



ENERGY REGULATORY UPDATE

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The Dodd-Frank Act's Effect on Hedging Activities of Energy Companies and Large Energy Consumers

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). This update examines how Title VII of the Act may affect the risk hedging activities of energy companies and major consumers of energy that have traded or may be interested in trading in over-the-counter ("OTC") derivatives. This information may be of particular interest to end-users of OTC derivatives, such as electric and natural gas utilities, oil companies and refiners, other sellers or traders of petroleum products, electricity, natural gas and other forms of energy, and companies that are major consumers of energy and wish to hedge their risk exposure to energy price fluctuations (collectively, the "Energy Industry").

1. When will the Act become effective?

Many of the Act's provisions require action by the applicable regulatory agencies¹ before they will become effective. Unless otherwise provided in the Act, the provisions of Title VII take effect not earlier than 360 days after July 21, 2010. To the extent a provision of Title VII requires rulemaking, such provision will be effective not less than 60 days after publication of the final implementing regulations.

2. How will the role of the current federal, state and local energy regulators change after July 21, 2010?

Electric and natural gas utilities are subject to comprehensive regulation by, among other regulatory authorities, the Federal Energy Regulatory Commission ("FERC") and State public utility commissions. Under the Act, the subject matter jurisdiction of the Commodity Futures Trading Commission ("CFTC"), FERC, the Securities and Exchange Commission ("SEC") and relevant State and municipal regulatory authorities, as well as the intersection between the mandates and authorities of those regulatory agencies, remains to be clarified. The CFTC and FERC are required by the

¹ The agencies with regulatory jurisdiction or implementation responsibilities growing out of the Act include: (1) the CFTC as the agency responsible for regulations under the Commodity Exchange Act; (2) the SEC as the agency responsible for regulations under the Securities Exchange Act of 1934; and (3) the prudential regulators having jurisdiction over certain financial institutions acting in OTC derivatives markets, such as the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

Act to establish procedures not later than 180 days after July 21, 2010 to clarify the jurisdiction between the two agencies and avoid conflicts and duplication. It remains to be seen what agreements these two agencies will reach as to jurisdictional matters, and whether the agreements the agencies are able to reach by the statutorily-mandated deadline are sufficiently specific and clear to provide useful guidance to potential regulatory market participants. Particularly in light of disagreements between FERC and the CFTC with respect to the scope of certain enforcement authorities growing out of the Energy Policy Act of 2005, it is not clear whether the two agencies will be able to forge a workable agreement that clarifies their authorities.

The CFTC is required to adopt regulations that will impose aggregate position limits across futures contracts and swaps that are not centrally executed and perform a significant price discovery function in the underlying commodity, but may exclude bona fide hedge exemptions. For energy products, the CFTC must adopt these new regulations within 180 days after July 21, 2010. Aggregate position limits may restrict the ability to take OTC swap positions as a substitute for futures positions once a trader exceeds position limits in the futures market.

3. How will the Act's repeal of Section 2(h) of the Commodity Exchange Act affect the Energy Industry's derivative activities to hedge commercial risk?

Title VII of the Act repealed Section 2(h) of the Commodity Exchange Act, which provided, among other exemptions, that OTC transactions in non-agricultural energy products (among certain other "exempt commodities") (1) that were entered into between "eligible contract participants" (an "ECP") (*e.g.*, entities with total assets exceeding \$10 million) or (2) that were entered into on electronic trading facilities by "eligible commercial entities" (*e.g.*, ECPs that also regularly enter into transactions to purchase or sell the underlying commodity), were excluded from almost all provisions of the Commodity Exchange Act. However, Title VII of the Act has a grandfather provision that provides that not later than 60 days after July 21, 2010, a person may submit to the CFTC a petition to remain subject to Section 2(h) as in effect on the day before the Act

was signed into law ("Old 2(h)") for an additional one-year period, although it is unclear when the additional year commences.

The scope of the CFTC's authority to grandfather persons, groups or categories of persons under Old 2(h) is not specified in the Act. The CFTC will have to decide, in the first instance, whether it will grant individualized relief to petitioning persons or grant relief to companies situated similarly to such petitioning persons, or even to the entire Energy Industry. For purposes of the remaining part of this update, we assume that no such relief is granted.

4. Will Energy Industry end-users be regulated as swap dealers or major swap participants²?

New substantive regulatory regimes will apply to swap dealers and major swap participants (collectively, "regulated swap entities"). The new regimes can be expected to include

² The Act retains the historically-based two-regulator structure (plus applicable prudential regulators for financial institutions and FERC for electric and natural gas utilities) within the executive branch and accordingly sets up bifurcated regulatory regimes for OTC derivative transactions, OTC market participants and OTC markets taken as a whole, based on whether the relevant OTC derivative transaction is a swap or a security-based swap ("SB Swap"). The Act gives the SEC jurisdiction over SB Swaps and CFTC jurisdiction over non-SB swaps ("Swaps"). The Act does not expressly withdraw substantive regulatory jurisdiction otherwise accorded to the CFTC and the SEC under prior law. The base definition of a "swap" is sufficiently broad to include virtually any OTC derivative with the important exception of options on individual securities or any group or index of securities (whether broad-based or narrow-based) and certain other limited exceptions. SB Swaps are then excluded from the "Swap" definition, which is generally intended to serve as the "default" categorization, in order to avoid regulatory redundancy. SB Swaps are defined as swaps based on the value of single securities or loans, based on the performance of narrow-based securities indices, or based on the occurrence of credit events or similar contingencies with respect to single security issuers or the issuers in a narrow-based securities index. The OTC derivatives conducted by the Energy Industry to hedge its commercial risk are presumed herein primarily to consist of Swaps. In this update, we focus on Swaps and certain terms and provisions related to Swaps.

registration on prescribed forms with each applicable regulator, transactional record-keeping and central reporting, supervision of business dealings, position limits, business conduct standards, customer disclosure, balanced customer communication, restrictions on conflicts of interest, capital and margin requirements, and periodic examination provisions, among other broad areas in which the CFTC is required to regulate. Each regulated swap entity will be required to appoint a compliance officer. No later than one year after July 21, 2010, the CFTC must issue rules to provide for the registration of regulated swap entities.

A “swap dealer” is defined to be any person who holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties in the ordinary course of business for its own account, or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. The determination by the CFTC of whether a person is or is not a dealer is intended to be broken down by applicable types of swaps, with the CFTC having the authority to classify swaps by applicable type.

The determination of what is a “major swap participant” (including the interpretation of related definitional constructs such as “substantial position”, “commercial risk”, “financial entity” and “highly leveraged”) is left to the applicable regulators. As a result, the Act creates a significant amount of uncertainty about which entities will be regulated as “major swap participants”. **The term potentially could capture non-financial entities, such as members of the Energy Industry, that engage in OTC derivatives to hedge commercial risks.**

In addition, the Act expressly excludes from “major swap participant” any entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more

of which are manufactured by the parent company or another subsidiary of the parent company.

To summarize, a person can be designated as a “swap dealer” or a “major swap participant” with respect to one category of swap but not another category. It is unclear what types of transactions will be treated as belonging to a given “category”. In any case, an Energy Industry end-user can potentially be a major swap participant if it holds a “substantial position” with respect to one class of swaps, and not a major swap participant with respect to other classes of swaps, and, if it meets the definition for “swap dealer”, is a swap dealer with respect to certain classes of swaps.

5. Will Energy Industry end-users’ hedging swap activities be subject to mandatory clearing, and how will the “end user exemption” work?

For swaps entered into after July 21, 2010, the Act requires swaps to be submitted to a registered or exempt derivatives clearing organization (“DCO”) if the swap belongs to a category of swaps that a DCO will accept and has been approved by the CFTC to clear. Mandatory clearing requirements will go into effect no sooner than 360 days after July 21, 2010, but the clearing requirement will not apply until the applicable regulator has mandated clearing of the swap or category of swaps, and until a DCO has obtained permission from the regulatory agency to clear swaps in the applicable category. Swaps entered into before July 21, 2010 or before application of the clearing requirement will be exempt from mandatory clearing as long as they are appropriately reported.

The Act provides an “end-user mandatory clearing exemption” under which the explicit mandatory clearing requirement does not apply to a swap if one of the parties to the swap is not a financial entity, is using swaps to hedge or mitigate commercial risk, notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps, and opts out of mandatory clearing. An affiliate of a person that meets the end-user mandatory clearing exemption criteria may itself rely on such exemption if such affiliate, acting as agent on

behalf of the person, uses the swap to hedge or mitigate commercial risk of the person or another affiliate of the person that is not a financial entity.³

Similar to “major swap participant”, for purposes of the mandatory swap clearing exception, the Act expressly excludes from “financial entity” any entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company.

Whether a particular Energy Industry entity can take advantage of the exemption contained in the Act will depend on the entity’s particular facts and circumstances, and in some cases will depend on how the relevant agencies interpret terms in the Act. For example, “financial entity” is a fairly broad term that includes, among other entities, all regulated swap entities. “Commercial risk” itself is not expressly defined in the Act but is left to the CFTC to define if they determine to do so. There is no guidance on what standards will satisfy the CFTC when a person explains how it generally meets its financial obligations under non-cleared swaps. It will be advisable for Energy Industry participants to discuss these matters with their legal counsel, and perhaps for them to have appropriate discussions with the CFTC staff concerning their particular facts and circumstances.

If an Energy Industry end-user that is not a financial entity and uses swaps to hedge its commercial risks notifies and satisfies the CFTC how it generally meets its financial obligations

³ An affiliate, subsidiary, or a wholly owned entity of an end-user meeting the end-user mandatory clearing exemption criteria that is predominantly engaged in providing financing for the purchase or lease of merchandise or manufactured goods of the person will be exempt from the mandatory clearing requirement with regard to swaps entered into to mitigate the risk of the financing activities for not less than a two-year period beginning on July 21, 2010 of this clause.

associated with entering into non-cleared swaps, then it and its affiliate(s) described in the preceding paragraph will not be subject to mandatory clearing. If that is the case, then it still has the right to opt for clearing and, if it does so, has the right to select the clearinghouse for such swap.

6. Will Energy Industry end-users’ hedging swap activities be subject to mandatory exchange- trading?

Swaps entered into before July 21, 2010 or before application of the clearing requirement will also be exempt from mandatory exchange trading but nevertheless are required to be appropriately reported as described in the answer to question 7 below.

For post-enactment swaps, swaps that are subject to mandatory clearing must also be executed on a board of trade designated as a contract market (“DCM”), a national securities exchange or a registered or exempt swap execution facility (“SEF”), as applicable. The mandatory exchange-trading requirement will not apply if no DCM, exchange or SEF lists the swap for trading or if the transaction is subject to the end-user mandatory clearing exemption.

SEFs are facilities, trading systems or platforms in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, including any trading facility that facilitates the execution of swaps between persons. The term “facility”, “trading system” and “platforms” are not defined under the Act. Therefore, the term “SEF” in the Act may be sufficiently broad to include so called “voice brokers,” thus potentially permitting such an entity to register and be regulated as an SEF using its existing business model (subject to favorable agency interpretation of the core principles and approval of its rules).

7. Will Energy Industry end-users be obligated to report any swaps?

Swaps entered into before July 21, 2010 must be reported to a registered “swap data repository” (a new regulatory category) or to the CFTC, no later than 180 days after the effective date

of the relevant section, pursuant to the general transitional provisions of the Act.⁴ Non-cleared swaps entered into before July 21, 2010, the terms of which have not expired as of July 21, 2010, are subject to an additional, potentially shorter reporting deadline under the transitional provisions for non-cleared swaps, which is not later than (1) 30 days after issuance of the interim final rule⁵ or (2) such other period as the CFTC determines to be appropriate. Swaps entered into on or after July 21, 2010 must be reported to a registered swap data repository or to the CFTC, no later than the later of (1) 90 days after the effective date of the Act and (2) such other time after entering into the swap as the CFTC may prescribe. Foreign exchange forwards or swaps, even if determined by Treasury Secretary not to be regulated as swaps, must still be reported to a swap data repository or to the CFTC, as applicable.

If only one party to a non-cleared swap is a swap dealer, then such swap dealer must report the swap. If only one party to a non-cleared swap is a regulated swap entity, then such regulated swap entity must report the swap. If neither party to a non-cleared swap is a regulated swap entity, then the two parties must select which of them will report the swap.

8. Will Energy Industry end-users be subject to margin requirements for non-cleared hedging swaps?

The Act gives the CFTC (and prudential regulators with respect to those parties that have a prudential regulator) broad authority to impose on regulated swap entities capital requirements and both initial and variation margin

⁴ A swap data repository is “any person that collects and maintains information or records with respect to transactions of positions on, or the terms and conditions of, swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for swaps.” Swaps data repositories will be required to register with, and will be regulated by, the CFTC. The Act permits DCOs also to perform the functions of, and to be registered and regulated as, a swap data repository.

⁵ The CFTC is required to promulgate an interim final rule within 90 days following July 21, 2010 providing for the reporting of each swap entered into before July 21, 2010 and whose terms have not expired as of July 21, 2010.

requirements with respect to non-cleared swaps. However, no margin requirements will exist until the agencies adopt implementing regulations.

The Act provides no express guidance on whether non-cleared pre-enactment swaps will be subject to margin requirements. The mandate on the regulators to adopt rules requiring margin could be interpreted as allowing no exceptions for pre-enactment swaps, although it is not clear that they must be so interpreted.

A clause previously in both the Senate and House versions of the Act explicitly exempting end-users from margin requirements in non-cleared swaps was removed before the final version of the legislation was approved by Congress and the Act was signed into law without such clause. Senators Christopher Dodd and Blanche Lincoln, in their capacities as the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs and the Chairman of the Senate Committee on Agriculture, Nutrition and Forestry, respectively, in a letter dated June 30, 2010 to the Chairmen of House Financial Services Committee and House Committee on Agriculture, wrote that it was not Congress’ intent to make hedging so costly that it becomes prohibitively expensive for end-users to manage their risks and said that the Act does not authorize regulators to impose margin requirements on end-users that use derivatives to hedge or mitigate commercial risk. However, the expression of intent is not binding upon the regulators who are authorized by the Act to further define the scope of such exemption. It is unclear how the regulators will respond when proposing the relevant rules. There are concerns that the regulators have authority to impose margin on both parties of non-cleared swaps, including end-users. Energy Industry participants may wish to consider addressing these matters with the CFTC staff either in private meetings or in the public meetings that the CFTC will be holding in the Fall.

At this writing, it is unclear how the margin requirements will work in practice. For example, it is unclear as to who must deposit margin with whom under the Act. In existing OTC

derivatives markets, dealers ordinarily obtain collateral from non-dealer counterparties, but the non-dealer counterparties are much less likely to obtain collateral from the dealer. In addition, certain provisions of the Act give counterparties the right to require collateral, but do not compel them to do so. It is unclear whether the margin requirements that are intended to apply to swap dealers will only apply to swaps between swap dealers.

In addition, in practice, end-users tend to enter into swaps with regulated swap entities. Because of that, when the regulators set margin requirements for regulated swap entities for any non-cleared swaps, there is some likelihood that, even if regulators do not directly impose margin requirements on end-users for non-cleared swaps, the regulated swap entities will pass the costs attributable to their margining through to the end-user counterparties.

9. Foreign exchange forwards or swaps may be excluded from certain requirements of Title VII.

Foreign exchange forwards or swaps that are not cleared or traded through one of the facilities may be excluded from certain requirements of Title VII if the Treasury Secretary determines in a report to Congress that they should not be regulated as swaps under the Act and that they are not structured to evade the Act in violation of a rule adopted by the CFTC. However, foreign exchange forwards or swaps that are traded on a DCM or SEF will not be exempted from any applicable antifraud and anti-manipulation provisions under Title VII. In addition, any swap dealer or major swap participant entering into such trades will be subject to business conduct rules.

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