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Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | [www.law360.com](http://www.law360.com)  
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | [customerservice@portfoliomedia.com](mailto:customerservice@portfoliomedia.com)

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## Regulatory 'Round Holes' In OTC Derivatives Markets

*Law360, New York (November 02, 2009)* -- Not all markets are alike. Policymakers must understand how markets differ before they create and impose a one-size-fits-all market structure on all OTC derivatives markets. Otherwise, existing markets will be negatively affected — for which the policymakers must accept responsibility.

Electric utilities and other end-users of OTC derivatives are not saying, "Don't regulate the credit default swap markets" or any of the other markets that policymakers have reason to believe caused the 2008 economic crisis.

Nor are they saying, "Don't require more reporting/market transparency/price discovery information in the OTC derivatives markets," or "Don't encourage regulated exchanges or clearing entities to list and clear more OTC derivatives products."

Instead, they are asking policymakers to slow down their race to regulate, and to take time to understand how overbroad regulation will harm the existing OTC markets that have functioned well.

They are asking for reasonable exemptions and regulatory accommodations to preserve commercial companies' risk management choices and keep those choices affordable.

In the power industry, negative consequences of bad regulatory policymaking for the OTC power markets will include increased power costs and rates, price volatility, fewer risk-management options for electric utilities, substantially less money available for investment in energy infrastructure, and fewer long-term, financiable power contracts and projects.

Markets are different from each other in four principal ways:

1) Products bought and sold in a "market" have different inherent characteristics — securities and financial instruments (including foreign exchange, interest rate and credit

default swaps), agricultural commodities, energy commodities (and, a further subset, regulated energy commodities).

The financial markets created some of these standardized products. Others exist independently in the real world. Some are produced or required locally, some globally. Electric power is unique. It must be consumed when generated, it cannot be stored and it can disappear in a instant if a power plant trips off line, a storm knocks out a wire or a heat wave overloads the system.

2) Market participants are different — commercial entities participate in some markets principal to principal (electric utility to natural gas company, utility to utility, utility to electric cooperative), without financial intermediaries, and have done so for years.

Not all market participants are financial institutions with simple financial assets located in N.Y. and large back-office administrative staffs. Consumers don't participate in all markets. And some market participants — like natural gas and electric companies — are already extensively regulated by other regulations with other regulatory priorities. See 4 below.

3) Market structures are different — and so are risk management structures for participants in those markets. Some markets are predominantly principal to principal (end-user to end-user).

Other OTC bilateral markets are dominated by financial players — financial institutions "sell" interest rate or currency products. Some markets are intermediated by brokers. Some are dominated by exchanges or clearing firms who manage trading accounts for their corporate and/or individual customers.

In particular, credit risk management is very different in different market structures — depending on who holds the credit risk. It is typically that entity which initially and periodically evaluates and prices the credit risk, and analyzes what credit support or collateral is available from the party creating the credit risk.

That entity also manages the ongoing credit risk of an outstanding transaction by calculating the fluctuating credit risk "exposure." It is that credit risk holder which then holds, or arranges a custodian to hold, the credit support to reduce/manage its risk.

In the OTC derivatives markets, credit risk assessment, management and administration is bilateral. Margining thresholds and administrative procedures are negotiated and established reciprocally by the parties themselves, based on relative sophistication and relative credit risk assessments.

Financial market participants sometimes envision themselves in bilateral OTC relationships as "lenders" or "credit risk specialists" when dealing with commercial entities. These financial institutions (who may be "selling" financial products) usually

require that credit support be posted by their commercial counterparty, but may decline to post credit support themselves.

Financial institution concepts of financial metrics, legal concepts of secured credit and collateral, and trading concepts of "margining" are useful, but not dominant or comprehensive in markets where financial institutions or intermediaries are less important players.

The OTC power and power derivatives "markets" are relatively new. Exchange-traded power products, and clearing entities which accept power products, are relatively new and few. A large percentage of the power and power derivatives markets operate in a customized bilateral, unsecured, informal "credit relationship" market structure.

4) Where multiple regulators have jurisdiction over one particular type of market, regulatory priorities can be different. This fourth difference introduces a geometric level of policymaking complexity. Historically, regulatory structures evolved based on an understanding of the market structures and a balancing of regulatory priorities. They were not created from whole cloth without testing or tailoring.

FERC and state energy regulators, which have regulated the power industry for over 50 years, focus on reliability first, affordability second, and other financial market priorities like transparency, price discovery, equality of information, regulation of "market manipulation" — a distant third.

Environmental regulators focus on achieving a social good — reduction of emissions levels on the global, national or state level. Affordability is a distant second priority for these regulators, and reliability is irrelevant (it's someone else's issue).

Today in Washington, policymakers are proposing a one-size-fits-all, new market structure for all OTC derivatives. Let's call it a safe, simple regulatory "round hole" by policy fiat. In theory, all derivatives trading would be "safer" if exchange-traded and cleared. Yes ... But ...

The fact is that some existing OTC derivatives markets are square pegs (foreign exchange). Some are rectangular pegs (global oil markets). Some are more like hexagons (agricultural derivatives). The natural gas markets are more like cubes, introducing the geometric complexity of energy regulator involvement. The power markets are the most geometrically complex — more of a three-dimensional energy star.

Electric utilities and electric generators are trying to explain to policymakers the real world negative business consequences of well-meaning one-size-fits-all theoretical policymaking, and include in the legislation and regulation sensible exemptions and regulatory accommodations.

Electric utilities and generators didn't cause the 2008 financial crisis. They are not trying to "add loopholes." They are fully supportive of appropriate regulation, including additional regulation of the energy markets.

But it is important to electric utilities and generators that the power markets continue to function as a valuable commercial risk-management tool. It is important that financial institutions and other entities choose to participate actively in those markets, and that the cost to use these risk management tools is not burdensome.

The policymakers must acknowledge and accommodate market differences, or accept responsibility for the negative consequences of rigid regulatory "round holes."

--By Patricia Dondanville, Schiff Hardin LLP

Ms. Dondanville is a partner in the Chicago-based national law firm Schiff Hardin LLP. She concentrates her practice in corporate and finance matters, often representing energy companies. In particular, Ms. Dondanville provides strategic counsel on corporate governance, risk management, contracting, and related credit risk, collateral and credit support matters. Her clients include energy marketing companies, generators, electric cooperatives, and utility and energy holding companies. Ms Dondanville also provides legal analysis with respect to legislation and regulatory policy at the increasingly important intersection between the energy industry and the financial markets. Ms. Dondanville served for several years as a deputy general counsel for a major energy holding company. She also served as Co-Chair, and remains a member, of the Edison Electric Institute's Contract Drafting Committee, which drafted the EEI Master Purchase and Sale Agreement, the model for current energy trading contracts. Ms. Dondanville is a frequent speaker and panel member on programs dealing with corporate finance, derivatives risks and energy marketing.

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