

The CFTC's Proposed Rules on Enhanced Regulation of Exempt Commercial Markets

The U.S. Commodity Futures Trading Commission (the "CFTC") on December 11, 2008, proposed implementing new authority (the "Proposed Rules") over certain energy and other commodity derivatives traded on Exempt Commercial Markets ("ECM"), like the Intercontinental Exchange (ICE).¹ The Proposed Rules will have a direct regulatory impact on ECMs. But the Proposals also would create new, albeit indirect, regulatory requirements and risks for ECM market participants. Comments on the Proposed Rules are due February 10, 2009. In particular:

- ♦ The Proposed Rules will subject ECMs to significantly more stringent levels of regulation.
- ♦ The Proposed Rules will likely impact ECM market participants by increasing the level of regulatory scrutiny on their activities; directly or indirectly requiring increased disclosure of information to ECMs, clearing firms and/or the CFTC; mandating accountability or position limits by ECMs; and subjecting ECM market participants to uncertainty from the exercise of "emergency authority" by the ECM.

New CFTC Statutory Authority over ECMs

In the CFTC Reauthorization Act of 2008 (the "2008 Act"), passed as part of the Farm Bill, Congress created a new classification of derivative instrument called a Significant Price Discovery Contract ("SPDC"). SPDCs are energy contracts and other derivatives which are traded on a "principal to principal" basis (no brokers) on ECMs among sophisticated or well-capitalized businesses; which the CFTC finds perform a significant price discovery function. Before the 2008 Act, these contracts were largely exempt from the Commodity Exchange Act's regulatory framework for futures trading on regulated exchanges. Congress was concerned that some market participants were side-stepping position limits and reporting requirements for traditional futures trading by entering into energy and other derivative transactions on ECMs. Under the 2008 Act and the Proposed Rules, once the CFTC determines that a class of derivative transactions serves a price discovery function, the ECM executing such transactions becomes subject to many of the same types of regulatory protections and obligations as exist for regulated futures exchanges. Consequently, market participants in SPDCs traded on ECMs would face many of the same regulatory obligations and risks as are borne by participants on regulated futures exchanges.

Content of the Proposed Rules and Their Impact on ECM Participants

Submission of Information by ECMs

If adopted, the CFTC's Proposed Rules will specify new information submission requirements for all ECMs, with increased information required for ECMs that list for trading a contract the CFTC finds to be an SPDC. All ECMs will be required to provide, among other information, quarterly and weekly reports of trading activity (except for very thinly traded contracts). ECMs with SPDCs will be required to comply with the daily

reporting and publication requirements under CFTC regulations. Accordingly, the activities of market participants on ECMs trading in SPDCs would become subject to routine scrutiny by the CFTC. Armed with such information, the CFTC would be in a position to make more frequent and detailed inquiries into the activities of ECM market participants.

Identification of Significant Price Discovery Contracts

If the Proposed Rules become final, Part 36 of the CFTC's regulations will be amended to specify: a) the criteria upon which the CFTC will rely in determining whether a contract, agreement or transaction is an SPDC; b) what factors will trigger an obligation by ECMs to report that it may be trading an SPDC; c) the procedures the CFTC will follow in determining that a contract, agreement or transaction has become, or is no longer, an SPDC; and d) the procedures and standards by which an ECM with an SPDC must demonstrate compliance with the core principles established by the 2008 Act. These regulations will affect ECM market participants by increasing the regulatory regime around trading SPDCs on ECMs.

Guidance and Acceptable Practices for Compliance with Core Principles

Under the Proposed Rules, the CFTC would adopt a new Appendix to Part 36 of its regulations providing guidance and specifying acceptable practices for compliance with each of the nine core principles established by the 2008 Act including: a) the

submission and/or publication of information; b) establishment of position limits or accountability rules; and c) adoption of rules for the exercise of emergency authority. The submission and publication requirements could be passed through, in effect, to ECM participants, which may be asked to submit information in a specified format and manner so as to facilitate the ECM's obligations. The establishment of accountability or position limits will, at minimum, create new reporting obligations on significant market participants. Finally the existence of "emergency authority" will subject market participants to new uncertainty.

Market, Transaction and Large Trader Reporting Rules

In applying the CFTC's existing market and large trader reporting rules to ECMs the Proposed Rules would, among other measures: a) make SPDC traders subject to special call provisions for reportable positions; b) adopt changes in provisions governing appointment of agents upon which to serve process in order to expedite communications with foreign individual and agents, and c) require ECMs listing SPDCs to report on a daily basis trade data and related information for each transaction that is executed in its market. Where applicable, clearing firms will also be required to file large trader reports for their customers that trade SPDCs. All these measures can be expected to increase the regulatory scrutiny of the CFTC on the activities of ECM market participants.

¹ 73 Fed. Reg. 75888 (Dec. 12, 2008).

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