

Congress Passes Dodd-Frank Wall Street Reform and Consumer Protection Act, Overhauling Regulation of Over-the-Counter Derivatives in Energy and Other Commodities

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INTRODUCTION

This week, the President is expected to sign into law the financial reform bill— known as the Dodd-Frank Wall Street Reform and Consumer Protection Act, or H.R. 4173. On July 15, 2010, the United States Senate passed the conference report on the Dodd-Frank Act by a vote of 60 to 38. The measure passed with support from three Republicans (Sen. Brown (R-MA), Sen. Collins (R-ME) and Sen. Snowe (R-ME)) and 57 Democrats (Sen. Feingold (D-WI) was the lone Democrat opposing the bill). The conference report was passed in the House of Representatives on June 30, 2010, by a vote of 237 to 192.

Among the many issues addressed in the Dodd-Frank Act, the most important to the energy industry are new regulations impacting the trading of over-the-counter (OTC) derivatives in energy and energy-related commodities such as oil, natural gas, electricity, greenhouse gas offset credits, emission allowances, and renewable energy and energy efficiency credits. These transactions, which are commonly used by utilities and industrial firms to manage commercial risk, have until now gone largely unregulated under the Commodity Exchange Act (CEA). Over the coming year, this situation will change dramatically as the provisions of the Dodd-Frank Act take effect and the Commodity Futures Trading Commission (CFTC) begins to undertake the approximately eighty rulemakings and administrative actions required by Title VII of the new law.


MAJOR OTC DERIVATIVES PROVISIONS OF THE DODD-FRANK ACT

The OTC derivatives provisions in Title VII of the new law strongly resemble the legislative language reported from the Senate Agriculture Committee in April 2010 (see Van Ness Feldman's April 23, 2010 Issue Alert at: <http://www.vnf.com/news-alerts-455.html>) and subsequently incorporated into the Senate version of the financial reform bill (see Van Ness Feldman's May 25, 2010 Issue Alert at: <http://www.vnf.com/news-alerts-467.html>). Major elements of Title VII of the Dodd-Frank Act include:

- *“End user” exception.* A swap in which at least one party is not a “financial entity” (defined in the bill), and whose purpose is to mitigate “commercial risk” (to be defined by the CFTC), is eligible for an exemption from the clearing and exchange trading requirements of the law. This “end user” exception is not available for swaps in which both parties are major swap participants, swap dealers, or other “financial entities.”



- “Swaps” are defined as a category of transactions which is defined to include most derivatives except contracts for future delivery, forwards, and certain other transactions.
- “Swap Dealer” is defined as any person who holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps as an ordinary course of business, or engages in activities causing the person to be commonly known as a dealer or market maker in swaps.
- “Major Swap Participant” is defined as any person who is not a swap dealer and maintains a substantial position in swaps (excluding positions held for hedging commercial risk); whose positions create substantial counterparty exposure that could adversely affect the U.S. banking system or financial markets; or is a highly leveraged financial entity with substantial swap positions that is not subject to capital requirements.
- *Clearing requirements.* Swaps meeting five statutory criteria, as determined by the CFTC, must be processed by a derivatives clearing organization. The CFTC will be obligated to review all categories of swaps on an ongoing basis to determine whether clearing of those swaps is required. While yet to be proposed CFTC regulations will affect mandatory clearing requirements, it should be expected that mandatory clearing will demand some level of standardization of contracts and require posted collateral.
- *Capital and margin requirements.* While the conference report imposes capital requirements and initial and variation margin requirements on swaps not cleared by a registered derivatives clearing house, the conference report did not explicitly exempt from those margin requirements swaps for which an end-user exemption from clearing was claimed. In a June 30, 2010, letter from Chairman Dodd and Chairman Lincoln to Chairman Frank and Chairman Peterson, Senators Dodd and Lincoln emphasized the legislation’s intent to not impose margin and capital requirements on end-users.
- *Exchange trading.* Swaps that are required to be cleared will also be required to be executed on either a “designated contract market” (the most heavily regulated form of CFTC-registered commodity exchange) or a new class of exchanges known as a “swaps execution facility” (which will only be available to large, sophisticated traders and investors).
- *Registration and oversight of “major swap participants” and “swap dealers.”* Entities that are defined by the CFTC to be swap dealers, or major participants in the swap markets, are required to register with the CFTC and submit to minimum capital requirements, initial margin requirements on individual transactions, and variation margin requirements.
- *Reporting.* Most swaps, including uncleared swaps, will be required to be reported to a “swap data repository” or the CFTC itself.



In addition, the Dodd-Frank Act tightly restricts the ability of swap dealers and major swap participants to receive any federal assistance (including federal deposit insurance), which some have argued will raise the cost of using derivatives. In contrast to previous versions of the bill, the final language was relaxed in the conference report to allow insured depository institutions to engage in swaps trading on a restricted basis related to bona fide hedging and traditional banking activities.

Many provisions of Title VII of the Dodd-Frank Act require CFTC rulemaking in order to further clarify terms; establish administrative procedures; or fully specify registration, reporting, and other requirements. Almost all of the approximately eighty rulemakings or administrative actions required in Title VII must take place within the next year, although certain key rulemakings and requirements have shorter deadlines. Key rulemakings will address:

- Capital and margin requirements for major swap participants and swap dealers;
- Position limits on futures and options in “exempt” commodities;
- Reporting requirements for swaps, including swaps entered into before the date of the enactment of the new law; and
- Clarifications of key terms such as “commercial risk” and “major swap participants.”

IMPACTS ON DERIVATIVES IN ENERGY AND ENERGY-RELATED COMMODITIES

Until now, transactions in non-agricultural commodities – including energy commodities and environmental compliance instruments – have qualified for broad statutory exemptions from regulation under the CEA, most of which are repealed under the Dodd-Frank Act. As a result, entities that use swaps in energy and energy-related commodities will now need to carefully monitor their trading activities, and CFTC rulemakings, to ensure compliance with the provisions of the CEA and its implementing regulations.

Although the “end user” exception is expected to apply to a large number of swap transactions entered into by energy companies that use derivatives for hedging purposes, users of these derivatives will still need to verify that individual transactions meet the eligibility criteria for the end user exception. In addition, standardized futures contracts in energy and other non-agricultural commodities (which are distinct from “swaps” under the Dodd-Frank Act) will likely become subject to many of the regulatory requirements (such as required trading on designated contract markets) that currently apply to agricultural futures contracts.

In general, we expect that the costs of using derivatives will increase as a result of the Dodd-Frank Act, even in transactions that are exempt from the new regulations, due to the capital that will have to be reserved and margin that will have to be posted by financial institutions, swap dealers, and major swap participants. However, the full extent and impact of the Dodd-Frank Act will not be clear until CFTC begins promulgating



regulations and administering requirements under the new law.

FOR ADDITIONAL INFORMATION

Van Ness Feldman regularly counsels clients on regulation of energy transactions, and is actively engaged in the policy debates concerning reforms to the financial regulatory system as they relate to the energy sector. If you are interested in additional information regarding the Dodd-Frank Act, related CFTC actions, 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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