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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: Proposed Rule; Interpretations, *Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants* (RIN 3038-AE54)

Dear Mr. Kirkpatrick:

I. INTRODUCTION

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Sutherland Asbill & Brennan LLP submits this letter in response to the request for public comment set forth in the Commodity Futures Trading Commission's (the "**CFTC**" or "**Commission**") Proposed Rule; Interpretations, *Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants* (the "**Cross-Border NOPR**").[1] Specifically, the Working Group is concerned that the CFTC's proposed treatment of "Foreign Consolidated Subsidiaries" ("**FCSs**")[2] will create an unbalanced playing field that will place U.S. companies' foreign subsidiaries at a distinct disadvantage when transacting in non-U.S. derivatives markets with little to no benefit to the American public.

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[1] *See* Proposed Rule; Interpretations, *Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 71,946 (Oct. 18, 2016), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-24905a.pdf.

[2] The Cross-Border NOPR defines "Foreign Consolidated Subsidiary" as a Non-U.S. Person in which an ultimate parent entity that is a U.S. Person ("**U.S. Ultimate Parent Entity**") has a controlling financial interest, in accordance with U.S. generally accepted accounting principles ("**U.S. GAAP**"), such that the U.S. Ultimate Parent Entity includes the Non-U.S. Person's operating results, financial position, and statement of cash flows in the U.S. Ultimate Parent Entity's consolidated financial statements, in accordance with U.S. GAAP. *See* Proposed CFTC Regulation 1.3(aaaaa)(1). As used herein, "**Non-U.S. Person**" means a person that is not a "U.S. Person," as defined in proposed CFTC Regulation 1.3(aaaaa)(5) of the Cross-Border NOPR.

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

II. COMMENTS OF THE WORKING GROUP

A. SWAPS WITH AN FCS AS A COUNTERPARTY DO NOT INHERENTLY HAVE A DIRECT AND SIGNIFICANT CONNECTION WITH ACTIVITIES IN, OR EFFECT ON, U.S. COMMERCE.

1. The Breadth of the FCS Definition Exceeds the Scope of the Commission's Cross-Border Authority.

The Commission's proposed approach to the treatment of FCS likely exceeds its statutory authority. Specifically, the Cross-Border NOPR would (i) require FCSs to include all of their swaps activity in their corporate family's swap dealer ("**SD**") and major swap participant ("**MSP**") registration analysis and (ii) require "**Other Non-U.S. Persons**"[3] to include transactions with any FCS in their corporate family's SD and MSP registration analysis. However, Commodity Exchange Act ("**CEA**") Section 2(i) dictates that the swaps provisions of the CEA, including the provisions regarding registration as a swap dealer, "will not apply to activities outside the United States unless those activities":

- "have a direct and significant connection with activities in, or effect on, commerce of the United States"; or
- "contravene such rules or regulations as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by [Title VII of the Dodd-Frank Act]."

The Commission has interpreted the word "direct" in this context to mean "a reasonably proximate causal nexus,"[4] and has provided some guidance on when activities outside the United States have a "significant" connection with, or effect on, commerce of the United States. For example, in the 2013 Guidance, "the Commission notes that under its interpretation of [CEA]

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[3] Under the Cross-Border NOPR, an "Other Non-U.S. Person" is a Non-U.S. Person that is neither an FCS nor a U.S. Guaranteed Entity. A "U.S. Guaranteed Entity," under the Cross-Border NOPR, is a U.S. Person or a Non-U.S. Person whose obligations under the relevant swap are guaranteed by a U.S. Person.

[4] *See* Interpretive Guidance and Policy Statement, *Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations*, 78 Fed. Reg. 45,292, 45,301 (July 26, 2013) (the "**2013 Guidance**"), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf.

[S]ection 2(i), a non-U.S. person that is not a guaranteed or conduit affiliate would not have to count its swap dealing transactions with other non-U.S. persons that are not guaranteed affiliates because…such swap dealing activity would **not** have the requisite 'direct and significant connection with activities in, or effect on, U.S. commerce.'"[5] (emphasis added).

The CFTC has also provided a number of distinct examples from the 2008 financial crisis where activity by financial institutions outside of the United States was significant enough to "have a substantial impact on the U.S. financial system."[6] The prime example cited by the Commission is AIG Financial Products.[7] In that case, losses on the credit default swap activity of a non-U.S. person, AIG Financial Products, guaranteed by its U.S. parent, American International Group ("**AIG**"), were the primary reason the U.S. government was forced to bail-out AIG.[8]

The CFTC has proposed a construct in the Cross-Border NOPR that does not come within its statutory authority in CEA Section 2(i), even as interpreted by the Commission. As noted above, the Cross-Border NOPR's proposed paradigm for FCSs would subject activities to the CFTC's regulatory regime that the Commission has already concluded do **not** have "the requisite 'direct and significant connection with activities in, or effect on, U.S. commerce.'"[9] The CFTC offers no explanation of position change and does not identify any flaws with its prior position.

The CFTC does not provide an explanation as to why the derivatives trading activity of FCSs that (i) have an ultimate parent that is a commercial entity or (ii) are commercial entities has a "direct and significant connection with activities in, or effect on, commerce of the United States." The Working Group recognizes that, in cases where the U.S. Ultimate Parent Entity at issue is a systemically important financial institution, that "the default or insolvency of an Other Non U.S. Person could have a direct adverse effect on an FCS, which through the interconnection to its U.S. Ultimate Parent Entity, could have knock-on effects, potentially leading to disruptions to the U.S. financial system."[10] However, the Working Group believes there are no examples of a default or insolvency of an FCS that was not affiliated with a financial institution (*e.g.,* a commercial firm) resulting in the type of financial contagion that the CFTC seeks to mitigate.

In addition, it is likely that any financial contagion risk related to derivatives has been mitigated by U.S. and international derivatives reform measures to the extent that no "direct and significant" off-shore activity remains to support the CFTC's expansive definition of "Foreign

5 2013 Guidance at 45,324.

6 *Id*. at 45,293.

7 *Id*.

8 *Id*.

9 *Id.* at 45,324.

10 Cross Border NOPR at 71,956.

Consolidated Subsidiary." *First*, under mandatory exchange trading and mandatory clearing requirements, a significant amount of derivatives trading has transformed counterparty credit risk into central counterparty credit risk. *Second*, much of the remaining over-the-counter trading involves firms that are already registered as swap dealers.[11] *Third*, financial firms active outside the United States likely are regulated in some form by other governments. *Fourth*, currently there are significant efforts by international financial regulators to implement measures to facilitate the resolution of insolvent significant financial institutions, which include the effectively mandatory inclusion of certain contractual provisions into derivatives trading agreements. For example, ISDA currently has two open protocols for the treatment of trading contracts in such an insolvency.[12] Accordingly, it likely would be difficult, if not impossible, for the CFTC to establish that any derivatives trading activity not affected by global derivatives reform measures presents "direct and significant" effect on U.S. commerce, a task made even more difficult if focusing on FCSs that are part of commercial firms.

The Commission's proposed paradigm for the treatment of FCSs is a blunt and overly broad approach to addressing an acute problem. If the Commission is worried about the spread of contagion in financial markets through derivatives, it can address that issue by focusing on activities that are "significant," such as those of systematically important financial institutions, without imposing additional compliance burdens on activities that are not "significant." As discussed further below, this can be quite easily done by differentiating between entities affiliated with financial institutions and those that are not without having to regulate the activity of Non-U.S. Persons solely because they are FCSs.

2. The Cross-Border NOPR Fails to Account for the Difference Between Financial Institutions and Commercial Enterprises.

An easy method to differentiate whether activity is "significant" or not for purposes of CEA Section 2(i) is to look to the counterparties to a transaction. In fact, the Commission has done this on numerous occasions by contrasting the risk posed by transactions between financial institutions with the lower risk posed by transactions where a commercial entity is a counterparty.[13] However, it is clear from the discussion in the Cross-Border NOPR that the Commission's concern and focus is on the activities of "global financial institutions," "financial

[11] *See* Order, *Order Establishing De Minimis Threshold Phase-In Termination Date*, 81 Fed. Reg. 71,605, 71,606 (Oct. 18, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-10-18/pdf/2016-25143.pdf (stating "[d]ata reviewed for the Final Report indicated that approximately 96% of all reported swap transaction involved at least one registered swap dealer").

[12] *See* ISDA Resolution Stay Jurisdictional Modular Protocol (Open from May 3, 2016), *available at* http://www2.isda.org/functional-areas/protocol-management/protocol/24; *see also* ISDA 2016 Bail-in Art 55 BRRD Protocol (Open from July 14, 2016), *available at* http://www2.isda.org/functional-areas/protocol-management/protocol/28.

[13] *See* 2013 Guidance at 45,324 discussing why transactions between Non-U.S. persons and Non-U.S. persons with a guarantee from a non-financial U.S. person need not be included non-guaranteed counterparty's *de minimis* analysis.

groups," and "large U.S. financial firms" and their "highly integrated corporate structure."[14] Nowhere in the Cross-Border NOPR does the CFTC discuss or consider the implications of its proposal on commercial entities.

The Working Group requests that the Commission follow its existing interpretation under the 2013 Guidance with respect to the reach of CEA Section 2(i) and the activities of commercial entities. For example, to support its decision to allow non-U.S. persons that are neither guaranteed nor conduit affiliates of U.S. persons to not count toward their *de minimis* thresholds their swap dealing transactions with a guaranteed affiliate guaranteed by a non-financial entity, the Commission stated "this exception is appropriate given that the risks to the U.S. financial markets are mitigated because the U.S. guarantor is a non-financial entity."[15] Further, in support of its recognition of "the more modest risk to the U.S. financial markets from swaps activities with non-financial entities organized outside the United States," the CFTC noted that the Basel Committee on Banking Supervision and the International Organization of Securities Commissions recommended that margin requirements not apply to uncleared swaps of non-financial entities "given that such transactions are viewed as posing little or no systemic risk and are exempt from clearing mandates."[16]

If the Commission elects to move forward with the proposed FCS construct, the Working Group requests that the Commission exclude from the definition of "Foreign Consolidated Subsidiary" any entity whose ultimate parent is a non-financial entity. Doing so would be consistent with the CFTC's existing interpretation of CEA Section 2(i) and that interpretation's applicability to the activities of commercial entities.

B. The Cross-Border NOPR's Proposed Treatment of FCSs Would Likely Place U.S. Companies at a Significant Competitive Disadvantage.

If finalized as proposed, the Cross-Border NOPR's paradigm for FCSs would likely place U.S. companies at a significant disadvantage in non-U.S. derivatives markets. Requiring Other Non-U.S. Persons to treat any swap with an FCS as a potential swap dealing transaction will likely cause many Other Non-U.S. Persons to avoid transacting with FCSs rather than implementing potentially costly compliance procedures to analyze and track their swap dealing activity. The process of determining whether a transaction is a swap dealing transaction can be a fact-intensive and subjective exercise. Consequently, that exercise can be time consuming and resource intensive. In addition, capturing and tracking that information across a global corporate structure where many subsidiaries do not coordinate or communicate on a regular basis could also be resource intensive.

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[14] Cross-Border NOPR at 71,947-48.

[15] 2013 Guidance at 45,324.

[16] *Id*. at 45,325.

In short, the Cross-Border NOPR's proposed paradigm for FCSs would be a material disincentive for Other Non-U.S. Persons to transact with FCSs. This would likely significantly limit counterparty availability and increase the cost of hedging for FCSs. Such a result would be disadvantageous for U.S. interests overseas.[17] As discussed below, this disadvantage particularly affects commercial firms. Thus, while the Cross-Border NOPR might intend to address issues in the financial sector, its effect would be felt by "Main Street" as well. Therefore, the Working Group respectfully suggests that the Commission retain its existing approach under the 2013 Guidance[18] with respect to the treatment of non-U.S. persons such that the presence of a U.S. person guarantee may trigger inclusion of a swap in a non-U.S. person's *de minimis* determination, but the mere fact that an entity has a U.S. Ultimate Parent Entity does not. In the alternative, and as discussed further below, the Working Group requests that the CFTC exclude entities that (i) have an ultimate parent that is a non-financial entity or (ii) are non-financial entities from the definition of "Foreign Consolidated Subsidiary."

C. THE EXEMPTION FOR SWAPS ANONYMOUSLY EXECUTED ON AN EXCHANGE AND CLEARED SWAPS SHOULD BE EXPANDED.

The Cross-Border NOPR would permit Other Non-U.S. Persons to categorically exclude from their *de minimis* analysis any swap "that is executed anonymously on a registered SEF, DCM, or FBOT and…is cleared through a registered or exempt DCO."[19] The reasoning underlying this exclusion is sound: there are significant practical difficulties associated with determining the identity of a counterparty to an anonymously executed, cleared transaction.[20] In fact, that rationale supports an exclusion for all anonymously executed, cleared transactions – not just those executed on CFTC registered or exempt exchanges and cleared through a registered or exempt designated clearing organization. Said another way, it is the anonymity of the counterparties to the transaction that is important and not the classification of the trading platform and the clearinghouse. Therefore, the Working Group requests that the Commission allow Other Non-U.S. Persons to exclude from their *de minimis* analysis any cleared swap entered into anonymously that is executed on a trading platform.

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[17] The Working Group notes that the FCS definition also runs contrary to efforts by commercial firms to separate business units for compliance purposes, particularly those enterprises that may have global operations potentially subject to regulations in many different jurisdictions.

[18] 2013 Guidance at 45,318-19.

[19] Cross-Border NOPR at 71-956.

[20] *Id*. at 71-956-57.

III. CONCLUSION

The Working Group appreciates this opportunity to comment on the Cross-Border NOPR and respectfully requests that the Commission not adopt the contemplated paradigm for FCSs.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ David T. McIndoe
David T. McIndoe
Alexander S. Holtan

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