## Executive Summary: Legal/Regulatory Risks in Energy Trading and End-User Hedging Programs

The potential impact of several key regulatory changes – including rulings on clearing, position limits and OTC margin requirements – was the focus of a recent GARP webcast. The following is a synopsis of the key issues that were addressed during that in-depth discussion.

**By Edward Hancox**

The regulatory environment for companies based in G20 nations remains in flux. Alex Holtan, counsel from the Washington DC-based law firm of Sutherland Asbill & Brennan LLP, recently said this is especially true for energy companies and firms dealing with energy-based commodities and derivatives, as key aspects of the implementation of the Dodd-Frank regulatory framework are still being developed – six years after it was adopted. What's more, similar regulatory frameworks in the European Union and G20 nations are still being formulated, providing additional uncertainty for the users of energy-based derivative contracts.

A key provision of Dodd-Frank – as well as similar regulatory regimes proposed by other G20 nations – was to encourage the use of central clearinghouses for derivative transactions. While this has worked well for some asset classes, Holtan explained that the results for energy derivatives so far have been mixed. One unexpected result of the new regulatory environment has been a marked reduction in the number of clearing brokers, or Futures Commission Merchants (FCMs), active in the market.

In the United States, the number of FCMs that handle futures and cleared swaps has declined sharply, from nearly 200 eight years ago to between 50 and 60 today, according to Holtan. The result is that clearing has become more expensive, with added credit risk for market participants should an FCM become insolvent.

Holtan attributed the decline in the number of FCMs to several factors, including greater regulatory oversight in the wake of the collapse of MF Global and the Peregrin Financial Group fraud case; the current low interest rate environment, which has weakened the profitability of FCMs; and higher bank capital requirements imposed by Basel III, which have increased the operating costs for some FCMs.

### Liquidity Changes

While market participants have been grappling with higher clearing costs, Holtan said that the changes in the FCM market have also resulted in lower liquidity for some energy commodity positions – such as the out-months of the ICE LD1 contract – that had previously been highly liquid.

Holtan attributed this decline to several factors, including the low price environment for energy commodities and the increased cost of clearing transactions. But he also indicated that the lack of liquidity has driven some hedgers to move from the cleared market back to the OTC market, in an effort to secure the long-dated positions they require.

Another contributing factor in the transition to the OTC market for firms operating in the US was a change in the CFTC's regulation of exchange-traded energy contracts. Holtan said that prior to October

2012, “most of the exchange-traded energy contracts were regulated as swaps [and] were subjected to a significantly lower regulatory burden than futures.” But in October 2012, the CFTC’s new definition of swaps came online, and futures were suddenly the more lightly regulated product. “So what ICE and NYMEX did, for the US futures products, was literally cross out the word swap and replace it with the word futures, and decrease the regulatory burden associated with using those contracts,” Holtan elaborated.

**Margin Rules**

The new margin requirements on OTC transactions that have come into focus in the US over the past four to five years, and that continue to evolve in the EU, was another topic of discussion. The OTC margin requirements typically only apply in transactions that are dealer to dealer, or dealer to financial end-user. Holtan said that most energy companies are generally exempt from the new margin requirements, because they do not typically meet the definition of a financial end-user.

However, he also cautioned that the news for energy companies is not all good. While energy companies that participate in the dealer market are not directly subject to the higher margin requirements for OTC transactions, they will feel the economic effect of higher margin costs.

One example is a refinery entering into a hedge transaction with swap dealer. To hedge its exposure to the refinery, the swap dealer will create an offsetting OTC position, likely with another financial institution. This dealer-to-dealer/dealer-to-bank transaction *would* be subject to the margin rules, with the swap dealer passing the additional margining costs on to the refinery.

In Europe, the OTC margin rules are currently similar to those found in the United States. Holtan noted that the most material difference is a more conservative application of the rules in Europe. While energy companies are generally exempt from higher margin requirements on OTC contracts in the US, they may face a higher margin threshold on some OTC transactions in Europe.

EU margin rules also require “NFC+” organizations to comply with margin requirements. An NFC+ is defined as a non-financial counterparty that is part of a corporate group with a proprietary trading book that exceeds a defined position threshold. NFC+s meeting this definition, under EU rules, are therefore treated as a financial entity and subject to margin requirements. Under certain circumstances, when dealing with European counterparties, these requirements extend to US-based energy companies.

**Position Limits**

A final decision on position limits remains outstanding after the CFTC’s attempt at establishing limits was overturned by court order. Holtan said that while new position limits were scheduled to be announced before 2017, the timeframe for the rollout will likely now be delayed beyond the CFTC’s target date.

The new position limit rules are expected to impose a “hard cap” (a limit that cannot be exceeded) on aggregate exchange-traded and OTC speculative positions in t spot-month, in-month and out-month contracts.  Positions taken for bona fide hedging purposes will most-likely be eligible for an exemption to the position limit rules.

What will actually qualify as a “bona fide hedge,” though, remains an open question, according to Holtan. For example, a position taken by a refiner to lock in a fixed price for an expected future purchase of physical crude oil will likely not qualify as a bona fide hedge. The exemption would also not be available to a natural gas producer that takes a position to hedge its storage assets (e.g., storage tanks, pipeline capacity, etc).

Another key question is who will opine on what qualifies as a bona fide hedge. This power currently lies with the CFTC, but there has been a strong argument made for exchanges like NYMEX and the ICE to assume the responsibility. Holtan said that governing bodies across Europe are also working to establish local position limit rules, though the first attempt at establishing such limits was scrapped recently, sending regulators back to the drawing board.

**Reform Issues**

Holtan also addressed the issue of resolution reform: e.g., the effort by G20 members to address the impact of insolvency by a systemically important financial institution. Regulators would ideally prefer to address the issue by granting jurisdiction to a single host country whose local laws would be applied in all resolution proceedings, regardless of where an individual business unit is located.

To illustrate the proposed reforms, Holtan gave a hypothetical example involving a US energy company that has an ISDA in place with a US-based affiliate of a major Japanese bank. If the Japanese bank were to become insolvent, even though the ISDA allows for a cross-default to take place, the proposed new rules would prevent that from happening. “The entire resolution of open issues with the US sub of the Japanese parent counterparty would be resolved under Japanese law, even if your ISDA says US, or English, law,” Holtan said. He further explained that even if the US counterparty were to default in this hypothetical scenario, the matter would still be conducted under Japanese law.

Citing an investigation by the CFTC into the alleged manipulation of US wheat markets by Kraft – a major end-user of wheat – Holtan also noted that there has been increased focus by regulators on the trading behavior of end-users. The increased regulatory scrutiny of end-users, who had previously received far less attention, is a strong indication that they should focus attention on developing an effective regulatory compliance framework.

“Spoofing” – the practice of intentionally placing and rescinding market orders to favorably move commodity prices – has also received greater scrutiny by regulators recently. While typically related to high-frequency traders, Holtan said that manual traders – particularly those who maintain large standing orders – have now also become the focus of spoofing investigations.

He explained that there have been investigations into a number of alleged spoofing cases where a trader with a “resting” hedge position has placed a large number of orders on the other side of the market. These types of cases – in which a trader creates a convergence of prices toward his or her hedge position, before unwinding the large orders without filling them – are now drawing increased scrutiny.

Spoofing investigations, Holtan said, are an example of the scope and breadth of new enforcement powers bestowed upon regulators under Dodd-Frank.

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