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Legal Update
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End Users and OTC Energy Derivatives: Potential Impacts Under the Wall Street Transparency and Accountability Act of 2010

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, titled as the Wall Street Transparency and Accountability Act of 2010 (the "Act"), significantly impacts businesses outside the financial services industry. The Act eliminates the exemption from regulation under the Commodity Exchange Act (codified at 7 U.S.C. §§1-27f) for most over-the-counter (OTC) energy derivatives; it imposes a new regulatory regime for OTC derivatives, which will, at a minimum, increase the transaction costs to US transportation companies, utilities, manufacturers, energy producers and other businesses actively hedging their exposure to fluctuating energy prices; and it could potentially subject some such businesses to the same increased regulatory oversight, including minimum capital requirements and minimum initial and variation margin requirements, as is mandated for those participants in the OTC derivatives market that qualify as "swap dealers" or "major swap participants."

Most of the provisions of the Act do not become effective until 360 days after the July 21, 2010, enactment date. However, due to the complexity of, and current uncertainty concerning, many provisions of the Act, as well as the extensive mandated rulemakings required by the Commodities Futures Trading Commission (the "CFTC") (often to be joint with the SEC and also in some cases to require consultation with the Board of Governors of the Federal Reserve System), businesses should begin now to understand the impact the Act may have on their hedging activities. Notably, within days of the Act's enactment, some energy companies were reporting the potential negative effects of the Act on their businesses in required public filings.

Subtitle A of the Act, which is applicable to energy and other commodity derivatives, sets forth the reforms for those swaps other than security-based swaps. The term "swap" is broadly defined pursuant to Section 721(b) of the Act to not only encompass commodity swaps and options, as traditionally used in the OTC derivatives market, but also to arguably capture transactions beyond traditional OTC derivatives in the energy commodity market, such as financial transmission rights. Importantly, each nonfinancial commodity sale is specifically excluded from the definition of swap as long as "the transaction is intended to be physically settled"; however, the Act does not indicate when, to what extent or to whom such intent must be demonstrated in order for the exclusion to apply.

The CFTC, in consultation and coordination with the SEC, is required under the Act to further refine the definition of swaps (as well as other key definitions of the Act). This refining will determine just how narrow—or how broad—the Act's reach will be. To that end, the CFTC and the SEC have recently issued an advance notice of proposed rulemaking that requests public comments on such definitions.[1]

Active participants in the OTC commodity derivatives market that are eligible to use the so-called "end user exemption" under the Act should experience the least impact from the requirements of the Act. To qualify for such exemption (herein, an "end user") under Section 723 of the Act, a business must (i) not be a financial entity (which is defined under the Act to include, among others, swap dealers and major swap participants), (ii) be hedging or mitigating commercial risk (as to be defined by the CFTC), and (iii) notify the CFTC how it generally satisfies its obligations for swaps that are not subject to centralized clearing. Thus, at a minimum, hedging end users will need to file the required notice with the CFTC in order to utilize such exemption.

The term "major swap participant" is broadly defined to include, among others, a business that maintains a "substantial position" in outstanding swaps (excluding positions held for hedging or mitigating commercial risk). As a result, large energy producing or consuming companies that are active in the OTC derivatives market will need to monitor their positions against the final rules promulgated by the CFTC that establish the parameters for a "major swap participant" in order to ensure that they do not inadvertently fail to qualify for the "end user exemption" under the Act, or otherwise become subject to the registration, minimum capital requirements and minimum initial and variation margin and other regulatory requirements mandated for major swap participants.

One particular issue to watch as the regulations develop is whether hedging commercial risk applies only on an entity-by-entity basis under the Act. If it does, then to utilize the end user exemption, a company currently executing its hedges at the parent holding company level when the actual commercial exposure being hedged is located in its operating subsidiaries will need to push down those hedging activities into those subsidiaries. This could result in staffing duplications, inefficiencies due to loss of netting and impairing of a business' ability to efficiently hedge on a global basis.

The capital and margin requirements mandated for those active participants in the OTC derivatives market that qualify as swap dealers or major swap participants are anticipated to lead to increased spreads imposed on end users executing hedges with such entities. In addition to imposing such capital and margin requirements on financial entities (as defined in the Act), a key feature of the Act's reforms of the OTC derivatives market is the mandatory centralized clearing for those "standardized" swaps determined by the CFTC to be subject to central clearing and that are accepted by one or more clearinghouses for clearing. Such centrally cleared swaps will be subject to the margin requirements and other procedures established by the applicable derivatives clearing organization.

When executing a derivative that otherwise is required to be centrally cleared, an end user will have the option as to whether such transaction will be centrally cleared. End users should be aware that the Act's requirements of central clearing for "standard" swaps may effectively reduce liquidity (and thereby negatively affect related pricing) for more customized (i.e., non-standard) derivatives, which is likely to lead to increased basis risk exposure and/or unhedged exposures for affected businesses.

In addition, hedging end users who execute both centrally cleared swaps and custom swaps may face increased collateral posting requirements as they are likely to lose the ability to net exposure under centrally cleared transactions against exposure under the customized derivatives and, if more than one derivatives clearing organization is involved, between or among those derivatives clearing organizations.

Concern has also been expressed that language in Section 731 of the Act that requires all non-cleared swaps executed by a swap dealer or major swap participant to be subject to margin posting requirements to be established by the CFTC also applies to swaps executed with end users. Senators Christopher Dodd and Blanche Lincoln sent a letter on July 30, 2010, to House Chairmen Barney Frank and Colin Peterson indicating that Congress' intent was not to impose the increased margin and capital requirements on those end users only hedging their commercial risk. However, it remains to be seen whether the CFTC, when promulgating its regulations, adheres to the guidelines expressed in this letter.

Increased reporting requirements are imposed upon participants in the OTC energy derivatives market, including end users. The Act requires that all swaps, both those existing before enactment of the Act and those subsequently executed, be reported to either a swap data repository or to the CFTC, depending upon the various features of the transaction. While most of these reporting obligations will fall upon a swap dealer or major swap participant, under certain circumstances, an end user may be the party required to report the swap.

While a thorough analysis of the impacts of the Act on end users hedging their energy price risk is beyond the scope of this Legal Update, and is premature until the implementing regulations are promulgated, even businesses that expect to qualify for the end user exemption of the Act should keep abreast of these regulatory developments. In addition, all affected businesses should review any proposed rules and provide comments (or participate in industry groups that are providing comments). Doing so can help to prevent unintended consequences of the Act and can seek to ensure, to the fullest extent practicable, that a hedging program designed to mitigate commercial risk for a company can still be implemented without either substantially increasing the cost of doing business for such company or materially increasing retained risk that cannot be cost-effectively hedged.

Endnote

[1] For more information about the advance notice of proposed rulemaking, see our August 23, 2010, Legal Update "Comments Requested on Proposed 'Key Definitions' of the Wall Street Transparency and Accountability Act," available at http://www.mayerbrown.com/publications/article.asp?id=9509&nid=6.

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