

August 11, 2009

CFTC Hearings on Energy Markets

Hearings Focused on Current Application of Position Limits and Hedge Exemptions but CFTC Did Not Take Further Action

SUMMARY

The Commodity Futures Trading Commission (CFTC) recently concluded a series of three hearings to seek input from representatives of various groups and industries on whether the CFTC should take certain actions to address concerns over “excessive speculation” in the energy futures markets. The CFTC indicated, prior to and during the hearings, that its actions could include the direct imposition by the CFTC of federal speculative positions on energy commodities. The CFTC also sought additional comments on whether it should eliminate hedge exemptions for swap dealers with respect to their positions in futures contracts that offset their exposure to their noncommercial counterparties. While the CFTC did not announce or propose any specific steps with regard to position limits or hedge exemptions at the hearings, it indicated that it intends to issue proposals on these issues in the fall.

THE HEARINGS

Under the Commodity Exchange Act, the CFTC has the authority to impose position limits, as necessary to address “excessive speculation.” At present, the CFTC establishes and enforces position limits only with respect to certain agricultural commodities and permits the relevant exchanges to administer position limits on all other commodities. In response to recent volatility in the energy markets, the dramatic increase in energy prices in 2008 and other factors, a number of proposals have recently been introduced in Congress that would, among other things, require the CFTC to set position limits on all commodities and eliminate hedge exemptions for swap dealers and other “non-commercials.” The CFTC hearings

SULLIVAN & CROMWELL LLP

were conducted in the context of these legislative proposals¹ and were designed in part to underscore the CFTC's view that it has sufficient authority under existing law to take the actions proposed by Congress.²

Over the course of the three hearings, held July 28, July 29 and August 5, the CFTC heard from over 20 witnesses, including Senator Bernie Sanders (Ind., VT) and Congressman Bart Stupak (D., MI). The CFTC invited a wide variety of industry participants, including representatives from IntercontinentalExchange and the Chicago Mercantile Exchange ("CME"); the airline and trucking industries; consumer groups; hedge funds; investment banks; and commodity index investors; as well as several academics.³

While transparency, hedge exemptions, and speculative position limits were discussed at great length, the Commissioners and the panelists also touched on a variety of other issues, including regulation of OTC derivatives; the need for differential treatment of "standardized" and "customized" OTC contracts; regulation of credit default swaps; the impact of index investors on the futures markets; high-frequency trading and co-location issues; and institutional firewalls.

Position Limits

Chairman Gary Gensler noted at the hearings that with the CME's announcement of its support of a hard limit regime⁴, the debate over position limits had shifted from whether or not hard position limits should be imposed in the futures market to the issue of whether the exchanges or the CFTC should set these position limits. Chairman Gensler noted that the CFTC has the statutory authority to establish position limits on all commodities and is better placed to strike the balance between the interests of market participants and the public. Chairman Gensler also questioned why position limits should not be applied consistently to all noncommercial market participants.

Interestingly, Chairman Gensler noted that he wanted the CFTC to impose position limits not only to reduce price volatility, but to prevent the energy market from being dominated by large financial

¹ For additional information on the CFTC hearings, see our Memorandum, CFTC Considers Direct Imposition of Speculative Position Limits on Energy and Other Commodities, dated July 9, 2009.

² This spring, the CFTC released a Concept Release on whether or not to eliminate bona fide hedge exemptions for swap dealers, and to replace them with limited risk management exemptions.

The Concept Release is available at:

<http://www.cftc.gov/stellent/groups/public/@Irfederalregister/documents/file/e9-6187a.pdf>.

For additional information on the Concept Release, see our Memorandum, CFTC Issues Concept Release Seeking Comment on Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Exemption from Speculative Position Limits, dated March 24, 2009.

³ To access full list of participants, their testimony, and to view archived webcast of the hearings, see: <http://www.cftc.gov/newsroom/cftcevents/index.htm>. See attachment for written questions posed by the CFTC to the panelists.

⁴ Hard limits refer to fixed speculative position limits that cannot be exceeded without a hedge exemption in contrast to accountability levels that trigger exchange scrutiny. Currently, the hard limit regime only applies to agricultural commodities.

SULLIVAN & CROMWELL LLP

institutions. Chairman Gensler appeared more concerned about the presence of large financial institutions and other market participants in the futures markets, citing his belief that having a large variety of market participants, as opposed to a few with a large presence, brought additional liquidity to the markets. Members of Congress, who have been calling for the imposition of position limits since the dramatic run-up in energy prices last year, have based their demands over concerns that excessive volatility in the energy markets is harmful to consumers, especially those who are heavily energy-dependent. Many of those calling for position limits have blamed the influx of financial investors, such as commodity index investors, for influencing the energy markets and increasing price volatility to unacceptable levels.

Issues addressed at the hearings that the CFTC will have to consider include:

- Will the CFTC set agricultural commodity style limits for energy – last 3 days, spot month, any month, all months combined? Will there be aggregate position limits across all markets – futures, exempt commercial markets and bilateral OTC?
- Will the hard position limits also apply to Exempt Commercial Markets (ICE)? Financially-settled contracts (ICE and NYMEX Clearport)? Foreign Boards of Trade trading similar products?
- How will position limits address spreads?
- Will position limits be applied to OTC transactions (which would require Congressional action)?

Hedge Exemptions for Swap Dealers

With regard to hedge exemptions for swap dealers, there was repeated questioning by the Commissioners as to why noncommercial market participants, such as swap dealers, should continue to receive hedge exemptions, even when acting on behalf of counterparties engaged in speculation. Chairman Gensler questioned whether a swaps business could be described as a “passive” investment and noted that he viewed the swap business as a highly sophisticated risk business. He asked why position limits should be applied to end-users but not for aggregators of risk (e.g. swaps dealers), an idea put forward by several of the panelists. He also noted that while he believes that the CFTC should maintain exemptions for bona fide commercial hedgers, he was concerned that granting exemptions for financial risk management can defeat the effectiveness of position limits.

Commissioner Bart Chilton, noting that the CFTC was working on a new report on whether speculators played a significant role in the recent greater volatility in energy prices,⁵ was confident that the new report would not reach the same conclusion as the CFTC report issued in September, 2008 (which found that market fundamentals, not the role of speculators, were primarily responsible for price increases and volatility in 2008).

⁵ See, 2008 Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations. (Showing that the volatility in commodity prices were the result of supply and demand imbalances, not a result of additional activity in the markets from noncommercial participants.)

SULLIVAN & CROMWELL LLP

Issues addressed at the hearings that the CFTC will have to consider include:

- Will the CFTC require swap dealers to determine the intentions of their swap counterparties (e.g., commercial v. speculation or index) and/or report position limits of their counterparties?
- Will the CFTC look-through the swap dealer to impose position limits on noncommercial end-users?
- Will swap dealers lose their hedge exemptions for transactions with commodity index investors? Will commodity index investors lose their hedge exemptions?

Transparency

Prior to the hearings, the CFTC announced that it would enhance its weekly Commitment of Traders reports, by separating swap dealers from the current “commercial” category and separating out professionally managed market positions, such as hedge funds, from the current noncommercial category. The CFTC will also incorporate the data it receives from foreign contracts linked to domestic contracts and from significant price discovery contracts (“SPDCs”). Finally, the CFTC will continue the Special Call to swaps dealers and index traders that it began issuing in 2008 and will release the information gathered on a quarterly basis, with the aim to release it more frequently in the future. The various panelists uniformly welcomed the additional transparency into the markets and the continuation of the Special Call, along with the more frequent reporting.

Additional Issues

Chairman Gensler and Commissioner Michael Dunn reiterated their belief that the CFTC does not have the authority it needs to regulate excessive speculation on OTC contracts and foreign boards of trade (“FBOT”) or to set aggregate position limits on OTC contacts, that is needed to prevent market participants from moving their large positions off-exchange or to foreign exchanges. Several of the Commissioners expressed their interest in harmonization of international regulations, but cautioned that they would reserve the right to take action against volatility, speculation, and fraud in U.S. futures markets, even if their foreign counterparts do not take aggressive actions.

Commissioner Dunn stated that the CFTC will be looking into the issues of firewalls⁶ and high-frequency trading operations⁷ later this fall.

⁶ Several Commissioners raised concerns about the trading activity of firms (who also undertake trading activities on behalf of institutional investors), who also have research units that cover the products being traded. Some panelists suggested that the internal firewalls were insufficient to prevent traders from accessing data before it was released and made available to clients

⁷ Recent reports have suggested that some entities are profiting from using super high-speed computers with special proprietary algorithms to execute transactions in milliseconds, allowing them to profit from price arbitrage data that other traders cannot capitalize on. In addition, firms that employ high frequency trading pay a fee to “co-locate” server space within or near the exchange’s computer servers to get access to trading faster than other investors.

OUTLOOK

While the CFTC did not propose any specific action at the hearings, it is clear that the CFTC is strongly leaning toward taking over the direct imposition of speculative position limits for all finite, physical commodities, although the form, level and scope of the new limits remain unclear. It is very likely that the CFTC will issue proposed regulations in the fall and, subject to public comment, will move forward with position limits and related requirements in energy futures markets. With regard to hedge exemptions, it remains unclear if that would entail position limits on swap dealers or if the CFTC would “look-through” the transactions and impose position limits on end-users and swap dealers entering into proprietary trades. The CFTC is also likely to address this issue this fall as well.

The direct imposition and enforcement of position limits on energy and other commodities by the CFTC and the elimination or restriction of hedge exemptions for swap dealers would represent a significant change in the regulation of trading in derivatives markets that will substantially affect market participants trading in the futures or over-the-counter markets.

* * *

SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance and corporate transactions, significant litigation and corporate investigations, and complex regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 700 lawyers on four continents, with four offices in the U.S., including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Jennifer Rish (+1-212-558-3715; rishj@sullcrom.com) or Alison Alifano (+1-212-558-4896; alifanoa@sullcrom.com) in our New York office.

CONTACTS

New York

David J. Gilberg	+1-212-558-4680	gilbergd@sullcrom.com
Kenneth M. Raisler	+1-212-558-4675	raislerk@sullcrom.com

Washington, D.C.

Dennis C. Sullivan	+1 202 956 7554	sullivand@sullcrom.com
--------------------	-----------------	--

WRITTEN QUESTIONS TO CFTC HEARING PANELISTS:

1. Applying position limits consistently across all markets and participants, including index traders, managers of Exchange Traded Funds, and issues of Exchange Traded Notes;
2. The effect of position limits on market function, integrity and efficiency;
3. The effect of position limits on facilitating the risk management of clearinghouses;
4. Whether the CFTC needs additional authority to implement such limits;
5. What methodology the Commission should use to determine position limit levels for each market.
 - a. What quantitative measures should be used in setting limits on the size of an individual trader's position?
 - b. Should limits be established by percentage or proportion of the open interest of the market or by fixed number of allowed contracts?
 - c. Should limits apply in all months combined, in individual months, and in the delivery month?
 - d. How should spread trades be incorporated in this calculation?
6. Should the Commission limit the aggregate positions held by one person across different markets?
7. Should exemptions from position limits be permitted for anyone other than bona fide hedgers for the conduct and management of a commercial enterprise?
 - a. The statute states exemptions should only be granted to bona fide hedgers. What should the qualifying factors be for an entity to meet the definition of a bona fide hedger?
8. Finally, if you believe the Commission should not set position limits on energy contracts, please address the inconsistent approach for other commodities with a finite, physically deliverable supply, such as certain agriculture commodities.