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Sent:	Monday, September 20, 2010 4:40 PM
To:	OTCDefinitions <OTCDefinitions@CFTC.gov>
Cc:	secretary <secretary@CFTC.gov>
Subject:	Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act - Definition of Major Swap Participant
Attach:	CFTC ANOPR - Comments on Definition of Major Swap Participant_(32289348)_(13).pdf; Sweeney, R. Michael.vcf

Via Electronic Delivery

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP hereby submits this letter in response to the request for comments set forth in the advanced notice of proposed rulemaking published in the *Federal Register* on August 20, 2010, addressing the definition of "Major Swap Participant" adopted in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act").

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial and residential consumers. Members of the Working Group include energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

The Working Group appreciates the opportunity to submit these comments and looks forward to working with the Commodity Futures Trading Commission and Securities and Exchange Commission to further define and clarify this definition as part of the formal rulemaking process implementing Title VII of the Act.

If you have any questions, or if the Working Group may be of further assistance, please do not hesitate to contact me directly at the number listed below.

– Respectfully submitted,

R. Michael Sweeney, Jr.

<<CFTC ANOPR - Comments on Definition of Major Swap Participant_(32289348)_(13).pdf>>

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September 20, 2010

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC MAIL

Re: *Definitions and Required Rulemakings Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act - Definition of Major Swap Participant*

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter in response to the Advanced Notice of Proposed Rulemaking jointly issued by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions") published in the *Federal Register* on August 20, 2010, concerning the further definition of certain key terms (specifically "Swap," "Security-Based Swap," "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," "Eligible Contract Participant" and "Security-Based Swap Agreement").[1]

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial and residential consumers. Members of the Working Group are energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

The comments herein specifically address the definition of "Major Swap Participant" set forth in new Section 1a(33) of the Commodity Exchange Act (the "CEA") as adopted in

[1] *Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, 75 Fed. Reg. 51,429 (Aug. 20, 2010) ("ANOPR").

Title VII, Subtitle A, Section 721(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Working Group appreciates the opportunity to submit these comments in response to the ANOPR and looks forward to working with the Commissions to further define the term "Major Swap Participant" as part of the formal rulemaking process for implementing this and other key definitions contained in Title VII.

II. COMMENTS OF THE WORKING GROUP OF COMMERCIAL ENERGY FIRMS.

A. REGULATORY STRUCTURE CONSISTENT WITH CONGRESSIONAL INTENT.

Title VII of the Act establishes two categories of participants in the Swap markets that will be subject to comprehensive regulation: Swap Dealers and Major Swap Participants.[2] Major Swap Participants are defined as companies that are important to the financial system of the United States because they have the potential to create very large financial losses that threaten the financial network. While there may be some overlap between the categories, the Commissions should promulgate guidance that defines "Major Swap Participant" and "Swap Dealer" distinctly.[3] The Working Group respectfully submits that this approach is consistent with the intent of Congress and with the requirements and structure of Title VII.

B. DEFINITION OF THE TERM "MAJOR SWAP PARTICIPANT."

1. DEFINITION OF "SUBSTANTIAL POSITION."

The first prong of the definition of "Major Swap Participant" sets forth a standard that deems any entity as a Major Swap Participant that "maintains a substantial position in Swaps," excluding, among other things, positions "held for hedging or mitigating commercial risk."[4] In new CEA Section 1a(33)(B) Congress directed the Commissions to define the term "substantial position" at "the threshold that the Commission[s] determine to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States."[5] In general, this prong identifies as "Major Swap Participants" those firms that have amassed speculative positions in Swaps that are sufficiently large such that losses on these positions could have a materially adverse effect on the financial network.

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[2] It is acknowledged that several market participants may already be subject to prudential regulation by virtue of being a bank, insurance company, utility or other regulated entity.

[3] Concurrently herewith, the Working Group is submitting separate comments addressing the definition of "Swap Dealer" in response to the ANOPR.

[4] New CEA Section 1a(33)(A)(i).

[5] As discussed in connection with the definition of "substantial counterparty exposure," when determining whether a position is a "substantial position," the following swaps should be excluded: (a) swaps that are centrally cleared; (b) swaps to the extent their market value is collateralized and (c) swaps entered into between affiliates. These swaps do not have any significance to the stability of the financial system of the United States.

The test for whether a market participant has a "substantial position" in any of the major Swap categories designated by the Commission should not include positions in commodities and exempt commodities. The Commission is required to assess whether speculative position limits should apply to transactions in such products. Any position that would rise to the level of significantly impacting the financial system of the United States will be an order of magnitude higher than a speculative position limit because of the more narrowly focused purpose that speculative position limits serve. Accordingly, positions that are in compliance with a position limit categorically cannot be large enough to constitute a "substantial position" for purposes of categorizing a firm as a Major Swap Participant.

A "substantial position" may be held in "any of the major Swap categories as determined by the Commission."[6] This measurement by category reflects Congress's appreciation that not all Swap markets are the same. This appreciation is further demonstrated in the definition of "Major Swap Participant" in that a person may be designated a Major Swap Participant for one or more categories of Swaps without being classified a Major Swap Participant for all classes of Swaps."[7]

2. DEFINITION OF "COMMERCIAL RISK."

When determining whether a firm holds a "substantial position" under the first prong of the definition of Major Swap Participant, Swap transactions that hedge "commercial risk" are removed from the analysis.[8] The Commissions should use their authority to further define what constitutes "commercial risk" to give entities legal certainty as to which transactions they are permitted to remove from the "substantial position" determination.

In defining the term "commercial risk," the Commissions should adopt a broad meaning of "commercial risk." A broad interpretation of the term "commercial risk" is consistent with the Congressional intent underlying the definition of "substantial position." A broad construction of the term "commercial risk" will allow the Commissions to accurately assess whether an entity does in fact have a "substantial position" in Swaps that rises to a level of systemic importance.

The Working Group recommends the following definition of "commercial risk":

> Commercial Risk. This term means any risk that a person or governmental entity incurs, or anticipates incurring, in connection with the ownership, procurement, production, manufacture, processing, merchandising, marketing, transportation, storage, or distribution, of a commodity, any byproduct of a commodity, or a product or service whose value or cost is linked to a commodity, including, but not

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6 New CEA Section 1a(33)(A)(i).

7 New CEA Section 1a(33)(C).

8 New CEA Section 1a(33)(A)(i)(I).

limited to: market risk; credit risk; operational and operating risk; liquidity risk and financial statement risk.

3. DEFINITION OF "SUBSTANTIAL COUNTERPARTY EXPOSURE."

a. CONGRESSIONAL STANDARD.

The second prong of the definition of "Major Swap Participant" set forth in new CEA Section 1a(33)(A)(ii) defines a "Major Swap Participant" as a party whose "outstanding Swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets." Congress clearly intended this standard to be a substantial threshold.

b. COUNTERPARTY EXPOSURE.

The second prong of the definition of "Major Swap Participant" addresses the systemic risk that a firm could inject huge losses into the financial network by defaulting on its Swap portfolio, whether or not the default is particular to Swaps.[9] In contrast to the first prong of the definition, the second prong contemplates potential losses beyond those inherent with an entity's actual Swap positions.[10] The harm to the financial network should a firm default on its Swaps portfolio is not only a function of the size of the exposure, but also the degree to which the entity's interconnection with other market participants transmits the impact of the default to the larger financial system.

The goal of the Act is the mitigation of systemic risk through the regulation of financial markets, financial entities and those firms that might harm such markets or financial entities. Congress has identified a set of institutions that require enhanced regulatory oversight because their failure or materially impaired operation would have a significant adverse effect of the financial system of the United States. Title I of the Act designates certain bank holding companies and "nonbank financial companies" as such firms (each, a "Title I Institution").[11]

When defining "substantial counterparty exposure," the Commissions should establish a definition that encompasses only those counterparty exposures that are sufficiently large such that, if the relevant entity defaulted on its Swap portfolio, the associated losses would materially harm one or more Title I Institutions and substantially impair the financial network. The definition of "substantial counterparty exposure" also should take into account the degree

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[9] *E.g.*, a Major Swap Participant becomes insolvent upon suffering massive losses on its portfolio of residential mortgage investments.

[10] However, the term "substantial counterparty exposure" likely looks at potential liabilities due from the Major Swap Participants to institutions in the financial network of the United States. It does address potential gains due from such institutions to a Major Swap Participant. A true risk measure, however, would net these exposures.

[11] See Sections 121 and 113 of the Act, respectively.

to which such exposure is allocated among one or more Title I Institutions. If counterparty exposure is spread sufficiently, no single Title I Institution would be substantially impaired if such exposure became losses.[12]

When determining an entity's counterparty exposure the Commissions should exclude an entity's Swap liabilities that do not present risks to counterparties in the financial network. This includes (a) Swaps that are centrally cleared, (b) Swaps to the extent that their market value is collateralized and (c) Swaps between affiliated entities. In these circumstances, there is no material counterparty exposure or credit support has mitigated the potential for suffering actual losses.

4. DEFINITION OF "FINANCIAL ENTITY."

Under the third prong of the definition of "Major Swap Participant" set forth in new CEA Section 1a(33), the Commissions can deem certain highly leveraged "financial entities" to be Major Swap Participants. With respect to this part of the definition of "Major Swap Participant," the Working Group urges the Commissions to define "financial entity" as a category limited to those firms with a primary business of providing financial services.

The definition should be internally consistent with the other provisions of the Act that require a determination as to whether an entity is a financial entity. Both Section 102(a)(6) of the Act and new CEA Section 2(h)(7)(C)(viii) look to whether an entity is "predominantly engaged" in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956 to determine if an entity is a financial entity.[13] The Working Group respectfully requests that the Commissions adopt the "predominantly engaged" test set forth in both Section 102(a)(6) and new CEA Section 2(h)(7)(C)(viii) when defining the term "financial entity" for the purposes of the definition of "Major Swap Participant."

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[12] The Working Group recommends the Commissions, in defining "substantial counterparty exposure," consider (a) the $50 billion of capital a bank holding company must preside over in order to be a Title I Firm and (b) that AIG is understood to have written credit protection for over more than $440 billion in bonds (*Reuters*, How AIG Fell Apart, Sept. 18, 2008, www.reuters.com/article/idUSMAR85972720080918).

[13] Section 102(a)(4) of the Act defines a nonbank financial company as an entity that is, among other things, "predominantly engaged in …financial activities, as defined in paragraph (6)." Section 102(a)(6) deems an entity as predominantly engaged in financial activities if "(A) the annual gross revenues derived by the company and all of its subsidiaries from activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) …represents 85 percent or more of the consolidated annual gross revenues of the company; or (B) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) … represents 85 percent or more of the consolidated assets of the company." The activities that are financial in nature under Section 4(k) of the Bank Holding Company Act of 1956 are further defined in Regulation Y. (12 C.F.R. 225 et seq.)

One of the criteria that can qualify an entity as a financial entity for the purposes of the exemption from mandatory central clearing in new Section 2(h)(7) of the CEA is if "a person predominantly [is] engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956."

C. THE MAJOR SWAP PARTICIPANT DETERMINATION SHOULD BE CONDUCTED AT THE LEGAL ENTITY LEVEL.

The Working Group respectfully requests that the Major Swap Participant determination be conducted at the legal entity level, which is consistent with modern credit and bankruptcy practices. A legal entity might have multiple groups or divisions that enter into Swaps that, in some cases, might be offsetting. Moreover, if a firm is going to inject losses into the financial system as result of its Swaps Portfolio, such losses will be realized only after all assets of the firm are exhausted.[14]

D. THE MAJOR SWAP PARTICIPANT DETERMINATION PROCESS SHOULD BE COMMISSION INITIATED.

The Commissions should adopt a process for the determination of which entities are Major Swap Participants that requires the Commissions to proactively notify specific market participants that they are potentially Major Swap Participants. The process should allow a market participant the opportunity to respond to such notification with an explanation as to why they should not be deemed a Major Swap Participant. In the absence of such notification, market participants will be free to operate with confidence in the fact that they are not a Major Swap Participant.

Through the Act's new reporting requirements, the Commissions will have information that should indicate which firms possibly could be Major Swap Participants. The recommended process will allow the Commissions to focus on those firms they determine could be a Major Swap Participant and will prevent market participants from inundating the Commissions with request for no action relief as they seek legal certainty that they are not a Major Swap Participant.

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[14] Conducting the determination of Major Swap Participant at an entity level also promotes certain other regulatory objectives. For example, interactions between traditional, franchised public utilities with captive customers and their market-regulated power sales affiliates are highly regulated at both the federal and state level to prevent potential affiliate abuse, including cross-subsidization, that could benefit shareholders to the detriment of captive ratepayers.

III. CONCLUSION.

The Working Group appreciates this opportunity to comment, and requests that the Commissions consider these comments as it develops proposed rules or regulations further defining the term Major Swap Participant. The Working Group looks forward to offering its views in response to the notice of proposed rulemaking addressing this definition.

Respectfully submitted,

/s/ R. Michael Sweeney, Jr.

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