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**Submitted Electronically**

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

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

Dear Mr. Stawick:

The American Petroleum Institute (“API”) submits these comments in response to the notice of proposed rulemaking (“NOPR”) issued by the Commodity Futures Trading Commission (the “Commission”) concerning the end-user exception to mandatory clearing of swaps under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).<sup>1</sup>

API is a national trade association representing more than 450 oil and natural gas companies. API’s members transact in physical and financial, exchange-traded, and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business of delivering energy to wholesale and retail consumers. Associated with the hedging of physical exposures, API members enter into swap transactions to offset credit risks and to facilitate physical transactions. API members range from the largest major oil company to the smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry. Because API members rely on the integrity of markets under the Commission’s jurisdiction, we appreciate the opportunity to comment.

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<sup>1</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010). The proposed rules are set forth in End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80,747 (proposed Dec. 23, 2010) (to be codified at 17 C.F.R. pt. 39). On May 4, 2011, the Commission reopened the comment period for this proposed rulemaking. See Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 25,274 (May 4, 2011).

## I. Introduction

As the Commission's new regulatory requirements for derivatives go into effect, many API members will rely on the end-user clearing exception to enter into uncleared swaps to hedge their commercial risk. This is exactly what Congress intended. In adopting the end-user clearing exception, Congress intended to preserve market participants' ability to hedge or mitigate commercial risk through the responsible use of derivatives. As members of Congress have stated, it is critically important that, in implementing this exception, the Commission not impose unnecessary transaction costs and regulatory burdens that will discourage hedging or raise costs to consumers.<sup>2</sup> In light of these congressional objectives, API offers the following comments:

- The definition of "hedge or mitigate commercial risk" should be broad enough to cover the hedging and risk management needs of market participants. In this regard, swaps that hedge risk associated with physical transactions should not be deemed held for speculative or trading purposes.
- The proposed transaction-specific notification and board-approval requirements would be unnecessarily costly, complex, and burdensome for market participants. API recommends that end users be able to discharge their notification obligation through a general filing and boards of directors be able to approve uncleared swaps through a general policy.
- The potential costs of transaction-specific reporting are most acute in the context of swaps where the end user will also be the reporting counterparty. As API explains in greater detail in response to the real-time public reporting proposed rulemaking, the high costs of system development and implementation outweigh the regulatory benefits of real-time information about end-user, hedging transactions.

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<sup>2</sup> See Letter from Sens. Dodd and Lincoln to Reps. Frank and Peterson (June 30, 2010), in 156 Cong. Rec. S6192 (daily ed. July 22, 2010) ("Whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool. Regulators, namely the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the prudential regulators, must not make hedging so costly it becomes prohibitively expensive for end users to manage their risk."); Letter from Reps. Bachus and Lucas to Secretary Geithner, Chairman Gensler, Chairman Schapiro, and Chairman Bernanke (Dec. 16, 2010), available at <http://sec.gov/comments/s7-39-10/s73910-5.pdf> ("End-users must be able to rely upon their exemption from the clearing and exchange trading requirements without having to overcome unnecessary bureaucratic obstacles.").

## **II. The Commission Should Define “Hedge or Mitigate Commercial Risk” Broadly for Integrated Oil and Gas Businesses**

API appreciates that the Commission has proposed a broad definition of “hedge or mitigate commercial risk.” That definition covers not only positions that qualify for hedge accounting treatment or the bona fide hedge exemption from position limits, but also swaps used to hedge or mitigate business risks in six categories listed by the Commission. The categories of transactions that “hedge or mitigate commercial risk” for purposes of the end-user clearing exception include a swap that is economically appropriate to the reduction of risks that arise from the “potential change in the value . . . commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of business of the enterprise.”<sup>3</sup> In the context of integrated oil and gas firms, this language should cover a wide range of transactions used to optimize physical assets.

As the Commission and API have commented previously, “the line between speculation and hedging can at times be difficult to discern”<sup>4</sup> -- especially in the context of integrated oil and gas businesses. In this regard, API urges the Commission to clarify how it will distinguish between hedge positions, on the one hand, and speculative or trading positions, on the other. Specifically, in a footnote, the Commission suggests that “[s]wap positions that hedge other positions that themselves are held for the purpose of speculation or trading are also speculative or trading positions.”<sup>5</sup> To the extent that it suggests that only a producer or purchaser of a commodity could claim that a swap was entered into to hedge or mitigate commercial risk, this language is inconsistent with Dodd-Frank. API members may enter into various physical transactions as part of their integrated oil and gas businesses that they must, in turn, hedge through swaps. Swaps hedging these physical positions should qualify for the end-user exception. Accordingly, API asks the Commission to clarify that swap positions that hedge other *swap* positions held for speculation or trading are also speculative or trading positions, but swap positions that hedge physical positions will not be so characterized.

## **III. The Commission Should Reduce Compliance Burdens for End Users By Simplifying the Notification and Board-Approval Requirements**

The Commission has now received many comments regarding the proposed notification requirements for the end-user exception. These comments express widespread concern that, in contrast to Dodd-Frank’s general notification and board-approval requirements,

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<sup>3</sup> NOPR, 75 Fed. Reg. at 80,757 (proposed 17 C.F.R. § 39.6(c)(1)(D)).

<sup>4</sup> *Id.* at 80,753.

<sup>5</sup> *Id.* at 80,752 n.23.

the Commission appears to have mandated transaction-specific notification and board approval. API agrees with those comments that have stated that these transaction-specific requirements are not required by Dodd-Frank and will impose unwarranted costs and regulatory burdens on end users. Accordingly, API urges the Commission to simplify the notification and board-approval requirements.

**A. End Users Should Be Able to Make a One-Time Notification to the Commission of How They Generally Meet Their Financial Obligations**

Dodd-Frank requires an end user electing the clearing exception to “notif[y] the Commission . . . how it *generally* meets its financial obligations associated with entering into non-cleared swaps.”<sup>6</sup> The congressional requirement of a general disclosure with respect to all uncleared swaps is consistent with market practice. Market participants generally use master agreements that set forth the financial obligations of counterparties with respect to all uncleared swaps made subject to the agreement.

Contrary to Dodd-Frank and market practice, the proposed rules require that the reporting counterparty provide up to twelve items of information “each time the end-user clearing exception is elected.”<sup>7</sup> This requirement would increase the costs and regulatory burdens of complying with the end-user exception. Further, swap-by-swap notification would not provide additional information to the Commission. API believes that it would be more efficient for both market participants and regulators for there to be a single general disclosure of financial information.

API supports those comments that have suggested that a one-time, general notification to the Commission of how the end user generally meets its financial obligations associated with entering into uncleared swaps should satisfy Dodd-Frank’s notification requirement. End users could then update their notification to the Commission if the methods they use to meet their financial obligations change.

**B. An Appropriate Committee of a Board of Directors Should Be Able to Approve Swaps Through a General Hedging Policy**

Similarly, Dodd-Frank states that the end-user clearing exception “shall be available to a counterparty that is an issuer of securities . . . only if an appropriate committee of the issuer’s board or governing body has reviewed and approved its decision to enter into swaps that are subject to such exemptions.”<sup>8</sup> Generally, governing bodies approve a hedging plan that

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<sup>6</sup> Dodd-Frank § 723(a)(3) (CEA § 2(h)(7)(A)) (emphasis added).

<sup>7</sup> See NOPR, 75 Fed. Reg. at 80,748.

<sup>8</sup> See Dodd-Frank § 723(b) (CEA § 2(j)).

governs all approved swaps. Boards of directors, which are not typically involved in the day-to-day management of the commercial enterprise, do not approve each particular swap. Any requirement that they approve each swap would further be impractical in the fast-moving trading environments where API members hedge risk. Like other commenters, API urges the Commission to clarify that board approval will not be required for each individual swap on a transaction-specific basis.

The proposed end-user exception rules are ambiguous on this point. In a footnote, the Commission recognized the practical considerations of board approval in a dynamic market by acknowledging that

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.<sup>9</sup>

The proposed rules require the issuer of securities to certify, however, that "an appropriate committee of the board of directors (or equivalent body) has reviewed and approved the decision not to clear *the swap*."<sup>10</sup> To the extent this language suggests particular board approval of an individual swap, it is inconsistent with Dodd-Frank's board-approval requirement and the practical reality of the market.

The footnote quoted above suggests that the Commission did not intend to require particularized board approval. API supports the approach described in the footnote, which would permit a board of directors to approve policies or procedures regarding uncleared swaps or to approve uncleared swaps periodically. Accordingly, API urges the Commission to clarify in the final rule that an issuer of securities need only certify that an appropriate committee of the board of directors (or equivalent body) has reviewed and approved the decision not to clear *swaps*.

#### **IV. The Commission Should Remain Sensitive to the Costs of System Development and Implementation for End Users**

The proposed rules contemplate that the "reporting counterparty" defined in the swap data recordkeeping and reporting rules will transmit the required notification to the swap

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<sup>9</sup> NOPR, 75 Fed. Reg. at 80,750 n.18.

<sup>10</sup> *Id.* at 80,757 (proposed 17 C.F.R. § 39.6(b)(6)(ii)) (emphasis added).

data repository.<sup>11</sup> Under the swap data recordkeeping and reporting rules, if both counterparties to an uncleared swap are end users, they must agree as a term of the transaction which party must make the required reports.<sup>12</sup> As the Commission has noted in connection with its proposed recordkeeping and reporting rules, end users will be less likely to have systems in place that are capable of meeting the new reporting requirements.<sup>13</sup> As API has argued in other comments, the proposed real-time reporting requirements for end users and uncleared swaps are particularly burdensome, because end users typically reconcile swap data by the end of each day, not in real time. API urges the Commission to balance the need for additional reporting requirements against the significant costs of new technological systems and new personnel, which may not be warranted for end users. API believes that end-user-to-end-user, uncleared swaps are unlikely to cause systemic risk or significantly influence price discovery. Accordingly, while API appreciates the need for an end-user notification requirement, API urges the Commission to streamline the reporting process, so as not to impose unwarranted costs on end users.

## V. Conclusion

For the reasons described in these comments, API urges the Commission to simplify the proposed end-user clearing exception rule to avoid imposing unwarranted new costs and regulatory burdens on end users. Substantively, API urges the Commission to clarify the broad scope of its definition of “hedge or mitigate commercial risk.” This definition should capture swaps that hedge physical transactions entered into for a variety of commercial purposes in connection with optimizing assets in the operation of an integrated oil and gas business. Procedurally, API joins the many other commenters who have suggested that, as Dodd-Frank contemplates, end users should be able to make general, rather than transaction-specific, reports to the Commission about how they meet their financial obligations. Further, API urges the Commission to clarify that a board of directors may approve a general hedging policy related to uncleared swaps; the board need not approve each specific swap in a manner that would be inconsistent with Dodd-Frank and the demands of a fast-moving market. These changes would serve Congress’s intent that the end-user exception preserve end users’ ability to hedge risk in a manner that benefits the economy and American consumers.

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<sup>11</sup> See *id.* at 80,748-49.

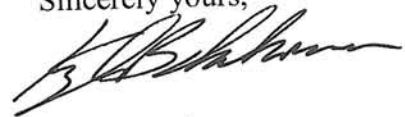
<sup>12</sup> See Swap Data Recordkeeping and Reporting Requirements, 75 Fed. Reg. 76,574, 76,604 (proposed Dec. 8, 2010) (proposed 17 C.F.R. § 45.5(c)).

<sup>13</sup> See, e.g., *id.* at 76,593 (“The Commission also believes it is appropriate for SDs and MSPs to have the responsibility of reporting with respect to the majority of swaps, because they are more likely than other counterparties to have automated systems in place that can facilitate reporting.”); *id.* at 76,597 (“Time may also be needed for registered entities and potential swap counterparties to adapt or create automated systems capable of fulfilling the requirements of Commission regulations concerning swap data reporting.”).

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API appreciates the opportunity to provide these comments. We would be pleased to provide additional information regarding our views on the proposed rule, and would welcome the opportunity to work with the Commission.

Sincerely yours,



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Vice President  
Regulatory and Economic Policy  
American Petroleum Institute

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner  
Honorable Bart Chilton, Commissioner  
Honorable Scott D. O'Malia, Commissioner

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