REPORT OF THE FINANCE & TRANSACTIONS COMMITTEE

The period covered by this report is July 1, 2010, through January 20, 2011.*

I. OVERALL OBJECTIVES OF DODD-FRANK TITLE VII

In the words of the current chair of the CFTC, Commissioner Gary Gensler, the key objective of Title VII of Dodd-Frank is to "bring the unregulated over-the-counter derivatives markets under comprehensive regulation. Those derivatives, also known as 'swaps,' were not the only cause of the 2008 financial crisis, but they played a significant role."[2] Dodd-Frank does not apply particularly or solely to energy companies; however, companies participating in every sector of the energy business – oil, natural gas, coal, uranium, electricity – rely on swaps to hedge or manage their commodity price risks as well as exposures to interest rates and, in some cases, foreign currencies. All of these hedging transactions will be impacted in some way by Dodd-Frank.

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2. Gary Gensler, Chairman of the CFTC, Remarks, Implementing the Dodd-Frank Act, George Washington School of Law (Jan. 14, 2011), http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-65.html; Dodd-Frank § 124.

Until Dodd-Frank becomes effective, there are broad exemptions for energy commodity derivatives from CFTC regulation.[3] Dodd-Frank amends the Commodity Exchange Act[4] to repeal those exemptions and regulate all over-the-counter swaps transactions for the first time. Dodd-Frank was signed into law on July 21, 2010.[5] Most of its provisions will not take effect until July 16, 2011, or 60 days after publication of final rules from the CFTC and other affected agencies.[6] The transactions and the markets on which they are transacted are complex; therefore, these statutory provisions and regulations are equally complex. This report is intended to aid the industry in considering the likely impacts of Dodd-Frank on the way that they conduct hedging transactions in the future.

II. KEY FEATURES OF DODD-FRANK TITLE VII AFFECTING ENERGY COMPANIES

"Markets work best when they are transparent, open and competitive."[7] To achieve that goal for swaps markets, Dodd-Frank requires that all swaps must be transacted on an exchange (for pre-trade transparency) and reported as directed by the CFTC, with data made publicly available (for post-trade transparency).[8] To reduce risks perceived to have contributed to the 2008 financial crisis, swaps must also be backed by collateral and cleared by a clearinghouse.[9] "End-users," such as airlines and utilities, when they use swaps to hedge against commercial risk, will be exempt from the exchange-trading and clearing requirements (for public companies, the board must approve entering into exempt swaps), as well as the capital and margin rules.[10]

Even though regulations promulgated by the CFTC under Dodd-Frank might exempt most or all of an energy company's swaps under the so-called "end user exemption" from the exchange-trading and clearing requirements,[11] market conditions might require the company to transact on exchanges or with clearinghouses, all of which have margin requirements, and position limits on swaps may be imposed by the CFTC to assure market integrity. In all cases, there are reporting requirements that could become the burden of an energy company, even though it qualifies for the end user exemption.[12]

3. Commodity Exchange Act, 7 U.S.C. § 2(h) (2010). Even though exempt from direct regulation, the anti-fraud and manipulation rules of the CEA still apply to participants in these exempt swaps. *Id.*

4. *Id.* § 2. Dodd-Frank also amends the Securities Exchange Act of 1934 (SEA), 15 U.S.C. §§ 78aaa-78111, to address "security-based swaps" and regulate the markets upon which such swaps are and will be traded, but this report does not include discussion of that type of derivative instruments. *Id.*

5. Dodd-Frank § 124.

6. *Id.* § 754.

7. Gensler, *supra* note 2.

8. *Id.*

9. *Id.*

10. *Id.*

11. Dodd-Frank § 124.

12. *Id.*

A. End User Exemption from Clearing and Exchange-Trading Requirements

Dodd-Frank amends section 2(h)(1)(A) of the CEA[13] to make it unlawful for anyone to enter into a swap that is required to be cleared unless the swap is submitted to a designated clearing organization for clearing.[14] In new section 2(h)(7) of the CEA, however, Dodd-Frank provides an exemption giving "end users" the option not to clear swaps.[15] Under Dodd-Frank, the end-user exemption applies when one counterparty to the swap: "(i) is not a financial entity; (ii) [uses the relevant] swaps to hedge or mitigate commercial risk; and (iii) notifies the [CFTC] . . . how it . . . meets its financial obligations associated with . . . [un]cleared swaps."[16] Swaps qualifying for this exemption also do not have to be traded on an exchange.[17]

New section 2(h)(7)(C)(i) of the CEA defines the term "financial entity"[18] to include: (i) swap dealers and security-based swap dealers, (ii) major swap participants and major security-based swap participants, (iii) commodity pools, (iv) private funds as defined in the Investment Advisers Act of 1940,[19] (v) employee benefit plans as defined in the Employee Retirement Income Security Act of 1974,[20] and (vi) persons predominantly engaged in banking or financial activities, as defined in the Bank Holding Company Act of 1956.[21]

In addition, to be eligible for the end-user exemption, the appropriate committee or governing body of a public company[22] must review and approve the public company's decision to enter into swaps that are exempt from the clearing and exchange trading requirements under Dodd-Frank.[23]

In December 2010, the CFTC and the SEC each issued proposed rules on implementing the "end-user exception" to the mandatory clearing of swaps.[24] Comments on the CFTC's proposed rules were due on February 22, 2011, for the

13. Commodity Exchange Act, 7 U.S.C. § 2 (2010).

14. *Id.* § 2(h)(1)(A).

15. Dodd-Frank § 124. The term "end user" does not appear in the statute, but the industry has used this label in its proposals that would have exempted most energy companies who use swaps to manage their exposures to energy prices and that were submitted to Congress during the legislative process that resulted in Dodd-Frank. *See generally* Letter from Chairman Christopher Dodd, Senate Committee on Banking, Housing, and Urban Affairs, United States Senate, and Chairman Blanche Lincoln, Senate Committee on Agriculture, Nutrition, and Forestry, United States Senate, to The Honorable Chairman Barney Frank, Financial Services Committee, United States House of Representatives and The Honorable Chairman Colin Peterson, Committee on Agriculture, United States House of Representatives (June 30, 2010), *available at* http://www.sec.gov/comments/s7-16-10/s71610-2.pdf (urging regulators to implement Dodd-Frank to protect "end users" from burdensome costs).

16. 7 U.S.C. § 2(h)(7) (as amended by Dodd-Frank § 723).

17. *Id.* § 2(h)(8) (as amended by Dodd-Frank § 723).

18. *Id.* § 2(h)(7)(C)(i) (as amended by Dodd-Frank § 723).

19. Investment Advisors Act, 15 U.S.C. § 80-b-2(a) (2006).

20. Employee Retirement Income Security Act, 29 U.S.C. § 1002 (2006).

21. Bank Holding Company Act, 12 U.S.C. § 1841 (2006).

22. An issuer of securities registered under Exchange Act § 12 or required to file reports under Exchange Act § 15(d).

23. 7 U.S.C. § 2(j) (as amended by Dodd-Frank § 723).

24. Proposed Rulemaking, End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80,747, at 80,752 (2010) (to be codified at 17 C.F.R. pt. 39) (CFTC End-User Proposed Rule); Proposed Rulemaking, End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. 79,992 (2010) (to be codified at 17 C.F.R. pt. 240) (SEC End-User Proposed Rule).

CFTC's proposed rule.[25] Comments on the SEC's proposed rule were due on February 4, 2011.[26] Under the proposed rule, an end user claiming the exception would notify a swap data repository (SDR), if available, under a check-the-box approach.[27]

The proposed CFTC rule considers a swap used to hedge or mitigate commercial risk, and therefore qualifying for the exemption, if: (i) the swap is economically appropriate for reducing certain business risks, including the potential change in value of assets, liabilities, or services, or fluctuations in foreign exchange or interest rates; (ii) the swap qualifies as a bona fide hedge for purposes of an exemption from CEA position limits;[28] or (iii) the swap qualifies for hedging treatment for accounting purposes.[29] Furthermore, the swap must also not be disqualified from the exemption, which will occur if it:

- is used for a purpose that is in the nature of speculation, investing or trading; or
- is used to hedge or mitigate the risk of another swap, unless that swap is itself used to hedge or mitigate commercial risk.[30]

The CFTC has requested comments about every aspect of this proposed rule, including whether it should limit the exemption to only non-financial commodity hedges; whether this purpose test should be determined on a single risk or aggregate risk basis and for a single entity or on a consolidated basis; whether industry-specific rules are appropriate; whether hedge effectiveness should be considered; and whether asset optimization and dynamic hedging should be included.[31]

B. *Reporting and Record Retention Requirements*

Under Dodd-Frank section 727, certain information regarding swaps, regardless of whether those swaps are subject to the clearing and exchange-trading requirements, must be reported to a swap data repository (SDR) or to the CFTC.[32] Under the Reporting Requirements Final Rulemaking, if a Swap Execution Facility, Designated Contract Market, or Derivatives Clearing Organization has not already reported the required swap creation data to the SDR, then it falls to the reporting counterparty to do the reporting.[33] Under the Reporting Requirements Final Rule, the required swap creation data to be

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25. End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80,747.

26. *Id.*

27. *Id.* at 80,751.

28. 7 U.S.C. § 2 (as amended by Dodd-Frank § 737(c)). A bona fide hedge:

> (A)(i) represents a substitute for transactions made or to be made . . . in a physical marketing channel; (ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and (iii) arises from the potential change in the value of - assets . . . ; liabilities . . . ; or services [of a person] . . . ; or (B) reduces risks attendant to a position resulting from a swap that [is a bona fide hedge]. *Id.* (internal quotation marks omitted).

29. End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. at 80,752.

30. *Id.*

31. *Id*. at 80,753.

32. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 727, 124 Stat. 1376 (2010).

33. *Id.*

reported is slightly different for different types of swaps.[34] The reporting counterparty required to make submissions to the SDR is the swap dealer (SD), or if there is no SD, then the major swap participant (MSP), and if neither counterparty is a SD or MSP, or both are SDs or both are MSPs, then the two parties decide which one will be the reporting counterparty.[35] It is important to note, however, that if only one counterparty is a U.S. person, that U.S. person will be the reporting counterparty.[36]

There have been two interim final rules under Dodd-Frank regarding the reporting of (i) swaps entered into before the enactment of Dodd-Frank (which were still in effect on the day of enactment) and (ii) swaps that are entered into post-enactment but before the effective date of the Reporting Requirements Final Rule.[37] These interim reporting requirements will remain in effect until the effective date of the Reporting Requirements Final Rule.

Under section 723 and section 729 of Dodd-Frank, the CFTC has established an interim final rule effective October 14, 2010, which requires a counterparty to a swap entered into before July 21, 2010 (date of enactment), which was still in effect on July 21, 2010, to report to a SDR, or to the CFTC if there is no SDR, certain information regarding that swap no later than the first to occur of 180 days after the effectiveness of CEA section 2(h)(5)(A)[38] or sixty days after a SDR becomes registered with the CFTC.[39] Similarly, in an interim final rule effective December 17, 2010, a counterparty to a swap entered into after July 21, 2010, but before the enactment of the Reporting Requirements Final Rule, must report to a SDR, or to the CFTC if there is no SDR, certain information regarding that swap no later than the first to occur of ninety days after the effectiveness of CEA section 2(h)(5)(B)[40] or sixty days after a SDR becomes registered with the CFTC.[41] The counterparty required to report the information is determined in the same manner as described in the Reporting Requirements Final Rule discussed above.

The required reported information under the interim rules is generally: "(i) [a] copy of the transaction confirmation in electronic form, if available, or in written form if there is no electronic copy; [and] (ii) if available, the time the transaction was executed" as well as "any information relating to such transaction during the time that this interim final rule is in effect" upon a request from the CFTC.[42]

For all post-enactment swaps, the CFTC

34. *Id.*

35. *See* Interim Final Rule for Reporting Pre-Enactment Swap Transactions, 75 Fed. Reg. 63,080, at 63,081 (2010) (to be codified at 17 C.F.R. pt. 44.02).

36. Proposed Rulemaking, Swap Data Recordkeeping and Reporting Requirements, 75 Fed. Reg. 76,574 (2010) (to be codified at 17 C.F.R. pt. 45.5(d)).

37. 75 Fed. Reg. 63,080, at 63,081.

38. Commodity Exchange Act, 7 U.S.C. § 2(h)(5)(A) (as amended by Dodd-Frank § 723).

39. 75 Fed. Reg. 63,080, at 63,080.

40. 7 U.S.C. § 2(h)(5)(B) (as amended by Dodd-Frank § 723).

41. *See* Interim Final Rule and Request for Comment, Reporting Certain Post-Enactment Swap Transactions, 75 Fed. Reg. 78,892 (2010) (to be codified at 17 C.F.R. pt. 44.03).

42. *Id.* at 78,893.

> expects that counterparties to existing swaps routinely retain, consistent with reasonable business practice, information including but not limited to: (i) Any information necessary to identify and value the transaction (e.g., underlying asset and tenor); (ii) the date and time of execution of the transaction; (iii) volume (e.g., notional or principal amount); (iv) information relevant to the price and payment of the transaction until the swap is terminated, reaches maturity, or is novated; (v) whether the transaction was accepted for clearing by any clearing agency or derivatives clearing organization, and if so, the identity of such agency or organization; (vi) any modification(s) to the terms of the transaction; and (vii) the final confirmation of the transaction.[43]

C. Key Definitions: Swap Dealer and Major Swap Participant Swap Dealer

1. Swap Dealer

Dodd-Frank adds "swap dealer" as a new definition in section 1a(49) of the CEA.[44] This definition generally states that a 'swap dealer' is

> any person who - (i) holds [it]self out as a dealer in . . . swaps; (ii) makes a market in . . . swaps; (iii) regularly enters into . . . swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing [the person] to be commonly known in the trade as a dealer or market maker in . . . swaps [unless such activity is considered de minimis swap activity].[45]

"A person may be designated as a . . . swap dealer for a single type or single class or category of . . . swap or activities," but not considered a swap dealer for other types of swaps.[46] A "swap dealer does not include a person that enters into . . . swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business."[47] These definitions are the subject of a CFTC proposed rulemaking, and comments are requested by February 22, 2011.[48]

2. Major Swap Participant

Dodd-Frank section 721(a)(16) adds a definition of "major swap participant" as a new section 1a(33) of the CEA.[49]

> The term 'major swap participant' means any person who is not a swap dealer, and [either] (i) maintains a substantial position in swaps for any of the major swap categories . . . excluding (I) positions held for hedging or mitigating commercial risk; and (II) positions maintained by any employee benefit plan . . . for . . . hedging or mitigating any risk directly associated with the operation of the plan; (ii) whose outstanding swaps create substantial counterparty exposure that could have serious

43. *Id.* at 78,894 (emphasis omitted).

44. 7 U.S.C. § 1a(49) (as amended by Dodd-Frank § 721).

45. *Id.* (internal quotation marks omitted).

46. *Id.*

47. 7 U.S.C. § 1a(49)(C) (as amended by Dodd-Frank § 721) (internal quotation marks omitted). Dodd-Frank adds an almost identical definition of "security-based swap dealer" in section 3(a)(71) of the SEA. Dodd-Frank § 124.

48. Proposed Rulemaking, Further Definition of "Swap Dealer," Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80,174 (2010) (to be codified at 17 C.F.R. pts. 1, 240).

49. Dodd-Frank § 721 (adding 7 U.S.C. § 1a(33)).

> adverse effects on the financial stability of the United States banking system or financial markets; or (iii)(I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and (II) maintains a substantial position in outstanding swaps in any major swap category as determined by the [CFTC].[50]

This does not include an entity

> whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.[51]

Several terms in these definitions and the definitions themselves are the subject of a CFTC Proposed Rulemaking; including "substantial position;" "major swap categories;" "hedging or mitigation commercial risk;" and "substantial counterparty exposure."[52]

3. Consequences of Being a Swap Dealer or Major Swap Participant

"Dodd-Frank requires swap dealers and major swap participants to register with the CFTC . . . ."[53] Registration must occur before the one year anniversary of the date of enactment of Dodd-Frank, which will occur July 21, 2011. In addition to registration, swap dealers and major swap participants are subject to increased monitoring, oversight, and reporting requirements by the CFTC and must satisfy certain capital and margin requirements.[54]

D. Collateral Segregation and Credit Risk Assessments

The CFTC has long provided for the segregation of customers' funds and property.[55] CEA section 4d(a)(2) provides that a futures commission merchant may not commingle its own funds with property received in order to margin, guarantee, or secure the exchange traded contracts of any customer.[56] Similarly, the futures commission merchant may not use those funds to guarantee the trades or contracts of any person other than the one for whom such funds are held.[57]

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50. *Id.* (internal quotation marks omitted).

51. *Id.* Dodd-Frank adds an almost identical definition of "major security-based swap participant" in section 3(a)(67) of the SEA. *Id.*

52. Proposed Rulemaking, Further Definition of "Swap Dealer," Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80,174 (2010) (to be codified at 17 C.F.R. pts. 1, 240). Comments on these proposed rules were due to be filed on February 22, 2011.

53. Ted Knutson, *CFTC Offers Rules Under Dodd-Frank for Swap: Industry CCOs, Whistleblowers*, COMPLINET (Nov. 11, 2010), http://www.complinet.com/dodd-frank/news/articles/article/cftc-offers-rules-under-dodd-frank-for-swap-industry-ccos-and-whistleblowers.html.

54. Commodity Exchange Act, 7 U.S.C. § 4s (as amended by Dodd-Frank § 731).

55. *See* Use of Customer Funds Restricted, 17 C.F.R. § 1.22 (2010).

56. 7 U.S.C. § 6d(a)(2) (2006).

57. *Id*.

Section 724 of Dodd-Frank amends the CEA and addresses collateral segregation requirements for cleared and uncleared swaps.[58] New CEA section 4d(f)(2) addresses cleared swaps and tracks the language in CEA section 4d(a)(2), but it is not identical.[59] CEA section 4d(f)(2) provides that "property of a swaps customer" received to margin a swap "shall not be commingled with the funds of the futures commission merchant or be used to margin, secure, or guarantee . . . trades or contracts of . . . swaps customer or person other than the [one] for whom the same are held."[60]

New CEA section 4s(1) establishes requirements for segregating collateral supplied for margining, guaranteeing, or securing uncleared swaps.[61] For example, the counterparty to a swap transaction has the right to require segregation of the funds or other property that it provides to margin, guarantee, or secure its obligations in a swap transaction, and swap dealers and major swap participants must notify each counterparty at the beginning of a swap transaction of this right.[62] Accordingly, at the request of the counterparty, the swap dealer or major swap participant must segregate funds or other property with an independent third party.[63]

While Dodd-Frank imposes a general segregation-of-assets requirement, the regulations currently being crafted by the CFTC will determine how burdensome the segregation requirements will be for energy companies. For example, the CFTC has requested comments on the appropriate model for protecting the margin collateral posted by customers that are clearing swaps transactions.[64] The CFTC has proposed four alternative models for segregating funds, each of which would allocate risks differently among customers, the futures commission merchant, and the derivatives clearing organization.[65]

Briefly, the "Full Physical Segregation" model would require individual segregation of each customer's collateral at the futures commission merchant, the derivatives clearing organization, and each custodian.[66] Such a model would resemble arrangements for an uncleared bilateral swap transaction in which each counterparty is required to post margin and neither counterparty is permitted to hold collateral but must transfer it to a custodian. The "Legal Segregation with Commingling" model would permit collateral of multiple customers to be commingled, but the value of the collateral for each customer's position would be treated on an individual basis.[67] "Moving Customers to the Back of the Waterfall" is a model that would permit the use of collateral of non-defaulting customers in the event of the futures commission merchant's default only after

58. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 724(a), (c), 124 Stat. 1376 (2010).

59. *Id.* § 724(a).

60. *Id*.

61. *Id.* § 724(c).

62. *Id*.

63. *Id*.

64. *See* Notice, Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 Fed. Reg. 75,162 (2010) (to be codified at 17 C.F.R. pt. 190).

65. *Id*. at 75,164.

66. *Id*.

67. *Id*.

other elements of the clearing house's default resources package were used, including the clearinghouse's own contribution and member-funded guarantee fund.[68] Finally, a "Baseline Model" would treat futures commission merchants' customers on an omnibus basis and basically describes the current scheme for futures contracts traded on an exchange through a futures commission merchant.[69] This means that if the futures commission merchant cannot cover for a customer with insufficient funds, the derivative clearing organization could access collateral from all customers of the defaulting futures commission merchant.[70]

Depending on which model prevails, energy companies forced to clear swaps to control risks could find themselves exposed under the "Baseline Model" to the additional risk of fellow customers who cannot pay their obligations.[71]

E. Position Limits

Dodd-Frank section 737 expands the authority of the CFTC to include defining and applying "position limits" to "swaps that perform or affect a significant price discovery function with respect to registered entities."[72] The CEA currently provides:

> Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities, or *swaps that perform or affect a significant price discovery function with respect to registered entities* causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity. For the purpose of diminishing, eliminating, or preventing such burden, the Commission shall . . . proclaim and fix such limits on the amounts of trading which may be done or positions which may be held by any person . . . as the Commission finds are necessary to diminish, eliminate, or prevent such burden.[73]

The authority to establish position limits for futures contracts and other financial instruments regulated by the CFTC dates back to the CEA's passage in 1936.[74] Moreover, this authority has been regularly exercised, either directly or through rules adopted by the CFTC regulated exchanges upon which futures and other financial contracts are traded, since 1936.[75] Dodd-Frank section 737

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68. *Id*.

69. *Id*.

70. *Id*. at 75,163.

71. *Id.* at 75,164.

72. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 727, 124 Stat. 1376 (2010).

73. Commodity Exchange Act, 7 U.S.C. § 6a(1) (2010) (emphasis added).

74. *Id.* § 1.

75. *See generally* Notice of Proposed Rulemaking, Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4,144 (2010) (to be codified at 17 C.F.R. pts. 1, 20, 151) (ECPL Proposed Rule). The Rule for a description of the history of application of position limits upon futures and options contracts by the CFTC and its forebears. A description of the principal exchange-traded energy related futures contracts (i.e., for grades of crude oil, refined products, and natural gas) are also provided. These contracts have not been subject to CFTC established position limits, but rather to limits imposed by the exchange which created them and upon which they have been traded.

expands this authority to cover the previously unregulated "swaps market" including "swaps that are economically equivalent to contracts of sale for future delivery or to options on the contracts or commodities traded on or subject to the rules of a designated contract market," and to the establishment of "aggregate position limits" involving these previously unregulated instruments.[76] Existing language in the CEA permits imposing limits on "the spot month, each other month, and the aggregate number of positions that may be held by any person for all months."[77] Trading or the creation of market positions in excess of the limits established by the CFTC is prohibited.[78] Such limits, however, are not to prevent any person from establishing "bona-fide hedge positions," and the Commission is empowered to grant exemptions from these limitations.[79]

The CFTC has stated that the necessity for this authority arises from the mechanics of market operation and is intended to prevent a single entity or class of entities with similar objectives from controlling a specific commodity market's price discovery function.[80] Price is established in commodity markets by the magnitude of buyer and seller demand and by the merging of differing commodity value judgments resulting in transactions between these many market participants.[81] However, if one or a class of related participants (either buyers or sellers) develops a dominant position as compared to the entirety of market volume, price can be influenced to affect only those participants' valuation judgments or objectives.[82] Indeed, even though such entities do not seek to alter price levels, if their positions become too large relative to market volume, the creation or unwinding of those positions can unreasonably raise or depress prices to the injury of the public. Position limits are seen as an effective regulatory response to prevent that injury.[83] They may be established by the

76. 7 U.S.C. §§ 4a(a), 6a (as amended by Dodd-Frank § 737).

77. *Id.* § 6a.

78. CFTC, *Speculative Limits*, http://www.cftc.gov/IndustryOversight/MarketSurveillance/SpeculativeLimits/index.htm (last visited Feb. 22, 2011).

79. 7 U.S.C. §§ 6a(2)(A), (3)(A), (6)(a), 6b, 6c. Explicit statutory standards are provided for determining when a swap serves a significant price discovery function, is economically equivalent to an exchange traded future or option contract, or when a bona fide hedging position has been developed. A bona fide hedging position is, among other criteria, a position that is "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise." A "spot month" is not in fact a standard calendar period, but rather a trading period (often only a 3 day calendar period) which immediately precedes the delivery period for a physically-delivered futures contract and related other financial instruments. *See generally* note 85 *infra* at p. 19.

80. Statement of Dan M. Berkovitz, General Counsel, CFTC, Background on Position Limits and the Hedge Exemption (Jan. 14, 2010), http://www.cftc.gov/PressRoom/SpeechesTestimony/proposedrule011410_berkovitz.html.

81. *Id.*

82. *Id.*

83. Notice of Proposed Rulemaking, Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4,144, 4,144-45, 4,148-49 (2010) (to be codified at 17 C.F.R. pts. 1, 20, 151). In this Proposed Rule, which has been withdrawn and will not be adopted, the CFTC, prior to the passage of Dodd-Frank, was seeking to impose direct position limits (i.e., not merely those established by an exchange) on a number of exchange-traded energy contracts in response to concerns that certain trading by financial interests had unreasonably increased particularly crude oil and products prices to an extent not supported by market demand and supply fundamentals and thereby imposing injuries upon the public.

CFTC "prophylactically," i.e., prior to any evidence or CFTC finding of an existing injury or likely future burden on commerce.[84]

On January 13, 2011, after extensive debate at two public meetings, the CFTC issued a proposed rule on Position Limits for Derivatives.[85] Under the proposed rule, position limits will be established in two phases.[86] First, existing limits upon exchange-traded futures, options, and other financial instruments by the exchanges will become direct position limits enforceable by the CFTC.[87] For derivatives and other financial instruments not traded solely on an exchange, and for aggregate position limits that will apply across different trading venues to contracts based on the same underlying commodity, data must first be collected to determine the relevant market volume of such transactions before appropriate position limits can be established.[88] As noted above, disruptive price movements and improper price discovery occurs when one or a limited class of trader positions becomes too large to be absorbed within total market volume. Knowledge of total market volume (not presently available for these previously unregulated swaps transactions) is necessary to establish effective position limits or aggregate limits involving swap contracts.[89] Necessary data is expected to be collected by early 2012, and a further order will be issued (after allowing comment by market participants) establishing specific limits for such instruments as well as aggregate limits.[90] Exemptions are provided for bona fide hedging transactions, i.e., available to both the end-user mitigating commercial risk and its counterparty who may enter into such transactions even though that may result in one or both of them exceeding CFTC established position limits.[91] The proposed rules also establish "visibility regulations" which require position reporting to assist in enforcement of the new limits.[92] Comments are requested by March 28, 2011, assuring that the proposed rules will not be in effect by the statutory deadline of January 17, 2011.[93]

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84. *Id.*

85. Notice of Proposed Rulemaking, Position Limits for Derivatives, 76 Fed. Reg. 4,752 (2011) (to be codified at 17 C.F.R. pts. 1, 150, 151). The necessity for position limits to prevent disruptive price movements, including a description of CFTC studies supporting the need and past regulatory actions, is contained in the descriptive preface to the proposed rule. *Id.* at 4,752-56. Separate spot month limits are set for contracts requiring physical delivery and cash settled contracts, with the limit for the former set at 25% and the latter at five times that level. A formula is proposed for establishing position limits for non-spot months and for aggregate positions so that no trader will be permitted to establish a position above 10% of market volume for markets with 25,000 or less open interest contracts. For larger contract volume markets, the formula will adjust this threshold level by 2.5% of all additional contracts. The bona fide hedging exception is discussed. *Id.*

86. *Id.* at 4,752.

87. *Id.*

88. *Id.*

89. *Id.* at 4,756.

90. The necessary data is to be collected through reporting requirements imposed by this rule and under a separate proposed rule also not yet final. *See generally* Notice of Proposed Rulemaking, Position Reports for Physical Commodity Swaps, 75 Fed. Reg. 67,258 (2010) (to be codified at 17 C.F.R. pts. 15, 20).

91. 76 Fed. Reg. 4,752, at 4,756.

92. *Id.* at 4,753.

93. *Id.* at 4,752.

F. Commodity Futures Trading Commission (CFTC), Federal Energy Regulatory Commission (FERC), and State Public Utility Commission (PUC) Jurisdiction Issues

In recent years, the CFTC and the FERC have stepped into each other's jurisdictional turf with regard to claims of manipulation in the natural gas markets and oversight of instruments such as financial transmission rights (FTRs). For example, in September 2009, the CFTC issued a notice seeking comments about whether certain electricity contracts perform significant price discovery functions and should therefore be subject to CFTC oversight.[94] The FERC responded by filing a comment that the CFTC's question might conflict with the FERC's exclusive jurisdiction under the Federal Power Act (FPA)[95] over the transmission or sale for resale of electric energy in interstate commerce or with its other regulatory responsibilities under the FPA.[96] The episode triggered discussions throughout the industry about instruments and platforms traditionally regulated by the FERC, such as FTRs, real-time and day-ahead energy markets, capacity markets, and ancillary services. Section 722 of Dodd-Frank addresses such jurisdictional questions.[97]

Specifically, section 722(e) provides that Dodd-Frank will not limit or affect any statutory authority of the FERC, or any state regulatory authority (as defined by the FPA) with respect to an agreement, contract, or transaction that is entered into under a tariff or rate schedule approved by the FERC, so long as it is (1) not executed, traded, or cleared on a registered entity or trading facility, or (2) executed, traded, or cleared on a registered entity or trading facility owned or operated by a regional transmission organization or independent system operator.[98]

Dodd-Frank further addresses the FERC's jurisdiction regarding its authority over natural gas transportation and markets. Specifically, section 722(g) states that nothing in Dodd-Frank or any amendments to the CEA made by Dodd-Frank limit or affect any FERC statutory enforcement authority pursuant to FPA section 222 and section 4A of the Natural Gas Act[99] that existed before Dodd-Frank was enacted.[100]

Finally, Dodd-Frank directs the CFTC and the FERC to "negotiate a memorandum of understanding to establish procedures for - (A) applying their respective authorities in a manner so as to ensure effective and efficient regulation in the public interest; (B) resolving conflicts concerning overlapping

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94. Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Mid-C Financial Peak Contract; Mid-C Financial Peak Daily Contract; Mid-C Financial Off-Peak Contract; and Mid-C Financial Off-Peak Daily Contract, Offered for Trading on the Intercontinental Exchange, Inc., Perform Significant Price Discovery Functions, 74 Fed. Reg. 51,264 (2009).

95. Federal Power Act, 16 U.S.C. §§ 791-828c, ch. 12 (2006).

96. Letter from Thomas R. Sheets, General Counsel, Federal Energy Regulatory Commission, to David Stawick, Secretary, Commodity Futures Trading Commission, CL 01 (Oct. 20, 2009), *available at* http://www.cftc.gov/LawRegulation/FederalRegister/CommentFiles/09-011.html.

97. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 722(e), 124 Stat. 1376 (2010).

98. *Id.*

99. Natural Gas Act, 15 U.S.C. § 717 (2008).

100. Dodd-Frank § 722(g).

jurisdiction between the 2 agencies; and (C) avoiding, to the extent possible, conflicting or duplicative regulation."[101] The commissions are also directed to negotiate a memorandum of understanding about sharing information that may be requested where either commission is conducting an investigation into potential manipulation, fraud, or market power abuse in markets subject to both commissions' oversight.[102] The January 17, 2011 deadline imposed by Dodd-Frank section 720 passed without the commissions finalizing the memoranda.

G. Whistleblower Awards

Dodd-Frank section 748 amends the CEA by adding section 23 and implementing protections and penalties with regard to "commodity whistleblowers."[103] CEA section 23 defines a whistleblower as "any individual, or 2 or more individuals acting jointly, who provides information relating to a violation of [the CEA] to the Commission, in a manner established by rule or regulation by the [CFTC]."[104] The provision generally directs the CFTC to pay an award to a whistleblower that voluntarily provides the CFTC with original information about a violation that leads to the successful enforcement of an action brought by the CFTC and which results in monetary sanctions exceeding $1,000,000.[105] CEA section 23 establishes confidentiality requirements,[106] protections against retaliation,[107] and investment in customer education initiatives designed to help customers protect themselves against fraud or other violations of the CEA.[108]

Under currently proposed rules, the CFTC would define "'independent knowledge' as factual information in the whistleblower's possession that is not obtained from publicly available sources."[109] The definition "would include such sources as corporate filings, media, and the Internet."[110] The definition would not require that "independent knowledge" mean "that a whistleblower have direct, first-hand knowledge of potential violations."[111] Instead, the whistleblower can get independent knowledge from "any of the whistleblower's experiences, observations, or communications (subject to the exclusion for knowledge obtained from public sources)."[112]

The CFTC's proposed regulations have four exclusions to what constitutes "independent knowledge."

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101. *Id.* §§ 720(a)(1)(A), (B), (C).

102. *Id.* § 720(b).

103. *Id.* § 748.

104. Commodity Exchange Act, 7 U.S.C. § 26(a)(7) (2010).

105. *Id*. § 26(b).

106. *Id*. § 26(h)(2).

107. *Id*. § 26(h)(1).

108. *Id*. § 26(g)(2)(B).

109. Notice of Proposed Rulemaking, Implementing the Whistleblower Provisions of Section 23 of the Commodity Exchange Act, 75 Fed. Reg. 75,728, at 75,729 (2011) (to be codified at 17 C.F.R. pt. 165).

110. *Id*.

111. *Id*.

112. *Id*.

> The first exclusion contemplated is for information that was obtained through a communication that is subject to the attorney-client privilege.[113]
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> . . . .
>
> The second exclusion . . . applies when a person with legal, compliance, audit, supervisory, or governance responsibilities for an entity receives information about potential violations, and the information was communicated to the person with the reasonable expectation that the person would take appropriate steps to cause the entity to remedy the violation.[114]
>
> . . . .
>
> The third exclusion applies . . . any other time that information is obtained from or through an entity's legal, compliance, audit, or similar functions or processes for identifying, reporting, and addressing potential non-compliance with applicable law.[115]
>
> . . . .
>
> The fourth and final exclusion . . . applies if the whistleblower obtains the information by means or in a manner that violates applicable federal or state criminal law.[116]

The CFTC has proposed steps for determining whether information leads to the successful enforcement of an action. It further establishes a process by which the whistleblower must submit the original information and how the CFTC will determine if the information is, in fact, original.[117]

III. KEY FEATURES OF TITLE IX AFFECTING ENERGY COMPANIES

A. Shareholder Votes on Executive Compensation and Golden Parachutes

A further impact of Dodd-Frank for energy companies arises from Title IX, Subtitle E – Accountability and Executive Compensation.[118] Similar to Title VII, Title IX does not apply particularly or solely to energy companies.[119] Unlike Title VII, Title IX expands requirements in an already regulated subject matter – shareholder relations and proxy voting – and will be implemented by the SEC.[120]

Section 951 of Dodd-Frank[121] amends the Securities Exchange Act of 1934 (SEA)[122] to add section 14A – Shareholder Approval of Executive Compensation, which requires public companies regulated under the SEA to present to their shareholders as part of their proxy materials in connection with the annual shareholders' meeting, a resolution to approve the compensation of

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113. *Id.* at 75,730 (Proposed Rule §§ 165.2(g)(2), (3)).

114. *Id.* (Proposed Rule § 165.2(g)(4)).

115. *Id.* (Proposed Rule § 165.2(g)(5)).

116. *Id.* (Proposed Rule § 165.2(g)(6)).

117. *Id.* at 75,733 (Proposed Rule § 165.2(l)).

118. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010).

119. *Id.*

120. *Id.*

121. *Id.*

122. Securities Exchange Act, 15 U.S.C. § 78a (1934).

certain senior executives. The approval or disapproval by shareholders is non-binding. If the resolution is not approved, the company is not required to change compensation; however, disapproval and failure to respond could create shareholder relations issues for the company.[123] Proposed SEC rules implementing this provision require disclosure to shareholders in subsequent reports and proxy materials of the results of this vote and management's response to it.[124] The resolution and disclosures, which have been labeled "say-on-pay," must be presented to shareholders at least once every three years, and, further, a second resolution must be presented (labeled "say-when-on-pay") permitting shareholders to specify how often the say-on-pay vote shall occur, i.e., once annually, biannually, or triennially.[125] Company management is permitted to recommend a frequency, but the shareholder vote controls. Affected companies are required to implement these requirements for all annual meetings occurring after January 21, 2011.[126] Similarly, golden parachutes (i.e., executive officer compensation of both acquiring and acquired companies in connection with a merger, acquisition, consolidation, or proposed sale or other disposition of all or substantially all of a company's assets) must be disclosed and subjected to a non-binding shareholder vote unless a previous vote on the transaction's payment terms has been made under the new "say-on-pay" rules.[127] Golden parachute compensation must be disclosed whether present, deferred, or contingent, and all conditions related to its payment must be disclosed.[128] The SEC may, by rule, exempt issuers from these requirements.[129]

In addition, public companies regulated under the SEA must disclose in proxy materials the relationship between executive compensation and the company's financial performance, as well as the ratio of the chief executive officer's compensation and that of median annual total compensation of all other employees.[130] If compensation is erroneously awarded, e.g., incentive compensation has been improperly paid based on errors in financial information

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123. Similar non-binding shareholder approval requirements of executive compensation were implemented in connection with the Troubled Asset Relief Program. Shareholders of three major companies voted in 2010 not to approve executive compensation packages. *See Sounding Off on Executive Compensation Shareholders Will Have A Greater Say on Executive Pay in 2011*, HUM. RESOURCES MGMT. MAG., Dec. 1, 2010, at 68, http://findarticles.com/p/articles/mi_m3495/is_12_55/ai_n56525783/?tag=content;coll.

124. Proposed Rulemaking, Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 75 Fed. Reg. 66,590 (2010) (to be codified at 17 C.F.R. pts. 229, 240, 249). In a companion rule, the SEC required institutional investment managers who own public company shares to report annually to the SEC how they voted such shares on SEA 14A executive compensation issues. Proposed Rulemaking, Reporting of Proxy Votes on Executive Compensation and Other Matters, 75 Fed. Reg. 66,622 (2010) (to be codified at 17 C.F.R. pts. 240, 249, 270, 274). In addition, Dodd-Frank § 957 prohibits brokers holding public company shares from voting those shares on director elections, executive compensation matters, or other SEC defined significant matters unless the brokers are provided voting instructions by the beneficial owners.

125. *Sounding Off on Executive Compensation: Shareholders Will Have A Greater Say on Executive Pay in 2011*, HUM. RESOURCES MGMT. MAG., Dec. 1, 2010, at 68, http://findarticles.com/p/articles/mi_m3495/is_12_55/ai_n56525783/?tag=content;coll.

126. *Id.*

127. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010) (adding §14A to the Securities Exchange Act).

128. *Id.*

129. *Id.*

130. Dodd-Frank § 953.

required to be reported under the securities laws, such amounts must be recovered from the executive if paid within three years prior to the filing of a required restatement of such erroneous financial information.[131] Dodd-Frank section 952 imposes an additional requirement that the compensation committee of the board of directors and consultants retained to advise them must be independent from company management.[132] Independence is to be determined, at least in part, through review of compensation received from the company, stock ownership, or other basis of corporate affiliation. Annual meeting proxy materials must disclose whether a compensation consultant was retained and any conflicts of interest raised by the work of that consultant and how the conflict was resolved.[133] If the requirements of Dodd-Frank sections 952 and 954 are not met, the National Securities Exchanges and Associations must prohibit the listing of securities of the issuers that fail to comply with them.[134]

B. New Disclosure Rules for Oil and Gas Developers

Dodd-Frank section 1504 creates section 13(q) of the SEA, which requires the SEC to adopt final rules requiring an issuer[135] that engages in the commercial development of oil, natural gas, or minerals to include in its annual report information relating to any payment made by such issuer, its subsidiary, or an entity under its control to the U.S. government or any non-U.S. government for the purpose of the commercial development of oil, natural gas, or minerals. Information to be reported includes: "(i) the type and total amount of such payments made for each project . . . ; and (ii) the type[136] and total amount of such payments made to each government," with additional details as specified in the statute or by the SEC.[137] The statute expressly notes that its objective is to implement "the commitment of the [f]ederal [g]overnment to international transparency promotion efforts relating to the commercial development of oil, natural gas, or minerals," such as the Extractive Industries Transparency Initiative.[138] The information must be submitted in an interactive data format with electronic tags identifying amounts, currency, financial period, business segments, project, the government receiving payments, and other information in the public interest, pursuant to the SEC rules to be promulgated under section 1504.[139] The SEC is directed to compile the information collected, to the extent

131. *Id.* § 954. Disclosure is also required about whether executives are permitted by the issuer to purchase financial instruments to hedge against losses in issuer stock value received as part of his/her compensation or otherwise owned. *Id.* § 955.

132. *Id.* § 952.

133. *Id.* The SEC is directed to issue rules implementing the requirements of sections 952, 953, 954, and the rules were announced in January 2011, *available at* http://www.sec.gov/news/press/2011/2011-25.htm.

134. *Id.* §§ 952(a), 954 (adding §10C and §10D to the Securities Exchange Act).

135. An "issuer" is an entity that is required to file an annual report with the SEC. Securities Exchange Act § 13(q)(1)(D)(i).

136. Payment types include "taxes, royalties, fees (including license fees), production entitlements, bonuses, and other material benefits . . . part of the commonly recognized revenue stream for the commercial development of oil, natural gas, or minerals." Dodd-Frank, Title VII: Wall Street Transparency Accountability Act §1504 (adding Securities Exchange Act §13(q)(1)(C)).

137. *Id.* §1504.

138. *Id.*

139. *Id.* §1504 (adding Securities Exchange Act § 13(q)(2)(D)).

practicable, and make it available to the public online.[140] Dodd-Frank section 1504 requires the SEC to set forth final rules no later than 270 days after enactment of Dodd-Frank, or April 17, 2011.[141] Final rules are effective for the fiscal year that ends one year after the SEC issues its final rules.[142] The SEC has issued proposed rules to implement section 1504, but they are not yet final.[143]

140. *Id.*

141. *Id.* §1504 (adding Securities Exchange Act § 13(q)(2)(A)).

142. *Id.* §1504 (adding Securities Exchange Act § 13(q)(2)(F)).

143. Proposed Rulemaking, Disclosure of Payments by Resource Extraction Issuers, 75 Fed. Reg. 80,978 (2010) (to be codified at 17 C.F.R. pts. 229, 249).