

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue cap at the top. The globe in the top bulb is dark blue, and the globe in the bottom bulb is light blue. The hourglass is centered on the page.

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The Enron Loophole

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Abstract. The Commodity Exchange Act exempts certain energy derivatives contracts from regulation by the Commodity Futures Trading Commission (CFTC). These exemptions are popularly known as the "Enron loophole." Soaring energy prices have raised concerns about whether the CFTC has enough information about these unregulated markets to monitor energy trading in a comprehensive manner. The Farm Bill (P.L. 110-234) established a more stringent regulatory regime for electronic trading facilities that offer contracts that play a significant role in setting energy prices. A number of other bills in the 110th Congress would impose new reporting or regulatory requirements on the bilateral energy swaps market, which was not addressed by the Farm Bill.

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CRS Report for Congress

The Enron Loophole

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Summary

The Commodity Exchange Act exempts certain energy derivatives contracts from regulation by the Commodity Futures Trading Commission (CFTC). These exemptions are popularly known as the “Enron loophole.” Soaring energy prices have raised concerns about whether the CFTC has enough information about these unregulated markets to monitor energy trading in a comprehensive manner. The Farm Bill (P.L. 110-234) established a more stringent regulatory regime for electronic trading facilities that offer contracts that play a significant role in setting energy prices. A number of other bills in the 110th Congress would impose new reporting or regulatory requirements on the bilateral energy swaps market, which was not addressed by the Farm Bill. This report will be updated as legislative developments warrant.

Background

In 2000, Congress passed the Commodity Futures Modernization Act (CFMA, P.L. 106-554), whose central purpose was to set out the conditions under which derivative financial contracts — instruments like futures, options, or swaps, whose value is linked to the price of some underlying commodity — could be legally traded in the over-the-counter (OTC) market, that is, off the futures exchanges that are regulated by the Commodity Futures Trading Commission (CFTC). The CFMA established three categories of commodities and made them subject to varying degrees of regulation: financial commodities (such as interest rates, currency prices, or stock indexes) were defined as *excluded commodities*. Excluded commodities can be traded in the OTC market with minimal CFTC oversight, provided that small public investors are not allowed to trade. A second category is *agricultural commodities*; here, because of concerns about price manipulation, the law specifies that all derivatives based on farm commodities must be traded on a CFTC-regulated exchange, unless the CFTC issues a specific exemption after finding that a proposed OTC agricultural contract would be consistent with the public interest.¹ Finally, there is a third “all-other” category — *exempt commodities* — which includes whatever is neither financial nor agricultural. In today’s markets, this means primarily metals and energy commodities. The statutory exemption

¹ This exemptive authority is in Section 4(c) of the Commodity Exchange Act.

from regulation provided by the CFMA for exempt commodities is commonly known as the “Enron loophole.”²

What Is Exempt From Regulation?

The CFMA added a new Section 2(h) to the Commodity Exchange Act, exempting two classes of transactions from most CFTC regulation. First, bilateral contracts between “eligible contract participants”³ that are not executed on a trading facility⁴ are exempt from the Commodity Exchange Act, except for certain anti-fraud and manipulation provisions. Second, contracts in exempt commodities between “eligible commercial entities”⁵ that are executed on an “electronic trading facility”⁶ are also exempt from most provisions of the Commodity Exchange Act. Substantial volumes of trading in energy contracts avail themselves of each of these exemptions.

The Bilateral Swaps Market

In the bilateral swaps⁷ market, there is no centralized marketplace equivalent to the futures exchanges like Nymex or the Chicago Board of Trade. Instead, a number of financial institutions — large commercial and investment banks — act as dealers. They stand ready to offer contracts linked to commodity prices, taking the other side of their customers’ positions. The customers include hedgers (producers and commercial buyers of commodities), other financial institutions, and speculators such as hedge funds and institutional investors. Eligible contract participants may enter into swaps directly with each other, but the market is dominated by large dealers partly because of concerns about credit risk, or the risk of counterparty default.

Very little information is available about OTC commodity markets. The Bank for International Settlements (BIS) conducts surveys of swap dealers, which probably capture

² Before its collapse in 2001, Enron Corp. was a pioneer in OTC energy trading and developed an electronic market (Enron Online) for trading physical and derivative contracts based on a number of energy products.

³ Defined in the law as financial institutions, insurance companies, broker/dealers, government units, professional futures traders, and businesses and individuals meeting certain asset and income thresholds. The presumption is that these are sophisticated traders who do not need the protections offered by government regulation.

⁴ “Trading facility” is defined in law as a “facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system.”

⁵ These are defined as eligible contract participants (see note 3 above) who (1) deal in the physical commodity or (2) regularly provide risk management or hedging services to those who do.

⁶ Defined as a trading facility (see note 4 above) that operates over an electronic or telecommunications network and maintains an audit trail of transactions.

⁷ A swap is a derivative contract economically equivalent to a futures contract. Two counterparties agree to exchange payments over the life of the contract. The payments fluctuate according to changes in the underlying commodity’s price, so that the net cash flow is always positive for one party, and negative for the other.

most of the market, but the BIS data do not break out individual commodities. They report that the notional value⁸ of outstanding OTC derivatives on commodities other than precious metals at the end of 2007 was \$8.3 trillion, up from \$5.0 trillion in 2005. In terms of gross market values, the figures were \$673 billion in 2007 and \$813 billion in 2005.⁹

Market value, also called fair value, measures the current worth of a derivative, based on whether the related cash flows are positive or negative, the time remaining to the contract's expiration, and the volatility of the underlying price. At the end of 2007, two of the largest dealers in energy swaps, Morgan Stanley and Goldman Sachs, reported that the fair value of their commodity derivatives totaled \$41.2 billion and \$28.8 billion, respectively.¹⁰

Electronic Trading Facilities

Since the passage of the CFMA in 2000, an exchange-like market for energy derivatives has come into being. Trading occurs on electronic platforms among eligible commercial entities. Under the CFMA, the CFTC had no substantive regulatory authority over these electronic trading facilities. The markets were required to notify the CFTC that they were operating and provide very basic information about the owners of the market. CFTC regulations refer to these trading facilities as "exempt commercial markets (ECMs)." The CFTC website lists 18 ECMs, 12 of which trade energy contracts. A 2007 CFTC study reported that eight of these were active and suggests that only a single ECM handled a volume of energy transactions comparable to the regulated exchanges. That market is operated by IntercontinentalExchange, Inc. (ICE).¹¹

While the ECMs are not subject to reporting requirements under the Commodity Exchange Act, some information about ICE's activities appears in the firm's Securities and Exchange Commission filings. ICE's electronic platform offers hundreds of different contracts, but most of the volume is accounted for by about two dozen highly liquid contracts in North American natural gas and electrical power and global crude oil. Trading volume in 2007 for these three commodities was 158 million contracts (natural gas), 8.3 million (power), and 8.5 million (oil). The notional value of the natural gas contracts traded was \$2.7 trillion, comparable to the Nymex figure of \$2.9 billion.¹²

⁸ Notional value is the value of the underlying commodity. In derivatives, however, since traders do not own or purchase the underlying commodity, notional value is merely a reference point used to calculate gains and losses, which are based on changes in price.

⁹ Bank for International Settlements, *Quarterly Review*, June 2008, Table A110.

¹⁰ Morgan Stanley, *Form 10-K*, annual report for fiscal year ending Nov. 30, 2007, p. 95; Goldman Sachs Group, Inc., *Form 10-K*, annual report for fiscal year ending Dec. 31, 2007, p. 93. These are gross figures — the sum of assets and liabilities.

¹¹ CFTC, *Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets*, Oct. 2007, p. 9. Another ECM, the Natural Gas Exchange (NGX), handles substantial volumes of OTC contracts, but it is based in Canada and used primarily by Canadian firms and traders.

¹² IntercontinentalExchange, Inc., *Form 10 — K*, annual report for fiscal year ending Dec. 31, (continued...)

In the crude oil derivatives market, ICE's OTC volume appears to represent a much smaller share of the total market: Nymex traded 150 million crude oil contracts in 2007, ICE Futures Europe (a regulated exchange in the United Kingdom, owned by ICE) traded 111 million, and the MCX (located in India, partly owned by Nymex) traded 14 million.¹³ U.S. exchanges have tried to establish a market for electricity futures, but have never succeeded.

According to the CFTC, the ICE and Nymex natural gas markets are economically linked and function as a single market. The major traders on ICE are also the major traders on Nymex. As a result, the CFTC concluded in October 2007 that its capacity to monitor trading on Nymex was limited and that it needed "further transparency" with regard to ICE's OTC market.¹⁴ The CFTC made recommendations for legislation that would extend CFTC oversight to certain electronic trading facilities offering contracts based on exempt commodities.

Closing the Enron Loophole: The Farm Bill

In late 2007, both the House and Senate considered legislation that generally followed the CFTC's recommendations. In May 2008, provisions addressing the regulation of ECMs were included in Title XIII of the Farm Bill (H.R. 2419) and enacted as P.L. 110-234.

The Farm Bill amends Section 2(h) of the Commodity Exchange Act to provide for CFTC regulation of electronic trading facilities that offer "significant price discovery contracts" in exempt commodities. These contracts are those that "perform a significant price discovery function," that is, contracts (1) with a settlement price linked to a regulated market's contract, (2) that may be the subject of arbitrage trading involving exchange-listed contracts, (3) that are traded in sufficient volume to have an effect on other market prices, or (4) that are used as a reference point for pricing transactions in other markets. Once the CFTC determines that a contract meets one or more of these criteria, the electronic trading facility becomes subject to exchange-like regulation.

An electronic trading facility on which the CFTC determines that significant price discovery contracts are traded will be required to comply with nine core regulatory principles. The facility will have to

- ensure that contracts are not readily susceptible to manipulation;
- monitor trading in significant price discovery contracts to prevent market manipulation, price distortion, and disruptions of the delivery or cash-settlement process;

¹² (...continued)

2007, p. 8; and "Volume Surges Again," *Futures Industry Magazine*, Mar./Apr. 2008, p. 23.

¹³ *Ibid.* Contract size varies from market to market.

¹⁴ CFTC, *Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets*, Oct. 2007, p. 12.

- establish and enforce rules that will allow it to obtain any necessary information to monitor trading;
- adopt position limits or position accountability levels for speculators in significant price discovery contracts;
- provide for emergency authority to liquidate open positions and to suspend trading in a significant price discovery contract;
- publish daily trading information on price and volume;
- monitor and enforce compliance with the rules of the electronic trading facility applicable to significant price discovery contracts, including the terms and conditions of the contracts and any limitations on access to the market; and
- avoid conflicts of interest and antitrust violations.

These core principles are very similar to the principles that apply to the futures exchanges, except that the exchanges must comply with additional principles dealing with protection of small public customers. The Farm Bill does not alter provisions in current law that limit trading on electronic trading facilities to eligible commercial entities (see note 5 above), who are presumed to be sophisticated traders who do not need government protection.

In addition, the Farm Bill requires that trading in significant price discovery contracts be subject to the CFTC's large trader reporting system. The CFTC receives daily reports on all positions that exceed specified size thresholds, and publishes the data in aggregate form in its weekly Commitments of Traders reports, distinguishing between hedging and speculative positions.

Is the Loophole Still Open?

The Farm Bill provisions will bring major changes to markets where the CFTC identifies significant price discovery contracts. They will become self-regulatory organizations, with formal enforcement responsibilities. The CFTC will have enhanced authority; not only will it routinely receive data about trading and the positions of hedgers and speculators, but it will have power to suspend or revoke the operations or regulatory status of an electronic trading facility that fails to comply with the core principles, fails to enforce its own rules, or violates applicable CFTC regulations.

There is a question of how far the new regulatory regime will extend, since the key designation is a significant price discovery *contract*, rather than market. Could the new regulations apply to a single contract traded on a market, but not the market as a whole? In terms of trade data and position reporting requirements, the answer appears to be yes, but in other areas, it is not clear. Since the electronic trading facility with a single significant price discovery contract would be required to set up a market surveillance operation to prevent manipulation, why would it limit that operation to a single contract? It might enhance trader confidence and improve its competitive position by applying that surveillance system to all trading.

The Farm Bill does not affect bilateral swaps that are negotiated between two parties rather than executed on a trading facility accessible to multiple market participants. The commodity swaps market is large and growing, and it can be argued that the logic that led the CFTC to call for more regulation of electronic facilities — that such facilities were economically linked to the regulated markets and used by the same traders — also applies to the swaps market. The major dealers in commodity swaps also trade on Nymex (leading Wall Street firms all have seats on the exchange), and it is very likely that major commercial hedgers, such as oil companies, utilities, and transportation firms, also use the exchange and swaps markets simultaneously. Speculators, like hedge funds and investment banks' proprietary trading desks, constantly seek out arbitrage opportunities among the various markets.

It is not clear why, if the CFTC expects to benefit from more transparency in the electronic trading facility market, it would not similarly benefit if new disclosure or self-regulatory requirements were applied to bilateral swaps. However, in its October 2007 report on exempt commercial markets, the agency concluded that “staff experience in surveillance of these markets [does] not suggest that the OTC bilateral or voice broker energy markets exhibit significant price discovery attributes. Thus, their direct impact on other parties and markets is limited. In addition, the non-standardized form and significant size and dispersion of these markets would make it extremely costly and difficult to extrapolate beneficial market surveillance information on a routine basis.”¹⁵

Further Legislative Proposals

Several bills before the 110th Congress propose to regulate or otherwise affect the OTC bilateral energy swaps market. Several bills (H.R. 6330, H.R. 6341, H.R. 6372, and S. 3134) would remove energy commodities from the category of “exempt commodities” and place them on the same regulatory footing as agricultural commodities. This would require that OTC energy contracts be approved by the CFTC before they could be traded.

H.R. 6264 would limit participation in the OTC energy market to firms that deal in the physical commodities.

H.R. 3009, S. 577, S. 3131, and S. 3202 would impose new reporting requirements on energy swap dealers and/or other OTC market participants.

Summaries of these bills are available in CRS Report RL34555, *Speculation and Energy Prices: Legislative Responses*, by Mark Jickling and Lynn J. Cunningham.

¹⁵ Ibid, p. 20.