American Bar Association
Section of Business Law
Committee on Futures Regulation:
The Aftermath of Enron:
More Regulation or Continued Deregulation
August 13, 2002

CFTC Regulation of Energy Derivatives: An Overview

Susan C. Ervin
Dechert
Washington, D.C.
susan.ervin@dechert.com

Copyright Dechert 2002

CFTC REGULATION OF ENERGY DERIVATIVES: AN OVERVIEW

During the past two decades, the growth of the energy derivatives markets has spawned caselaw, regulatory initiatives and Congressional action to address the status of energy derivative products under the Commodity Exchange Act ("CEA").[1] As the principal federal regulator of futures and other derivative products, the Commodity Futures Trading Commission ("CFTC") has often been at the center of controversy as it has sought to adapt the fifty-year old CEA to a burgeoning over-the-counter ("OTC") market for forwards, swaps and other derivatives on energy products and other commodities.

Until recently, the primary issue concerning the regulation of OTC energy derivatives under the CEA has concerned the critical distinction between unregulated commercial transactions, subject to the statutory exclusion from regulation for "forward contracts," and futures contracts, unlawful unless traded on CFTC-regulated futures exchanges. The risk that an OTC derivatives contract (whether on energy or other commodities) might be held to be an illegal off-exchange futures contract has fueled regulatory and legislative initiatives to refine the CEA and the CFTC's regulatory program to establish legal certainty for qualifying OTC derivative products.

Issues relating to legal uncertainty and the disparate regulation of OTC and exchange markets culminated in the enactment in December 2000 of the Commodity Futures Modernization Act of 2000 ("CFMA"). The CFMA substantially rewrote the CEA, creating a complex new web of exclusions and exemptions from regulation designed to put to rest questions concerning the legal validity of OTC derivative transactions.

Under the regulatory framework administered by the CFTC post-CFMA, energy derivatives may be traded outside of exchange marketplaces under an array of overlapping statutory exemptions and exclusions from regulation and on exchange markets under general oversight principles applicable to exchange trading facilities for all futures contracts. In addition to a statutorily codified exemption for swap contracts, the CEA now includes an exclusion for bilateral transactions in exempt commodities, including energy products, and an exclusion for multilateral trading of such contracts on electronic trading systems.

I. Pre-CFMA Issues: The Forward Contract Exclusion and CFTC Interpretations

Historically, contracts for the purchase or sale of a commodity for future delivery have been divided into two categories: futures contracts and forward contracts. However, beginning

[1] 7 U.S.C. §1 et seq.

in the late 1980's, the CFTC created regulatory safe harbors and exemptions for swap contracts reaching a variety of cash-settled contracts between qualifying parties. The CFTC was also called upon to provide special guidance concerning energy derivatives and acted by rule and interpretative guidance to impart legal certainty to such transactions.

A. Traditional View of the Forward Contract Exclusion

The CFTC and the courts have construed the forward contract exclusion from regulation under the CEA to reach contracts between commercial counterparts settled by actual delivery of a commodity: "The intent of the exemption for forward contracts in Section 2(a)(1)(A) is to exclude marketing transactions in the normal stream of commerce for a commodity or its byproducts where delivery is intended, but delivery is delayed for commercial convenience or necessity."[2] Under the traditional view of forward contracts, the following criteria must be satisfied:

- the agreement provides for delivery of a physical commodity but delivery is delayed or deferred for purposes of convenience or necessity.

- the parties to the agreement are commercial parties who intend and can accommodate physical transfer of the actual commodity.[3]

B. The Forward vs. Futures Dichotomy Reaches the Courts: Transnor Ltd. v. BP North America Petroleum

The evolution of forward contract markets, such as the Brent oil market, beyond the simple commercial delivery vehicles contemplated by the original forward contract definition became the subject of the landmark decision in *Transnor Ltd. v. BP North America Petroleum*.[4] The *Transnor* case was a watershed event for energy derivatives trading and the CFTC's approach to OTC derivative products, upholding on a motion for summary judgment a complaint contending that Brent oil contracts were futures contracts subject to the anti-manipulation provisions of the CEA. The *Transnor* decision addressed a major commercial marketplace in which the challenged transactions were not evidently designed to take advantage of members of the general public but instead were arms-length dealings between large institutional counterparties, many of whom would qualify as commercial counterparties with the capacity to make or take physical delivery of the underlying commodity. The *Transnor* decision imparted real heft to the often expressed concerns that a variety of OTC derivatives could be challenged as de facto futures contracts, violative of the CEA unless transacted on approved exchange markets.

---

[2] *Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options*, 50 Fed. Reg. 39656-02, 39660 (Sept. 30, 1985).

[3] See, e.g., *Commodity Futures Trading Commission v. Co Petro Marketing Group, Inc.*, 680 F.2d 573, 578-79 (9th Cir. 1982).

[4] 738 F. Supp. 1472 (S.D.N.Y. 1990) ("*Transnor*").

The *Transnor* court found that "[t]he 15-day Brent Market has . . . assumed aspects of the futures market while retaining elements of the forward contract."[5] Acknowledging the hybrid nature of 15-day Brent contracts, the court found that, notwithstanding that the contracts represented binding commitments to buy or sell physical oil, the transactions were in fact speculative and "tacitly expected to end by means other than delivery."[6] Citing evidence that only a minority of Brent transactions resulted in delivery, the court concluded that:

> the interests of Brent participants, which include investment and brokerage houses, do not parallel those of the farmer who sold grain or the elevator operator who bought it for deferred delivery, so that each could benefit from a guaranteed price.
>
> While there is no contractual entitlement to satisfy Brent obligations by means other than delivery, the likelihood of avoiding delivery has enabled participants to develop what is essentially a "paper" market for speculative or hedging purposes rather than for physical transfer. The Court therefore concludes that the 15-day Brent transactions do not constitute forward contracts excepted from the CEA . . . . The volume of contracts traded and the high standardization of the contracts demonstrate the essential investment character of the 15-day Brent market. "With an eye toward [their] underlying purpose," the Court concludes that Transnor's 15-day Brent transactions constitute futures contracts.[7]

C. The CFTC's 1990 Statutory Interpretation Responds to *Transnor*

On September 25, 1990, some five months after the *Transnor* decision, the CFTC issued its "Statutory Interpretation Concerning Forward Transactions."[8] The CFTC's Interpretation acknowledged that the CFTC had recently received "numerous inquiries" concerning the applicability of the forward contract exclusion to various "commercial transactions," including "certain transactions for the purchase or sale of Brent crude oil commonly known as 15-day Brent contracts."[9] The CFTC referred to the *Transnor* court's conclusion that certain 15-day Brent contracts were futures contracts within the meaning of the CEA, noting that "the specific transactions at issue in *Transnor* apparently created no specific delivery obligations between the parties thereto because the contracts . . . were executed as part of an arrangement between the

---

[5] Id. at 1490.

[6] Id. at 1492.

[7] Id. at 1492-93.

[8] 55 Fed. Reg. 39188-03 (Sept. 25, 1990).

[9] Id. at 39188-89.

parties that they would be offset."[10] By contrast, the CFTC stressed that because 15-day Brent contracts generally created no right to offset without delivery, the parties were exposed to significant delivery risk, even if delivery did not actually occur:

> "15-day Brent" contracts specify that delivery of the cargo is to be made during a specific month in the future. The seller of the 15-Day Brent cargo must give the purchaser at least 15 day's [sic] prior notice of the three-day period during the delivery month in which the cargo must be lifted by the purchaser's designated vessel . . . . 15-day Brent contracts have no right of offset, do not rely upon a variation margining and settlement system and do not permit assignment of contractual obligations without counterparty consent. Thus, parties enter into such contracts with the recognition that they may be required to make or take delivery.[11]

Even though 15-day Brent contracts were frequently settled by negotiated cancellation agreements, commonly known as "book-outs" or "close-outs," resulting in cash payment of differences rather than delivery, these book-out agreements are "separate, individually negotiated and do not diminish the fact that the initial contracts created real delivery obligations." In sum, the CFTC concluded that transactions "which are entered into between commercial participants in connection with their business, which create specific delivery obligations that impose substantial economic risks of a commercial nature to those participants . . . are within the scope of the Section 2(a)(1) exclusion from the Commission's regulatory jurisdiction."[12]

D. CFTC Adopts Energy Exemption in 1993 to Bolster Legal Certainty

Exercising exemptive authority newly granted by the Futures Trading Practices Act of 1992, the CFTC further addressed energy derivative products in an April 1993 exemptive order designed to strengthen the legal foundation for certain contracts for deferred purchase or sale of specified energy products.[13] The CFTC's Order exempted qualifying transactions from all provisions of the CEA other than the prohibition against manipulation of the market price of a commodity.[14]

---

[10] Id. at 39189 n.1.

[11] Id. at 39189.

[12] Id. at 39191-92.

[13] *Exemption for Certain Contracts Involving Energy Products*, 58 Fed. Reg. 21286-02 (April 20, 1993). The Commission's Order was issued in response to an application for exemptive relief filed by a group of entities which represented that each was a producer, processor and/or merchandiser of crude oil, natural gas and/or other crude oil or natural gas products, or was otherwise engaged in a commercial business in these commodities.

[14] CFTC Commissioner Sheila Bair dissented from the CFTC's Order because of its failure to preserve the applicability of the antifraud prohibitions in CEA Sections 4b and 4o.

The CFTC's order was limited to:

- Commercial participants who, in connection with their business activities, incur risks, in addition to price risk, related to the underlying physical commodity, have a demonstrable capacity to make or take delivery and are banks, broker-dealers, governmental entities, and corporations, partnerships or other enumerated business entities with net worth exceeding $1 million or total assets exceeding $5 million, and other specified types of entities.

- Contracts for the purchase and sale of crude oil, condensates, natural gas, natural gas liquids or their derivatives which are used primarily as an energy source; and

- Bilateral contracts whose material economic terms are subject to individual negotiation by the parties and which impose binding obligations on the parties to make and receive delivery of the underlying commodity or commodities, with no right of either party to effect a cash settlement of their obligations without the consent of the other party (except pursuant to a bona fide termination right).[15]

E. CFTC Enforcement Action in *In the Matter of MG Refining and Marketing, Inc.* Revives Fears of Enforcement Risk for Cash-Settled Contracts

In July 1995, the futures/forward distinction assumed a central role in a CFTC enforcement proceeding against MG Refining and Marketing, Inc. ("MGRM") and MG Futures, Inc., subsidies of the German conglomerate, Metallgesellschaft, AG. The CFTC simultaneously instituted and settled an enforcement proceeding in an order which included findings that MGRM had entered into illegal off-exchange futures contracts in violation of the exchange-trading requirement of Section 4(a) of the CEA.[16]

From December 1991 through January 1994, MGRM's principal business involved the marketing, offer and sale of petroleum product contracts to gasoline station operators and heating oil distributors. Among these contracts were "Firm Fixed Price (45-Day) Agreements for the Sale of Petroleum Products." The CFTC finding concerning the illegality of MGRM contracts was based upon a "blow-out" termination provision included in contracts providing for delivery

---

[15] Id. at 21294. Book-outs or other contracts providing for settlement of the obligation in a manner other than by physical delivery of the commodity specified in the contract entered into subsequent to the original delivery contract were not precluded.

[16] *In the Matter of MG Refining and Marketing, Inc. and MG Futures, Inc.*, CFTC Docket No. 95-14, 1995 WL 447455 (July 27, 1995) ("*MG*").

of petroleum products in the future. In fact, no deliveries were made and the evident intent of the parties to the contracts was to speculate on the price of the underlying commodity:

> The 45 Day Agreements purportedly provided for delivery of petroleum product to purchasers in the future at a price which was established by the parties at initiation . . . . The 45 Day Agreements, however, did not require any rateable, monthly deliveries of petroleum product to customers. In fact, delivery of any, or all, product pursuant to the 45-Day Agreements could be deferred for a period of as long as five or ten years. The Agreements could also be satisfied without any deliveries whatsoever pursuant to a so-called "blow-out" provision in the contract. The "blow-out" provision enabled purchasers to terminate the contract and obtain a cash payment from MGR&M if the price of the underlying product (based upon price levels of energy futures contracts traded on the NYMEX) reached a pre-established exit level.

The CFTC found that the 45 Day Agreements "contain all the essential elements of a futures contract: they call for the making or taking of delivery of a commodity in the future at a price or pricing formula established at initiation; they may be satisfied either by delivery of the commodity or by engaging in an offsetting transaction without delivery; the purpose of the transaction is primarily to speculate or hedge the risk of price change in the commodity without actually acquiring the underlying commodity."[17]

II. The President's Working Group on Financial Markets Stresses Need for Legislative Change to Address Legal Uncertainty

In November 1999, the President's Working Group on Financial Markets[18] ("Working Group") issued a report, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," (the *"Report"*) which sets forth a clear brief and roadmap for wholesale amendment of the CEA to address legal uncertainty risks and other barriers to innovation.

The Working Group found that legal certainty is "a crucial consideration when parties to OTC derivative contracts decide with whom and where to conduct their business" and that "[a]n environment of legal certainty for OTC derivatives . . . will help to reduce systemic risk in the U.S. financial markets and enhance the competitiveness of the U.S. financial sector."[19] Although the 1992 FTPA and CFTC actions pursuant to its authority under the FTPA afforded practical relief for a "broad range of transactions," the Working Group found that legal uncertainty

---

17 Id., at *3.

18 The Working Group is composed of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission, and the Chairman of the CFTC.

19 *Report* at 6.

concerns persisted.[20] For example, in a 1998 Concept Release on OTC derivatives, the CFTC sought comment on the appropriateness of regulation of OTC derivatives and the form which any such regulation should take.[21] The Concept Release raised concerns among some market participants that the applicability of existing relief for swaps had been called into question. The seriousness of these concerns was punctuated by an unprecedented and successful initiative immediately following the Concept Release by the Working Group members other than the CFTC to obtain legislation to freeze the legal status of swaps and hybrid products and prevent CFTC rulemaking on those subjects for an interim period.

The Working Group's *Report* made specific recommendations for exclusion from CEA regulation altogether of bilateral swap agreements and related OTC derivatives. The Working Group stressed, however, that this exclusionary approach was appropriate for the vast majority of OTC derivatives, which are either settled in cash or based on a highly liquid market with a virtually unlimited deliverable supply. The Working Group unanimously recommended that derivatives based upon "non-financial commodities with finite supplies" not be made subject to the statutory exclusion. As to these transactions, the Working Group recommended that the CFTC "retain its current authority to grant exemptions . . . where exemptions are in the public interest and otherwise consistent with the CEA."[22]

III. Energy Derivatives under the CFMA

The Working Group's *Report* presented a blueprint and policy rationale for much of the CFMA's approach to the key legal and regulatory challenges to the CEA regulatory framework presented by the OTC derivatives market. The CFMA was designed to redress the legal uncertainty surrounding OTC derivatives by creating carveouts from regulation that do not depend upon delivery of the underlying commodity and that rest upon objective criteria relating to the type of contracting parties, the commodity traded and the trading facility. The CFMA was also designed to produce a more flexible regulatory approach toward supervision of exchange markets, one which would create a more consistent and unified regulatory approach to exchange and OTC derivative markets.

A. CFMA Creates New Exemptive Structure

The CFMA responds to the legal uncertainty issue by providing broad new exclusions and exemptions from regulation and providing that no agreement or transaction between qualifying parties, as defined below, shall be void, unenforceable or subject to rescission under any provision of federal or state law based solely on the failure of the agreement or transaction to comply with the terms or conditions of an exclusion or exemption form the CEA or CFTC

---

20 *Report* at 10-12.

21 *Over-the-Counter Derivatives*, 63 Fed. Reg. 26114-02 (May 12, 1998).

22 *Report* at 16-17.

regulations. This complex of new exclusions and exemptions creates a solid, if unduly complicated, statutory footing for wholly or largely unregulated OTC transactions and transactions traded on electronic trading facilities.

The CFMA's new approach to the OTC derivatives marketplace focuses on three variables relevant to the transaction: the nature and financial accreditation of the parties; the type of commodity underlying the transaction; and the method by which the transaction is undertaken:

- **Participant Criteria.** The CFMA employs the term ***eligible contract participant*** ("***ECP***") to refer to a category of institutional and highly accredited customers based generally on the definition of "eligible swap participant" used in the CFTC's Part 35 swaps exemption (17 C.F.R. Part 35). ECPs include, among others: financial institutions; insurance companies; registered investment companies; corporations, partnerships, trusts and other entities having total assets exceeding $10,000,000; employee benefit plans subject to ERISA that have total assets exceeding $5,000,000; governmental entities; and natural persons having more than $10,000,000 in total assets or more than $5,000,000 in assets and who are entering into the relevant transaction for risk management purposes. ***Eligible commercial entity*** refers to a subset of ECPs including, among others, entities who have a demonstrable ability to make or take delivery of the underlying commodity, incur risk in addition to price risk related to the commodity, or are dealers regularly providing risk management or hedging services to or engaging in market-making activities with other eligible commercial entities.

- **Commodity Distinctions.** The CFMA divides commodities into three primary categories. ***Excluded commodities*** include: interest rates, exchange rates, currencies, securities, security indices, credit risks or measures, and other indices based solely on commodities that have no cash market or on prices, rates, values, or levels that are not within the control of any party to the relevant transaction. ***Exempt commodities*** are all commodities that are not "excluded commodities" or agricultural commodities. Metals, energy products, and bandwidth, for example, are exempt commodities. The third category, ***agricultural commodities,*** is not specifically defined in the CFMA and it remains unclear whether agricultural commodities are limited to the agricultural commodities specifically enumerated in Section 1a of the CEA.

- **Transaction Criteria.** In various provisions, the CFMA distinguishes among transactions that are executed on a trading facility, on an electronic trading facility, or otherwise. ***Trading facility*** is defined as a person providing a facility in which multiple persons have the ability to execute or trade contracts by accepting bids and offers from multiple participants. An ***organized exchange*** is a trading facility that: (i) permits trading by or on behalf of persons who are not ECPs or by persons other than on a principal-to-principal

basis or (ii) has adopted rules that govern the submission of orders or execution of transactions on the trading facility and include disciplinary sanctions other than exclusion of participants from trading. A "***board of trade***" is defined as any organized exchange or other trading facility.

B. Bilateral OTC and Electronically Traded Transactions in Exempt Commodities Between Qualifying Parties

Exempt Commodity Transactions. Under Section 2(h)(1) of the CEA, transactions in exempt commodities (such as energy products) are generally exempted from regulation under the CEA except for the antifraud and anti-manipulation prohibitions. Based upon this exemption, ECPs are permitted to enter contracts such as those addressed in the *Transnor* and *MG* cases, without regard to the likelihood of physical delivery of the underlying commodity. Transactions in energy commodities exempted under new Section 2(h) of the CEA, except for antifraud and anti-manipulation prohibitions, include transactions:

- entered into between ECPs and
- not entered into on a trading facility

Transactions in Exempt Commodities -- Eligible Commercial Entities. Under CEA Section 2(h)(3), transactions in exempt commodities between Eligible Commercial Entities other than on a trading facility are subject only to antimanipulation, but not to antifraud, prohibitions.

Transactions in Exempt Commodities -- Eligible Commercial Parties, Principal-to-Principal, Electronically-Traded. Under CEA Section 2(h)(3), transactions in exempt commodities entered into by Eligible Commercial Entities on a principal-to-principal basis and that are executed or traded on an electronic trading facility are largely exempt from regulation under the CEA except for antifraud and antimanipulation prohibitions. Electronic trading facilities must provide prior notice to the CFTC of an intention to rely upon this exclusion.

Excluded Swaps Transactions. Section 2(g) generally excludes from regulation under the CEA transactions:

- entered into between ECPs;
- subject to individual negotiation by the parties, and
- not executed or traded on a trading facility.

C. Tiered Regulation of Organized Exchanges

The CFMA creates a new multi-tiered structure for futures markets regulated by the CFTC. The designated contract market, previously the only type of futures exchange, continues to exist but is subject to a new form of oversight designed to afford greater flexibility than the

prior statutory and regulatory mandates. In addition, two new categories of less-regulated futures exchanges are created, the derivatives transaction execution facility and the exempt board of trade, both of which are subject to significant participant and commodity restrictions.

1. Designated Contract Markets

Designated contract markets are the only exchanges that may offer products to retail customers on an unrestricted basis. Unlike the other types of exchanges created by the new law, designated contract markets may trade contracts based upon any commodity and may have any type of participant, including non-ECPs. Contract markets are now subject to core principles which are intended to replace specific rule requirements previously applicable and are designed to reflect a shift in the CFTC's functions to "oversight" rather than regulation of exchange markets.

2. Derivatives Transaction Execution Facilities

The CFMA creates a new category of futures exchange, the derivatives transaction execution facility ("DTEF"), which is subject to fewer regulatory requirements than designated contract markets but is subject to both commodity and participant limitations. DTEFs may trade only contracts based upon commodities that satisfy the following criteria: (i) the underlying commodity has a "nearly exhaustible" deliverable supply; (ii) the underlying commodity has a deliverable supply that is sufficiently large that the contract is "highly unlikely to be susceptible" to the threat of manipulation; (iii) the underlying commodity has no cash market; (iv) the contract is a security futures product and the registered DTEF is a national securities exchange registered under the 1934 Act; (v) the CFTC determines, based on the market characteristics, surveillance history, self-regulatory record and capacity of the facility that trading in the contract is highly unlikely to be susceptible to the threat of manipulation; or (vi) the underlying commodity is not an agricultural commodity and trading access is limited to eligible commercial entities trading for their own accounts. Access to DTEFs must be confined to ECPs or to non-ECPs who trade through an FCM that is registered with the CFTC, is a member of a registered futures association (or, in the case of securities futures products, a registered securities association), is a clearing member of a derivatives clearing organization and has net capital of at least $20,000,000.

3. Exempt Boards of Trade

A third new form of futures market is the "exempt board of trade," which is, in essence, an unregulated market, subject only to residual CFTC antifraud and antimanipulation authority. To qualify for this exemption, the board of trade must limit trading to transactions between ECPs in futures (or options on futures) on commodities which: (1) have a nearly inexhaustible deliverable supply; (2) have a deliverable supply that is sufficiently large, and a cash market sufficiently liquid, to render any contract traded on the commodity highly unlikely to be susceptible to the threat of manipulation; or (3) have no cash market; and (4) are not securities or groups of securities or based on the value of any security or any group of securities. The

exemption extends to all provisions of the CEA except antifraud and antimanipulation prohibitions and state law preemption. In addition, if the CFTC determines that the exempt board of trade represents a significant source of price discovery for the commodity underlying any contract, the board of trade will be required to disseminate publicly, on a daily basis, trading volume, price data and other data "as appropriate to the market."

IV. Selected Post-Enron Legislative Initiatives

A. S.1951: The "Feinstein Bill"[23]

S. 1951, the post-Enron energy-related initiative that has received the greatest Congressional attention, was proposed by Senator Feinstein and co-sponsored by Senators Cantwell, Widen and Boxer. The Feinstein Bill was proposed as an amendment to S. 517, the Senate's comprehensive energy bill. S.1951 would repeal the CEA exemptions for transactions in energy and other exempt commodities and is intended to assure CFTC oversight of all energy derivative transactions (where there is generally no delivery) including transactions conducted on multilateral and electronic trading platforms. The Feinstein Bill is intended to give the Federal Energy Regulatory Commission ("FERC") authority over all energy derivative transactions involving delivery that are not regulated by the CFTC.

S.1951 would make, among others, the following changes to existing law:

- Amend the Commodity Exchange Act to repeal the definition of "exempt commodity," the Section 2(g) swaps exemption and the Section 2(h) exemption for transactions in exempt commodities.

- Create a new exemption applicable to all non-agricultural commodities that are: between ECPs, subject to individual negotiation, and not executed or traded on a trading facility. All such transactions would be subject to antifraud and antimanipulation prohibitions under the CEA.

- Repeal the exemption in Section 2(h)(3) for electronic trading facilities for transactions on exempt commodities between Eligible Commercial Entities.

- Require dealer trading facilities and systems to comply with CFTC regulations pertaining to: registration, reporting, recordkeeping, and net capital reserves.

Although the Feinstein Bill did not pass the Senate, the Senate energy bill, S. 517, would enhance transparency by authorizing the FERC to develop an electronic system for reporting the pricing and availability of wholesale electricity and transmission services. The reporting requirements would apply to brokers, exchanges and market-making entities.

---

[23] S.1951, 107th Cong. (2002).

B. The Market Oversight Consolidation and OTC Derivatives Regulation Act[24]

H.R. 4038, introduced by Representative Peter DeFazio, would merge the CFTC and SEC into the Securities and Derivatives Oversight Commission ("SDOC"), which would have jurisdiction over securities, futures and OTC derivatives. A new Federal Financial Markets Coordinating Council would coordinate the regulatory operations of financial oversight agencies. The SDOC would be responsible, inter alia, for promulgating rules concerning the eligibility of persons to trade OTC derivatives; registration, capital, margin, sales practices, risk control and other requirements for OTC derivative dealers; and requirements for daily and quarterly reporting to the SDOC concerning OTC derivatives transactions.

C. The Energy Trading Oversight Act[25]

The Energy Trading Oversight Act would strike paragraphs (3) through (6) of section 2(h) of the CEA, thereby removing the Section 2(h) exemption for exempt commodities traded by eligible commercial entities on an electronic trading facility.

V. Conclusion

Regulation of energy derivatives under the CEA and CFTC regulations reflects a high degree of interaction between the marketplace and the public sector. The forces of market innovation and competition have pressed regulators to adapt and refine pre-existing rules to deal with unforeseen products. Judicial and agency enforcement proceedings perceived to create legal risk to market participants have generated calls for further refinement of the regulatory structure, and legislative initiatives have been pursued when agency action was perceived to be unresponsive or insensitive to marketplace needs for legal certainty. The CFMA represented a legislative response to legal uncertainty risks, the immediacy and importance of which were validated by the Working Group's *Report*. The legislative response, as codified in the multiple exclusions and exemptions of the CFMA, dramatically restricted the CFTC's regulatory jurisdiction in order to obviate further legal uncertainty issues. The CFMA's broad exclusionary approach to OTC energy derivative products has been challenged in the wake of Enron but as of this date remains in place undisturbed.

June 25, 2002

211405.2.03 8/20/2002 11:30 PM

24 H.R. 4038, 107th Cong. (2002). H.R. 4038 was referred to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on April 15, 2002.

25 H.R. 3914, 107th Cong. (2002). H.R. 3914 was referred to the Subcommittee on Farm Commodities and Risk Management on March 14, 2002.