SUTHERLAND

LEGAL ALERT

July 2, 2010

CFTC Designates Mid-C Financial Peak and Off-Peak Contracts Significant Price Discovery Contracts; Mid-C Daily Contracts and Fuel Oil-180 Singapore Swap Are Not

In three orders published today in the Federal Register, the Commodity Futures Trading Commission (CFTC) designated the Mid-C Financial Peak (MDC) and Mid-C Financial Off-Peak (OMC) contracts traded on the IntercontinentalExchange, Inc. (ICE) as “significant price discovery contracts” (SPDCs). As SPDCs, these contracts will be subject to regulation similar to futures contracts.

In separate orders also published today, the CFTC determined that the Mid-C Financial Peak Daily (MPD) contract, the Mid-C Financial Off-Peak Daily (MXO) contract, and the Fuel Oil-180 Singapore Swap (SZS) contract do not perform a significant price discovery function.

What this Means

Because ICE already offers other SPDCs, it must demonstrate compliance with the nine core principles described in Appendix B to Part 36 of the CFTC’s regulations in connection with the MDC and OMC contracts within 30 calendar days of the orders (July 25, 2010). At that time, market participants will have up to 90 days to come into compliance with any resulting position limits, accountability levels and rulebook changes. The MDC and OMC contracts are likely to be subject to the rules contained in existing “Annex L” to the ICE OTC Regulatory Rulebook for Significant Price Discovery Contracts.

Traders also should expect to continue to be required to file large trader reports with ICE and the CFTC. ICE has required large traders to submit reports since October 2009 and could maintain the same reporting threshold (25 lots) unless or until it determines another threshold is warranted.

For SPDCs, such as the MDC and OMC contracts, where there are no existing economically equivalent contracts with position limits or accountability levels, ICE must develop new limits and levels from scratch. For physically delivered contracts, position limits must be no greater than 25 percent of the estimated deliverable supply. However, in the case of financially settled contracts, such as the MDC and OMC contracts, ICE is tasked with setting limits “at a level that minimizes the potential for price manipulation or distortion.” Accountability levels must be set at “no greater than 10 percent of the average combined futures and delta-adjusted option month-end open interest for the most recent calendar year.”

Background

The CFTC Reauthorization Act of 2008 expanded the CFTC’s authority over Exempt Commercial Markets (ECMs) that offer trading of SPDCs. On March 16, 2009, the CFTC adopted Rule 36.3, implementing its new authority and establishing procedures for identifying SPDCs and core principles to be implemented by ECMs offering SPDCs. On October 6, 2009, the CFTC issued notices of intent to determine whether 16 electricity contracts, including the MDC, OMC, MPD and MXO contracts, perform a significant price discovery function. Likewise, on November 4, 2009, the CFTC issued a notice of intent to determinate whether the SZS contract performs a significant price discovery function.

SUTHERLAND

The CFTC is required to consider four criteria when determining whether a contract is an SPDC: (1) price linkage; (2) arbitrage; (3) material price reference; and (4) material liquidity. Relying solely on its conclusion that both contracts satisfy the material price reference and material liquidity criteria, the CFTC designated the MDC and OMC contracts as SPDCs. With regard to material price reference, it concluded that "cash market transactions are priced either explicitly or implicitly on a frequent and recurring basis at a differential to the [contracts' prices]" and the contracts' price data are sold to market participants. With regard to material liquidity, the CFTC concluded that there is sufficient trading activity to have a material effect on other exchange-traded contracts.

With regard to the MPD and MXO contracts, the CFTC concluded that the contracts failed to satisfy both the material price reference and liquidity criteria. The CFTC explained that cash market transactions are not priced on a frequent and recurring basis at a differential to the contracts. With regard to liquidity, the CFTC concluded that the contracts averaged only slightly more than five contracts per day and experienced similar trading activity to that of minor futures markets.

With regard to the SZS contract, the CFTC found that it satisfied neither the material price reference criterion nor the liquidity criterion. It concluded that market transactions "are not priced on a frequent and recurring basis at a differential to the SZS contract's price," and "market participants likely do not specifically purchase the ICE data packages for the SZS contract's prices and do not consult such prices on a frequent and recurring basis in pricing cash market transactions." Despite Singapore being one of the most utilized ports in the world, the CFTC concluded that traders use the SZS contract's price "as an indicator of arbitrage potential between two fuel oil markets," but "traders do not regularly keep track of the SZS contract's prices" because market conditions are not always right for diverting oil to Singapore. The CFTC also concluded that the SZS contract "experiences trading activity similar to that of other thinly-traded contracts."

The orders published today did not address the remaining 12 electricity contracts.

Highlights of CFTC Analysis

Distinguishing the MPD and MXO contracts from the MDC and OMC contracts, the CFTC focused on the duration of the contracts. It concluded that market participants can use the MDC and OMC contracts to lock-in electricity prices far into the future (up to 86 days), while the MPD and MXO contracts are available for shorter periods (up to 38 days and 70 days, respectively).

The CFTC explained, "With such a limited timeframe, the forward pricing capability of the [MPD and MXO contracts] is constrained relative to that of the [MDC and OMC contracts]." It also concluded that traders likely do not consult the MPD and MXO contracts data "on a frequent and recurring basis in pricing cash market transactions."

■ ■ ■

If you have any questions about this Legal Alert, please feel free to contact the attorneys listed below or the Sutherland attorney with whom you regularly work.

Michael W. Brooks	202.383.0863	michael.brooks@sutherland.com
Catherine M. Krupka	202.383.0248	catherine.krupka@sutherland.com