

# Food, Conservation and Energy Act of 2008 Removes Enron Loophole and Reforms Electronic Energy Markets

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## Introduction

A measure reauthorizing the CFTC and closing the Enron loophole is included in the massive Farm Bill that has been reported out of a House-Senate conference, passed by Congress, and awaits presidential action. Provisions in the Food, Conservation and Energy Act of 2008 ([HR 2419](#)) would end the Enron-inspired exemption from federal oversight now provided to electronic energy trading markets set up for large traders. It will ensure the ability of the CFTC to police all U.S. energy exchanges to prevent price manipulation and excessive speculation. These bipartisan provisions would give the CFTC the ability to scrutinize these transactions in energy commodities and prosecute traders that are manipulating energy prices. The House passed the bill by a 318-106 vote; the Senate vote was 81-15.

The Enron loophole was codified in Section 2(h)(3) of the Commodity Exchange Act. It exempts from oversight the electronic trading of energy commodities by large traders. In closing the Enron Loophole, the measure would increase federal oversight to detect and prevent manipulation and to limit speculation in U.S. electronic energy markets. It would increase transparency, and create an audit trail, impose firm speculation limits, and significantly increase financial penalties for cases of market manipulation and excessive speculation. The measure was approved as part of the CFTC Reauthorization Act of 2008, which is Title XIII of the Act.

The Enron loophole in the law, included in the Commodity Futures Modernization Act, CFMA, of 2000, has allowed large volumes of energy derivatives contracts to be traded over-the-counter and on electronic platforms without the federal oversight necessary to protect both the integrity of the market and energy consumers

Under Section 2(h)(3), transactions in exempt commodities executed or traded on an electronic trading facility have been largely exempt from regulation under the CEA. The Act puts all significant energy trades on electronic platforms within the regulatory confines of the CFTC and imposes limits on the size of trader's positions to prevent excessive speculation. It also ensures that there is an audit trail, imposes recordkeeping requirements, and forces electronic exchanges to monitor trading behavior and prevent manipulation.

For contracts that are significant in determining commodity market prices, the CFTC will require the electronic exchange to provide strict oversight, similar to what takes place on regulated markets like the New York and Chicago Mercantile Exchanges. The exchanges will be required to monitor trading to prevent manipulation and price distortion; ensuring that contracts are not susceptible to manipulation; limiting the size of positions to prevent excessive speculation, and; reducing holdings of traders in violation of position limits. The exchanges will also have to establish an audit trail by collecting information on trading activity and supplying large trader reports to the CFTC. They will also have to enhance transparency by publishing price, trading volume, and other trading data on a daily basis.

Regarding electronic contract oversight, the Act directs the CFTC to review all electronic contracts to identify those that are significant in determining market prices and thus must be regulated under the Act. The CFTC will consider three factors in making that determination. Specifically, it will consider whether the contract:

- (1) is traded in significant volumes;
- (2) is used by traders to help determine the price of subsequent contracts (analogous to using “comps” in the real estate market or “Blue Book” for auto sales); or
- (3) is equivalent to a regulated contract and used the same way by traders (the CFTC refers to these contracts as “look-alikes”).

The legislation increases transparency in energy markets to deter traders from manipulating the price of oil and natural gas futures traded on electronic markets. It requires energy traders to keep records so that there is transparency and an audit trail. It requires electronic energy traders to report trading in significant price discovery contracts to the CFTC so that the agency would have the information to effectively oversee the energy futures market. Manipulators could then be identified and punished by the CFTC.

The Act gives the CFTC new authority to punish manipulation, fraud, and price distortion. It requires electronic trading platforms to actively monitor their markets to prevent manipulation and price distortion of contracts that are significant in determining the price of the market.

One prime genesis of the measure was the fact that, when the Amaranth hedge fund was directed to reduce its position in regulated natural gas contracts, it simply moved its position to an unregulated exchange. The Act would essentially say that similar contracts on ICE and NYMEX will be regulated the same way. Last October, the four CFTC Commissioners released a report underscoring the critical need for increased oversight in U.S. energy markets. According to Sen. Feinstein, this bill includes what they asked for.

Congress determined that the current system regarding exempt commercial markets lacks transparency. Traders are able to avoid revelations of their identity within these exempt commercial markets. In fact, based on a Senate investigation, it was discovered that the Amaranth hedge fund had excessively traded natural gas contracts to such a degree that it controlled 40 percent of all natural gas contracts on the New York Mercantile.

The New York Mercantile, which is subject to CFTC regulation, required Amaranth to reduce its holdings of natural gas contracts. The hedge fund’s response was simply to move its dealings to the exempt commodity market, thereby defeating the entire purpose of CFTC regulation and cloaking its potentially manipulative market power.

This was pursuant to the Enron loophole in the law, included in the CFMA, which has allowed large volumes of energy derivatives contracts to be traded over-the-counter and on electronic platforms without federal oversight. The Enron loophole was inserted at the last minute into the CFMA and passed by Congress in late December 2000, in the waning hours of the 106th Congress. This loophole exempted from federal oversight the

electronic trading of energy commodities by large traders. The loophole has helped foster the explosive growth of trading on unregulated electronic energy exchanges.

The measure grants the CFTC new authority to impose important requirements on electronic, OTC transactions that rely on the current exemption contained in Section 2(h)(3) of the CEA, but serve a significant price discovery function. These requirements include the implementation of market monitoring, the establishment of position limitations or accountability levels, the daily publication of trading information, and a number of other standards key to restoring transparency to this important corner of the energy markets.

## Electronic Exchanges

The legislation would do more than require CFTC oversight. It would also require electronic exchanges, for the first time, to begin policing their own trading operations and become self-regulatory organizations in the same manner as futures exchanges like NYMEX. Specifically, the legislation would establish five core principles to which electronic exchanges must adhere, each of which parallels core principles already applicable to other CFTC-regulated exchanges and clearing facilities.

Implementing these core principles would require an electronic exchange to: monitor the trading of contracts that the CFTC has determined affect energy prices; ensure these contracts are not susceptible to manipulation; require traders to supply information about these contracts when necessary; supply large trader reports to the CFTC related to these contracts; and publish daily trading data on the price, trading volume, opening and closing ranges, and open interest for these contracts. In addition, the electronic exchanges would have to establish position limits and accountability levels for individual traders buying or selling these contracts in order to prevent price manipulation and excessive speculation.

Electronic exchanges should implement these position limits and accountability levels in the same way as futures exchanges like NYMEX. Moreover, it is intended that the CFTC will take steps to ensure that the position limits and accountability levels on all exchanges are comparable to prevent traders from playing one exchange off another.

The legislation would also require electronic exchanges to establish procedures to prevent conflicts of interest and antitrust violations in their operations. These provisions parallel core principles already applicable to other CFTC-regulated exchanges and clearing facilities and are intended to function in a similar manner. These provisions are not restricted to trades involving contracts that affect energy prices, but apply to the entire exchange to ensure it operates in a fair manner.

In addition to requiring electronic exchanges to become self-regulatory organizations, the legislation would require the CFTC to oversee these exchanges in the same general way that it currently oversees futures exchanges like NYMEX. The legislation also, however, assigns the CFTC a unique responsibility not present in its oversight of other types of

exchanges and clearing facilities. The legislation would require the CFTC to review the contracts on each electronic exchange to identify those which perform a significant price discovery function or, in other words, have a significant effect on energy prices.

The Act sets forth criteria for the Commission to consider in determining whether a contract qualifies as a significant price discovery contract: including: price linkage; arbitrage; material price reference; and material liquidity and other such material factors as the Commission specifies by rule. The Act applies core principles to exempt commercial market contracts that are determined to perform a significant price discovery function by the Commission. These core principles are derived from selected core principles and designation criteria set forth in CEA section 5. These core principles include those relating to: contracts not being readily susceptible to manipulation, monitoring of trading, the ability of the Commission to obtain information, position limitations or accountability limitations, emergency authority, daily publication of trading information, antitrust considerations, and conflict of interest.

Specifically, the exempt commercial market must list only contracts that are not susceptible to manipulation and monitor trading in significant price discovery contracts to prevent manipulation and price distortion. The electronic trading facility must also adopt rules providing for the exercise of emergency authority, in consultation with the Commission, where necessary, including the authority to liquidate open positions in a significant price discovery contract and to suspend or curtail trading in a significant price discovery contract. Another core principle is to make public daily information on price, trading volume, and other trading data to the extent appropriate for significant price discovery contracts. In addition, with respect to significant price discovery contracts, the facility must establish and enforce rules minimizing conflicts of interest in its decisionmaking process and establish a process for resolving conflicts of interest.

The Act gives the electronic trading facility the explicit discretion to take into account differences between cleared and uncleared significant price discovery contracts only in applying the emergency authority and the position limits or accountability core principles and directs the Commission to take such differences into consideration when reviewing implementation of such principles by the electronic trading facility. The conference report clarifies that an electronic trading facility will have reasonable discretion to account for differences between cleared and uncleared contracts in complying with all the core principles applicable under this Act to significant price discovery contracts.

The Act requires an electronic trading facility to notify the Commission whenever it has reason to believe that an agreement, contract or transaction conducted in reliance on the exemption provided in 2(h)(3) displays any of the factors relating to a significant price discovery function. Further, the Act directs the Commission to conduct an annual evaluation to determine whether any agreement, contract or transaction conducted on an electronic trading facility in reliance on the exemption in 2(h)(3) performs a significant price discovery function. See Section 13201.

Congress does not intend that the Commission conduct an exhaustive annual examination of every contract traded on an electronic trading facility pursuant to the section 2(h)(3)

exemption, but instead to concentrate on those contracts that are most likely to meet the criteria for performing a significant price discovery function. In addition, the Commission should conduct such examinations in the course of its normal monitoring of ECM contracts and surveillance of designated contract market and derivatives transaction execution facility contracts when considering the potential for arbitrage or price linkage as the basis for a significant price discovery determination.

The Act gives the CFTC new authority to punish manipulation, fraud, and price distortion. It requires electronic trading platforms to actively monitor their markets to prevent manipulation and price distortion of contracts that are significant in determining the price of the market. The CFTC will consider a number of factors in making the determination that a contract performs a significant price discovery function, including trading volume, whether significant volumes of a commodity are traded on a daily basis; price referencing, if the contract is used by traders to help determine the price of subsequent contracts; and price linkage, if the contract is equivalent to a NYMEX contract and used the same way by traders

## **Significant Price Discovery Contracts**

The CFTC is directed to adopt rules implementing the authorities provided by this Act regarding significant price discovery contracts. The conference report indicates that the Commission can consider the potential for arbitrage between a potential significant price discovery contract and an existing such contract in making a determination whether a contract has that status.

The conference report clarifies that, in determining appropriate position limits or position accountability limits under the Act, an electronic trading facility must consider cleared swaps transactions that are treated by a derivatives clearing organization as fungible with significant price discovery contracts. The report also clarifies that the conflict of interest and antitrust considerations core principles apply to electronic trading facilities only with respect to significant price discovery contracts traded on such facilities.

Not all the listed factors must be present to make a determination that a contract performs a significant price discovery function. However, Congress intends that the Commission should not make a determination that a contract performs a significant price discovery function on the basis of the price linkage factor unless the contract has sufficient volume to impact other regulated contracts or to become an independent price reference or benchmark that is regularly utilized by the public.

The core principles are derived from selected designated contract market core principles and designation criteria set forth in CEA section 5, and Congress intends that they will be construed in like manner as the DCM core principles.

The Act requires reporting and recordkeeping of every person registered with the Commission regarding the transactions and positions of such person in any significant price discovery contract traded or executed on an electronic trading facility. Also, any

person buying or selling significant price discovery contracts on an electronic trading facility subject to reporting requirements set by the Commission and to require such person to report and keep records on transactions or positions equal to or in excess of any reporting threshold the Commission has set.

Large trader reporting requirements imposed by the Act for significant price discovery contracts must include contracts that are treated by a derivatives clearing organization as fungible with significant price discovery contracts.

## **Portfolio Margining**

Following enactment of the CFMA, the CFTC and the SEC jointly promulgated rules relating to the margining of security futures products. Under those rules, security futures products have been subject to the same fixed-rate strategy-based margining scheme applicable to security options customer accounts, rather than the risk-based portfolio margining system typical in the futures industry. Many have argued that this has contributed to the low volume of trading in such products that, by contrast, have been successful in Europe.

The Act directs the CFTC and SEC to use their existing authorities to allow customers to benefit from the use of a risk-based portfolio margining system for both security options and security futures products. The detailed statutory test of a narrow-based security index was tailored to fit the U.S. equity markets, which are by far the largest, deepest and most liquid securities markets in the world. The Act provides clarity in this area by requiring the CFTC and the SEC to adopt rules providing criteria that will exclude broad-based indexes on foreign equities from the definition of narrow-based security index as appropriate.

Thus, the measure requires the President's Working Group on Financial Markets to work with the SEC and the CFTC to allow risk-based portfolio margining for security options and security futures products by September 30, 2009; and the trading of futures on security indexes by June 30, 2009, by resolving issues related to foreign security indexes.

## **Background and Purpose**

It had become quite apparent that the current system regarding exempt commercial markets lacked transparency and failed to provide an essential tenet to any futures market. Traders were able to avoid revelations of their identity within these exempt commercial markets. In fact, based on one of the investigations that took place by a Senate subcommittee, it was discovered the Amaranth hedge fund had excessively traded natural gas contracts to such a degree that in 2006, it controlled 40 percent of all natural gas contracts in the New York Mercantile. One hedge fund controlled 40 percent of all the natural gas deliveries in the United States. The positions were so substantial the company could unilaterally alter the prices for natural gas. See Senator Olympia Snow, Cong. Record, Dec 13, 2007, S5442.

The New York Mercantile, which is subject to the CFTC regulation, required Amaranth in August of 2006 to reduce their holdings of natural gas contracts. Their response, the hedge fund's response, was simply to move its dealings to the exempt commodity market, thereby defeating the entire purpose of the CFTC regulation and cloaking its potentially manipulative market power for further regulation. This was an unacceptable gap in the law.

## **Enron Loophole**

The Enron loophole has, since 2000, exempted electronic energy markets for large traders from government oversight. This loophole opened the door to price manipulation and excessive speculation. The Enron loophole is a provision that was inserted at the last minute, without opportunity for debate, into commodity legislation that was attached to an omnibus appropriations bill and passed by Congress in late December 2000, in the waning hours of the 106th Congress.

This loophole exempted from U.S. government oversight the electronic trading of energy commodities by large traders. The loophole has helped foster the explosive growth of trading on unregulated electronic energy exchanges. It has also rendered U.S. energy markets more vulnerable to price manipulation and excessive speculation, with resulting price distortions.

Since 2001, the Subcommittee on Investigations has been examining the vulnerability of U.S. energy commodity markets to price manipulation and excessive speculation. Beginning in 2002, they held six days of hearings and issued four reports on issues related to inflated energy prices.

The subcommittee first documented some of the weaknesses in U.S. crude oil markets in a 2003 staff report which found that crude oil prices were affected by trading not only on regulated exchanges like the NYMEX, but also on unregulated "over-the-counter" (OTC) markets that have become major trading centers for energy contracts and derivatives. The lack of information on prices and large positions in these OTC markets makes it difficult in many instances, if not impossible in practice, to determine whether traders have manipulated crude oil prices.

In June 2006, staff issued a report entitled, "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat." This bipartisan staff report analyzed the extent to which the increasing amount of financial speculation in energy markets had contributed to the steep rise in energy prices over the past few years. The report concluded that speculation has contributed to rising U.S. energy prices, and endorsed the estimate of various analysts that the influx of speculative investments into crude oil futures accounted for approximately \$20 of the then-prevailing crude oil price of approximately \$70 per barrel.

The 2006 report recommended that the CFTC be provided with the same authority to regulate and monitor electronic energy exchanges, such as ICE, as it has with respect to

the fully regulated futures markets, such as NYMEX, to ensure that excessive speculation in the energy markets did not adversely effect the availability and affordability of vital energy commodities through unwarranted price increases. In June 2007, the subcommittee released another bipartisan report entitled “Excessive Speculation in the Natural Gas Market,” which found that a single hedge fund named Amaranth had dominated the U.S. natural gas market during the spring and summer of 2006, and Amaranth’s large-scale trading significantly distorted natural gas prices from their fundamental values based on supply and demand.

The report concluded that the current regulatory system was unable to prevent these distortions because much of Amaranth’s trading took place on an unregulated electronic market and recommended that Congress close the Enron loophole that exempted such markets from regulation. The report describes in detail how Amaranth used the major unregulated electronic market, ICE, to amass huge positions in natural gas contracts, outside regulatory scrutiny, and beyond any regulatory authority.

Finally, when Amaranth’s positions on the regulated futures market, NYMEX, became so large that NYMEX directed Amaranth to reduce the size of its positions on NYMEX, Amaranth simply switched those positions to ICE, an unregulated market that is beyond the reach of the CFTC. In other words, in response to NYMEX’s order, Amaranth did not reduce its size; it merely moved it from a regulated market to an unregulated market.

The Amaranth case history showed Congress that it was time to put the cop on the beat in all of energy exchanges.

## **FERC and CFTC**

Ensuring that proper oversight exists in these markets is of critical importance to energy consumers, and to the efficient operation of the physical, or cash, energy markets that fall under the purview of the Federal Energy Regulatory Commission. The Energy Policy Act of 2005 provided FERC these much-needed, new authorities in response to the Western energy crisis. However, it is also clear that further regulatory authority is needed, to ensure the CFTC has the tools at its disposal to ensure the integrity of financial energy markets.

The present circumstance is one in which the CFTC has essentially been blind to a large portion of these markets for a number of years. The energy markets are linked. In fact, there is significant reason to believe that these markets have become more fully intertwined in recent years. In its 2006 State of the Markets Report, FERC devoted an entire section, section 7, to the “Growing Influence of Futures and Financial Energy Markets” on physical energy prices. The report notes that this impact is particularly acute as it relates to natural gas prices—but effects electricity prices as well, to the extent that a growing percentage of electric generating capacity is gas-fired. The FERC report details the link between prices set in the financial derivatives market, and the physical natural gas contracts that ultimately dictate the prices paid by consumers.

FERC Chairman Joseph Kelliher in December 12, 2007, testimony before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce said that it is important to understand that price formation in sophisticated energy markets has become increasingly complex. Regulators must understand and consider the interplay between financial and futures energy markets, on the one hand, and physical energy markets, on the other hand. While FERC has jurisdiction over physical wholesale gas sales, and the CFTC has jurisdiction over futures, the link between futures and physical markets cannot be overstated. In a sense, these markets have effectively converged. Manipulation does not recognize jurisdictional boundaries and regulators must be vigilant in monitoring the interplay of these markets.

The Act would enhance the CFTC's authority to protect the integrity of financial energy markets, which in turn play an increasingly important price discovery role in physical energy markets. And it would do so in a manner that also preserves FERC's important role in guarding against market manipulation and protecting natural gas and electricity consumers.

A colloquy (Cong. Record, Dec 13, 2007, S15446) between Senator Jeff Bingaman, Chair of the Energy Committee, and Senators Levin, Harkin and Feinstein clarified the respective jurisdictions of the FERC and the CFTC. The colloquy revealed that nothing in the bill would prejudice or interfere with ongoing, energy market enforcement-related litigation or administrative proceedings currently involving FERC and the CFTC. Sen. Harkin assured that the current jurisdictional boundaries between the two Commissions are maintained in the legislation, with respect to the authority of FERC under the Federal Power and Natural Gas Act and the CFTC under the Commodity Exchange Act. Sen. Harkin said that nothing in the bill would erode either Commission's authorities under the statutes. Similarly, nothing in the bill would limit FERC's existing ability to gain information from market participants.

Senator Feinstein, a primary author of the amendment that bears her name, as well as one of the coauthors of sections 315 and 1283 in the Energy Policy Act of 2005, which gave FERC additional anti-manipulation authorities under the Federal Power and Natural Gas Acts. Nothing in this amendment undermines or alters those authorities. Section 13203 of the Commodity Reauthorization Act, which preserves FERC's existing authority, does not undermine or alter those authorities.

The bill expands the CFTC's authority with respect to the requirements it may impose on transactions it deems significant price discovery contracts. This significant price discovery contract determination may be applied to contracts, agreements, and transactions that are conducted in reliance on the exemption included in section 2(h)(3) of the Commodity Exchange Act. In closing the Enron loophole, the bill extends the CFTC's exclusive jurisdiction over these significant price discovery contracts.

As a forward-looking matter, Sen. Bingaman clarified the intent of the bill with respect to this new class of significant price discovery contracts. Electronic trading facilities that currently operate under the exemption included in section 2(h)(3) of the Commodity Exchange Act for purposes of trading energy swaps also trade physical or cash contracts

in electricity and natural gas. For oversight and enforcement purposes, emphasized Sen. Bingaman, it is crucial that FERC retain its jurisdiction over these physical energy transactions.

According to Sen. Levin, in addition to the savings clause in the bill that preserves FERC's jurisdiction under its statutes as a threshold matter, FERC's jurisdiction over these transactions would, in any event, be preserved. These kinds of cash transactions would not be captured within the bill's significant price discovery contract test. The test is reserved for those transactions conducted in reliance on the exemption in paragraph 2(h)(3) of the Commodity Exchange Act. Because the CEA does not apply to cash transactions for purposes of regulation, these transactions cannot, by definition, be conducted in reliance on this exemption. As such, FERC's authority in this area is preserved on all accounts.

Finally, Sen. Bingaman noted that regional transmission organizations often deal in the auction of financial transmission rights and ancillary services associated with the orderly operation of electricity markets. In the view of Sen. Levin, FERC's authority over RTOs would be unaffected by the bill. To his knowledge, no RTO operates pursuant to the exemption in paragraph 2(h)(3) of the Commodity Exchange Act.

## About the Author

**James Hamilton** is a Principal Analyst at Wolters Kluwer Law & Business, a leading provider of corporate and securities information, and a prolific blogger (Jim Hamilton's World of Securities Regulation at <http://jimhamiltonblog.blogspot.com/>). Hamilton has been tracking, analyzing and explaining securities law and regulation for nearly 30 years as an analyst for CCH. He has written and spoken extensively on federal securities law and has been cited as an authority by a federal court. His analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules*, is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law*, the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.