February 22, 2011

VIA ELECTRONIC SUBMISSION

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581

Re: Comments on Proposed Rule Regarding End-User Exception to Mandatory Clearing of Swaps (RIN 3038–AD10)

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 proposed rule ("Proposed Rule") issued by the Commodity Futures Trading Commission ("CFTC" or "Commission") regarding the end-user clearing exception in Section 723 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The Joint Associations have been active participants in the Commission's Dodd-Frank Act rulemaking process, and welcome the opportunity to continue to discuss end-user-related issues with the Commission and its staff.

The Dodd-Frank Act reflects Congress' intent to provide end-users with broad exemptions from the registration and clearing requirements of the Commodity Exchange Act, as amended by the Dodd-Frank Act ("CEA"). The Joint Associations respectfully submit that, in implementing the requirements of the Dodd-Frank Act, the Commission should ensure that, consistent with Congress' intent, end-users and their non-financial affiliates are able to avail themselves of the end-user clearing exception in a commercially practical manner for all transactions that hedge or mitigate commercial risk.

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 rule implementing the end-user exception to mandatory clearing of *swaps*, before the Commission has further defined this fundamental term. It is difficult for the Joint Associations

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[1] End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80,747, RIN 3038-AD10 (Dec. 23, 2010); Pub. L. No. 111-203 (2010).

and other interested 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 recommend that the Commission modify the Proposed Rule by:

- Establishing an end-user Financial Obligation Notice requirement that is commercially practicable and consistent with Congress' intent. It should require a one-time, general Financial Obligation Notice, coupled with an obligation to update the notice as needed;
- Ensuring compliance with the end-user clearing exception by requiring end-users to make a one-time representation that they will only elect to use the end-user clearing exception when they are hedging commercial risk rather by than imposing new reporting requirements. Similarly, the Commission should allow the appropriate committee of a publicly-traded end-user's board of directors to provide blanket approval for an entity's use of the end-user clearing exception when hedging commercial risk;
- If the Commission declines to adopt the Joint Associations' one-time representation recommendation, implementing a Financial Obligation Notice requirement that is sufficiently flexible, particularly in cases in which an end-user is the "reporting counterparty;"
- Not limiting the ability of end-users to hedge commercial risk through an affiliated entity;

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[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).

- Adopting a broad and commercially practicable definition of "hedging or mitigating commercial risk" as substantially proposed;
- Not prohibiting an entity that is designated as a swap dealer for one category of swaps activity from utilizing the end-user clearing exception for other categories of swaps activities for which it is not a dealer; and
- Providing market participants with a reasonable transition period of at least one year from the effective date of the upcoming final rule to comply with new regulatory requirements.

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, who 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' members are not financial entities. Rather, they are physical commodity market participants that rely on swaps primarily to hedge and mitigate their commercial risk. Regulations that make effective risk management options more costly for end-users of swaps will likely result in higher and more volatile energy prices for retail, commercial, and industrial customers. As end-users of commodity swaps to hedge commercial risk, the Joint Associations' members have a direct and significant interest in how the Commission implements the end-user clearing exception.

IV. Proposed Scope of the End-User Exception to Mandatory Clearing of Swaps

The Dodd-Frank Act imposes clearing and trade execution requirements on all standardized swaps with one important exception.[4] CEA Section 2(h)(7), as amended by Section 723(a)(3) of the Dodd-Frank Act, excepts from the exchange-trading and clearing requirements

[4] Section 723(a)(3) of the Dodd-Frank Act amends the CEA to provide that "it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization [("DCO")] that is registered under [the CEA] or a [DCO] that is exempt from registration under [the CEA] if the swap is required to be cleared." Dodd-Frank Act § 723(a)(3) (to be codified as CEA § 2(h)(1)(A)). In a separate rulemaking, the CFTC proposed a process for determining which swaps are sufficiently standardized to be eligible for mandatory clearing. Process for Review of Swaps for Mandatory Clearing, 75 Fed. Reg. 67,277 (Nov. 2, 2010).

any swap used by a non-financial entity[5] to hedge or mitigate commercial risk, provided that such an end-user notifies the Commission, in the manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps (the "end-user clearing exception").[6] Separately, CEA Section 2(j) provides that any entity that is an issuer of securities under Section 12 of the Securities Exchange Act of 1934 ("Exchange Act") or is required to file reports under Section 15(d) of the Exchange Act may only use the end-user clearing exception after its board of directors or governing body has reviewed and approved the decision to enter into swaps pursuant to the end-user clearing exception.[7]

The Proposed Rule implements the end-user clearing exception and other sections of the Dodd-Frank Act by requiring end-users to report ten or twelve items of information each time they elect to rely on the end-user clearing exception.[8] This information falls broadly into two categories:

- Financial Obligation Notice. Pursuant to CEA Section 2(h)(7)(A)(iii), each end-user that relies on the end-user clearing exception is required to notify the Commission "how it generally meets its financial obligations associated with entering into non-cleared swaps."[9] Accordingly, proposed Rule 39.6(b)(5) requires any entity relying on the end-user clearing exception to provide (or cause to be provided) for each non-cleared swap five items of information regarding the end-user's use of methods of mitigating counterparty credit risk, including: (1) written credit support agreements, (2) pledged or segregated assets, (3) third-party guarantees, (4) its own financial resources, and (5) any other means it may use to satisfy its financial obligations.[10]

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[5] CEA Section 2(h)(7)(C) provides that, for the purposes of the end-user exception, the term "financial entity" means, in relevant part—

(I) a swap dealer;

(II) a security-based swap dealer;

(III) a major swap participant;

(IV) a major security-based swap participant; . . .

(VIII) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956. Dodd Frank Act § 723(a)(3) (to be codified as CEA § 2(h)(7)(C)).

[6] Dodd Frank Act § 723(a)(3) (to be codified as CEA § 2(h)(7)).

[7] Dodd-Frank Act § 723(b) (to be codified as CEA § 2(j)).

[8] 75 Fed Reg. at 80,749. All reporting end-users are required to report at least 10 items, while end-users that are issuers of securities under Section 12 of the Exchange Act or required to file reports under Section 15(d) of the Exchange Act must report two additional items.

[9] Dodd-Frank Act § 723(a) (to be codified as CEA 2(h)(7)(A)(iii)).

[10] Proposed Rule § 39.6(b)(5)(i)-(v), 75 Fed. Reg. at 80,757.

- Other Required Information. As proposed, Rules 39.6(b)(1)-(4) and (6) also require an end-user to "confirm compliance with particular requirements of the CEA" by providing five or seven additional items of information each time it elects to use the end-user clearing exception. According to the Proposed Rule, this information, which includes verification that the end-user is a non-financial entity and that it is using a swap to hedge or mitigate commercial risk, is needed to "prevent abuse of the end-user clearing exception."[11]

The Proposed Rule describes this reporting process generally as a "check-the-box" process.[12] It also further defines the term "hedging or mitigating commercial risk" as used in the context of the end-user clearing exception.

V. The Commission Should Establish an End-User Notification Requirement that is Commercially Practicable and Consistent with Congress' Intent

A. The Commission Should Only Require a One-Time, General Financial Obligation Notice

CEA Section 2(h)(7)(A)(iii) provides that each end-user that relies on the end-user clearing exception must "notif[y] the Commission, in a manner set forth by the Commission, how it *generally* meets its financial obligations associated with entering into non-cleared swaps."[13] The Proposed Rule would require an end-user to provide general information regarding its use of various forms of credit support *each time* the end-user elects to rely on the clearing exception. The Joint Associations believe that the proposed requirement is broader than the express language in the Dodd-Frank Act, and ultimately is not the most effective way for the CFTC to obtain information about how end-users manage credit risk in connection with non-cleared swaps.

The Joint Associations agree that, as provided in the Proposed Rule, information regarding an end-user's use of written credit support agreements, pledged or segregated assets, third-party guarantees, and other forms of credit support is relevant to how the end-user "generally meets its financial obligations associated with entering into non-cleared swaps." However, the Joint Associations believe that the Commission, consistent with the language in CEA Section 2(h)(7)(A)(iii), should establish a Financial Obligation Notice that allows end-users to provide this general information once, and to update it as necessary. A one-time notice requirement would be more effective than the "check-the-box" approach described in the Proposed Rule.

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[11] 75 Fed. Reg. at 80,750. The Commission has proposed requiring parties to include similar information in swap trading relationship documentation. *See* Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 6,715, 6,726 (Feb. 8, 2011).

[12] 75 Fed. Reg. at 80,755 (describing the Proposed Rule as a "user-friendly, check-the-box approach to the Dodd-Frank Act's notification requirement.").

[13] Dodd-Frank Act § 723(a) (to be codified as CEA § 2(h)(7)(A)(iii)) (emphasis added).

End-users, like most participants in the swap markets, typically establish trading relationships with counterparties by negotiating a master agreement (*e.g.*, the ISDA Master Agreement) that contains general terms and conditions, and then executing relatively simple confirmations that document the commercial terms of each individual transaction. Although master agreements (including the ISDA Master Agreement) may contain default credit provisions, these contracts can, and often are, supplemented by a credit support agreement (*e.g.*, the ISDA Credit Support Annex) that provides specific terms that govern margin, the treatment of collateral, and other issues related to credit risk.[14] As with a master agreement, the terms of a credit support agreement apply to *all* transactions executed between the parties unless an exception is made in a particular confirmation.[15] The same is generally true when market participants use other forms of credit support (*e.g.*, pledged or segregated assets, third-party guarantees) to manage the potential financial obligations associated with non-cleared swaps. As a practical matter, the way in which market participants manage credit risk in an established trading relationship usually does not change significantly from one transaction to the next. Similarly, in the vast majority of cases, end-users do not determine how they will meet the financial obligations associated with entering into non-cleared swaps separately for each transaction.

Because of the way in which end-users and other market participants actually manage risk, the Joint Associations believe that a one-time notice, coupled with an obligation to report any material exceptions or changes, would be a more effective and less burdensome means of implementing the Financial Obligation Notice in CEA Section 2(h)(7)(A)(iii) than a "check-the-box" form.[16] For example, a one-time Financial Obligation Notice that permits end-users to provide a general description of their financial resources and related risk management

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[14] The ISDA Credit Support Annex sets forth detailed procedures under which each party will provide security under the Master Agreement. The ISDA Credit Support Annex allows counterparties to make various elections, including the Collateral Threshold, Independent Amount, Minimum Transfer Amount, and Rounding Amount that apply to the counterparties to the Master Agreement.

[15] Because market participants manage risk on a portfolio basis, a reporting requirement that attempts to survey credit risk management practices on a transaction-by-transaction basis may be misleading or even inaccurate. For example, a commercial end-user may have a letter of credit to support positions with a counterparty under an ISDA Master Agreement with a Collateral Support Annex (collectively, the "ISDA"). Some of the transactions under the ISDA may be non-cleared swaps that use the end-user clearing exception. Other transactions may be physical trades that are not swaps, and therefore, not subject to mandatory clearing. However, both types of transactions are supported by the same letter of credit. Reporting one aspect of the trading relationship (the swaps), but not the other (the physical trades), whether or not the reporting is done on a transaction-by-transaction basis or not, will not provide the CFTC with complete and accurate information as to how the end-user manages its credit risk in connection with non-cleared swaps.

[16] In the Proposed Rule, the Commission asked: "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? For example, is it necessary or appropriate for the Commission to collect . . . [a]dditional general information on the credit support agreement and the collateral practices under the agreement . . . ?" 75 Fed. Reg. at 80,750-51. The Joint Associations' discussion in this section responds to the Commission's request for comment.

procedures, including how the entity identifies and mitigates its risk, will provide the CFTC with more useful information than the results of a "check-the-box" form. Moreover, because end-users would be obligated to notify the CFTC of any material exceptions or changes, a one-time notice would still provide the CFTC with accurate and timely information regarding the financial practices of end-users that are parties to non-cleared swaps.[17]

Moreover, a one-time, general Financial Obligation Notice would more aptly implement Congress' intent in CEA Section 2(h)(7)(A)(iii). The plain language of CEA Section 2(h)(7)(A)(iii) requires end-users who rely on the end-user clearing exception to provide only a "general" notice.[18] The Joint Associations respectfully submit that requiring end-users to report information about their financial resources and related risk management procedures for *every* non-cleared swap is not a "general" notice, and therefore, not fully consistent with Congress' intent.

If the Commission chooses to adopt a periodic Financial Obligation Notice, the Joint Associations urge the Commission to require reporting no more than once per year.[19] Requiring end-users to provide the Commission with information about credit arrangements more frequently (particularly in connection with each non-cleared swap transaction) would be inconsistent with the "general" notice requirement in CEA Section 2(h)(7)(A)(iii), would impose a substantial burden on end-users, and, importantly, would provide the CFTC with information that likely would be too superficial to provide the basis for meaningful analysis.

Although the Joint Associations do not believe that the "check-the-box" approach described in the Proposed Rule is consistent with the statutory language or the most effective way to implement the Financial Obligation Notice, the Joint Associations offer comments on this approach in the event that the Commission decides not to adopt the more commercially practical recommendations made by the end-user community. End-users vary tremendously in terms of their businesses and corporate structures, how they hedge commercial risk, and how they maintain financial information and other commercial records. Any Financial Obligation Notice

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[17] A one-time notice avoids legal and operational problems that are likely in situations where the reporting party is not the electing party. Under the Proposed Rule, the reporting party will be required to report information regarding the end-user's methods in meeting its financial obligations in an accurate and timely manner. As a practical matter, this will require the reporting counterparty to make representations with potential legal consequences regarding the policies and procedures of a non-affiliated electing party, in most cases, without the ability to verify their accuracy in a timely manner. The Joint Associations proposal effectively addresses the foreseeable legal and operational problems associated with this scenario. However, regardless of how the Commission ultimately implements the end-user clearing exception, the Commission should clarify that if both parties to the transaction are "electing counterparties," *each* party may provide its own required information to a swap data repository or to the Commission.

[18] Dodd-Frank Act § 723(a) (to be codified as CEA § 2(h)(7)(A)(iii)).

[19] Note that the Commission has proposed a similar yearly reporting requirement for notifying counterparties of their right to segregate collateral in the Commission's notice of proposed rulemaking regarding Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy. *See* 75 Fed. Reg. 75,432, 75,434 (Dec. 3, 2010).

adopted by the Commission should accommodate the many ways in which end-users are organized and manage their commercial risk.

B. The Commission Should Ensure Compliance with the End-User Clearing Exception through Contractual Representations Rather than by Imposing Additional Reporting Requirements

1. *The Commission Does Not Need an Additional Reporting Requirement to Confirm Compliance with or Prevent Abuse of the End-User Clearing Exception*

In addition to the Financial Obligation Notice required by CEA Section 2(h)(7)(A)(iii), the Proposed Rule would require end-users to "confirm compliance with particular requirements of [the] CEA" by providing supplemental information for each swap that uses the end-user clearing exception.[20] No provision in the CEA compels the Commission to collect these five or seven additional items of information.[21] Instead, the Proposed Rule explains that this information may be "necessary or useful to . . . prevent abuse of the end-user clearing exception."[22] The Commission further explains that requiring parties to confirm their eligibility for the end-user clearing exception with each transaction is important because the "empirical data collected [under the proposed reporting requirement] will aid [the Commission's] ability to evaluate how the end-user clearing exception is being used and encourage appropriate deliberation by counterparties prior to its use."[23] The Joint Associations respectfully submit that transaction-by-transaction reporting will not provide the data that the Commission seeks in a cost-effective manner and will not promote the "appropriate deliberation" that the Commission envisions.[24]

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[20] Under the Proposed Rule, the reporting party for a non-cleared swap entered into pursuant to the end-user clearing exception will be required to report (1) the identity of the counterparty electing not to clear the swap, (2) whether the counterparty electing not to clear the swap is a financial entity, (3) whether the counterparty electing not to clear the swap is a captive finance affiliate of an end-user, (4) whether the swap is being used to hedge or mitigate commercial risk, and (5) whether the counterparty electing not to clear the swap is an SEC Filer subject to the CEA § 2(j) board approval requirement. If the counterparty electing not to clear the swap is an SEC Filer, the reporting party must further provide (6) the SEC Filer's Central Index Key number and (7) confirmation that an appropriately authorized committee of the board of directors or equivalent governing body has reviewed and approved the decision not to clear the swap. 75 Fed. Reg. at 80,750.

[21] In the Proposed Rule, the Commission asked: "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?" 75 Fed. Reg. at 80,751. The Joint Associations' discussion in this section responds to the Commission's request for comment.

[22] 75 Fed. Reg. at 80,750.

[23] 75 Fed. Reg. at 80,751.

[24] *Id*.

As with the Financial Obligation Notice, virtually all of the information that the Commission proposes to require end-users to report with each use of the end-user clearing exception will change very infrequently and cannot be the subject of significant deliberation in the time frames during which trades are conducted. For example, an end-user's identity and its SEC Central Index Key number rarely change. Similarly, once an end-user's legal and business personnel have determined that it is a not a financial entity (or financial affiliate), that determination is unlikely to change prior to any particular trade. In addition, whether an appropriate committee of the board of directors has authorized use of the end-user exception is not subject to frequent change. A board of directors or one of its sub-committees does not meet on an hourly, daily, or weekly basis and thus will not authorize use of the end-user exception for individual transactions. Instead, a board of directors likely will grant a blanket authorization to use the end-user clearing exception for hedging commercial risk that will be valid for an extended period of time.

In addition, there are already substantial penalties in place to discourage market participants from invoking the end-user clearing exception inappropriately. For example, even absent a new reporting requirement, it is unlawful for any person to enter into a non-cleared swap if the swap is required to be cleared.[25] The details of every swap, whether cleared or not, also must be reported to a swap data repository (or the Commission) pursuant to new swap data reporting rules, and knowingly reporting false information to the CFTC is a felony.[26] Accordingly, the Joint Associations respectfully submit that the Commission does not need the information requested in proposed Rules 39.6(b)(1)-(4) or (6) to confirm compliance with the particular requirements of CEA Section 2(h)(7) or to prevent abuse of the end-user clearing exception.

2. *The Commission Should Allow End-Users to Confirm that they Qualify to Use the End-User Clearing Exception through a One-Time Representation*

As an alternative, the Joint Associations suggest that the Commission only require an end-user to provide a one-time representation that it is not a financial entity and that any swap it enters into that relies on the end-user clearing exception is hedging or mitigating commercial risk.[27] The Commission could mandate that any transaction documents containing such representations be made available to the CFTC upon its request. Such an approach would allow the Commission to oversee how the end-user clearing exception is used in the market without the need for an entirely new reporting regime. Moreover, because it would not require any new

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[25] Dodd-Frank Act § 723(a) (to be codified as CEA § 2(h)(1).

[26] Dodd-Frank Act §§ 727, 753 (to be codified as CEA §§ 2(a)(13), 6(c)).

[27] A contractual representation that any non-cleared swap (or swaps) is hedging or mitigating commercial risk could be made either in a master agreement or in individual confirmations executed by the parties. The Joint Associations note that such an approach is not only efficient and commercially practicable, but also consistent with the Commission's approach on this issue in other rulemakings. *See* 76 Fed. Reg. at 6,726 (requiring swap dealers to obtain transaction documentation from end-users that "provide[s] a reasonable basis on which to believe that [the end-user] meets the statutory conditions required for an exception from a mandatory clearing requirement . . . .").

regulatory procedures, the Joint Associations believe that this approach would be more efficient and easier to implement for both market participants and the CFTC.

3. *The Commission Should Allow End-Users that are Registered or File Reports under the Exchange Act to Rely upon a Blanket Approval by an Appropriate Committee of the Entity's Board of Directors Authorizing Them to Use the End-User Clearing Exception*

Section 2(j) of the CEA provides that end-users that are issuers of securities under Section 12 of the Exchange Act or required to file reports under Section 15(d) of the Exchange Act (and any end-user subsidiaries that are controlled by such a company) must obtain approval of its election to rely on the end-user exception from the appropriate committee of its board or governing body.[28] The Joint Associations request that the Commission clarify that the appropriate committee of an end-user's board of directors may provide a blanket approval for use of the end-user clearing exception.[29] Proposed Rule 39.6(b)(6)(ii) would require that the end-user notification include "whether an appropriate committee of the board of directors (or equivalent body) has reviewed and approved the decision not to clear *the swap.*"[30] Section 2(j) of the CEA, in contrast, requires that an "appropriate committee of the issuer's board or governing body [review and approve] its decision to enter into *swaps* that are subject to [the clearing and exchange trading] exemptions."[31] This statutory language expressly contemplates allowing an appropriately authorized board committee to sanction the use of the end-user exception on an omnibus, rather than a swap-by-swap basis.[32] The Joint Associations request that the Commission clarify Proposed Rule 39.6(b)(6)(ii) to conform with the language in CEA Section 2(j). If the Commission were to require separate approval for each individual swap, it would, as described above, create tremendous operational problems for all public company end-users, and their controlled end-user subsidiaries.

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[28] Section 2(j) of the CEA, as amended, does not require approval by an appropriate committee of an entity's board or governing body for swaps that are not subject to the mandatory clearing or exchange trading requirements.

[29] In the Proposed Rule, the Commission asked: "Should the Commission provide additional clarity to the requirements of CEA Section 2(j) to facilitate compliance with proposed § 39.6 by parties electing to use the end-user clearing exception? 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?" 75 Fed. Reg. at 80,751. The Joint Associations' discussion in this section responds to the Commission's request for comment.

[30] 75 Fed. Reg. at 80,757 (emphasis added).

[31] Dodd-Frank Act § 723(b) (to be codified as CEA § 2(j)).

[32] 75 Fed. Reg. at 80,750, n.18. The Commission appears to specifically contemplate such a blanket approval in the Proposed Rule when it states, "such 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 determined to be satisfactory to the board committee." *Id.*

The Commission also should clarify that the appropriate committee of an end-user's board of directors is authorized to adopt such a blanket approval for a specified period of time (*e.g.*, one or more years).[33] A provision that allows for such an approval would impose minimal burdens on end-users and is consistent with other statements in the Proposed Rule. For example, the Proposed Rule states: "a board resolution or an amendment to a board committee's charter could expressly authorize such committee to review and approve decisions of the electing person not to clear the swap being reported. In turn, such 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 determined to be satisfactory to the board committee."[34]

The Joint Associations believe that it should be sufficient for an end-user to maintain a copy of the approval documentation and make it available for inspection by the Commission upon request. This is consistent with the Dodd-Frank Act, which does not require end-users to notify the Commission of their compliance with CEA Section 2(j). However, to the extent that the Commission requires an affirmative statement, it should permit an end-user to provide a one-time notice that its use of the end-user clearing exception is consistent with an internal company policy that has been approved by an appropriate committee of the end-user's board and is available for the CFTC to review upon request.[35] Requiring end-users to report that the decision to enter into each non-cleared swap has been approved by an appropriate committee of its board of directors is not necessary to prevent abuse of the end-user clearing exception.[36] Moreover, the Committee approval required under Section 2(j) is unrelated to the notification required under Section 2(h)(7), which addresses only how an end-user meets its financial obligations with respect to non-cleared swaps, and does not require an end-user to provide the CFTC with notice or a copy of its committee's approval. The Commission should not adopt rules that commingle these unrelated statutory requirements.

C. If the Commission Does Not Adopt the Recommended One-Time Notification, It Should Adopt a Flexible Transaction-by-Transaction Notification Requirement, Particularly When an End-User is the "Reporting Counterparty"

In the event that the Commission elects not to adopt the Joint Associations' commercially practical recommendations for modifying the Proposed Rule in accordance with the statutory mandate, we provide the following alternative comments on the Commission's rule proposal. The Proposed Rule requires the "reporting counterparty" to report the ten (or twelve) items of information described in Rule 39.6(b) to a registered swap data repository or the Commission.

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33 *See Id*.

34 *Id*.

35 However, if the Commission requires end-users to report the board committee approval in connection with each non-cleared swap transaction, end-users should be allowed to satisfy this requirement through a "check-the-box" process.

36 The plain language of Section 2(j) does not require a transaction level approval by the board.

Under the proposed swap data recordkeeping and reporting rule, in most cases the reporting counterparty will not be an end-user.[37] However, in several scenarios, end-users will be required to report certain information relating to their non-cleared swaps.[38] For example, an end-user will be the reporting counterparty when both parties to the swap are end-users, and when an end-user's swap counterparty is a foreign entity.[39] These scenarios may impose a substantial burden on some end-users, particularly those with limited information technology resources.[40]

The Joint Associations respectfully request that the Commission provide market participants, particularly end-users, with sufficient flexibility to allow them to comply with the end-user clearing exception notification process and other swap reporting requirements in the most efficient and cost-effective manner possible.[41] First, and most importantly, the Commission should establish reasonable time frames for reporting swap information. End-users

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[37] Proposed Rule 17 C.F.R. § 45.5, Swap Data Recordkeeping and Reporting Requirements, 75 Fed. Reg. 76,574, 76,604 (Dec. 8, 2010). Proposed Rule § 45.5 provides the following guidance on which party will constitute the "reporting party" in a swaps transaction:

> (a) If only one counterparty is a [swap dealer], the [swap dealer] shall fulfill all counterparty reporting obligations.
>
> (b) If neither party is a [swap dealer], and only one counterparty is a [major swap participant], the [major swap participant] shall fulfill all counterparty reporting obligations.
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> (c) If both counterparties are [swap dealers], or both counterparties are [major swap participants], or both counterparties are non-[swap dealer]/[major swap participant] counterparties, the counterparties shall agree as one term of their swap transaction which counterparty shall fulfill reporting obligations with respect to that swap; and the counterparty so selected shall fulfill all counterparty reporting obligations.

Proposed Rule § 45.5(d) further provides that in cases where only one counterparty is a U.S. entity, the U.S. entity will be the reporting party. This would cause end-users that transact swaps with non-U.S. entities to be reporting parties for at least some of their swaps.

[38] 75 Fed. Reg. at 80,748-49. The Commission estimates that there are approximately 1,000 end-users who will be the reporting counterparty in a given year, and that the reporting obligation will require no more than one hour of burden per year. 75 Fed. Reg. at 80,756. The Joint Associations believe that this estimate may be too low. In addition, in the Proposed Rule, the Commission asked: "Are there international or cross-border issues related to the end-user exception that the Commission should address?" 75 Fed. Reg. at 80,752. The Joint Associations submit that the discussion in this section responds to the Commission's request for comment.

[39] For example, some of the Joint Associations' members enter into swaps with Canadian banks. If the Canadian bank is determined to be a non-U.S. person, the end-user would be the "reporting counterparty."

[40] The Joint Associations note that, under the proposed swap data recordkeeping and reporting rule, when an end-user is the reporting counterparty, it would be required to report all swap transaction data, including the primary economic terms of the transaction, confirmation data, and valuation data, in addition to the financial notice information (required under CEA Section 2(h)(7)(A)(iii)) and other information designed to confirm compliance with the CEA and prevent abuse of the end-user clearing exception required by the Proposed Rule. 75 Fed. Reg. 76,573.

[41] On February 7, 2011, the Coalition of Energy End Users filed comments in response to various proposed swap reporting requirements. *See* Coalition of Energy End Users, Recordkeeping and Reporting of Swap Transaction Data (RIN No. 3038-AD19) (Feb. 7, 2011), and Real-Time Public Reporting of Swap Transaction Data (RIN No. 3038-AD08) (Feb. 7, 2011).

that manually confirm transactions and that do not have robust information technology systems will have difficulty reporting accurate information within minutes of execution. Second, in addition to the automated electronic process that appears to be contemplated by the Proposed Rule, the Commission should provide alternatives for reporting the end-user clearing notification information. The automated process may not be workable, at least as an initial matter, for some end-users.

1. *The Commission Should Establish Reasonable Time Frames for Reporting Swap Information*

Under the Proposed Rule, when an end-user enters into a swap and is not the designated reporting counterparty, the end-user must communicate the specified information to the reporting counterparty so that it can be relayed to a swap data repository (or the Commission). Through no fault of the parties to the transaction, there may at times be delays in the ability of end-users and the reporting counterparty to convey this information to one another.[42] The Commission should clarify that submission of the end-user notification information is not subject to the same reporting time frames as dealer-to-dealer transaction data that must be reported to swap data repositories, and that the end-user notification information may be provided according to a more flexible timeline.[43]

2. *The Commission Should Provide for Alternatives to the Automated Electronic Reporting Processes*

CFTC staff have indicated that the required information in the end-user notification would be collected by the reporting counterparty as part of the execution and confirmation process. For example, the notification information could be recorded and reported electronically in FpML format, or through a dedicated online portal where the end-user can report the requested information using a form with pre-defined choices. However, to minimize costs for all end-users, the Commission should provide end-users with the flexibility to elect the reporting method that is most effective and economical for its business. The Commission should give end-users the option to submit the end-user notification either to the reporting counterparty or directly to a swap data repository. A flexible requirement that gives end-users a choice of submitting the end-user notification information through the reporting counterparty, when doing so is commercially

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[42] In the Proposed Rule, the Commission asked: "How long would it be expected to take for the person reporting information to the [swap data repository] to gather the information required under proposed § 39.6? Will the time needed to gather the required information disrupt the transaction process for swaps to any material extent?" 75 Fed. Reg. at 80,752. The Joint Associations submit that the discussion in this section responds to the Commission's request for comment.

[43] The Joint Associations are aware of no compelling need for the financial notice information or other information required in the Proposed Rule to be reported in a real-time or expedited manner. The cost of transmitting this information instantaneously (or nearly instantaneously) may be significant, and the benefit of receiving such information quickly likely is relatively small.

practicable, but that also permits end-users to submit the information directly to a swap data repository, is a more pragmatic alternative.[44]

If the Commission imposes timelines that are too short or technological requirements that are too onerous, market participants may not be able to comply with the end-user clearing exception notification process and other swap reporting requirements without incurring considerable costs or enduring significant operational burdens.[45] Although transmitting the information contained in the end-user notification to a reporting counterparty along with other details of the transaction may be practical in some circumstances (*e.g.*, when a transaction is confirmed electronically and recorded using FpML), this process may create significant operational issues in other circumstances (*e.g.*, when a transaction is manually confirmed). A flexible swap reporting requirement that is not overly prescriptive will be cost-effective for end-users and will not compromise the Commission's ability to obtain timely, accurate information.

D. The Commission Should Not Limit the Ability of End-Users to Hedge Commercial Risk Through an Affiliated Entity

Congress did "not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business."[46] Consequently, the Commission should not condition the availability of the end-user clearing exception on how an end-user has structured its business. Instead, the exception should be interpreted in a commercially practicable way that allows end-users to continue to manage their commercial risk under the Dodd-Frank Act with minimal disruption to their existing commercial activities, however they are structured. In particular, the Commission should clarify that the end-user exception is available to any end-user that is using swaps to hedge or mitigate commercial risk, regardless of whether it hedges its risk directly or through an affiliated entity.

The Proposed Rule requires the party electing to use the end-user clearing exception in a transaction with a third party to indicate whether it is an affiliate of another entity that qualifies for the exception. The Joint Associations do not object to this requirement, but they encourage the Commission to treat hedges that are executed through an affiliate the same way it treats

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[44] In addition, end-users should be permitted to provide the information contained in the end-user notification electronically or as an addendum to the swap containing the notification information.

[45] In the Proposed Rule, the Commission asked: "Would it be difficult or prohibitively expensive for persons to report the information required under the proposed § 39.6? If so, why?" 75 Fed. Reg. at 80,750. The Joint Associations submit that the cost for end-users to comply with the notification requirement will depend on: (1) whether the Commission requires frequent and detailed reporting, and (2) the sophistication of the end-user. Any operational issues associated with providing the end-user notification would increase exponentially if end-users are required to provide the notice in connection with every non-cleared swap. In addition, the discussion in this section responds to the Commission's request for comment.

[46] 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).

hedges that are executed directly with a third party. In particular, CEA Section 2(h)(7)(D)(i) provides that "[a]n affiliate of a person that qualifies for [the end-user exception] . . . may qualify for the exception only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity."[47]

The Joint Associations understand that the Commission interprets this language as permitting *two* types of common hedging scenarios: (1) a transaction where an end-user hedges or mitigates its commercial risk by entering into a non-cleared swap with a third-party through an affiliated entity (*e.g.*, a "sleeve"); and (2) a transaction where an end-user hedges or mitigates its commercial risk by entering into a non-cleared swap with an affiliated hedging entity, followed by a second non-cleared transaction where the hedging affiliate enters into an equivalent transaction with a third-party. Accordingly, the Joint Associations recommend that the Commission clarify in the regulatory text, as follows, that "acting on behalf of the [end-user] and as an agent" to hedge or mitigate commercial risk includes inter-affiliate transactions.

§ 39.6 Electing to use the end-user exception to mandatory swap clearing.

(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), including the commercial risk of an affiliated person that is not prohibited from electing to use the exception under section 2(h)(7)(D)(ii) of the Act, 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). More than one counterparty to a swap may be an electing counterparty. If there is more than one electing counterparty to a swap, the information specified in § 39.6(b) shall be provided with respect to each of the electing counterparties.

This clarification will provide end-users with flexibility to structure their risk management practices in a commercially practical manner. If the forgoing description and proposed regulatory text do not accurately reflect the Commission's interpretation of CEA Section 2(h)(7)(D)(i), the Joint Associations request that the Commission clarify how the end-user

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[47] Dodd-Frank Act § 723(a) (to be codified as CEA § 2(h)(7)(D)(i)).

clearing exception will apply to end-users seeking to hedge or mitigate commercial risk by using inter-affiliate swaps.[48]

VI. The Commission Should Adopt the Broad and Commercially Practicable Definition of "Hedging or Mitigating Commercial Risk" in the Proposed Rule

The Joint Associations support the Commission's decision to propose a broad and consistent definition of "hedging or mitigating commercial risk" for all sections of the CEA as proposed in Rule 39.6(c). The Joint Associations agree that an effective definition of "hedging or mitigating commercial risk" should include "swaps used to hedge or mitigate any of a person's business risks . . . regardless of their status under accounting guidelines or the bona fide hedging exemption."[49] We also agree that a parallel approach to defining "hedging or mitigating commercial risk" allows "consistency of interpretation across the CEA as a whole and help[s] provide for fair and equivalent treatment for similarly situated parties."[50]

Although the Commission asks in the Proposed Rule "whether swaps facilitating asset optimization or dynamic hedging should be included" in the definition of "hedging or mitigating commercial risk," the Joint Associations do not believe the proposed definition requires clarification.[51] Asset optimization and dynamic hedging are types of transactions that unambiguously fall within the definition of bona fide hedging transactions and positions.[52] Excluding such transactions would introduce uncertainty into an otherwise clear and commercially practicable definition, and would limit the ability of end-users in the electric industry to effectively manage the risks related to their commercial businesses.

Similarly, the Joint Associations do not believe that the Commission should limit swaps qualifying as hedging or risk mitigating to those swaps where the underlying risk is a non-financial commodity.[53] As the Commission acknowledges in the Proposed Rule, the definition of "hedging or mitigating commercial risk" must be broad enough to accommodate "swaps used

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[48] If Congress considered it appropriate to exempt inter-affiliate swaps within financial entities, it is also appropriate to exempt inter-affiliate swaps used by end-users to hedge or mitigate commercial risk. See 156 Cong. Rec. S5921 (daily ed. July 15, 2010) (statement of Sen. Lincoln) (noting that it would be appropriate to except from the clearing requirement financial entities' inter-affiliate swaps).

[49] 75 Fed. Reg. at 80,752.

[50] 75 Fed. Reg. at 80,753.

[51] *Id*.

[52] Asset optimization and dynamic hedging are simply an elaborate way of saying that an entity actively manages its hedge positions by establishing and removing positions based on changes in the market and the entity's own risk profile. However, any time a hedge is in place, it is a bona fide hedge. The fact that an entity may modify that hedge position in the future does not change its basic function.

[53] In the Proposed Rule, the Commission asked: "Should swaps qualifying as hedging or risk mitigating be limited to swaps where the underlying hedged item is a non-financial commodity?" 75 Fed. Reg. at 80,753. The Joint Associations' discussion in this section responds to the Commission's request for comment.

to hedge or mitigate *any* of a person's business risks . . . ."[54] Commercial businesses incur and must manage credit risk, liquidity risk, operating risk, financial statement risk and other forms of commercial risk, regardless of whether such risks are managed on a portfolio or trade-by-trade basis. In particular, members of the Joint Associations manage potential changes in interest rates because they issue debt and invest substantial sums in electric industry infrastructure and equipment purchases. Neither interest rates nor other financial risks can be hedged or mitigated with a swap based on a non-financial commodity. If the Commission limits the definition of "hedging or mitigating commercial risk" to swaps where the underlying hedged item is a non-financial commodity, end-users will be unable to hedge effectively the risks associated with significant parts of their commercial businesses.

In addition, the Joint Associations believe that an entity that is designated as a swap dealer for one category of swaps or activities should not, based on that designation alone, be treated as a "financial entity" that is disqualified from electing to use the end-user clearing exception for other categories of swaps activities. Disqualifying such entities would effectively expand the definition of swap dealer to capture entities (potentially including many end-users) that by the Commission's own definition are not dealers in those markets and, presumably, do not engage in activity in those markets that increases systemic risk or otherwise creates a need for additional Commission oversight. Such an interpretation is unnecessary, and is inconsistent with Congress' express intent to provide a process to allow for swap dealers to be granted a limited designation.[55] Therefore, the Joint Associations request that the Commission not classify an entity that is a swap dealer for *some* categories of swaps or activities as a financial entity that is disqualified from using the end-user clearing exception for *all* categories of swaps and activities.

VII. The Commission Should Provide an Adequate Transition Period that Allows All Market Participants to Come into Compliance in a Cost-Effective Manner

All market participants, and in particular end-users, need a reasonable amount of time to comply with the new requirements imposed by the Dodd-Frank Act and the CFTC's implementing regulations. The Commission has previously recognized the potential need to provide market participants with more time to comply with the Dodd-Frank Act's new statutory and regulatory requirements. In its notice regarding Petitions Seeking Grandfather Relief for Trading Activity Done in Reliance Upon Section 2(h)(1)–(2) of the CEA, the Commission represented to the public that, while it was not granting such grandfather relief, it was "prepared to revisit its decision in the future should it be necessary to ensure a smooth transition to the new

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[54] 75 Fed. Reg. at 80,752 (emphasis added).

[55] CEA Section 1a(49)(B) provides that "[a] person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities." Dodd Frank Act § 721 (to be codified as CEA § 1a(49)(B)). *See also* 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, 80,182 (Dec. 21, 2010).

regulatory regime . . . ."[56] Furthermore, the Commission confirmed that it would "strive to ensure that current practices will not be unduly disrupted during the transition to the new regulatory regime" and would "use its available exemptive authorities to address" situations in which required regulations may pose "particular difficulties [for persons who rely on Section 2(h)] that cannot be addressed in final regulations . . . ."[57]

Although the Dodd-Frank Act provides that no final rule will become effective *less* than 60 days after its publication in the Federal Register, the Joint Associations' members and other similarly situated market participants need more time to come into compliance with the many new requirements in this and other proposed rules. Congress specifically included a grandfather clause authorizing the Commission to provide a reasonable compliance period, up to one year, for physical commodity market participants, because it recognized the potentially disruptive effect that the Dodd-Frank Act could have on them.[58] For example, some end-users have limited information technology capabilities and will need a reasonable period of time, after the issuance of final regulations, to update and modify their information technology systems to ensure compliance. Accordingly, the Joint Associations respectfully request that the Commission provide market participants with a transition period of at least one year from the date on which the final version of this rule is promulgated. Without such a reasonable transition period, many end-users and other similarly situated entities will have substantial difficulty complying in full with their new regulatory obligations.

VIII. Conclusion

The Joint Associations commend the Commission for its commitment to safeguarding the hedging and trading activities of end-users of swaps, and look forward to continuing to work with the Commission as the Dodd-Frank Act rulemaking process continues. As explained herein, we encourage the Commission to ensure that end-users and their non-financial affiliates can commercially, practicably, and cost-effectively avail themselves of the end-user clearing exception, and are exempted from regulatory requirements that Congress intended to apply only to swap dealers and major swap participants.

In addition, the Joint Associations request that the Commission hold open and reopen the comment periods for all rules being promulgated under the Dodd-Frank Act for a reasonable period of time following the issuance of all rules to enable interested parties to consider and comment upon the regulations and the corresponding definitions as a whole.

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[56] Notice Regarding the Treatment of Petitions Seeking Grandfather Relief for Trading Activity Done in Reliance Upon Section 2(h)(1)-(2) of the Commodity Exchange Act, 75 Fed. Reg. 56,512, (Sept. 16, 2010).

[57] 75 Fed. Reg. at 56,513.

[58] *See* Section 723(c)(1) of the Dodd-Frank Act providing persons transacting in exempt commodities in reliance on Section 2(h) of the CEA the right to petition the Commission for grandfather relief.

Please contact us at the numbers listed below if you have any questions regarding these comments.

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