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# Derivatives Provisions in the American Clean Energy and Security Act of 2009

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## Introduction

On May 15, 2009, the House Energy and Commerce Committee Chairman Henry A. Waxman and Subcommittee Chairman Edward J. Markey introduced H.R. 2454, the American Clean Energy and Security Act of 2009 (the "Waxman-Markey Bill" or the "Bill"). The Energy and Commerce Committee approved the Bill on May 21, 2009. Eight other House panels, including Financial Services, have jurisdiction to review the Bill. The Waxman-Markey Bill comprehensively addresses a broad range of issues relating to energy and climate change policy.

Subtitles D and E of Title III of the Waxman-Markey Bill contain significant provisions relating to the regulation of over-the-counter ("OTC") derivatives generally and energy derivatives in particular (the "Derivatives Provisions"). First, the Bill would shut the Enron Loophole, the London Loophole and the Swaps Loophole (each as described below). Second, the Bill would subject all OTC derivatives to centralized clearing. Third, the Bill would make "naked" credit default swaps illegal and rescind the preemption of state gaming laws with respect thereto. Finally, the Bill would give the Commodity Futures Trading Commission ("CFTC") initial jurisdiction over markets for "regulated allowance derivatives" to regulate in the same manner as energy transactions.

This memorandum provides a brief background on energy derivatives regulation to place the Waxman-Markey Bill in context. It then provides a summary and discussion of the key Derivatives Provisions of the Bill.

## Energy Derivatives

- » Energy Derivatives are traded on:
  - designated contract markets
  - OTC markets
  - exempt commercial markets
- » Traditionally, legislators and regulators have agreed to treat individually negotiated energy derivatives and swaps traded off-exchange as generally exempt from CFTC jurisdiction

## Background on Energy Derivatives Regulation

### *Types of Energy Derivatives Markets*

Energy derivatives are traded on CFTC-regulated futures markets (called "designated contract markets"), in OTC markets and on "exempt commercial markets" ("ECMs"). The New York Mercantile Exchange is the leading U.S. designated contract market for futures on, among other things, crude oil, natural gas, heating oil and gasoline. ECMs are electronic platforms on which multiple eligible parties can trade, but which, except for certain notification and informational requirements, are exempt from CFTC regulation.

### *Prior Regulation of Energy Derivatives*

Regulation of energy derivatives has evolved with the markets since the creation of the CFTC in 1974. At inception, the CFTC was given exclusive jurisdiction over all futures contracts, and all such contracts were required to be traded on regulated futures exchanges. The two major exceptions were for physically settled forward contracts and for foreign currencies and Treasury securities; these continued to trade "off-exchange."

During the 1980s, an OTC market for swaps and derivatives (including energy derivatives) developed. In response, the CFTC issued a policy statement exempting swaps so long as they met certain criteria intended to differentiate them from futures. Acting on additional authority granted by Congress in the Futures Trading Practices Act of 1992 and in response to a request from a group of energy producers, processors and merchandisers, the CFTC issued an order exempting from the Commodity Exchange Act ("CEA") certain individually negotiated energy derivatives entered into between commercial participants.

In 1998, the CFTC issued a concept release seeking comments on whether OTC derivatives should be subject to additional regulation. Reflecting strong industry opposition, Congress included in the Omnibus Appropriations Act a provision preventing the CFTC from proposing or issuing any new regulations of swaps before March 31, 1999. In November 1999, the President's Working Group on Financial Markets issued a report entitled "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," which recommended excluding from the CEA certain bilateral derivatives between sophisticated

### *Current Regulatory Treatment of Energy Derivatives*

» The CFMA created three types of commodities:

- agricultural commodities
- excluded commodities (interest rates, currencies and other financial commodities)
- exempt commodities (energy and precious metal commodities)

» Derivatives and swaps on energy commodities are generally exempt from most regulation under the CEA if traded off-exchange among eligible contract participants

counterparties other than commodities with limited supplies (such as agricultural commodities).

In 2000, Congress passed the Commodity Futures Modernization Act ("CFMA"). This legislation generally created three types of commodities that attracted different levels of regulation: (i) agricultural commodities (a term which is not defined in the CEA), futures contracts on which would continue to be regulated by the CFTC and traded on a futures exchange; (ii) "excluded" commodities (such as interest rates, securities indices, currencies and other financial commodities), OTC derivatives on which, if traded among "eligible contract participants," would be excluded from the purview of the CEA; and (iii) "exempt" commodities (that is, everything else, but essentially energy products and metals), OTC derivatives on which, if traded among eligible contract participants, would be exempt from most regulation under the CEA. Derivatives on such "exempt" commodities (including energy products) would be subject to certain antifraud and anti-manipulation provisions of the CEA. In addition, the CFTC was given certain oversight authority over any electronic trading facility for transactions on such "exempt" commodities.

## *Prior Legislative Efforts to Regulate Energy Derivatives*

In the last ten years, a number of major scandals involving manipulation of energy markets (*e.g.*, Enron) and concerns that unchecked speculation caused spikes in energy prices led to legislative efforts to regulate energy derivatives. The major focus of these efforts has been to (i) extend regulation to previously unregulated OTC derivatives on energy commodities (commonly referred to as the "Enron Loophole"); (ii) prevent market participants, particularly speculators, from indirectly accessing U.S. energy markets through foreign futures markets (commonly referred to as the "London Loophole"[1]) ; and (iii) prevent institutional investors from using swaps to avoid position limits that would be applicable to direct transactions in the underlying futures (commonly referred to as the "Swaps Loophole"[2]).

[1] The London Loophole is a reference to foreign futures exchanges, such as ICE Futures Europe ("ICE") or the Dubai Mercantile Exchange (the "DME"), on which "look-alike" contracts (*i.e.*, futures contracts that mirror those traded on U.S. futures exchanges) trade. Under CFTC no-action letters, these foreign futures exchanges are not subject to CFTC regulation. While the CFTC has amended its no-action letters with respect to ICE and the DME to impose certain regulatory requirements, the CFTC's letters are limited to those particular exchanges.

[2] The Swaps Loophole is a reference to the synthetic positions of primarily institutional investors in energy commodities through swaps that are hedged by dealers in the futures markets.

### *Other Legislative Efforts to Regulate Energy Transactions—the Stupak Bill*

- Imposes position limits and large-trader reporting for all energy transactions
- Subjects U.S. energy trades conducted on foreign boards of trade to domestic regulation
- Eliminates the exemption for hedging of swap contracts
- Contains similar provisions as the Peterson Bill, but the Stupak Bill also calls for banning "naked" credit default swaps and requiring all OTC trades to be centrally settled and cleared

In 2008, Congress passed the Food, Conservation, and Energy Act of 2008 (the "2008 Farm Bill"), which included provisions to limit the Enron Loophole. Prior to the 2008 Farm Bill, Section 2(h)(1) of the CEA exempted derivatives in exempt commodities (such as energy products and metals) between eligible contract participants entered into off-exchange, and Section 2(h)(3) of the CEA exempted principal-to-principal trades in exempt commodities entered into on an electronic trading facility. Under the 2008 Farm Bill, if the CFTC determines that a contract traded on such a facility plays a significant price discovery role (*i.e.*, if the prices it generates are used as reference points for other transactions and markets), the facility will come under CFTC regulation. The market will have to register with the CFTC and demonstrate its capacity to comply with several core principles articulated in the CFMA and now in the CEA. These include maintaining and enforcing rules against manipulation, establishing position limits or accountability levels to prevent excessive speculation, and providing the CFTC with daily reports on large traders' positions. The 2008 Farm Bill, however, does not regulate OTC energy derivatives and, to this extent, the Enron Loophole is still an issue for some legislators.

While there have been prior legislative proposals to close the London Loophole and the Swaps Loophole, none of these have been signed into law.

For example, on May 14, 2009, the House Energy and Commerce Subcommittee Chairman Bart Stupak introduced H.R. 2448, the Prevent Unfair Manipulation of Prices Act (the "Stupak Bill"). The Stupak Bill is intended to curb excessive speculation in energy markets, increase oversight of OTC derivatives and extend those provisions to the trading of U.S. carbon emission allowances once a market is established. The Stupak Bill contains provisions that would subject all energy transactions to uniform position limits and large-trader reporting, treat U.S. energy trades transacted from a U.S. computer terminal on a foreign board of trade to the same position and accountability limits as domestically regulated markets, eliminate hedge exemptions for swaps contracts and disclose market data on the positions of swap dealers and index funds.

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Because the dealer is hedged, it can take advantage of the hedge exemption from position limits under the CEA. In this way, the unhedged or speculative position of the investor will not be subject to the CEA's position limits.

### *Proposed Amendments to the Commodity Exchange Act—the Enron Loophole*

- Bring energy commodities and included energy transactions under the CFTC's jurisdiction
- No longer treat an energy commodity as an exempt commodity under the CEA
- Rescind the exemption for OTC swaps and derivatives on energy commodities and make these contracts subject to the CFTC's jurisdiction

Some provisions of the Stupak Bill are similar to language included in H.R. 977, the Derivatives Markets Transparency and Accountability Act of 2009, introduced on February 11, 2009 by House Agriculture Committee Chairman Collin Peterson (the "Peterson Bill"). (The Peterson Bill passed committee in February 2009, but was referred to the House Financial Services Committee, which has not taken action on it.) However, the Stupak Bill also contains key differences, including the requirement that all OTC trades be submitted to a CFTC-registered derivatives clearing organization and banning "naked" credit default swaps. In addition, the Stupak Bill would define carbon emission allowances as an energy commodity and require that all carbon-related markets be regulated by the CFTC. The Stupak Bill, as of the date of this memorandum, is currently pending in the House Energy and Commerce, House Agriculture and House Financial Services Committees.

## Key Derivatives Provisions of the Waxman-Markey Bill

### *Shutting the Enron Loophole*

Currently under the CEA, "exempt" commodities consist primarily of energy products (and metals). Consequently, energy derivatives between eligible contract participants transacting off-exchange or in principal-to-principal trades on an electronic trading facility are generally excluded from regulation under the CEA. The Waxman-Markey Bill would define "energy commodity" and "included energy transaction" as new categories of commodities and derivatives under the CEA, and the Bill would exclude energy commodities from the definition of exempt commodity in the CEA as follows:

- "energy commodity" would be added to the CEA and would mean coal, crude oil, gas, electricity,[3] natural gas and any other substance that the CFTC determines is used as a source of energy (except an excluded commodity or an agricultural commodity[4]);

[3] With respect to electricity, the Bill expressly excludes "financial transmission rights" (*i.e.*, capacity trading), which remain under the jurisdiction of the Federal Energy Regulatory Commission. In contrast, capacity trading with respect to the storage rights associated with crude oil and natural gas (which forms a significant part of trading in such commodities) is not similarly excluded, leaving open the question of whether capacity trading with respect to crude oil and natural gas is included in the definition of energy commodity.

[4] The Bill leaves open the question of where the line between an "agricultural commodity" (which is undefined in the CEA) and an "energy commodity" is (*e.g.*, denatured ethanol). The Bill would give the CFTC authority to make such determinations on an *ad hoc* basis.

*Proposed Amendments to the Commodity Exchange Act—the London Loophole*

» Extend CFTC jurisdiction to included energy transactions (*i.e.*, transactions with a U.S. nexus) made on foreign boards of trade

» "included energy transaction" would be added to the CEA and would mean a contract, agreement or transaction in an energy commodity for future delivery within the U.S. (or offered or transacted on or through a computer terminal located in the U.S.); and

» "exempt commodity" would be amended to mean a commodity that is not an excluded commodity, an energy commodity or an agricultural commodity.

### *Extending CFTC Regulatory Authority to OTC Derivatives and Swaps on Energy Commodities*

The Waxman-Markey Bill would rescind the current exemption for OTC derivatives and swaps on energy commodities and bring these types of contracts and transactions under the jurisdiction of the CFTC by making the following amendments to the CEA:

» swap transactions excluded from CFTC jurisdiction by Section 2(g) of the CEA would expressly exclude swaps on an energy commodity; and

» OTC swaps in exempt commodities excluded from CFTC jurisdiction by Section 2(h)(1) of the CEA would expressly exclude swaps on an energy commodity.

### *Shutting the London Loophole*

Currently under the CEA, CFTC regulation of futures trading does not apply to contracts made on foreign boards of trade, and the CFTC's regulation of foreign transactions by U.S. persons does not extend to approving or governing any rules, contracts or actions of foreign boards of trade. The Waxman-Markey Bill would extend CFTC regulatory authority to energy derivatives with a connection to the U.S. that trade on foreign boards of trade and limit the CFTC's authority to grant exemptions with respect thereto:

» the CFTC's jurisdiction would be extended to include agreements, contracts or transactions made on foreign boards of trade with respect to included energy transactions, that is, transactions with a U.S. nexus; and

» the CFTC would be prohibited from exempting under its public interest authority any included energy transaction from the requirements of the

CEA unless the CFTC provides notice to Congress and PLEAG (as defined below) and solicits public comment.

### *Imposing Uniform Speculative Positions*

The Waxman-Markey Bill would amend the CEA by requiring the CFTC to fix monthly position limits for energy transactions across all markets subject to CFTC jurisdiction. The Bill would also require detailed position reporting and disaggregation of market data and provides that:

- the CFTC would convene a Position Limit Energy Advisory Group ("PLEAG") consisting of representatives from markets for energy commodities;
- PLEAG would submit position limit recommendations to the CFTC sixty days after being convened and annually thereafter;
- the CFTC would have exclusive authority to grant exemptions for *bona fide* hedging transactions and positions from the position limits imposed by the Bill; and
- the CFTC would identify each person with a position in excess of the limits imposed under Section 4i of the CEA.

Despite the different types of energy products (*e.g.*, oil, gas, electricity, coal, *etc.*), the Waxman-Markey Bill does not indicate whether PLEAG representatives are to be drawn from across the variety of energy product backgrounds.

The Waxman-Markey Bill would also direct the CFTC to define "*bona fide* hedging" to effectively carve out transactions to hedge synthetic positions that are speculative, thereby preventing institutional investors from using swaps to avoid position limits that would be applicable to direct transactions in the underlying futures contracts.

### *Forcing OTC Derivatives onto Central Clearing Platforms*

The Waxman-Markey Bill would amend the exemptions for OTC derivatives (including transactions with respect to underlying assets *other* than energy commodities) so that these exemptions would only be available if the transaction were cleared through a derivatives clearing organization ("DCO"). DCOs are defined in Section 1a(9) of the CEA and must be registered with the

#### *Proposed Amendments to the Commodity Exchange Act—the Swaps Loophole*

- Establish an energy advisory group with respect to position limits and require the CFTC to regularly fix position limits for energy transactions
- Prevent institutional investors from using swaps to avoid position limits applicable to underlying futures contracts by amending the definition of *bona fide* hedging transaction to exclude synthetic hedging positions that are speculative

### *Proposed Amendments to the Commodity Exchange Act—Central Clearing of OTC Derivatives*

» OTC swaps and derivatives currently exempted or excluded under the CEA or pursuant to the CFTC's public interest authority would lose their exempt status unless centrally settled and cleared

» Additional requirements for registering a derivatives clearing organization with the CFTC

» Alternatives to central clearing permitted in limited circumstances

CFTC. The Bill contemplates alternative types of clearing platforms subject to other regulators' jurisdiction, such as an entity registered as a clearing agency under the Securities Exchange Act of 1934, and includes provisions to coordinate these platforms among the relevant regulators. In addition, the Waxman-Markey Bill would amend the CEA to include additional requirements for registering as a DCO with the CFTC.

The main points in this portion of the Waxman-Markey Bill are summarized as follows:

» The following categories under the CEA would only be available to contracts and transactions settled and cleared through a DCO:

- "excluded derivative transactions" under Sections 2(d)(1) and 2(d)(2) of the CEA;
- "excluded swap transactions" under Section 2(g) of the CEA;
- "transactions in exempt commodities" under Sections 2(h)(1) and 2(h)(3) of the CEA; and
- the CFTC's general public interest exemptive authority under Section 4(c) of the CEA.

» The CFTC may waive the DCO requirement by consulting with the Securities and Exchange Commission (the "SEC") and the Board of Governors of the Federal Reserve System (the "Federal Reserve") regarding a waiver relating to an excluded commodity or entity for which the SEC or Federal Reserve serves as the primary regulator.

» The CFTC may grant such waiver if the contract is highly customized as to its material terms; transacted infrequently; and is being entered into by parties who can demonstrate a standard of financial integrity satisfactory to the CFTC.

» Any contract exempted from the DCO requirements would be reported to the CFTC.

The Bill does not indicate how the CFTC would implement its discretion to waive the DCO requirement. For example, the requirement to consult with the SEC and the Federal Reserve does not impose a time frame or the manner in which such consultation should take place. Alternatively, a waiver of the

### Proposed Amendments to the Commodity Exchange Act—Credit Default Swaps

» Credit default swaps would be defined as contracts providing credit protection to a party against a risk such as a default or credit downgrade

» Prohibition of naked credit default swaps (*i.e.*, swaps in which the buyer of credit protection would not experience an actual financial loss if a credit event that is the subject of the swap were to occur)

» Preemption of state gaming or bucket shop laws would not apply to naked credit default swaps

DCO requirement based on the "infrequency" of the contract in question may mean that this proposed exemption would have such limited application in derivatives markets as deep as the United States as to render it impracticable. As well, the grant of a waiver requires the CFTC to scrutinize whether a contract is "highly customized" as opposed to making the determination that a contract is nonstandard. The language of the Bill does not provide any meaningful guidance to the CFTC in making such determinations.

In any event, requiring OTC derivatives to be centrally cleared through a DCO may not necessarily result in the relative benefit and stability experienced by futures markets because the success of these markets in terms of transparency and price discovery mechanisms is due in part to the deep liquidity of the markets for the underlying assets (*e.g.*, agricultural, energy and mineral products) being traded.

It can also be noted that the entity serving as the DCO will be pressured to set margin rates for trades as accurately as possible because of its inherent credit and counterparty risk. This may not be feasible where there is a lack of a well established market for the OTC derivative in question. In contrast, so long as credit risk is situated with the DCO, dealers and buy-side participants (who will partially comprise PLEAG) will be incentivized to set such margins rates as low as possible.

## *Prohibition of "Naked" Credit Default Swaps and Rescission of Preemption of State Gaming Laws*

The Waxman-Markey Bill would flatly prohibit "naked" credit default swaps and rescind the preemption of state gaming laws with respect thereto.

» A person would be prohibited from entering into a credit default swap ("CDS") unless the person:

- owns a credit instrument referenced by the CDS;
- would experience financial loss if an event that is the subject of the CDS with respect to the credit instrument were to occur; and
- meets minimum capital adequacy standards established by the CFTC in consultation with the Federal Reserve.

» A CDS would be defined as a contract that provides credit protection to a party against the risk that an entity may experience a loss of value as a result of an event specified in the contract, such as a default or credit downgrade.

The conditions described above under which a person may enter into a CDS seem to confuse buyers of credit protection with sellers of credit protection. For example, the Bill provides that such a person must own the credit instrument referenced by the CDS. It appears that a seller of credit protection would also need to satisfy this requirement before it could enter into a CDS; however, it is not clear why this requirement should be imposed on the seller in addition to the buyer of credit protection. Furthermore, any financial loss experienced as a result of a credit event under the CDS would only affect the buyer of credit protection. Finally, the condition that a person entering into a CDS satisfy certain minimum capital adequacy standards appears better suited to the seller community as it is the buyer of credit protection who faces counterparty risk if there is a credit event under the terms of the CDS requiring a payment by the seller to the buyer of credit protection.

### *CFTC Initial Jurisdiction Over Regulated Allowance Derivatives*

A "regulated allowance derivative" is an instrument that would be used to trade the carbon emission allowances provided under the Waxman-Markey Bill's carbon markets regime contained in Subtitle D (*Carbon Market Assurance*) of Title III. Generally, a "regulated allowance derivative" would be in the character of an option or swap or a futures contract, the value of which is expressly linked to the price of a "regulated allowance," namely, any emission allowance, offset credit or renewable energy credit. Oversight of the market for "regulated allowances" would fall to the Federal Energy Regulatory Commission under the Federal Power Act, while "regulated allowance derivatives" would be generally treated in the same manner as included energy transactions under the CEA (as amended by the Waxman-Markey Bill) and, accordingly, fall under the jurisdiction of the CFTC.

## Other Considerations

Currently, energy commodities (as defined by the Bill) are generally exempt from the requirements of the CEA. The Waxman-Markey Bill's proposal to eliminate this exemption may have unanticipated consequences for energy markets and their participants in the United States. While the Bill addresses supposed "excessive" speculation, ostensibly linked to increased energy prices, subjecting energy commodities to the jurisdiction of the CFTC may simply result in the transfer of a significant portion of the market for energy-related derivatives offshore. Instead of limiting speculation, this might increase it and further erode the ability of the United States to regulate these markets. Furthermore, the Waxman-Markey Bill's cap-and-trade system for carbon emissions may be undermined by the regulation of energy commodities under the CEA. An effective cap-and-trade system will likely depend on a deep and liquid market for carbon emission credits and allowances. An OTC market for derivatives on emission allowances would create liquidity for those hedging their long-term climate obligations or investing in green energy technology and businesses. However, driving the OTC market offshore by regulating allowance derivatives as energy commodities under the CEA could discourage the growth of a liquid market. Creating separate regulators for carbon emission allowances and derivatives linked to such allowances and credits, namely, the Federal Energy Regulatory Commission and the CFTC, respectively, might result in regulatory uncertainty that depresses participation in and growth of these markets.

Closing the London Loophole by authorizing the CFTC to regulate energy derivatives traded on a foreign board of trade may exceed U.S. jurisdictional authority and invite other nations to regulate trading on U.S. boards of trade.

It should also be noted that the Waxman-Markey Bill's broader derivative provisions, which include, among other things, a prohibition of naked credit default swaps and a requirement that currently exempted or excluded OTC derivative and swap transactions be centrally settled and cleared, are unrelated to energy policy and inconsistent with proposals relating to OTC derivatives recently made by the Obama Administration. The Administration's plans for regulating the OTC market would require all standardized derivatives to be centrally settled and cleared, while customized (*i.e.*, nonstandard) trades would be reported to a central trade repository. It remains to be seen whether the Derivatives Provisions in the Bill will affect the debate regarding the Administration's proposals.

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» The American Clean Energy and Security Act of 2009 (May 15, 2009)

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