

# ISDA

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## Implications of Feinstein Amendment to S. 517

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### Overview

- **The amendment would significantly undermine the legal certainty achieved in the Commodity Futures Modernization Act of 2000 (the “CFMA”) and once again require market participants, in determining their own regulatory status and the regulatory status of derivatives, to rely on distinctions that have proven untenable in the past.**
- **The amendment would affect transactions in a range of products that are not limited to electricity and natural gas and thus go well beyond issues raised by the California energy crisis and the Enron bankruptcy.**
- **The amendment would also potentially regulate a range of market participants that have not previously been subject to regulation under the Commodity Exchange Act (the “CEA”) or otherwise, and for which there is no demonstrated need for regulation. This would include market participants that are not dealers.**
- **The amendment would regulate systems that are not trading facilities, potentially including corporate procurement systems, used to enter into transactions in a range of products.**
- **The amendment would establish unclear jurisdictional divisions between the Commodity Futures Trading Commission (the “CFTC”) and the Federal Energy Regulatory Commission (the “FERC”) that are likely to consume significant resources in inter-agency jurisdictional disputes.**

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**The amendment would create uncertainty as to which categories of energy (and other exempt commodity) transactions are subject to the jurisdiction of the CFTC, reviving problems that had been largely settled by the CFMA.**

- The allocation of jurisdiction between the FERC and the CFTC will give rise to untenable distinctions and jurisdictional confusion.
- The amendment modifies the Federal Power Act to provide that if the FERC determines that a transaction that comes before the FERC is not under its jurisdiction, it will refer the transaction to the appropriate federal agency. It is not clear what would happen if no such agency has jurisdiction over the transaction or multiple agencies may have jurisdiction over the transaction.
- At the same time, the amendment provides that the revised exemption provided under the CEA for energy commodity transactions does not affect the power of the FERC to regulate transactions under its jurisdiction.
- Taken together, these provisions create uncertainty as to whether energy transactions and market participants are subject to the jurisdiction of FERC, the CFTC, some other federal agency or a combination thereof. As a practical matter, each of the FERC and the CFTC will likely end up having overlapping jurisdiction and potentially inconsistent or duplicative regulatory requirements.
- The elimination of the statutory exemption for energy and metal transactions will require market participants to analyze whether a derivatives transaction is a futures contract or commodity option subject to regulation under the CEA. This inquiry proved untenable as the derivatives markets developed, and was a primary motivation for the enactment of the CFMA.

**The amendment would authorize the CFTC to regulate a wide range of market participants in energy and metal commodity transactions and trading systems used for executing those transactions. This authority (1) would not be limited to futures contracts (or even to derivatives transactions generally), and (2) would not be limited to traditional dealers or trading systems.**

- Any person or group of persons that “constitutes, maintains, administers or provides” a physical or electronic system on which a transaction in an energy or metal commodity can be conducted would be subject to the CFTC’s new authority.
- This would include any system in which a person uses an electronic or other facility through which it can enter into transactions with more than one other person.
  - This obviously goes well beyond the systems, such as Enron Online, that the provision is purported to be intended to address.
  - The provision is not by its terms limited to futures contracts or commodity options otherwise subject to the CFTC’s jurisdiction, but applies to any

agreement, contract or transaction (other than a transaction in an excluded commodity).<sup>1</sup>

- Accordingly, dealing in cash market transactions may be subject to this provision. Because of the breadth of the definition of commodity under the CEA and of the range of covered facilities and systems, this provision could potentially capture procurement systems for manufacturing companies.
- Although the amendment appears to be intended to limit the scope of this provision to systems dealing in energy and metal commodity transactions, it is not clear that this result has been achieved.
- The CFTC could impose registration, reporting (including large trader reporting), net capital and recordkeeping requirements on persons subject to this provision, a category not limited to dealers. The CFTC could also require public dissemination of any information it deems appropriate.
- In addition, any eligible contract participant (whether or not a dealer) trading on or through a covered dealer, facility or system would be required to provide to the CFTC, on request, information relating to its transactions conducted through that dealer, facility or system.
- These provisions impose significant new regulatory burdens on participants in a number of markets without any empirical basis for concluding that there are issues unaddressed by existing regulation. In addition, the amendment makes no provision for the avoidance of duplicative regulation of entities, such as banks, that are already subject to federal regulation or oversight.

**The amendment would eliminate the statutory exemptions for transactions in energy and metal commodities, creating uncertainty as to whether various types of transactions are subject to the jurisdiction of the CFTC and as to the regulatory status of dealers and other users of these products and of systems and facilities on which transactions in these products can be conducted.**

- The amendment would amend Section 2(h) of the CEA—the exemption for transactions in exempt commodities between eligible contract participants that are not conducted on a trading facility and for transactions in exempt commodities between eligible commercial entities conducted on an electronic trading facility—so that it does not apply to transactions in energy or metal commodities.

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<sup>1</sup> The proposed statutory language of any “agreement, contract or transaction” is on its face much broader than the futures contracts and commodity options that have historically been subject to the jurisdiction of the CFTC. The CFMA expressly took account of this distinction in CEA Section 12(e)(2)(B), which extends preemption of state gaming and bucket shop laws to any excluded or exempt agreement, contract or transaction “(regardless of whether any such agreement, contract or transaction is otherwise subject to the Act)”. A reading of “agreement, contract or transaction” that is limited to transactions otherwise subject to the CFTC’s jurisdiction would render the parenthetical meaningless and, accordingly, would contravene fundamental principles of statutory construction. It is thus clear that the reference to agreement, contract or transaction in the new provisions covers all kinds of transactions, and not merely the futures contracts and commodity options that define the CFTC’s current jurisdiction.

- Although the exemption in CEA Section 2(g) would remain available for energy and metal commodity transactions, that exemption (as it would be amended) requires that a transaction be subject to individual negotiation and not be executed on an electronic trading facility. There would thus be no statutory exemption for energy and metal transactions conducted on an electronic trading facility or for transactions that do not meet the individual negotiation requirement but are not conducted on a trading facility.
- To the extent the Section 2(g) exemption were not available, market participants in energy and metal commodity transactions would have to rely on the pre-CFMA administrative exemptions and interpretations, such as the Part 35 Swap Exemption and CFTC Energy Forward Exemption, to avoid the risk that the transaction could be regarded as an illegal off-exchange futures contract.
- The amendment does not define energy and metal commodities for purposes of these provisions.

**The amendment extends the application of the CFTC’s antifraud and antimanipulation provisions to transactions in exempt commodities.**

- The amendment would provide that transactions in energy and metal commodities (including otherwise exempt transactions in such commodities) would be subject to the antifraud and antimanipulation provisions of the CEA, as well as certain related enforcement provisions.
- The amendment would also provide that the antifraud and antimanipulation provisions of the CEA would apply to any energy or metal commodity transaction that would otherwise be exempted by the CFTC under its Section 4(c) administrative exemption authority.
  - This would affect the CFTC’s energy forward exemption, under which the antifraud provisions of the CEA did not apply to qualifying contracts.
- The amendment would expand the CEA’s antifraud provision, Section 4b, to cover any transaction in a commodity subject to the CEA.
  - The revised provision is not limited to transactions that are futures contracts or commodity options subject to regulation under the CEA, and thus expands the CFTC’s authority to cover a range of transactions that have never previously been subject to the CEA.
  - The provision retains the prohibition on “bucketing” or taking the other side of a transaction. The application of this prohibition in the context of principal-to-principal transactions is inappropriate on its face.
- Because of the way in which they have been drafted, these amendments to the CFTC’s antifraud jurisdiction, however well intentioned, raise new and unintended questions as to the scope of the CFTC’s authority and as to the legal status of a range of derivatives transactions.