

What Does Cap-and-Trade Have to Do with Derivatives Regulation?

When U.S. Representative Henry Waxman (D-CA) introduced his much-touted cap-and-trade bill, "The American Clean Energy and Security Act of 2009" ("Cap-and-Trade Bill") on May 15, 2009, included in the tome of approximately one thousand pages are several relatively short but significant sections dealing with the regulation of derivatives. While some of the proposals deal primarily with energy derivatives, other sections deal more broadly with derivatives in general and, in particular, credit default swaps. The proposals come on the heels of a letter released to Congress on May 13, 2009 by the Secretary of the Treasury, Timothy Geithner, outlining the Obama administration's proposed regulatory framework for over-the-counter ("OTC") derivatives.

OTC trading is regulated by the Commodities Exchange Act ("CEA") and securities laws, but The Commodity Futures Modernization Act of 2000 allowed most derivatives to exist outside of the scope of regulation of both the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC"). The Obama administration is proposing that the CEA and the securities laws be amended to bring derivatives into the scope of federal regulation.

The Secretary's Proposal

Secretary Geithner's letter expands on congressional testimony regarding regulatory reform that the Secretary gave in March 2009, and details four objectives for the increased regulation of OTC derivatives:

Preventing Activities in OTC Derivatives Markets from Posing Risk to the Financial System

The letter proposes that all standardized OTC derivatives be cleared through regulated central counterparties ("CCPs"). The CCPs would impose risk controls, such as robust margin requirements, to prevent customized OTC derivatives from being used to avoid clearing trades through a CCP. If a derivative is accepted for clearing, it would be presumed to be a standardized contract required to be cleared through a CCP.

In addition, it was recommended that all OTC derivatives dealers and other firms whose activities create large exposures to counterparties should be subject to a "robust and appropriate" regulatory regime including "conservative capital requirements, business conduct standards, reporting requirements, and conservative requirements relating to initial margins on counterparty credit exposures," but the letter does not elaborate further on this point.

Promoting Efficiency and Transparency in OTC Derivatives Markets

The letter recommends imposing recordkeeping and reporting requirements (including audit trails) on all OTC derivatives, either by clearing the standardized transactions through a CCP or by reporting customized transactions to a regulated trade repository. CCPs, trade repositories and other market participants should be required to make publicly available both aggregate data on open positions and trading volumes, and to provide individual counterparty trade data to regulators on a confidential basis, to provide a complete picture of activity on the OTC markets and assist regulators in detecting abuses.

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Along with requiring that standardized contracts be cleared through CCPs, the standardized parts of the market should be moved onto regulated exchanges and regulated transparent electronic trade execution systems, and regulated financial institutions should be encouraged to make greater use of regulated exchange-traded derivatives. The Obama administration believes that, combined with the development of a system for timely reporting of trades and dissemination of prices and trade information, standardized OTC derivatives trading could be competitive, efficient and transparent.

Preventing Market Manipulation, Fraud, and Other Market Abuse

The Obama administration would like to ensure that the CFTC and SEC have the clear authority to police fraud, manipulation and other abuses, and to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to futures markets.

Ensuring that OTC Derivatives are not Marketed Inappropriately to Unsophisticated Parties

While current law limits the types of counterparties that can participate in derivatives markets, the letter states that the CFTC and SEC are reviewing the limits and disclosure requirements to recommend how the CEA and the securities laws should be amended to better protect less sophisticated counterparties from entering into inappropriate derivatives transactions.

An outline of the proposal and Secretary Geithner's letter to Congress can be found at the Department of Treasury Web site at:

<http://www.ustreas.gov/press/releases/tg129.htm>

Cap-and-Trade Legislation and Derivatives

Two days after Secretary Geithner sent his letter to Congress, Representative Waxman introduced the Cap-and-Trade Bill into the House of Representatives. The bill has been considered by the Committee on Energy and Commerce, and on May 21, 2009, the Committee approved it by a 33-25 vote. As currently drafted, the bill contains some provisions that parallel the proposals of the Obama administration, others that bring energy swaps into the regulatory structure, and a provision limiting the eligibility to enter into a credit default swap ("CDS").

Parallel Provisions to the Obama Administration Proposal

The Cap-and-Trade Bill, as drafted, would require the settlement and clearing of standardized OTC derivatives through registered derivatives-clearing organizations, and provides for exemptions for clearing for non-standardized swaps based on complexity, rarity, and certain other standards to be enacted by the CFTC, which may include capital requirements higher than those set for cleared derivatives. All exempted transactions would be subject to reporting to the CFTC, which would share the information with the SEC and the Board of Governors of the Federal Reserve System. All derivative-clearing organizations would be subject to broad disclosure requirements of their daily trading information, and the terms and conditions of transactions cleared and settled. The cost of monitoring the new regulatory system for OTC derivatives would be offset by the establishment of a CFTC transaction fee.

Provisions Relating to Energy Swaps

With regard to energy swaps, the Cap-and-Trade Bill proposes to extend regulatory authority to swaps involving energy transactions while eliminating the current "exempt" commodity status of energy swaps under the CEA, and limiting the CFTC's authority to provide exemptions from the CEA for energy transactions, in general and via no-action letters. The bill would also require the CFTC to establish uniform speculative position limits for energy transactions, which would include setting limits on an aggregate number of positions that may be held

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by any person for each month across all markets, and convening a position limited energy advisory group of market participants when considering the establishment of these position limits. The “swaps loophole” (the use of swaps to avoid position limits set on futures contracts) would be eliminated by limiting the *bona fide* hedge exemption concept to include only physical or commercial risk, and not speculative synthetic hedging positions.

Provision Relating to Credit Default Swaps

Importantly, the proposals in the Cap-and-Trade Bill would greatly limit the CDS market by prohibiting any person from entering into a CDS unless the person (i) owns a credit instrument insured by the CDS; (ii) would experience financial loss if an event that is the subject of the CDS occurs with respect to the credit instrument; and (iii) meets minimum capital adequacy standards established by the CFTC or any more stringent capital standards under the law of any state in which the CDS is originated or entered into.

Legislative Process

Eight other bills relating to derivatives regulation have been introduced into the House and Senate this term, but the central concepts from each of them have been consolidated into the text of the Cap-and-Trade Bill. While the Cap-and-Trade Bill has made its way through the Committee on Energy and Commerce with scant change to the provisions affecting derivatives, eight other committees also claim jurisdiction over the bill, including the House Committee on Financial Services. There is always the possibility that the derivatives provisions could be altered or stripped from the bill entirely by the time it reaches the floor of the House or in conference with the Senate.

The text and a summary of the bill can be found at the Committee on Energy and Commerce's Web site at:

http://energycommerce.house.gov/index.php?option=com_content&view=article&id=1629:chairmen-waxman-and-markey-introduce-the-american-clean-energy-and-security-act&catid=141:full-committee&Itemid=85

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