

Dodd-Frank Act Will Create New Compliance Requirements and Increase Costs for Entities Using Financial Instruments to Hedge Physical Natural Gas Transactions

In July of this year, in response to the financial crisis that began during the fall of 2008, Congress passed, and the President signed, the Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The Dodd-Frank Act introduces new regulatory oversight of derivative financial instruments called “swaps,” which many market participants use to hedge physical natural gas transactions. The Act has the potential to impose significant new compliance requirements and costs—either direct costs associated with clearing of swaps or indirect costs passed on by others—on participants in swaps markets. Much of this depends on the dozens of rulemakings required of the Commodity Futures Trading Commission (“CFTC”) between now and July 2011. Therefore, U.S. Energy will be closely monitoring the CFTC’s rulemaking efforts on behalf of its customers.

Mandatory Centralized Clearing of Swaps. A central requirement of the new regulatory regime is that, subject to an “end user exception,” all standardized swaps must be submitted to a derivatives clearing organization for clearing and executed on either a swap execution facility or a designated contract market. The term “swap” is broadly defined to include virtually all derivative contracts except already-regulated futures contracts. The term specifically excludes sales of nonfinancial commodities for deferred shipment or delivery intended to be physically settled (the so-called “forward contract exclusion”). The centralized clearing requirement has the potential to increase transaction costs for market participants, since clearing organizations will be required to impose margin requirements and other risk control mechanisms on participants.

An exception to the clearing requirement exists for non-swap dealers and non-major swap participants (entities defined below) who use swaps to hedge commercial risk. However, an end user’s ability to make use of this exception will depend on upcoming CFTC rulemakings. Regardless, even an end user claiming the exception will have to notify the CFTC regarding “how it generally meets its financial obligations associated with entering into non-cleared swaps.”

Comprehensive Regulation of Swap Dealers and Major Swap Participants. Congress created two new categories of market participants in swaps markets—“swap dealers”¹ and “major swap participants”²—to describe entities especially likely to have significant financial effects on swaps markets. Such entities will be subject to comprehensive regulation under the Act, including: required registration with the CFTC, minimum capital and margin requirements,

¹ A “swap dealer” is defined as any person who, subject to a “de minimis” exception, holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties as an ordinary course of business for its own account, or engages in activity causing the person to be commonly known as a dealer or market maker in swaps.

² A “major swap participant” is any person who maintains a “substantial position” in swaps (not including end user positions held for hedging commercial risk), has outstanding positions in swaps that create substantial counterparty exposure or systemic financial risk, or is a highly leveraged financial entity that maintains a substantial position in swaps.

independent reporting and recordkeeping requirements, business conduct standards, and conflict of interest rules. While the available end-user exceptions will hopefully relieve end users from these requirements, end users will nevertheless likely experience increased transaction costs passed on by swap dealer and major swap participant counterparties.

Other Requirements—Reporting and Recordkeeping, Position Limits. Both cleared and non-cleared swaps will be required to be reported to swap data repositories or the CFTC under the Act. Although the mechanisms for reporting are not yet in place, the CFTC has issued an interim final rule regarding what kind of data should be preserved for non-cleared swaps open as of July 21, 2010, namely:

- Any information necessary to identify and value the transaction;
- The date and time of execution;
- Information related to the price of the transaction;
- Whether the transaction was accepted for clearing and, if so, the identity of the clearing organization;
- Any modification(s) to the transaction;
- The final confirmation of the transaction.

The CFTC also has authority to establish new position limits across derivative contracts, including certain kinds of swaps. Positions held for “bona fide hedging” will not count towards the limits.

CFTC Rulemakings. The CFTC is tasked with over 60 required rulemakings to implement the Dodd-Frank Act by July 16, 2011 and is planning to release a number of important rules in December 2010. Given the potential impact of the new rulemakings, U.S. Energy is working with the Minneapolis law firm of Leonard, Street & Deinard (Nate Endrud, nathan.endrud@leonard.com, (612) 335-1585 and Bob Fallon, (202) 346-6910, fallonr@leonard.com) to closely monitor the CFTC’s actions. For further information about the CFTC rulemakings, contact U.S. Energy’s General Counsel, Michael Auger, (763) 543-4697, mauger@usenergyservices.com, or visit Leonard, Street & Deinard’s Dodd-Frank blog at <http://dodd-frank.com>.

The information contained in this update is neither designed nor intended to be relied upon as specific legal advice to any individual or organization. Readers should always consult with their attorney about specific legal matters.