

Senate Agriculture Committee Reports Bill to Reform Regulation of Commodity Derivatives

On April 21, 2010, the Senate Committee on Agriculture, Nutrition and Forestry reported Chairman Blanche Lincoln's (D-AR) derivatives reform legislation, the Wall Street Transparency and Accountability Act of 2010 (the "Lincoln bill"), by a vote of 13 to 8. One Republican member of the Committee, Senator Chuck Grassley (R-IA), joined the Committee's Democrats in approving the Lincoln bill. The Lincoln bill will likely be merged with the larger financial reform bill crafted by Chairman Chris Dodd (D-CT) of the Senate Committee on Banking, Housing and Urban Affairs, the Restoring American Financial Stability Act of 2010 (S. 3217), which was reported on a 13-10 party line vote from the Senate Banking Committee on April 15, 2010. The Senate is expected to debate financial reform on the floor in the coming weeks, possibly as soon as the week of April 26th.

If enacted, the Lincoln bill would dramatically alter federal regulation of commodity derivatives, including the largely unregulated market for customized "swaps" used by many industries to hedge commercial risks. Among other things, the Lincoln bill would require most swaps – except those used by non-financial companies to hedge commercial risk – to be "cleared" by clearinghouses registered with the Commodity Futures Trading Commission (CFTC); require swaps that are subject to clearing to trade on CFTC-registered exchanges; and direct the CFTC to establish aggregate position limits for swaps.

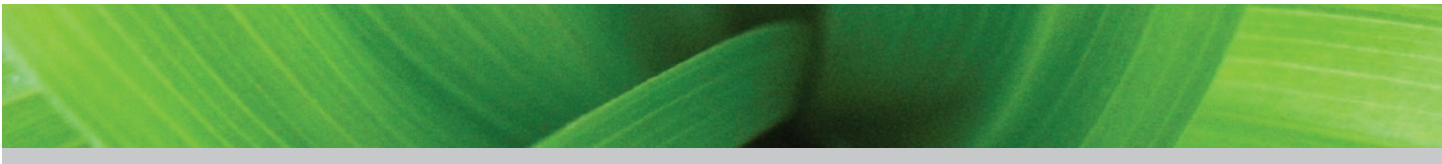
BACKGROUND

The Commodity Exchange Act (CEA) gives the CFTC jurisdiction over standardized futures and options traded on CFTC-regulated exchanges. However, non-standardized or customized derivatives that are traded by large, sophisticated companies and investors are largely unregulated under current law. These derivatives are usually executed on a bilateral basis ("over-the-counter") rather than on regulated exchanges, and are often not cleared through clearinghouses.

The global financial crisis – and more specifically, the controversy surrounding AIG's large-scale sales of credit default swaps – prompted leading members of Congress to identify the market for over-the-counter derivatives as a potential risk to the financial system. Major financial reform proposals, including the Lincoln bill and the financial reform bill (H.R. 4173) passed by the House last fall, have featured various policies intended to bring transparency to this market and enhance the stability of the financial system. These proposals have also attempted to balance these goals with the needs of companies that regularly use derivatives as a form of insurance against fluctuations in commodity prices, and would face high costs if subjected to clearing and exchange requirements.

MAJOR ELEMENTS OF THE LEGISLATION

The Lincoln bill would repeal the CEA's current exemptions for certain derivatives in non-agricultural commodities, and replace them with new requirements including:



Clearing Requirements for Certain Swaps. In general, swaps would be required to “clear” through a CFTC-registered clearinghouse if (a) the swap is available for clearing on a registered clearinghouse and (b) the CFTC determines that the swap should be cleared, based on criteria and procedures provided in the bill. Where the CFTC finds that a swap should be required to clear, but that swap is not available for clearing by a registered clearinghouse, the CFTC would be empowered to require the parties to the swap to retain “adequate” margin or capital.

Exemption for Commercial End-Users. The mandatory clearing requirement would not be binding on a swap where one of the counterparties is a “commercial end-user” using the swap to hedge commercial risk. The CFTC would define the term “commercial risk.” As defined in the legislation, the term “commercial end-user” broadly encompasses almost any non-financial firm whose “primary business activity” relates to the use, manufacture, or sale of “goods, services, or commodities (which shall include but not be limited to coal, natural gas, electricity, ethanol, crude oil, gasoline, propane, distillates, and other hydrocarbons).” Affiliates of commercial end-users would also be able to claim this exemption, provided that the affiliates use the swap to hedge the commercial risk of the commercial end-user. Financial firms, however, would not be able to invoke this exemption. The commercial end-user exemption reflects the widely-held view that non-financial companies that use swaps as insurance – as opposed to speculation – should not be subject to the costly process of clearing.

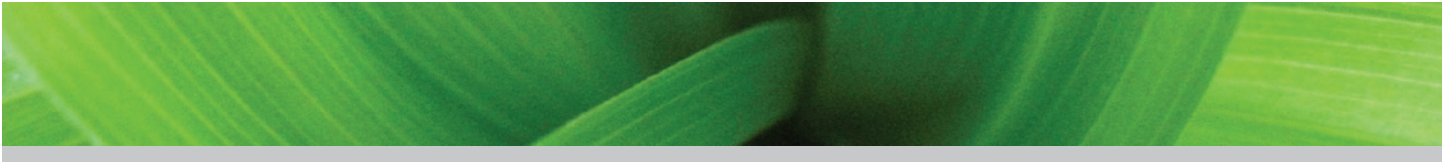
Treatment of Major Swap Participants and Swap Dealers. The Lincoln bill would recognize two new categories of market participants – “major swap participants” and “swap dealers” – that would be subject to intense regulatory scrutiny. First, both types of entities would be required to register with the CFTC and abide by new minimum capital requirements and margin requirements prescribed by the CFTC (or by federal banking regulatory agencies, in the case of banking institutions). Second, neither major swap participants nor swap dealers would be allowed to claim the commercial end-user exemption described above.

In general, a “major swap participant” is defined as an entity that engages in substantial trading of swaps for purposes other than hedging; an entity whose swap activities create substantial risks for the U.S. financial system; or a highly-leveraged financial institution with a substantial position in outstanding swaps. “Swap dealers” would include entities that make a market in swaps, hold themselves out as swap dealers or become known in the trade as swap dealers, or regularly purchase and sell swaps in the “ordinary course of business.”

Exchange Trading. The Lincoln bill would require any swap that is required to clear to also be executed on a CFTC-registered exchange. Commercial end-users that are exempt from clearing would also be exempt from the exchange trading requirement.

Position Limits. The Lincoln bill would direct the CFTC to establish quantitative limits on the aggregate volume of swaps in each month that any person may hold on the same commodity. These position limits would apply to swaps on CFTC-registered exchanges, swaps on foreign boards of trade that are linked to U.S. markets, and swaps that perform a “significant price discovery function.” The CFTC would be permitted to make discretionary exemptions from these position limits, as well as allow exemptions for hedging transactions.

Reporting and Recordkeeping. The Lincoln bill would require the reporting of uncleared swaps to a CFTC-registered data repository or the CFTC itself. The public would have access to aggregate data on trading volumes



and positions for swaps reported in this manner, but would not have access to data on individual participants or transactions. In addition, the CFTC would be required to provide the public with real-time reporting of transaction and pricing data for swaps that are subject to clearing.

NEXT STEPS

Chairman Lincoln has indicated that she expects the bill reported by the Agriculture Committee to be dovetailed with Chairman Dodd's larger financial reform bill. It is not yet clear when or how this would happen. Leader Reid has announced plans to hold a motion to proceed vote on financial reform legislation on Monday, April 26th at 5:00 pm EST. However, it remains uncertain whether the financial reform bill will be able to attract the bipartisan support needed to break a possible Republican filibuster. Chairman Dodd and Ranking Member Shelby are supposedly still in negotiations to resolve remaining differences about the bill. If and when the Senate passes a financial reform bill, it will have to be reconciled with counterpart legislation passed by the House of Representatives in fall 2009, H.R. 4173 (the Wall Street Reform and Consumer Protection Act of 2009).

FOR ADDITIONAL INFORMATION

Van Ness Feldman regularly counsels clients on regulation of energy transactions. Van Ness Feldman is also actively engaged in the ongoing policy debates concerning reforms to the financial regulatory system (e.g., proposals to regulate the over-the-counter derivatives markets) as they relate to the energy sector. If you are interested in additional information regarding the Lincoln bill or other financial reform initiatives, please contact Curt Moffatt at (202) 298-1885, Lisa Epifani at (202) 298-1947, or John Buchovecky at (202) 298-1887.

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