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Dodd-Frank Wall Street Reform and Consumer Protection Act

An Energy Industry Analysis

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), enacted on July 21, 2010, represents the most comprehensive legislation change to the financial sector since the 1930s. While the resulting changes will predominantly affect financial institutions, several changes will largely affect energy companies as well. Due to the broad discretion of authority granted to regulators under the Dodd-Frank Act, the full impact of these changes will not be known until the regulatory implementation of the act is complete. As such, it is important for energy companies to recognize, and consider participating in, the upcoming regulatory proceedings and rulemakings that will fully implement the Dodd-Frank Act. While nearly all of the Titles within the Dodd-Frank Act can have some indirect impact on energy companies, this memorandum focuses on the titles that will directly or could significantly affect the traditional functions of energy companies within the utility industry.

EXECUTIVE SUMMARY

Derivatives Reform and Wall Street Transparency (Title VII)

The title that could have the largest impact on energy companies in the Dodd-Frank Act is Title VII, the "Wall Street Transparency and Accountability Act of 2010." Title VII creates a new regulatory framework for both swaps and over-the-counter ("OTC") derivatives in an attempt to remove the perceived systemic risk in those markets.[1] Prior to the Dodd-Frank Act, section 2(h) of the Commodity Exchange Act ("CEA"), which came into effect pursuant to the Commodity Futures Modernization Act of 2000, provided an exemption from many CEA regulations, including regulations for contracts, agreements, or transactions in an "exempt commodity" such as energy. Specifically, OTC derivatives transactions in exempt commodities not entered into on a trading facility, but between eligible contract participants were largely exempt from Commodity Futures Trading Commission (the "CFTC") regulation (as were certain transactions between eligible commercial entities executed on an electronic trading facility). The Dodd-Frank Act ends the previously limited OTC derivatives regulatory scheme by, among other things, repealing the 2(h) exemption for exempt commodities.

[1] This executive summary does not include a discussion of security-based swaps, which are to be regulated by the Securities and Exchange Commission ("SEC").

Title VII, among other things, will require that: (i) certain swaps be centrally cleared, exchange traded and publicly reported; (ii) certain market participants register with the CFTC as "swap dealers" and/or "major swap participants;" and (iii) the CFTC establish capital and margin requirements for certain swap dealers and major swap participants.

The Dodd-Frank Act does, however, allow energy companies to seek a short-term extension of the CEA's 2(h) exemption that was in effect before the enactment of the Dodd-Frank Act. The extension would allow companies to transact swaps in exempt commodities in a more limited regulatory regime. To obtain the short-term extension, Title VII provides that no later than 60 days after the date of enactment of the Dodd-Frank Act, a person may submit a petition to the CFTC. Once the petition is submitted, the CFTC has the authority to allow a person to continue operating subject to section 2(h) of the CEA "as in effect on the date before the date of enactment" of the Dodd-Frank Act for "no longer than a 1-year period."

Generally, the provisions of Title VII will become effective on the later of 360 days after its enactment or, in the event a provision requires rulemaking, 60 days after publication of a final rule implementing a provision that requires a rulemaking. Some of the main issues for energy companies that engage in swap transactions to consider monitoring include:

- Definitions of Swap Dealer and Major Swap Participant: The definitions of "swap dealer" and "major swap participant" will be critical to energy companies. Being deemed a "swap dealer" or "major swap participant" will subject such persons to additional requirements under Title VII, including clearing requirements, registration requirements, minimum capital standards, margin requirements for uncleared swaps, record-keeping obligations, and business conduct standards. On August 13, 2010, the CFTC asked for public comment on all aspects of these definitions as it prepares to further define and interpret these definitions. Thus, energy companies should closely monitor how the CFTC further defines these key definitions.

- Mandatory Clearing of Swaps: Title VII requires the mandatory clearing of swaps that appropriate regulators determine need to be cleared through a derivatives clearing organization. Absent an exemption from such clearing requirement, the swap must be cleared. As such, energy companies should monitor the rules the CFTC must adopt within one year of the enactment of the Dodd-Frank Act regarding how the CFTC will determine what swaps need to be cleared.

- Margin Requirements: While there was a significant push to ensure that companies (including energy companies) that use OTC derivatives only for hedging purposes ("commercial end-users") would not be subject to margin requirements, the Dodd-Frank Act does not provide for a definitive exemption for those commercial end-users. Some estimates indicate that margin requirements for energy companies could tie up hundreds of millions of dollars that could otherwise be deployed on capital projects. Energy companies may be able to point to the June 30, 2010 letter from Chairmen Dodd and Lincoln indicating "that the margin and capital requirements are not to be imposed on end-users." However, the legislative history of the Dodd-Frank Act does not guarantee the exemption. As such, energy companies should closely monitor,

and consider participating in, the regulatory process to ensure that commercial end-users are not subject to margin requirements.

- Data Repositories: Even if an energy company's swap transaction is exempt from the mandatory clearing requirement or it was entered into prior to the enactment or effectiveness of the Dodd-Frank Act, it will still need to be reported to a swap data repository or the CFTC. Energy companies should prepare to comply with the real-time reporting requirements for non-cleared swaps.

- Position Limits: Title VII will also greatly expand the number of contracts subject to position limits for energy companies. Earlier this year, the CFTC commenced a rulemaking proceeding to impose position limits on four specific, exchange-traded energy futures contracts. Under Title VII, the CFTC will have authority to establish position limits on certain futures contracts as well as non-financial commodities that are traded on swap execution facilities and non-cleared swaps that perform a significant price discovery function with respect to a registered entity. Comments received from the CFTC's rulemaking proceeding earlier this year predominantly focused on costs, liquidity issues, and risk management activities associated with enforcing position limits. While the forthcoming position limits from the CFTC will exempt positions for bona fide hedging purposes, the previously expressed concerns of energy companies will most likely be repeated. Since it is anticipated that position limits will be applied in the energy sector, energy companies should begin to assess their technological and procedural capabilities to monitor trading positions across its organization.

- Incentives for Whistleblowers: Energy companies will be further encouraged to prohibit any type of fraud or manipulation based on new provisions within Title VII (as well as Title IX regarding securities reform) by incentivizing whistleblowers to report allegations of wrongdoing before the CFTC and SEC. Specifically, individuals who provide independent information that is not otherwise known by the CFTC or SEC will receive a bounty totaling 10-30% of the monetary sanctions recovered in actions exceeding $1 million. The new law also allows whistleblowers to remain anonymous until their bounty is due and prohibits retaliation against whistleblowers. Energy companies should consider updating or creating the necessary framework to prevent all types of fraud and manipulation, as well as ensuring the proper procedures are in place to immediately self-report any incidents that could lead to monetary sanctions.

Investor Protections and Improvements to the Regulation of Securities (Title IX)

Title IX primarily addresses a broad array of securities issues. Such changes include reforms to executive compensation, changes in federal jurisdiction, and future SEC rulemakings regarding services provided to investors. The issues and provisions that energy companies may want to follow under Title IX include:

- Disclosure of Executive Compensation: Most public companies, including energy companies, must comply with the various disclosure provisions regarding executive compensation. These disclosures will include: (i) the median of annual total compensation of all employees other than the CEO; (ii) the annual total compensation for the CEO; and (iii) the ratio of the two amounts. Additionally, Title IX will

allow shareholders to have a non-binding vote on executive compensation and on golden parachute agreements created under a public company's proposed merger, acquisition, or substantial sale of its assets.

- Executive Clawback Provisions: Energy companies that have securities listed on a national exchange must adopt new executive pay clawback (or compensation recovery) policies. These policies will apply if the company has to prepare an accounting restatement due to noncompliance with a securities law, regardless of whether the individual was involved in the noncompliance.

- Changes in Federal Jurisdiction: Energy companies may want to prepare for new changes to the federal jurisdiction of cases regarding claims brought by the SEC against foreign issuers, regardless of whether the underlying transaction occurred overseas. Applicable cases will be limited to fraud prohibitions within the Securities Exchange Act of 1934 ("Securities Exchange Act") and Advisers Act of 1940 ("Advisers Act"), as well as certain fraud or deceit involving securities and security-based swaps within the Securities Act of 1933 ("Securities Act"). Federal jurisdiction will apply if: (i) significant steps were taken in the U.S. in furtherance of the violation; and (ii) the conduct occurring outside of the U.S. had a foreseeable, substantial effect within the U.S.

- Other actions that energy companies may want to take in response to specific provisions within Title IX include:

    - Monitoring the reports of the newly created Investor Advocate within the SEC that will recommend regulations to protect investors;

    - Monitoring and participating in any new rulemakings from the SEC regarding new fiduciary duties for brokers and dealers that energy companies use or employ; and

    - Identifying if credit ratings will have to be updated in Registration Statements due to new regulations that require the "expert consent" of the rating agencies.

Miscellaneous Provisions (Title XV)

Title XV includes additional, miscellaneous provisions that can affect energy companies. For instance, Section 1503 of Title XV requires operators of, or companies that have subsidiaries that operate, a coal mine to include information in SEC reports regarding the number of violations of health or safety standards. These operators must also disclose to the SEC the receipt of an "imminent danger order" under the Federal Mine Safety and Health Act of 1977.

Section 1504 requires a resource extraction issuer to disclose information relating to payments to the federal government (and foreign governments) in order to further the commercial development of oil, natural gas, or minerals. A resource extraction issuer is an issuer that "(i) is required to file an annual report with the SEC and

(ii) engages in the commercial development of oil, natural gas, or minerals." The SEC will issue final rules within 270 days after the enactment of the Dodd-Frank Act that will require each resource extraction issuer to include this information in their annual report. The broad definitions within this section might encompass energy companies beyond traditional energy producers. As such, energy companies may want to monitor, and participate in, any rulemaking proceedings initiated by the SEC under this section.

Bureau of Consumer Financial Protection (Title X)

Title X establishes the new Bureau of Consumer Financial Protection ("BCFP") as an independent branch of the Board of Governors of the Federal Reserve System ("Federal Reserve"). The BCFP will have exclusive regulation over a large group of consumer financial products and services in order to ensure the markets for consumer financial products and services are fair, transparent, and competitive. Title X defines a consumer financial product or service as a financial product or service offered or provided for use by consumers primarily for personal, family, or household purposes, or delivered, offered or provided in connection with such a product or service. These products and services include: (i) extending credit and servicing loans; (ii) sale, provision, or issuance or payment instrument or stored value instrument; (iii) collecting consumer debt; and (iv) other product or services as defined by the BCFP. This broad definition of entities and products covered makes it uncertain as to whether energy companies will be governed by the BCFP. Because energy companies can sell services (such as electricity) on credit, it is plausible that they will have to abide by the BCFP's regulations. Certain industries were excluded from jurisdiction (*e.g.*, auto dealers, insurers, and real estate brokerages). Because energy companies were not expressly listed as an excluded industry, it is possible that several energy companies will be subject to BCFP's rulemaking.

If energy companies choose to seek an exemption, then it may be in their interest to lobby the BCFP, as well the Federal Trade Commission, the agency transferring authority over to the BCFP within one year of the enactment of the Dodd-Frank Act. Otherwise, energy companies should consider monitoring the regulations and rulemakings of the BCFP in order to determine if they will be considered a person offering or providing a consumer financial product or service.

Financial Stability Oversight Council (Title I)

Title I establishes a Financial Stability Oversight Council to "identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies or that could arise outside the financial services marketplace." Under Title I, nonbank financial companies are companies "predominantly engaged in financial activities," or if that companies' gross revenues and the gross revenues of its subsidiaries are from financial activities or the assets of the company are financial in nature. Nonbank financial companies can be required to submit reports, follow specific prudential standards, disclose certain pieces of information, and acquire voting shares in a more limited capacity. While Title I does not appear to apply to energy companies, energy companies nonetheless may want to generally monitor which nonbank financial companies are included

under Title I since the definition of nonbank financial companies can grow and expand under the broad authority granted under Title 1.

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