

T O U R F R I E N D S A N D C L I E N T S

M e m o r a n d u m



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June 11, 2008

## CFTC Update

Several significant developments have recently occurred: (1) The CFTC Reauthorization Act of 2008, which was included as a separate title of the Food, Conservation and Energy Act of 2008 (better known as the "Farm Bill"), was enacted into law on May 22, 2008, when Congress overrode President Bush's veto of the Farm Bill; (2) on June 2, 2008, the Commodity Futures Trading Commission ("CFTC") announced a number of initiatives to enhance transparency in the energy futures markets in apparent response to Congressional and public concern about recent dramatic increases in the price of crude oil; (3) on June 3, 2008, the CFTC announced several policy initiatives which are designed to address various concerns expressed by agribusiness and farm representatives during the CFTC's April 22nd agricultural markets roundtable, including with respect to convergence between agricultural futures and cash market prices and the role of speculators and index traders in the agricultural futures markets; and (4) on June 10, 2008, the CFTC announced the formation of an interagency task force to evaluate developments in commodity markets. This memorandum summarizes these developments.

### **I. CFTC Reauthorization Act of 2008**

The CFTC Reauthorization Act of 2008 (the "CRA") amends the Commodity Exchange Act (the "CEA") in a number of significant respects. These amendments are the first substantive amendments to the CEA since the adoption of the Commodity Futures Modernization Act of 2000 (the "CFMA") at the end of that year and are designed to address various market and related developments during the last several years. Although these amendments do not by themselves substantially revamp the CEA or reverse the deregulatory thrust of the CFMA, they do make some important changes in the law.

In summary, the CRA (i) reauthorizes the CFTC through fiscal year 2013; (ii) clarifies and expands the CFTC's jurisdiction with respect to over-the-counter foreign currency transactions at the retail level, in response to recent judicial decisions construing the CFTC's jurisdiction in a manner which has impeded the CFTC's enforcement program in this area; (iii) directs the CFTC and the Securities and Exchange Commission (the "SEC"), or both, as appropriate, to take actions under their pre-existing authority to permit (A) by September 30, 2009, risk-based portfolio margining for security options and security futures

products (i.e., single stock and narrow-based stock index futures) and (B) by June 30, 2009, “the trading of futures on certain security indexes by resolving issues related to foreign security indexes”; (iv) strengthens the CFTC’s oversight authority with respect to any “significant price discovery contract” listed on an electronic trading facility operating as an exempt commercial market (“ECM”) under Section 2(h)(3) of the CEA (e.g., Intercontinental Exchange) by modifying the terms of that exemption<sup>1</sup>; (v) extends the antifraud prohibition in Section 4b of the CEA to include certain principal-to-principal transactions; and (vi) increases the civil monetary penalty for manipulation, attempted manipulation and certain related violations under the CEA to US\$1m per violation. The CRA also makes various technical and conforming amendments to the CEA.

## **II. CFTC Announces Initiatives to Enhance Energy Market Transparency**

The CFTC’s initiatives include (i) expanding information-sharing with the United Kingdom’s Financial Services Authority and ICE Futures Europe to facilitate the CFTC’s surveillance of non-US energy futures contracts with US delivery points, i.e., WTI crude oil futures contracts traded on both the New York Mercantile Exchange and ICE Futures Europe; (ii) using the CFTC’s “special call” authority to require market participants to provide monthly reports of index-related trading activity; (iii) proposing that index traders and swap dealers using the futures markets be required to provide the CFTC with more detailed information about their activities on a routine basis; (iv) reviewing whether classification of these types of traders as “commercial” users can be improved for regulatory and reporting purposes; and (v) reviewing the trading practices of index traders in the futures markets, with a view to determining whether such activity is adversely affecting the price discovery process. In an unusual step, the CFTC also announced that it has been conducting a nationwide investigation into crude oil prices, with special focus on the purchase, transportation, storage and trading of the commodity and related derivative contracts. The CFTC stated that these initiatives are designed to improve oversight of the energy futures markets and to help assure that trading activity in these markets reflects fundamental forces of supply and demand.

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<sup>1</sup> The CRA sets forth certain factors for the CFTC to consider in determining whether a contract performs a significant price discovery function. These factors include the trading volume and liquidity of the contract, as well as any price relationships between the contract and the prices of exchange-traded futures contracts. The CRA directs the CFTC to propose a rule within 180 days (and issue a final rule within 270 days) after the date of its enactment identifying the standards, terms, and conditions under which an ECM will have the responsibility to notify the CFTC that a contract may perform a significant price discovery function. The CRA also requires the CFTC to complete a review of the agreements, contracts and transactions trading on each ECM operating on the effective date of that rule not later than 180 days thereafter to determine whether any such agreement, contract, or transaction performs a significant price discovery function.

An ECM must comply with certain core principles with respect to the trading of any contract which the CFTC has determined is a significant price discovery contract. Among others, an ECM may only list a significant price discovery contract that is not readily susceptible to manipulation; must monitor trading in significant price discovery contracts; must adopt position limits or position accountability standards for significant price discovery contracts; must make certain market data public on a daily basis for significant price discovery contracts; and must monitor and enforce compliance with its rules applicable to significant price discovery contracts. In addition, the CRA imposes large trader reporting and recordkeeping requirements with respect to significant price discovery contracts traded on an ECM, and by amending Section 4a of the CEA, the CRA provides the CFTC with the authority to establish speculative position limits with respect to such contracts.

### **III. CFTC Announces Agricultural Market Initiatives**

The CFTC's initiatives include (i) withdrawing the proposed rulemakings that would have increased the federal speculative position limits in certain agricultural futures contracts (e.g., corn, soybeans and wheat) (72 Fed. Reg. 65483) and would have added a risk management exemption from federal speculative position limits in those agricultural futures contracts for certain passively managed commodity indexing positions (72 Fed. Reg. 66097); (ii) reviewing the CFTC staff's policy granting relief from the federal speculative position limits relating to agricultural commodity index trading; (iii) directing the staff to develop a new CFTC monthly publication on trader data for agricultural and other markets, beginning in July 2008, to provide greater transparency; (iv) taking the unusual step of announcing an ongoing investigation of the February/March 2008 price run-up in the cotton futures market; and (v) asking the CFTC's Agricultural Advisory Committee to explore several additional issues, including convergence in the futures and cash markets, exchange practices for determining margin, daily price limits and methodologies of setting settlement prices, the role and size of over-the-counter agricultural swaps and whether the CFTC should undertake additional studies relating to current agricultural commodity prices. The CFTC stated that these initiatives are designed to ensure that the agricultural futures markets perform their price discovery and risk transfer functions properly.<sup>2</sup>

### **IV. CFTC Announces Interagency Task Force to Study Commodity Markets**

On June 10, 2008, the CFTC announced the formation of an interagency task force to evaluate developments in commodity markets in view of the recent increases in crude oil and other commodity prices and the influx of new investors into commodity futures markets. The task force, which includes staff representatives from the CFTC, the Federal Reserve Board, the Department of the Treasury, the SEC, the Department of Energy, and the Department of Agriculture, will examine investor practices, fundamental supply and demand factors, and study the role of speculators and index traders in the commodity markets. The CFTC stated that the task force will aid public and regulatory understanding of the forces that are affecting the functioning of the commodity markets, will endeavor to complete its work as expeditiously as possible, and will make public the results.

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<sup>2</sup> The CFTC also reiterated its intention to develop a proposal to routinely require more detailed information from index traders and swap dealers in the futures markets and to review whether the classification of these types of traders can be improved for regulatory and reporting purposes.

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