

January 19, 2016

VIA ELECTRONIC SUBMISSION

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Comments on the Swap Dealer *De Minimis* Exception Preliminary Report

Dear Mr. Kirkpatrick:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the “**Working Group**”), Sutherland Asbill & Brennan LLP hereby submits this letter in response to the request for public comment set forth in the Commodity Futures Trading Commission (the “**CFTC**” or “**Commission**”) staff’s Swap Dealer *De Minimis* Exception Preliminary Report (the “**Preliminary Report**”).¹ The Working Group appreciates the opportunity to provide comments on the Preliminary Report and looks forward to working with the Commission as it works through a multi-step process of considering changes to the *de minimis* exception from registration as a swap dealer (the “**De Minimis Exception**”) and the notional value threshold of the *De Minimis* Exception (the “**De Minimis Threshold**”). Consistent with the preliminary and high-level nature of the analysis in the Preliminary Report, the Working Group’s comments are preliminary. The Working Group expects to submit comments that are more granular as the process unfolds.

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 producers, processors, merchandisers, and owners of energy commodities. Among the

¹ See Swap Dealer *De Minimis* Exception Preliminary Report: A Report by Staff of the Commodity Futures Trading Commission Pursuant to Regulation 1.3(ggg) (Nov. 18, 2015), available at http://www.cftc.gov/idx/groups/public/@swaps/documents/file/dfreport_sddeminis_1115.pdf.

members of the Working Group are some of the largest users of energy derivatives in the United States and globally. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

The Working Group views the Preliminary Report as a good first step in the CFTC's undertaking to develop a better understanding of the impact of swap dealer registration and regulation on swap markets. The Preliminary Report provides some valuable insights, but more comprehensive data and further analysis are necessary before the Commission makes any changes to the current *De Minimis* Exception or *De Minimis* Threshold. To avoid any negative impact that may result from the automatic reduction of the *De Minimis* Threshold or change to the *De Minimis* Exception based on analysis conducted with incomplete information, the Working Group respectfully urges the CFTC to issue an interim final rule that would maintain the current *De Minimis* Threshold of an \$8 billion gross notional value at least until better data is available and the Commission is able to solicit market participants' feedback on meaningful analysis and make fully informed decisions.

II. COMMENTS OF THE WORKING GROUP.

The Working Group's comments contained herein: (i) request an interim final rule to prevent an automatic drop in the *De Minimis* Threshold from \$8 billion to \$3 billion; (ii) identify areas the CFTC should focus on in its final report on the *De Minimis* Exception (the "**Final Report**"); (iii) address issues with the Preliminary Report resulting from the use of limited data; (iv) respond to specific questions on physical commodity swap markets; and (v) explain why the proposed alternative approaches to the *De Minimis* Exception are flawed, and, consequently, why the CFTC should maintain its current approach to the *De Minimis* Exception.

A. **An Interim Final Rule Preventing the *De Minimis* Threshold from Dropping from \$8 billion to \$3 billion Is Necessary to Provide the Market with Regulatory Certainty.**

The Working Group requests that the Commission issue an interim final rule to maintain the *De Minimis* Threshold at \$8 billion. Doing so would provide much needed regulatory certainty to swap market participants. Determining whether an entity has exceeded the *De Minimis* Threshold and, therefore, must register as a swap dealer, requires a look back over the prior 12 months of activity. With the *De Minimis* Threshold scheduled to drop to \$3 billion in December 2017, it is unclear whether activity in the 12 months prior to such date will be looked to in order to determine whether the new \$3 billion threshold has been exceeded. At a minimum, fairness dictates that if swap dealing activity engaged in prior to December 2017 will be factored into whether a market participant will have exceeded the \$3 billion *De Minimis* Threshold in December 2017, market participants should be notified prior to the measurement period. Many companies plan their business activity and resource allocation more than a year in advance. A potential for the automatic drop in the *De Minimis* Threshold might cause market disruption as early as the first quarter of 2016 as some market participants, in anticipation of a potential \$3 billion *De Minimis* Threshold, begin to scale back their swap dealing activity in order to avoid an

abrupt disruption to their business while they try to avoid potential swap dealer registration in December 2017.

Issuing an interim final rule, as requested above, would also ensure that the Commission acts consistent with the intent of Congress. Specifically, H.Rpt. 114-205 directs “the [CFTC] to promulgate a rulemaking either maintaining the Swap Dealer de Minimis threshold at \$8,000,000,000, the amount currently set forth in regulation, or above this amount...”² Also, Congress, in an explanatory statement accompanying the Consolidated Appropriations Act of 2016,³ directed “the [CFTC] to comply with [H.Rpt. 114-205’s] directive regarding swap dealer de minimis.”⁴

B. Areas the CFTC Should Focus on in the Final Report.

i. The Final Report Should Focus on the Market Composition Implications of Any Potential Change to the De Minimis Threshold.

To avoid negative impacts to market composition and to further the CFTC’s policy objectives of protecting “swap market transparency, orderliness, and efficiency”⁵ and “encouraging new participants to enter the market, and providing greater regulatory efficiency,”⁶ the CFTC’s careful consideration regarding any potential reduction to the *De Minimis* Threshold or change to the *De Minimis* Exception is imperative.

The Final Report should focus on the market composition implications of any potential change to the *De Minimis* Threshold as any significant change in the *De Minimis* Threshold would likely cause a material change in the number of participants in a market and the nature of other participants’ activity.⁷ For example, lowering the *De Minimis* Threshold would likely cause many commercial market participants (*i.e.*, non-financial entities whose primary business involves the production, delivery, or consumption of physical commodities) to limit their swap activity to avoid transactions that could remotely be considered swap dealing activity. In turn, this change may impact market composition by (i) lowering liquidity, (ii) further consolidating risk in large financial institutions, (iii) increasing volatility, and (iv) reducing competitive pricing. All of these outcomes, whether together or individually, are not in the public interest as they will likely result in consumers paying more for energy.

² H.Rpt. 114-205 at 76 (July 14, 2015), available at <https://www.congress.gov/114/crpt/hrpt205/CRPT-114hrpt205.pdf>.

³ See generally Consolidated Appropriations Act of 2016, H.R. 2029, Pub. L. No. 114-113 (Dec. 18, 2015), available at <https://www.congress.gov/bill/114th-congress/house-bill/2029/text?q=%7B%22search%22%3A%5B%22hr2029%22%5D%7D&resultIndex=1>.

⁴ Accompanying Statement to the Consolidated Appropriations Act of 2016, Explanatory Statement Division A at 32 (Dec. 2015), available at <http://docs.house.gov/meetings/RU/RU00/20151216/104298/HMTG-114-RU00-20151216-SD002.pdf>.

⁵ Preliminary Report at 36.

⁶ *Id.*

⁷ See *id.* at 49.

Any reduction in liquidity would further compound liquidity issues that have existed in energy swap markets since the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”).⁸ These liquidity issues have been noted in both the press⁹ and by members of the Commission’s Energy and Environmental Markets Advisory Committee (“**EEMAC**”). Specially, Paul Hughes of Southern Company stated before EEMAC that

...when I’m looking to go offset risks[,] in the past[,] I would have been able to do it, [but] there’s no more players out there. Those ponds [of liquidity] have dried up. And I think you can’t necessarily attribute that to one specific rule...but I do think Dodd-Frank has had an impact on the markets and we can’t ignore that.¹⁰

Hughes’ testimony goes on attribute that drop in liquidity to the absence of market participants willing to engage in swap dealing activity.¹¹ As discussed further below, the implications of the CFTC’s actions will likely be most acute with respect to the non-financial commodity swaps asset class.¹²

The negative consequences to market composition, and more specifically, liquidity, resulting from a *De Minimis* Threshold that is set too low are not theoretical – they are very real. Specifically, the CFTC has already observed these negative consequences to market composition when it set a *De Minimis* Threshold of \$25 million for swap dealing activity with special entities¹³ (the “**Special Entity De Minimis Threshold**”).¹⁴

⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, Pub. L. No. 111-203 (July 21, 2010), available at <https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf>.

⁹ See *Few Commodity Traders Saw Improved Liquidity in 2015 – Poll*, Alexander Osipovich, Energy Risk (Jan. 8, 2016), available at <http://www.risk.net/energy-risk/news/2440802/few-commodity-traders-saw-improved-liquidity-in-2015-poll>; *U.S. Energy Firms Lament Liquidity “Void” After Bank Exits*, Alexander Osipovich, Energy Risk (May 15, 2015), available at <http://www.risk.net/energy-risk/news/2408668/us-energy-firms-lament-liquidity-void-after-bank-exits>; *Bank Exits from Commodity Trading Hurt U.S. Power Firms*, Peter Maloney, Energy Risk (Nov. 20, 2015), available at <http://www.risk.net/energy-risk/feature/2435373/bank-exits-from-commodity-trading-hurt-us-power-firms>.

¹⁰ Transcript of the CFTC EEMAC Meeting of Feb. 26, 2015 at 221, available at <http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/emaactranscript022615.pdf> (quoting Paul Hughes of Southern Company, an Associate Member of EEMAC).

¹¹ See *id.* at 226. Specifically, Hughes stated “I used to maybe have eight or ten counterparties that...I could call on and reliably expect to be there. Some of those counterparties have just left. Some of them have kind of left the marketplace, some of them got completely out of the business. Some of them have moved overseas.” *Id.*

¹² Preliminary Report at 38-39.

¹³ “Special entity” is defined to include (i) federal, state, city, county, or municipal governments, entities, or agencies, (ii) certain employee benefit plans, and (iii) certain non-profit entities. See CFTC Regulation 23.401(c).

¹⁴ See generally Final Rule, *Exclusion of Utility Operations-Related Swaps with Utility Special Entities from De Minimis Threshold for Swaps with Special Entities*, 79 Fed. Reg. 57,767 (Sept. 26, 2014) (the “**Utility Special**”).

In setting the Special Entity *De Minimis* Threshold, the CFTC intended to protect special entities.¹⁵ However, certain special entities that rely on energy swaps to hedge commercial risk were harmed by the CFTC's action. Because the Special Entity *De Minimis* Threshold was so low and the consequences of becoming a swap dealer are so significant, many of those special entities' non-financial end-user counterparties refused to enter into swaps with them.¹⁶ For example, one special entity lost two of its three largest end-user counterparties, experienced a greatly diminished ability to hedge risk, and was subject to a wider bid-ask spread from its swap dealer counterparties.¹⁷

To resolve these negative impacts to market composition, the Commission issued a final rule to provide that certain swaps (*i.e.*, utility operations-related swaps with utility special entities) counted toward the \$8 billion *De Minimis* Threshold rather than the \$25 billion Special Entity *De Minimis* Threshold.¹⁸ The Working Group's hope is that this experience informs the CFTC when it is considering any reduction to the *De Minimis* Threshold, or change to the *De Minimis* Exception generally.

ii. *In the Final Report, the CFTC's Policy Objectives Should Include Protection of the Integrity of Physical Commodity Markets.*

In the Final Report, the CFTC's policy objectives should explicitly include protection of the integrity of physical commodity markets. Protecting the integrity of physical commodity markets is not specifically listed in the CFTC's list of policy objectives with respect to its definition of "swap dealer" or the *De Minimis* Exception. However, protecting the integrity of physical commodity markets merits strong consideration because physical commodity markets and physical commodity swap markets are inextricably intertwined. A change to the regulatory infrastructure of non-financial commodity swaps markets that creates a disincentive to be active in those markets, like a reduction in the *De Minimis* Threshold, could have a similar detrimental effect on related physical commodity markets. For example, if liquidity in financial markets decreases, hedging physical commodity risk will be more expensive and more difficult. The absence of efficient hedging options could cause certain market participants to be less active in physical commodity markets. Finally, any decrease in liquidity in physical commodity markets

Entity Rule"), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-22966a.pdf> (responding to issues facing certain special entities).

¹⁵ See Joint Final Rule, Joint Interim Final Rule, and Interpretations, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant,"* 77 Fed. Reg. 30,596, 30,642 (May 23, 2012) ("**Entity Definitions Rule**"), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-10562a.pdf>.

¹⁶ See Statement of Donald Russak Testifying on Behalf of the American Public Power Association Before the Senate Committee on Agriculture, Nutrition and Forestry at 5 (July 17, 2013), available at <http://www.ag.senate.gov/download/?id=e52dcd01-b668-4c05-abe6-a1798e60c124>.

¹⁷ See Statement of Terrance Naulty Testifying on Behalf of the American Public Power Association Before the House Committee on Agriculture at 5 (Mar. 14, 2013), available at <https://archives-agriculture.house.gov/sites/repUBLICans.agriculture.house.gov/files/pdf/hearings/Naulty130314.pdf>.

¹⁸ See generally Utility Special Entity Rule.

could have significant consequences for markets that are in the process of grappling with the liquidity implications of banks exiting such markets.¹⁹

C. Issues with the Preliminary Report Resulting from the Use of Limited Data.

- i. The Commission Should Focus on Improving and Refining Data for Certain Asset Classes Prior to Contemplating a Change to the De Minimis Exception or the De Minimis Threshold.*

The CFTC should focus on improving and refining data for certain asset classes prior to contemplating a change to the *De Minimis* Exception or the *De Minimis* Threshold. The Commission's solicitation of public comments in its Draft Technical Specifications for Certain Swap Data Elements (the "**Draft Specifications**") is a first step in that process.²⁰

As any change to the *De Minimis* Exception or reduction in the *De Minimis* Threshold may cause significant consequences to the markets, any analysis of potential changes must be based on relevant, sound data. An analysis to change the *De Minimis* Exception or reduce the *De Minimis* Threshold that is not based on relevant, sound data cannot adequately support any conclusion as to the implications of such changes or may be inaccurate. Given the importance of relevant and sound data, the Working Group has concerns about the analysis in the Preliminary Report with respect to certain asset classes.

Notably, CFTC staff highlights that there were "some limitations on working with the data" relied upon in drafting the Preliminary Report.²¹ The CFTC's data issues were especially pronounced for the non-interest rate swap and credit default swap asset classes for which "additional information...would be necessary for a comprehensive analysis."²² For example, because of data-related issues, CFTC staff was unable to calculate notional value for swaps in the non-financial commodity, foreign exchange, and equity asset classes and had to rely on other metrics to analyze potential swap dealing activity with respect to those asset classes.²³

In an attempt to conduct meaningful analysis in the absence of good data, the CFTC was forced to make a number of assumptions. Primarily, the CFTC assumed that two simple metrics – transaction count and counterparty count – were useful in analyzing swap dealing activity across asset classes²⁴ even though the Commission previously rejected using those metrics as

¹⁹ *Bank Exodus from Commodities Could Hurt Liquidity Short Term; Otherwise Limited Impact Seen*, Forbes Contributor Kitko News (July 22, 2014), available at <http://www.forbes.com/sites/kitconews/2014/07/22/bank-exodus-from-commodities-could-hurt-liquidity-short-term-otherwise-limited-impact-seen/>.

²⁰ Draft Technical Specifications for Certain Swap Data Elements: A Request for Comment by the Staff of the CFTC (Dec. 22, 2015), available at <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/specificationsswapdata122215.pdf>.

²¹ Preliminary Report at 11.

²² *Id.* at 48.

²³ *Id.* at 18.

²⁴ *Id.* at 19.

part of the *De Minimis* Exception and the transaction count metric has only a “loose correlation with dealing activity.”²⁵

In short, as discussed further below, the metrics used in the Preliminary Report provide a limited, descriptive picture of certain characteristics of the non-financial commodity, foreign exchange, and equity asset classes, but that picture is not nearly sufficient to permit the CFTC to begin to quantify the potential implications of changes to the *De Minimis* Exception or a reduction to the *De Minimis* Threshold. Therefore, the Working Group respectfully requests that the CFTC work to improve and refine data with respect to those asset classes before it contemplates any change to the *De Minimis* Exception or reduction to the *De Minimis* Threshold. Said another way, the CFTC should only make regulatory changes that could have significant consequences to swap markets and physical commodity markets when it has relevant, sound data that will allow it to understand the implications of such changes.

The CFTC should be able to gather the information it needs through certain of the proposed changes discussed in the Draft Specifications. However, as the Working Group will discuss more fully in comments on the Draft Specifications, the CFTC’s current proposed approach to gathering swap dealing-related data is materially flawed. Among other things, the proposed approach assumes that every transaction has a counterparty that is engaged in swap dealing activity.²⁶ As noted in the section below, that is not the case for many swap transactions in physical commodity swap markets.

ii. *The Preliminary Report’s Analysis of the Physical Commodity Swap Markets Is Limited and Should Be Understood in Context.*

The Preliminary Report provides limited analysis with respect to the non-financial commodity asset class. While that analysis identifies a few differences between activity in physical commodity swap markets and other swap markets,²⁷ those differences (i) do not necessitate a change in the *De Minimis* Exception or a reduction in the *De Minimis* Threshold with respect to those markets and (ii) should be understood in the context of such markets.

As discussed herein, physical commodity swap markets are unique in that many of the market participants that engage in swap dealing activity do so as an ancillary part of their business, and that activity is typically tied to an existing physical trading relationship. As swap dealing activity is not a core business for most non-financial entities that engage in such activity, the amount of swap dealing risk that such entities’ management permits them to take is usually quite limited and strictly monitored. In fact, regulating these non-financial entities as swap

²⁵ *Id.* at 56.

²⁶ *See, e.g.*, Draft Specifications at 13-14. The Draft Specifications propose a reporting field where a counterparty would be required to identify the exclusion from swap dealing activity upon which it is relying. If no exclusion is identified, then the counterparty is assumed to be engaged in swap dealing. That is a faulty assumption. Certain types of trading activity (*e.g.*, price discovery and investing) do not qualify for any of the proposed express exclusions from swap dealing activity, but, nonetheless are not swap dealing.

²⁷ *See* Preliminary Report at 41-42.

dealers would be largely in conflict with Chairman Massad's recent statement that "the swap activities of commercial end-users were not a source of significant risk in the financial crisis, and we must make sure that they can continue using the derivatives markets effectively and efficiently."²⁸

The CFTC states that the "data shows that non-financial entities play a significant part in the Non-Financial Commodity swap market and, accordingly, a decision to exclude such firms from swap dealer registration may require further analysis to assess whether such an exclusion could result in a greater than *de minimis* amount of unregistered dealing activity."²⁹ The CFTC is correct in one part – non-financial entities play a significant part in physical commodity swap markets. However, that does not mean that there is a greater than *de minimis* amount of unregistered swap dealing activity occurring in physical commodity swap markets.

Not every physical commodity swap has a counterparty acting as a swap dealer. As a result of the unique composition of physical commodity swap markets and nature of the businesses of non-financial entities that participate in those markets, there are a meaningful number of transactions between non-financial entities where neither counterparty is acting as a swap dealer. Those counterparties are typically addressing their own commercial needs and not facilitating the needs of, or making a market for, their counterparty. For example, two commercial market participants may have naturally offsetting risk profiles (*e.g.*, a producer and a refiner). Such offsetting risk profiles allow these counterparties to engage in transactions that have the mutually beneficial purpose of reducing their respective physical commodity price risk exposure while neither is engaged in swap dealing.

Given the uniqueness of the physical commodity swap markets noted above, the Commission should not apply conclusions that may hold true with respect to other swap markets to physical commodity swap markets. In addition, conclusions or inferences drawn by the CFTC with respect to financial entities transacting in physical commodity swap markets likely do not hold true for non-financial entities. Thus, the CFTC staff's conclusion that "at least some non-financial entities had Counterparty and Transaction Counts that were comparable to financial entities and may be indicative of dealing"³⁰ likely is flawed.

To conclude that certain non-financial entities may be engaged in a more than *de minimis* amount of swap dealing activity because their transaction and counterparty counts are similar to those of financial entities that may be engaged in a more than *de minimis* amount of swap dealing activity does not account for the role that non-financial entities play in physical commodity swap markets. To fulfill the needs of their underlying physical business, many non-financial entities may be quite active in the physical commodity swap markets and may have a broad array of counterparties. For many non-financial entities, a large majority of that activity is likely not swap dealing activity. Non-financial entities have a number of reasons to enter into

²⁸ Statement of Chairman Timothy Massad Regarding the Final Rule on Margin for Uncleared Swaps (Dec. 16, 2015), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement121615d>.

²⁹ Preliminary Report at 42.

³⁰ *Id.* at 41.

physical commodity swaps, such as hedging physical commodity risk, price discovery for both financial and physical markets, and speculative trading. None of these types of trades constitute swap dealing activity. In contrast, financial entities typically do not have physical commodity risk to hedge or engage in price discovery for physical markets, and certain financial entities are prohibited from engaging in speculative proprietary trading under the Volcker Rule.³¹

Finally, the notional value of physical commodity swaps is a direct function of the current price of the relevant underlying commodity. To some degree, this issue is unique, or at least, most pronounced, in physical commodity swap markets given (i) that notional amounts are denominated in commodity units and (ii) the potential volatility in the prices of certain commodities. This relationship between commodity price and notional value has implications for the *De Minimis* Threshold. Stated simply, unless market participants reduce their amount of swap dealing activity, the same level of activity could take them over the *De Minimis* Threshold independent of any actions they take in the face of rising prices. As commodity prices are currently at historical lows,³² the Commission should take care not to make changes to the *De Minimis* Threshold that could have a detrimental impact on liquidity if market participants are forced to reduce their swap dealing activity in the face of rebounding commodity prices in order to avoid exceeding an artificially low *De Minimis* Threshold.

iii. *The Absence of Final Rules on Capital Requirements for Non-Bank Swap Dealers Limits the Effectiveness of Any Analysis of the De Minimis Exception.*

The Working Group requests that the Commission not reduce the *De Minimis* Threshold or change the *De Minimis* Exception until final rules on capital have been fully implemented. While most of the rulemakings imposing obligations on swap dealers have been finalized, the CFTC has yet to finalize capital rules for swap dealers not subject to oversight by a prudential regulator.³³ As the Working Group's Cost-Benefit Analysis of the CFTC's Proposed Swap

³¹ See generally Final Rule, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5,808 (Jan. 31, 2014), available at <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2013-31476a.pdf>; Joint Final Rule, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5,536 (Jan. 31, 2014), available at <https://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/2013-31511.pdf>.

³² See *Oil Prices: What's Behind the Drop? Simple Economics*, Clifford Krauss, The New York Times (Updated Jan. 15, 2016), available at http://www.nytimes.com/interactive/2015/business/energy-environment/oil-prices.html?_r=0; *Iron Ore Reaches Record Post-2008 Low in Steel Demand Slide*, Henry Sanderson, The Financial Times (Nov. 24, 2015), available at <http://www.ft.com/intl/cms/s/0/82aad028-92ba-11e5-94e6-c5413829caa5.html#axzz3uW2PKo8O>; *Natural-Gas Prices Drop to Lowest Level Since 1999*, Nicole Friedman, The Wall Street Journal (Dec. 15, 2015), available at <http://www.wsj.com/articles/natural-gas-prices-continue-slump-1450193642>; *Gas Prices 2015: \$2 a Gallon Expected Soon Following Record Low in Cost of Crude Oil*, Elizabeth Whitman, International Business Times (Dec. 9, 2015), available at <http://www.ibtimes.com/gas-prices-2015-2-gallon-expected-soon-following-record-low-cost-crude-oil-2217862>.

³³ See CFTC Final Rule and Interim Final Rule, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636, n.4 (Jan. 6, 2016), available at <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf>.

Dealer Definition demonstrated, regulatory capital requirements will likely be one of the most significant costs faced by a swap dealer, if not the most significant cost.³⁴ In the absence of final rules on capital, it is impossible for market participants to make a fully informed decision on whether the costs of registering as a swap dealer outweigh the benefits. Therefore, the true impact of any reduction in the *De Minimis* Threshold or any change to the *De Minimis* Exception will likely be unknown until capital rules are finalized.

iv. *The Preliminary Report's Analysis of the Interest Rate Swap and Credit Default Swap Markets Provides Limited, But Meaningful Insight.*

Because the Commission was able to calculate notional value for the interest rate swap and credit default swap asset classes, the Preliminary Report provides a rough approximation of the impact a change to the *De Minimis* Threshold would have on those asset classes, which constitute over 80% of the derivatives market in U.S.³⁵ and globally³⁶ (commodities-related derivatives are less than 1% of the U.S.³⁷ and global³⁸ derivatives markets).

Table 19 of the Preliminary Report provides an overview of the Preliminary Report's findings for the interest rate swap and credit default swap asset classes, analyzed together.³⁹ Table 19 estimates that if the *De Minimis* Threshold decreased to \$3 billion, 83 additional potential swap dealing entities may be required to register. However, the increase in notional activity, swaps, and unique counterparties covered by swap dealer regulation would only increase by 1-2%.⁴⁰

Such a result would be inconsistent with the Commission's policy objective of "regulatory efficiency" with respect to the *De Minimis* Exception.⁴¹ An estimated 64% increase in the number of registered swap dealers to only increase the percentage of notional activity, swaps, and unique counterparties covered by swap dealer regulation by 1-2% would not be

³⁴ See Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition, Prepared for the Working Group of Commercial Energy Firms by NERA Economic Consulting (Dec. 20, 2011), available at http://www.nera.com/content/dam/nera/publications/archive2/PUB_SwapDealer_1211.pdf. In February 2012, the Working Group of Commercial Energy Firms reconstituted itself as "The Commercial Energy Working Group."

³⁵ Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities (Second Quarter 2015) ("OCC Report") at 1, available at <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq215.pdf>.

³⁶ Bank for International Settlements, Statistical Release, OTC Derivatives Statistics at End-June 2015 (Nov. 2015) ("BIS Report") at 3-5, available at https://www.bis.org/publ/otc_hy1511.pdf.

³⁷ See OCC Report at Graph 3.

³⁸ See BIS Report at 7.

³⁹ See Preliminary Report at 48.

⁴⁰ See *id.* at 49.

⁴¹ The Preliminary Report notes that the CFTC's policy objectives underlying the definition of "swap dealer" are "swap market transparency, orderliness, and efficiency," and the CFTC's policy objectives underlying its *De Minimis* Exception are "providing regulatory certainty, allowing limited swap dealing in connection with other client services, encouraging new participants to enter the market, and providing greater regulatory efficiency." *Id.* at 36.

efficient.⁴² Not only would the additional potential swap dealers be subject to a significant regulatory burden, but regulating up to 83 additional entities as swap dealers would further strain the CFTC's already limited resources.⁴³ In addition, some of those 83 potential swap dealers may choose to reduce or cease their swap dealing activity to avoid the substantial regulatory burden that comes with registering as a swap dealer, which could have material consequences for price efficiency and liquidity.

The CFTC's limited analysis of the consequences for the interest rate swap and credit default swap markets of lowering the *De Minimis* Threshold from \$8 billion to \$3 billion shows that such a change may be an undesirable regulatory outcome. Coupling that with the fact the Commission believes "additional information...would be necessary for a comprehensive analysis"⁴⁴ of the other three major asset classes, the Commission must hold off on making any changes to the *De Minimis* Threshold or the *De Minimis* Exception generally until a thorough analysis of the implications for all major asset classes can be done.

D. Responses to Specific Questions in the Preliminary Report on Physical Commodity Swap Markets.

To better understand swap dealing activity in physical commodity swap markets, the CFTC staff asks questions in the Preliminary Report with respect to the structure and character of such markets. Provided below are the Working Group's responses to those questions, which are included for reference.

- 1. What has been the impact of the current *de minimis* threshold on the Non-Financial Commodity swap market, including, but not limited to, the ability of end-users to hedge their risk? Staff requests quantitative analysis of the impact, including various measures of transaction costs and liquidity.**

The impact of the current *De Minimis* Threshold of \$8 billion on physical commodity swap markets is difficult to measure. As noted above, liquidity in energy swaps markets has suffered since the implementation of the Dodd-Frank Act. In fact, one informal poll of traders comparing then-current liquidity in long dated energy markets to liquidity in the same markets prior to the financial crisis in 2008 described the then-current liquidity as a 1 on a scale of 1 to 10 – with 10 corresponding to the level of liquidity seen prior to the 2008 financial crisis.⁴⁵ However, that decline in liquidity cannot be attributed solely to the current *De Minimis* Threshold.

⁴² See *id.* at 49.

⁴³ See Statement of Chairman Timothy Massad on the Fiscal Year 2016 Budget Agreement (Dec. 21, 2015), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement122115>.

⁴⁴ Preliminary Report at 48.

⁴⁵ See *Fuel Hedgers Bemoan Bank Retrenchment from Commodities*, Alexander Osipovich, Energy Risk (May 22, 2014), available at <http://www.risk.net/energy-risk/news/2346115/fuel-hedgers-bemoan-bank-retrenchment-from-commodities>.

In the Working Group's members' experience, the level of counterparty availability and liquidity under the current *De Minimis* Threshold has allowed end-users to effectively hedge their risk, though in a less cost effective manner than prior to the implementation of the Dodd-Frank Act. Any decrease in the current *De Minimis* Threshold could impact energy swaps markets in a manner similar to the experience of special entities under the \$25 million Special Entity *De Minimis* Threshold where special entities had fewer available counterparties and, consequently, experienced difficulties hedging their risk efficiently and effectively.

The level of the current *De Minimis* Threshold has allowed some degree of regulatory efficiency. Specifically, the current *De Minimis* Threshold has limited the use of time and resources that both market participants and the Commission have had to dedicate to complex and fact dependent determinations of when a particular transaction is swap dealing activity if the threshold were set lower. The difficulties with the analysis of whether a transaction is swap dealing are numerous and are discussed in the Working Group's comments to the Commission's advanced notice of proposed rulemaking and proposed rulemaking on, among other things, the definition of "swap dealer."⁴⁶

The \$8 billion *De Minimis* Threshold has allowed certain market participants to be conservative (*i.e.*, over inclusive) in which transactions they consider swap dealing activity while still being comfortable that they are not close to breaching that threshold. If the Commission were to lower the *De Minimis* Threshold, it may require both the Commission and market participants to undertake a large amount of fact intensive, difficult interpretive analysis to determine whether an entity must register as a swap dealer. That would be an inefficient outcome that can be avoided by raising the *De Minimis* Threshold or, at the very least, retaining the current *De Minimis* Threshold of \$8 billion. If the Commission decides to lower the *De Minimis* Threshold, it must do so in conjunction with providing more concrete guidance on what types of activity constitute swap dealing activity to at least mitigate a potential drop in liquidity and counterparty options.

2. Have participants in the Non-Financial Commodity swap market limited their swap dealing activity to remain below the *de minimis* threshold?

Several non-financial market participants have limited, and will limit, their swap dealing activity to remain below the *De Minimis* Threshold. These entities actively monitor the level of their swap dealing activity in comparison to the *De Minimis* Threshold and, by a matter of

⁴⁶ See Comments of the Working Group of Commercial Energy Firms on the Definition of "Swap Dealer" (Sept. 20, 2010), available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26228&SearchText=>; Comments of the Working Group of Commercial Energy Firms on the Joint Notice of Proposed Rulemaking on the Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant (Feb. 22, 2011), available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27902&SearchText=>; Supplemental Comments of the Working Group of Commercial Energy Firms on the Definition of "Swap Dealer" (June 3, 2011), available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=44672&SearchText=>. In February 2012, the Working Group of Commercial Energy Firms reconstituted itself as "The Commercial Energy Working Group."

internal policy, stay well below that threshold. In addition, as swap dealing activity is typically ancillary to the core business of those non-financial entities, the Working Group anticipates that any lowering of the *De Minimis* Threshold would cause such entities to reduce their swap dealing activity to avoid registration as a swap dealer. That reduction could have material adverse consequences for liquidity and counterparty choice in these markets, which may ultimately increase the cost of hedging, and consequently, increase the cost of energy for American consumers.

3. Does the dealing activity of financial entities in the Non-Financial Commodity swap market differ from the dealing activity of non-financial entities?

Unlike non-financial market participants, financial entities' swap dealing activity is generally not tied to or bound by a physical business and physical trading relationships. As such, it is likely that financial entities' swap dealing activity more closely resembles the activity of swap dealers in interest rate swap and credit default swap markets than it does any swap dealing activity engaged in by non-financial entities in physical commodity swap markets.

In addition, where certain non-financial entities may engage in swap dealing activity as an ancillary part of their overall physical business, financial entities are probably more likely to view swap dealing activity in these markets as a core line of business. This may be best illustrated by the resources a typical non-financial entity may dedicate to swap dealing activity, which generally include a low limit in the amount of capital that can be dedicated to swap dealing often evidenced by low Value at Risk limits and limited front- and back-office resources dedicated to the activity.

In contrast, a financial entity engaged in swap dealing activity in physical commodity swap markets would be more likely to have higher Value at Risk limits for that activity and more internal resources dedicated to that activity.

E. The Current Approach to the *De Minimis* Exception Should Be Continued.

As required by the CFTC's regulations, the Preliminary Report proposes a number of potential alternatives to the current *De Minimis* Exception. Included in those alternatives are the use of a different *De Minimis* Threshold for each asset class, a counterparty count threshold, or a transaction count threshold. Each of those alternatives raises serious issues.

First, as noted above, the CFTC does not have data that is adequate enough to analyze the three non-interest rate and non-credit asset classes let alone set well calibrated specific *De Minimis* Thresholds for those asset classes.

Second, a counterparty count threshold was already proposed and rejected by the Commission.⁴⁷ A counterparty count threshold would put smaller market participants at a

⁴⁷ Entity Definitions Rule at 30,630 (noting that the *De Minimis* Exception adopted by the CFTC does not limit the number of swaps or the number of an entity's counterparties to "[reflect] commenter concerns that a

significant disadvantage. A counterparty count threshold would create a strong incentive for swap dealers to only transact with counterparties that engage in a large number of swaps, which would typically be the most profitable counterparties. A similar phenomenon is currently being observed in futures markets and interbank foreign exchange markets as certain futures commission merchants and foreign exchange prime brokers are dropping smaller, less profitable customers.⁴⁸

Third, as noted by Commissioner Giancarlo and the Preliminary Report, transaction count is a “poor proxy for dealing activity”⁴⁹ and may be “less indicative of dealing activity” and “may be less effective as an alternative or additional metric for the *de minimis* exception.”⁵⁰ As such, transaction count is not an appropriate metric to use for the *De Minimis* Exception.

The Working Group urges the Commission to only pursue potential changes to the *De Minimis* Exception if it finds the current approach to the *De Minimis* Exception is deficient. Said another way, the current notional value-based approach to the *De Minimis* Exception seems to be functioning well, and, unless the Commission believes that there is a material deficiency with the current approach, that approach should remain unchanged.

standard based on the number of swaps...or counterparties can produce arbitrary results by giving disproportionate weight to a series of smaller transactions or counterparties”).

⁴⁸ See *Commodity End-Users Fret Over Shrinking Number of FCMs*, Alexander Osipovich, Energy Risk (Sept. 23, 2015), available at <http://www.risk.net/energy-risk/news/2427127/commodity-end-users-fret-over-shrinking-number-of-fcms>; *Banks Reconsider Prime Brokerage Models*, Robert Mackenzie Smith, FX Week (Jan. 31, 2014), available at <http://www.fxweek.com/fx-week/news/2326109/banks-reconsider-prime-brokerage-models>.

⁴⁹ See *CFTC De Minimis Report Worries U.S. Energy Firms*, Alexander Osipovich, Energy Risk (Jan. 5, 2016), available at <http://www.risk.net/energy-risk/news/2440497/cftc-de-minimis-report-worries-us-energy-firms> (quoting Commissioner Giancarlo).

⁵⁰ See Preliminary Report at 56.

Mr. Christopher Kirkpatrick
January 19, 2016
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III. CONCLUSION.

The Working Group appreciates this opportunity to provide comments on the Preliminary Report and respectfully requests that the Commission consider the comments set forth herein as it develops the Final Report and any final rulemaking in this proceeding.

If you have any questions, please contact the undersigned.

Respectfully submitted,

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