

February 22, 2011

Via Online Submission

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

Re: COMMENTS OF COALITION OF PHYSICAL ENERGY COMPANIES
End-User Exception to Mandatory Clearing of Swaps, RIN No. 3038-AD10

Dear Mr. Stawick:

By notice of proposed rulemaking published in the Federal Register on December 23, 2010,¹ the Commodity Futures Trading Commission ("CFTC" or the "Commission") proposed regulations to implement the elective exception to mandatory clearing for certain swaps (the "End-User Clearing Exception") provided under Section 723 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").² Section 723, *Clearing*, revises various sections of the Commodity Exchange Act ("CEA")³ to add requirements for the mandatory clearing of most swap transactions under Dodd-Frank.⁴ Revised § 2(h)(7) of the CEA provides for the End-User Clearing Exception where one party to a swap: is not a financial entity; is using the swap to hedge or mitigate commercial risk; and notifies the Commission, in a manner set by regulation, how it generally meets its financial obligations associated with entering into non-cleared swaps.⁵ The NOPR proposes new regulations to implement the End-User Clearing Exception, including proposed requirements for counterparties to notify the Commission as to how they meet their financial obligations with respect to non-cleared swaps in order to take advantage of the exception.

¹ End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80747 (Dec. 23, 2010) (the "NOPR").

² Public Law No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank").

³ Public Law No. 74-765, 49 Stat. 149 (1936).

⁴ Dodd-Frank § 723 (as codified at 7 U.S.C. § 2(d) *et seq.*).

⁵ Dodd-Frank § 723 (as codified at 7 U.S.C. § 2(h)(7)(A)); *see also* NOPR at 80748.

The Coalition of Physical Energy ("COPE")⁶ generally supports the NOPR's implementation of the End-User Clearing Exception, and believes the Commission has proposed a proper definition of the term "hedge or mitigate commercial risk." COPE believes that this proposed definition would enable non-financial energy industry companies that use swaps to manage the physical commodity price risk associated with their businesses to elect to not to clear swaps they use to hedge commercial risk.⁷ However, COPE respectfully requests that the CFTC not implement these regulations in a manner that will place undue burdens on end-users by mandating burdensome and repetitive reporting obligations in order to be entitled to the End-User Clearing Exception.

Comments

A. Definition of "Hedging or Mitigating Commercial Risk"

As active participants in many facets of energy commodity production, processing, transportation, and retail businesses, COPE members utilize swaps to mitigate risks arising from volatility in energy commodity prices. As Dodd-Frank establishes that only swaps used to hedge or mitigate commercial risk are entitled to the End-User Clearing Exception, the definition of the phrase "hedging or mitigating commercial risk" is critical to COPE members.

Fundamentally, commercial risk in this context is any risk arising from a physical energy company's business activities that can be hedged with a swap. In a separate proposed rulemaking to further define certain terms under Title VII of Dodd-Frank, the Commission has proposed a definition of "hedging or mitigating commercial risk"⁸ which is substantially identical to the criteria set forth in the NOPR, in proposed § 39.6(c), that will be used to determine a given swap's eligibility for the End-User Clearing Exception.⁹ As proposed, that criteria covers swaps that hedge changes in: the value of outputs, inputs, liabilities, services, interest rates, and currency exchange rates, or that qualify for a bona fide hedge exemption or hedging treatment under relevant accounting standards. While COPE will provide specific comments to the definition of the phrase "hedging or mitigating commercial risk" in the context of the Definitions NOPR, the scope of swap positions covered by the NOPR's

⁶ The members of the Coalition of Physical Energy Companies are: Apache Corporation; Competitive Power Ventures, Inc.; El Paso Corporation; Iberdrola Renewables, Inc.; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; Shell Energy North America (US), L.P.; and SouthStar Energy Services LLC.

⁷ COPE notes that the Commission has not yet proposed a regulatory definition of the term "swap" to be used in its implementation of Dodd-Frank. For the purposes of these comments, COPE will use the term "swap" to mean a financially settling agreement where parties owe each other cash payments based upon a fixed or floating price multiplied by a notional amount, with the "in the money" party receiving a net payment from its counterparty.

⁸ Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80174, 80214 (Dec. 21, 2010) ("Definitions NOPR").

⁹ NOPR at 80757.

proposed criteria for the End-User Clearing Exception appears to capture the hedging activities of COPE members.

B. Reporting Obligations For Electing Counterparties

In the NOPR, the Commission proposes that a person electing to use the End-User Clearing Exception report or cause to be reported "ten additional items of information."¹⁰ The only transaction-specific item among the required information is the fact that the particular swap in question is being used to hedge or mitigate commercial risk. Since all of the other additional items to be reported are not transaction-specific, COPE requests that end-users electing not to clear swaps not be required to report these additional items on a transaction-by-transaction basis.

Dodd-Frank requires a person electing to use the End-User Clearing Exemption to notify the Commission as to "how it generally meets its financial obligations associated with non-cleared swaps."¹¹ COPE members, like other end-users, have various approaches to meeting such obligations. These approaches include asset pledges, provision of credit support, provision of a guarantee, stand-alone balance sheet strength, or some combination of the foregoing. Regardless of the approach each member uses, it typically does not do so on a transaction-by-transaction basis.

COPE members use International Swaps and Derivatives Association ("ISDA") Agreements to execute their non-cleared swaps. These ISDA Agreements are the vehicle through which the financial obligations associated with a non-cleared swap are defined and met. The ISDA Agreement is a master agreement, with each swap transaction between the counterparties made subject to and part of the ISDA Agreement, and with the combined credit exposure of the swaps collectively secured. As a result, the manner in which non-cleared swap financial obligations are addressed is not transaction-specific.

The various methods for meeting financial obligations listed in § 39.6 (b)(5) of the NOPR's proposed regulations appear to capture the types of security utilized by COPE members and other end-users in typical non-cleared swap transactions. Since the method of meeting these financial obligations does not vary from trade to trade under the ISDA process described above, COPE requests that the Commission permit a notice to be filed by an end-user that will serve to meet the requirements of § 723 of Dodd-Frank and § 39.6(b)(5) of the proposed regulations as long as the manner of meeting non-cleared swap financial obligations does not change. As proposed, COPE is concerned that the regulation would require redundant filings of the same material regarding the meeting of non-cleared swap financial obligations, and would only impose costs and burdens without serving any regulatory purpose. This notification should be made on a "one time basis," subject to updates for any changed circumstances.

¹⁰ *Id.* at 80749.

¹¹ Dodd-Frank § 723 (as codified at 7 U.S.C. § 2(h)(7)(A)(iii)); *see also* NOPR at 80749, 80757.

Similarly, COPE members and other end-users do not obtain board approval for each non-cleared swap into which they enter. Swaps are entered into in dynamic markets; they are not the type of static matter that could be brought to the board or relevant committee for approval. Moreover, in corporate governance, the board of directors approves broad policy and provides broad direction to a company. The board does not engage in the day-to-day management of the company. Rather, the board or its relevant committee will approve risk policies and oversee their implementation at a high level. As required by § 723 (b) of Dodd-Frank, COPE expects that its affected members will obtain board approval of a hedging program that includes swaps that are exempt from Dodd-Frank's otherwise applicable clearing requirement.¹² That programmatic approval would meet the requirements of § 723(b) of Dodd-Frank and could, together with any revisions or updates, be made available to the Commission.¹³ However, since no transaction-specific board actions exist, they should not be required to be reported under any final rules implementing the End-User Clearing Exception. The Commission should make clear in any final rule corresponding to proposed § 39.6(b)(6)(ii) that evidence that an appropriate committee of the board of directors has approved a hedging program with which a given swap conforms will be sufficient to satisfy the requirements of that rule, and that swap transaction-specific approval need not be demonstrated.

On the other hand, because a swap's qualification for the End-User Clearing Exception is transaction specific, COPE agrees with the Commission that the election of an end-user not to clear a swap pursuant to its rights under Section 2(h)(7) of the CEA can be reported to a swap data repository at the time the swap is otherwise reported in accordance with the reporting and recordkeeping rules separately proposed by the Commission.¹⁴ As such, under the reporting hierarchy set forth in the Swap Reporting NOPRS, only off-exchange end-user to end-user swaps for which the clearing exception is elected would be reported by end-users such as the COPE members. All other swaps subject to the clearing exception would be reported by exchange, Swap Dealer, or Major Swap Participant counterparties. This limited transaction-specific reporting requirement for end-users will not be redundant or burdensome to end-users and will serve the regulatory purposes of Dodd-Frank.

Conclusion

COPE generally supports the Commission's proposed definition of the term "hedging or mitigating commercial risk" as used in the NOPR. Further, COPE does not oppose the reporting of the election of the End-User Clearing Exception on a transaction-specific basis in conjunction with the reporting hierarchy proposed by the Commission in its Swap Reporting NOPRS.

¹² Dodd-Frank § 723 (b) (as codified at 7 U.S.C. § 2(j)).

¹³ Of course, in conjunction with this board material, the affected end-user could also provide its SEC Central Index Key number.

¹⁴ Swap Data Recordkeeping and Reporting Requirements, 75 Fed. Reg. 76574 (Dec. 8, 2010); Real-Time Public Reporting of Swap Transaction Data, 75 Fed. Reg. 76140 (Dec. 7, 2010) (together, the "Swap Reporting NOPRS").

However, COPE believes the reporting of non-transaction-specific information with each swap is redundant, burdensome, and in some cases impossible (*e.g.* transaction-specific board approvals). Accordingly, COPE requests that the Commission revise the regulations regarding the End-User Clearing Exception set forth in the NOPR to require an end-user, in addition to any other reporting requirements that may apply, to provide: (1) a notification of how it generally meets its financial obligations associated with non-cleared swaps that would be effective unless and until the security technique changes with respect to a swap sought to be excepted from clearing; and (2) evidence of its board or relevant committee approval of a hedging program including the company engaging in non-cleared swaps, together with any revisions or updates. COPE requests that the Commission implement these changes instead of requiring swap transaction-specific reporting on these issues for each swap that an end-user seeks to have excepted from clearing. Similarly, if the person availing itself of the End User Clearing Exception is a finance affiliate as described in proposed § 39.6 (b)(3), that information could also be provided in a single notice, as it will not change with each transaction.¹⁵ COPE members could provide this material either to a Swap Data Repository or the Commission. As a result, duplicative filings which provide no meaningful information can be avoided and the statutory and regulatory requirements of Dodd-Frank and the Commission's implementing regulations will be met.

Respectfully submitted,

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cc: COPE Members

Attachment

¹⁵ See NOPR at 80757.

ANNEX TO COPE COMMENTS

COPE Responses to Select Commission Questions

I. Responses to NOPR Questions on Page 80752

Questions 1-5:

1. Is it appropriate for the Commission to require notification regarding use of the end-user clearing exception to be made through SDRs? What are the advantages or disadvantages of the Commission's proposal?
2. Does collecting Financial Obligation Notice information through SDRs provide sufficient assurance that the end-user clearing exception will be available to non-financial entities wishing to use the exception? Are SDRs reliable enough to be used for these purposes?
3. Is Financial Obligation Notice information different from other information collected by SDRs in any respect that makes use of SDRs for these purposes inappropriate? If so, how is the notice information different and why is it inappropriate to use SDRs to collect the information?
4. Is there a more feasible and cost effective way for the Commission to receive notification regarding the use of the end-user clearing exception? If so, what is the better alternative and in what ways is it better?
5. Do the CEA and the associated rules and proposed rules regulating SDRs and parties to swaps create sufficient assurance that notice information collected through SDRs will be accurate? Are there additional protections the Commission should establish to create greater assurance that the notice information collected will be accurate? If so, what are they and how will they improve the information collection process?

Response to Questions 1-5:

As noted above, COPE believes that the financial obligation notice should not be transaction-specific. COPE believes that non-transaction specific information should be filed with the Commission. Transaction-specific information can be filed with the SDR.

Question 6-7:

6. Would the person reporting information to the SDR be in a position to have or be able to obtain, in all cases, the information the Commission is requiring to be reported under proposed Rule 39.6? If not, why not? Are there special considerations in this regard when a swap is between two non-financial entities that are each seeking to elect to use this exception? Are representations and warranties and similar established market practices associated with documenting swaps adequate to ensure the person reporting information to the SDR can obtain such information when necessary?
7. How long would it be expected to take for the person reporting information to the SDR to gather the information required under proposed Rule 39.6? Will the time needed to gather the required information disrupt the transaction process for swaps to any material extent?

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Response to Questions 6-7:

If the approach recommended in response to questions 1-5 is adopted, SDR reporting would be appropriate for relevant material. COPE's general comments address the idea that certain of the Rule 39.6 information should not be required to be reported on a transaction-by-transaction basis, since as proposed, the rule does pose the risk that information gathering and reporting could disrupt the transaction process to a material extent.

Question 8:

8. If so, Should the Commission require persons electing to use the end-user clearing exception to follow additional compliance practices in some circumstances? For example, should the Commission require electing persons to create a record of the means being used to mitigate the credit risk of the swap? Would such a requirement be redundant or duplicative of other proposed recordkeeping requirements?

Response to Question 8:

No. The non-transactional material will reflect the ongoing status of the end-users swap execution policies and procedures. The transaction-specific materials will be provided only when the End-User Clearing exemption is exercised. Requiring repetitive submissions of non-transactional material would be burdensome and lack any regulatory purpose.

Questions 9-11:

9. Will collecting notice information together with other transaction information have the advantages expected by the Commission? For example, will it be useful to analyze information regarding use of the end-user clearing exception by product type and other transaction characteristics? Are there other advantages or disadvantages related to collecting notice information through SDRs that the Commission should consider? If so, what are they?
10. Is there reason to believe that collecting information through SDRs will make it more or less difficult for the Commission to take action to prevent abuse of the clearing exception? If so, what Commission actions might be more or less difficult and what alternatives should the Commission consider?
11. Does collecting notice information regarding use of the end-user clearing exception through SDRs create significantly greater burdens for some parties to swaps compared to others? For example, will parties who frequently enter into swaps face higher or lower burdens compared to parties that enter swaps less frequently? Will small companies face different burdens than large companies? Will non-financial entities that enter into swaps with other non-financial entities face different burdens? If so, what steps should the Commission consider taking to account for these differences?

Response to Questions 9-11:

No. As proposed, the information will be redundant and burdensome. The process proposed by COPE will be more efficient and should meet the Commission's needs.

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Question 12:

12. Are there international or cross-border issues related to the end-user exception that the Commission should address?

Response to Question 12:

N/A – COPE provides no opinion on this question.

II. Responses to NOPR Questions on Page 80753

Question 1:

1. Should swaps qualifying as hedging or risk mitigating be limited to swaps where the underlying hedged item is a non-financial commodity?

Response to Questions 1:

No. Interest rates or currencies, etc., are a commercial risk that end-users (including COPE members) may want to the hedge.

Question 2:

2. Should the Commission consider adopting a definition of "hedge or mitigate commercial risk" in proposed Rule 39.6(c) that is different from definition of "hedging or mitigating commercial risk" in the major swap participant definitions rule and is specifically designed to address the circumstances of the end-user clearing exception? If so, what are the specific considerations associated with the end-user clearing exception that make a separate definition desirable? What features would such a definition need in order to be effective and what would be the benefits of adopting them?

Response to Questions 2:

No. It is critical that the Commission adopt a single definition of "hedge/hedging or mitigate/mitigating commercial risk." The context in which the term is used in proposed Rule 39.6(c) is no different than the context in which it is used to define the term "Major Swap Participant." Creating a different definition for this similar use would be unjustified and confusing.