Hunton & Williams
Client Alert

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The Derivatives Trading Integrity Act – Beginning of the End for OTC Trading?

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In November, Senate Agriculture Committee Chairman Tom Harkin (D-Iowa) introduced the Derivatives Trading Integrity Act of 2008 ("the Bill"), hoping to end "casino capitalism" in the market for over-the-counter (OTC) derivatives. The Bill amends the Commodity Exchange Act (CEA) to require that all contracts with future delivery trade on regulated exchanges similar to how commodity futures currently trade. The Bill also provides the Commodity Futures Trading Commission (CFTC) with jurisdiction over nearly all trading contracts other than spot transactions. Thus, the provisions of the Bill, if enacted, will dramatically reshape the commodities and derivatives markets, including the burgeoning U.S. market for emission credits.

Although the Bill is unlikely to pass before this congressional session ends, many Washington observers view the Bill as a "test of the waters" and expect that it will be re-introduced and considered in the next Congress, where it may receive broader support under an expanded Democratic majority. The Bill follows several other legislative proposals, introduced in the 110th Congress by Sen. Harry Reid (D-NV) and Rep. Mike Stupak (D-MI), designed to more broadly regulate OTC trading. The Bill also follows on the heels of the Commodity Markets Transparency and Accountability Act (H.R. 6604), which passed the House in mid-September. Chairman Harkin has called for a December hearing on the role of derivatives in the recent turmoil in the financial market.

Hunton & Williams continues to monitor the Bill as a recent development in the larger legislative and regulatory debate about the future of OTC markets for energy, emissions and other commodities and derivatives transactions.

No Exclusion for Swap Transactions

The Commodities Futures Modernization Act of 2000 (CFMA) codified a longstanding doctrine that certain contracts for future delivery (for nonagricultural commodities) are not subject to CFTC oversight if they are (i) between "eligible contract participants" (essentially, sophisticated parties), (ii) subject to individual negotiation by the parties and (iii) not executed or traded on a trading facility.[1] This provision generally placed OTC transactions outside the CEA. The Bill reverses this provision, forcing swap transactions to be conducted on designated or registered clearing houses or derivatives clearing organizations.

The removal of this exclusion for OTC transaction will have substantial

[1] 7 U.S.C. 2(g)

ramifications for the commodities and derivatives markets. Forcing every OTC contract onto an exchange, while simple in theory, likely will be difficult to implement in practice. Trading on registered exchanges depends heavily on uniformity among contracts. In contrast, the OTC market provides for unlimited customization, which enables a party to maximize the efficiency of a hedge or to make more precise speculative trades. OTC trading also allows for greater creativity and liquidity in the market. The Bill does not clarify exactly how the many unique contracts should be put on an exchange, nor does it specify how a regulator would assimilate innumerable unique trades into some meaningful understanding of trends and risks in the market place. Thus, the Bill, by requiring all OTC contracts to be executed on a regulated exchange, may create more issues for the market than it solves.

Market and regulatory pressures are already forcing certain types of trading onto clearing houses, where principal-to-principal credit risk is mitigated and market transparency is increased. Most notably, several trading platforms for credit default swaps have recently launched and are in various stages of the regulatory approval process to become clearing houses.

No Excluded or Exempt Commodities

The CEA currently defines two groups of commodities, "Excluded Commodities" and "Exempt Commodities," under which certain trading activities fall outside the scope of the CEA. "Excluded Commodities" generally include interest rates, exchange rates, currencies, securities, security indexes, credit risks, inflation, other macroeconomic measures or any indexes based on measures not within the control of contracting parties.[2] The universe of commodities remaining after subtracting out Excluded Commodities and agricultural commodities are "Exempt Commodities."[3] The Bill eliminates (i) the definitions for "Excluded Commodities" and "Exempt Commodities" and (ii) the CEA provisions that place transactions in Excluded Commodities or Exempt Commodities outside of CFTC oversight.[4]

Senator Harkin's press release expresses an intent to eliminate any disparity in regulatory treatment of contracts with future delivery that is based upon the nature of the commodity. This wholesale jettison of CEA provisions leaves significant issues to be resolved. For example, these changes reverse some clarity in the longstanding debate about whether contracts referencing securities fall within the jurisdiction of the CFTC or the Securities Exchange Commission. In addition, initiating trades with new commodities or units of measure will require complex CEA analysis and uncertainty when attempting to register such trades on a regulated exchange.

No CFTC Authority to Exempt Certain Transactions

The Bill removes the CFTC's ability to exempt any agreement, contract or transaction from all or portions of the CEA. Removing the CFTC's authority to exempt contracts or transactions further compels any contract with future delivery to be registered on an exchange, even if contrary to the public interest. The removal of the CFTC's exemptive authority would have significant legal consequences. For example, the removal of the CFTC's authority may eliminate the CFTC's ability to provide market participants with legal certainty regarding any particular transaction, because it would no longer be possible for parties to make applications with the CFTC for exempt status.

No Exempt Exchanges

Under the CEA, a board of trade may elect to be exempt from the CEA if the only contract that is traded on that exchange (i) references commodities for which there is effectively an unlimited supply available for delivery, (ii) is sufficiently liquid so as to prevent the threat of market manipulation or (iii) has no cash market.[5] If trading on an exempt exchange constitutes significant price discovery for a commodity, an exchange currently is subject to certain reporting requirements. The Bill removes the operative provision allowing for such exempt exchanges, bringing under the CFTC's oversight every exchange for contracts with future delivery. As with other provisions of the Bill, the focus of these modifications seems to be the elimination of distinctions among commodities (in this case, highly liquid ones) that result in disparate regulatory oversight.

Physical Trading

If enacted, the Bill will have a substantial, adverse impact on entities that engage in exempt OTC derivative transactions to hedge the purchase or sale of physical commodities (*i.e.*, contracts for physical delivery). The impacts to the energy sector, in particular the electric and natural gas industries, would be unprecedented. Entities that are already

[2] 7 U.S.C. 1a(13)
[3] 7 U.S.C. 1a(14)
[4] 7 U.S.C. 2 (d),(e) and (h)

[5] 7 U.S.C. 7a-3

subject to pervasive federal and state regulatory requirements — such as traditional electric utilities, natural gas companies, and energy marketers — will be subject to yet an additional layer of regulatory oversight by the CFTC. Further, independent system operators and regional transmission organizations that are authorized by the Federal Energy Regulatory Commission (FERC) to administer and oversee real-time and forward competitive wholesale electricity markets could become subject to direct CFTC oversight.

Presently, for example, physical trading of electricity and natural gas is subject to the exclusive jurisdiction of the FERC under authority granted under the Federal Power Act (FPA) and the Natural Gas Act (NGA). Under the Bill, entities engaging exempt OTC derivatives transactions to hedge risks associated with more conservative physical trading strategies — such as trading around a portfolio of assets, long-term contracts for physical delivery, or firm transmission rights — would be subject to the dual regulation of the CFTC and the FERC.

Both the CFTC and the FERC have broad and well-established statutory authority to address, prohibit, and penalize the manipulation of electricity and natural gas markets. The FERC was recently granted new authority under the FPA and NGA to prohibit energy market manipulation under the Energy Policy Act of 2005. The FERC's anti-manipulation authority is based on Section 10b of the Securities Exchange Act of 1934. Consequently, the FERC may prosecute claims of energy market manipulation in cases where an entity engaged in a fraudulent or deceptive act directly or indirectly in connection with a jurisdictional transaction (*e.g.*, purchase or sale of electric energy or natural gas at wholesale or the purchase or sale of transmission services at wholesale for such commodities). The CFTC has broad authority under the CEA to prosecute claims of alleged and actual manipulation.

As the derivative and physical markets for electricity and natural gas continue to converge, regulatory uncertainty regarding the boundaries of FERC's and CFTC's jurisdiction over activities that affect the physical trading of these commodities continues to increase. This uncertainty is reflected in current litigation pending between the FERC and the CFTC regarding the scope of the FERC's jurisdiction redress behavior in natural gas futures markets that is specifically intended to manipulate the price for the physical sale or purchase of this commodity.

The Bill does not address the growing jurisdictional conflict between the CFTC and the FERC. If enacted as currently proposed, the Bill will create regulatory uncertainty, which would likely have a chilling effect on the use of OTC derivative hedging strategies by traditional electric utilities, natural gas companies, and energy markets. Such an effect may reduce liquidity in competitive wholesale energy markets and put substantial upward pressure on electricity and natural gas end-user prices.

In addition, the Bill will create jurisdictional uncertainty between the Environmental Protection Agency and the CFTC, as well as impact existing and future emissions trading programs. Because physical emission credits trading currently occurs in the over-the-counter market and not on exchanges, the Bill would have an immediate impact for the current market for SO_2 and NO_x trading and a substantial influence on the future design of a national cap-and-trade regulatory system for greenhouse gases.

How We Can Help

Hunton & Williams assists clients by monitoring and participating in legislative and regulatory developments affecting the financial and energy markets, as well as developments affecting federal climate change policy. Lawyers from the firm's government relations, derivatives, commodities and energy practices collaborate to advise our clients on proposed legislation like the Bill. Please let us know how we can assist you.

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