

July 23, 2012

Via Electronic Submission

David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Comments on Interim Final Rule Excluding Swaps Entered Into for Hedging Physical Positions from Dealing Activity (RIN 3235-AK65)

Dear Mr. Stawick:

The Edison Electric Institute (“**EI**”) respectfully submits these comments in response to the Commodity Futures Trading Commission’s (“**CFTC**” or “**Commission**”) interim final rule regarding the definition of hedging for purposes of excluding certain swaps transactions from “dealing” activity under the swap dealer definition (the “**Interim Final Rule**”).¹ On May 23, 2012, the Commission issued the final rule further defining the term “swap dealer” (“**Swap Dealer Definition**”), which provides market participants with guidance about whether a company’s swaps activities would cause it to fall within the definition of swap dealer.²

The Swap Dealer Definition requires market participants to apply a facts and circumstances test to their swaps activities to determine if they fall under one of the four prongs of the statutory definition of swap dealer, as further defined in the Entity Definitions Final Rule. However, the Swap Dealer Definition provides that an entity may exclude from its swap dealer analysis certain types of swaps activities, including swaps entered into to hedge physical positions (“**SD Hedge Definition**”). Because the proposed definition of swap dealer did not exclude swaps used to hedge physical positions from the determination of whether an entity’s activities constitute swap dealing, the Commission adopted the SD Hedge Definition on an interim-final basis to provide market participants additional time to comment on the nature and scope of the exclusion for hedging activities.³

¹ Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 77 Fed. Reg. 30596 (May 23, 2012) (the “**Entity Definitions Final Rule**”).

² *Id.*

³ *Id.* at 30613.

EEI greatly appreciates the Commission's decision, in response to comments by EEI and other market participants, to exclude swaps used to hedge physical positions from the determination of whether an entity's activities constitute swap dealing. Nevertheless, as discussed more fully herein, EEI respectfully requests that the Commission replace the SD Hedge Definition with the definition of "hedging or mitigating commercial risk" adopted in the End-User Exception to the Clearing Requirement for Swaps Rule ("**End-User Hedge Definition**") for purposes of excluding hedging transactions from dealing activity.⁴ In addition to reducing the number of different hedging definitions in the Commission's regulations from four to three, adopting the End-User Hedge Definition for the SD Hedge Definition appropriately will provide market participants with legal certainty about the swap transactions that they can exclude from the analysis of what swap-related activities constitute swap "dealing." It also would reduce the operational burdens on end-users of having to analyze and track the same transaction under multiple hedging definitions.

I. Summary of EEI's Comments on the Interim Final 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. EEI's members are physical commodity market participants that rely on swaps and futures contracts primarily to hedge and mitigate their commercial risk. They are not financial entities.

As users of commodity swaps, trade options and futures contracts to hedge commercial risk, EEI's members have a significant interest in the SD Hedge Definition in the Interim Final Rule. It is important to EEI's members and other commercial commodity market participants that transactions which hedge or mitigate commercial risk be expressly excluded from dealing activity in the Swap Dealer Definition. Otherwise, commercial end-users face legal uncertainty about the types of legitimate risk mitigation transactions that regulators might construe as "dealing" activity that will require registration as a swap dealer if those transactions exceed the *de minimis* exception. Furthermore, from an operational perspective, unless the Commission replaces the SD Hedge Definition with the End-User Hedge Definition, commercial end-users will have to track multiple different hedging definitions to comply with various Commission rules. These legal and operational risks will make cost-effective risk management more difficult for commercial companies that use swaps to hedge or mitigate the risks that they incur in their businesses, and may result in higher and more volatile energy prices for residential, commercial,

⁴ *End-User Exception to the Clearing Requirement for Swaps*, 77 Fed. Reg. 42560 (hereafter "**End-User Clearing Exception Rule**").

and industrial customers. For example, absent further guidance from the Commission about how properly to implement these multiple hedging definitions, EEI members are concerned that engaging in portfolio hedging strategies may become impracticable and more costly for market participants.

For these reasons, EEI respectfully requests that the Commission:

- Replace the SD Hedge Definition with the End-User Hedge Definition for the purpose of excluding hedging activity from dealing activity; and
- Adopt the same definition of hedging or mitigating commercial risk in the SD Hedge Definition and the End-User Hedge Definition in order to reduce the regulatory compliance and operational burdens on commercial market participants, particularly with respect to portfolio hedging strategies.

II. The Commission Should Replace the SD Hedge Definition with the End-User Hedge Definition for the Purpose of Excluding Hedging Activity from Swap Dealing Activity

EEI supports the Commission's conclusion that swaps entered "for the purpose of hedging [are] inconsistent with swap dealing."⁵ Swaps that hedge or mitigate commercial risk should not be considered for purposes of determining whether an entity is engaged in swap dealing. As the Commission noted, swaps entered into "for the purpose of hedging one's own risks generally would not be indicative of" making a market in swaps or swap dealing as a "regular business".⁶ EEI urges the Commission to adopt a SD Hedge Definition that expressly reflects the Commission's view that swaps entered into for the purpose of hedging or mitigating commercial risk, whether physical or financial, do not constitute swap dealing activity. As discussed further below, by replacing the SD Hedge Definition with the End-User Hedge Definition, the Commission would provide market participants with greater certainty about the regulatory treatment of their legitimate, risk-reducing hedging activities and will reduce the operational risks associated with tracking whether swaps fall within multiple different definitions of hedging. Furthermore, because the End-User Hedge Definition is effectively the same as the MSP Hedge Definition, adopting the End-User Hedge Definition as the SD Hedge Definition would allow end-users to perform one analysis to determine if it qualifies for the end-user clearing exception and if it is eligible for the SD Hedge Definition safe harbor.

⁵ See *Entity Definitions Final Rule*, 77 Fed. Reg. at 30611.

⁶ *Id.* at n.214.

Adopting a SD Hedge Definition that expressly includes swaps entered into for the purpose of hedging or mitigating commercial risk is fully consistent with the underlying goals of the Swap Dealer Definition.⁷ Restricting the SD Hedge Definition's exclusion of hedging activity to a safe harbor limited to physical positions fails to acknowledge that the hedging of all commercial risks does not constitute swap dealing, regardless of whether the swap hedges physical or non-physical commodities.

For many commercial companies, the hedging of physical and non-physical positions are directly related. For example, an energy company constructing a new power plant may need to enter into swaps to hedge both physical and financial risks associated with the plant's construction. In this situation, the project lender may require the energy company to hedge the price exposures related to its future electricity sales and fuel purchases. In turn, depending upon the terms of the construction financing, the energy company may also wish to enter into an interest rate swap to hedge its interest rate exposure on the loan. Although the interest rate swap would not fall within the SD Hedge Definition's exclusion from dealing activity, it is a hedge of commercial risk. Moreover, under the Swap Dealer Definition's facts and circumstances test, the energy company ultimately should be able to treat the interest rate swap as hedging activity excluded from dealing activity.

Limiting the SD Hedge Definition to physical positions should not change the outcome of a company's swap dealer analysis, but does create legal uncertainty in the process. While companies may feel confident that they have accurately distinguished swaps entered into for hedging purposes from other swaps activities, because some swaps may not fall within the SD Hedge Definition's express exclusion from dealing activity there still remains some risk that regulators might perceive the conduct involved in executing those swaps as dealing activity. EEI believes that the Commission should treat hedging activity the same way under the SD Hedge Definition and the End-User Hedge Definition, allowing market participants unambiguously to exclude hedging transactions from the swap dealer analysis.

EEI understands that the Commission has concerns over potential abuse of the SD Hedge Definition should it be expanded beyond hedges of physical positions.⁸ However, EEI believes that these concerns are best addressed through anti-evasion provisions such as CFTC Rule 1.3(ggg)(6)(iii)(E), which excludes from the SD Hedge Definition transactions entered into for the purpose of evading designation as a swap dealer. This provision addresses the Commission's

⁷ As the Commission noted, "entering into a swap for the purpose of hedging is inconsistent with swap dealing." *Id.* at 30611. Expressly excluding hedging activity from swap dealing activity would not undermine the identification and regulation of entities actually engaged in swap dealing but would provide market participants with certainty that their legitimate hedging activity would not be viewed as swap dealing.

⁸ The CFTC noted that "no method has yet been developed to reliably distinguish, through a *per se* rule, between: (i) Swaps entered into for the purpose of hedging or mitigating commercial risk; and (ii) swaps that are entered into for the purpose of accommodating the counterparty's needs or demands or otherwise constitute swap dealing activity, but which also have a hedging consequence." *Id.* at 30613.

concern about the potential abuse of the SD Hedge Definition without imposing the unnecessary costs caused by creating two different definitions of hedging in the SD Hedge Definition and the MSP and End-User Hedge Definitions.

A. Adopting the Same Definition of Hedging In the SD Hedge Definition and the End-User Hedge Definition Would Facilitate and Simplify Market Participants' Entity Status Determination

Including two different definitions of hedging in the Entity Definitions Final Rule complicates and increases the costs of market participants' analysis of their status. By adopting the End-User Hedge Definition as the SD Hedge Definition, the Commission would simplify the process of determining a company's entity status.⁹ Additionally, by adopting an identical definition of hedging in the End-User Clearing Exception and SD Definition, the Commission would enable end-users to analyze and track future swap transactions one time to determine whether they must be cleared and if they fall within the SD and MSP Hedge Definitions.

However, if the Commission retains the Interim Final Rule's SD Hedge Definition, EEI's members and other commercial companies will have to examine each swap twice to determine whether it falls within (1) the SD Hedge Definition and, therefore, can be excluded from the definition of swap dealer, and (2) the MSP Hedge Definition and, therefore, can be excluded from the definition of MSP. Market participants will have to conduct these analyses not only to determine their initial regulatory obligations, but also their ongoing regulatory obligations. This redundant process will impose significant burdens and costs on the commercial, legal, compliance, operational and information technology personnel and systems of end-users. Yet, incurring these burdens and costs does nothing to further the Commission's entity definition and registration goals because the Commission already has acknowledged that swaps entered into for the purpose of hedging are inconsistent with swap dealing activity.

For all of these reasons, EEI believes that the Commission should replace the SD Hedge Definition with the End-User Hedge Definition. The End-User Hedge Definition is not limited to physical commodity hedges and incorporates concepts that market participants have traditionally used to classify their hedging activity, such as swaps that: are economically appropriate to the reduction of risk in the conduct of a commercial enterprise, are exempt from position limits as *bona fide* hedges, or qualify for hedging treatment under the Financial Accounting Standards Board ("FASB") Statement No. 133 or Governmental Accounting Standards Board ("GASB") Statement 53, *Accounting and Financial Reporting for Derivative Instruments*.¹⁰ Adopting the End-User Hedge Definition as the SD Hedge Definition would

⁹ The MSP Hedge Definition and the End-User Hedge Definition effectively provide the same definition of "hedging or mitigating commercial risk." See *infra* note 15.

¹⁰ As discussed further below, a consistent definition of hedging in the Entity Definitions Final Rule and the End-User Hedge Definition would also facilitate market participants' use of portfolio hedging.

provide market participants with greater legal certainty as to the status of their hedging transactions and reduce market participants' compliance costs.¹¹

III. The Commission Should Adopt the Same Definition of Hedging in the SD Hedge Definition and the End-User Hedge Definition

The Commission has either proposed or adopted four separate definitions of hedging in its rules. Currently CFTC regulations subject market participants to the following four different definitions of hedging:

- Part 151 of the CFTC's regulations excludes "*bona fide* hedging" transactions from speculative position limits for exempt and agricultural commodity transactions.¹² The definition of a "*bona fide* hedge" limits hedging activities to the eight enumerated categories of hedging transactions listed in CFTC Rule 151.5.¹³
- CFTC Rule 1.3(z) excludes *bona fide* hedging transactions from speculative position limits for excluded commodity transactions. Unlike CFTC Rule 151.5, CFTC Rule 1.3(z) specifically provides for non-enumerated hedging transactions; further, its list of enumerated hedges does not correspond to the list of enumerated hedges in CFTC Rule 151.5.¹⁴
- The End-User Hedge Definition and the MSP Hedge Definition effectively provide the same definition of "hedging or mitigating commercial risk."¹⁵

¹¹ The Interim Final Rule's SD Hedge Definition would also impose a significant strain on the Commission's resources by requiring the Commission to continuously provide guidance to market participants regarding the application of the "facts and circumstances" test to their hedging transactions. To date, the Commission has not issued any formal guidance on the implementation of the four different hedging definitions; instead, market participants have individually contacted Commission staff for guidance in informal discussions.

¹² See *Position Limits for Futures and Swaps*, 76 Fed. Reg. 71626 (Nov. 18, 2011).

¹³ See CFTC Rule 151.5(a)(2).

¹⁴ *Id.*

¹⁵ Although the MSP Hedge Definition and the End-User Hedge Definition are virtually identical, there are two differences: (1) the End-User Hedge Definition only applies to non-financial entities; and (2) the MSP Hedge Definition includes transactions entered into to reduce risks "in the conduct and management of a commercial enterprise (or of a majority-owned affiliate of the enterprise)". There is an additional non-substantive difference in that (1) under the MSP Hedge Definition, one cannot hold a position to "hedge or mitigate the risk of another swap or security-based swap position, unless that other position is itself for the purpose of hedging or mitigating commercial risk", while (2) under the End-User Hedge Definition, one cannot hold a position to "hedge or mitigate the risk of another swap or security-based swap position, unless that other position itself is used to hedge or mitigate commercial risk." See CFTC Rule 1.3(kkk)(2)(ii) and CFTC Rule 39.6(c)(2)(ii). Under either definition, swaps held to hedge or mitigate the risk of another swap only qualify as a hedge if the other swap was entered into to hedge or mitigate commercial risk.

- The SD Hedge Definition, unlike the End-User Hedge Definition and the MSP Hedge Definition, is limited to the hedging of physical positions. Although similar to the definition of *bona fide* hedging under CFTC Rule 151.5, the SD Hedge Definition is broader because it is not limited to the eight enumerated categories of hedging transactions.

This disparity among the Commission's hedging definitions will impose significant, unnecessary compliance costs on market participants. It forces commercial companies to examine a single transaction under multiple hedging definitions in order to determine its regulatory status as a hedge or non-hedge. As noted above, by adopting the End-User Hedge Definition as the SD Hedge Definition, the Commission would facilitate a company's determination of its entity status, both at the time of initial registration and on a going-forward basis. Further, by adopting the End-User Hedge Definition, which is effectively the same as the MSP Hedge Definition, the Commission would facilitate compliance and minimize unnecessary costs for end-users under the End-User Clearing Exception Rule.

The multiple hedging definitions in the CFTC's rules create substantial operational and compliance difficulties for EEI members and other market participants. In practice, companies frequently will have to determine whether the contemplated hedging transaction falls within one or more of the rules' various hedge definitions in order to classify the transaction as a hedge. Companies must determine the trade's hedge status in real-time because in many circumstances, *e.g.*, to exceed a position limit or execute non-cleared or pass-through swaps, they will not be able execute the trade if it does not qualify under a particular hedge definition.¹⁶

Determining a trade's hedging status under multiple different definitions at or about the time of a transaction in rapidly changing markets is commercially impractical. End-users incur risks on a moment-by-moment basis and must be able to mitigate those risks as they arise. This is particularly true with respect to assets and liabilities that are exposed to highly volatile electricity prices.¹⁷ Market participants need straight-forward and consistent definitions by

¹⁶ For example, if the trade is in a Referenced Contract, the company must be certain that it qualifies as a hedge that is exempt from position limits, regardless of whether it qualifies as a hedge under any other definition.

¹⁷ Ann Ku, *Forecasting to Understand Uncertainty in Electricity Prices*, PLATTS ENERGY BUSINESS AND TECHNOLOGY, May/June 2002, at 59 (“[E]conometric models, such as those used in load forecasting, assume that consumers will behave in the future much as they have in the past. But in the electricity business, today and tomorrow are often very different than yesterday. The introduction of ancillary service markets and markets with different rules and protocols, new supplies coming on-line, and the volatility of fuel prices make traditional econometric models poor foundations for price forecasting.”); Volatility of Power Grids under Real-Time Pricing, *Competition in Wholesale Electric Power Markets*, 23 ENERGY L.J. 281, 299 (2002) (“Electricity is an unusual commodity. It is non-storable, non-directable on the grid, and the present infrastructure has been engineered with little ability to alter power use based on cost or price signals. These features make electricity prices volatile when electricity is traded freely.”)

which to categorize their transactions. Otherwise, they will struggle to comply with regulatory requirements that do not accommodate commercial obligations.

A. The Commission Should Ensure that Commercial End-Users Can Continue to Utilize Portfolio Hedging Strategies by Minimizing the Number of Hedging Definitions in Its Regulations

EEI appreciates the Commission's clarification that the exclusion from dealing activity for hedging transactions includes portfolio hedging transactions that fall within the SD Hedge Definition.¹⁸ Further, EEI supports the Commission's recognition in both the Interim Final Rule and the End-User Clearing Exception Rule that dynamic hedging transactions will qualify under both the SD Hedge Definition, in whatever form ultimately adopted, and the End-User Hedge Definition.¹⁹ However, EEI members remain concerned that their ability to hedge their assets, liabilities and services on a portfolio basis will be circumscribed by the multiple hedging definitions in the Commission's regulations, including within the Entity Definitions Final Rule.

EEI's members may track a portfolio of physical and financial transactions that includes asset positions (power plant capacity, forward contract purchase of fuel, related hedges), liabilities (load serving obligations, forward contract sales, related hedges), services (transmission and transportation contracts, storage), and associated hedges. Even if a portfolio is comprised of physical positions, commercial companies may elect to hedge only their net exposure (after adding together all of their long and short exposures). When the portfolio includes options or forward contracts with embedded volumetric options, the gross or net quantity that needs to be hedged will change on an intraday basis. Market participants also may hedge position portfolios on a dynamic basis in an effort to optimize the cost-effectiveness of their hedging program.

Given the multiple hedging definitions in the Commission's regulations, it is unclear how market participants will be able to continue to hedge on a portfolio basis. If market participants enter into a transaction to hedge a portfolio like the one described above, it appears that in order to classify that transaction accurately as a hedge in their books, they would need to verify which of the Commission's multiple hedging definitions it falls under. If a hedge of the portfolio

¹⁸ *Interim Final Rule*, 77 Fed. Reg. at 30612 ("And, as in the *bona fide* hedging rule, the exclusion utilizes the word 'several' to reflect that there is no requirement that swaps hedge risk on a one-to-one transactional basis in order to be excluded, but rather they may hedge on a portfolio basis.").

¹⁹ The Commission noted in the Interim Final Rule that "qualification as *bona fide* hedging has never been understood to require that hedges, once entered into, must remain static. We expect that entities would move to update their hedges periodically when pricing relationships or other market factors applicable to the hedge change." *Interim Final Rule*, 77 Fed. Reg. at 30612 n.218; *End-User Clearing Exception Rule*, 77 Fed. Reg. at 42575 ("The Commission notes that qualification as *bona fide* hedging does not require that hedges, once entered into, must remain static. The Commission recognizes that entities may update their hedges periodically when pricing relationships or other market factors applicable to the hedges change.").

qualifies under one, but not all, of the various definitions of hedging, the market participant would need to develop a way to categorize the transaction as a hedge for some purposes and as non-hedge transaction for others.²⁰ This result seems to assume a static world in which market participants hedge each physical position with a separate and specifically identified swap or futures contract, which in turn greatly diminishes the efficiency of portfolio hedging. In order to continue engaging in portfolio hedging, market participants may have to create multiple hedging portfolio books in order to properly group their portfolio hedging activities (*e.g.*, create separate portfolios, or sub-categories within a single portfolio, for load serving obligations, asset transactions, *etc.*).

Requiring commercial firms to review each transaction entered into to hedge a portfolio under all of the Commission's hedging definitions would be impractical and problematic from a transaction execution, recordkeeping and reporting perspective, and does not match the commercial realities of portfolio hedging. The review and classification of a single transaction multiple times within a company's records is unduly burdensome and requires a level of technological sophistication that many market participants do not currently possess and that is not currently available from software vendors. Given that the Commission intended to allow market participants to hedge on a portfolio basis, EEI requests that the Commission confirm that hedges of a portion of the gross or net exposure of a portfolio of positions qualify as hedges under all of its hedging definitions that relate, at least in part, to physical positions.

V. Conclusion

EEI appreciates the Commission's consideration of our comments on the Interim Final Rule's SD Hedge Definition. For the foregoing reasons, we respectfully request that the Commission replace the SD Hedge Definition with the End-User Hedge Definition

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²⁰ For example, a hedge of a company's interest rate risk associated with its ownership of physical assets would qualify under the CFTC Rule 1.3(z), the MSP Hedge Definition and the End-User Hedge Definition. However, the same transaction may have a different status under the SD Hedge Definition and the Position Limits Rule. Although an interest rate hedge would not fall within the SD Hedge Definition, it may still ultimately qualify as a hedge of commercial risk that may be excluded from dealing activity under the Swap Dealer Definition. The result is that market participants may lack the certainty at the time the transaction is executed to classify it as a portfolio hedge. Further, the hedge transaction described above would not qualify under the Position Limits Rule under any circumstances because it does not hedge a physical position. Similarly, it is possible that a hedge under the SD Hedge Definition would not qualify as a *bona fide* hedge under the Position Limits Rule because it did not fall within one of the enumerated hedging transactions (*e.g.*, an anticipated hedging transaction of a physical commodity that exceeds one year would not qualify under CFTC Rule 151.5(a)(2)(v), but would qualify under the SD Hedge Definition).

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

Respectfully submitted,



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