

UPDATE ON THE 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”). The legislation addresses a broad range of issues relating to energy and climate change policy, as described in Davis Polk’s client memorandum entitled “[U.S. House of Representatives Approves Landmark Climate Change Legislation](#).” As previously reported in [Davis Polk’s client memorandum](#) dated June 1, 2009, the Waxman-Markey Bill also contains significant provisions relating to the regulation of over-the-counter derivatives generally and energy derivatives in particular (the “Derivatives Provisions”).

The Waxman-Markey Bill was approved by the Energy and Commerce Committee on May 21, 2009. None of the other House panels that had jurisdiction over it, including Financial Services, marked it up. Rather, the legislation was amended on the House floor. On June 26, 2009, an amended version of the Waxman-Markey Bill (the “Revised Bill”), including significant changes in the form of a “manager’s amendment” introduced by Representative Waxman, was passed by the House of Representatives by a vote of 219-212.

The Revised Bill generally does not change the Derivatives Provisions contained in the original Waxman-Markey Bill. These provisions would rescind the current exemption under the Commodity Exchange Act for certain derivatives on energy products, extend regulatory jurisdiction to U.S.-related energy transactions effected on foreign boards of trade, require over-the-counter derivatives to be centrally cleared and prohibit “naked” credit default swaps.

The Revised Bill, however, would impact jurisdiction and regulatory treatment of “regulated allowance derivatives.” It also contains a sunset clause for the Derivatives Provisions in the event of future regulatory reform and provides for Presidential review of regulations. This memorandum provides a summary of the key changes made to the Derivatives Provisions by the Revised Bill and also considers the progress of this legislation through the Senate. Davis Polk is monitoring developments in this area and will issue updated memoranda from time to time.

Amendments to the Derivatives Provisions

- The following provisions of the Revised Bill, as passed by the House, are largely unchanged. They would regulate OTC derivatives and energy commodities by:
 - rescinding the current exemption under the Commodity Exchange Act for certain derivatives on energy products,
 - extending regulatory jurisdiction to U.S.-related energy transactions effected on foreign boards of trade,
 - requiring over-the-counter derivatives to be centrally cleared, and
 - prohibiting “naked” credit default swaps.
- The CFTC would be granted sole jurisdiction over regulated allowance derivatives.
- The Derivatives Provisions (except those applicable to regulated allowance derivatives) would be repealed upon the enactment of future legislation that includes derivatives regulation.
- The President would review regulations under the Derivatives Provisions to determine if the U.S. financial system is adequately protected from systemic risk.

Amendments to the Waxman-Markey Bill

Regulated Allowance Derivatives

Under the Waxman-Markey Bill’s carbon markets regime, a “regulated allowance derivative” is an instrument that would be used to trade carbon emission allowances. The original Waxman-Markey Bill defined a “regulated allowance derivative” generally as an instrument 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. Under the original version of the Waxman-Markey Bill, jurisdiction over the markets for regulated allowance derivatives would have been granted to the Commodity Futures Trading Commission (“CFTC”) unless the President delegated regulatory responsibility to a different Federal agency.

The Revised Bill would amend the Commodity Exchange Act (“CEA”) by expressly carving out regulated allowances from the definition of “exempt commodity.” The practical result is that regulated allowances would be treated as any other commodity covered by the CEA and subject to the CFTC’s jurisdiction. Accordingly, the Revised Bill expressly grants jurisdiction over regulated allowance derivatives to the CFTC without the President delegating regulatory responsibility to a different Federal agency. The Revised Bill would also prohibit the CFTC from exercising its exemptive authority under Section 4(c) of the CEA with respect to regulated allowance derivatives, whereas under the original Waxman-Markey Bill, exemptive relief would have been available to regulated allowance derivatives as long as the CFTC gave the appropriate notice and solicited public comment.

Interestingly, “regulated allowance derivative” is no longer a defined term in the Revised Bill. By removing the definition, the drafters of the legislation may have been seeking to avoid restricting the meaning of “regulated allowance derivative,” but this approach may lead to substantial ambiguity and uncertainty.

Sunset Provisions

The Revised Bill provides that the Derivatives Provisions (except the provisions applicable to regulated allowance derivatives) would be repealed, and any regulations promulgated thereunder considered null and void, upon the passage of “legislation that includes derivatives regulatory reform.” These sunset clauses suggest that the drafters viewed the Derivatives Provisions as provisional and intended them to be superseded by legislation that resulted from broader Congressional and Administrative derivatives regulatory reform, notably including the Obama Administration’s White Paper on Financial Regulatory Reform, issued on June 17, 2009. The broad language applicable to the sunset provisions (“legislation that includes derivatives regulatory reform”) implies that *any* derivatives regulatory reform would result in the repeal of the Derivatives Provisions and not necessarily

legislative reform that meets or exceeds the requirements imposed by the Derivatives Provisions. As previously noted, the sunset provisions would not result in the repeal of the rules applicable to regulated allowance derivatives.

Presidential Review

The Revised Bill considers the possibility that the regulations issued pursuant to the Derivatives Provisions, if not annulled by other legislative efforts, may be inadequate. In this regard, the Revised Bill provides that the President would review the offset regulations and derivatives regulations promulgated thereunder not later than twenty-four months after enactment to determine if such regulations “adequately protect” the U.S. financial system from systemic risk. The Revised Bill does not indicate what steps, if any, are to be taken if those regulations are considered inadequate, but presumably it allows the Administration to step in with further reforms in the event systemic risk is not sufficiently abated after enactment of the legislation.

On the Horizon

The Senate is expected to begin considering its own climate change legislation later this month. It is unclear the extent to which the Senate version of the American Clean Energy and Security Act of 2009 will be modeled on the Revised Bill that passed in the House or whether the Senate version will contain substantially the same form of the Derivatives Provisions. We can expect to see substantial review and analysis of the Derivatives Provisions by the Senate. The Environment and Public Works Committee will be the first Senate panel to begin hearings on the legislation. Furthermore, we understand that Senate Majority Leader Harry Reid (D-NV) has given the other committees that may have jurisdiction, including Finance, Agriculture and Foreign Relations, a September 28, 2009 deadline to complete their markups of the legislation.

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References

- [The American Clean Energy and Security Act of 2009 \(H.R. 2454 EH\) \(June 26, 2009\)](#)



This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

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