



June 3, 2011

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

VIA ELECTRONIC SUBMISSION

RE: **Footnote 128**, *Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Dealer,” and “Eligible Contract Participant”* (“Definitions Proposed Rule”), RIN 3038-AD06

**Footnote 23**, *End-User Exception to Mandatory Clearing of Swaps* (“End-User Exception Proposed Rule”), RIN 3038-AD10

Dear Secretary Stawick:

**I. INTRODUCTION.**

On behalf of the Working Group of Commercial Energy Firms (the “Working Group”)<sup>1</sup> and the Commodity Markets Council (“CMC”)<sup>2</sup> (collectively, the “Commercial Alliance”),<sup>3</sup> Hunton & Williams LLP<sup>4</sup> hereby submits these comments in response to the request for public comment set forth in the Commodity Futures Trading Commission’s (the “CFTC” or “Commission”) *Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, published in the *Federal*

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<sup>1</sup> The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial and residential consumers. Members of the Working Group are energy producers, marketers and utilities.

<sup>2</sup> CMC is a trade association bringing together commodity exchanges with their industry counterparts. The activities of our members represent the complete spectrum of commercial users of all futures markets including agriculture. Specifically, our industry member firms are regular users of the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Kansas City Board of Trade, Minneapolis Grain Exchange, and New York Mercantile Exchange.

<sup>3</sup> The Commercial Alliance is a combined effort among commercial agriculture and energy companies to address significant issues under the Commission’s rulemakings to implement derivatives reform under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

<sup>4</sup> Please note that Hunton & Williams LLP is not counsel to CMC.

*Register* on May 4, 2011, which reopens and extends until June 3, 2011, the comment period of many of the CFTC's proposed rulemakings.<sup>5</sup> Specifically, the Commercial Alliance submits these comments to express its concerns with the virtually identical language set forth in footnote 128 and footnote 23 (collectively, the "Footnotes") of the Definitions Proposed Rule<sup>6</sup> and the End-User Exception Proposed Rule,<sup>7</sup> respectively (collectively, the "Proposals").

The Commercial Alliance appreciates the opportunity to comment and submits for the Commission's consideration comments and recommendations it believes will assist the Commission in developing final rules that will preserve the integrity of the swap markets and serve the best interests of market participants.

## **II. COMMENTS OF THE COMMERCIAL ALLIANCE.**

### **A. "HEDGING OR MITIGATING COMMERCIAL RISK".**

#### **1. Relevant Statutory Provisions in Title VII of the Act.**

New Commodity Exchange Act ("CEA") Section 1a(33)(A)(i) provides that positions held for "hedging or mitigating commercial risk" are excluded for purposes of determining whether a person holds a "substantial position" in swaps and is consequently a Major Swap Participant ("MSP"). In addition, new CEA Section 2(h)(7) provides an exception to the mandatory clearing requirement for a non-financial end-user that is using swaps to "hedge or mitigate commercial risk." These two provisions make clear that Congress intended that certain activities involving hedging or mitigating commercial risk be treated differently from other swap activities.

#### **2. Swaps Held for Speculative Purposes Do Not Qualify as Swaps that "Hedge or Mitigate Commercial Risk".**

Both of the Proposals provide that "hedging or mitigating commercial risk" will include swaps that (i) are economically appropriate to the reduction of risks in a commercial enterprise; (ii) qualify as bona fide hedging for purposes of an exemption from the position limit rules; or (iii) qualify for hedging treatment under the Financial Accounting Standards Board Accounting Standards. On the other hand, swap positions held for a "speculative, investing, or trading" purpose would not qualify as swaps that "hedge or mitigate commercial risk."<sup>8</sup>

<sup>5</sup> *Reopening and Extension of Comment Periods for Rulemaking Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 76 Fed. Reg. 25,274 (May 4, 2011). See also *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. 111-203, 124 Stat. 1376 (2010).

<sup>6</sup> *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Dealer," and "Eligible Contract Participant,"* Joint Proposed Rule, 75 Fed. Reg. 80,174 (Dec. 21, 2010) (hereinafter "Definitions Proposed Rule").

<sup>7</sup> *End-User Exception to Mandatory Clearing of Swaps*, Notice of Proposed Rulemaking, 75 Fed. Reg. 80,747 (Dec. 23, 2010) (hereinafter "End-User Exception Proposed Rule").

<sup>8</sup> Notably, while the Commission uses the terms "speculating," "trading," or "investing," in the Proposals, such terms are neither defined in the Act nor the CEA.

**3. The Footnotes Inexplicably State that Swaps Held to Hedge or Mitigate Risk Associated with Certain Underlying Physical Commodity Positions Do Not Qualify as Swaps that “Hedge or Mitigate Commercial Risk”.**

In providing interpretive guidance on the phrase “hedging or mitigating commercial risk,” the Commission states its intention to exclude certain swaps entered into to hedge physical market positions. Specifically, footnote 128 of the Definitions Proposed Rule and footnote 23 of the End-User Exception Proposed Rule state, in part: “Swap positions that hedge *other positions that themselves are held for the purpose of speculation or trading* are also *speculative or trading* positions.”<sup>9</sup> Thus, a swap that hedges a “trading” position in a physical commodity (*i.e.*, a wholesale market transaction in the chain between producer and consumer) or an inventory position held in the “speculative” anticipation of a potential increase in price would not qualify as “hedging or mitigating commercial risk” even though the owner of the underlying physical commodity had significant price risk.

As a consequence, an energy or agricultural firm engaged in “trading” activities would be unable (i) to deduct its exposure on swap positions used to hedge commercial risk associated with its trading positions in a physical commodity in applying the “substantial position” test to determine whether it is an MSP, and (ii) to avail itself of the end-user exception to mandatory clearing for a swap used to hedge commercial risk associated with its trading positions in a physical commodity. The energy or agricultural firm would be equally constrained in holding inventory or another position in the underlying physical commodity that was deemed to be “speculative.”

In short, and as further described below, the Commission’s interpretive guidance provided in the Footnotes (1) is inconsistent with Congress’s intent, (2) has no policy rationale, and (3) could produce material, adverse impacts on both physical commodity and swap markets.

**B. THERE IS NO BASIS FOR TREATING “TRADING” POSITIONS IN A PHYSICAL COMMODITY DIFFERENTLY FROM OTHER PHYSICAL POSITIONS.**

As a general matter, commodities in the physical marketing chain do not pass directly from the producer to the consumer. Rather, middlemen, commonly known as “merchants,” “merchandisers,” or “marketers,” facilitate this process by participating in the wholesale market through transactions sometimes referred to as “trading” transactions. At times, middlemen will buy with an equivalent sales transaction in a physical commodity already in place; other times, they will buy and hold a “speculative” or “trading” position in the physical commodity until they can arrange the onward sale of the commodity.

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<sup>9</sup> Definitions Proposed Rule at 80,195 n.128 (emphasis added); End-User Exception Proposed Rule at 80,752 n.23 (emphasis added).

Conversely, middlemen will sometimes sell their interest before securing the actual commodity. In connection with these activities, middlemen will often transport and store the particular commodity, and generally own the commodity and incur all the attendant risks and costs of owning such commodity, including, but not limited to, price risk. Notably, vertically integrated firms, as well as other producers, processors, and end-users, often participate in the “trading market” for reasons such as (i) optimizing their returns on their purchases or sales, (ii) reacting to variability in their production or processing or consumption needs, (iii) maximizing efficiency of hedging position in current, volatile economic climate, and (iv) capitalizing on trends in market supply and demand fundamentals. Most importantly, commercial parties *hold significant price risk* with respect to these positions, and use swaps to *prudently hedge or mitigate such price risk*.

The Commercial Alliance submits that Congress neither expressly nor implicitly intended that there be differential treatment among types of hedges (*i.e.*, a differentiation between hedges relating to producing, processing, merchandising or consuming). Congress meant, if at all, to differentiate between commercial hedges involving ownership or potential ownership of the physical commodity on the one hand, and purely financial transactions on the other. Paradoxically, the hedging of physical “trading” positions would qualify as *bona fide* hedges under Section 737 of the Act, but would not qualify as “hedging or mitigating commercial risk” under the Footnotes.

The Commercial Alliance respectfully submits that this interpretation is inconsistent with the Congressional intent underlying new CEA Sections 1a(33)(A)(i) and 2(h)(7)(A) and is not supported by legal or policy rationale. If the final rules implementing the definition of MSP and the End-User Exception ultimately state that the hedge of a physical market position that is a “trading” position (*i.e.*, held as a merchant or merchandiser in the commodity) or a “speculative” position would not qualify for treatment as “hedging or mitigating commercial risk,” serious consequences to the physical commodity markets for energy and agricultural commodities will result.

**C. THE COMMISSION SHOULD CORRECT THE LANGUAGE IN THE FOOTNOTES.**

The Commercial Alliance respectfully requests that, if the Footnotes are retained in any final rule issued in these proceedings, the Commission should correct the language in the second sentence by adopting the following language:

Swap positions that hedge ~~other~~ positions (**other than physical positions in exempt or agricultural commodities**) that themselves are held for the purpose of speculation or trading are also speculative or trading positions. . . .

**D. THE FOOTNOTES ALSO MISCHARACTERIZE CERTAIN SWAPS THAT REFLECT ARBITRAGE POSITIONS.**

Prior to the sentence quoted in Part II.C, above, the Footnotes also state:

The Commission preliminarily believes that swap positions that are held for the purpose of speculation or trading are, for example, those positions that are held

primarily to take an outright view on the direction of the market, including positions held for short term resale, or to **obtain arbitrage profits**. . . .<sup>10</sup>

The Commercial Alliance respectfully suggests that, with respect to physical commodities, many swaps that represent “arbitrage” positions are themselves hedges and not the type of speculative trades that should be denied hedging treatment. Additionally, the Commercial Alliance submits that the liquidation or offsetting of such a swap should not change its characterization as “hedging or mitigating commercial risk.” This point is more thoroughly discussed in the Working Group’s comments addressing the Position Limits Proposed Rule.<sup>11</sup>

Specifically, many energy and agricultural firms move physical products from one location to another and profit when the price differential between the two points exceeds the various costs associated with transportation or storage of the products. The potential variability of these price differentials is therefore a substantial commercial risk borne by these firms. Given appropriate market conditions, commercial firms will hedge the exposures associated with the differentials in pricing between the two locations, often by entering into a basis swap or other type of swap tied to different types of differential risks. The swaps that are entered into may lock-in the price differentials between the two locations whether or not the entity currently has an underlying physical commitment, as the swap hedges the future profitability of a price differential transaction executed at a future date. In other words, these transactions are often used in anticipation of future physical transactions. While such a transaction can look like financial “arbitrage,” due to the value of the commodity at the two different delivery locations, and can generate a profit or avoid loss, its characterization as “hedging or mitigating commercial risk” should not be altered. As discussed in the Working Group’s comments on the Position Limits Proposed Rule, such transactions should also qualify as a *bona fide* hedge.<sup>12</sup>

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<sup>10</sup> See Definitions Proposed Rule at 80,195 n.128 (emphasis added); End-User Exception Proposed Rule at 80,752 n.23 (emphasis added).

<sup>11</sup> See *Position Limits Proposed Rule*, Working Group Comments (Mar. 28, 2011).

<sup>12</sup> *Id.*

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**III. CONCLUSION.**

The Commercial Alliance supports tailored regulation that brings transparency and stability to the energy swap markets in the United States. The Commercial Alliance respectfully submits that the Commission consider these comments regarding the language set forth in footnote 128 of the Definitions Proposed Rule and footnote 23 of the End-User Exception Proposed Rule.

If you have any questions, please contact Christine Cochran, President, CMC, at (202) 842-0400, or R. Michael Sweeney, Jr., counsel to the Working Group, at (202) 955-1944.

Respectfully submitted,

/s/ Mark W. Menezes

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*on behalf of the Commercial Alliance*