Regulation of Oil Markets - Current Reforms and Implications
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OVERVIEW OF CURRENT REGULATORY REFORMS OF COMMODITY DERIVATIVES

Prepared Background Notes for the Workshop Discussion

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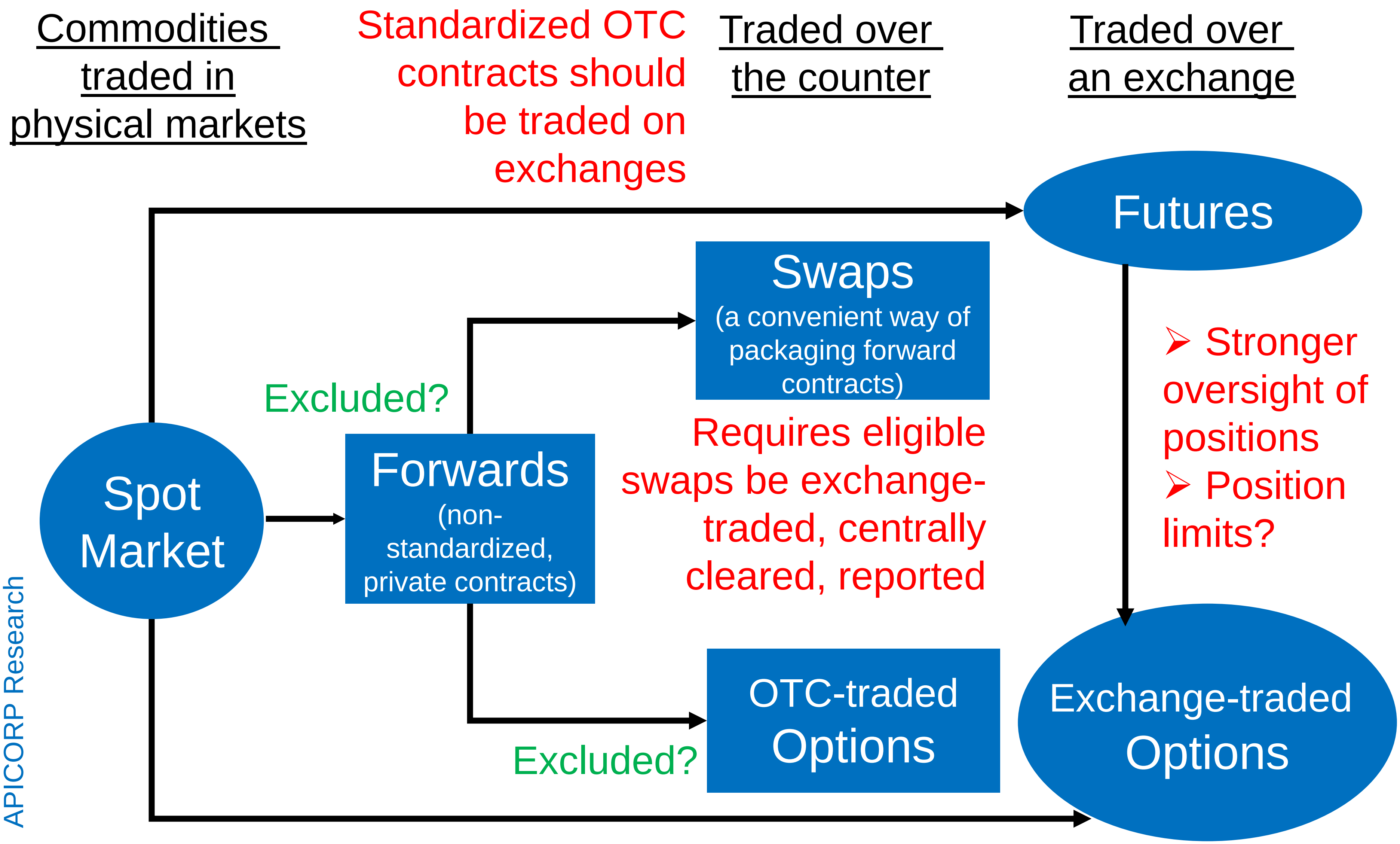
Preamble

- These notes have been prepared to support discussion and input during the OIES workshop on the regulation of the oil market
- The focus is on current regulatory reforms of commodity derivatives
- Material is based on reading notes and own analyses using:
  - Ongoing rule making under the Dodd-Frank Act (CFTC)
  - Relevant international resolutions (G20)
  - European proposal (ESMA-EC)
  - Trade press reporting and industry analyses

What is being regulated?



OTC derivatives – Some facts and figures

- Derivatives are financial instruments used to hedge risks or for investment/speculation
- They are derived from class assets such as equity, bonds, loans, currencies and commodities
- Contrary to futures, OTC (swaps) are neither traded on exchange, nor cleared through central counterparties, nor subject to reporting rules
- OTC account for 90% of global derivatives and total some $615 billions outstanding, half of it in the U.S.

OTC commodity (energy) derivatives

- Currently, commodities derivatives represent less than 0.5% of the global derivatives market
- OTC commodities derivatives, especially energy derivatives, are inherently more robust than financial derivatives
- Used for commercial risk management function by businesses with an energy price exposure
- They are underwritten by physical assets or commodity and therefore not subject to the same degree of systemic risk as purely financially based derivatives
- Unchecked trading activities, however, are thought to have contributed to price increases, price dislocation and volatility

Key initiatives and ongoing regulation of OTC derivatives

- G20 resolution(Pittsburg, Sep 2009)
- Dodd-Frank process (Act July 2010)
- Implementation of Chapter VII of Dodd-Frank Act: CFTC/SEC
- Commitment to G20: EC (ESMA) Proposal

Dodd-Frank - Wall Street Reform and Consumer Protection - Act

- The law provides for a sweeping overhaul of US financial regulation with the aim of:
  - promoting financial stability
  - Identifying and addressing systemic risks
  - organizing orderly liquidation of systemically important firms (the ‘too big to fail’)
  - ending taxpayer-funded bailouts
  - ensuring transparency and accountability of Wall Street
  - protecting investors and consumers from misleading and abusive practices of financial services providers
- Title VII of the Act - Wall Street Transparency and Accountability

Dodd-Frank Act -Title VII

- Gives SEC and CFTC authority to regulate OTC instruments
  - SEC’s authority: security-based swaps
  - CFTC’s authority: commodity-based swaps
- Code of conduct for all registered swap dealers
- Requires certain swaps to be exchange-traded, centrally cleared and publicly reported

Title VII – Transparent Trading

- The legislation enables futures exchanges to also offer swaps for trading
- In addition, it establishes a new category of trading platform – the "swap execution facilities (SEFs)" - that can only trade swaps
- Standardized swaps, other than block trade, are required to be traded on the above venues

Focus of attention on categories of market participants and clearing obligations

- Definition of "swap“ left open to review and amendment
  - Swap dealers (SD): market maker in swaps enter into routine swaps : any transactions entered into would have to be cleared
  - Major swap participants (MSP): A financial entity holding a ‘substantial position’ in any swap categories (ex. Commodity swap), not used for hedging, whose exposure could have adverse effect on financial stability: any transactions entered into would have to be cleared
  - Commercial end users (EU): commercial hedgers mitigating their risk: exempt

End-user exception to clearing

- End-user exception to clearing covers counterparties that:
  - are not financial entities;
  - are using swaps to hedge or mitigate commercial risks;
  - and have notified the CFTC as to how they generally meet their financial obligations associated with non-cleared swaps
- Where clearing is not required, the non-swap dealer and non-major swap participant counterparty may nonetheless elect to require that the swap be cleared

CFTC Process

- Charted all rulemaking from Dodd-Frank
- Rulemaking clustered into 30 areas divided into eight groups
  - Comprehensive Regulation of Swap Dealers & Major Swap Participants
  - Clearing
  - Trading
  - Data
  - Particular Products
  - Enforcement
  - Position Limits
  - Others (incl. Volcker Rule)

Key issue: Position limits to prevent undue market influence

- Position limits are the maximum number of contracts that a trader (speculator) may hold
- Dodd-Frank Act charges CFTC with “promulgating regulations, as appropriate, to limit the amount of positions, other than *bona fide* hedge positions, that may be held by any person with respect to commodity futures and option contracts…”
- New section 4a(a)(6)(A) of the Act requires CFTC-set position limits “to apply aggregately across DCMs to contracts that are based on the same commodity”.

G20 resolution on OTC derivatives markets

- All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest
- OTC derivative contracts should be reported to trade repositories
- Non-centrally cleared contracts should be subject to higher capital requirements

EC Proposal

- To meet G20 commitments
- Three-fold approach
  - Regulate the OTC derivatives markets through enhanced market oversight
  - Review of the Market Abuse Directive (MAD)
  - Revision of the Markets in Financial Instruments Directive (MiFID)
- Three key objectives
  - increase market transparency
  - reduce counterparty credit and operational risks
  - Strengthen market infrastructure

Proposed European Market Infrastructure Regulation (EMIR)

- Greater standardization and oversight of the over-the-counter (OTC) derivatives market
- Clearing obligation, through central counterparties, for eligible contracts

The European Securities and Markets Authority (ESMA)

- This new pan-European regulatory body will be responsible for the
  - identification of contracts subject to clearing obligations (those standardized)
  - surveillance of trade repositories
  - drafting specific binding technical standards for the implementation of the Regulation
- National supervisors retain responsibility for CCP (established in their territory) authorization and supervision

Further ESMA’s responsibilities

- To decide which derivatives contracts will be eligible for mandatory clearing
- To maximize the number of OTC contacts eligible, along a two-way approach:
  - bottom-up: from national regulator to ESMA
  - top-down approach: ESMA initiative in consultation with the European Systemic Risk Board (ESRB)

Obligations and Exemptions from clearing and reporting

- Obligation to clear OTC derivatives through a CCP and report them to trade repositories apply to financial firms and to non-financial firms that have large positions
- Exemptions apply in the following cases:
  - exemption from reporting: contracts between two non-financials firms where neither firm exceeds an “information threshold”
  - exemption from clearing: contracts between two non-financials firms below a “clearing threshold”
  - “information” and “clearing” thresholds will be determined by ESMA in consultation with the European Systemic Risk Board (ESRB)

Towards a convergence between CFTC and EC (ESMA) on the regulation of commodity derivatives

Key areas	CFTC	ESMA (EC)
Scope and focus	• OTC swaps eligible for clearing • Forward contracts excluded	• OTC instruments eligible for clearing • No specific exclusion
New market infrastructure	• Derivative Clearing Organizations (DCOs) • Swap Data Repositories (SDRs)	• Central Clearing Counterparties (CCPs) • Trade Repositories (TRs)
Clearing & reporting Obligations	• Financial counterparties	• Financial counterparties (FCs) • Limited exemptions for non-FCs
Position reporting & position limit regime	• Positions to be reported • Limits “as appropriate”	• Positions to be reported • Limits undecided yet
Prudential requirements	• Margin and capital requirements for not cleared OTC	• Idem
Volcker rule	• Prohibiting any “banking entity” from proprietary trading	• No such a provision yet
Regimes for foreign, cross-border SDRs	• May be subject to stricter regime than the resident ones	• Re-affirmation of principle of equivalency of regulatory regimes
Implementation	• By July 2011	• During 2012

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