Edison Electric Institute
Power by Association

epsa
Electric Power Supply Association
Advocating the power of competition

February 22, 2011

VIA ELECTRONIC SUBMISSION

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C.

Re: Definitions of Swap Dealer and Major Swap Participant (RIN 3038-AD06)

Dear Mr. Stawick:

The Edison Electric Institute ("EEI") and Electric Power Supply Association ("EPSA") (hereafter "Joint Associations") respectfully submit these comments in response to the Commodity Futures Trading Commission's ("Commission" or "CFTC") and Securities and Exchange Commission's December 21, 2010 joint proposed rule (the "Proposed Rule") further defining key terms contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1]

The Joint Associations appreciate the opportunity to provide the CFTC with their comments on the impact that the definitions of "swap dealer," "major swap participant," and "hedging or mitigating commercial risk" may have on the business operations of physical energy companies and other commercial end-users of swaps. Because the Joint Associations' members use, process, produce and market energy commodities, these comments focus primarily on the commodity-related aspects of the definitions in the Proposed Rule. The Joint Associations have been active participants in the Commission's Dodd-Frank Act rulemaking process, and welcome the opportunity to continue to discuss these issues further with the Commission and its staff.

I. Preliminary Statement

The definition of "swap" is the predicate for all of the Commission's rules implementing the Dodd-Frank Act. However, under the Commission's regulatory implementation schedule, the Joint Associations and other interested parties must submit comments on many proposed rules that are directly and significantly linked to the definition of "swap," including the proposed definition of "*swap* dealer" and "major *swap* participant," before the Commission has further defined this fundamental term. It is difficult for the Joint Associations and other interested

---

[1] 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, RIN 3038-AD06 (Dec. 21, 2010); Pub. L. No. 111-203 (2010).

parties to review and provide complete and meaningful comments in response to the Proposed Rule without prior notice of how the Commission will define what constitutes a "swap."

For purposes of these comments, the Joint Associations rely on the definition in Section 721(a) of the Dodd-Frank Act, which generally provides that "swap" means an agreement that, by its terms, settles financially and that, in most cases, involves an exchange of fixed-for-floating payments based upon the value of a notional quantity of a commodity.[2] To the extent the Commission further defines "swap" in a manner that modifies materially the commonly understood meaning of this term, the Joint Associations respectfully reserve the right to amend and supplement these comments.[3]

II. Summary of the Joint Associations' Comments

- The Joint Associations believe that the intent of the Proposed Rule is to implement Congress' intent to exclude commercial end-users of swaps from the definition of swap dealer and major swap participant. Accordingly, the Joint Associations' comments, including our recommended revisions to the proposed definitions, are designed to clarify the regulatory text in a manner that is consistent with the Commission's statutory mandate. For further clarification, the Joint Associations provide a number of examples to illustrate how our proposed regulatory text would apply to specific hedging and other swap activities.

- The Joint Associations recommend that the Commission simplify the *de minimis* exception by focusing only on the aggregate effective notional amount of an entity's dealing activity relative to the size of the U.S. swap market.

- The Joint Associations recommend that the Commission provide in the final rule that transactions which transfer commercial risks between affiliated persons will not be considered in determining whether a person is engaged in swap dealing or holds a substantial position in swaps.

- Finally, the Joint Associations recommend that the Commission adopt a broad and commercially practicable definition of "hedging or mitigating commercial risk" that is generally consistent with the definition in the Proposed Rule.

---

[2] A fixed-for-floating swap falls within the definition of swap in Section 721(a), which provides that the term "swap" includes a contract "that provides on an executory basis for the exchange . . . of 1 or more payments based on the value . . . of 1 or more . . . commodities . . . and that transfers, as between the parties . . . the financial risk associated with a future change in any such value . . . without also conveying a current or future direct or indirect ownership in [the underlying commodity]." Dodd-Frank Act § 721(a) (to be codified as CEA § 1a(47)(A)(iii)).

[3] The Joint Associations refer the Commission to EEI's comments filed on September 20, 2010 in response to the Advance Notice of Proposed Rulemaking regarding key definitions in the Dodd-Frank Act. Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51,429 (Aug. 20, 2010).

III. Description of the Joint Associations and Their Interest in the Proposed Rule

EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry. EEI also has more than 65 international electric companies as Affiliate members, and more than 170 industry suppliers and related organizations as Associate members.

EPSA is the national trade association representing competitive power suppliers, including generators and marketers. These suppliers, which account for nearly 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers.

The Joint Associations represent members that are active participants in many aspects of the physical electricity business. They own and operate electric generation, transmission and distribution facilities. They generate, transmit, and supply electricity to wholesale and retail customers. The Joint Associations' members are not financial entities, engaged in a financial business, or most importantly, in a regular business of dealing in swaps. Rather, as commercial end-users, the Joint Associations' members rely on cost-effective, customized swaps to protect them and their customers from volatile changes in the prices of electricity, natural gas and other commodities related to the generation, purchase, sale, and transmission of electricity. Swaps enable end-users to *reduce* risk by offsetting their exposure to commodity prices and other unpredictable variables that are an inherent part of operating any commercial businesses. At times, some of the Joint Associations' members also may take proprietary positions in swaps to benefit from changes in the price of the underlying commodity.

The Joint Associations have a significant interest in the Proposed Rule. In particular, the way in which the Commission defines key terms in the Dodd-Frank Act, including "swap dealer" and "hedging or mitigating commercial risk," will have a direct and substantial impact on how their members manage their commercial risk and their ability to continue to provide reliable energy at predictable prices to their customers. Although the Joint Associations believe that the Proposed Rule generally implements Congress' intent to exclude commercial end-users of swaps from the definition of swap dealer and major swap participant, we are providing the Commission with these comments, including suggested modifications of the Proposed Rule, to further clarify the definitions in a manner that is consistent with the Commission's statutory mandate.

IV. The Commission Should Clarify the Definition of Swap Dealer

Title VII of the Dodd-Frank Act establishes a new framework for the regulation of swaps and participants in the swap markets. Although Title VII implements a "comprehensive" regulatory regime for swaps, it does not regulate every swap and every swap market participant in the same way. As the Commission notes in the Proposed Rule, the goal of Title VII is to "reduce risk, increase transparency, and promote market integrity within the financial system . . .

by [among other things] [p]roviding for the registration and comprehensive regulation of swap dealers . . . and major swap participants."[4] By its own terms, Title VII does *not* regulate commercial end-users or other entities that, due to the type or volume of their swap activity, do not increase risk, or undermine financial integrity within the financial system. Indeed, as Congressman Collin Peterson explained, when Congress passed the Dodd-Frank Act "[it] focused on creating a regulatory approach that permits the so-called end-users to continue using derivatives to hedge risks associated with their underlying businesses, whether it is energy exploration, manufacturing or commercial activities. End-users did not cause the financial crisis of 2008."[5]

The Dodd-Frank Act defines "swap dealer" based upon the types and regularity of swap-related activities (*i.e.*, dealing or market-making as a regular business) and conduct (*i.e.*, holding itself out as a dealer) in which a person engages.[6] Under Section 1a(49) of the Commodity Exchange Act, as amended ("CEA"), an entity is a swap dealer if it: (1) holds itself out as a dealer in swaps; (2) makes a market in swaps; (3) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.[7] In addition, the Dodd-Frank Act explicitly excludes from the definition of swap dealer any entity that "enters into swaps for such person's own account, either individually or in a fiduciary capacity, *but not* as a part of a regular business"[8] or that engages in a "*de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers."[9]

According to the Commission's interpretive guidance in the preamble to the Proposed Rule, the Commission seeks to further define swap dealer "in a functional manner" that considers both the nature of an entity's activities and how the market generally perceives those activities.[10] In the Commission's view, "persons who enter into swaps as a part of a 'regular business' are those persons *whose function* is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties." Conversely, the Commission explained that "persons who do not fulfill this function [(*i.e.*, who do not accommodate demand for swaps from other parties, or enter into swaps in response to interest expressed by other parties)] should not be deemed to enter into swaps as part of a 'regular business' and are not likely to be swap dealers."[11]

---

[4] 75 Fed. Reg. at 80,174.

[5] 156 Cong. Rec. H5245 (daily ed. June 30, 2010) (statement of Rep. Collin Peterson).

[6] 75 Fed. Reg. at 80,175.

[7] Dodd-Frank Act § 721(a) (to be codified as CEA § 1a(49)).

[8] Dodd-Frank Act § 721(a) (to be codified as CEA § 1a(49)(C)) (emphasis added).

[9] Dodd-Frank Act § 721(a) (to be codified as CEA § 1a(49)(D)).

[10] 75 Fed. Reg. at 80,176.

[11] 75 Fed. Reg. at 80,177.

The Joint Associations agree with the Commission that, to the extent that an entity accommodates demand for swaps (above a *de minimis* level) as a regular business (rather than hedging or trading), it is engaged in "dealing," and must register with the CFTC and comply with all regulatory requirements applicable to swap dealers. At the same time, the Joint Associations believe that under the Proposed Rule and consistent with Congress' intent, electric utilities, suppliers, and other non-financial entities in the physical commodity markets that use swaps primarily to hedge or mitigate the commercial risks associated with their businesses, to benefit from future changes in the price of the underlying commodity, or for price discovery should not be required to register as swap dealers.

Even though the Proposed Rule is generally consistent with the language of the Dodd-Frank Act and Congress' expressed intent regarding the treatment of commercial end-users, the Joint Associations believe that the Commission can provide greater certainty for market participants and more effectively advance the Dodd-Frank Act's goal of promoting financial stability by modifying the final regulatory text to define with more detail the activities that constitute dealing, and therefore, which entities will be required to register as swap dealers.[12] For example, the Joint Associations believe that the regulatory text should clarify that accommodating demand for swaps from other parties and entering into swaps in response to interest expressed by other parties will constitute entering into swaps as part of a "regular business." In addition, the Joint Associations believe that the regulatory text should expressly exclude from a person's "regular business" swaps that hedge or mitigate a person's commercial risk, swaps that are entered into for the purpose of benefiting from future market price changes, and most swaps entered into on an exchange. Although the Proposed Rule implicates many of these concepts, the text provides little practical guidance for market participants.[13]

---

[12] *El Comite Para El Bienestar De Earlimart v. Warmerdam*, 539 F.3d 1062, 1070 (9th Cir. 2008) (describing language in the preamble published in the Notice of Proposed Final Rulemaking as "sources that have little legal traction," and explaining that "the preamble language should not be considered unless the regulation itself is ambiguous. . . . [because] unlike the statute's operative part, the preamble does not 'prescribe rights and duties and otherwise declare the legislative will,' nor does it 'enlarge or confer powers on administrative agencies or officers.'") (internal citations omitted).

[13] The purpose of regulatory text is to provide clarity and certainty for market participants. To this end, the Joint Associations believe that the Commission's approach to further defining the term "major swap participant" is more useful for market participants because it provides clear guidelines that a person can use to determine whether or not it will fall within the definition. In contrast, the proposed definition of "swap dealer" provides little detail beyond the language provided in the statute. Without commenting on the specifics of the proposed definition of "major swap participant," the Joint Associations believe that the method that the Commission has used to further define "major swap participant" is effective and should, to the extent possible, be used for the definition of "swap dealer" as well.

The Joint Associations respectfully submit that the following amendments to the proposed definition of swap dealer will increase regulatory certainty and predictability for physical commodity market participants, particularly in the electricity markets, while remaining consistent with the purpose of the Dodd-Frank Act (additions to the Commission's proposed text are underlined):

(ppp) *Swap Dealer.* (1) In general. The term "*swap dealer*" means any person who:

(i) Holds itself out as a dealer in swaps;

(ii) Makes a market in swaps;

(iii) Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

(iv) Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.

(A) "Dealer" means a person that makes a market in swaps.

(B) "Makes a market" or "making a market" means regularly quoting bid and offer prices for, and standing ready to enter into, a swap for a person's own account for the purpose of accommodating customer transactions.

provided, however, that in no event shall a person be considered to be a swap dealer to the extent that it enters into transactions for the purpose of transferring risk within a group of affiliated persons.[14]

(2) *Exception.* The term "*swap dealer*" does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of [a] regular business.[15]

---

[14] The treatment of inter-affiliate swaps is discussed in detail in Section VII below.

[15] Section 721(a) of the Dodd-Frank Act excepts swap activity that is entered into, "but not as a part of *a* regular business." Dodd-Frank Act § 721(a) (emphasis added). In contrast, the Proposed Rule refers to swap activity that is entered into "but not as a part of regular business." 75 Fed. Reg. at 80,212. The Joint Associations believe that the Proposed Rule's use of "regular business" rather than "a regular business" was an inadvertent error that will be corrected when the final rule is promulgated.

(i) The term "Regular Business" means a usual business activity of a person whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties.[16]

(A) The term "accommodate demand" means enters into swaps to satisfy a business need of other parties.

(B) The term "interest expressed by other parties" means requests by other parties to enter into swaps for the purpose of satisfying their business purposes.

(ii) The following activities do not constitute a Regular Business for purposes of this provision:[17]

(A) Entering into swaps for the purpose of hedging or mitigating commercial risk, as defined in Section 1.3(ttt);

(B) Entering into swaps for the purpose of benefiting from future changes in the price of the underlying commodity;

(C) Entering into swaps on a designated contract market or swap execution facility, unless such swaps are entered into by a party who holds itself out as making a market in the corresponding category of swaps.[18]

The Joint Associations' proposed regulatory text is consistent with the plain language of the Dodd-Frank Act and further implements Congress' expressed intent for the Commission to define "swap dealer" in a manner that does not "regulate end-users . . . just because they use

---

[16] Because Congress did not define the term "regular" in the Dodd-Frank Act, the Joint Associations have interpreted this term consistently with its common meaning. *Perrin v. United States*, 444 U.S. 37 (1979) ("A fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning.") Accordingly, the Joint Associations interpret "regular" as meaning "usual, customary, normal or general." Gerald v. American Cas. Co. of Reading, Pa., 249 F. Supp. 355, 357 (M.D.N.C. 1966); *see also Black's Law Dictionary* 1398 (9th ed. 2009) (defining "regular course of business" as an "ordinary course of business").

[17] In the alternative, the Joint Associations' suggested clarifications to the definition of "Regular Business" could be made in the form of exclusions from the general definition of "Swap Dealer" in proposed Part 1.3(ppp)(1) above.

[18] Some exchanges and trading platforms (*e.g.*, ICE) allow certain parties that trade for exclusively non-hedging purposes to be designated as "market makers." Unlike other traders, market makers receive tangible benefits (*e.g.*, no trading fees, rebates, etc.) in exchange for performing certain contractually defined responsibilities (*e.g.*, being ready, willing and able to effect transactions, and/or provide bids and offers to other market participants). The Joint Associations do not believe that making a market, whether on a designated contract market or swap execution facility or elsewhere, should be excluded from the definition of a Regular Business.

swaps to hedge or manage the commercial risks associated with their business."[19] Furthermore, the Joint Associations' proposed regulatory text will provide commercial participants in the physical commodity markets with practical guidelines as to how the statutory exceptions to the definition of "swap dealer" will apply to their most common swap-related activities. For example:

Proposed Regulatory Text	Reason for Clarification
Entering into swaps for the purpose of hedging or mitigating commercial risk, as defined in Section 1.3 (ttt).	Swaps used for the purpose of hedging or mitigating commercial risk are not part of a Regular Business of a swap dealer because they do not accommodate demand in response to a request from other parties. Instead, they hedge a company's commercial risks, and are in fact the demand that the swap dealer accommodates.
Entering into swaps for the purpose of benefiting from future changes in the price of the underlying commodity.	Swaps entered into for the purpose of benefiting from future changes in the price of the underlying commodity are not part of a Regular Business of a swap dealer because they do not accommodate demand in response to a request from other parties. They are entered into for the purpose of earning profits through speculation.[20] Congress regulated large speculators and other traders in the swaps markets separately by requiring the registration and regulation of major swap participants.[21]
Entering into swaps on a designated contract market or swap execution facility, unless such swaps are entered into by a person who holds itself out as making a market in the corresponding category of swaps.	Entering into swaps on an exchange generally does not constitute "dealing" because the swaps, like futures contracts, are entered into through an organized market where the counterparty is the clearinghouse. Unless offered by a market-maker, neither party to the swap is "accommodating demand" or responding to other parties' interest in a particular transaction.

[19] 156 Cong. Rec. H5248 (daily ed. June 30, 2010) (Letter from Sen. Christopher Dodd and Sen. Blanche Lincoln to Rep. Barney Frank and Rep. Collin Peterson) ("Dodd-Lincoln Letter").

[20] The proposed rule implementing the end-user exception to the mandatory clearing of swaps stated that, in contrast to swaps held to hedge or mitigate commercial risk, "swap positions that are held for the purpose of speculation or trading are... positions... 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." End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80,747, 80,752 n.23 (Dec. 23, 2010). Similarly, the CFTC's web site defines a "trader" as either "[a] merchant involved in cash commodities [or] a professional speculator who trades for his own account and who typically holds exchange trading privileges." CFTC Glossary, available at http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/.

[21] Dodd-Frank Act § 731 (to be codified as CEA § 4s).

V. The Commission Should Modify and Simplify the "*De Minimis*" Exception From the Definition of "Swap Dealer"

The Dodd-Frank Act provides an independent exception from the definition of swap dealer for any entity that "engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers."[22] Although the swap dealer definition generally focuses on the type of swap activities that an entity engages in, rather than the "amount or significance" of those activities, as the Proposed Rule explains, "the '*de minimis*' exemption . . . [is meant to] address amounts of dealing activity that are sufficiently small that they do not warrant registration to address concerns implicated by the regulations governing swap dealers . . . ."[23]

The Commission acknowledged that the *de minimis* standard "does not . . . readily translate into objective criteria" and that "a range of alternative approaches may be reasonable."[24] Nevertheless, the Proposed Rule defines a *de minimis* quantity of swap dealing as an amount of swap activity that is below *all* of the following objective thresholds:

- The aggregate effective notional amount (measured on a gross basis) of swaps entered into over the preceding 12 months in connection with dealing activities must not exceed $100 million;
- The aggregate effective notional amount of swaps with "special entities" over the preceding 12 months in connection with dealing activities must not exceed $25 million;
- The entity must not enter into swaps as a dealer with more than 15 counterparties over the prior 12 months; and
- The entity must not enter more than 20 swaps as a dealer over the prior 12 months.[25]

---

[22] Dodd-Frank Act § 721 (to be codified as CEA § 1a(49)(D)). "Congress incorporated a de minimis exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation." Dodd-Lincoln Letter. *See also* 75 Fed. Reg. at 80,179 ("The Commissions preliminarily believe that the '*de minimis*' exemption should be interpreted to address amounts of dealing activity that are sufficiently small that they do not warrant registration to address concerns implicated by the regulations governing swap dealers and security-based swap dealers.").

[23] 75 Fed. Reg. at 80,179. Contrary to the Commission's observation with respect to the notional amount element of its proposed criteria, there is no indication in the text of the *de minimis* exception or related Congressional statements that the exception focuses on "the customer protection issues raised by swaps . . . ." 75 Fed. Reg. at 80,180.

[24] 75 Fed. Reg. at 80,180.

[25] 75 Fed. Reg. at 80,218.

The Joint Associations respectfully suggest that the most meaningful measure of the magnitude of "swap dealing" activity is the aggregate effective notional amount of an entity's dealing activity, measured on a gross basis over a discrete period of time. An entity's aggregate effective notional amount of swap dealing reflects both the gross volume of swap activity that the entity engages in, and the relative monetary value of that activity. In contrast, neither the number of swaps that an entity may enter into with one or more swap counterparties, nor the number of swap counterparties that a person trades with over a 12-month period, in each case without regard to the exposure created by those swaps, are meaningful proxies for determining whether that entity is engaged in a sufficient volume of dealing activity to warrant regulation as a swap dealer under the CEA.[26] Indeed, the Commission has not explained how entering into more than 20 swaps or entering into swaps with more then 15 counterparties over a twelve month period without being registered as a swap dealer might adversely affect "Title VII's orderly market goals."[27] A small volume of swap activity, whether it is concentrated in a single transaction or divided among numerous counterparties, is not material to the underlying purposes of the Dodd-Frank Act.[28]

The Joint Associations recommend that the Commission adopt a higher threshold that is explicitly linked to the aggregate gross notional size of the U.S. swap market as the notional amount of swaps that qualifies for the *de minimis* exception.[29] In particular, the Joint Associations recommend that the Commission set the threshold for the *de minimis* exception at 1/1,000th of a percent of the aggregate gross notional size of the U.S. swap market over the preceding 12 months, or 1/10,000th of a percent of the aggregate gross notional size of the U.S. swap market over the preceding 12 months for swaps in which the counterparty is a "special entity." This level of swap dealing activity more accurately corresponds to an amount that arguably could pose a potential risk to the stability of the financial system. In contrast, the Commission's proposed *de minimis* levels of $100 million and $25 million likely will capture

---

26 The Joint Associations further note that placing artificial limits on the number of counterparties and swaps that an entity may enter into before potentially falling within the swap dealer definition may provide a disincentive for market participants to enter into swaps with small notional values with small market participants. As a result, these limits could reduce liquidity for many small commercial entities who rely on small notional value derivatives products.

27 75 Fed. Reg. at 80,180.

28 The stated purpose of the Dodd-Frank Act is, among other things, "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ''too big to fail'', to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices . . . ." Dodd-Frank Act, preamble.

29 In testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on February 17, 2011, Commission Chairman Gary Gensler stated that, "[t]he swaps market that the [Dodd-Frank Act] tasks the CFTC with regulating has a notional amount roughly seven times the size of that of the futures market and is significantly more complex. Based upon figures compiled by the Office of the Comptroller of the Currency, the largest 25 bank holding companies currently have $277 trillion notional amount of swaps."

many entities "for which registration would not be warranted from a regulatory point of view in light of the limited nature of their dealing activities."[30]

The Joint Associations suggest that the Commission modify the proposed regulatory text as follows:

(4) *De minimis exception.* A person shall not be deemed to be a swap dealer as a result of swap dealing activity involving counterparties, ~~that meets each of the following conditions :~~

~~(i) The swap positions connected with those activities into which the person enters~~ for which the associated swaps entered into over the course of the immediately preceding 12 months have an aggregate gross notional amount of no more than ~~$100 million~~ 1/1,000th of a percent of the total estimated gross notional size of the U.S. swap market, and have an aggregate gross notional amount of no more than ~~$25 million~~ 1/10,000th with regard to swaps in which the counterparty is a "special entity" (as that term is defined in Section 4s(h)(2)(C) of the Commodity Exchange Act). For purposes of this paragraph, if the stated notional amount of a swap is leveraged or enhanced by the structure of the swap, the calculation shall be based on the effective notional amount of the swap rather than on the stated notional amount.[31]

~~(ii) The person has not entered into swaps in connection with those activities with more than 15 counterparties, other than swap dealers, over the course of the immediately preceding 12 months. In determining the number of counterparties, all counterparties that are members of a single group of persons under common control shall be considered to be a single counterparty.~~

~~(iii) The person has not entered into more than 20 swaps in connection with those activities over the course of the immediately preceding 12 months. For purposes of this paragraph, each transaction entered into under a master agreement for swaps shall constitute a distinct swap, but entering into an amendment of an existing swap in which the counterparty to such swap remains the same and the item underlying such swap remains substantially the same shall not constitute entering into a swap.~~

---

[30] 75 Fed. Reg. at 80,180.

[31] The Joint Associations respectfully request that if the Commission declines to adopt *de minimis* thresholds based on a portion of the U.S. swap market, as recommended in this letter, that it provide market participants with an additional opportunity to review and comment on the regulatory text implementing the *de minimis* exception before promulgating a final rule.

These proposed modifications to the regulatory text are intended to clarify, using objective and functional terms, that the definition of *de minimis* is inherently tied to the size of the overall swap market. As the swap market grows or contracts, the definition of what is *de minimis* will rise and fall proportionally. The Joint Associations believe that the simple *de minimis* exception that focuses only on the aggregate effective notional amount of dealing activity, described above, will clarify and provide regulatory certainty for end-users without reducing the Commission's ability to regulate effectively those entities that regularly act as swap dealers and market-makers.

VI. Examples Illustrating the Practical Application of the Proposed Regulatory Text

Commercial entities in the electric utility industry are organized and operate in many different ways. To better explain how the Joint Associations' proposed regulatory text would apply to specific hedging and other swap activities, we set forth below for the Commission's consideration examples of how swaps are used as an integral part of several common business models in the electric industry. These examples illustrate, in practical terms, how the Joint Associations' proposed regulatory text would apply the swap dealer definition to the types of activities described below. This clarity is essential for the Joint Associations' members and other end-users that rely on swaps to manage effectively the risks associated with their businesses, and that need to know how their activities will be characterized under the final definitions.

Company No. 1 – Commercial Firm

> Company A owns an electric generating plant that sells in the electricity spot market. Company B is a retail seller of electricity that sells electricity to its customers at fixed prices, but purchases the electricity it sells in the spot market.
>
> Company A desires to hedge its spot sales exposure by entering into a swap in which it pays a floating price and receives a fixed price payment. Company B desires to hedge its spot purchase exposure by entering into a swap where it pays a fixed price and receives a floating price payment.
>
> Company A and Company B have bilateral trading documents and agreed credit terms in place. They are aware of each other's business needs and periodically communicate regarding the possibility of mutually beneficial trades to hedge their respective commercial risks.
>
> Company A and Company B enter into a swap where Company A is the floating price payer and Company B is the fixed price payer. The swap is priced such that Company B makes a margin between the fixed price it receives from its retail customers and the fixed price it pays to Company A. The floating price is the spot electricity price.

Company A and Company B would not be characterized as swap dealers. They each are entering into a swap to hedge their respective commercial risks. Company A has fixed its output price. Company B has locked in its margin and hedged its purchase price. While the companies could achieve the same result by using an intermediary, such as a swap dealer, their transaction is more economic because it does not involve an intermediary.

Company No. 2 – Power Generator

Company No. 2 is an electricity generating company that owns a fleet of power plants. The company enters into swaps to hedge the price risk of the collective output of the generating fleet by entering into longer-term transactions that fix the price it receives for that output, thereby avoiding the risk associated with volatility and market forces during the terms of those transactions and, to a lesser extent, to hedge the price risk associated with some of the fuel supply it uses to generate the electricity. Company No. 2 adjusts its swap position over shorter time frames to address changes in expected output by buying back swaps if it expects output to be lower, or entering into new swaps if it expects output to be higher, whether due to changing macroeconomic market fundamentals such as fuel price changes, changes in expected demand, or plant-specific events such as an extended forced outage. Principally to discover prices, Company No. 2 enters into a small number of swaps, subject to low VaR (value at risk) limits, that are not for hedging.

Company No. 2 would not be characterized as a swap dealer. Its swaps are primarily for the purpose of hedging or mitigating the commercial risk arising from its physical generation business. As such, Company No. 2 does not accommodate demand by entering into swaps in response to interest expressed by other parties. The only swaps Company No. 2 enters into, other than for the purpose of hedging, are primarily for the purpose of price discovery. Its portfolio or book of these types of trades, however, is a very small percentage of its total book of swaps to ensure that any losses are insignificant.

Company No. 3 – Energy Marketer

Company No. 3 is an energy marketing company with limited capital. Company No. 3 does not own production or act for affiliates that own production. Company No. 3 enters into swaps either to hedge physical forward index-based electricity contracts it has executed, or to take positions it finds economically advantageous based on its expectation of changes in prices of the underlying commodity over the terms of the swaps. Company No. 3 also makes a small market in natural gas swaptions.

Company No. 3 would not be characterized as a swap dealer. Its market-making activity falls below the Joint Associations' proposed *de minimis* threshold, and its other swaps activities are either hedging commercial risk or speculative transactions.

Company No. 4 – Financial Entity Business

Company No. 4 is a well-capitalized financial company that makes a market primarily in currency and interest rate swaps. In addition, Company No. 4 also makes markets in electricity swaps to capture the prevailing margin on the bid/ask spread. The regular business of Company No. 4's is to stand ready and willing to enter into multiple swap transactions in the hope of benefiting financially from them due to the differences between the prices it pays and the prices it receives in the market. Its swap dealing activity in electricity swaps exceeds the Joint Association's proposed *de minimis* threshold.

Company No. 4 would be characterized as a swap dealer in electricity swaps.

Company No. 5 – Financial Entity Commodity Business

Company No. 5 is identical to Company No. 4, except that Company No. 5 also owns two power plants. Company No. 5 has entered into contracts with public utilities to sell power covering a portion of the utilities' wholesale power requirements needed to serve some of their retail electric customers. In connection with this physical business, Company No. 5 enters into some swaps to hedge its obligations to the utilities, and other swaps to hedge its generation length.

Company No. 5 would be characterized as a swap dealer in electricity swaps. Despite its hedging activity relating to its physical positions, its market-making business in electricity swaps is in excess of the Joint Association's proposed *de minimis* threshold.

Company No. 6 – Investor Owned Utility

Company No. 6 is an investor owned electric utility whose regular business is providing retail electric services to residential, commercial and industrial customers within its service territory. It owns and operates electric transmission and distribution facilities needed to distribute power within the service territory. In addition, in order to meet its retail electric customer demand for power, it owns and operates a fleet of power generation plants. It also purchases the output of power plants owned by third parties and purchases power from the market not tied to the output of a specific power plant. To the extent that Company No. 6's portfolio of owned and contracted generation assets is greater than the requirements of its retail customers, Company No. 6 may sell that excess supply into the market and to third parties (or its FERC-designated regional transmission organization or independent system operator) at wholesale. Company No. 6 is extensively regulated by a state public utilities commission and has its retail service rates set by that commission.

Company No. 6(a): In some cases, rate regulation limits the revenues that Company No. 6 can collect for its services and allows it to recover prudently incurred costs of service,

including those incurred in the wholesale physical commodity markets. Its state regulator allows Company No. 6 to enter into swaps to hedge the price volatility of the wholesale physical markets for its retail electric customers to ensure predictable and steady retail rates. However, the state regulator places specific limits on Company No. 6's participation in the swaps markets. Such limits are designed to restrict trading activities to *bona fide* hedging activity and to avoid potential harm to retail electric customers from speculative activity that could undermine the financial stability of Company No. 6. Acting within the limitations of its state regulatory oversight, Company No. 6 enters into a swap to hedge the commercial risk inherent in the business of electric power supply and distribution. All of the benefits from the risk reduction received from its hedging activity are passed directly onto its retail electric customers by reducing the rates they would otherwise have to pay if Company No. 6 were unable to engage in that activity.

Company No. 6(b): In other cases, Company No. 6 is a traditional supplier of power to municipalities, cooperatives and small utilities that operate in and near its service territory. Company No. 6 engages in power and related natural gas trading, involving a combination of physical forward, futures and cleared and non-cleared swaps products. This trading is conducted variously for price discovery, to hedge its net generation and supply obligations, and also for purposes of benefiting from future changes in the price of the underlying commodities (electricity and natural gas). A substantial portion of the margins realized by Company No. 6 from its market activity, including its swaps activity, is shared with its retail electric customers and reduces the rates they would otherwise have to pay if Company No. 6 did not engage in that activity.

Company No. 6(a) would not be characterized as a swap dealer. Its swaps are exclusively for the purpose of hedging or mitigating the commercial risk arising from its obligation to provide electric service to its retail customers. Furthermore, Company No. 6(a) does not accommodate demand by entering into swaps in response to interest expressed by other parties. Rather, Company No. 6 enters into swaps to hedge its commercial risk.

Company No. 6(b) also would not be characterized as a swap dealer. Its trading activities in swaps are either for purposes of price discovery, hedging its physical generation and supply obligations, or to benefit from future changes in the price of electricity and natural gas.

Company No. 7 – Generator Asset Management

Company No. 7 is an energy management company that provides forecasting, bidding, fuel procurement and power scheduling services for affiliated and third-party entities that own power plants. Company No. 7 is in a fee-for-service business. Company No. 7's business is to assist power plants in interfacing with the physical electricity market. Accordingly, it interfaces on behalf of the power plants with grid operators and fuel providers, and provides advice concerning market conditions to the power plant owners.

In limited circumstances, as an adjunct to its services, Company No. 7 enters into swaps with the power plant owners and exchanges and/or other parties to hedge the fuel and power price risks of the power plants. Company No. 7 recovers the cost of such hedges, along with charges for forecasting, bidding, fuel procurement and/or power scheduling from the third-party generator as part of its generator management service. Company No. 7 does not provide this service to market participants that are not fee-for-service generator asset management customers, nor does it make a market for any category of swaps.

The activities of Company No. 7 would not be characterized as swap dealing. It performs the same functions and engages in the same activities as would the plant owner if it had the capabilities and experience to do so for itself. It is a service provider that procures fuel and offers the physical output of power plants into the electric markets. Company No. 7's limited swap activity does not accommodate demand by entering into swaps in response to interest expressed by other parties. Company No 7. does not make markets or engage in a regular swaps business. Its swap activities are merely a "pass through" service to its generator asset management customers.

Company No. 8 – Retail Energy Provider

Company No. 8 is a retail energy supplier in the business of providing retail electricity to residential, commercial and industrial customers. The local utility owns the distribution facilities and delivers the electricity to consumers on behalf of the retail energy supplier. The retail energy supplier purchases supply from energy marketers and generators, including affiliated generators, to serve its customers. When the retail energy supplier sells fixed price power, it enters into swaps to hedge its forward price risk.

Company No. 8 would not be characterized as a swap dealer. Its swaps are exclusively for the purpose of hedging or mitigating the commercial risk arising from its obligation to provide retail electric service to its end-user customers. Furthermore, Company No. 8 does not accommodate demand by entering into swaps in response to interest expressed by other parties. Company No. 8 enters into swaps to hedge commercial risk.

VII. The Commission Should Exclude Transactions that Transfer Risk Between Affiliates When Considering Whether an Entity is Acting as a Swap Dealer or a Major Swap Participant

Many affiliated groups of companies, including members of the Joint Associations, use a central hedge desk located within one affiliate to manage the commercial risks associated with their commodity businesses, and to reduce their hedging and trading transaction costs. Affiliates within the group transfer their price risk to the central hedging affiliate, which in turn will hedge that risk on an exchange or through an over-the-counter swap with a swap dealer or other commercial end-user. The hedging affiliate and other affiliates typically effect these internal risk transfers through entries in their respective trade capture or other accounting systems without

sending confirmations.[32] The Commission is well aware of this widespread commercial practice and has issued interpretations confirming that it is permitted under the CEA.[33]

The Joint Associations believe that the Dodd-Frank Act and the Commission's implementing regulations should not limit the prudent and long-standing internal risk management practices of physical commodity market participants.[34] Indeed, the Commission acknowledged in the Proposed Rule that "[s]waps . . . between persons under common control may not involve the interaction with unaffiliated persons that we believe is a hallmark of the elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a dealer."[35] Similarly, in the context of the definition of "major swap participant," the Commission explained that "swaps . . . among wholly-owned affiliates may not pose the exceptional risks to the U.S. financial system that are the basis for the major participant definitions."[36] Accordingly, the Commission stated that "when a person analyzes its swap . . . positions under the major participant definitions, it would be appropriate . . . to consider the economic reality of any swaps . . . it enters into with wholly owned affiliates, including whether the swaps . . . simply represent an allocation of risk within a corporate group."[37]

The Joint Associations agree that internal risk transfers between affiliated companies do not implicate the key market-facing attributes of swap dealing activity and do not "pose a high degree of risk to the U.S. financial system generally" that would warrant regulation as either a swap dealer or a major swap participant.[38] These longstanding practices are based on sound risk management protocols and are not designed to evade the regulatory requirements applicable to

---

[32] In the case of an end-user, regardless of whether it hedges directly or through an affiliate, the goal of the transaction is to manage its commercial risk by entering into futures or swap transactions.

[33] *See*, *e.g.*, CFTC Division of Trading and Markets, 1994 CFTC Ltr. No. 94-95 Lexis 42, at *1-2 (May 9, 1994) ("Commission staff historically has considered commonly owned and controlled entities to be a single entity or the 'same person' for purposes of compliance with Commission regulation 1.3(z) [regarding bona fide hedging]. As to EFPs, the Commission staff previously has focused ... on the legitimacy of the cash leg of an EFP and the nature of the relationship between the contra parties. The staff has not required that ... the same legal entity handle both the physical and futures legs on one side of an EFP.")

[34] Companies should be allowed to structure their business operations as efficiently as possible as long as that structure is consistent with the over-arching goals of the Dodd-Frank Act, which seeks to promote, not limit, prudent risk management practices. As Rep. Collin Peterson explained, in passing the Dodd-Frank Act, Congress "focused on creating a regulatory approach that permits the so-called end-users to continue using derivatives to hedge risks associated with their underlying businesses . . . ." 156 Cong. Rec. H5245 (daily ed. June 30, 2010) (statement of Rep. Collin Peterson).

[35] 75 Fed. Reg. at 80,183.

[36] 75 Fed. Reg. at 80,202.

[37] *Id.*

[38] 75 Fed. Reg. at 80,185.

swap dealers and major swap participants. Accordingly, the Joint Associations request that the Commission state explicitly in the final rule that it will not consider transactions that transfer risk between affiliates in determining whether an entity is acting as a swap dealer or a major swap participant. The Joint Associations respectfully submit that the following modification to the proposed definition of "swap dealer" will achieve this result:

> (ppp) *Swap Dealer.* (1) In general. The term "*swap dealer*" means any person who:
>
> * * * * *
>
> provided, however, that in no event shall a person be considered to be a swap dealer to the extent that it enters into swaps transactions for the purpose of transferring risk within a group of affiliated persons.

Similarly, the Joint Associations respectfully submit that the following modification to the proposed definition of "substantial position" will further clarify which entities will be required to register as major swap participants:

> (sss) *Substantial position.* (1) *In general.* For purposes of Section 1a(33) of the Commodity Exchange Act and § 1.3(qqq), the term substantial position means swap positions, other than positions that transfer risk within a group of affiliated persons and other positions that are excluded from consideration, that equal or exceed any of the following thresholds in the specified major category of swaps:

The foregoing clarifications by the Commission would provide end-users with certainty that the common business practice of transferring risk across entities within a group of affiliated persons will continue to be permitted under the CEA, as amended by the Dodd-Frank Act.[39]

VIII. The Commission Should Adopt a Broad and Commercially Practicable Definition of "Hedging or Mitigating Commercial Risk."

Section 721(b) of the Dodd-Frank Act provides that the Commission "may adopt a rule to define . . . the term 'commercial risk'; and . . . any other term included in an amendment to the Commodity Exchange Act . . . ." The Joint Associations support the Commission's decision to propose a generally broad and consistent definition of commercial risk for all sections of the CEA. As the Commission notes in the Proposed Rule for the End-User Exception to Mandatory Clearing of Swaps, a parallel approach to defining "hedging or mitigating commercial risk"

---

[39] Making this clarification would not run contrary to the Commission's belief "that the word 'person' in the swap dealer and security-based swap dealer definitions should be interpreted to mean that the designation applies with respect to a particular legal person." *See* 75 Fed. Reg. at 80,183.

allows "consistency of interpretation across the CEA as a whole and help[s] provide for fair and equivalent treatment for similarly situated parties."[40]

In the Proposed Rule, the Commission requests comment on various aspects of the proposed definition of "hedging or mitigating commercial risk." Many of the Commission's questions relate to how, when, and to what extent the Commission should judge the "effectiveness" or intended purpose of hedging transactions. For example, the Commission specifically asks:

- Should the test be generally identical to the proposed test, but with the substitution of the phrase "highly effective" or "reasonably effective" (or another standard) for "economically appropriate"?
- If a swap that was hedging at inception were no longer to serve a hedging purpose over time, should it no longer fall within the definition of hedging or mitigating commercial risk?
- Is it appropriate not to permit any speculative or trading positions from being deemed for the purpose of hedging or mitigating commercial risk?

The Joint Associations generally support the proposed definition of "hedging or mitigating commercial risk." However, the Joint Associations respectfully request that the Commission finalize the proposed definition consistently with the comments below. A practical definition of hedging or mitigating commercial risk, coupled with a flexible standard for evaluating hedging effectiveness, will allow end-users to continue to hedge their risk in an efficient and commercially practicable manner.

The Joint Associations believe that the Commission should retain the phrase "economically appropriate" in the proposed definition, and should not adopt a test for whether an entity is "hedging or mitigating commercial risk" that relies on whether a hedge is "highly effective" or "reasonably effective."[41] Requiring market participants to demonstrate that hedges

---

[40] End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80,747, 80,753 (Dec. 23, 2010).

[41] The Joint Associations note that a "highly effective" hedging standard is currently used under Financial Accounting Standards Board Accounting Standards Codification Topic 815, formerly known as Statement No. 133 ("FASB Statement No. 133"). As proposed, a swap position may be characterized as "hedging or mitigating commercial risk" if it: (1) qualifies as bona fide hedging under CEA rules; (2) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise in the ordinary course of business and the swap satisfies certain other requirements; *or* (3) qualifies for hedging treatment under FASB Statement No. 133. 75 Fed. Reg. at 80,214-15. In other words, companies that currently rely on FASB Statement No. 133 can also characterize their hedging transactions as "hedging or mitigating commercial risk." However, many companies do not elect "hedge treatment" under FASB Statement No. 133 because it imposes substantial administrative burdens. The Joint Associations urge the Commission not to modify the proposed definition of "hedging or mitigating commercial risk" to include a "highly effective" hedging standard or in any other way that may, inadvertently, require companies to use "hedge treatment" FASB Statement No. 133 when doing so is not otherwise necessary.

are "highly effective" would impose a subjective standard that, in practice, would be difficult for most entities to satisfy on a continuous basis, and would do little, if anything, to reduce systemic risk. Hedging commercial risk involves managing a number of complex and, in some cases, constantly changing variables such as the price, term, quantity, commodity-type and delivery location, and in the case of options, volatility, of the underlying transaction. Members of the Joint Associations deliver power and purchase fuels at thousands of locations throughout the United States. As a result, many of their transactions expose them to basis risk by commodity type and delivery location. In addition, the volumes of long-term transactions change over their term as capacity and demand fluctuates. Because of these many complex variables, it generally is not possible always to execute and maintain perfect hedges. A standard that only acknowledges perfect (or near-perfect) hedges would be inconsistent with the commercial risks that physical market participants must manage on a daily basis.

Similarly, the Commission should consider whether a position hedges or mitigates commercial risk only when the position is established. The Joint Associations believe that ongoing assessment and reporting of hedging effectiveness will be costly both in terms of new technology and personnel. The "appropriateness" of a particular hedge is reflected more properly in a market participant's view of conditions and forecasts when it executes or confirms the transaction rather than in a post-hoc analysis of events occurring after the execution or confirmation of the same transaction. If a hedge turns out to be less effective than originally anticipated, it should not affect a market participant's status as an end-user or obviate the fact that the transaction was entered into as a hedge. A one-time assessment of the hedging or mitigating character of a swap represents a practical and effective way to delineate between hedges and non-hedges.[42]

A swap that does not perfectly hedge a related physical position should not be deemed to be speculative if its intended *purpose* is to hedge or mitigate commercial risk. As explained above, the performance of a hedge is contingent on market conditions, and may change over time. Such changes should not cause a swap to be considered speculative retroactively if the swap was correctly characterized as a hedging or mitigating transaction when it was executed. In addition, whether a hedger intends to hold a position for a short or a long period of time is not relevant to whether the position hedges or mitigates commercial risk. The general relationship of a swap to an underlying commercial risk that needs to be hedged, not the precision of the hedge or changes in the duration of the underlying risk, distinguishes hedging positions from other swap positions.

---

[42] For example, the Commission's current rules for *bona fide* hedging transactions or positions for futures look at the character of a trade at its inception and not thereafter. *See* 17 C.F.R. § 1.3(z).

IX. Conclusion

The Joint Associations commend the Commission for its commitment to implementing the Dodd-Frank Act's intent to safeguard the hedging and trading activities of end-users of physical commodities and swaps, and look forward to continuing to work constructively with the Commission throughout the Dodd-Frank Act rulemaking process. We welcome the opportunity to discuss these issues further with the Commission and its Staff at your convenience.

Please contact us at the numbers listed below if you have any questions about the Joint Associations' comments.

Respectfully submitted,

Richard F. McMahon, Jr.
Vice President
Edison Electric Institute
701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
Phone: (202) 508-5571
Email: rmcmahon@eei.org

Dan Dolan
Vice President, Policy Research & Communications
Electric Power Supply Association
1401 New York Avenue, N.W., 11th Floor
Washington, D.C. 20005
Phone: (202) 349-0153
Email: ddolan@epsa.org

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner
Dan M. Berkovitz, General Counsel
Terry S. Arbit, Deputy General Counsel
Mark Fajfar, Assistant General Counsel
Julian E. Hammar, Assistant General Counsel
David E. Aron, Counsel