

Energy Prosecutions: Is the CFTC Out of Gas?

BY MICHAEL S. SACKHEIM¹

A. Introduction

Beginning in 2002, the U.S. Commodity Futures Trading Commission (“CFTC”) has brought attempted manipulation and false reporting enforcement cases against 42 public energy companies and 31 individual traders alleging violations of Section 9(a)(2) of the Commodity Exchange Act (“CEA”)² with respect to their privately negotiated, principal-to-principal, bilateral energy product transactions, assessing \$445 million in civil monetary penalties.³ Section 9(a)(2), entitled “Criminal Penalties,” has distinct prongs for manipulations, corners, false reporting of commodity prices and general antifraud violations under the CEA.⁴ Section 9(a)(2) provides:

It shall be a felony punishable by a fine ... or imprisonment ... for

Any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity or knowingly to deliver or cause to be delivered for transmission through the mails or interstate commerce by telegraph, telephone, wireless, or other means of communication false or misleading or knowingly inaccurate reports

concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce or knowingly to violate the provisions of [specified antifraud sections of the CEA]. (Emphasis added)

This article will discuss whether the CFTC has exceeded its authority in bringing these cases against traders based on off-exchange, negotiated bilateral transactions that fall outside of the CFTC’s jurisdiction.

B. Exclusion for Over-the-Counter Transactions

In 2000, the Commodity Futures Modernization Act (“CFMA”) codified exclusions for swap transactions which provided legal certainty in the markets for over-the-counter (“OTC”) derivatives transactions. Individually negotiated bilateral transactions between eligible contract participants (“ECPs”)⁵ not executed or traded on a trading facility benefit from an exclusion

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from the provisions of the CEA, including prosecution under Section 9(a)(2). Section 2(g) of the CEA, entitled “Excluded Swap Transactions” (the “OTC Exclusion”),⁶ adopted pursuant to the CFMA, excludes from all provisions of the CEA (other than provisions addressing clearing and preemption of certain state laws) any agreement, contract or transaction in a commodity (other than an agricultural commodity) that is (i) entered into only between persons that are ECPs at the time they enter into the transaction, (ii) subject to individual negotiation by the parties and (iii) not executed or traded on a trading facility.

Industry practices dictate that virtually all OTC energy transactions be entered into pursuant to a negotiated master agreement, typically one published by the International Swaps and Derivatives Association, Inc. for swap agreements or the Edison Electricity Institute master power purchase agreement for physical transactions, or similar documentation evidencing compliance with the criteria set forth in the OTC Exclusion.

In July 2002, then CFTC Commissioner Thomas J. Erickson, agreed with this position and testified before Congress that:

...the vast majority of OTC swap transactions in energy and metal commodities become excluded. As a result, they are not subject to the CFTC’s fraud or manipulation authorities. Not only do these transactions fall outside the jurisdictional reach of the CFTC, but in most cases, they are beyond the reach of any other federal financial regulator... the regulatory regime in place today turns a blind eye to the manipulation of these very same commodities, if effected through OTC derivatives transactions.⁷

Therefore, OTC energy transactions that are the subject of individual negotiations, entered into between energy companies and power marketers that are ECPs, and not traded on a trading facility should be excluded from the coverage of Section 9(a)(2).⁸ This position has been confirmed by the CFTC’s staff (its former Division of Trading and Markets staff, not its Enforcement Division staff) in CFTC Letter No. 02-44. But, notwithstanding the clear language of the OTC Exclusion, the

CFTC has continuously brought civil enforcement actions alleging attempted manipulation against ECPs concerning their privately negotiated, bilateral energy swaps. However, the brakes may have been applied to such prosecutions due to a federal court recently holding that the OTC Exclusion disapplies Section 9(a)(2) to these types of transactions.

C. Energy Enforcement Cases

Since 2002, the CFTC has commenced enforcement actions and, in settled cases, assessed hundreds of millions in civil monetary penalties against 31 OTC energy market traders and 42 power marketing companies.⁹ These settlements were not the results of final adjudications that examined the CFTC’s enforcement or jurisdictional authority. The energy enforcement actions were civilly prosecuted under the CEA, notwithstanding the OTC Exclusion. In the first of its energy enforcement cases alleging Section 9(a)(2) attempted manipulation violations, in 2002 the CFTC simultaneously filed and settled an administrative action against Dynegy Marketing and Trade and West Coast Power LLC.¹⁰ In an uncontested settlement order, the CFTC found that in violation of Section 9(a)(2), the respondents reported false natural gas trading information, including price and volume information, to certain reporting firms that publish daily industry trade data reports, in an attempt to manipulate the price of natural gas in interstate commerce. The CFTC concluded that such activity constituted an attempted manipulation, charges repeated in other energy enforcement cases brought by the CFTC discussed below. The CFTC further found, without citing any empirical evidence, that this attempted manipulation, if successful, could have affected prices of NYMEX natural gas futures contracts. Without admitting or denying its findings, the respondents consented to the entry of an order that ordered them to cease and desist from further violations and imposed a \$5 million civil monetary penalty.

In March 2002, the CFTC simultaneously filed and settled an administrative action against energy company El Paso Merchant Energy, L.P.

("EPME"), a division of El Paso Corporation, finding that EPME committed attempted manipulation and false reporting.¹¹ Again, without admitting or denying any findings, respondents consented to cease and desist from further violations, the payment of a civil monetary penalty of \$20 million, and compliance with various undertakings, including cooperation with the CFTC in any investigations of matters involving the reporting of natural gas trading information.

Repeating this practice of prosecuting cases under the CEA alleging that the false reporting of commodity trade data constitutes an attempted manipulation of cash commodity prices and/or futures prices, in 2003, the CFTC simultaneously filed and settled an administrative action against WD Energy Services, Inc., the U.S.-based energy trading unit of EnCana Corporation.¹² According to the CFTC, WD Energy's conduct constituted an attempted manipulation under the CEA, which, if successful, could have affected prices of NYMEX natural gas futures contracts. Without admitting or denying the findings, WD Energy consented to pay a \$20 million civil monetary penalty, among other remedies. The CFTC simultaneously filed and settled an administrative action against Enserco Energy, Inc., a subsidiary of Black Hills Corporation.¹³ Again according to the CFTC, Enserco's conduct constituted an attempted manipulation under the CEA, which, if successful, could have affected prices of NYMEX natural gas futures contracts. Without admitting or denying the findings, Enserco consented to pay a \$3 million civil monetary penalty, among other remedies.

These cases, commenced in the CFTC's own administrative forum rather than in federal court, were brought and settled by the CFTC against energy companies and traders based on their individually negotiated, bilateral OTC transactions.

D. CEA Jurisdiction Rejected in Federal Court

A federal criminal court recently dismissed Section 9(a)(2) criminal charges against four former employees of BP America Inc. on the basis of a

lack of jurisdiction pursuant to the OTC Exclusion created by Section 2(g) by the CEA.

In *U.S. v. Radley, et al.* ("Radley"),¹⁴ the government charged that four BP Products North America, Inc. ("BP") traders responsible for trading natural gas liquids, including TET propane, criminally violated Section 9(a)(2) of the CEA.

Propane is a by-product of natural gas processing and petroleum refining. "TET" is an acronym for the Texas Eastern Transmission Corporation. The phrase "TET propane" refers to propane that is deliverable at the Texas Eastern Products Pipeline Co., LLC's storage facility in Mont Belvieu, Texas or elsewhere within its system. The Mont Belvieu storage facility is the delivery location for the propane futures contract traded on the New York Mercantile Exchange. Propane is used in the petrochemical industry to produce plastics and is a source of energy for residential and commercial heating. It was stipulated that TET propane is a commodity as defined in Section 1a(4) of the CEA.

The BP traders traded TET propane with other energy counterparties in the OTC market in three ways: (1) directly between two parties, (2) through voice brokers, and (3) through an electronic trading platform known as Chalkboard. Voice brokers communicated information about bids, offers, and recent sales prices of TET propane. Chalkboard transactions involved buyers and sellers posting anonymous bids and offers on Chalkboard's website. Buyers and sellers were matched up and only learned each other's identity upon completing a transaction. When a transaction was completed on Chalkboard, the price associated with the transaction was published to all traders with access to Chalkboard. However, the counterparties involved were not identified.

Based on information collected from propane traders and voice brokers, prices of TET propane sales were published daily in the Oil Price Information Service ("OPIS"). At the end of every trading day, OPIS published the highest and lowest priced transactions as well as the "OPIS average," the midpoint between the high and low transactions for that day. OPIS published prices based on when the TET propane was to be delivered. A price outside of the range of recent transactions would likely affect the OPIS average for that day,

and OPIS published prices had the potential to affect prices paid by traders and end users. TET propane traders sometimes entered into contracts for future delivery based on the daily or monthly OPIS average price prevailing at the time of delivery. Parties entering into an “OPIS average transaction” would not know the actual price to be paid at the time of execution. Accordingly, a sale which affected the OPIS average would in turn affect the prices of any OPIS average transactions.

The indictment charged that the four BP traders conspired to manipulate the price of February 2004 TET propane, corner the market for February 2004 TET propane, and defraud counterparties who purchased February 2004 TET propane based on the OPIS average price. The government alleged that the BP traders conspired to acquire dominance in the 2004 TET propane market and withhold a portion of the commodity from sale in order to artificially inflate the price to enrich BP when it sold propane at artificially high prices and enrich themselves by obtaining bonuses based on BP’s profits generated from the sales of TET propane at these artificially high prices. This meant that BP would benefit if the cost of propane went up during the month because it would be entitled to buy at a previously negotiated lower price. In order to capitalize on this position, the BP traders allegedly set out to increase the price of TET propane by misleading the market about the true supply of February 2004 TET propane by presenting “show” offers designed to falsely convey that BP wished to sell propane and simultaneously present multiple bids to buy on Chalkboard, creating the impression that multiple counterparties wished to buy propane. After achieving the desired price increase, the BP traders allegedly would then sell TET propane at the higher price and would also sell TET propane at the OPIS average price, which was also higher allegedly due to their actions.

Although the indictment alleged that the BP traders attempted to manipulate and corner the February 2004 TET propane market in violation of Section 9(a)(2) of the CEA, in bringing charges under the CEA the government disregarded the OTC Exclusion that excludes these types of trans-

actions from the coverage of the CEA. The *Radley* court had to determine whether the TET propane transactions satisfied the criteria of the OTC Exclusion. It was stipulated that TET propane is a commodity other than an agricultural commodity and that BP and all of its counterparties were ECPs.

However, the government argued that the BP traders’ actions were not covered by the OTC Exclusion because their actions did not constitute an “agreement, contract, or transaction,” but instead constituted *activity* that was not exempt. The government cited *Commodity Futures Trading Com’n v. Johnson*¹⁵ where the defendants allegedly “delivered. . . inaccurate market information as well as entirely fictitious purported gas trades and/or failed to include actual natural gas trades made by themselves.”¹⁶ In holding that Section 2(g) did not apply to defendants’ activities, the court in *Johnson* found that these reporting activities were not contracts, agreements, or transactions, which assume “mutual exchanges between parties creating rights or obligations that are enforceable at law.”¹⁷ Distinguishing *Johnson*, the court in *Radley* found that the BP traders’ means of alleged price manipulation and cornering involved actual bids and offers, some of which were accepted, rather than wholly fictitious transactions. In all cases, the bids and offers would have created legally enforceable obligations if accepted. The government conceded that there were actual prices associated with actual transactions. Every case relied on by the government in the *Radley* prosecution dealt with *wholly fictitious* activity, not actual transactions.¹⁸ In *Radley*, there was no allegation that the BP defendants reported transactions which did not actually occur. The government also argued that once the transactions were reported on Chalkboard and communicated to other Chalkboard subscribers, the wrongdoing went beyond transacting because *communications* do not fall within the meaning of “agreement, contract, or transaction.” The *Radley* court reasoned that if the OTC Exclusion is inapplicable to any transaction once it is communicated to others, then a transaction must be kept secret in order to qualify for its protection. The court found that there was no indication in

the statutory language or legislative history that Congress intended this outcome. The court concluded that the government's interpretation of the statute would stifle communicative activity within the market and thwart the goal of providing legal certainty to ECPs entering into bilateral negotiated OTC transactions. Accordingly, the *Radley* court found that the allegations contained in the indictment all involved *actual* agreements, contracts, or transactions.

Next, the government argued that the transactions at issue were not subject to individual negotiation by the parties, as required under the OTC Exclusion. The TET propane contracts had standard terms for delivery location and quality specifications, but also contained negotiated financial, credit, and legal terms. The court reasoned that the fact that certain terms are the same in any contract for a given commodity cannot make a contract ineligible for the protection of the OTC Exclusion. If it did, the exception would be so narrow that it would not bring certainty to the market. In 1993 the CFTC apparently came to the same conclusion, finding that "the terms regarding the quality and location of energy contracts, as well as other conventions surrounding their trading, are standardized. Nevertheless, these transactions can be distinguished by the fact that, because their credit terms are individual to the counterparties, they are not fungible and are created through the direct negotiation of the parties to the transaction."¹⁹ The *Radley* court also found that the involvement of a third-party TET propane pipeline transmission center is consistent with a contract that has been negotiated between the parties. To suggest otherwise would require counterparties to own the means of delivery and distribution for any commodity they are trading in order to benefit from the OTC Exclusion. Despite the existence of some standard terms, the court found that the TET propane contracts were individually negotiated between the parties.

Finally, applying the OTC Exclusion requirement that the agreement, contract or transaction may not be traded on a "trading facility," the court looked to the definition of a "trading facility" under Section 1a(34) of the CEA. Section 1a(34)(B)(1) provides that the term "trad-

ing facility" does not include "a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm." The court in *Radley* found that Chalkboard fell under the exclusion from the term "trading facility" because Chalkboard enabled parties to negotiate the terms of and enter into bilateral transactions. Because the TET propane contracts were not executed or traded on a trading facility and satisfied the other criteria of Section 2(g), they qualified for the OTC Exclusion.

E. Conclusion

In dismissing all Section 9(a)(2) charges against the BP traders, the *Radley* court found that the transactions met all of the requirements of the Section 2(g) OTC Exclusion and therefore were not covered by the CEA.²⁰ The *Radley* decision calls into question the jurisdictional underpinning for future CFTC civil prosecutions against ECPs alleging false reporting or attempted manipulation involving any commodity based on *actual* privately negotiated transactions that qualify for the OTC Exclusion.²¹

NOTES

1. The author is a partner in the New York office of Sidley Austin LLP. The views expressed in this article are solely the views of the author and do not necessarily reflect the views of Sidley Austin LLP or its clients.
2. 7 U.S.C. Section 13(a)(2) (2000). The CEA originated in 1922 as the Grain Futures Act. In 1936 the legislation was renamed the Commodity Exchange Act. The CFTC is an independent federal agency created in 1974 and given enforcement and oversight powers similar to those of the Securities and Exchange Commission. The CFTC administers and enforces the CEA.
3. See CFTC Press Release 5562-08, October 2, 2008.
4. See, *United States v. Geiger* (Crim. No. H-02-712, S.D. Texas, Houston Div., Nov. 13, 2003), at 1 ("Geiger is charged under the third prong of this statute."); and *United States v. Valencia* (Crim. No. H-03-024, S.D. Texas, Houston Div., Nov. 13, 2003), at 1, fn. 1 ("Valencia is charged under the third prong of this statute.").
5. The definition of ECP in Section 1a(12) of the CEA includes financial institutions, state-regulated or foreign-regulated insurance companies (and their regulated subsidiaries and affiliates), broker-dealers (or regulated foreign persons performing a similar function), material associated persons of broker-dealers, investment bank holding companies, futures commission merchants (or regulated foreign persons performing a similar function), floor brokers, floor traders, governmental entities, certain investment companies, commodity pools and ERISA plans. Corporations or other entities that have more than \$10 million in assets (or are supported by certain keepwell or other arrangements), or have a net worth of more than \$1 million and enter into the transaction for certain risk management purposes, qualify as ECPs. Natural persons qualify as ECPs if they have total assets (i) in excess of \$10 million or (ii) in excess of \$5 million and the transaction is entered into for risk management purposes.
6. 7 U.S.C. Section 2(g).
7. Testimony of Thomas J. Erickson before the Committee on Agriculture, Nutrition and Forestry, United States Senate, July 10, 2002. Available at <http://www.CFTC.gov>.
8. This argument was made in 2004, in Sackheim, *False Reporting of OTC Energy Transactions*, The Review of Securities & Commodities Regulation (V. 13, N. 14, August 2004), at 149.
9. Power marketers are deemed to be jurisdictional public utilities under the Federal Power Act, requiring compliance with some but not all filing and reporting requirements for public utilities.
10. *In re Dynegy Marketing and Trade, et al.*, CFTC Docket No. 03-03 (Dec. 18, 2002).
11. *In re El Paso Merchant Energy, L.P.*, CFTC Docket No. 03-09 (March 26, 2003).
12. *In re WD Energy Services Inc.*, CFTC Docket No. 03-20 (July 29, 2003).
13. *In re Enserco Energy, Inc.*, CFTC Docket No. 03-22 (July 31, 2003).
14. Criminal Action H-08-411 (S.D. Texas, Houston Div., Sept. 17, 2009).
15. 408 F. Supp. 2d 259 (S.D. Tex. 2005).
16. *Johnson*, 408 F. Supp. 2d at 266.
17. *Johnson*, 408 F. Supp. 2d at 266.
18. See *U.S. v. Futch*, 278 Fed. Appx. 387 (5th Cir. 2008); *U.S. Commodity Futures Trading Com'n v. Atha*, 420 F. Supp. 2d 1373 (N.D. Ga. 2006); *U.S. Commodity Futures Trading Com'n v. Bradley*, 408 F. Supp. 2d 1214 (N.D. Okla. 2005).
19. CFTC Final Order, *Exemption for Certain Contracts Involving Energy Products*, 58 Fed. Reg. 21,286, at 21,291 (April 20, 1993) [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) § 25, 633.
20. Section 2(g) is entitled "Excluded Swap Transactions." The title arguably could be read to modify the scope of the exclusion under Section 2(g), resulting in the disapplication of all provisions of the CEA, including Section 9(a)(2), solely with respect to excluded swaps, but not its disapplication to the effect that an excluded swap transaction or conduct related to the swap has on commodity prices in interstate commerce or the futures market. There is no legislative history that supports a conclusion that the intent of the OTC Exclusion was to disapply Section 9(a)(2) to ECPs generally. However, the lack of any relevant legislative history requires a plain reading of Section 2(g), which starts with "No provision of this Act... shall apply to or govern any agreement, contract or transaction..." Therefore, a Section 9(a)(2) violation cannot be predicated solely upon transactions that fall within the Section 2(g) safe harbor, even if the conduct results in a commodity price manipulation or corner (remedial statutes other than the CEA may be applicable). Section 2(g) should be

compared to the exclusion from regulation under the CEA created by Section 2(h) for OTC transactions in "exempt commodities" entered into between ECPs. Section 2(h)(2)(c) explicitly applies specified sections of the CEA, including Section 9(a)(2), "to the extent such sections prohibit manipulation...and the agreement, contract or transaction would otherwise be subject to such sections." Whereas Section 2(h) explicitly reserves antimanipulation jurisdiction over transactions in exempt commodities, Section 2(g) does not reserve antimanipulation jurisdiction with respect to excluded swap transactions. Both provisions were enacted in 2000 with the passage of the CFMA.

21. This jurisdictional issue may be alleviated through amendments to the CEA. Current proposals pending in Congress would overhaul the CEA and repeal the Section 2(g) OTC Exclusion. See, e.g., H.R. 3795, the "Over-the-Counter Derivatives Markets Act of 2009."