

MEMORANDUM

To: ABA SEER Peers
Cc: EMA Board
From: Jeremy Weinstein
Re: Market Regulation Provisions of Waxman-Markey
Date: June 17, 2009

Title III Subtitles D and E of the American Clean Energy and Security Act of 2009 (Waxman-Markey) has provisions regulating over-the-counter derivatives in general and, specifically, energy derivatives. These provisions reverse now-disfavored provisions of the Clinton-era Commodity Futures Modernization Act of 2000 (“CFMA”), including “closing the Enron Loophole” by increasing regulation of OTC energy commodities; “closing the London Loophole” by preventing energy market participants from accessing US energy markets through foreign futures markets; give the CFTC initial jurisdiction over carbon credit allowances to regulate in the same manner as energy transactions; bring all energy derivatives under the jurisdiction of the CFTC; and require energy derivatives transactions to be settled and cleared through a designated clearing organization regulated by the CFTC.

Legislation creating greater transparency regarding market participant positions and price discovery, or prohibiting manipulative activity is beneficial. However, in evaluating these provisions, as well as comparable or analogous provisions in other proposed federal legislation, full care and attention should be paid to the following matters, among many others:

- A new regulator and mandatory oversight and clearing is mandated for carbon compliance instruments before the instruments have even been issued, even though there has been no need for such additional regulation in existing successful environmental commodities programs, such as that in SO₂ allowances. As the instruments do not yet exist, there cannot have been any showing of risk or abuse in the instruments themselves to justify the pre-emptive regulatory oversight.
- Transactions, domestically and overseas, should be permitted in instruments that could be connected with a U.S. cap-and-trade program, such as instruments under the flexible mechanisms of the Kyoto Protocol. Trading internationally in instruments created under international law is a not “loophole.”
- Requiring that all OTC derivatives be cleared through a central counterparty could substantially increase collateral requirements on market participants, which are now generally transacted with substantial unsecured credit. The need for collateral will affect funding liquidity for market participants, and thus reduce market liquidity.
- Businesses need to be able to hedge their risks, including their Carbon risks. It is easy to add new regulators, but it is impossible to know what that regulators will do next with that authority. To the extent the hedging instruments best suited to protect exposures are rendered unavailable, for reasons ranging from regulatory uncertainty to outright prohibition, the volatility and market risks associated will render budgets

uncertain, results more volatile, and capital concomitantly more expensive, all of which will increase costs and threaten financial performance.

- The regulation of derivatives should not concern transactions for physical delivery of commodities, or transactions conducted through regional transmission organization markets. Instruments such as financial transmission rights, virtual transactions, and other ancillary services products are financially settled. New regulatory regimes imposed on RTOs would likely be highly disruptive to those markets, as each RTO winds through its own unique processes of addressing the changes and counterparty activity seeking compliance.
- Requiring use of regulated exchanges in place of OTC derivatives should not be wealth transfer from customers and shareholders of operating companies to members and shareholders of exchanges.
- To the extent clearing is mandatory, the capital and activities of the clearing houses must be regulated to ensure that a brand new “systemic risk” is not created
- Avoid multiple federal regulators of the single activity of compliance environmental commodity transactions. Joint EPA, CFTC and FERC regulatory authority over the activity of transacting in environmental compliance instruments sets the stage for “dueling regulators,” which is hostile to market liquidity. Legislation that limits liquidity of compliance instruments will increase cost of compliance. Multiple regulators of a single product or action can create confusion and paralysis.
- Multiple pieces of legislation have been introduced to address a perceived need for additional oversight. Several of the provisions in Waxman-Markey simply repeal CFMA exemptions, and there were transactions in derivatives before the CFMA was passed. Rather than addressing issues related to over-the-counter derivatives as part of tangentially related broader legislation, these issues be addressed on their own merits in a consolidated manner.
- To the extent legislation defers to regulators to develop rules, firm timelines should be set for the development of those rules to minimize periods of market uncertainty.