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VIA ELECTRONIC SUBMISSION

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

Re: *End-User Exception to Mandatory Clearing of Swaps,* RIN 3038-AD10

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP hereby submits these comments in response to the request for public comment set forth in the Commodity Futures Trading Commission's (the "CFTC" or "Commission") Notice of Proposed Rulemaking, *End-User Exception to Mandatory Clearing of Swaps* (the "*Proposed Rule*"), published in the *Federal Register* on December 23, 2010,[1] which proposes to provide "non-financial entities," *i.e.,* commercial firms, with an exception from the mandatory clearing requirements ("End-User Exception") pursuant to new Section 2(h)(7) of the Commodity Exchange Act ("CEA"), as established by Section 723 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act").[2]

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 provide these comments in response to the *Proposed Rule* and respectfully requests that the Commission consider the comments set forth herein. The Working Group looks forward to working with the Commission to further develop and define the End-User Exception prior to the effective date of Title VII.

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[1] *End-User Exception to Mandatory Clearing of Swaps,* Notice of Proposed Rulemaking, 75 Fed. Reg. 80,747 (Dec. 23, 2010).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

II. EXECUTIVE SUMMARY.

The Working Group strongly supports the goals of the Act to enhance transparency and reduce systemic risk in the swap markets. To that end, the Working Group submits for the Commission's consideration comments and recommendations it believes will assist the Commission in developing a final rule that preserves the integrity of the swap markets and serves the best interests of market participants. Specifically, the Working Group requests the Commission adopt the following recommendations:

1. Revise Proposed CFTC Rule 39.6(b) to Require a Single, Omnibus Annual Notification Filing. The Working Group submits that requiring notification to the Commission each time a non-financial entity elects to use the End-User Exception is inconsistent with Section 2(h)(7)(A) of the Act. Additionally, such requirement is overly burdensome and will disrupt the trade execution process. In light of the foregoing, the Working Group strongly suggests that the Commission require a single, omnibus annual filing that reports such notification in the same prospective, narrative, and comprehensive form as the Commission's current Form 40.

2. Recognize Discretion Granted to the Board in Meeting its Obligation to Review and Approve Election to Use End-User Exception. Contrary to new CEA Section 2(j), which permits an appropriate committee of the board of directors (or equivalent governing body) (collectively, the "Board") broad discretion in meeting its obligation to review and approve the use of the End-User Exception by an SEC Filer,[3] proposed CFTC Rule 39.6(b)(6)(ii) requires board review and approval on a transaction-by-transaction basis. As such, the Commission should reconcile the proposed rule with the clear and unambiguous new CEA Section 2(j) to permit the board (i) to adopt a single, continuing resolution approving any decision by an SEC Filer to use the End-User Exception and (ii) to delegate its obligation to appropriate supervisory personnel with direct knowledge and oversight responsibility of swap trading activities.

3. Adopt a Definition of "Hedging" or "Mitigating Commercial Risk" that Appropriately Reflects Commonly Used Practices In Energy Markets. Because the unambiguous language of the proposed definition of "commercial risk" eliminates the need to adopt regulatory text indentifying transactions that fall outside of the scope of this definition, proposed CFTC Rule 39.6(c)(2)(i) should be struck from any final rule adopted in this proceeding. Further, commercial energy firms do not generally execute swaps transactions to hedge a particular underlying physical trade. Indeed, in order to mitigate commercial risk, commercial energy firms hedge their underlying physical positions dynamically and on a portfolio basis, which do not involve the matching of hedges to specific underlying physical positions. Thus, any definition of "hedging" adopted by the Commission must contemplate such market practices.

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[3] An "SEC Filer" refers to an issuer of securities that is registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781) or that is required to file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 780).

4. Exempt Inter-Affiliate Swap Transactions from Mandatory Clearing. Because inter-affiliate transactions do not have any bearing on, or reflection of, swap markets, these transactions should be exempt from the mandatory clearing requirements. At a minimum, the Working Group recommends that the Commission confirm that otherwise qualified non-financial entities may engage in uncleared swap transactions with a swap dealer or major swap participant affiliate.

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

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. As commercial firms, the Working Group members function primarily as principals, not intermediaries, by transacting futures and energy-related derivatives on a daily basis, among other things, to mitigate or hedge the commercial risk associated with their core businesses of delivering electricity, heating oil, crude oil, natural gas, propane, gasoline, and other energy commodities to U.S. consumers.

The Working Group generally supports the intent of the *Proposed Rule* implementing new CEA Section (2)(h)(7). By exempting qualifying transactions involving "non-financial entities" from the mandatory clearing requirements, this exception permits the continuation of a well-established and long-standing practice in the energy markets of accommodating the unique credit profiles of certain market participants. Unlike centralized clearing arrangements that demand uniformity in credit support based upon each underlying exposure, current practice in energy markets is for market participants to extend credit based on fundamental analysis of the ability of each counterparty to continue as a going concern, or through the use of alternative collateral support.[4]

The ability to transact swaps on an uncleared basis provides a significant cost benefit by permitting commercial energy firms to preserve capital and operating cash flow. This is particularly critical in such firms' efforts to implement major capital spending programs designed to (i) enhance and expand energy infrastructure, (ii) develop and deploy technologies that promote energy independence, and (iii) comply with new environmental rules, regulations, and policies. More importantly, the ability of commercial energy firms to transact swaps on an uncleared basis is the most effective and efficient means to protect both themselves and consumers from the effects of volatility in physical energy markets.

In recognition of the above factors, the Working Group respectfully recommends that the Commission adopt the revisions proposed herein to ensure that any final rule will promote efficient and orderly energy markets while ensuring transparency in accordance with the requirements of new CEA Section 2(h)(7).

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[4] For instance, certain commercial firms in the energy sector use asset-based collateral arrangements (*i.e.,* first liens in generating facilities). These collateral arrangements are accepted in energy markets as an appropriate form of credit support for liabilities and derivatives exposures.

A. AN ANNUAL FILING IS SUFFICIENT TO MEET THE NOTICE REQUIREMENT REGARDING THE ELECTION TO USE THE END-USER EXCEPTION.

New Section 2(h)(7)(A) of the CEA provides counterparties to a swap an exception from mandatory clearing if one of the counterparties "(i) is a non-financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps." Proposed CFTC Rule 39.6(b) requires the "reporting counterparty" to provide notification of the manner in which the non-financial electing party expects to meet its financial obligations associated with the qualifying, non-cleared swap.

Specifically, such notification must be submitted to a swap data repository ("SDR") pursuant to the protocol for "reporting counterparties" set forth in the proposed rule for *Swap Data Recordkeeping and Reporting Requirements* (the "*Proposed General Reporting Rule)*[5] and must contain several items of information associated with a non-financial entity's election to use the End-User Exception.[6] Where the counterparty electing to use the End-User Exception is an SEC Filer,[7] the notification must include two additional items of information: (i) the relevant SEC Central Index Key number for that counterparty; and (ii) whether the Board has reviewed and approved the decision not to clear the swap.

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[5] *Proposed Rule* at 80,748. *See Swap Data Recordkeeping and Reporting Requirements*, Notice of Proposed Rulemaking, 75 Fed. Reg. 76,574 (Dec. 8, 2010).

[6] *See* proposed CFTC Rule § 39.6(b). These items generally include: (1) the identity of the electing counterparty to the swap; (2) whether the electing counterparty is a "financial entity" as defined in new CEA Section 2(h)(7)(C)(i); (3) whether the electing counterparty is a finance affiliate meeting the requirements of new CEA Sections 2(h)(7)(C)(iii) or 2(h)(7)(D); (4) whether the swap is used by the electing counterparty to hedge or mitigate commercial risk as defined in proposed CFTC Rule § 39.6(c); (5) the method or mechanism by which the electing counterparty generally expects to meet its financial obligations associated with its non-cleared swaps; and (6) whether the electing counterparty is an issuer of securities registered under section 12 of, or is required to file reports under section 15(d) of, the Securities Exchange Act of 1934.

[7] Unlike the Act, the *Proposed Rule* defines an issuer of securities to include a counterparty that is controlled by a person that is an issuer of securities. *See Proposed Rule* at 80,750 n.15. That is, the *Proposed Rule* broadens the definition of an issuer of securities as set forth in the Act to include subsidiaries. The Working Group submits that there is no policy or purpose that supports the expansion of the definition of issuer of securities beyond that which is provided under the Act. Indeed, while the Working Group acknowledges the Commission's concern in ensuring proper Board oversight of a non-financial entity's swap trading activity, the Commission required such only for an SEC Filer. If the Commission were seeking to accomplish such an objective, then it should have imposed the requirement on all non-financial entities that use swap trades. Because it did not, the *Proposed Rule* results in unreasonable disparate treatment of market participants.

The *Proposed Rule* states that the submission of information required by proposed CFTC Rule 39.6(b) must be submitted to an SDR on a transaction-by-transaction basis.[8] Notwithstanding this requirement, the *Proposed Rule* requests comment on whether it would be difficult or prohibitively expensive for persons to report the information that must be included in the notification required by proposed CFTC Rule 39.6(b). The Working Group submits that it would be prohibitively expensive for persons to do so and suggests a much less burdensome approach.

1. A Single, Omnibus Annual Filing Is Consistent with, and in Furtherance of, the Statutory Objectives of New CEA 2(h)(7)(A).

To maximize efficiency, minimize administrative burdens and costs, and ensure consistency with the express language of new CEA Section 2(h)(7)(A), the Working Group submits that this notification only be submitted annually and recommends that such notification should be reported in the same manner and form as the Commission's current Form 40 applicable to large traders with reportable futures positions. Specifically, the Working Group envisions that the notification would be (i) prospective in nature (*i.e.,* for the forthcoming calendar year beginning on January 1), and (ii) provide all information required by proposed CFTC Rule 39.6(b) on a narrative and consolidated basis.

Proposed CFTC Rule 39.6(a) requires submission of the notification of the election of the End-User Exception to be on a transaction-by-transaction basis. Moreover, the *Proposed Rule* interprets this provision to require market participants to determine whether a swap qualifies for the End-User Exception at the time of execution. As noted below, these requirements conflict with the plain language of new CEA Section 2(h)(7)(A). This apparent conflict should be reconciled by the Commission in any final rule issued in this proceeding.

Proposed CFTC Rule 39.6(a) states, in relevant part:

> (a) A counterparty to a swap (an "electing counterparty") may elect to use the exception to mandatory clearing under section 2(h)(7)(A)(iii) of the Act if the electing counterparty is not a "financial entity" as defined in section 2(h)(7)(C)(i) of the Act, *is* ***using the swap*** *to hedge or mitigate commercial risk* as defined in § 39.6(c), and provides or causes to be provided to a registered swap data repository or, if no registered swap data repository is available, the Commission, the information specified in § 39.6(b). . . .

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[8] In relevant part, the *Proposed Rule* states:

> The Commission proposes in § 39.6(b) to require non-financial entities to notify the Commission *each time the end-user clearing exception is elect*ed by delivering specified information to an SDR in the manner required by proposed rules for swaps data recordkeeping and reporting.

Proposed Rule at 80,748 (emphasis added; footnote omitted).

(emphasis added).[9]

In contrast, new CEA Section 2(h)(7)(A) states:

> (A) IN GENERAL.—The requirements of paragraph (1)(A) shall not apply to a swap if 1 of the counterparties to the swap—
>
> (i) is not a financial entity;
>
> (ii) *is* ***using swaps*** *to hedge or mitigate commercial risk*; ***and***
>
> (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared ***swaps***.

(emphasis added).

The language of new CEA Section 2(h)(7)(A)(ii) and (iii), highlighted above, demonstrates a clear and unambiguous intent by Congress to permit a non-financial entity to make a general election to use the End-User Exception. Use of the singular form of the word "*swap*" in proposed CFTC Rule 39.6(a) is in direct conflict with the statutory use of "*swaps*" in CEA Section 2(h)(7)(A)(ii) and (iii). The conjunctive requirements of CEA Section 2(h)(7)(A) make clear that the election to use the End-User Exception will not be required on a transaction-by-transaction basis. That is, this language cannot be reasonably construed by the Commission to require market participants to identify or provide notification that a particular swap qualifies for the End-User Exception at the time it is entered into. Consequently, since the election is not on a transaction-by-transaction basis, notification cannot be on a transaction-by-transaction basis unless the statute indicates otherwise. As stated above, however, new CEA Section 2(h)(7)(A)(iii) references "swaps" in the plural, which does not contemplate notification on a transaction-by-transaction basis. Accordingly, although new CEA Section 2(h)(7)(A)(iii) provides the Commission with the discretion to prescribe the manner (*i.e.,* the form and format) in which such notification may be provided to it, the Commission must interpret this provision consistent with the express language of, and the Congressional intent underlying, new CEA Section 2(h)(7)(A)(ii) and (iii), which clearly permits the use of the Working Group's proposed annual omnibus notification in the form described above.

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[9] Notwithstanding the statement in proposed CFTC Rule 39.6(a) that "a counterparty to a swap (the 'electing counterparty') may elect to use the exception to mandatory clearing under section 2(h)(7)(A)(iii) of the Act," new CEA Section 2(h)(7)(A) is drafted in the conjunctive and, therefore, should be read in its entirety as the End-User Exception. The Commission's reliance on new CEA Section 2(h)(7)(A)(iii) as the specific End-User Exception is misplaced. This interpretation effectively swallows the other statutory criteria that must be satisfied by a market participant to avail itself of the End-User Exception. The Working Group respectfully submits that new CEA Section 2(h)(7)(A)(iii) constitutes only the "notice" element of the End-User Exception that must be interpreted consistent with the express language of, and Congressional intent, underlying the other statutory elements.

2. Notification Should be Submitted by the Non-Financial Entity Electing to Use the End-User Exception.

The Working Group submits that it is not appropriate to impose an obligation on a "reporting counterparty," as that term is defined in the *General Reporting Rule*, to submit information to an SDR associated with a non-financial entity counterparty's election to use the End-User Exception.[10] In order to minimize the potential for administrative errors or conflicts between parties that could disrupt the trade execution process, proposed CFTC Rule 39.6(b) should be revised to require the counterparty electing to use the End-User Exception to submit any required information to an SDR, not the reporting counterparty.

To the extent that the Commission has concerns regarding possible abuse of this exception, new CEA Section 2(h)(7)(F) provides it with the authority to request information from any non-financial entity claiming the use of the End-User Exception. The Commission may also solicit such information by issuing a formal special call pursuant to CFTC Rule 21.[11] In addition, the Commission's broad statutory enforcement authority under the CEA, as enhanced by the enactment of Title VII, is a strong deterrent to situations in which the End-User Exception could be abused through the knowing and willful submission of false information.

B. BOARD REVIEW AND APPROVAL OF USE OF END-USER EXCEPTION BY AN SEC FILER.

As noted above, pursuant to proposed CFTC Rule 39.6(b)(6)(ii), the End-User Exception is only available to an SEC Filer if the Board has reviewed and approved its decision to enter into swap transactions subject to this exception. Further, this provision requires the notification submitted to an SDR relating to a counterparty's election to use the End-User Exception to include confirmation that the required Board review and approval has been obtained.

The scope and application of proposed CFTC Rule 39.6(b)(6)(ii) raises two concerns that should be addressed by the Commission in any final rule issued in this proceeding. First, the requirement for an SEC Filer to obtain Board review and approval each time a non-financial entity elects to use the End-User Exception is inconsistent with the statutory language of CEA Section 2(j) requiring a Board to review and approve the decision to enter into swaps, not each individual swap. Second, the *Proposed Rule* is not clear whether the Board review and approval requirement may be delegated to executive officers or other senior managers that have the direct corporate oversight responsibility for (i) stand-alone subsidiaries or affiliates of an SEC Filer engaged in swap trading activities, or (ii) functional business units of a corporate entity in which swap trading activities are organizationally housed. The Working Group's concerns are discussed separately below.

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[10] The Working Group believes that placing this obligation on the reporting counterparty is improper as it could create an inherent conflict of interest between the parties to a commercial transaction that should be avoided by the Commission.

[11] *See* 17 C.F.R. § 21 (2010).

1. Board Review and Approval of an SEC Filer's Decision to Use the End-User Exception.

Based upon the express language of proposed CFTC Rule 39.6(b)(6)(ii) and related interpretative guidance in the *Proposed Rule*, it appears that an SEC Filer must obtain on a transaction-by-transaction basis Board review and approval of each and every election to use the End-User Exception.[12] Specifically, proposed CFTC Rule 39.6(b)(6)(ii) states, in relevant part, as follows:

> (6) Whether the electing counterparty is an entity that is an issuer of securities registered under section 12 of, or is required to file reports under 15(d) of, the Securities Exchange Act of 1934, and if so:
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> . . .
>
> (ii) Whether an appropriate committee of the board of directors (or equivalent body) has ***reviewed and approved the decision not to clear the swap***.

(emphasis added).

This language violates new CEA Section 2(j) which states:

> (j) COMMITTEE APPROVAL BY BOARD.—Exemptions from the requirements of subsection (h)(1) to clear a swap and subsection (h)(8) to execute a swap through a board of trade or swap execution facility shall be available to a counterparty that is an issuer of securities that are registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o) only if an appropriate committee of the issuer's board or governing body has ***reviewed and approved its decision to enter into swaps*** that are subject to such exemptions.

(emphasis added).

The use of the phrase "decision to enter into swaps," namely, the singular form of "decision" and plural form of "swaps," in new CEA Section 2(j) cannot be reasonably interpreted by the Commission to require Board review and approval of an SEC Filer's decision to elect the End-User Exception on a transaction-by-transaction basis. In contrast, such language actually requires only that a Board review and approve an SEC Filer's general decision to enter into multiple swaps qualifying for the End-User Exception. Accordingly, pursuant to new CEA Section 2(j), a Board of an SEC Filer may adopt a single, continuing resolution approving the decision to use the End-User Exception.

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[12] *See* Proposed Rule at 80,748, 80,757 § 39.6(b)(6)(ii) (stating that the Commission must be notified "*each time*" the End-User Exception is elected, and where the non-financial party is an SEC Filer, such notification must include confirmation that the Board has approved the decision not to clear the swap).

The Working Group's reading of new CEA Section 2(j) is supported by a statement in footnote 18 of the *Proposed Rule* that a "board committee could adopt policies and procedures to review and approve decisions not to clear swaps, on a periodic basis or subject to other conditions deemed satisfactory to the board committee."[13] Specifically, this statement demonstrates a recognition by the Commission that a Board may review and approve an SEC Filer's decision to use the End-User Exception at its discretion. A transaction-by-transaction review and approval process is not required. Recognizing the importance of appropriate and diligent corporate oversight as required by applicable state laws, the Board may modify the proposed resolution upon determining that a material change in circumstances warrants such action.

Accordingly, to eliminate any regulatory uncertainty created by the *Proposed Rule*, the Commission should reconcile and conform the language of proposed CFTC Rule 39.6(b)(6)(ii) with new CEA Section 2(j). In doing so, the Commission will ensure that proposed CFTC Rule 39.6(b)(6)(ii) is consistent with, and gives meaning to, the Congressional intent underlying new CEA Section 2(j).

2. <u>Delegation of Board Review and Approval Obligation To Duly Authorized Personnel Should Be Permitted</u>.

The Commission should clarify that, for non-financial entities formed as a stand-alone subsidiary or affiliate of a parent holding company, the Board, for that subsidiary or affiliate, is permitted to review and approve the decision to use the End-User Exception. That is, Board review and approval for that non-financial entity is sufficient to meet the requirements of proposed CFTC Rule 39.6(b)(6)(ii), and such review and approval need not be obtained from the Board of the parent holding company.

The Commission should further clarify that, for any non-financial entity operating as a functional business unit within a single corporate entity, the obligation to review and approve the use of the End-User Exception under proposed CFTC Rule 39.6(b)(6)(ii) may be delegated by the Board to duly authorized executive officers or other senior managers with direct oversight responsibility for swap trading activities.

The delegation of the Board review and approval requirement in proposed CFTC Rule 39.6(b)(6)(ii) to such executive officers and other senior managers will ensure that duly authorized supervisory personnel with day-to-day knowledge of the operation of the relevant swap markets and their participants are in the position to review and approve a non-financial entity's use of the End-User Exception. Furthermore, such delegation is supported by statements in footnotes 16 and 18 of the *Proposed Rule*, which expressly contemplate the review and approval of an SEC Filer's decision to use the End-User Exception to be undertaken by duly authorized personnel.[14] The exercise of such delegated authority may be guided by internal

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[13] *Proposed Rule* at 80,750 n.18.

[14] *See Proposed Rule* at 80,750 nn.16 & 18.

policies and procedures adopted pursuant to proposed CFTC Rule 39.6(b)(6)(ii) or other conditions established by the Board itself.

C. SCOPE AND APPLICATION OF END-USER EXCEPTION TO TRANSACTIONS INTENDED TO HEDGE "COMMERCIAL RISK."

The Working Group supports the Commission's proposed interpretation of the term "commercial risk" in proposed CFTC Rule 39.6(c)(1), and the consistency of this interpretation with the use of the same term in the pending joint rulemaking further defining "Major Swap Participant."[15] However, to ensure regulatory certainty, the Commission should (i) strictly limit this definition to identifying those swaps that hedge or mitigate "commercial risk," as defined in proposed CFTC Rule 39.6(c)(1); and (ii) strike proposed CFTC Rule 39.6(c)(2)(i) from any final regulations implementing this definition.[16] In addition, swaps that are executed to mitigate or hedge commercial risk on a dynamic or portfolio basis should unconditionally qualify for the End-User Exception.

1. The Proposed Definition of Commercial Risk Obviates the Need for Proposed CFTC Rule 39.6(c)(2)(i).

Proposed CFTC Rule 39.6(c)(2)(i) is unnecessary and excessive in light of the proper scope and specificity of the proposed definition of "commercial risk" in proposed CFTC Rule 39.6(c)(1). Any transaction that does not fall within the definition "commercial risk" cannot, by definition and in any way, qualify for the End-User Exception. The Working Group is concerned that, if adopted, the broad and vague regulatory text in proposed CFTC Rule 39.6(c)(2)(i) will dilute and weaken the proposed definition of "commercial risk" in proposed CFTC Rule 39.6(c)(1).

In addition, the terms "investing" and "trading," set forth in proposed CFTC Rule 39.6(c)(2)(i) are beyond the scope of the CEA, as amended by Title VII of the Dodd-Frank Act. Moreover, these terms, as well as the term "speculation," are not defined and are widely used in swap markets in a variety of contexts.[17] In energy markets, for instance, the term "trading" is

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[15] *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"* 75 Fed. Reg. 80,174 (Dec. 21, 2010).

[16] The Working Group supports proposed CFTC Rule § 39.6(c)(1)(iii), which provides that a swap transaction hedges or mitigates commercial risk if such swap "qualifies for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133). Yet the Working Group submits that other accounting regimes exist and are used by market participants. As such, any final rule should include those in addition to the standards of the Financial Accounting Standards Board.

[17] Nowhere in Title VII do the terms "speculation," "investing," or "trading" appear together. Further, there are open questions about what activity constitutes "investing" or "trading." Even if such terms were to be defined, it is unclear whether Title VII affords the same treatment for swaps used for investing and trading as it does for swaps entered into for speculation.

often used to describe activity involving both bona fide hedging as well as proprietary trading.[18] Notwithstanding that the regulation of "investing" and "trading" is beyond the scope of the CEA, the adoption of regulatory text containing such undefined, yet commonly used, terms will lead to conflicting interpretations regarding the scope and application of the End-User Exception. Confusion as to what constitutes investing, trading, and speculation will inject unnecessary and harmful uncertainty into swap markets.

The Working Group respectfully submits that such a result is neither in the public interest nor is it consistent with the Congressional intent underlying the new CEA Section 2(h)(7)(A). Because the clear and unambiguous language of the proposed definition of "commercial risk" eliminates the need to adopt regulatory text indentifying transactions that fall outside of the scope of this definition, the Commission should strike proposed CFTC Rule 39.6(c)(2)(i) from the final regulations implementing the End-User Exception.

2. Swaps Used to Offset Risks Associated with Underlying Position in Physical Commodity Markets Hedge or Mitigate "Commercial Risk."

Interpretive guidance in the *Proposed Rule* creates uncertainty whether the Commission is attempting to create different categories of activity in physical commodity markets in order to distinguish whether a swaps transaction is hedging or mitigating commercial risk. Such uncertainty arises from interpretive guidance set forth in footnote 23 of the *Proposed Rule*:

> The Commission preliminarily believes that swap positions that are held for the purpose of speculation or trading are, for example, those positions that are held primarily to take an outright view on the direction of the market, including positions held for short term resale, or to obtain arbitrage profits. Swap positions that hedge ***other positions*** that themselves are held for the purpose of speculation or trading are also speculative or trading positions.[19]

The Working Group seeks clarification that the highlighted language above is intended to apply to **other *swaps* positions** "that themselves are held for the purpose of speculation", and not any other position that would also include physical positions. Otherwise the Working Group is concerned that the Commission has adopted a preliminary view that certain exposures in physical commodity markets would not fall within the definition of "commercial risk" in proposed CFTC Rule 39.6(c)(1). This view is not supported by any policy rationale, is inconsistent with the proposed language under proposed CFTC Rule 39.6, and could lead to

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[18] The Working Group is particularly concerned that the word "trading" might impermissibly include the buying and selling of commodities by parties that are primarily in the business of producing, delivering, storing, marketing, and managing physical commodities. This is traditional "commercial activity." Yet, it may also come within the meaning of "trading." Swaps executed in connection with this trading likely would constitute bona fide hedging transactions. In other words, proposed CFTC Rule 39.6(c)(2)(i) would effectively nullify the force and effect of proposed CFTC Rule 39.6(c)(1)(ii), which cannot be the intention of the Commission.

[19] *Proposed Rule* at 80,752 at n.23.

absurd results that would have material, adverse impacts on both physical commodity and swap markets. All physical market participants, from car manufacturers, to toy stores, to merchant energy companies, are in the business of trying to sell a commodity for more than the cost of producing or procuring the commodity. An energy company procuring supply in advance of the summer driving season, or a toy store stocking its shelves in advance of a holiday, are both arguably taking a position in a physical market to trade based on speculation that there will be increased demand. If the phrase "other positions" is interpreted as applying to physical market positions, it could have the perverse result of treating certain bona fide hedges of positions as outright speculative swap positions. This interpretation is not consistent with the Congressional intent underlying new CEA Section 2(h)(7)(A).

In light of the foregoing, the Working Group respectfully requests that the Commission clarify that the language in the interpretive guidance set forth in footnote 23 of the *Proposed Rule* is the result of imprecise drafting that should be corrected in any final rule issued in this proceeding. As long as a swap transaction is intended to (i) offset the types of risks, or (ii) meet other qualifying criteria, identified in proposed CFTC Rule 39.6(c)(1), it should be viewed as hedging or mitigating "commercial risk." To remedy the uncertainty created by the above-quoted text in footnote 23 of the *Proposed Rule*, the Working Group requests that the Commission clarify that the phrase "other positions" is intended to mean "other swap positions."

3. Swaps that Hedge Commercial Risk on a Portfolio or Dynamic Basis Should Qualify for the End-User Exception.

The Working Group respectfully requests the Commission to recognize that, although participants in physical energy commodity markets use swaps and futures to hedge underlying physical positions, they do not, as a general matter, execute such transactions specifically for the purpose of hedging a specified underlying physical position only. With this in mind, the End-User Exception should not be interpreted by the Commission to implement a "one-size-fits-all" approach to hedging by requiring an entity claiming use of this exception to match a swap that hedges or mitigates commercial risk with a specified underlying physical commodity transaction only.

In physical energy markets, the predominant risk management practice used by commercial firms is to hedge underlying physical assets and related positions on a portfolio or aggregate basis. In order to effectively and efficiently mitigate commercial risk associated with underlying physical assets and related positions, commercial energy firms will dynamically hedge their aggregate exposures on a regular and on-going basis. A commercial firm will normally hedge these exposures utilizing physical transactions, futures, and swaps, the exact combinations of which will be determined by various characteristics which may be unique to such firm. A prescriptive one-to-one matching requirement of each swap to a specific physical transaction or an asset position is contrary to the statutory language, and is unnecessary and overly burdensome.

Another well-established practice used by commercial energy firms to mitigate commercial risk is to hedge dynamically to optimize the value of underlying physical assets or

portfolios. A key aspect of dynamic hedging is the ability to modify the hedging structure related to the physical asset or positions when the relevant pricing relationships applicable to that asset change.[20] Dynamic hedging may involve leaving an asset or position unhedged when necessary to mitigate lost opportunity cost risk, which may require hedges to be established, unwound, and re-established on an iterative basis over time. The hedging of commercial risk should therefore include all hedging activity that maximizes the value of the asset.

Given the customary use of portfolio and dynamic hedging in energy markets, it would be impracticable, if not impossible, for the vast majority of energy market participants to link hedges with specified underlying physical positions for purposes of complying with the End-User Exception. Accordingly, the Working Group respectfully submits that, as long as these transactions meet the underlying requirements of new CEA Section 2(h)(7)(A) and proposed CFTC Rule 39.6(a), they should unconditionally qualify for the End-User Exception. In the alternative, the cost burdens would be drastic, and the potential effects on liquidity would be severe, without resulting benefits to participants or the markets.

D. THE APPLICABILITY OF THE END-USER EXCEPTION TO CERTAIN AFFILIATE TRANSACTIONS NEEDS TO BE CLARIFIED.

New CEA Section 2(h)(7)(D)(i) permits an affiliate of a non-financial entity to use the End-User Exception if that affiliate, "acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of" the non-financial entity or other affiliate that

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[20] The following provides an example of dynamic hedging of natural gas and power prices by a commercial energy firm in over-the-counter swap markets. The dynamic hedging transactions relate to the sale of power from a gas-fired, electric generating facility (the "Asset"). The impact of the strategy set forth below is to hedge commercial risk associated with changing market conditions to (i) facilitate a cumulative improvement on the return of the Asset, and (ii) allow for a better economic allocation of the underlying physical commodities being used or generated by the Asset.

- Step 1: Power Prices Exceed Gas Prices; Asset Hedged to Lock in Positive Margin. The commercial energy firm purchases fixed price swaps to fix the prices for natural gas fuel supply and power output produced by the Asset ("Initial Hedges"). At the time the Initial Hedges are entered into, power prices exceeded natural gas prices. This strategy locks in a specified positive margin for the Asset.
- Step 2: Power Prices and Gas Prices Reverse; Asset Unhedged to Capture Additional Positive Margin. At a later date, the relative prices of natural gas and power reversed (*i.e.,* gas prices exceeded power prices to the point where the natural gas was worth more sold as gas than it would be if it was converted to electricity), the commercial energy firm bought back the Initial Hedges to maximize the positive margin on the Asset. The repurchase of the Initial Hedges left the Asset in an unhedged position. The repurchase of the Initial Hedges made economic sense because it would have been uneconomic from the physical commodity pricing perspective to run the Asset. Specifically, it allowed the commercial energy firm to earn an additional positive margin on the Asset under the then-existing market conditions by mitigating lost opportunity costs associated with holding gas positions that were worth more than the power it could have generated.
- Step 3: Power Prices and Gas Prices Reverse Again; Asset Re-Hedged to Capture Additional Positive Margin. As the relative prices of natural gas and power reverse again a few months later it becomes economical to produce output from the Asset and enter into new fixed price natural gas and power price hedges to lock in an additional positive margin on the Asset.

also qualifies as a non-financial entity. Notwithstanding this language, new CEA Section 2(h)(7)(D)(ii) prohibits an affiliate from using the End-User Exception if it is, among other things, a Swap Dealer or Major Swap Participant. These provisions are, however, silent with respect to swap transactions between affiliates within the same corporate family that are used to manage and allocate risk. The Commission should use the authority granted to it under new CEA Section 2(h)(2) to explicitly exempt such inter-affiliate swap transactions from mandatory clearing and, as applicable, the End-User Exception notification requirements set forth in proposed CFTC Rule 39.6(b).[21]

The Working Group respectfully submits that there is no benefit to the public interest or the Commission to require mandatory clearing or (as applicable) reporting of information pursuant to proposed CFTC Rule 39.6(b) with respect to inter-affiliate swaps that are used to manage and allocate risk within a holding company system or other organizational structure. Inter-affiliate swaps do not in any way enhance systemic risk, nor do they affect liquidity in swap markets. Information relating to such swap transactions is neither responsive to one of the central policy goals of Title VII of the Act—to enhance transparency in swap markets—nor is it necessary to prevent abuse.

Should the Commission decline to grant the requested explicit exception from mandatory clearing and End-User Exception notification requirements for inter-affiliate swaps, the Working Group requests that, at a minimum, it clarify that otherwise qualified non-financial entities are not prohibited from utilizing the End-User Exception when engaged in swap transactions with Swap Dealer or Major Swap Participant affiliates.

E. PRESUMPTION OF STATUS AS A NON-FINANCIAL ENTITY.

As noted in other comments filed with the Commission by the Working Group, the framework adopted in Title VII for the regulation of over-the-counter swap markets is based upon the existence of distinct classes of market participants.[22] New CEA Section 2(h)(7) and provisions of the *Proposed Rule* implementing the End-User Exception recognize two distinct classes of market participants: (i) financial entities that are ineligible for this exception, and (ii) non-financial entities that are eligible for this exception upon compliance with certain conditions. In order to provide legal and regulatory certainty, and to be faithful to the intent of the Act, the Commission should not adopt any presumption that a "financial entity" as defined in new CEA Sections 2(h)(7)(C) and (D)(ii) for one kind of swap is also a financial entity for other kinds of swaps. Instead, market participants should be permitted to seek the exemption for each swap for which they are not registered as a swap dealer. Alternatively, the Commission should adopt a presumption that a market participant is a non-financial entity until proven otherwise.

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[21] New CEA Section 2(h)(2) provides the Commission with the ability to determine whether a specific swap or group, category, type, or class of swaps should be required to be cleared.

[22] *See* Working Group, Comment Letter on Joint Notice of Proposed Rulemaking on Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," Notice of Proposed Rulemaking (Feb. 22, 2011).

F. THE PROPOSED RULE FAILS TO ADEQUATELY CONSIDER ANTICIPATED COMPLIANCE COSTS.

Section 15(a) of the CEA requires the CFTC, before promulgating a rule, to "consider the costs and benefits of the action of the Commission."[23] The *Proposed Rule* does not, as a general matter, provide any empirical data regarding the specific costs and benefit analysis specific to the implementation of proposed CFTC Rule 39.6 by market participants.[24] The Working Group requests that the Commission (i) consider the costs and benefits associated with the *Proposed Rule* in the manner prescribed by CEA Section 15(a), (ii) issue a supplemental new rule in this proceeding setting forth empirical data supporting its conclusions regarding the costs and benefits of the *Proposed Rule*, and (iii) notice the supplemental rule in the *Federal Register* for public comment.

IV. RESPONSES TO SPECIFIC REQUESTS FOR COMMENT.

A. SPECIFIC REQUESTS FOR COMMENT ADDRESSING NOTIFICATION TO THE COMMISSION.

Question: Are there clarifications or instructions the Commission could adopt that are useful for parties seeking to elect to use the end-user clearing exception? If so, what are they and what would be the benefits of adopting them?

Response: As stated under Part III.A, above, the Working Group believes the non-financial entity electing to use the End-User Exception should be required to submit any relevant information in the same manner and form as the Commission's current Form 40.

Question: Would it be difficult or prohibitively expensive for persons to report the information required under the proposed § 39.6? If so, why?

Response: As discussed under Part III.A, the Working Group believes that notification on a transaction-by-transaction basis will be prohibitively burdensome and expensive. Too many entities other than the traders would have to be involved in each deal if this cannot be handled on an aggregate basis. As such, the ability to hedge with an adequate price will be slowed due to data collection and additional employees needed to collect and report information.

Question: Is the information the Commission proposes to collect in connection with the Financial Obligation Notice sufficient? Is other information needed to achieve the purposes of the Dodd- Frank Act?

Response: The Working Group believes that no additional information is necessary to achieve the transparency objectives of new CEA Section 2(h)(7).

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[23] 7 U.S.C. § 19.

[24] *Proposed Rule* at 80,754-55.

Question: Is it necessary or appropriate for the Commission to collect additional general information on the credit support agreement and the collateral practices under the agreement, such as the level of margin collateral outstanding (*e.g.,* less than or equal to a specified dollar amount, or greater than a series of progressively higher dollar amounts); the types of collateral provided (*e.g.,* cash, government securities, other securities, other collateral), or the frequency of portfolio reconciliation?

Response: The Working Group does not believe this additional information should be required, as such is not required by the CEA or the Act.

Question: Is it necessary or appropriate for the Commission to collect additional general information on specific terms of the credit support agreement, such as whether the collateral requirements are unilateral or bilateral provisions and whether there are contractual terms triggered by changes in the credit rating or other financial circumstances of one or both of the counterparties?

Response: The Working Group does not believe such additional information is necessary as such information provides no benefit to the Commission.

Question: Is it necessary or appropriate for the Commission to collect additional general information about the guarantor, such as whether or not the guarantor is a parent or affiliate of the person electing to use the end-user clearing exception?

Response: The Working Group does not believe such additional information.

Question: Is it necessary or appropriate for the Commission to collect additional general information regarding the assets pledged, such as the type of security interest or the type of property being used as collateral?

Response: The Working Group does not believe such additional information is necessary.

Question: Is it necessary or appropriate for the Commission to collect additional general information regarding the segregation arrangements, such as the identity of the collateral agent or other third party involved in the arrangement, and information regarding whether the arrangement involves a custodian, triparty or different type of relationship?

Response: The Working Group does not believe such additional information is necessary.

Question: Is it necessary or appropriate for the Commission to collect additional general information regarding the adequacy of other means being used, or the adequacy of the financial resources available, to meet the financial obligations associated with the non-cleared swap?

Response: The Working Group does not believe such additional information is necessary as such information provides no benefit to the Commission.

Question: Should the Commission consider requiring parties electing to use the end user clearing exception to report additional types of information, either in order to limit abuse of the exception or for other reasons? If so, what other information should be reported and what would be the benefit of requiring such information to be reported? What categories of information, if any, should not be required to be reported and why?

Response: The Working Group does not believe additional information is necessary. As discussed under Part III.A.2, above, the Commission has adequate authority to limit abuses.

B. SPECIFIC REQUEST FOR COMMENT REGARDING TREATMENT OF AFFILIATES.

Question: Should the Commission provide additional clarity to the terms used in CEA Sections 2(h)(7)(C)(iii) and 2(h)(7)(D) in proposed § 39.6 for affiliates electing to use the end-user clearing exception?

Response: The Working Group submits its response to this question under Part III.D, above.

C. SPECIFIC REQUESTS FOR COMMENT ADDRESSING BOARD APPROVAL REQUIREMENT.

Question: Should the Commission provide additional clarity to the requirements of CEA Section 2(j) [board approval] to facilitate compliance with proposed § 39.6 by parties electing to use the end-user clearing exception?

Response: The Working Group submits its response to this question under Part III.B, above.

Question: Should the Commission adopt more specific requirements to implement the provisions of CEA Section 2(j)? If so, what specific rules should the Commission consider and what would be the benefits of adopting them?

Response: The Working Group submits its response to this question under Part III.B, above.

D. SPECIFIC REQUESTS FOR COMMENT ADDRESSING NOTIFICATION OF THE COMMISSION.

Question: 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?

Response: The Working Group submits its response to this question under Part III.A, above.

Question: 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?

Response: The Working Group submits its response to this question under Part III.A, above

Question: 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?

Response: The Working Group submits its response to this question under Part III.A.2, above.

Question: 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: The Working Group submits that no additional compliance practices are required. The transactions at issue are governed by the terms of industry standard bilateral master agreements, which incorporate negotiated credit terms.

E. SPECIFIC REQUESTS FOR COMMENT ADDRESS THE HEDGING OF COMMERCIAL RISK.

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

Response: The Working Group supports the Commission's proposed definition of "commercial risk" in proposed CFTC Rule 39.6(c)(1). Non-financial commodities such as interest rate and foreign currency present risk that is central to the effective and efficient operations of a commercial enterprise. As such, swaps entered into to mitigate or hedge interest rate risk or currency risk should fall within the proposed definition of "commercial risk" and should be eligible for the End-User Exception (assuming the other qualifying requirements are satisfied).

Question: Commenters may also address whether swaps qualifying as hedging or risk mitigating should hedge or mitigate commercial risk on a single risk or an aggregate risk basis, and on a single entity or a consolidated basis.

Response: The Working Group submits its response to this question under Part III.C, above.

Question: Whether swaps facilitating asset optimization or dynamic hedging should be included; and whether hedge effectiveness should be addressed.

Response: The Working Group submits its response to this question under Part III.C, above.

V. OPEN COMMENT PERIOD.

Given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure over-the-counter derivatives markets, the Working Group respectfully requests that the Commission hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on proposed rules. The resulting comprehensive comments will allow the Commission to better understand how its proposed rules will impact swap markets.

VI. CONCLUSION.

The Working Group supports appropriate regulation that brings transparency and stability to the energy swap markets in the United States. The Working Group appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein as it develops a final rule in this proceeding.

The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, please contact the undersigned

Respectfully submitted,

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