

held in customer segregated funds totaled approximately \$5.45 billion as of October 31, 2011, whereas the CFTC reported that MFG held approximately \$7.27 billion as of August 31, 2011, a decrease of over \$1.8 billion in the past two months.

- 21 As it turns out, six different FCMs accepted the transfer of open futures positions held on the books of MFG by Friday, November 4<sup>th</sup>. This involved the transfer of approximately 15,000 futures customers and approximately \$1.45 billion in cash and collateral from the CME. Other clearing houses and exchanges cooperated as well and made similar transfers.
- 22 See "Order Granting Emergency Motion of James w. Giddens, Trustee for the Liquidation of MF Global Inc., for an Order Approving the Transfer of Certain Segregated Customer Commodity Positions and Extending the Trustee's Authorization to Operate the Business of MF Global Inc. in the Ordinary Course", case No. 11-2790 (MG) SIPA, November 2, 2011.
- 23 Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, 124 Stat. 1376 (2010).

## Quicksand in the Hedges

BY JEREMY D. WEINSTEIN<sup>1</sup>

*The following excerpt from a novel in progress highlights the risks faced by lawyers when structuring transactions that on their face might not seem to be swaps transactions. Such transactions may nonetheless fall within the ambit of the Dodd-Frank Act, with potentially serious consequences.*

"This is starting to sound accusatory." David Mann actually was beginning to get nervous.

"We're just looking for you to cooperate, Mr. Mann." The FBI agent was leaning back in his cheap metal chair, looking coolly across the cheap metal table at David.

"Cooperate? Two FBI guys came to my office last week saying the FBI was doing a background check on a friend applying for a job as an Assistant U.S. Attorney who gave me as a reference. I talked to them. One of you two called and asked me to come in here this morning to follow up. I came in. I sat in this stuffy little gray room for

forty minutes alone before you came in, and for the past half hour we have not been talking about my friend at all. I have cooperated, but you have been asking a lot about what I've been doing at Central City Power & Light. Is there a problem?"

In the back of his mind, David knew he was being foolish by staying in this room talking, and not just getting up and leaving. But if he was doing something as in-house counsel at Central City Power & Light that was an issue for the FBI, he wanted to know so he could go back to the office and tell his boss and colleagues. Besides, the way the other, younger FBI guy named Cliff Burr kept jumping up and pacing around behind him made him feel hemmed into the room physically.

David tried to keep his eyes on these two as he looked around the room to see if there was a box of Kleenex to blow his nose. Since the older of his two daughters had hit nursery school, he suffered a constant cold. He wouldn't have believed a cold could last five years. He started digging around in his pockets, thinking if it came to it, he'd use a dollar bill.

"Well, Mr. Mann, now that you mention it, there is a problem, and it's you that has it." The sitting, older of the two FBI agents, who had introduced himself as Elliott Chaze, said this as he leaned forward, his jacket falling open to display a gun in a shoulder holster, presumably for his benefit, David thought. David also saw Chaze's underarm sweat stains and thought that David's wife would say the guy needed to get a better suit, or better shirt, or something; David's wife was always going on about how fabric needed to "breathe," although David wasn't clear on what that meant when it came to underarm sweat stains.

Chaze picked up the thick file folder sitting on the table, which David thought had been the file on his friend, and which seemed gratuitously over-thumbed, with colored bits of plastic and paper clips sticking out of the sides. Chaze then dropped the folder back on the table, for the noise, it seemed, and then picked it up again, and leaned back in his chair as he propped it open on his lap. He took out what David could see were a number of agreements. Chaze made a show of turning each document to its signature page, and

handed them as a group to Burr, who walked back around and laid them in front of David, one at a time. They were a power purchase agreement, a tolling agreement, and four confirmation agreements for the purchase of physical electricity, all of which David had negotiated, and signed off on, over the past year in his job as in-house counsel at Central City Power & Light.

"Recognize these, Mr. Mann?" asked Chaze. Burr picked up a pen and leaned over David. He pointed with the pen to the signature line for the utility on each document, next to each of which were David's initials. "Whose initials are those, Mr. Mann?" Burr was leaning in way too close; David could smell his breath even through his eternal cold and was surprised by that; Burr seemed clean-cut. On the other hand, Chaze had nicotine stains on his teeth and looked like a wreck, sweaty, wrinkled, and with circles under his eyes. But that might be a bad sign- maybe he looked so beat because he'd been working so hard on whatever it was that they were talking to him about.

Of course, David recognized his initials, which were the legal department's sign-off, next to the VP's signature on each of these documents. Burr stepped back and watched as David reached into his wallet to take out a dollar bill and blew his nose. David looked down at the bill and folded it back up and put in his pocket, not wanting to mess up his wallet, but didn't feel any relief to the stuffiness of his head, or, for that matter, of the room.

David shook his head to clear it and turned back to the pile of documents. All of them had been filed with the state public utilities commission under protective orders, so David didn't feel that he was divulging any client confidential information by saying, "These are agreements by which the company I work for gets physical electricity to sell to its customers, including you two if you live in Central City. There's nothing illegal or improper about them." At least, David hoped.

"That's where you're wrong!" Burr leaned back in close and slammed the cheap table's top, his hand hitting next to two overlapping coffee mug ring stains, making the documents jump. David thought that he was watching a circus

act, but it was also a pretty scary circus act, like Cirque de Soleil.

"Have you heard of a law called the Dodd-Frank Act of 2010?" asked agent Chaze, still leaning back in his chair, still trying to look casual as he kept his eyes close on David.

David actually knew a lot about the statute, since it was his job in the legal department to make sure that Central Power & Light's contracts stayed within the Act's exemptions. "Yes, I've not only heard of it, I've read it, but it regulates trading in swaps, not trading in physical commodities. These deals are all for physical energy commodities that are physically delivered, not swaps."

"The Dodd-Frank definition for Section 1a47 may be entitled 'swaps,' but it not only includes all commodity 'options,' 1a47(A)(iv) says a swap is any contract that in the future becomes commonly known to the trade- not 'in' the trade, but 'to' the trade- as a swap. The Commodity Futures Trading Commission, the federal agency that regulates this statute, gets to tell the trade what a swap is, and the only limit on that authority is what Congress specifically excluded from what could be a swap under Section 1a47(B)," Chaze offered.

"I think that's wrong about anything the CFTC wants to be a swap is a swap unless it is excluded, since this statute is about regulating swaps, but let's say you're right. Section 1a47(B)(ii) excludes transactions intended to be physically settled, which is these transactions, since we signed them intending to physically settle, and which is what we're doing. This energy is physically delivered."

"So you admit you know about this law, don't you?" Chaze said. "And you admit that these contracts were written with your full knowledge and intent that they not be swaps, too. You know what? You're free to leave any time, but maybe we should chat some more to get this clear. The Dodd-Frank Act covers these transactions very specifically. And the way these transactions were handled by you and your company, we're talking about ten years imprisonment for a felony."

David was too taken aback to respond. Chaze continued, "CFTC Rule 1.3(xxx)(6) says that a swap is anything that was structured to avoid being a swap under the Dodd-Frank Act and the

CFTC says there is no bright line test for evasion. You personally structured these transactions so they would fall within the exemption and would not be swaps, so you are guilty of evasion and you've dragged your company down with you." Chaze kept eyeing him for a reaction as he fanned himself with paper from the file that looked like regulations from the Federal Register.

David hoped he was keeping a poker face. "We have been structuring deals exactly like these to buy physical power since the market was deregulated in the late 1990s, long before there was a Dodd-Frank Act. There's nothing in any of these deals that is different from what we were doing before, and these documents do not have anything in them that is different from what we were doing, to avoid Dodd-Frank." A voice was screaming through the congestion in David's head telling him to shut the hell up.

"Oh, really? Well, how much more of this 'nothing different' are you doing now?" Chaze, still leaning back in his chair, reached into the file folder still open on his lap and pulled out Central City Power & Light's annual report, folded open to the pages with the financial footnotes, and chucked it on the table, where it slid towards David. David felt like a fool for being so easily played. "Your annual report seems to say a lot. Maybe you even helped write that footnote?"

In fact, David had, and he knew what it said without having to look. Central City Power & Light wanted to be a stable utility company for its customers and its shareholders, and did not want to be in the business of natural gas or electricity price speculation. To accomplish this, Central City used hedge transactions. Since the clearing requirements of the Dodd-Frank Act required much more capital for swap hedge transactions than was previously the case, the company was using more physical transactions to hedge its exposure. Hence a footnote that read: "In order to preserve capital for construction of infrastructure and to maintain low electricity rates, the company has reduced hedging market price exposure through swap transactions, and increased its reliance on physical transactions."

Chaze continued, "So what were you saying about not doing anything differently? You are do-

ing things differently. You had been hedging these transactions using swaps, and then decided you wanted to get around - evade - the clearing and transparency requirements of Dodd-Frank by doing these physical deals."

"You and your friends at the utility decided to sacrifice the safety and soundness of our financial system to selfishly keep your company's electric rates and shareholder returns stable. You put your company's capital into building power plants and keeping linemen employed instead of putting it onto the exchanges, where the law says it is supposed to go to reduce the systemic risk your transactions present to this country's financial system," Burr just about hissed in David's ear. "You and your Wall Street buddies trashed the economy in 2008 with your shady dealings and this statute is written to protect all of us from your doing it again."

David sat back in his chair, and exhaled deeply, somewhat stunned. Being an attorney for a service company buying wholesale electricity to serve its retail customers did not merit such a self-righteous onslaught. The California power crisis had marketers like Enron and Mirant as the villains, or at least the utilities were able to lay claim to victimhood. Today, this didn't seem to be the case from where David was sitting. "Look, these are just transaction counterparties- we're buying what they are selling. These are arms-length business relationships. We are not in cahoots with anyone. We just want to reliably serve our retail load and earn our allowed rate of return." David turned to look at Burr, mostly to get the side of his head out of the direct range of Burr's mouth, but sort of regretted doing so, since even though Burr was clean cut, he was pretty ugly.

Burr seemed to produce out of thin air a credit card receipt that he triumphantly lay across the bottom of one of the documents spread out on the table before David. "Here's the receipt for the lunch your Pierpont Morgan buddies took you and five of your colleagues to after you closed this deal. Your company's code of conduct does not let you accept gratuities from vendors. Did you report this or get permission?" David looked at the receipt from Salty's Sea Shack, remembered the lunch, which he mostly missed because he was

standing outside in the rain under an awning talking on his cellphone handling a crisis on another deal, but remembered thinking at the time that it was within Central Power & Light's Code of Conduct.

Chaze kept a level, unbroken gaze at David. "Mr. Mann, Central Power & Light, and you for your role in it, are in violation of the Dodd-Frank rules that required clearing, reporting, and conduct otherwise within the law when it comes to swaps, because this is a swap. It doesn't even matter what Central Power & Light intended. There are two parties to a swap transaction. CFTC Rule 1.3(xxx)(6) provides that the transaction becomes a swap if either party to the transaction was trying to get around Dodd-Frank. So it's a swap if just Pierpont Morgan was trying to evade Dodd-Frank, regardless of whatever was going on in the brain of anyone at the utility. Under this rule, we don't need to prove anything about what you were thinking or intending- we can just prove that the other party was evading, and the transaction becomes a swap, and we then have a whole host of rules regarding swap transactions that you and Central City Power & Light did not follow. Pierpont Morgan is on the verge of signing a settlement agreement with the Department of Justice on another big matter, and if I were you, I'd be concerned about what Pierpont Morgan is going to admit about this to help us out."

David replied, "These are physical deals, so they are not swaps." David needed to sneeze, and was hoping his accompanying facial expressions didn't create an impression he was uncertain in his position.

Chaze elaborately feigned patience. "Here's where you're wrong again. The law doesn't exempt a transaction because it is physically settled; it exempts it if it is 'intended to be physically settled,' and CFTC staff says 'intended' has an objective standard based on whether most of the transactions like it are physically settled, not a subjective standard of what you in your deal intended. The CFTC does not have time to review every transaction, but it can look at markets. The regulations under this law, and therefore the U.S. Attorney in this District, and not you or anyone else at Central City Power & Light, determine the

intent of your transaction. These are swaps because you evaded, because you have done more physical deals than you previously did to avoid the capital commitments of Dodd-Frank, and if you didn't evade, the other party to the deal evaded, because they told us so as part of a plea agreement, and are therefore swaps, and if you or they didn't evade, the CFTC objective standards and not you determine 'intent' to physically settle, and since this one has a delivery point that books out 80% of the time, the objective intent is absent. Five ways to Sunday, these are swaps that you wrote that Central Power & Light did not report, clear, and document on the required forms as required by the statute."

David's knowledge of his need to stay quiet was outweighed by the smug look on Chaze's face and the smirk on Burr's. "Nullum crimen sine lege." Take that, thought David, Latin. "How about the Constitution? The CFTC can't outlaw conduct after the fact without a bright line before the fact; if you today can't point to something written down beforehand, you can't prosecute me or Central City for it. The CFTC has no right to write regulations to make a physical transaction a swap simply by claiming the right to call anything a swap it's not affirmatively prohibited from calling a swap, or by making us bear a sanction for a totally separate party's conduct, or by substituting our intent for what it wants our intent to be, which is the sum total of what you're claiming."

Agent Chaze, still leaning back, smiled malevolently. "You and Central can fight that battle after you've both been indicted. You can argue that a CFTC rule that does not lay a bright line down for prohibited conduct, and that just says 'we'll know it when we see it,' will be voided for vagueness, or that the statute was supposed to address credit and mortgage derivatives, not energy procurement, but that's for a court to do, when it gets around to it. Arthur Andersen's conviction for shredding Enron accounting papers was unanimously reversed by the Supreme Court, but it didn't matter- 28,000 people lost their jobs and the firm was gone. So if your best argument is that the CFTC is exceeding its authority, that will be for some appeals court to decide years from now, after the prosecution against you and Central has

gone through a bunch of eager assistant U.S. attorneys, and the case has been the dominant fact of your life, while you've been unemployed and unemployable."

"And how many jobs lost at Central Power & Light do you want to be responsible for?" Burr leaned in again.

David looked over at Burr and now just rolled his eyes. He had enough and stood up to leave. "If the best you've got is a lunch receipt, a footnote in an annual report, and faith that rules that allow unfettered agency discretion will get you to first base in court, I'll take my chances." Burr stepped back, folding his arms hostilely and glowering. Chaze looked up, arched one eyebrow and said with a shrug, "Good day, Mr. Mann."

David stepped out into the seedy part of town that housed the federal building, blinking at the late morning sunshine, and regretted not having his sunglasses. He started walking back to the financial district, and soon the 85 year old art deco tower of Central City Power & Light's headquarters came into view. He looked at its top floor and mused about its rumored palatial offices, which had remained vacant for as long as he'd worked there due to some building material containment that, he had been assured, haunted only that floor. However, it made the building somewhat less inviting this morning. As he walked he thought about the line between giving good advice to a client to avoid regulatory and financial burdens, and this evasion discussion he had just had. If evasion meant whatever the executive agency decided it meant without having to write it down ahead of time, and with no regard to one's actual intent, maybe it was hopeless. If Central City Power & Light was going to stay within the law, and didn't have the capital to clear all its financial and physical hedges, it was going to have to be unhedged, and that would eventually cost the shareholders and ratepayers.

Soon along his right David saw a bar, under a rusty neon sign spelling "Jay's" in cursive. He stopped and looked in the window and saw exactly the crowd he would have expected to be drinking at 11 am. He turned his head and looked down the boulevard towards Central Power & Light's headquarters building, and back in Jay's

he saw several empty stools and thought even though the sign was rusty, the window seemed clean and none of the patrons would bother him. He took his cellphone out of his pocket, saw the five missed calls and 43 emails, turned it off, and stepped into the bar.

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#### NOTES

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