Transatlantic Cooperation or Regulatory Creep?

The United States Takes On Global Oil & Gas Derivatives Markets

By Prajakt Samant & Athena Velie

MANY UNITED STATES legislators blame speculators and a lack of market transparency for rising fuel prices. The US Congress, responding to rising oil and gas prices and a looming presidential election, have stepped up efforts to close some of the perceived 'loopholes' in US commodities regulation that have allowed certain over-the-counter (OTC) and offshore commodities trading to occur relatively unregulated.

In May 2008, the US Congress passed the first in a series of proposed legislation – the CFTC Reauthorization Act of 2008 (CRA 2008) – to increase US oversight of OTC energy markets. There still are over twenty bills pending that would place limits on speculation and increase transparency on both US and foreign exchanges. Some of this proposed legislation would authorise the Commodity Futures Trading Commission (CFTC), the federal agency charged with oversight of the US commodity derivatives markets) to impose regulatory controls, such as speculative position limits and mandatory reporting, on London-based and other non-US-based exchanges that allow direct electronic access to US traders, such as ICE Futures Europe, the London-based subsidiary of the Intercontinental-Exchange, Inc. (ICE).

The First Step: Closing the 'Enron Loophole'

Prior to the CRA 2008, the Commodity Exchange Act (CEA) exempted from regulation certain US markets that trade OTC derivatives in 'exempt' commodities (e.g., energy commodities) between eligible commercial entities (ECEs) (e.g., sophisticated market participants as specified in CEA § 1a(11)). These exempt commercial markets (ECMs), such as ICE, thus, operated largely outside the CFTC's view. Political pressure to repeal this exemption began to build following the 2000 energy crisis in California and the Enron manipulation scandal in the US. Many blamed the exemption (dubbed the 'Enron Loophole' because Enron was a principal proponent of the 2000 amendments to the CEA) for the disruption of US energy markets.

> There still are over twenty bills pending that would place limits on speculation and increase transparency

The CRA 2008 did not entirely repeal the ECM exemption, but it increased the CFTC's oversight with respect to contracts traded on ECMs that serve a 'significant price discovery function.' ECMs that list these significant price discovery contracts (SPDCs) are now required, among other things, to provide the CFTC with information on trader positions, adopt speculative position limits where necessary and appropriate, and make price and volume information available to the public. The CFTC is required to designate which contracts serve a significant price discovery function within 180 days following adoption of a final rule identifying the standards to be used in making the determination. Certain factors that the CFTC must consider are mandated by the CRA 2008. It is likely that many of the energy contracts currently traded on US ECMs will be designated as SPDCs.

Closing the 'London Loophole'

US regulators believe a significant amount of trading in US oil and gas contracts (e.g., the West Texas Intermediate (WTI) crude oil contract) takes place through US computer terminals operated by trading facilities based outside the US without any CFTC oversight. Under current US law, the CFTC is authorised to issue a no-action letter to a foreign exchange giving it direct access to US traders without having to register as a designated contract market (DCMs). In other words, the CFTC can allow a foreign exchange to operate in the US largely unregulated. This alleged regulatory gap has been dubbed by many the 'London Loophole.' Some industry participants have said they expect trading on such 'foreign' exchanges to increase in response to the CRA 2008. Many in Congress fear that unless they close the 'London Loophole', the CFTC's new authority to police SPDCs on US ECMs may be insufficient.

In June 2008, five US Senators introduced the so-called 'Close the London Loophole Act'. A companion bill was introduced in the House by Reps. Jim Matheson (D-Utah) and Charlie Melancon (D-Louisiana). Several similar bills also have been introduced in both the Senate and the House. The proposed legislation would generally require the CFTC to engage in a formal rule-making

process (instead of being able to issue a no-action letter) before allowing a foreign exchange to have direct access to US traders. The legislation would also impose speculative position limits and mandatory reporting requirements on such exchanges at least with respect to US-linked contracts. According to Senator Carl Levin, the sponsor of the 'Close the London Loophole Act', the proposed legislation "will strengthen the CFTC's ability to detect and prevent manipulation and excessive speculation [in the oil markets]".

The CFTC and the UK's FSA already have an agreement to share information, which was concluded in November 2006 (the CFTC-FSA 2006 Memorandum of Understanding), but this legislation would give the CFTC access to information directly from ICE Futures Europe.

Fact or Fiction: Will Increased Oversight of Foreign Exchanges Lower Oil and Gas Prices?

There has been extensive discussion in the US about speculators driving up the price of oil and gas merely by transacting in the OTC and futures markets. However, these vague fears are rarely (if ever) accompanied by any academic research, economic principles, court findings or other relevant authoritative source to support the grim predictions. In contrast, economic experts have made extensive findings that speculation is good for markets because it adds needed liquidity and allows the market to operate more efficiently. That said, without some limitation on the speculative positions one may hold, market risk arguably increases as does the potential for manipulative activity.

For example, in re Sumitomo Corp., Comm. Fut. L. Rep. (CCH) P27,327, 1998 CFTC LEXIS 96 (1998), Sumitomo entered into a settlement with the CFTC for allegedly cornering the copper market by establishing a dominant futures position in copper metal traded on the London Metal Exchange and then acquiring a controlling position in the cash market, thereby artificially increasing the price of copper, including in the US cash and futures markets. Sumitomo's principal copper trader allegedly engaged in the manipulative scheme to cover large losses from speculative trading.

Lack of transparency also arguably hinders US regulators from being able to detect at an early stage when manipulative activity might be occurring either on the foreign exchange or in a US OTC or futures market. Without greater transparency, commodity traders may be able to engage in manipulative activity undetected by taking positions in US OTC and futures markets for the purpose of benefiting their largely invisible positions on ICE Futures Europe and other non-US regulated markets. US regulators are concerned that, if the CFTC is unaware of these offshore positions, it will not recognise possible manipulative activity or be able to take steps to mitigate the activity.

Some US commentators point to the FSA's 'light touch' regime as being flawed and inadequate

Or is it really that US regulators don't trust the FSA to effectively monitor futures trading on ICE Futures Europe? It has not gone unnoticed that the FSA has brought no civil or criminal cases in the energy markets since its establishment in 1997. The FSA has expressed the view that public enforcement is not necessary to ensure compliance, but US regulators doubt that private 'slaps on the wrist' are enough to deter many market participants, including hedge funds, which do not necessarily need to co-exist with the FSA.

What this amounts to is little short of a philosophical (and maybe even a culture) clash on what it means to 'regulate' a market, and how that regulation is enacted and interpreted. The CFTC has always been an enforcement-led regulator, which takes a more overtly aggressive approach to 'policing' its markets. The FSA has placed more of the responsibility of 'front-line monitoring' – and the consequent creation of a culture of compliance – on its authorised market participants. As such, the FSA's Director of Markets Division, Alexander Justham, regards recent spikes in oil prices as part of "a global phenomenon," and believes that "there is not huge evidence of market abuse."

Some US commentators point to the FSA's 'light touch' regime as being flawed and inadequate on the basis of there having been no enforcement actions brought for commodity market manipulation, despite numerous such actions having been brought in the US. However, although the CFTC has pursued numerous manipulation actions in the US, none has been litigated to a successful conclusion. Rather, US enforcement has been carried out primarily through negotiated settlements. Perhaps in an attempt to reconcile these seemingly diametrically opposed modes of regulation, Alexander Justham stated; "We [the FSA] have exactly the same philosophy, just expressed and managed differently."

Responding to mounting Congressional pressure, the CFTC amended the previous no-action letter relief it had granted to ICE Futures Europe to condition direct access on its adoption of equivalent US speculative position limits and accountability rules with respect to the WTI contract. On July 7th 2008, the CFTC also amended the no-action letter it had issued to the Dubai Mercantile Exchange to impose similar conditions. Essentially, the CFTC's amendment means that ICE will be dually regulated by both the FSA and the CFTC. Such flexing of extra-territorial muscles on the part of the CFTC has given rise to accusations of 'regulatory creep' in certain quarters of the UK. However, the CFTC maintains that the global and interdependent nature of the commodity markets demands a coordinated and concerted response to ensure that regulation is effective across the board, even if that means crossing international borders.

The 'Close the London Loophole Act,' if it comes into force, would give the CFTC 'direct authority' to require a US-based trader to reduce his or her position (if deemed to be excessive) on a London exchange with direct access to US traders, such as ICE Futures Europe. That said, the proposed legislation would also require the CFTC to consult with the exchange as well as the FSA prior to issuing such an order. The FSA is yet to comment on this proposed legislation, and it remains to be seen whether or not the legislation will provoke the invocation of the so-called 'Balls Clause' (allowing the FSA the power to veto changes to UK exchange regulation which it deems to be 'excessive').

What Does This Mean for UK Trading Facilities?

The new proposals are not likely to have a significant impact on large US traders who are familiar with position limit and accountability rules on DCMs. However, the proposed legislation would mean big changes for UK-based trading facilities such as ICE Futures Europe, which would have to adapt to a new and additional regulator. ICE's position on these developments is quite clear and unequivocal. It believes that its OTC markets have no bearing on the price of crude oil, and do not have any hand in setting the price

> Certainly the evidence ... seems to point to the fact that price movements are primarily due to market fundamentals

for major benchmark products. Furthermore, as an exchange already subject to the FSA's regulation, ICE Futures Europe has been providing information regarding its WTI futures contract to the CFTC as a result of the CFTC-FSA 2006 Memorandum of Understanding. Trading in ICE Futures Europe's WTI futures contract comprises only 15% of the open positions in the global WTI market (as compared to NYMEX's 85%). Furthermore, ICE's WTI contract is a financially-settled product, which means that physical delivery of oil is neither made nor taken, thereby reducing the likelihood of a manipulative squeeze. The sentiment in the UK seems to be that a UK futures market is being penalised unjustly, for (non-UK) political and populist ends, for doing what it exists to do – act as a price discovery mechanism.

Future Outlook – Where is the US Headed Next?

Perhaps more worrisome than the proposed 'Close the London Loophole' legislation, is the expressed feeling (in certain US quarters) that the diversification of market participants in the energy commodity markets (to encompass institutional investors such as pension, sovereign wealth and hedge funds) has led to untenably speculative investment patterns which can only be stamped out by delimiting investor classes.

The crux of the question, therefore, is whether the seemingly inexorable rise in oil prices is to be attributed to speculation or to the operation of market fundamentals. Certainly, the evidence of hearings on both sides of the Atlantic, and recent price declines, seem to point to the fact that price movements are primarily due to market fundamentals. In the course of Treasury Select Committee hearings, convened in response to the US Congress' hearings, UK Prime Minister, Gordon Brown, said that high energy prices were being driven higher "[because] demand for oil in the world exceeds the supply of oil and it will exceed the supply of oil for years to come."

Brown's view is echoed by that of the CFTC. Walter Lukken, the CFTC's Acting Chairman, stated "I don't see market participants

driving this, but I do see supply and demand [issues]." Price spikes equally can be attributed to the response of market participants seeking a hedge against inflation, not to mention a number of geopolitical factors such as trouble in the Niger Delta, sabre-rattling between Iran and Israel, and the insatiable demand of the growing Chinese and Indian economies. Whilst added regulatory burdens on market participants may lead to less liquidity and (potentially) even higher prices, what is clear is that such burdens will have little (if any) effect on the operation of market fundamentals •

Prajakt Samant is a Partner in the Energy Group of McDermott Will & Emery UK LLP.

Athena Velie is a Partner in the Energy and Derivatives Markets Practice Group of the Washington, DC office of McDermott Will & Emery LLP.

www.mwe.com