Addressing regulatory uncertainty
Risk-informed options for energy companies subject to the Dodd-Frank Act
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Many energy companies have struggled for almost three years to avoid the so-called “collateral damage” to energy markets that has come with the Dodd-Frank Wall Street Reform and Consumer Protection Act (referred to as the Dodd-Frank Act in this paper) and associated rulemaking from the Commodity Futures Trading Commission (CFTC), a federal regulator writing many of the derivatives regulations. Moreover, the regulatory uncertainty facing energy market participants could ratchet up from current levels.

This white paper seeks to share insight on our understanding of recent regulatory policy developments, especially Dodd-Frank regulations. Our goal is to help clients analyze:
- whether to do something
- what to do
- when to do it

There is no “one-size fits all” answer or approach to address the Dodd-Frank regulatory requirements. This paper will seek to provide a risk-informed perspective, informing compliance leaders and those affected by compliance outcomes as they consider policy developments. In short, this paper will explore how to manage continuing policy uncertainty and corporate pressure to avoid wasteful spending while developing an effective and compliant organization.

Current Situation — Continued Speculation About Regulations

Since Dodd-Frank became law in July 2010, many expectations about future policies have been discussed. Recent discussion points have included potential changes in three of the five commissioners, including the chairman. A prevalent CFTC expectation for some time is the Chairman will leave his current position. The Chairman appears intent on completing selected additional rulemakings, potentially to leave a legacy in swap markets reform. The CFTC approved several such rules between May and July of 2013. The approvals addressed Swap Execution Facilities (SEF), minimum block sizes for large notional off-facility swaps, anti-disruptive trade practices, and key cross-border rule agreements.

In light of one Commissioner’s departure and another’s upcoming end-of-term, many energy market participants have concluded that the Dodd-Frank regulatory environment is hopelessly uncertain. We believe the actual situation is less uncertain than commonly perceived.

Potential Policy Outcomes of CFTC Leadership Situation

The CFTC leadership affects multiple Dodd-Frank policy dimensions, including:
- CFTC rule development
- CFTC enforcement
- CFTC budget situation
- CFTC’s relationship with Congress

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1 The “Dodd-Frank Act” or “Dodd-Frank” refers to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173). This Bill was signed into federal law by President Obama on July 21, 2010, largely as a response to 2007–2009 economic recession.
2 As used in this document, “we” or “Deloitte” means Deloitte LLP and its subsidiaries. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.
The CFTC leadership outlook is uncertain at the moment. Nevertheless, a small set of fairly likely leadership scenarios could play out and the potential policy implications of each scenario are relatively straightforward to anticipate.

For example, consider these scenarios:

- **Limited Changes**: Commission membership changes in a manner that shifts the center of gravity on policy to consensus closer to commodity trading industry preferences.
- **Increased Challenges**: The Chairman announces intent to leave but does not specify when this will happen. The White House indicates its intent to nominate someone for chairman without specifying that person or nominates someone signaling intent to “get tougher.” The outlooks of a Commissioner requiring re-appointment and of an empty Commissioner slot are uncertain.
- **Status Quo**: After changes in CFTC commissioners, policy preferences remain similar to the current situation.

Each of these Leadership Scenarios would have policy implications.

**Limited Change Scenario**

Under the Limited Change scenario, it is possible that the commissioners could be relatively willing to seek common ground on the remaining Dodd-Frank rulemaking areas. Recent approvals on SEFs, block size, anti-disruptive trade practices and cross-border rules could be followed with a possible revised Position Limits rule.

Other more contentious issues could await future developments. As the “Limited Change” Scenario speculates, change could begin rapidly if an existing centrist Commissioner were nominated to become Chairman. Moreover, a sitting Commissioner may be able to take authority as Acting Chairman. With a new leader in charge of the Commission’s agenda, change could proceed on other matters.

Public speculation has sometimes anticipated regulatory change to shift toward less onerous controls on commodity transactions (energy, agricultural, and other) under a Chairman chosen from sitting commissioners. Such a policy shift may accompany enhanced clarification of rules and Enforcement policy, with selected “no action” decisions or other guidance that reduces immediate threats or burdens on market participants. The developments on reporting, record-keeping, and margin requirements rules and enforcement that reduce the concerns of energy and agricultural industries could encourage Congressional appropriations committees to approve requested CFTC funding to accelerate and improve rule writing and enforcement.

**Increased Challenges Scenario**

We label this scenario “Increased Challenges” because it could possibly increase regulatory uncertainty beyond current levels. If the Chairman stays longer than anticipated, deadlock could continue on remaining Dodd-Frank issues, such as updates to the vacated and remanded Position Limits rule. Moreover, if there were no guidance from the White House regarding the timing of a replacement, there could be uncertainty about whether commodity markets could be more or less comfortable with the next CFTC Chairman. This uncertainty could encourage the CFTC Enforcement Office to withhold opinions until it had a sense of direction from a new leader.

This behavior at the CFTC could encourage Congress to maintain its tight budget posture toward the Commission until it learned more about likely future policies.

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3 The enabling CFTC statutes require the Chairman to be appointed by the President with consent of the Senate. Commodity Exchange Act, [SEC. 2(a)(2)(A)].

Status Quo Scenario
Under the “Status Quo” scenario, the path to further rule-making could likely be more productive than in the “Increased Challenges” scenario because commissioners might perceive a need to accommodate the Chairman’s wishes, and he theirs. These pressures could be particularly strong as long as the White House remained silent on the next steps. This path seems to have already been at least partially realized by recent CFTC actions that reveal some new compromising.

This path, however, could likely stimulate early industry action. Such action may focus on Congress (but it might also target the Administration).

Of particular importance is the legislation to re-authorize the CFTC. The Agricultural Committees of the Senate and House of Representatives have the responsibility to reauthorize federal funding of the Commission every five years.5

Industry action seeking legislation to “fix” various Dodd-Frank provisions may also gain some momentum. Under this scenario, many expect that industry will forcefully push for lower-cost commodity trading policies, a narrower definition of swap dealers, and greater clarity regarding regulatory uncertainty. At least one proposed bill calls for exempting companies using swaps for risk mitigation from margin requirements.6

Observations
In the current environment, champions for compliance within energy companies could gain some new leverage for proceeding with prudent expenditures intended to enhance trading surveillance, record-keeping and reporting processes, and systems. The CFTC appears unlikely to make fundamental changes in already-approved rules but clarifications, new enforcement concept announcements, and other fine-tuning can be expected.

A corporation can plan for each of the possibilities described above. The corporation’s Dodd-Frank compliance assessment and implementation teams, in concert with senior executives and/or outside advisers, can “handicap” these possibilities. This process should not only include estimating likelihoods, but use risk-informed forecasting to help identify paths that become more or less likely as signposts emerge. Risk-informed inputs might include a formal announcement on a commissioner’s tenure, a vote on an important rule (such as the cross border/extraterritoriality vote), or a significant enforcement action.

Timing is another important aspect of these policy scenarios. A smooth predictable path could be an aid to corporate planning. So far, however, lurches both forward and backward have been more common than has smooth progress. Therefore, it appears that compliance professionals should maintain some flexibility to react to surprises while proactively preparing for expected developments.

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5 The failure to pass reauthorization legislation may compel the Commission to rely on unauthorized appropriations to maintain operations, as it did from 2005 through 2008.
6 H.R. 634 http://www.johanns.senate.gov/public/?p=PressReleases&ContentRecord_id=b84dda55-96ee-4c2c-9a4b-5d0c46d9e534
Implications for compliance and enforcement

The combination of Dodd-Frank regulatory policy outcomes evolving in the Federal sector with the corporate outcomes emerging from business performance and management decision-making could yield likely outcomes with regard to the enforcement of Dodd-Frank by the CFTC’s Office of Enforcement. As summarized below, the CFTC has steadily increased the number of enforcement actions, and in FY2012, the CFTC imposed a record level of total monetary penalties:

Table 1 — CFTC Enforcement Actions 2006–2012

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of enforcement actions filed</td>
<td>33</td>
<td>37</td>
<td>39</td>
<td>50</td>
<td>57</td>
<td>99</td>
<td>102</td>
</tr>
<tr>
<td>Total monetary penalties recovered and sanctions imposed (millions)</td>
<td>$446</td>
<td>$542</td>
<td>$636</td>
<td>$280</td>
<td>$200</td>
<td>$450</td>
<td>$935</td>
</tr>
<tr>
<td>Manipulation, attempted manipulation, false reporting cases</td>
<td>2</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>6</td>
<td>*</td>
<td>**</td>
</tr>
</tbody>
</table>

* The CFTC provided limited data for FY 2011, and did not provide a case breakdown in the Annual Performance Report as it had done in past years.
** The Summary of Performance and Financial Information for FY 2012 does not contain a complete case breakdown.

The CFTC’s enforcement function pursues a broad variety of offenses, from Ponzi schemes to fraudulent trader schemes, and succeeds in penalizing their targets. Of interest to those trying to anticipate enforcement of Dodd-Frank matters, we see evidence of prior enforcement of violations related to reporting requirements, fraudulent trading, price manipulations, registration requirements, and position limits. Extensions to Dodd-Frank rules are relatively straightforward in each of these areas.

<table>
<thead>
<tr>
<th>Charge type</th>
<th>Charge descriptions</th>
<th>Number of charges</th>
<th>Highest financial penalty</th>
<th>Total financial impact</th>
<th>Other penalties</th>
<th>Charges pending in litigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price Manipulation</td>
<td>• Manipulation of commodity futures contract prices</td>
<td>8</td>
<td>$700M</td>
<td>$1,041.4M</td>
<td>• Trading limitations</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>• Reporting orders without intent to execute</td>
<td></td>
<td></td>
<td></td>
<td>• Permanent ban from trading CFTC-regulated products</td>
<td></td>
</tr>
<tr>
<td>Fraudulent Trading and Schemes</td>
<td>• Ponzi Schemes</td>
<td>101</td>
<td>$240M</td>
<td>$617.7M</td>
<td>• Registration revocation</td>
<td>32</td>
</tr>
<tr>
<td></td>
<td>• Non-competitive trading</td>
<td></td>
<td></td>
<td></td>
<td>• Permanent trading and registration bans</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Fraud provision violation</td>
<td></td>
<td></td>
<td></td>
<td>• Individual fees and injunctions</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Wash Trading</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Pre-arranged trades</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Fictitious sales</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reporting and Representation</td>
<td>• Filing inaccurate reports</td>
<td>14</td>
<td>$200M</td>
<td>$263.1M</td>
<td>• Order to take steps to ensure report integrity</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>• Report manipulation</td>
<td></td>
<td></td>
<td></td>
<td>• Permanent trading and registration bans</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Failing to file reports</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>• Making false representation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Supervision</td>
<td>• Failure to supervise the handling of accounts</td>
<td>22</td>
<td>$14.2M</td>
<td>$32.6M</td>
<td>• Required to retain three-year trade execution monitoring</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>• Failure to investigate questionable conduct</td>
<td></td>
<td></td>
<td></td>
<td>• Requires implementation of compliance programs</td>
<td></td>
</tr>
<tr>
<td>Fund Misappropriation</td>
<td>• Violations of customer fund segregation laws</td>
<td>10</td>
<td>$20M</td>
<td>$25.3M</td>
<td>• Asset freeze</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>• Handling mechanism required</td>
<td></td>
<td></td>
<td></td>
<td>• Handling mechanism required</td>
<td></td>
</tr>
<tr>
<td>Registration</td>
<td>• Failure to register as a commodity trading advisor</td>
<td>18</td>
<td>$1.2M</td>
<td>$4.0M</td>
<td>• Permanent trading and registration ban</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>• Illegal solicitation of customers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Capital requirement shortfall</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Position Limits</td>
<td>• Exceeding position limits for futures contracts</td>
<td>7</td>
<td>$1.5M</td>
<td>$3.6M</td>
<td>• Cease and desist orders</td>
<td>0</td>
</tr>
</tbody>
</table>

8 http://cftc.gov/LawRegulation/Enforcement/EnforcementActions/index.htm
Next steps: Corporate planning to address uncertainty

With recent developments in the publication of key final Dodd-Frank rules, it appears the regulatory foundation is largely in place for companies to move forward with regulatory compliance. Corporate compliance professionals responsible for Dodd-Frank compliance should assess the impact of the three likely policy scenarios and have a plan to execute a strategic path forward based on their company’s risk strategy.

Delineate Reponses
A company’s assessment of the impact of these scenarios should take account of the company’s approach to regulatory risk and anticipated compliance resources.

Federal regulators expect companies to comply fully with all applicable regulations. During the uncertain start-up phase of Dodd-Frank regulations, such compliance is challenging given the uncertainty regarding how regulations will be interpreted, interpretation of technical standards, and reliance upon other market participants. For example, some companies proceeded to obey mandates to post certain data at a Swap Data Repository (SDR) and then found it was not possible to successfully submit the data. Others encountered guidance that they could not apply to their circumstances, sought further guidance, and did not receive actionable responses by deadlines.

Postures toward regulatory risk that a management team might consider include:
• Cost-effective compliance
• Await completion until rulemaking is "complete"
• No regrets spending

"Cost-Effective" compliance represents the ideal compliance strategy.

"Await Completion" complacency is a tempting option for some commodity trading entities. Awaiting completion, however, could mean never proceeding because some rules will be changing long after regulators approve a full set of rules.

“Cost-Effective” is another management discipline that has required compliance teams to provide intensive justification to proceed with compliance spending. Compliance teams have been directed to spend no resources to prepare for rules that might not be approved by regulators. This approach over-restricts the judgment of a company’s compliance professional because it could hinder small early expenditures when certain regulatory developments appear likely but are not certain.

In addition, some commodity transacting companies have made management decisions that they will be exempt from all provisions of the Dodd-Frank Act because they are exempt as “End Users”. Of course, legal counsel should provide guidance on this matter, but we have not yet found a company that transacts swaps to be fully exempt from Dodd-Frank.

Determine Resources and Execute Strategic Plan
A company will generally take two major factors into account in determining the resources (funds, staff, technology, and others) to devote to a particular compliance project. These factors are:
• the importance of the Dodd-Frank regulated business activities to the economic performance of the company;
• management determinations about whether to support compliance in a generous, stable, or tight-fisted manner

Industry-wide economic performance, a significant element of corporate planning, is beyond the control of an individual company. Corporate planners are considering various market indicators to project a range of economic forecasts: accelerated recovery, continued modest recovery, slow recovery and even a second-dip recession. Input to compliance executives and senior management should account for the collective effect of compliance performance and various economic conditions. For example, a compliance failure could create significant reputational risk and fiscal penalty, exacerbated by a high-stress period of economic challenges and uncertainty.
Management options regarding how to fund the compliance requirements identified by the compliance program management team can include:

- Full immediate funding
- Full funding of early tasks and a re-visit in one quarter (or another check-in period)
- Minimal funding to achieve compliance
- Partial funding
- Delay of funding

Generally, a company that pursues effective compliance with adequate resources and managerial support to make a cost-effective investment in Dodd-Frank compliance would likely not incur severe CFTC Enforcement penalties in the transition period now underway. We believe this could be true under any of the three illustrative policy scenarios considered.

If a company elects to wait until rulemaking progress is clear and short-changes the compliance team’s demonstrated need for resources, less favorable results are possible.

**Enterprise Risk Management**

One of the key lessons from the economic downturn was the importance of situational awareness for top corporate leaders. Despite the many controls and regulations in place for finance, some traders entered into transactions that created immense systemic risk within corporations and throughout the financial system.

We view the current transformational moment for all commodity traders as a window of opportunity to integrate multiple stove pipes of risk management and compliance activities into a broad ERM system.

**Summary**

The current Dodd-Frank regulatory outlook for companies engaged in commodity swaps and futures remains uncertain and challenging. Compliance professionals can move forward by taking a risk-informed assessment of current potential regulatory policy outcomes, examining their organization’s risk preferences regarding Dodd-Frank regulatory risk, and crafting a strategy based on the likelihood of selected scenarios through discussions within their relevant Dodd-Frank response teams — and drawing upon other executive resources, as feasible.

This approach can help the compliance team to:

- Stay engaged
- Enhance the company’s understanding and control of the risks arising through its trading activities
- Create a contemporaneous record of how compliance decisions were made, including discussions of uncertainty or ambiguity
- Build evidence of an effective culture of compliance and of good faith efforts to comply
- Enhance the company’s ability to explain the problems with specific policy measures proposed as part of the Dodd-Frank regulatory regime
- Avoid major expenditures that do not improve the company’s business prospects going forward
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