protection which became effective in September 2010

- Requires CFTC to pay awards to whistleblowers if provided information leads to successful enforcement of CFTC action.
 - Enforcement must produce monetary sanctions >\$1million.
- Certain criteria evaluated to determine issuance of reward:
 - Significance of information.
 - Degree of assistance in support of covered judicial or administrative action.
 - Public policy
- Certain government employees are ineligible to be granted whistleblower rewards

¹ <http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm>

Classification and potential impact on an organization

Classification determines impact on an organization

How would an organization characterize its swap activity*?

e.g., hedging, asset optimization, speculation, potentially volume and intent.

Many of the reporting requirements fall upon the SD/MSP categories including reporting some information on behalf of the non-SD.

A common question: What is our comfort level as an organization relying upon others' records and how do we want to validate this data?

Balance cost/benefit of registering as a Swap Dealer



***Strongly consider the role of external counsel in interpretation of rules.**

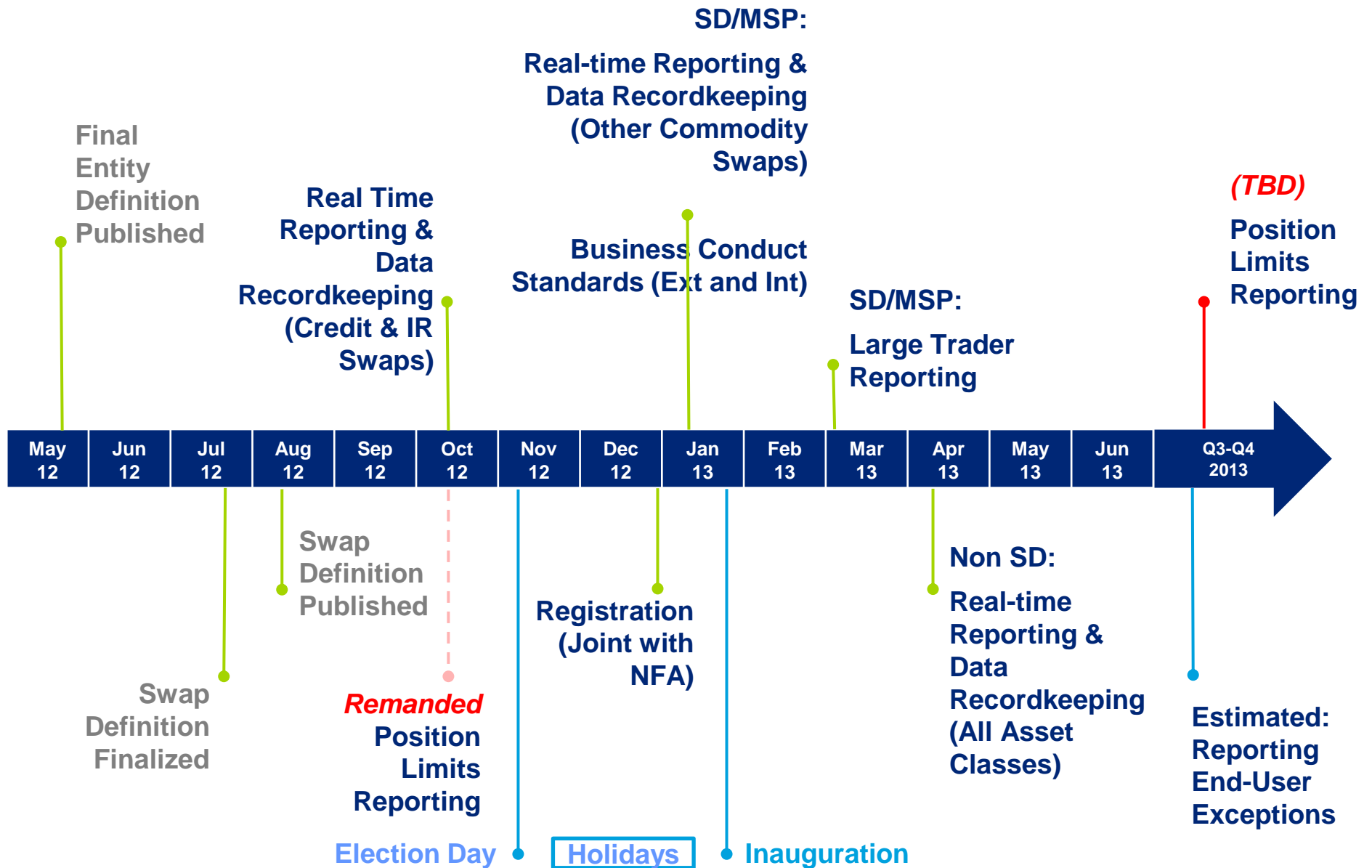
Major requirements, timeline updates and recent changes

Requirements applicable to all energy market participants

Basic Requirements	Details
Reporting and Recordkeeping	<ul style="list-style-type: none"> • Retention and reporting of pre-execution, execution and post execution transaction information including orders, executions, oral and written communications; all indexed to the transaction • Data kept for the entire existence of a swap and five years after the swap's termination or expiration. • Data must be "<i>readily accessible</i>", and records must be retrievable by the recordkeeping counterparty within five business days.
Clearing	<ul style="list-style-type: none"> • All swaps must be cleared with limited exceptions
End-Use Exception To Clearing	<ul style="list-style-type: none"> • Process at time of transaction, with pre and post execution documentation and controls
Compliance with exchange rules	<ul style="list-style-type: none"> • Adherence to margin and collateral requirements for transactions executed on the exchange platforms
Adherence to trade practices	<ul style="list-style-type: none"> • Enhanced anti-manipulation authority requiring stronger self-surveillance along with anti-fraud protection.
<i>Position limits</i>	<ul style="list-style-type: none"> • <i>Monitoring and reporting to be defined at a later date</i>

There is a general misconception by non-financial entities that if “all we are doing is hedging (or asset optimization)” there are little or no compliance obligations. There currently is no broad “end-user exemption” or classification that would be applied.

Illustrative Dodd-Frank regulation timeline

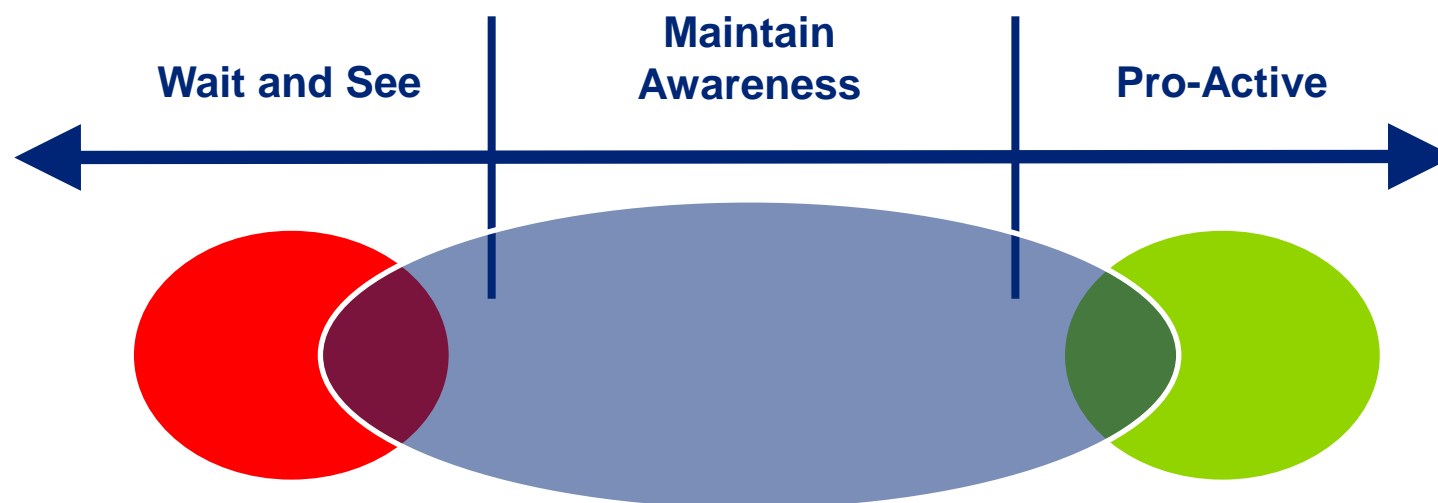


Where the energy industry is struggling

Key challenges summary

1. Scope of the impact across operations
 2. Major uncertainty within regulatory environment
 3. SD vs. non-SD classification (considering future operations and prices)
 4. To clear or not to clear?
 5. Potential hedging & end-user exception violations
 6. Changes to contracts with counterparties, SDR, DCO, etc.
 7. System enhancements
 8. Corporate changes and decision making
 9. Position limit compliance (TBD)
- Technical issues outstanding include
 - Bookouts
 - Notional value calculations
 - Swap definitions

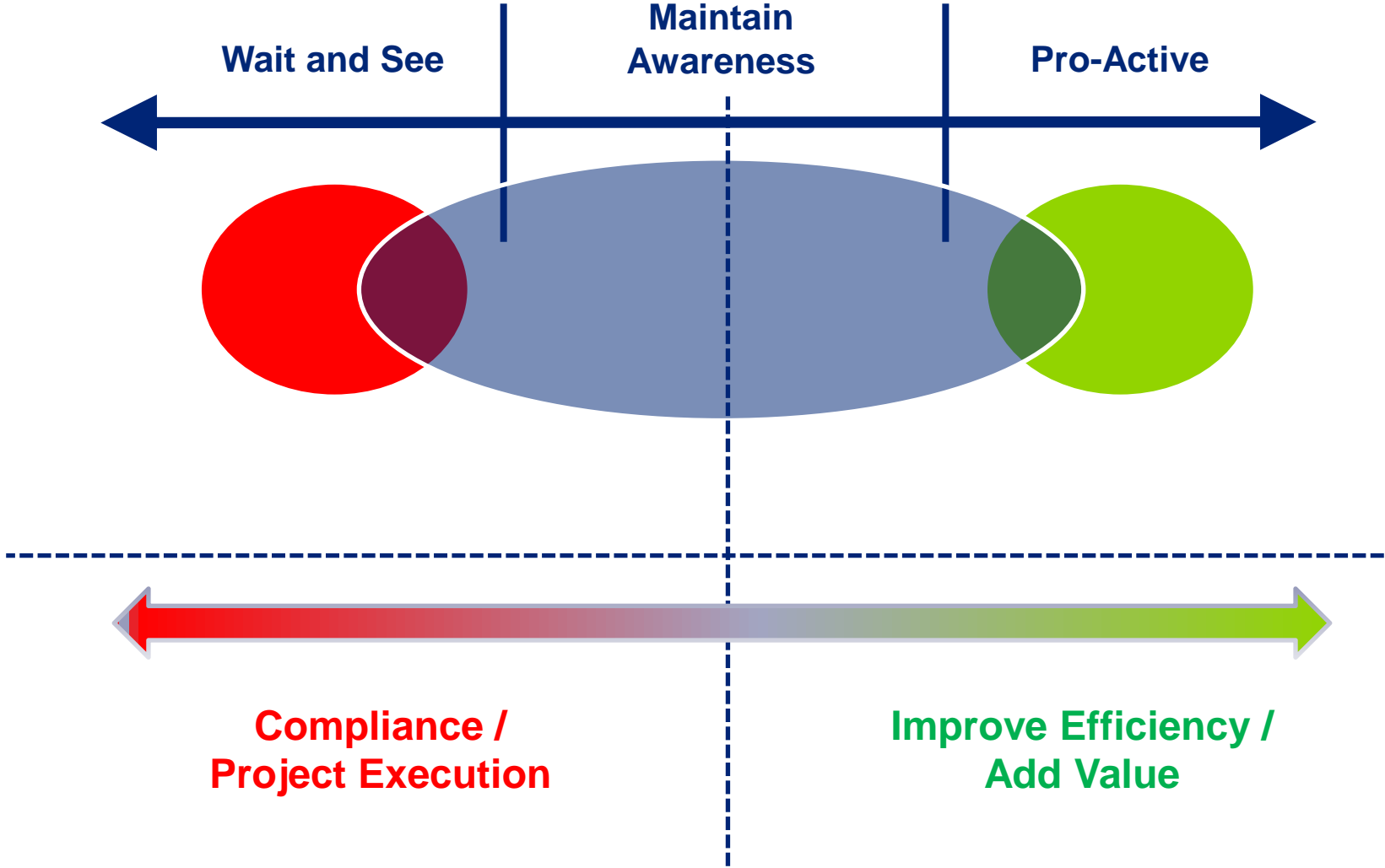
Illustrative spectrum of industry reaction



How to move forward when faced with uncertainty?

1. *Deal with this as you would any other project.*
2. *Act on the known and plan for the unknown – assess the potential impact of change to both.*
3. ***Balance the cost of waiting and higher potential cost if significant external resources are called in at the last minute.***
4. *Always have a plan!*

Illustrative spectrum of IA responsibility



What companies and internal audit should consider doing now

What energy companies should consider doing now

1) Deploying Cross-functional Dodd-Frank Implementation Team

- Engage risk, IT, compliance, accounting
- Engage external counsel
- Deploy a detailed plan, with estimates of resources/budget
- Maintain awareness with Senior Management and Board of Directors

2) Assessing Likelihood of Being an SD/MSP

- Detail all swap transactions
- Confirm ability to identify and aggregate all needed data
- Disaggregate cleared vs. non-cleared and hedges
- Document counterparties and “special entities” dealing
- Conduct rule by rule gap assessment

3) Validating Recordkeeping Capabilities and Preparing for Real-Time and General Reporting Obligations

- Identify process changes across front, middle, and back office
- Ensure all transition swap documentation is being maintained
- Identify reporting counterparty
- Develop the process for data verification and correction
- Develop processes for capturing recordkeeping data elements

4) Evaluating Technology Requirements and Capabilities

- Developing short term reporting solutions
- Identifying immediate and long term changes to ETRM systems
- Understanding and building connectivity with SEF/SDR

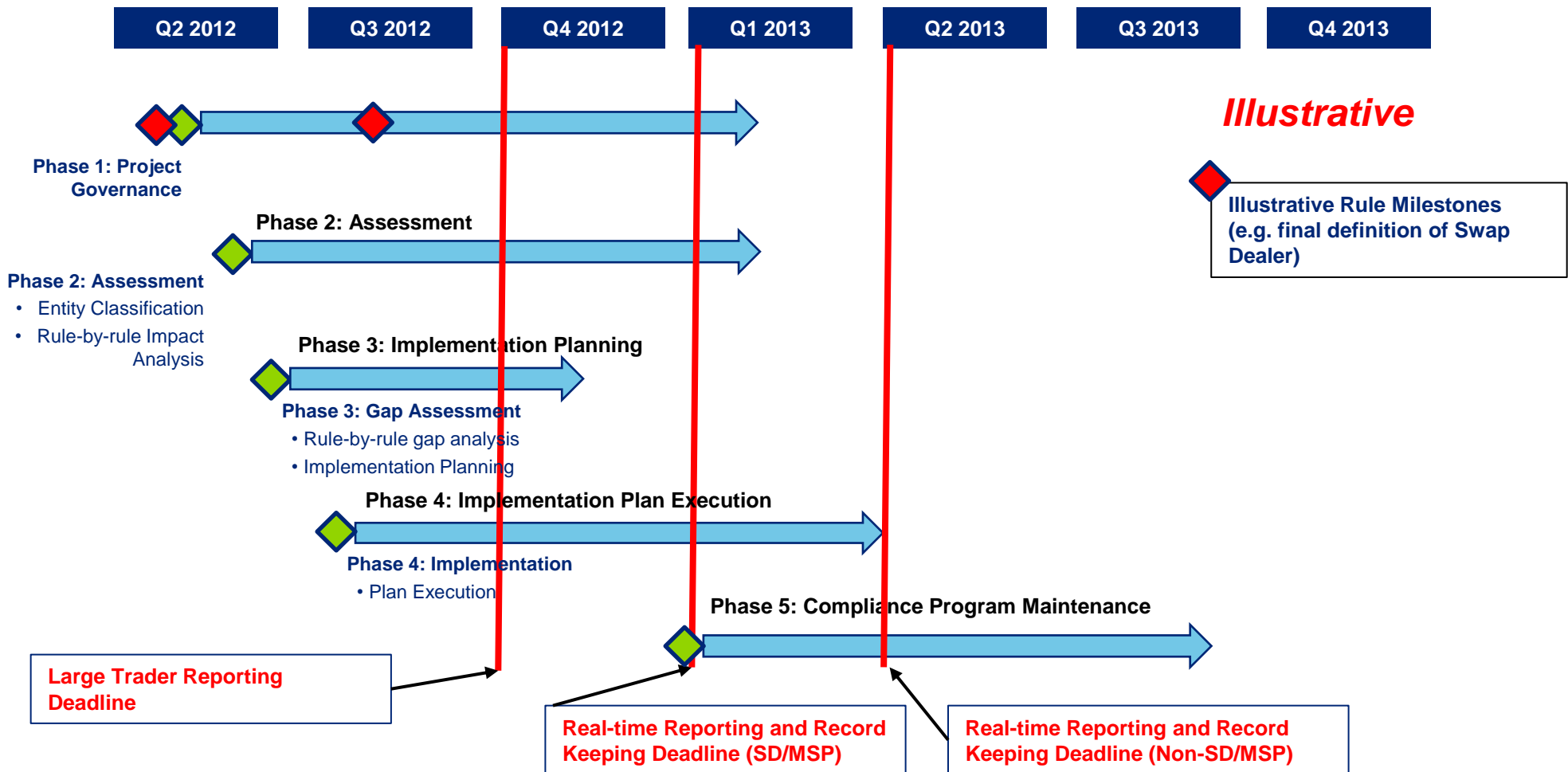
5) Evaluating Potential Credit Implications

- Analyze liquidity impacts of margin posting for cleared swaps
- For uncleared swaps, determine if counterparties are subject to CFTC or bank regulator margin rules
- Determine if changes are needed to counterparty mix
- Reviewing existing contract mix

6) Preparing for Position Limit Obligations (TBD)

- Work with IT to document needed changes and functional requirements for tracking positions
- Identify and aggregate positions across entities
- Confirm internal notification capabilities exist

Illustrative long term Dodd-Frank compliance



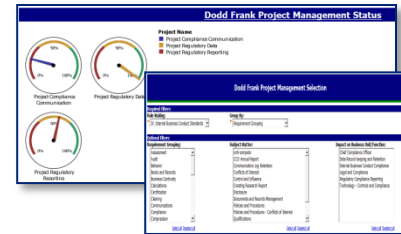
Decisions required

- Allocation of resources for PMO and Implementation Support – internal/external
- Allocation of resources to change management – internal/external
- Impact across trading systems and/or reliance upon vendor solutions

Any approach should balance cost/resource requirements with regulatory risk tolerance and the ability to sustain a program

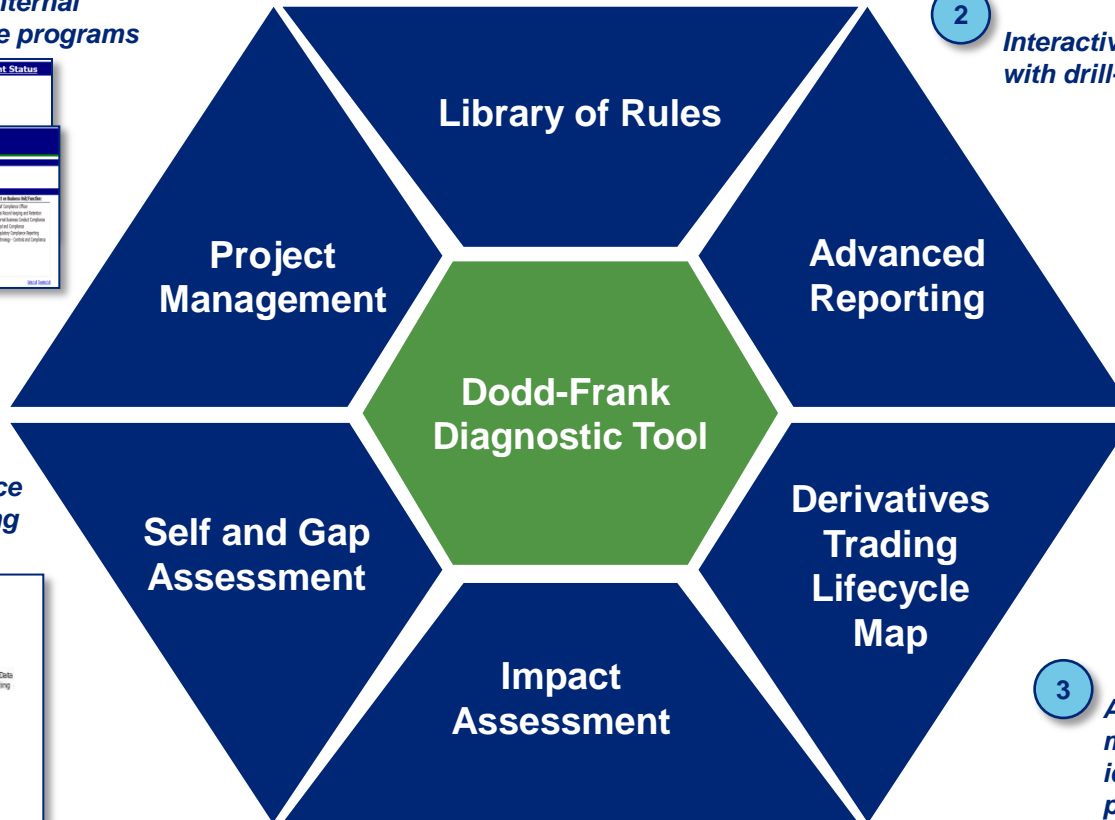
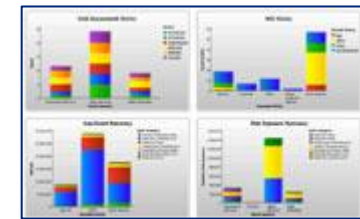
Illustrative Example of Customizable Deloitte Methodology

6 A list of implementation activities and interdependencies to drive project planning for internal regulatory compliance programs

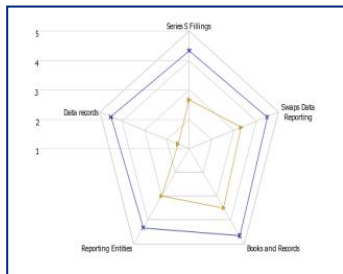


A library maintaining Dodd-Frank Title VII rules from CFTC and SEC

2 Interactive dashboards and report with drill-down capabilities

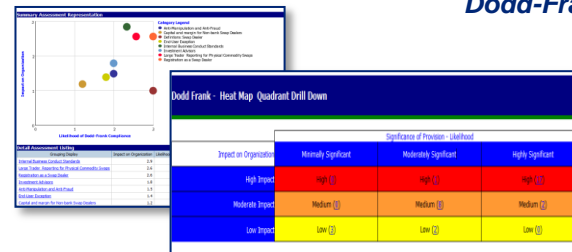


5 A Gap assessment to determine the compliance level, gaps and mitigating steps



3 An interactive derivatives trade lifecycle mapped to relevant rules and identifying existing and new business processes impacted as a result of Dodd-Frank regulation

4 Heat Map to visualize the impact of Dodd-Frank Title VII regulations on different aspects of business – capital, liquidity, legal entity structure, compliance, information systems, workforce etc.



Illustrative Examples of QuickStart Methodology & Components

QuickStart may provide an out-of-the-box solution for assessment and implementation planning

Workplan

Project Leader: Deloitte		Project: Client X DFA Compliance Readiness		Date: wlc 5/14/12	
Objectives	Major Activities	On-Site	Off-Site	Schedule	
1	Perform Qualitative Assessment of Transaction Types and Business Strategies				
2	Summarize and Finalize Assessment Notes	X	X		
3	Derive Transaction data for Quantitative Analysis	X			
4	Confirm data exclusions for de minimus calculation	X	X		
5	Perform Gross National Value Calc	X	X		
6	Complete First Draft of Qualitative/Quantitative Analysis (Deliverable: Draft Classification Results)	X	X		
7	Facilitate Team discussion for Classification Determination	X			
8	Agree Classification and Document Conclusions (Deliverable: Final Classification Results)	X			
9	Perform Project Kick-off	X			
10	Facilitate Team discussion for classification compliance strategy	X			
11	Work with External Counsel to draft Compliance Policy Memo	X			
12	Analyze client's existing process documentation	X	X		
13	Perform Initial Analysis for Gap Assessment	X	X		
14	Develop RIMs Material for client staff; Conduct Info Sessions	X	X		
15	Customize Requirements Assessment Template/Tool	X	X		
16	Conduct Interviews for Gap Assessment (Rule-by-Rule)	X	X		
17	Position Limit Reporting Gaps	X			
18	Data Record Keeping and Reporting/Real Time Reporting Gaps	X			
19	Other (Add Rules based on Classification Results)	X			
20	Document Findings in DFA Template/Tool	X	X		
21	Create detailed Action Items List and validate findings	X	X		
22	Agree Gap Assessment Actions (Deliverable: Detailed Actions Inventory)	X	X		
23	Develop Implementation Strategy	X	X		
24	Map detailed Actions to Task Owners	X	X		
25	Develop Initial Recommendations on Resources, Task Owners, Priorities	X	X		
26	Review Initial Recommendations with client staff and close remaining questions	X	X		
27	Develop Implementation Plan	X	X		
28	Agree Implementation Plan (Deliverable: Project Plan and Timeline)	X	X		

The workplan will serve as a project plan and status dashboard. It can be customized to include specific project dates, milestones, and project team members

Templates

Gap Assessment						
ID	Reference	Requirement (Rule Text)	Gap Assessment Task/Activities	Potential Implementation Steps	IT Implications	Comment / Questions / Observations
1	45.2	Gap Assessment				
2	45.2	Recordkeeping				
14	45.2	Reporting				

The templates include customizable work products including rules/requirements inventories for each rulemaking area

Deliverables

Implementation Plan Template									
Reference #	Activities	Responsible	Inform	Priority	Effort	Gap	Action Steps	Start Date	End Date
General Project Considerations									
2	Form a DFA Working Group	PKM	All	High	Low	High	1. Identify all stakeholder groups that will be impacted by the DFA implementation, and identify a representative from each group for participation in the Working Group 2. Determine how communications will be handled with the Working Group 3. Determine how often the Working Group will meet on a formal basis for status meetings, etc. 4. Agree on a Project Terms of Reference	8/1/2012	9/30/2012
3	Form a DFA Steering Committee	PKM	All	High	Low	High	1. Identify members for DFA Steering Committee 2. Determine how communications will be handled with the Steering Committee 3. Determine how often the Steering Committee will meet on a formal basis	8/1/2012	9/30/2012
4	Educate stakeholder groups on Dodd-Frank Act and the impact to client	PKM	All	High	High	High	1. Determine which stakeholder groups should receive DFA Primer Training 2. Develop material and schedule sessions	8/1/2012	9/30/2012
Legal Considerations/Courtesy Management Activities									
5	Develop and maintain a list of counterparties and their legal designation, and develop process to revisit designation quarterly/semi-annually	Client Personnel	All	Medium	Medium	Low	1. Develop due diligence process for new counterparties to ascertain their registration status. 2. Develop the process quarterly/semi-annually 3. Confirm that legal entity identifier utility will be available through the CFTC or another mechanism 3.3 Determine means of capturing registration status in the reporting solution to be able automated reporting	TBD	TBD
6	Determine if client should report all swaps transactions to a (predefined) DSR, regardless of if reporting courtesy or not	Client Personnel	All	Medium	Medium	High	1. Work with predefined DSR to understand reporting capabilities and if all swaps can be reported 2. Develop process to report all swaps	TBD	TBD

Deliverables include the Final Report outline, final presentation outline, gap assessment inventories, and implementation plans

Reference Guide

Dodd-Frank Quickstart Reference Guide

Purpose

As part of a Dodd-Frank Quickstart engagement, the Deloitte Project Team has been provided with a package of supporting documents, templates and checklists. This document will act as an instructional guide on how the supporting materials were intended to be leveraged in the support of your project and provide you with tips from fellow Deloitte professionals in their experience on similar engagements.

Background

The Dodd-Frank Quickstart package was developed around the Deloitte Dodd-Frank Methodology and framed around the same project approach and final deliverables. Additionally, supporting documents have been developed and standardized in order for your project team to hit the ground running, generate efficiency and leverage the experience of previous Deloitte Dodd-Frank engagements through these tangible documents.

Inventory of Dodd-Frank Quickstart Supporting Materials

The following documents should be contained in your copy of Dodd-Frank Quickstart Materials:

- Workplan Template (Excel) – The workplan provides a structured sequence of key activities required to complete the Dodd-Frank Entity Classification, Gap Assessment, and Implementation

The reference guide provides step-by-step instructions for project setup, population of templates, and how to produce the final deliverables

Specific internal audit considerations

Audit Committee Considerations

While major responsibility lies with management and the Chief Compliance Officer, the implementation of these new rules should have thoughtful and ongoing oversight by the Audit Committee.

Implementation	Financial Reporting
<ul style="list-style-type: none">▪ High level implementation plans, timeline and resourcing▪ <i>Tone at the top</i> – management support for a culture of compliance▪ Risk management process▪ Role of Chief Compliance Officer and responsibilities▪ Impact on internal audit function and reporting▪ Change management	<ul style="list-style-type: none">▪ Impact of new external and internal reporting▪ Accounting policy changes affected by Dodd-Frank▪ Impact on earnings, equity, key ratios, performance indicators and compensations▪ Internal control certifications▪ Disclosure requirements
Impact on the board and board committees	Commercial and Operational Impact
<ul style="list-style-type: none">▪ Risks or changes relevant to board and its committees – level of commitment, internal controls and certifications▪ Education and training of board members▪ Impact on risks and oversight responsibilities▪ How this implementation affects competitive position vs. competitors	<ul style="list-style-type: none">▪ Assessments of new controls▪ Improvement opportunities and controls rationalization▪ Impact on management reporting within the enterprise – planning, budgeting and forecasting▪ Communication to stakeholders on impact

Recap and opportunities

- Understand and confirm key stakeholders expectations of internal audit - including audit committee and other key committees
- Validate expectations around Dodd-Frank assurance requirements
- Become a key player in the risk management program
- Dodd-Frank Act will impact people, process, governance & controls and technology – be prepared to factor this into the internal audit planning process and resources
- Forward looking organizations see regulatory changes as an opportunity to simplify, standardize, and transform their current processes and culture
- Engage executives and board members in thoughtful consideration of potential risks
- Continue being a trusted advisor and don't assume that Dodd-Frank is “going away”

Internal audit = Assurance, Insight, and Objectivity ¹

¹ Internal Audit Value Proposition. Insight: Delivering Value to Stakeholders 2011 by The Institute of Internal Auditors Research Foundation

Questions & Answers

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Center for Energy Solutions

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