DEFINING THE MARKET: ENTITY AND PRODUCT CLASSIFICATIONS UNDER TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

HEARING

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HOUSE OF REPRESENTATIVES

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DEFINING THE MARKET: ENTITY AND PRODUCT CLASSIFICATIONS UNDER TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

THURSDAY, MARCH 31, 2011

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Committee met, pursuant to call, at 2:14 p.m., in Room 1300, Longworth House Office Building, Hon. Frank D. Lucas [Chairman of the Committee] presiding.

Members present: Representatives Lucas, Goodlatte, Johnson, King, Neugebauer, Conaway, Fortenberry, Schmidt, Thompson, Rooney, Stutzman, Gibbs, Austin Scott of Georgia, Fincher, Tipton, Southerland, Crawford, Roby, DesJarlais, Gibson, Hultgren, Hartzler, Schilling, Peterson, Holden, McIntyre, Boswell, Baca, David Scott of Georgia, Cuellar, Costa, Kissell, Owens, Courtney, Welch, Sewell, and McGovern.

Staff present: Tamara Hinton, John Konya, Kevin Kramp, Josh Mathis, Ryan McKee, Matt Schertz, Debbie Smith, Liz Friedlander, Clark Ogilvie, and Jamie Mitchell.

OPENING STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

The CHAIRMAN. This hearing of the Committee on Agriculture, entitled, *Defining the Market: Equity and Product Classifications Under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act,* will come to order.

Today the Committee will continue its efforts in a series of hearings to review the implementation of the derivatives provisions of the Dodd-Frank Wall Street Reform Act. Already we have heard from diverse market participants, from farmer cooperatives to manufacturers to global financial institutions. Rarely does Congress consider an issue that has an impact on such diverse segments of the economy. That is why the oversight role of this Committee is so important, and that is why I am deeply concerned with the speed at which CFTC is crafting a new regulatory regime for a marketplace that is important all the way from the countryside to Wall Street, and for the U.S. economy as a whole.

Under the current time frame, the CFTC can't possibly comprehend the cumulative impact that over 40 proposed regulations will have on the markets, on the economy, or adequately evaluate and weigh the costs and the benefits of each rule. With an economy that is still fragile and under a directive from the American public that job growth should be our top priority, we simply cannot impose a wave of new regulations that are rushed and poorly vetted.

I have no doubt that today's hearing will identify potential consequences of a rushed rulemaking process. Dodd-Frank requires several new regulatory designations that will define the market and, very importantly, shape the ability for end-users across the country to affordably hedge their risk. While Congress gave CFTC broad discretion in defining key terms, it also directed the CFTC to provide exemptions where appropriate, to avoid imposing unjustified and unnecessary costs on market participants.

Yet, what we are seeing, and what we are going to hear today, is that CFTC has proposed very broad, far-reaching definitions, but very narrow interpretations of the exemptions Congress authorized. The result of this approach will be a spectrum of market participants subject to a new and sweeping regulatory regime that far exceeds the risks those entities pose to the financial system or to their counterparties.

One of Congress' principal objectives in Title VII was to mitigate risk to the financial system and to prevent another financial crisis. Yet, entities that do not come close to threatening the financial stability and who had no role in the financial crisis may be regulated in the same way that those that do. That simply doesn't make sense, and that is not what Congress intended.

Now we need to be cautious. The derivatives markets serve an important risk mitigation role across the economy and we cannot create significant economic disincentives to using those markets, especially for end-users and smaller entities that can least afford the cost of new regulation. We need to make sure we are not eliminating these tools for commercial hedgers, shifting more of the trading volume to the largest financial players, or sending activity to our competitors overseas.

I look forward to hearing our witnesses today.

PREPARED STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

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I have no doubt that today's hearing will identify potential consequences of a rushed rulemaking process. Dodd-Frank requires several new regulatory designations that will define the market, and very importantly—shape the ability for end-users across the country to affordably hedge their risks. And while Congress gave the CFTC broad discretion in defining key terms, it also directed the CFTC to provide exemptions where appropriate to avoid imposing unjustified and unnecessary costs on market participants.

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We need to be cautious. The derivatives markets serve an important risk mitigation role across the economy, and we cannot create significant economic disincentives to using these markets—especially for end-users and smaller entities that can least afford the costs of new regulation. We need to make sure we're not eliminating these tools for commercial hedgers, shifting more of the trading volume to the largest financial players, or sending activity to our competitors overseas.

I look forward to hearing from our witnesses today.

The CHAIRMAN. And with that, the chair would recognize the Ranking Member, Mr. Peterson, for his opening statement.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. PETERSON. Thank you, Mr. Chairman, for holding today's hearing. And Chairman Gensler, welcome back to the Committee.

We are here again reviewing the provisions of Title VII of the Dodd-Frank Act. When writing this legislation, the Committee's goal was to bring greater transparency and accountability to the derivatives marketplace. For too long, the over-the-counter swap market operated in darkness, and as a consequence, the actions of some financial institutions contributed to the worst recession our country has seen since the Great Depression. The Dodd-Frank Act gave regulators new tools to monitor derivatives trading. To accomplish this, we had to identify the market activities and participants that merited greater oversight.

However, we also worked very hard to ensure that those not responsible for the financial collapse, such as end-users using the market to mitigate risk, would not bear the burden of further oversight. After all, as was mentioned, they weren't the ones that got us into this mess in the first place.

Given that these markets have been hidden for so long, the challenge was to distinguish the products and the persons to which regulation should apply and to those to which it should not. I have heard from a lot of folks their concerns about how the CFTC proposed rules, or lack thereof, classifying certain entities and products could potentially impact them. I am sympathetic to those concerns, since they have been coming from groups that were not responsible for the financial crisis. We need to look closely at the situation before us to make sure that this is not the case.

However, I am equally concerned that some of the big financial firms whose irresponsible behavior Dodd-Frank seeks to address are looking at ways to use the end-user concerns to create loopholes for themselves. While I am not a big fan of regulation, the requirements under Title VII are necessary to ensure we don't get into another situation where the American taxpayer has to bail out large financial firms.

I hope the second panel of witnesses will speak to how their concerns can be addressed in a manner that precludes the possibility of inadvertently creating a loophole that renders the law obsolete.

Additionally, I would like to remind everyone that the process of implementing a law has to have a starting point. While not everybody may like where the CFTC is starting, these are proposed rules, not final rules.

Interested parties, and even Members of Congress, have and will continue to share their thoughts with the CFTC both in person and through the comment process. I have some optimism that at the end of the day, the resulting rules are going to be acceptable. If they aren't, it will definitely be an area for the Committee to address.

Again, I want to thank the chair for holding today's hearing and I look forward to hearing from our witnesses.

The CHAIRMAN. Absolutely.

The chair would request that other Members submit their opening statements for the record so the witnesses might begin their testimony to ensure there is ample time.

With that, I would like to welcome our first witness to the table, the Honorable Gary Gensler, Chairman of the Commodity Futures Trading Commission in Washington, D.C., a gentleman who has shown great patience in working with our schedule and timing for the hearing.

Now, Chairman Gensler, we have a series of votes beginning. I would ask perhaps with your agreement, you provide your opening testimony and then we will break for our series of votes and then return to begin the questioning, if that is agreeable, Mr. Chairman.

STATEMENT OF HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. GENSLER. I thank you, Mr. Chairman, and that is certainly agreeable, anything that helps you do your work and vote.

Chairman Lucas, Ranking Member Peterson, and Members of the Committee I thank you. Good afternoon.

I am pleased to testify on behalf of the Commodity Futures Trading Commission regarding our progress thus far on a number of rules you asked us to chat about. This is about the entity and product definitions and the end-user exception.

The Dodd-Frank Act was actually very detailed with regard to entity and product definitions as well as the exemption from clearing for the end-users. But Congress did direct the CFTC and the SEC, working together and jointly consulting with the Federal Reserve, to further define these entity and product definitions, though they were quite detailed in statute.

So the CFTC and SEC first put out what is called an advanced notice of proposed rulemaking, a list of questions, in essence. We received 80 comments, very helpful. Based on that and based on the statute, in December, we put out a joint rule on entity definitions. We received about 180 comments, some of them coming in after the comment period. Even this hearing, in essence, is a comment on those proposals, which will be very helpful.

The proposed *swap dealer* definition closely followed the criteria laid out by Congress. That criteria included whether an entity makes a market in swaps or it holds itself out as a swap dealer, is commonly referred to as a *swap dealer,* regularly enters into swaps in the ordinary course of business. I am actually reading statutory text. That is what Congress said.

So we have tried to further give some guidance to the market. Those 180 comments will be taken into consideration. The final rule will change from the proposal based on those comments.

The Dodd-Frank Act also defines something called a *major swap participant.* It was really an entity that was not a swap dealer but otherwise might prove to have systemic ramifications if it failed. So we put in the proposed rule various numbers and criteria trying to follow Congress' will that it would be a very small handful. And, in fact, the major swap participant category would be measured in the single digits. And so that proposed rule is out and we are waiting to think through. We are not going to move forward until we can summarize all the comments, we can get Commissioner input, other regulatory input and so forth.

We also put out a rule in December on the end-user exception. The Dodd-Frank Act is very clear, the intent of Congress is very clear, that if you are a nonfinancial entity hedging a commercial risk, you don't have to use a clearinghouse.

We have also said that even though we have not yet put out a rule on margin and capital; that when we do so, we are going to follow Congressional intent there as well, and the same nonfinancial end-users will not have to post or receive margin. I just want to cover that point because I know it is an important one.

The proposed rule went out in December. We have gotten 1,300 comments on that. It will take us a little longer to summarize those comments, but I think they are very helpful.

Last, I know you wanted me to chat a little bit about product definitions. Based upon the 80 comments to that advanced notice of proposed rulemaking, the SEC and CFTC are working on a product definition rule. The statute is very clear. Interest rate swaps, currency swaps, a swap, credit default swaps and so forth, these are swaps. But we are sorting through comments to make sure that people understand, as Congress intended, that insurance is not a swap, for instance, or commercial loans are not swaps. And very importantly to the community that you all oversee, that forwards and options embedded in forwards, just as they have been excluded from the definition of *futures* for many, many decades, they are also to be excluded from the definition of *swap.* And this is a very important point to the agriculture community and the energy community. And we will put that together in this proposal, but consistent with what the Congress has done.

I thought I would, for one moment, just say that on timing, we know that the Congress did say that we were supposed to complete this task in 360 days. But we are right now at a pause. We are analyzing all the comments.

We have two important rules still to propose: margin and capital and the product definitions. We are not moving forward on any final rules until we adequately summarize all the comments, get Commissioner feedback, get regulatory feedback. So, realistically we will start doing some final rules this spring. But the final rules will fall well into the Fall of this year. We are human; even that may change. But we are committed not to do anything until we actually can summarize the comments, summarize the cost-benefit analyses, get the feedback that is so important, and move forward.

Congress did give us some authorities on implementation phasing. Phasing of the effective dates is really important as well, to look at the whole mosaic of rules so that we can lower the cumulative cost. A rule might be finalized this summer, but you gave us the latitude that it might not have an effective date until much later. And we are looking at having effective dates for some of the rules to only go effective after other rules are effective; for instance, until a product definition rule is finalized, maybe some other rules shouldn't be effective. That would be one example. Or that for clearing and other transaction mandates, that they happen for the swap dealers early on, and then other market participants, hedge funds and the like and asset managers maybe a little later. Of course, there is no clearing mandate on the true end-users, the commercial end-users.

So with that I would be happy to take any questions after your break to go take a vote.

[The prepared statement of Mr. Gensler follows:]

PREPARED STATEMENT OF HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Good morning, Chairman Lucas, Ranking Member Peterson, and Members of the Committee. I thank you for inviting me to today's hearing on the Commodity Futures Trading Commission's (CFTC) progress thus far on rules relating to entity and product definitions under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. I am pleased to testify on behalf of the CFTC. I also thank my fellow Commissioners for their hard work and commitment on implementing the legislation.

The Dodd-Frank Act for the first time brought oversight to the swaps market. By bringing comprehensive regulation to swap dealers and mandating that standardized swaps be brought to clearing and transparent trading, the Dodd-Frank Act helps lower risk to the American public and bring transparency, openness and competition to these markets.

The Dodd-Frank Act was very detailed with regard to entity and product definitions as well as the exception from clearing for nonfinancial end-users. Congress did direct the CFTC, however, working with the Securities and Exchange Commission (SEC) and in consultation with the Federal Reserve, to further define those entities and products. The Dodd-Frank Act further provides the CFTC with authority to write rules with regard to the nonfinancial end-user clearing exception.

This afternoon I will discuss the joint rule on entity definitions that was proposed last fall, the CFTC's and SEC's work to propose a product definitions rulemaking and the CFTC's proposed rule with regard to the nonfinancial end-user exception from clearing. I also will briefly discuss the CFTC's rule-writing process and authority to phase effective dates of final rules. The CFTC and the SEC jointly released an advance notice of proposed rulemaking in September to seek public comment on entity and product definitions. Those comments informed both agencies as we worked to propose a joint rule on entity definitions and as we continue to work on a product definitions proposed rulemaking.

Entity Definitions Rulemaking

The Dodd-Frank Act defined two categories of market participants that would be subject to comprehensive regulation by the CFTC: swap dealers and major swap participants. This comprehensive regulation includes capital and margin requirements, business conduct standards and record-keeping and reporting requirements.

On December 1, 2010, the CFTC proposed a rule jointly with the SEC to fulfill Congress's direction to further define the terms "swap dealer," "major swap participant," "security-based swap dealer," "security-based major swap participant" and "eligible contract participant." The comment period ran through February 22, 2011. There are presently 180 comments in the comment file, including those that were received after the comment period closed. The Commission is considering all of these comments.

The proposed swap dealer definition closely follows the criteria laid out by Congress. These criteria include whether an entity makes a market in swaps, holds itself out as a swap dealer, is commonly referred to as a swap dealer or regularly enters into swaps in the ordinary course of business.

The proposed rule identified characteristics to be considered in determining whether persons are swap dealers, including whether they tend to accommodate demand for swaps from other parties; are generally available to enter into swaps to facilitate other parties' interest; tend not to request that other parties propose the terms of swaps; tend to enter into swaps on their own standard terms or on terms they arrange in response to other parties' interest; and tend to be able to arrange customized terms for swaps upon request, or to create new types of swaps at their own initiative.

The Dodd-Frank Act and the proposed joint rule provide an exclusion for an insured depository institution "to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." The exclusion in the proposed rule would apply to swaps that are connected to the financial terms of the loan itself.

The Dodd-Frank Act and the Commissions' joint proposed rule provide an exemption for a person who "engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers."

The Dodd-Frank Act also defined another category of market participants that would be subject to comprehensive regulation, called major swap participants. These entities were defined as those that are not otherwise swap dealers and whose failure would have systemic ramification given their substantial participation in the swaps market.

The major swap participant definition relies on Congress's three-prong test. In each of the three prongs, the Dodd-Frank Act spoke to an entity that has a substantial position in swaps or substantial counterparty exposure. The proposed rule focuses on net uncollateralized current exposure and potential future exposure. Therefore, it takes into consideration entities' uncleared *versus* cleared swaps as well as any netting or collateral arrangements that they may have with their counterparties.

Under the statute and the proposed rule, the major swap participant category is very clearly limited only to those non-swap dealer entities that have risk large enough to pose a threat to the U.S. financial system. It is likely that, under the joint proposed rule, this category will include only a handful of entities.

The joint proposed rule includes two changes to the definition of eligible contract participant (ECP). First, the proposed rule explicitly includes swap dealers and major swap participants within the definition of ECP. Second, the rule proposes clarifications to how certain commodity pools use retail foreign exchange products. These commodity pools must meet certain specific requirements of the current ECP definition.

Product Definitions

The Dodd-Frank Act was very specific in defining derivatives products that will be required to be regulated. The Act covers the entire swaps marketplace—both bilateral and cleared—and the entire product suite, including interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps.

The CFTC is working closely with the SEC on a proposed rule to further define swaps, security-based swaps, mixed swaps and security-based swap agreements, which are defined terms in the Dodd-Frank Act. We hope to jointly propose the products definitions rule in the near future.

In preparing the proposed rule, staff has been working to address the more than 80 comments that were submitted by the public in response to the joint advance notice of proposed rulemaking on definitions. Many of the commenters asked that the Commissions specifically provide guidance on what is not a swap or security-based swap.

Though staff is yet to make a formal recommendation to the two Commissions, I would like to address some thoughts on three areas.

Under the Commodity Exchange Act, the CFTC does not regulate forward contracts. Over the decades, there has been a series of orders, interpretations and cases that market participants have come to rely upon regarding the exception from futures regulation for forwards and forwards with embedded options. Consistent with that history, the Dodd-Frank Act excluded from the definition of swaps "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." I believe it would be appropriate to interpret that exclusion in a manner that is consistent with the Commission's previous history of the forward exclusion from futures regulation, including the Commission's treatment of bookouts.

Further, commenters have expressed the view that Congress did not intend that the swap definition include state or federally regulated insurance products that are provided by regulated insurance companies. The staffs of the Commissions are working to address these comments in a way that clarifies what products are insurance and therefore would not be considered swaps. In addition, commenters have suggested that the Commissions clarify that certain consumer and commercial arrangements that historically have not been considered swaps, such as consumer mortgage rate locks, contracts to lock the price of home heating oil and contracts relating to inventory or equipment, also should not be considered within the swap definition. The staffs of the Commissions also are working to address these comments in a way that clarifies that these products are not swaps.

End-User Exception

A central component of the Dodd-Frank Act is its provision to lower risk in the financial system by generally requiring the clearing of standardized swaps through regulated clearinghouses. Central clearing has been a feature of the U.S. futures markets since the late-19th century. Clearinghouses have functioned both in clear skies and during stormy times—through the Great Depression, numerous bank failures, two world wars and the 2008 financial crisis—to lower risk to the economy. Congress excepted swaps transactions involving nonfinancial end-users from the clearing requirement because they do not pose the same risk as transactions between two financial entities.

The CFTC proposed a rule on December 9, 2010 relating to the end-user exception. We have received 1,039 comments in response to the proposal. In essence, the proposal says that, if a nonfinancial company is using a swap to hedge an asset, liability, input or service that it currently has or uses or anticipates having or using, it would qualify for the end-user exception. In addition, the proposal says that if a swap meets generally accepted accounting principles as a hedge or if it is used for bona fide hedging, then the transaction would qualify for the end-user exception. Non-financial entities would be able to hedge interest rate risk, currency risk, physical commodity risk or other types of risk.

The proposed rule does, however, say that if an entity is taking a position to speculate, the transaction would not qualify for the end-user exception.

The Dodd-Frank recognized that swaps transactions involving nonfinancial end-users do not pose the same risk as transactions between two financial entities. Thus, the CFTC does not intend to impose margin requirements with regard to these transactions.

CFTC Rule-Writing Process

At this point in the process, the CFTC has come to a natural pause as we have now promulgated proposals in most of the areas required by the Dodd-Frank Act. As we receive comments from the public, we are looking at the whole mosaic of rules and how they interrelate. We will begin considering final rules only after staff can analyze, summarize and consider public comments, after the Commissioners are able to discuss the comments and provide direction to staff, and after the Commission consults with fellow regulators on the rules. We hope to move forward in the spring, summer and fall with final rules.

Phasing of Implementation

The Dodd-Frank Act gave the CFTC flexibility as to setting implementation or effective dates of the rules to implement the Dodd-Frank Act. For example, even if we finish finalizing rules in a particular order, that doesn't mean that the rules will be required to become effective in that order. Effective dates and implementation schedules for certain rules may be conditioned upon other rules being finalized, their effective dates and the associated implementation schedules. For instance, the effective dates of some final rules may come only after the CFTC and SEC jointly finalize the entity or product definitions rules.

The Commission has the authority to phase implementation dates based upon a number of factors, including asset class, type of market participant and whether the requirement would apply to market platforms, like clearinghouses, or to specific transactions, such as real time reporting. For example: a rule might become effective for one asset class or one group of market participants before it is effective for other asset classes or other groups of market participants. We are looking to phase in implementation, considering the whole mosaic of rules. We look forward to hearing from market participants and regulators, both in the U.S. and abroad, regarding the phasing of implementation.

Regardless of the eventual effective dates of the swaps rules, to provide regulatory certainty to the market, rules relating to mandatory clearing, real time reporting, the trading requirement, margin and business conduct standards will apply only prospectively to those transactions that are executed after the rules go into effect.

Conclusion

I again thank you again for inviting me to testify today. I'd be happy to take questions.

The CHAIRMAN. Thank you, Chairman Gensler, and the Committee now stands in recess until the conclusion of these two votes.

[Recess.]

The CHAIRMAN. The Committee will reconvene. A number of our colleagues are still proceeding back from the floor. They will be here shortly and join us in a timely fashion.

With that, the Chairman having concluded his opening statement, we will now turn to questions, and it gives me the great honor and privilege of beginning.

Mr. Chairman, in a recent speech, you put forth a timetable for the finalization of the rules that would have them completed by early fall. No similar indication has come from the Securities and Exchange Commission. Do you intend to move forward, Mr. Chairman, with the final rules even if the SEC is not on your timetable?

Mr. GENSLER. We have been working very closely with the Securities and Exchange Commission. And, in fact, our staffs even had a meeting yesterday about some of those schedules, both sequencing final rules and then implementation and phasing of the rules into the effective dates. Where we have joint rules, naturally we would work together with the Securities and Exchange Commission. Their agenda is much busier than ours, so we might finalize some rules before they do because they have a lot of other topics they are dealing with. But what we are trying to do in working with them is to align the effective dates and the phasing in of these in a consistent manner.

The CHAIRMAN. Let's talk for a moment, Chairman, about the—in your testimony you noted you had received 180 comments on the proposed definitions. And I would like to highlight some of those comments and then give you a chance to respond.

From the Coalition of Derivative End-Users, "The Commission's interpretation of the swap dealer and security-based swap dealer definitions could sweep a large number of derivative end-users into these categories."

Another quote from a letter signed by the Farm Bureau, the Soybean Association, the Wheat Growers, the National Cattlemen's Beef Association, the Corn Growers, the Farmers Cooperatives, the Grain and Feed Association, the Milk and Pork Producers: "We are concerned that the proposed definition of swap dealer is overly broad and would capture entities that were never intended by Congress to be regulated as swap dealers. If regulatory requirements intended for large financial firms are applied to those that offer risk management products to farmers, those tools would become less available and more expensive."

And then one final quote, and then your response, of course, Chairman, from the National Association of Regulatory Utility Commissioners, "We are concerned that if regulated utilities are swept into the swap dealer definition, this will result in unnecessary increases in consumer cost and reduce the capital available for essential investments".

Chairman, can you respond to these concerns from the comments?

Mr. GENSLER. The 180 comment letters are very helpful. We are trying to summarize them now. They have been in for a few weeks now. And you are correct on those three comment letters.

If I might just take the middle one as an example, the farm cooperatives, we have been working very closely and meeting with a number of the different cooperatives. We are hoping to have additional meetings with them. Whether it be—because of the very nature of these farm cooperatives as they deal almost exclusively with their members, and in some cases how they almost act as the farmers themselves, on their behalf, to get the feed and grain, and, in this case, risk management done—we are seeking a way to think through with them under the statute and consistent with what Congress did, this *swap dealer* definition. I think that we are working along with them to try to take those comments in line.

With regard to the energy participants—and they were in the first and the third category—tens of thousands of people use these products and need to use these products as end-users, and they are not swap dealers. There may be some handful of energy companies that actually do provide services very similar to Wall Street, and they may be swap dealers as Congress has defined it. But we are working closely with energy companies, we even have a meeting tomorrow with a group of energy companies, again on this very topic, the *swap dealer* definition.

The CHAIRMAN. But you would acknowledge that the concerns brought up by these three comments of the 180 comments that you mentioned in your testimony, there is the potential, then, for some of these entities to be defined as *swap dealer,* and their concerns are legitimate.

Mr. GENSLER. Well, it depends on their activities, because Congress had four tests in the statute about what is a swap dealer. We have given some further clarification on that, but it is really the test of whether you are making markets in swaps, whether it be interest rate swaps or oil swaps, if you are making a market in these swaps, and if you are known in the trade as dealing in these swaps and the like. I think that that is not a large group of companies, but there are companies that we are working very closely with and hearing their concerns. And we are not going to move forward on a final rule until we can adequately hear from them and work through this with our Commission.

The CHAIRMAN. Chairman Gensler, before my time expires, when should we anticipate the proposed rule on margin and capital?

Mr. GENSLER. I would anticipate in the next few weeks. This is one that we have been working very closely with the bank regulators as well, and the statute says, "To the greatest extent possible"—but it might have said to the maximal extent possible we are supposed to be consistent. So we are looking to try to do this in mid-April.

The CHAIRMAN. So then, when I follow that with a question along the line of what you have just addressed, will the rules proposed by CFTC and the Fed be similar in nature, your response would be?

Mr. GENSLER. Yes. Yes. Not identical, because we also have—and this is important—we have nonbank parties that might be dealers and they might even be nonfinancial entities, and so we have been really sorting through this in a way so that we don't just apply bank capital rules to companies that might be nonbanks.

The CHAIRMAN. You have made helpful comments, but you don't intend to apply margin transactions to transactions involving nonfinancial end-users. If the Fed does propose to impose margin transactions involving nonfinancial end-users, how will the agencies resolve that inconsistency?

Mr. GENSLER. I can't speak for the Federal Reserve, but I can speak for the Commodity Futures Trading Commission. We are not going to have a rule proposed that either requires a swap dealer to pay or collect margin, either direction, from these nonfinancial end-users. We think that is consistent with what Congress directed us.

The CHAIRMAN. My time has expired. I now turn to the Ranking Member for his questions.

Mr. PETERSON. Thank you, Mr. Chairman.

Chairman Gensler, welcome back again. The first question I have is, have you watched the movie *Inside Job?*

Mr. GENSLER. I am under oath, so I have to say no, I have not had the opportunity to see it.

Mr. PETERSON. I was hoping we could get a movie review here, but you need to watch it.

Mr. GENSLER. All right. I will commit to you to watch it before I appear to testify before you the next time. And I will try to open my statement with a review.

Mr. PETERSON. I imagine you have been a little busy.

Some of the witnesses in the next panel will ask Congress to push back the implementation date now scheduled for mid-July, because they believe that you need more time to consider views, and they need more time to see the whole picture of the new regulatory framework.

Do you need more time?

Mr. GENSLER. I don't think Congress needs to push back the date, but we are going to take more time. We are not going to move forward with these final rules and finish them all by July. We have already proposed 28 of the topic areas, but for two very important topic areas we have yet to propose, so we would not finalize those, at the earliest, until this fall. And you have already given us great latitude to phase the implementation dates.

But, the regulatory framework is largely out there, and it helps lower regulatory uncertainty that people see this whole mosaic. And they are commenting on it, obviously, right now.

Mr. PETERSON. That was my other question. So you think that the flexibility is there for you to do this in the right way and——

Mr. GENSLER. Yes. I am told by General Counsel of the CFTC that you all won't have me sent to jail if we miss the July deadline; maybe for other reasons, but not that.

Mr. PETERSON. And on the uncertainty issue, if Congress did push back this date with legislation, how much will this impact the regulatory uncertainty? Can you speculate about that?

Mr. GENSLER. Well, we have heard from many commenters about the specifics, but a broad overview as people want us to get on with—thoughtfully, just thoughtfully—get on with the job and then give them time to implement, and Congress gave us a lot of latitude to give time to implement.

But there was a crisis in 2008, and there also are a lot of people that want to bring greater transparency to the market, and the core of the statute is to bring greater transparency to these markets.

Mr. PETERSON. We have heard many complaints about the Commission not putting forth its proposed further definition of several terms, including *swap* and *mixed swap.* Congress directed you to further define these terms in conjunction with the SEC. I think you maybe touched on this a little bit, but how is that working with the SEC in terms of are you able to—are they bogging you down, or is that——

Mr. GENSLER. Let me say it has been an interesting process. But it is constructive. We are getting very close. I think that we are—I would say probably within 6 weeks that we will have something to propose. The most important thing, we had a lot of people commenting, and they wanted further clarification that insurance wasn't a swap. Well, we didn't think it was, but you have to write that all up—or that commercial loans aren't swaps—we had to write that all up—and forwards, and this is very important to the agriculture community, that forwards aren't swaps, just like they aren't futures. And I know you had a colloquy on this on the floor, I think other Members did, and we are following those colloquies and so forth.

Mr. PETERSON. Are the disagreements between the agencies the cause for this delay or is that what—you say it is an interesting process. Is it just you are not, you guys, there is just not agreement between you and the SEC?

Mr. GENSLER. We are now down to one small issue in a document that is over 100 pages long. So I am focusing forward. A lot of the delay has been that the 80 comments that came in asked for a lot of bright line tests and clarifications on these insurance issues, these forward issues, and these commercial loan issues. People asked questions on some very specific issues that we are trying to provide guidance on.

Mr. PETERSON. I think I recall that there was—this was something that kind of got in there at the end—but I think initially our position was that you were going to make this definition by yourself, and not the SEC. So I assume the answer, if we would have stuck with that and if it was you, you would have been given the responsibility for defining these terms, it would probably be done by now.

Mr. GENSLER. Well, you are kind to compliment us like that. But, it is going to be a very strong product and it is benefited by the SEC and CFTC sorting it through together. So it has taken a little longer, but it will be hopefully a good product and it will benefit from hundreds of public comments as well.

Mr. PETERSON. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. The chair now recognizes the gentleman from Illinois, Mr. Johnson, for 5 minutes.

Mr. JOHNSON. Thank you, Mr. Chairman.

Let me preface my comments, Mr. Gensler, by saying there is a relatively small number of people I would suggest who truly understand the nuances and the details of not only this bill but of its progeny. I, quite frankly, am not one of them, so you will forgive me if I ask questions that appear to be a little amateurish, but I will do the best I can here.

The first is, speaking as a Member of Congress, when we enacted this legislation a bit ago, I don't think anybody intended that end-users would be designated as swap dealers.

Under your proposed definition, is it possible for an end-user to be a swap dealer?

Mr. GENSLER. I don't think that an end-user will be a swap dealer. But there may be some nonbanks that are swap dealers, and Congress anticipated that because it gave the CFTC some authority over those, but it will be a very small number.

Mr. JOHNSON. You also in the past and otherwise have focused—and it is good—on the *de minimis* exception of the *swap dealer* definition. And you have also indicated that you are receiving and have received public comment since you last testified.

I can't speak for other Members of the Committee, but I don't think the Committee has heard from any entity that would actually qualify for the *de minimis* exception. Does that impact your thought and your analysis of this definition and the issue?

Mr. GENSLER. We did get comments. Congress asked us to have a *de minimis* exception. We made a proposal. It had three tests to it. I suspect, just as with many things, it will change; that the final rule will be reflective of many of the comments on the *de minimis*. This is particularly important in the farm co-op area. A number of the farm cooperatives have raised this and we are looking at that very closely.

Mr. JOHNSON. A lot of us, in fact a majority of Members of this Committee, represent districts that have a lot of small or mid-sized banks. Is it your intention, as you look forward, to exempt those small farm credit banks and credit unions, community banks, from the mandatory clearing requirement, as we authorized you to do?

Mr. GENSLER. Congress did ask us to consider it. We asked the public for some comments. We received about 15 comments on that, and so what we are doing now is working with the bank regulators, the Farm Credit Administration—I saw Russell here earlier with Lee Strom and his folks, and Debbie Matz over at the credit union. So we are working with them and sorting this through and looking to see how to best fulfill what Congress asked us to do.

Mr. JOHNSON. Just anticipating, without knowing that the second panel, very distinguished individuals like yourself, are going to have some significant concerns about their designation as swap dealers, specifically the Farm Credit Bank, the community bank. As you were here at the last Committee meeting, and I am quoting you as best I can, you indicated that the small—again, I am quoting specifically now, "The small entities, by and large, are not swap dealers. There may be one or two exceptions; I doubt many of them are swap dealers." Is that still your attitude?

Mr. GENSLER. It is still my understanding. I am not—there may be some out there, but I am not aware of community banks that have concerns—they haven't knocked on our door, and they have been focused, as your earlier question, on the clearing exception. But I haven't heard many community banks come in.

And in fact, Congress provided something in the statute explicitly, that if you are doing swaps in connection with originating a loan, just because you were doing a swap in connection with originating a loan, that does not make you a swap dealer. And it is something we included in our proposed rule in December. We have gotten some very thoughtful comments on the specificity of that exclusion, and like many things, we will probably change a little bit because of those comments.

Mr. JOHNSON. Let me just conclude because my time is running short here. Let me just conclude by making an observation more than a question.

Oftentimes we enact legislation that is implemented very differently than we intended it to be implemented. Quite frankly, sometimes we enact legislation that gets implemented the way we wrote the language of the bill, but not our intention.

There is a lot of impact that this legislation and your Commission is going to have on the future of the country and certainly of rural America. And I would just urge you to use good common sense, practicality, and good business sense in how you implement; because if you don't, the ramifications of what we did and what you do are going to be felt for a long, long time.

Mr. GENSLER. I appreciate that and I will try to do my best to follow that guideline.

The CHAIRMAN. The gentleman's time has expired. And the chair now recognizes the gentleman from Connecticut, Mr. Courtney, for 5 minutes.

Mr. COURTNEY. Thank you, Mr. Chairman and thank you Chairman Gensler for your testimony today. I think all your comments about the fact that we have to be smart about implementing the Wall Street Reform Act are to me just common sense. And I don't envy your job. This is a big task ahead of you. But on the other hand, it is also important to remember that not acting swiftly enough, aside from exposing us to what happened in 2008, frankly, there are things happening out there in the economy right now where not acting, is already causing real trouble.

And I would just again focus on energy contracts right now, which again the timeline has slipped in terms of limiting position limits on energy contracts.

We have a situation, I am going to give you a really small example, but I think it is connected to this. In New London County, Connecticut, right now oil dealers are refusing to do any lock-in contracts for next winter's home heating oil, because the market right now is just completely out of control. And these are guys who follow this stuff like a box score. Every day they follow what is going on in Cushing, Oklahoma, and I am just going to read you a quote from an oil dealer, Wilcox Fuel, Dave Foster: "We don't have a clue anymore. It is really driven by media news and Wall Street and it is disconnected from supply and demand.''

They are, again, are calling folks like me and they just are apoplectic about the fact that we have not recognized that there are forces in the market there that have nothing to do with them being able to run a real business. And so I just want to share that with you, that there are folks out there, they are not asking me about when are these rules going to be issued; they are asking me when are these rules going to be enforced.

And I would like, first, to give you an opportunity to give us an update in terms of where you are with that. Again, this affects consumer confidence all through the economy, by the way. I think this is bigger than New London County.

Mr. GENSLER. If I am allowed to, this is very much like what Congressman Johnson was saying, maybe from a different perspective. I think that what Congress has done is basically said this very large market, this swaps market, that is seven times the size of the futures market, should have the transparency, and so that the public, that fuel oil company in Connecticut, or anyone in rural America could have the confidence in these markets. Because at the core, if they don't have confidence in the markets, they might not use them as much.

These products are actually critical to our economy. They are critical to lock in a price and gain certainty so you can focus on what you are good at in your business, whether it is planting the crops or buying the oil or refining the oil, or just being a retailer.

Mr. COURTNEY. The irony is that these are the guys for whom this market was supposed to operate so they could hedge a risk and actually do a long-term contract and use it.

Mr. GENSLER. So realistically, if we are able to finish the rule sometime this fall—and we might slip from that too—but if we are able to, this marketplace will start to get more transparency in 2012. It won't all happen at once, because we do plan to use the authority you gave us to phase this. There will be some phasing-in on this.

Mr. COURTNEY. Again, there are folks that are really looking to you, frankly, very seriously for assistance.

The other point I just want to make real quick. My other committee is Armed Services. Secretary Mabus of the Navy was testifying before us the other day, and he pointed out that every $10 increase in a barrel of oil costs the U.S. Navy's annual fuel bill $300 million. Now society in general is calculating that speculation accounts for $20 of the price per barrel. I don't know if that is right or wrong, but I just throw that out there. It is a fairly credible source.

When we look at your budget and what is being proposed in terms of the H.R. 1 and the savings just to the Navy—Air Force uses even more fuel. Stabilizing in a rational market, fuel costs is not just for consumers out there, it is also for the taxpayer. And, again, we should hopefully put that in perspective about the importance of your agency and its mission.

Mr. GENSLER. I thank you. Our $168 million budget and what the President asked for in this year's budget of $261 million, or next year's budget of $308 million, I think is a good investment to the American public. I know it is a hard thing to ask for more money, but I know it is a good investment.

Mr. COURTNEY. Well we are going to pay for it, again in our DOD costs, which is the number one consumer of fossil fuels in the world, if we don't have a market that actually functions the way they can count on. With that, I yield back.

The CHAIRMAN. The gentleman yields back. The chair now turns to the gentleman from Texas, Mr. Conaway, to be recognized for his 5 minutes.

Mr. CONAWAY. Thank you, Mr. Chairman.

Chairman Gensler, welcome. Given the extensive comments on the *swap dealer* definition, do you have any intention of re-proposing that rule before you go final with it in order to make sure you get it right?

Mr. GENSLER. We are taking those comments in. We are going to be working with the Securities and Exchange Commission and our goal is to try to finalize this amongst one of the earlier rules, because a great many people in the market look for that. Again, Congress was very detailed in what a swap dealer was. We will modify——

Mr. CONAWAY. On the four tests, Mr. Gensler, do you have to beat all four tests? Because the last one says if you are just dealing, if you enter into swap transactions of a certain volume that captures you as a dealer. Is that your attitude that—we had a milk co-op sit there last time, after you left, and said they fall under the definition. And they simply do swap-like—some dealer-like stuff for their members. And so if the four tests include just doing it on behalf of yourself and your members, how do you get out from under the swap?

Mr. GENSLER. You are right. The Congressional statute was an *or* not an *and* and it is the fourth test. You are correct, it has this term about in the ordinary business or something. And so then we were trying to give some more meaning to that, to limit it in a sense, to give more clarity to that. But we have continued to meet with the farm co-ops, not just in dairy but in grain as well, because I think that——

Mr. CONAWAY. The idea, though, just to make sure you get it right. You mentioned earlier in the conversation that you are going to implement these rules in over a period of time. Will you expose that implementation scheme that you put in place, as you understand how these things roll out, for public comment to see that you have the wisdom of the collective group? I know that would be fully under your authority, but it would make some sense to me if you would expose that implementation scheme to the general public for some period of comment so that we will have a chance to——

Mr. GENSLER. That is something we are looking at. In each of our rules, we have asked for implementation phasing—or implementation dates from people. We have had a lot of people come in. We are looking at whether to have some public roundtables or, as you say, exploring how best to expose it.

Mr. CONAWAY. I do think it would be helpful for all of us to see what your team had proposed from an implementation issue to make sure that there wasn't something that you all are blind to that the rest of us might see.

We had some conversation the last time we were here about the cost-benefit analysis that you do, either under the CMA Act or under the President's Executive Order and all that kind of good stuff, but in one of your recent rulemakings on the cost-benefit, the statement was: For costs the Commission has determined that the cost to market participants and the public, if not adopted, are substantial. But then on the benefits you said: The Commission is determined that the benefits of the proposed rule are many and substantial.

Pretty casual swipe at a really important piece. Now many laws where agencies, not just yours, but other agencies who have done a cavalier approach to cost-benefit analysis, have been challenged in court. Can you help us understand that there is more depth to the cost-benefit analysis under these rules than just they are substantial, and if we don't do them or if we do do them, pretty cavalier comments just on the way you phrased it.

Mr. GENSLER. Well, one of the best ways of getting comments from the public is a hearing. And each of our teams summarizing public comments, one of the things they are specifically doing is summarizing all of the cost-benefit comments from the public, so that the Commissioners can take those into consideration, and whether it be qualitative or quantitative, that we can include that before we go to any final rule, and as you say, to include anything that we have heard from the public with that regard.

Mr. CONAWAY. There are some pretty dramatic differences between your cost—your expected cost to participants and folks that deal—in what they themselves see under these proposed rules. So making sure that we have not done something that costs way too much money *versus* the benefit that we get, would be helpful.

And one final comment. As you roll out this entire scheme when we get it in place, can we do an interim final rule for the whole package so that the industry, the participants, everyone can see how all of this matrix of new regulations fit together to make sure we get it right? I understand going at it a piece at a time, but it seems to me beneficial to the agency, as well as those who try to comply with your rules, if they saw the whole matrix at some final point, it would still allow for some fine-tuning, so to speak.

Mr. GENSLER. We have nearly completed all the proposals. There are these two that I think will be out to the public, capital and margin, hopefully in the next few weeks, and the product definition may be a few weeks after that. We don't plan to move on any final rules in April. There may be some very noncontroversial, small rules that we start to move on in May. We have the discretion to continue to take public comment and include it in public comment files, and have done so. We have used that discretion very liberally.

This meeting right here, this Committee meeting, will be part of our public comment file as well. So the mosaic will be out there really before we move on final rules of any substance.

Mr. CONAWAY. Thank you, Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman's time has expired.

The chair now recognizes the gentleman from Pennsylvania, Mr. Holden.

Mr. HOLDEN. Thank you, Mr. Chairman.

Chairman Gensler, it is nice to see you again. I had two issues I wanted to raise, but you more or less have addressed them; so I will just make a couple of comments about agreeing with my colleagues that we are, on this Committee, hearing a great deal from the agriculture sector and the energy sector, particularly public utilities, about the definition. So I am glad to hear you are going to be working with them.

And following up on Mr. Johnson's comments about the exemption for small banks, Farm Credit System, and credit unions, I would just encourage you to stay engaged and listen to their concerns, because it is my understanding that the overwhelming majority, over 90 percent of the swap dealing, is in the hands of 25 entities or fewer. So you will have to be very careful with smaller banks.

As a matter of fact, on the next panel, Mr. Cvrkel from Susquehanna Bank, headquartered in Pennsylvania, will be testifying. It is a bank of about $14 billion in assets, I believe, and I will ask him when he is testifying or taking questions. In the last 3 or 4 years, they have only done about 54 swaps compared to the overwhelming majority. I think you need to be careful that these are useful instruments in smaller banks and other entities, but at the same time if we are too burdensome on them, they are not going to participate.

So I just would encourage you to stay at the table and listen to what they have to say. Thank you. I yield back. Do you want to comment?

Mr. GENSLER. No. I appreciate the comment. I read the testimony and look forward to working not just with Susquehanna but many banks of similar ilk.

Mr. HOLDEN. Well, this is a Pennsylvania interest here.

The CHAIRMAN. The gentleman yields back.

The chair turns to the gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. I thank you, Mr. Chairman.

Chairman Gensler, thank you for being here. Yesterday you and I talked—just a while ago, one of your cohorts, Ms. Sommers, testified before my hearing that I had on the Financial Services Committee. She said some things that were very concerning to me. Kind of one of the things that she alluded to here, she says that we are voting on proposals containing a very short, boilerplate, cost-benefit analysis section. And she referred to the President's Executive Order, although it does not apply to your agency, and taking into account both quantitative and qualitative issues and the cost and the benefits of those. And one of the things that she brought up was an interesting point, is that when you do a better job of those cost-benefit analyses, and as you quantify those various proposed regulations and you put numbers onto them, that she feels like, she said, that she thinks Commissioners make better decisions. I think we would all agree that that would be hopefully the goal of every agency is that when we put people to serve in the capacity of Commissioners, that they avail themselves of every opportunity to make the best decisions.

And as I didn't get to hear all of my friend from Texas' testimony, but what we are talking about with Dodd-Frank is we are not talking about just a little tweaking here of the financial markets.

We are talking about a major change in those financial markets and maybe even influencing the way capital moves and how capital is priced and how capital is distributed in this country, which equates to jobs. Basically, the way we create jobs in this country is people have an idea and they find the capital to do that, or they have a business and they expand it. And these markets have become a very effective tool for many of the people that use them. They have created jobs and they have created more certainty in their companies.

And so I am a little concerned. What would be your response to Ms. Sommers' response, that you all aren't doing a good job over there doing your cost-benefit analysis?

Mr. GENSLER. I am very proud of the work of the staff and the five Commissioners. We are in compliance with the Commodities and Exchange Act, section 15(a), which Commissioner Sommers also said yesterday, and we are looking very closely at the comments that people have put forward on cost-benefit analysis. I can assure you we are not going to move forward on final rules until they are summarized and Commissioners get to deliberate with each other about that and with the staff.

I think that what the Dodd-Frank Act does at its core is it brings transparency to these markets and lowers risk in these markets, and competition and open competition in these markets will lower some of the barriers to entry to many banks. If a small bank wanted to actually enter the market in a way, right now this is a highly concentrated market where the information advantages are more towards the financial community in New York than to the tens of thousands of users, whether they be in Texas, my home State of Maryland or elsewhere.

And I think you all in passing the Act tried to tip that balance a little bit to most of the corporations that use these products.

Mr. NEUGEBAUER. I don't think she said that you weren't in compliance, but she said compliance is, to that particular section, is a relatively interpretive term. You can be in compliance or you can do a good job. I think what she was saying is that somehow within the agency, you all have come to the conclusion, hey, we are complying with that section.

But, as she said, as complicated and as important as many of these things are and with the speed with which they are coming out, that there is really not any way that the kind of comprehensive analysis that should be done for the potential impact and the consequences that these changes could make on the market. And as you say, I don't think anybody here disagrees with the fact that markets should operate with integrity and transparency.

But many of the rules that you are putting out will actually determine the people who can use some of these tools and how they can use them, and whether they can afford to use them and whether those tools continue to be advantageous to their organization.

And so I would just say that I think Mr. Bachus and I wrote all of you a letter here recently and said, Do you know what? We are not interested in speed here. We are interested in doing the right thing.

And if a lot of people think that Dodd-Frank is the right thing to do, I think all those same people who voted for it would probably also, without speaking on their behalf, would say, yes, we voted for it but we hope it does what we intended for it to do. We hope that the consequences and the outcome has been measured, and we know what we are getting before we go down that road. And some people say, well, Mr. Frank said today, "Well, we will fix it if we made a mistake."

The problem is when you start changing the behavior in a lot of these markets, then going back and trying to, "fix it," has even more dire consequences than taking a little extra time to make sure that we get this right.

And so what you are going to continue to hear from me is that I am concerned about the speed, I am concerned about the sequence, and I am certainly concerned about the analysis and thought that is going in in this rulemaking process.

With that, Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman's time has expired.

The chair now turns to the gentlelady from Alabama, Ms. Sewell, and recognizes her for 5 minutes.

Ms. SEWELL. Thank you so much.

First, welcome, Mr. Chairman. I admire what you are doing and really feel that the Commission has been charged with a very special duty, and I know it is to get it done in a timely fashion is what we all want, as well as to be fair.

I have one question really. Where are you in the decision making process when it comes to determining whether to exempt the Farm Credit System institutions from the definition of *end-user?*

Mr. GENSLER. We asked the public for some comments. We received about 15 comments on this. And now we are working with the Farm Credit Administration, as well as the banking regulators and the credit union folks, as to how to piece this together.

If we were to move forward, we would have to do a proposal under the statute and get further public comments on that. But right now we are in—similar to the rules, we are sort of taking the comments that we received and are working with the other regulators on how to craft something.

Ms. SEWELL. Where do you think you will come out on that?

Mr. GENSLER. I don't want to get ahead of the process and my fellow Commissioners. But we take seriously what Congress said, that we shall consider this, so I take it seriously in the entire statute, but this was the direction from Congress.

Ms. SEWELL. Absolutely. Thank you. I yield back the rest of my time.

The CHAIRMAN. The chair now turns to the gentleman from Alabama, Mr. Goodlatte, for his 5 minutes.

Mr. GOODLATTE. Except I am going to stay in Virginia.

The CHAIRMAN. Virginia. Virginia. Very good point.

Mr. GOODLATTE. I thank you, Mr. Chairman. I thank you for holding this hearing. And, Mr. Gensler, I thank you for participating today.

I understand that my colleague, Mr. Peterson, asked you if you had seen the movie, *Inside Job.* And you said you hadn't seen it yet. I recommend you see it.

And let me just ask you a question about my main concern here, why I voted against Dodd-Frank, and why I am concerned about where you are headed. I think that what we should be doing is clearly defining what you can and can't do and throwing the book at the bad guys who do what they are told they can't do, and not going into the amount of regulations that you are imposing on people who are trying to conduct a legitimate business and making it all that more difficult to do that.

So my first question is, one of the things revealed in that interesting documentary is the fact that apparently a number of the major investment banking firms sold various derivatives to their customers at the same time they were betting against their customers themselves.

What can you tell us about that? And what is being done to cure that?

Mr. GENSLER. Your question and much of what happened in that was in credit default swaps. Some of that jurisdiction will be at the Securities and Exchange Commission, but I will speak more broadly. Because what Congress gave the Securities and Exchange Commission and the Commodity Futures Trading Commission is new authorities on anti-manipulation and to protect the markets from abusive practices. And I don't know how the Securities and Exchange Commission will deal with that on these single name and these basket of credit default swaps where a lot of that, you are right, occurred.

What we are doing at the CFTC is we have proposed a new anti-manipulation standard which is consistent with what Congress did. Congress gave us a new anti-manipulation standard, and that is out for comment. We would like to finalize that to make sure that we can pursue actions in this marketplace.

Mr. GOODLATTE. One of the issues that—I don't know how related to that is—but attempting to cure some of this is—the categories of swap dealer and major swap participant are mutually exclusive. If an entity is a swap dealer, that entity may not be a major swap participant. This makes sense, because swap dealers are the sell-side of swaps and major swap participants are the buy-side, basically the largest customers. Sellers and buyers should not be in the same regulatory category, and Dodd-Frank appropriately provides for that.

Do your regulatory proposals take this basic difference into account?

Mr. GENSLER. Yes. I would think that there would be only, at most, a handful of major swap participants; that somebody who is not a swap dealer, but yet for some reason is so large or substantial—is what Congress used the term—that their failure would have a systemic effect on the economy.

And I should say on your first question, we do also have authorities on business conduct standards for selling swaps to pension funds and municipalities. And Congress asked us to be very focused on the sales practices in that regard as well.

Mr. GOODLATTE. I know that some have expressed concerns that swap dealers and major swap participants will be regulated the same. Do you propose to regulate them the same, even though one is the seller and one is the buyer? And why should buyers and sellers be subject to the same sales practice rules, when the buyers are not indeed sellers?

Mr. GENSLER. You raise a very good question, and I am going to go back and think about that and ask about that on the sales practices. But the basic answer is because the statute did not differentiate between the two. Once one is designated a major swap participant, one of these handful of companies that are so large, the statute just regulates them the same. But you raise a very good question about sales practices.

Mr. GOODLATTE. So are you suggesting that we need to take further legislative action because your hands are tied; or are you able to make a difference there?

Mr. GENSLER. Could I get back to you on that in terms of the sales practices for major swap participants?

Mr. GOODLATTE. My time is limited, so let me go on to another question.

I have heard from some businesses that they are uncertain about how they will be designated and which rulemaking will apply to them. Is there any documentation that provides various market entities, and specifically end-users, guidance regarding which of the various rulemakings are applicable to them?

Mr. GENSLER. Well, for the vast majority of end-users, they are not going to be swap dealers, they are not going to have to use a clearinghouse unless they choose to, and they will benefit from the transparency in the marketplace. There will be changes in the marketplace, of course, because the financial companies will be using these clearinghouses, but they will be out of it.

Mr. GOODLATTE. With the leave of the Chairman, I will ask you one more question.

I am concerned that the CFTC is putting out rules piecemeal for comment. Many of these regulations are highly interdependent, and I am concerned that we will not get to see the full picture of how they work together or a meaningful analysis of the cost and the impact of the regulations. Would you be willing to put forward a full package of proposed regulations for comment before they are all adopted, or at least put them in packages so that we and market participants are able to fully appreciate their cost and their impact?

Mr. GENSLER. I think, actually, that is nearly what we have done. We haven't finalized anything and we have two major rules left, which we will probably do in the next 4 to 6 weeks.

Mr. GOODLATTE. Will those rules be out and evaluated before the first rules you issued take effect?

Mr. GENSLER. Yes.

Mr. GOODLATTE. That is helpful.

Thank you, Mr. Chairman. I appreciate it

The CHAIRMAN. With that, the gentleman's time has expired. The chair will now try in a more accurate fashion to turn to the gentleman from Iowa, Mr. Boswell, and recognize him for his 5 minutes.

Mr. BOSWELL. Thank you, Mr. Chairman.

Just briefly, I wasn't here for all that you have been through already, but thank you for coming. You have a big job. And I am wondering if you want to comment on are we giving you the tools to do what you have to do. Have you got the tools to follow through?

Mr. GENSLER. Well, you are kind to ask. We have the tools to write the rules and excellent staff, but we do not have the tools to oversee the market. We have estimated that we need about 45 percent more people to oversee a market that is seven times the size of what we——

Mr. BOSWELL. We have talked about this before. Can you give us some kind of a figure—dollars, number of people?

Mr. GENSLER. The President has put forward a budget of $308 million for our agency for 2012, and $261 million for this year. We are currently funded at $168 million. In terms of people, we have about 675 people now, and the President has put forward 983 people.

We only spend $31 million on technology a year. We have asked to go up to about double that. That is less than about 1 day of technology spending for some of the biggest Wall Street banks.

Mr. BOSWELL. So what happens if we are going to have to—you can't do the job, you don't have the tools, you don't have the personnel if we continue with this; or do we back off and we don't do the regulation, or what happens?

Mr. GENSLER. I think the challenge for the agency is if we even kept flat on funding, is that we will have to shift resources that currently oversee the futures market, or even agricultural futures and energy futures, over to some of these financial swaps. The mission is, right now, far broader. The market is seven times its size and far more complex. And so we will not be able to pursue the Ponzi schemes. We will not be able to promote the transparency in the markets that I think the public deserves.

Mr. BOSWELL. Well, I will yield back, Mr. Chairman, in just a moment. But it just seems to me like we have to lay this out in broad daylight and decide what we want to do with it, whether we are going to give up the oversight, or whatever. I don't know. I don't envy your job here. I am not sure what we are going to do.

Thank you. I yield back.

The CHAIRMAN. The gentleman yields back.

The chair now turns to the gentlelady from Ohio, Mrs. Schmidt, for 5 minutes.

Mrs. SCHMIDT. Thank you, Mr. Chairman. And thank you, Mr. Gensler, for coming.

I want to focus a little bit on farm credit and community banks. Is it your intention to extend the insured deposit institution's swaps in connection with loans exemption to the farm credit banks?

Mr. GENSLER. I know that a number of comment letters have come in on this. The statute speaks of insured depository institutions and did not speak in a broader way, so I am familiar with the comments that have come in. I know that our staff and General Counsel's office is taking a close look at it because the statute actually just uses the term insured deposit institutions.

Mrs. SCHMIDT. So you don't know how you are going to handle that?

Mr. GENSLER. I don't know. I am apprised of it. I know that staff is looking very closely at it.

Mrs. SCHMIDT. Because I believe during the last hearing when you appeared before the Committee, you were asked about small banks and farm credit institutions. And I believe you said that the small entities, by and large, are not swap dealers; there may be one or two exceptions. And you further said you couldn't speak for thousands. And then you said, I doubt that many of them are swap dealers.

And in light of the fact that we have a farm credit bank and a community bank here today that have expressed concerns in their testimony—or will be expressing concerns, because we have received the written testimony—about being designated as swap dealer, what would you say in light of that response?

Mr. GENSLER. My answer was trying to answer a question about banks smaller than $10 billion. I think the banks you are hearing from today are $14 billion and maybe—I am sure they can tell you how large, $50 or $60 billion.

Mrs. SCHMIDT. You think $14 billion is a large bank?

Mr. GENSLER. Congress actually defined it in the statute. They used the term *small bank,* and then right below it it said $10 billion or less. So I was using a Congressional term.

Mrs. SCHMIDT. So do you think we should change that benchmark?

Mr. GENSLER. I am just using it——

Mrs. SCHMIDT. Because, sir, I come from a banking background, and $14 billion is not a large bank. I don't know why $10 billion was the threshold. That would be a very small bank, in my opinion, but it is certainly not a large bank. So should we change the benchmark, the definition?

Mr. GENSLER. I think the statute is a strong statute; I am not asking Congress for any changes.

Mrs. SCHMIDT. Okay. And then I just want to go back to the swap issue. We have heard concerns, and I know you have received public comments, that active trading in the swap market by itself could make an entity a swap dealer. Is that your intention?

Mr. GENSLER. What we have put forward is a rule that further defines what Congress laid out, four provisions for what a swap dealer is, and so we are taking those comments in. But the statutory language was, "if you make a market in swaps, or you are commonly known as a 'swap'."

And then the fourth prong, which was one that talked about in the ordinary course, is where we thought there was some need for further definition. But in essence, if you are accommodating demand or facilitating customers in swaps, it would be sort of part of the facts and circumstances.

Mrs. SCHMIDT. So again, back to this Act that you are now trying to implement rulemaking on, it appears there is a lot more ambiguity or questions that arise from the Act itself, and maybe we should revisit the Act.

Let me go on again. In the definition of *security-based swap dealer,* the SEC plans to adopt their dealer trade distinction with respect to who must register as a security-based swap dealer. The CFTC appears to have rejected this distinction for the *swap dealer* definition, and now again there seems to be some sort of tension. Can you clarify this?

Mr. GENSLER. Yes. We did not, as our markets are different. They have in that definition, that dealer and trader definition, they talk about inventory and the like; inventory of securities, which is not easily or readily adaptable to the interest rate swap market; what is the inventory of interest rates, for instance? Or even, for instance, in the oil markets, which is not like an inventory of securities. So there are some challenges just because of the specificity in their rule.

Mrs. SCHMIDT. I yield back, but——

Mr. HOLDEN. Will the gentlewoman yield on her point about $10 billion for me to ask the Chairman a question?

Mrs. SCHMIDT. Yes, please.

Mr. HOLDEN. I thank the gentlewoman.

Chairman, you do have the authority to exempt above $10 billion, correct? It is just below $10 billion you must?

Mr. GENSLER. Again, as I understand, the statute asked us that we shall consider exempting from the clearing requirement the small banks, and then it lists banks under $10 billion, credit unions under $10 billion, and of course farm credit institutions under $10 billion.

Mr. HOLDEN. But you have the authority above $10 billion as well.

Mr. GENSLER. I am just speaking to what—I mean, Congress directed us to take this up. We are taking it up right now, working with the institutions. I believe that the Congresswoman's question about swap dealers, what I said earlier and I will say now, I am not aware of institutions less than $10 billion. There may be some out there, but I am not aware of them. They haven't been knocking on our doors, that say they would be a swap dealer or anything like that.

Mrs. SCHMIDT. May I have just an additional 30 seconds?

The CHAIRMAN. The gentlelady reclaims her time. The gentlelady has an additional 30 seconds.

Mrs. SCHMIDT. Sir, you said that $10 billion was the threshold. I believe you said it is a suggestion, not an absolute benchmark of $10 billion. And I believe you have the authority to go above that, the way this law was written.

So, again, there is a lot of ambiguity in this Act, but $10 billion was not the absolute benchmark. You could go above that to $14 or $15 billion.

I yield back.

The CHAIRMAN. The gentlelady's time has expired.

The chair now recognizes the gentleman from California, Mr. Costa, for 5 minutes.

Mr. COSTA. Thank you very much, Mr. Chairman.

I want to first kind of revisit a subject that we discussed the last time you testified, as it related to the potential of regulating of foreign currency swaps. My understanding is that the Secretary of the Treasury is considering or leaning toward a decision that foreign currency swaps should be regulated. We are all following very closely what is happening with the Euro and a number of countries within the EU, and of course situations with China and other foreign currencies that obviously impact our trade.

And so I guess my question, my first question, is what impact would such a decision have, if any, on producing a definition of a *swap,* or any other rulemaking that is already underway, if we start to regulate foreign currency swaps?

Mr. GENSLER. I think we have contemplated that in our rulemaking and are contemplating it in the product side as well, that Congress gave the Secretary the determination; he could determine that foreign currency swaps are out, but we have sort of contemplated that in our rulemaking.

Mr. COSTA. Can that occur on a separate track?

Mr. GENSLER. I believe it can in terms of our rulemaking. We would take it into consideration in terms of phasing implementation. For instance, there is not a swap data repository for foreign currency right now. There are swap data repositories, for instance, in credit default swaps. That is one of the things we are taking into consideration. It might just take more time to stand up, for instance, some of the infrastructure.

Mr. COSTA. Can you tell us this afternoon, at this time, what you think you are going to do?

Mr. GENSLER. Well, it is the Secretary of the Treasury's determination.

Mr. COSTA. I understand.

Mr. GENSLER. No. I don't believe it would be prudent for me——

Mr. COSTA. Not before its time, right?

Mr. GENSLER. It wouldn't be prudent for me to——

Mr. COSTA. Following up on Mr. Boswell's line of questioning on resources, under the Dodd-Frank law there are a host of issues that we have discussed here this afternoon, from applications for new swap execution facilities, designated clearing organizations and swap data repositories, swaps to see if clearing mandates should apply, requests for exemptions to the law's provisions, and other requests from the business community.

You made a comment earlier on your current resources available and your fine staff and what your capabilities are today. When you go down that list that I just stated, what gets included or excluded based upon how much your budget is?

Mr. GENSLER. It really depends on where the budget is. If we were cut, a lot of it goes away; we can't even oversee the futures market much. If we just stay flat, we will have to start reallocating people. We did have a very real crisis in 2008. These markets are not as transparent as Congress has wished them to be. We would be relying on the markets to be complying with Dodd-Frank, but we wouldn't be able to actually examine for it and oversee the markets with regard to swaps, as you have directed us to.

Mr. COSTA. Well, to use a medical terminology, first, do no harm, when a surgeon is in ER, on a serious case they triage, and so they deal with the most urgent matters first. So on that list, I assume that when you do get a chance to sit down on a Friday afternoon with your staff and figure out, now that we have these rules almost presented and we are moving to the next stage, where are your priorities going to be?

Mr. GENSLER. Well, the biggest priority is to increase our technology budget so we can aggregate the data and actually make it public. We have proudly put out, every Friday, Commitments of

Traders Report in the futures market. We would like to do something similar in the swaps market if we could actually have the technology and aggregate data.

For the hundreds of applications that will come in, we would like to be responsive. We would like to have a professional on the end of the phone to answer the questions and try to walk people through some very new rules and give them regulatory guidance. I don't see how we will be able to do that.

Mr. COSTA. So if you get the President's full request, you can do all of the above?

Mr. GENSLER. I think that if we get the President's full request we can grow into it, and it will take a couple of years to grow into it. But, yes, the President's request helps us grow into these responsibilities.

Mr. COSTA. And if you get half of it or something less, you will have to do the prioritization.

Mr. GENSLER. That is correct. That is correct. And if we are cut from where we are now, at some point I would have to tell this Committee we could not fulfill our mission. We certainly could not fulfill it if we were cut back to 2008 funding levels.

Mr. COSTA. Well, I think that needs to be clear. And you should also tell this Committee if it is something less, half or less, what you can do and what you can't do. I think that is an area—when you try to create an expectation for a transparency level and for all elements of these derivatives, I just think people need to know what they can expect and what they can't.

Mr. GENSLER. Part of the investment in an agency like ours is it is like investing, and you don't know when—to use your medical analogy, it is like the doctor saying, "Stay on a diet and maybe don't smoke or something."

I can't tell you that in 2012 there will be a crisis. But we know in 2008 there was a crisis and swaps were part of it. And Congress reacted appropriately. We are trying to implement the law consistent with the intent, but if we don't oversee this market, the American public is prone to risk.

Mr. COSTA. I would like to quickly, before my time expires, move over to another area. You touched upon it, Mr. Conaway touched upon it. When we are dealing with some of the various commodities, whether we talk about wheat, soybean, milk, others—anecdotally, and I have nothing to base this on because I don't deal with these trades, but I get complaints from a lot of my farmers that there is a lack of transparency, there is a lack of activity, that it seems to be an in-house game.

It is hard from my perspective to really determine whether or not these anecdotal stories really—to what degree they are accurate. Have you got any sense, based upon getting back to the whole purpose on why this was created, going back to the 1930s—not the exotic sorts of mechanisms that you deal with today—but getting back to what is important out on the farm to see what is going on in Chicago and see what is going on elsewhere for our farmers and ranchers?

Mr. GENSLER. Well, hedgers meet speculators in a marketplace. If a farmer needs to lock in a price at harvest time, it is usually a speculator on the other side of that transaction.

But it is true that over the decades that the markets have been—the percent has gone up that are financial actors or speculators in that marketplace. And it is why people want the transparency, so they can still have the confidence that the price they get for their corn or wheat or soy or milk, as you said, is actually reflective of supply and demand, and that there is integrity in the market.

Mr. COSTA. A lot of my dairymen complain, they just think there is a total lack of transparency, that it is an in-house deal, and they have little way to really get a sense that prices aren't set without their ability to have the input.

Thank you.

The CHAIRMAN. The gentleman's time has expired.

The chair now turns to the gentleman from Colorado, Mr. Tipton, to be recognized for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman. Thank you, Mr. Gensler, for being here.

I just have a few questions that I would like to get some clarification on.

You commented earlier that you are seeking to work with the various entities in terms of some of the resolution in regards to the rulemaking. Can you describe what it means to be working with them? Is it just taking the comment; they put out an idea and you say, well, here is the problem? Is there that give-and-take going back and forth, or is it just receiving comment; we will consider it and we will make up our own mind.

Mr. GENSLER. If I might, there is some of both. We have had well over 600 meetings. I had one on the end here with the good gentleman at ConocoPhillips that is about to testify that we will put on our website as well. So he will be able to answer you whether there was give-and-take, but it is some of both, if I want to be——

Mr. TIPTON. Well, I appreciate that. I guess one of the big concerns that I always have—small business guy—and we are probably hearing that in terms of an underlying theme through some of the questioning that is going on—is really some of the cost-benefit analysis that is really going in that. Can you describe for me how you approached cost-benefit analysis in this process?

Mr. GENSLER. Many years ago in our statute a section you will hear about, it is called 15(a) was added, and it has five criteria, five characteristics we have to look at. And it talks about the integrity of the market and the price discovery function and the lowering of risk. So it is around those things that somewhat inherently are qualitative. Commenters have come in with some quantitative figures as well. And so we try to take all of that into consideration.

One thing for me, as one Commissioner, is trying to find what Congress asks us to do in a way that lessens the burden or cumulative cost, because there are things in the statute that will cost money, that is true. But then there is a way to find a least-cost way, or find a way that we can spread it out and have it phased in terms of implementation, to take into consideration the cost as well.

Mr. TIPTON. Can you maybe just tie that in just a little closer here? Like an electric utility, as a swaps dealer being designated, how are you going to approach the cost-benefit analysis on that?

Mr. GENSLER. The *swap dealer* definition is very precise in the statute. So many electric utilities wouldn't be; but if they were, then it is really trying to walk through with them what are the capital margining requirements—because we are supposed to set the capital and margin regime for these nonbanks. And it doesn't have to be the same as the banks. The statute says that to the maximum extent practical we have to be consistent, but it didn't say we have to be the same.

It is walking through the business conduct standards and how they might apply to some of these nonbank swap dealers, whether it is phasing the timing or whether they apply differently, to try to walk that through.

Mr. TIPTON. It sounds a little iffy to me in terms of setting some of those capital requirements. It just sounds a little iffy to me in terms of how you are trying to define those capital requirements for entities that are nonbanks.

Mr. GENSLER. Well, one of the challenges is that those capital rules have been done for banks, insurance companies, broker-dealers, and so Congress gave us a task and it was specific to nonbanks. We are hoping to propose that in the next few weeks. We are very much looking forward to public comment on it, because we will be assisted by that public comment. We have already been assisted by many of the meetings we have had with industry people.

Mr. TIPTON. Okay. And I appreciate that assistance.

I want to go back to an earlier question that was raised in regards to the packaging, the entire package. Did I understand you correctly that you are willing to be able to bring that back as a package for comment? Because I deeply respect the comments of *do no harm,* and *unintended consequences.*

Mr. GENSLER. Well, I just want to be precise. We have already put out rules on 28 of the 30 topic areas. There are two significant ones. There is capital and margin, there is a product definition, which will be out in a number of weeks. We don't intend to move on any final rules in April. So the mosaic is largely out there and will be, in essence, out there before we move on any major rule. There might be one or two very small rules that we move on—an example is the definition of *agricultural commodity.* This is one rule we might move on early, but it is not the same category.

Mr. TIPTON. I guess my point on this is it is not so much how I am viewing it as mosaic, as impressionistic art. When we are up close, we aren't really seeing it, it is coming in in little bits and pieces; when we step back, we see the whole picture. Being able to come back in and revisit these, once we then have that interaction with industry, the actual impacts that are going to be there.

Mr. GENSLER. We have used the discretion we have under the Administrative Procedures Act to continue to consider comments, just like this hearing is a comment. And we have gotten many comments we have put in even after it is out there.

With all respect, industry does know Dodd-Frank is a full mosaic itself, and now we are almost there; that we have finalized this proposal stage, and then we will move to the finalization stage.

Mr. TIPTON. Thank you, Mr. Chairman. Thank you, Mr. Gensler.

The CHAIRMAN. The gentleman's time has expired.

The chair turns to the gentleman from Pennsylvania, Mr. Thompson, for 5 minutes.

Mr. THOMPSON. Thank you, Mr. Chairman.

Chairman Gensler, thank you for being here and for your testimony.

My question has to do with the National Futures Association's petition to the CFTC to narrow the Rule 4.5 exemptions provided in mutual funds, among others, from the definition of the *commodity pool operator*. Now, the petition was based on the activities of three firms, yet your recent Rule 4.5 proposal would capture large swaps of mutual funds and subject them to duplicative and potentially conflicting CFTC regulation, when mutual funds are already highly regulated by the SEC.

Now this rule proposal seemed to have nothing to do with Dodd-Frank. And at a time when the CFTC has extensive new responsibilities under Dodd-Frank and is before Congress asking for additional financial resources to meet its new regulatory burden, why would the CFTC attempt to drastically expand its regulatory jurisdiction and extensive new responsibilities over mutual funds when the SEC already regulates this?

Mr. GENSLER. We have for decades regulated or overseen something called, "commodity pool operators." The public might just call them hedge funds, or the public might call them money managers and so forth. Commodity pool operators pool money and invest in futures. They can invest in other things. The SEC, for the first time in the Dodd-Frank Act, has reporting for hedge funds. Some of those hedge funds are also commodity pool operators. So the statute actually said we should do a joint rule with the Securities and Exchange Commission on information that would go to the SEC.

So we did choose to propose that joint rule in January. We did a sister rule—the one I think to which you are referring—on commodity pools that wouldn't necessarily be reporting to the SEC, to try to align that with what we are doing in that joint rule at the SEC. So that is why we took it off, because of Congress' mandate on this joint rule and trying to align some of that which we have done in these commodity pools. But I would be glad to come and see you one on one, and try to dig more into some of these issues, because I have to remind myself of all the details of each rule too.

Mr. THOMPSON. Well, Chairman Gensler, I appreciate it.

Mr. Chairman, I yield back the balance of my time.

Mr. CONAWAY. Would the gentleman yield his minute for one follow-up?

The CHAIRMAN. The gentleman—yes.

Mr. CONAWAY. Mr. Gensler, does the Administrative Procedures Act have any kind of a bright line requirement as to major changes to a proposed rule that would in effect require you to re-propose it; or is that fully within your discretion as to how much change drives going from proposed to final *versus* a re-proposal?

Mr. GENSLER. I think you are probably beyond my personal knowledge base and I have to ask my General Counsel.

Mr. CONAWAY. If you wouldn't mind providing that for the record.

Mr. GENSLER. What I am led to believe is if we are proposing something completely new, it hasn't been considered, it is not questioned and so forth, we might need to re-propose. But if we have laid out enough predicate, enough in the proposal, we don't need to re-propose. And often what is happening is we are getting comments from people that want us to narrow something and so forth.

I am just being handed a note, it says, "If it is a logical outgrowth"—those are the key words—"a logical outgrowth of the proposal."

Mr. CONAWAY. So there is some standard by which to judge what you would go final with, as to whether or not you would go final or re-propose?

Mr. GENSLER. Yes.

Mr. CONAWAY. Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentleman yields back.

And as the Chairman of the CFTC would know, there are sometimes, anymore, not a lot of pleasures that go with being Chairman of anything. But in my regard, I have the ability to control the time and I have a couple more questions for you, sir, if you don't mind. That is one of the few pleasures of this job these days.

As you know, Chairman Gensler, I recently joined Chairman Bachus and Chairman Kline in writing you and Chairman Schapiro and Secretary Solis about the potential conflict among the three agencies' regulatory proposals that could be detrimental to pension plans. Swaps are an important risk management tool for pension plans, and we need to take every caution not to jeopardize the benefits they provide to ensuring the retirement security of millions of Americans. In fact, when you appeared before the Committee last, you were asked if CFTC would take every precaution not to impose significant and additional new costs on pension funds. And you said, "Well, I think we are."

Yet shortly thereafter, we heard testimony from the American Benefits Council that the business conduct standards rules proposed by CFTC conflict with the DOL rule to the point that they would require a swap dealer to perform an illegal action or refrain from entering into a swap with a plan. In short, this would make it impossible for pensions to engage in swaps at all.

If the business conduct standards are finalized before this conflict is clearly and officially resolved, there would be significant and potentially harmful consequences for our pension system. Can you assure me that this conflict will be publicly resolved before the business conduct standards are finalized?

Mr. GENSLER. We have been meeting with the Department of Labor to harmonize the two. So to Congressman Tipton, who asked me earlier about how we are working together, this one we are really working together with the Department of Labor. I think they are going to be able to assist us and assist this Committee to harmonize that our business conduct standards, which Congress in essence said—the key to this, Mr. Chairman, is that Congress said that swap dealers have to, on a daily basis, value the swaps with their counterparties. Just because they value that swap on the other side's pension fund shouldn't make them a fiduciary.

And we are working with the Department of Labor to ensure that this Congressional mandate that we embedded in our business conduct doesn't somehow make somebody, solely because of that, a fiduciary under this Department of Labor rule. So we are working to harmonize it and get clear input from the Department of Labor that we can share publicly.

The CHAIRMAN. Thank you.

One other question. You recently traveled to Europe and spoke publicly about the need for international cooperation. Specifically you said, "Effective reform cannot be achieved by one nation alone." You also stated before this Committee that you are working very closely with foreign regulators to ensure as best we can—another quote again—"that we are consistent in our regulatory treatment."

In addition, you made remarks in Europe that it was important for them to pursue reforms that were consistent with Dodd-Frank in order for CFTC to recognize comparable regulatory regimes.

And I would like to submit for the record a copy of a letter submitted to the CFTC by the Financial Services Authority in the U.K. Seeing no objection, so ordered.

[The document referred to is located on p. 73.]

The CHAIRMAN. In the letter, the FSA expresses concern that CFTC's proposal to set a $50 million cap on the amount of capital clearinghouses can require of potential clearing members could actually increase risk to the system.

So I guess, Chairman, can you respond to the concerns expressed from a foreign regulator that your proposal would inject more risk into the system?

Mr. GENSLER. I am familiar with the letter. I think that currently the clearinghouses in the futures industry are well managed and they do not have the limits in the swap market. The swap marketplace, frankly, has been an exclusionary practice where they say you have to have $5 billion of capital or $1 trillion of swaps before you are a member of the clearinghouse.

We proposed in December that there be different limits, that it foster competition and not just be exclusively these large swap dealers. And we will take into consideration the FSA's letter, we will take it into consideration like all other letters. But what we think Congress was trying to do was have open access to this clearing and open access to these markets, and not have it so exclusive as it has been today.

The CHAIRMAN. And I am going to be brave with the time and ask one more question: Where else are there significant differences between your approach and the approach under consideration in Europe?

Mr. GENSLER. Europe is moving forward. In their European Parliament I was honored to be in front of a committee—the Economic Committee of the European Parliament. They are likely to move forward this summer on clearing, on the dealer regime, on data repositories. And it is not going to be identical, but it is quite similar.

Their timing on the real-time reporting and on the transparency that is brought forward in trading platforms called swap execution facilities, they are taking up in a reform later in the fall. And just as any legislative process, when something is a little later, it is a little less certain. They are committed to try to get their implementing rules done by next summer, the summer of 2012.

The CHAIRMAN. With that, the time for questions has expired. I wish to thank the Chairman of the CFTC once again for his time and his patience, and note that I am quite confident we will have several more visits before this year is over.

Mr. GENSLER. I look forward to it. I think these are helpful.

The CHAIRMAN. Absolutely, Chairman Gensler. Thank you.

I would like to now welcome our second panel of witnesses to the table as they prepare for their testimony.

Mr. James C. Allison, Gas and Power Risk Manager, North America, ConocoPhillips, on behalf of the Working Group of Commercial Energy Firms, Houston, Texas.

Mr. Mark J. Cvrkel, Chief Financial Officer of Susquehanna Bank, Lititz, Pennsylvania.

Mr. James M. Fields, Senior Vice President and Chief Financial Officer, Deere & Company, Moline, Illinois.

Mr. Richard J. McMahon, Vice President, Finance and Energy Supply, Edison Electric Institute Washington, D.C.

Ms. Ann Trakimas, Chief Operating Officer, CoBank, on behalf of the Farm Credit Council, Greenwood Village, Colorado.

Whenever you are ready, Mr. Allison, you may begin.

STATEMENT OF JAMES C. ALLISON, GAS AND POWER RISK MANAGER, NORTH AMERICA, CONOCOPHILLIPS, HOUSTON, TX; ON BEHALF OF WORKING GROUP OF COMMERCIAL ENERGY FIRMS

Mr. ALLISON. Chairman Lucas, Ranking Member Peterson, Members of the Committee, thank you for inviting me to discuss certain key implementation issues regarding Title VII of the Dodd-Frank Act.

I am Jim Allison, North American Gas and Power Risk Manager for ConocoPhillips. I am appearing today on behalf of the Working Group of Commercial Energy Firms. The Working Group is a diverse group of commercial energy firms whose primary business activity is the physical delivery of energy commodities to others.

My testimony today reflects the positions of the Working Group. It does not necessarily reflect the positions of ConocoPhillips or any individual member of the Working Group. My oral comments are a summarization of the written testimony, and I would like, if the Committee will allow me, to have that be part of the record.

The Working Group supports the policy goals of the Dodd-Frank Act, but is concerned that several of the CFTC's proposed rules will have significant unintended consequences. These include concentration of commodity market activity among large financial dealers—many of which have been considered too big to fail—increased market volatility, increased liquidity risk, increased cost for commercial firms and regulations that will ultimately lead to higher costs for energy consumers. Before I discuss these areas of concern, I would like to briefly describe how and why commercial energy firms use swaps.

Members of the Working Group are engaged in many aspects of the energy business, including electricity generation, oil and natural gas production, refining, storage and transportation, and merchandising and trading energy commodities. These activities expose the Working Group's members to many commercial risks. Fortunately, commodity derivatives give us the ability to manage some of these risks.

For example, we can buy or sell necessary feedstocks and end-products at predictable prices. They provide us with greater certainty around the income from our capital investments. We can take market positions where we are active, physical market participants, and it gives us the ability to increase our economic investments in U.S. energy infrastructure.

Managing the commercial risks enables delivery of energy at stable and affordable prices. The Working Group believes it was the intent of Congress to preserve this ability and to avoid market disruptions that would subject consumers to higher energy prices. The Working Group highlights three areas of concern where the CFTC's implementation efforts may run counter to Congressional intent.

First, the CFTC's proposed definitions of *swap dealer* and *major swap participant* are unnecessarily broad. As proposed, these definitions would impose costly regulation on many firms that do not pose a risk to the U.S. financial system. In response to these costs, firms will be faced with a choice to either pass the costs on to consumers or scale back business activities.

Second, overly broad entity definitions may deny commercial firms the benefits of the mandatory clearing exemption that was created by Congress to protect them. While clearing will reduce counterparty risk for these firms, it will increase liquidity risk.

Third, the CFTC's sequencing of proposed regulations is causing significant uncertainty for farms that are trying to determine the impact of and potential requirements for compliance with the proposed regulations.

We believe these concerns can be avoided. First, the CFTC should use the available statutory tools to avoid unnecessary regulation of commercial firms as swap dealers. This can be done by, first, adopting a distinction between the terms *dealer* and *trader* that is similar to the distinction adopted by the SEC; and second, implementing the *de minimis* exception in a way that recognizes the statutory distinction between customer and counterparty with a meaningful threshold that allows for a reasonable amount of customer-facing activity.

Second, the CFTC should adopt the definition of *major swap participant* that includes only those firms that truly threaten the U.S. financial system. Both dollar thresholds and assessments of firm exposure based on a percent of market value can be used to make those determinations.

Third, it is imperative that companies have an opportunity to evaluate in the aggregate the complex set of rules proposed by the CFTC. As of today, final rules defining *swap dealer* and *major swap participant* have not been issued, and the CFTC has not issued even a proposed rule defining *swap,* a critical definition needed to understand the impact of all the proposed rules.

The CFTC should ensure that rulemakings are logically sequenced and that effective dates for final rules provide firms adequate time to identify and implement the extensive systems changes that will be needed to ensure compliance.

I have highlighted today particular issues that may create unintended consequences, ultimately resulting in increased energy costs for consumers. The Working Group is confident that there are solutions for these issues, and we look forward to continuing to work with the CFTC to implement these solutions.

I thank the Committee for the opportunity to present this testimony on behalf of the Working Group of Commercial Energy Firms, and I would be pleased to answer any questions.

[The prepared statement of Mr. Allison follows:]

PREPARED STATEMENT OF JAMES C. ALLISON, GAS AND POWER RISK MANAGER, NORTH AMERICA, CONOCOPHILLIPS, HOUSTON, TX; ON BEHALF OF WORKING GROUP OF COMMERCIAL ENERGY FIRMS

I. Introduction

Chairman Lucas, Ranking Member Peterson, and Members of the Committee; thank you for this opportunity to discuss certain key issues regarding the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the regulation of commodity derivatives, including the regulation of entities and products in commodity derivatives markets.

I am Jim Allison, North America Gas & Power Risk Manager for ConocoPhillips Company, and I am appearing today on behalf of the Working Group of Commercial Energy Firms. The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of energy commodities to others, including industrial, commercial, and residential consumers. My testimony and statements made today reflect the positions of the Working Group, and do not necessarily reflect the positions of ConocoPhillips or any individual member of the Working Group.

The Working Group supports the policy goals of the Dodd-Frank Act to promote the financial stability of the United States by improving accountability and transparency in the financial system and to reduce systemic risk. However, achieving these goals without imposing excessive costs and burdens on the economy is contingent on successful implementation of a regulatory framework that accommodates the differences among the new entities, products, and markets that the CFTC will regulate under Title VII. Implementation of such regulations will be successful only if those regulations do not result in costs that are greater than the public benefit of the Dodd-Frank Act, and if those regulations are developed in a logical and prudent manner.

Among the Working Group's specific concerns with the CFTC's proposed rules regarding regulation of commodity derivatives markets are (1) the vagueness and potential breadth of the definitions of "swap dealer," "major swap participant," and "swap," and (2) the challenges posed by the CFTC's ongoing rulemaking process, including the sequencing of the issuance of proposed rules, the interdependent nature of many of those rules, and the limited amount of time stakeholders will have to analyze and plan for the effects of those rules. If these concerns are not appropriately addressed, they are likely to decrease the ability of commercial firms to use commodity derivatives to manage commercial risks, and, in the case of energy markets, are highly likely to result in increased costs for the ultimate consumers of energy products and decreased job opportunities. This reduction or elimination of involvement by commercial firms in commodity derivatives markets is likely to result in reduced competition in those markets. In the short-term, this reduction in competition would create decreased liquidity in commodity derivatives markets as commercial firms reduce their participation in those markets. In the long-term, this reduction in competition would create concentration of commodity derivatives transactions among the financial entities that have traditionally been recognized as swap dealers. Many of these are the firms that have been considered "too big to fail."

II. How and Why Commercial Firms Use Swaps

Members of the Working Group are engaged in many aspects of the energy business, including: (1) the basic creation or manufacturing processes, such as exploring for, producing, and marketing crude oil and natural gas; refining feedstocks into gasoline and other products, and marketing those products; and generating and marketing electricity, including electricity from renewable projects such as wind and solar; (2) the logistical activities that are fundamental to the energy business, including storing energy commodities and moving energy commodities by tanker, pipeline, transmission line, or other means from source to market or from one market to another; and (3) the associated merchandising and trading of energy commodities.

All of these activities expose the Working Group's members to a wide array of commercial risks, including risks that are similar to those experienced by any commercial firm engaged in manufacturing or logistics, such as operational risk, market risk, and credit risk. Like agricultural firms, the Working Group's members differ from some manufacturing firms in that their basic energy products are commodities around which financial derivatives have been developed. Those derivatives allow each Working Group member to manage the level of commercial risk to which it is exposed, scaling the commercial risk that has been created through its primary business activity up or down to achieve the level of exposure to that risk that the firm believes is appropriate for its stakeholders. For example, commercial energy firms can use commodity derivatives to:

- Buy or sell necessary commodity products, including feedstocks, end products, and inventories, at predictable prices;
- Provide greater certainty for future cash flow from investments;
- Take market positions in the commodities in which they are active physical market participants; and
- Increase the ability to make economic investments in U.S. energy infrastructure and the development of energy resources.

III. Specific Issues

A. The CFTC's Proposed Definition of "Swap Dealer" Could Result in Regulation of Commercial Energy Firms as Swap Dealers Where There Is No Public Benefit

1. The CFTC's Proposed Rule Does Not Recognize a Distinction Between Swaps Used for "Dealing" and "Trading" Purposes

The Dodd-Frank Act definition of "swap dealer" is based on four categories of activity that are comparable to the types of activities used to define "dealer" in the Securities Exchange Act of 1934. Based on that "dealer" definition, the SEC has applied a long-standing and well-known Dealer/Trader Distinction Rule. In general, the SEC's Dealer/Trader Distinction Rule recognizes that certain activities involving securities may at first appear to be dealing activities but are, in fact, trading activities, and that market participants engaging in such trading activities should not be regulated as dealers. There are significant similarities between the Dodd-Frank Act definition of "swap dealer" and the Securities Exchange Act of 1934 definition of "dealer"; however, the CFTC's proposed definition of "swap dealer" specifically rejects making a distinction between dealers and traders in commodity derivatives markets. The CFTC rejects the application of a dealer/trader distinction to these markets, which increases the likelihood of commercial energy firms being regulated as swap dealers, despite the fact that such firms use commodity derivatives to manage risks associated with their primary business activity of delivering physical energy commodities to others. The Working Group strongly recommends that the CFTC implement a framework that distinguishes between dealers and market participants that use commodity derivatives for their own hedging or trading purposes.

2. The CFTC's Proposed *De Minimis* Exception Is So Narrow That It Will Be Unavailable to Commercial Energy Firms That Do Engage in a Relatively Small Amount of Dealing Activity

The Working Group believes Congress intended the *de minimis* exception to apply to any person that would otherwise be a swap dealer but for the fact that it engages in limited amounts of swap dealing or whose notional amount of exposure is small. The CFTC's proposed *de minimis* exemption included in the definition of "swap dealer" is so narrow that commercial firms that may engage in a relatively small amount of transactions in a swap dealing capacity will be unable to claim the exemption and will be subject to full regulation as swap dealers. As noted above, there is no public benefit to regulating such firms as swap dealers. The CFTC's proposal inexplicably provides that any entity who enters annually into more than twenty swaps, has more than fifteen counterparties, or enters into swaps with more than $100 million in notional amount is a swap dealer regardless of its regular business. Such interpretation essentially makes every market participant in the swap markets a swap dealer and renders the express statutory definition superfluous. The CFTC has proposed this limited *de minimis* exception even when data indicates that the largest 25 bank holding companies control more than 90 percent of the U.S. swaps market. An appropriate interpretation of "*de minimis*" would provide a meaningful exception for entities other than these traditional financial institutions. It was not the intent of Congress to create a *de minimis* exception that applies to no one.

3. An Unnecessarily Broad Definition of "Swap Dealer" Will Harm Commodity Derivatives Markets

The Working Group is concerned that an unnecessarily broad definition of "swap dealer" will harm the liquidity and efficiency of commodity derivatives markets. Efficiency requires that regulations be designed to result in the least-cost approach to achieve a regulatory objective, and to ensure that the public benefit of those regulations is greater than the costs of those regulations. These costs include the costs for individual market participants to comply with regulations, public costs to implement and enforce the regulations, and the public and private costs created by the impact of the regulation on the regulated market and participants in that market.

Classification of commercial energy firms that use commodity derivatives as swap dealers would have significant implications for those firms, including:

- Applying capital and margin requirements that could consume or divert resources that might otherwise be available for infrastructure investment, including investment in the production of new energy resources; and
- Denying those firms the benefits of the end-user exception from mandatory (1) clearing and (2) on-facility execution of swaps.

Further, the excessive breadth of the definition of "swap dealer" will impose substantial additional and unnecessary burdens on regulators. A broad definition of "swap dealer" that results in regulation of commercial firms as swap dealers will result in a dilution of the CFTC's resources that will necessarily result in less oversight of large traditional swap dealers.

Commercial energy firms have not traditionally been considered swap dealers, do not cause systemic risk, and were not a cause of the financial crisis. The Working Group believes the CFTC has not justified the cost, relative to the public benefit, of a broad definition of "swap dealer," and should adopt a final definition of "swap dealer" that is tailored to regulate only those firms that truly function as swap dealers and not those firms that simply use commodity derivatives to manage commercial risks associated with their primary business activity of delivering physical commodities to others.

B. The CFTC's Proposed Definition of "Major Swap Participant" Could Result in Regulation of Commercial Energy Firms Even When Those Firms Do Not Create Systemic Risk

The CFTC's proposed definition of "Major Swap Participant" is overly broad and is likely to result in companies that are not systemically risky being unnecessarily subject to prudential regulation. Despite the Dodd-Frank Act's limitation on the definition of "major swap participant" to entities that are "systemically important or can significantly impact the financial system of the United States," the CFTC has chosen to classify companies as major swap participants based upon fixed exposure thresholds that the Working Group believes fall well below levels that actually pose a risk to the U.S. financial system. Importantly, these thresholds do not appear to have any direct relationship to systemic risk and will not adjust to changing market prices. Even if one could assume that the current CFTC-proposed thresholds are reasonable in the present market, over time, as commodity prices fluctuate, the CFTC will have to routinely revisit these thresholds to make sure they comply with Congressional intent. The effort to monitor and adjust these thresholds will be another unnecessary use of the CFTC's resources. If commodity prices increase as they have over the past several months, more and more companies will reach these fixed thresholds despite the fact that the relative market positions of these companies would have largely remained unchanged. Because of these effects, the Working Group respectfully suggests that the CFTC should test the systemic risk of companies in ways that account for current market conditions. Evaluating exposures as a percentage of market value rather than by relying on fixed thresholds is one way to do this. Given that regulation of major swap participants is very similar to regulation of swap dealers, many of the negative effects of a definition of "swap dealer" that unnecessarily results in regulation of commercial firms would also apply to unnecessary regulation of those firms categorized as major swap participants.

C. Mandatory Clearing Will Not Reduce Risk—It Will Only Transform Counterparty Risk into Liquidity Risk

The Working Group believes that mandatory clearing will only succeed in transforming counterparty risk into liquidity risk. One benefit of the end-user exception to mandatory clearing is that commercial firms will be protected from this liquidity risk. However, if the definitions of "swap dealer" and "major swap participant" are unnecessarily broad and result in commercial firms being regulated as swap dealers or major swap participants, then those firms will be fully exposed to this liquidity risk.

Clearing reduces counterparty risk by requiring every party to a transaction to provide (1) full cash margin on the change in the value of the cleared portfolio every day and (2) initial margin sufficient to cover the potential movement in value between daily margin calls. Daily margin calls must be settled in cash, on very strict and short deadlines, and they apply to changes in value caused by ordinary market movement and those caused by extraordinary market events.

When the financial system is functioning smoothly, a commercial firm can manage liquidity requirements caused by ordinary market movement through capital reserves and access to lines of credit. However, liquidity requirements caused by extraordinary market events may require a diversion of capital from other uses. This admittedly is an extreme scenario, but it is precisely these extreme scenarios that must be analyzed to understand how the CFTC's proposed rules affect risk in the financial system.

When combined with the vagueness and potential breadth of the definitions of "swap dealer" and "major swap participant," the transformation of counterparty risk to liquidity risk and the exposure of commercial firms to this liquidity risk may actually thwart the policy goals of the Dodd-Frank Act. The CFTC can avoid this by appropriately tailoring the definitions of "swap dealer" and "major swap participant" and not unnecessarily including commercial firms in either category of regulated entities.

D. The CFTC's Rulemaking Process Does Not Allow Stakeholders to Properly Consider the Interaction of the Rules Required for Regulation of Commodity Derivatives Under Title VII of the Dodd-Frank Act

Title VII represents a fundamental redesign of the regulatory regime applicable to commodity derivative markets, especially the commodity derivatives used by the Working Group's members to manage the risks associated with their primary business activity of delivering physical energy commodities to others. A threshold element of this redesign is the determination of which products and market participants will be regulated by the CFTC. Notwithstanding the CFTC's aggressive efforts to adopt all final rules required by the Dodd-Frank Act, as of March 29, 2011, the CFTC has not issued final rules defining "swap dealer" and "major swap participant," and it has not issued even a proposed definition of "swap." A direct result of the lack of final rules defining these key terms is that more than 8 months after passage of the Dodd-Frank Act, market participants still do not know with any certainty the universe of entities and products that will be subject to regulation under Title VII's provisions relating to commodity derivatives. Without full knowledge of which entities will be regulated as swap dealers and major swap participants and which products will be regulated as swaps, the Working Group's members and other commercial energy firms are not able to determine the impact of these rules on their businesses. This uncertainty is likely to result in disruption of energy markets and could have negative consequences on the broader economy, including, but not limited to, increased prices for ultimate consumers of those products. Such consequences are avoidable. Given the complexity of the rulemaking process, the Working Group believes it is imperative that the CFTC allow interested parties a period of time to analyze and comment on all of the rules proposed under Title VII of the Dodd-Frank Act in the aggregate. Further, once the CFTC issues final rules, the Working Group believes market participants should be given adequate time to evaluate their compliance obligations, and to design and implement measures to meet such obligations in an efficient manner. Many of these rules will require time-consuming and expensive changes to systems and processes, so reasonable compliance deadlines are critical.

IV. Conclusion

In closing, the Working Group restates its support for the policy goals of the Dodd-Frank Act to promote the financial stability of the United States by improving accountability and transparency in the financial system and to reduce systemic risk. Under Title VII of the Dodd-Frank Act, the CFTC has been asked to take on a significant amount of new regulatory oversight for derivative markets and derivative market participants. The Working Group appreciates the diligent efforts of the CFTC and its staff to understand our businesses and the markets in which we operate. However, if the CFTC's rules to implement Title VII of the Dodd-Frank Act are not designed to appropriately regulate commodity derivatives markets and if those rules are not implemented in a coordinated and prudent manner, commercial energy firms may either be subject to unnecessary and costly regulation or will reduce their use of commodity derivatives to manage commercial risks, each of which could ultimately result in increased energy costs for consumers.

I thank the Committee for the opportunity to present this testimony on behalf of the Working Group of Commercial Energy Firms and I will be pleased to answer any questions.

The CHAIRMAN. Thank you very much.

STATEMENT OF MARK J. CVRKEL, CHIEF FINANCIAL OFFICER, SUSQUEHANNA BANK, LITIZ, PA

Mr. CVRKEL. Chairman Lucas, and Members of the Committee, I appreciate the opportunity to testify today.

My name is Mark Cvrkel. I am a Chief Financial Officer of Susquehanna Bank, headquartered in Lititz, Pennsylvania.

Susquehanna Bank is a commercial bank with assets of approximately $14 billion, deposits of more than $9 billion, and more than 3,000 employees in 221 locations. At Susquehanna, we are committed to building the economic strength of the communities we serve in Pennsylvania, New Jersey, Maryland, and West Virginia.

As is the case with hundreds of community and regional banks, Susquehanna Bank's risk management strategy involves using interest rate derivatives to prudently manage risks that are inherent to the business of commercial banking. Additionally, we enter into certain interest rate and foreign exchange derivatives with commercial banking customers to facilitate their risk management needs.

My comments today stem from concerns that certain proposed rules released by the Commodity Futures Trading Commission could unnecessarily jeopardize our ability to manage risk, provide the services our clients demand, and remain competitive against much larger financial institutions.

I would like to focus today on four issues: the *swap dealer* definition; the potential exemption for small banks; the *eligible contract participant* definition; and the process and timing of rulemaking.

Several community and regional banks have expressed concern that the *swap dealer* definition in the CFTC's proposed rule could capture hundreds of community and regional banks that offer risk management products to commercial customers. This would hamper the ability for smaller banks to compete with larger financial institutions without any appreciable benefit in terms of enhanced market oversight or reduction in systemic risk.

Congress provided an exemption from the *swap dealer* definition for any swap offered by a bank to a customer in connection with originating a loan with that customer; however, the CFTC's proposed rule interpreting this exemption is very narrow.

In addition, we are concerned that the CFTC's proposed thresholds for the so-called "*de minimis* exception" from the *swap dealer* definition are extremely low. These low thresholds could have the effect of either subjecting many small banks to the substantial regulatory burden imposed on swap dealers, or causing them to cease offering certain risk management services to their customers.

We urge regulators to compare the thresholds for the *de minimis* exception against the volume of dealing done by large financial institutions that control the vast majority of the OTC derivatives market. Even an extremely conservative analysis of available data suggests that the CFTC could substantially increase the thresholds without running afoul of Congressional intent.

Congress provided the regulators with the authority to exempt small banks from the *financial entity* definition. If such an exemption were granted, these small banks still would have to meet certain conditions required for end-user exception to the clearing requirement.

Moreover, small banks already are subject to existing regulations, including rules that require adequate capital to be held against all assets, including derivatives. In addition, existing regulations allow examiners to take certain actions to prevent default or to limit bank losses in the event of default. These protections adequately mitigate risks associated with an exception for too-small banks. We respectfully ask that the Committee urge the regulators to exercise the authority to exempt small banks from the *financial entity* definition.

We appreciate Congress' efforts to ensure that OTC derivatives are not marketed to unsophisticated customers. However, we would urge the regulators to clarify that smaller, sophisticated firms could continue to enter into hedges over-the-counter, providing that they meet specific criteria already established by the CFTC and observed by market participants for more than 20 years.

Finally, community and regional banks are concerned with the aggressive pace of rulemaking. We would urge Congress to extend the statutory effective date for Title VII and set a sequence for rulemaking that supports thorough cost-benefit analysis and productive public comment.

Community and regional banks are essential to support job creation at small, middle-market businesses that forms the foundation for any economic recovery. We caution against finalizing rules that would place undue burdens on small banks that had nothing to do with the financial crisis, do not pose systemic risk, and collectively engage in a fraction of the derivatives traded by the large dealers.

Thank you for the opportunity to testify today, and I will answer any questions that you may have.

[The prepared statement of Mr. Cvrkel follows:]

PREPARED STATEMENT OF MARK J. CVRKEL, CHIEF FINANCIAL OFFICER, SUSQUEHANNA BANK, LITITZ, PA

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, I appreciate the opportunity to testify today on the key definitions in Title VII of the Dodd-Frank Act. My name is Mark Cvrkel and I am the Chief Financial Officer of Susquehanna Bank ("Susquehanna").

Headquartered in Lititz, PA, Susquehanna is a commercial bank with assets of approximately $14 billion, deposits of more than $9 billion and more than 3,000 employees in 221 locations. At Susquehanna we are committed to building the economic strength of the communities we serve in Pennsylvania, New Jersey, Maryland and West Virginia.

As is the case with hundreds of community and regional banks, Susquehanna's risk management strategy involves using interest rate derivatives to prudently manage risks that are inherent to the business of commercial banking. We do not use credit default swaps or use derivatives for speculation. At Susquehanna, we use derivatives to add stability to our interest income and expense and to modify the duration of specific assets and liabilities. In short, we use derivatives to manage exposure to fluctuations in interest rates over which we have no control.

Additionally, we enter into a relatively small amount of interest rate and foreign exchange derivatives with commercial banking customers to facilitate their risk management needs. For example, we are able to offer a borrower a competitive long-term financing at a fixed rate by pairing a variable-rate loan with an interest rate swap—thereby providing the customer with the fixed rate they desire without taking on any incremental interest rate risk at the bank. As another example, we may have a middle-market customer that sells its products in Canada. We can offer to enter into an FX forward with the customer so that when they are paid in Canadian dollars, they can fix the exchange rate and know the exact amount they will receive in U.S. dollars.

Neither our use nor our customers' use of derivatives poses systemic risk. As was shown during the financial crisis, systemic risk in the derivatives market is concentrated among a few very large and interconnected financial institutions. According to the Office of the Comptroller of the Currency's Quarterly Report on Bank Trading and Derivatives Activities, while more than 1,000 banks in the U.S. use derivatives, 96% of the notional and 86% of the credit exposure is held at the top five banks in the U.S.[1]

My comments today stem from concerns that certain proposed rules released by the Commodity Futures Trading Commission ("CFTC")—including those relating to the key definitions in Title VII—could unnecessarily jeopardize our ability to manage risk, provide the services our clients demand and remain competitive against much larger financial institutions.

I would like to focus today on four issues: the swap dealer definition, the potential exemption from the financial entity definition for small banks, the eligible contract participant definition and the process and timing for rulemaking.

(1) Swap Dealer Definition

Several community and regional banks have expressed concern that the swap dealer definition in the CFTC's proposed rule could capture hundreds of community and regional banks that offer risk management products to commercial customers. This would hamper the ability for many smaller banks to compete with larger financial institutions without any appreciable benefit in terms of enhanced market oversight or reduction in systemic risk.

Congress provided an exemption from the swap dealer definition for any swap offered by a bank to a customer in connection with originating a loan with that customer; however, the CFTC's proposed rule interpreting this exemption is very narrow. While not required by Title VII, the CFTC is considering whether to limit the exemption to swaps offered *contemporaneously* with origination of the loan. As it is very common for a borrower to enter into an interest rate swap before or after origination of the corresponding loan, the exemption should not be limited to any swap entered into contemporaneously with a loan. In addition, we would urge the CFTC to consider excluding from the swap dealer definition swaps offered by a bank in connection with syndications, participations and bond issuances that are facilitated by the bank.[2]

In addition we are concerned that the CFTC's proposed thresholds for the so-called "*de minimis* exception" from the swap dealer definition are *extremely* low. For example, if a bank were to offer just 21 FX hedges[3] to customers in one year, they would be required to register as a swap dealer. These low thresholds could have the effect of either subjecting many small banks to the substantial regulatory burden imposed on swap dealers, or causing them to cease offering certain risk management services to customers.

We urge regulators to compare the thresholds for the *de minimis* exception against the volume of dealing done by the large financial institutions that control the vast majority of the OTC derivatives market. For example, while executing more than 20 trades with customers in one year would require a bank to register as a swap dealer, it is known that Lehman Brothers had 900,000 trades in place at the time of its bankruptcy. Available data[4] suggests that the CFTC could substantially increase the thresholds without running afoul of congressional intent. We do not believe the benefit of regulatory oversight over smaller financial institutions engaged

[1] Please refer to page 1 of the report at: *http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq410.pdf*.

[2] Please refer to pages 3–4 of the comment letter submitted by Susquehanna Bank and 18 other community and regional banks to the CFTC for examples.

[3] Note that the Secretary of the Department of the Treasury has the authority to make a written determination exempting certain FX derivatives from certain regulatory requirements. Such a determination has not been made as of the writing of this statement.

[4] Please refer to pages 5 and 6 of the comment letter submitted by Susquehanna Bank and 18 other community and regional banks to the CFTC for additional comparative data: *http://www.chathamfinancial.com/wp-content/uploads/2011/02/Coalition-Comments-Small-Banks.pdf*.

in a relatively infinitesimal level of dealing activity outweighs the cost associated with registration and compliance for such firms.

(2) Potential Exemption for Small Financial Institutions

Congress provided the regulators with the authority to exempt small banks from the financial entity definition. If such an exemption were granted, these small banks *still* would have to meet the same conditions required for the end-user exception to the clearing requirement. Moreover, small banks already are subject to existing regulations, including rules that require adequate capital to be held against all assets, including derivatives. In addition, existing regulations allow examiners to take certain actions to prevent default, or to limit bank losses in the event of default. These protections adequately mitigate risks associated with an exception for small banks. We respectfully ask that the Committee urge the regulators to exercise the authority to exempt small banks from the financial entity definition.

(3) Eligible Contract Participant Definition

Section 723 of Title VII includes a Limitation of Participation provision prohibiting any firm that is not an "eligible contract participant" from entering into a hedge over-the-counter.[5] We appreciate Congress' efforts to ensure that OTC derivatives are not marketed to unsophisticated customers; however, many community and regional banks are concerned that certain customers—including small businesses and other firms that execute hedges out of pass-through entities—may not be able to use the customized, OTC derivatives that they require for risk management purposes. We would urge the regulators to clarify that smaller, sophisticated firms could continue to enter into hedges over-the-counter, providing that they meet specific criteria already established by the CFTC and observed by market participants for more than 20 years.[6]

(4) Process and Timing

Finally, while the regulatory agencies are to be commended for running an open and transparent rulemaking process, community and regional banks are very concerned with the aggressive pace of rulemaking. We would urge Congress to extend the statutory effective date for Title VII and set a sequence for rulemaking that supports thorough cost-benefit analysis and productive public comment. We would recommend a sequence for rulemaking that defines entity and product definitions and other key terms first, duties and obligations second and then the specific regulatory requirements that apply based on these terms, duties and obligations. Additionally, we would recommend that the regulators permit market participants to consider the entirety of the proposed rules for all of Title VII, once they are available, and provide additional comment before finalizing any of the proposed rules.

Conclusion

Community and regional banks are essential to support the job creation at small and middle-market businesses that forms the foundation of any economic recovery. We applaud the work of the regulators to strengthen the OTC derivatives market, but we urge caution against finalizing rules that would place undue burdens on small banks that had nothing to do with the financial crisis, do not pose systemic risk and collectively engage in a fraction of the derivatives traded by the large dealers. It is critical to get these definitions right in order to ensure that regulation of the derivatives market is effective and unintended consequences are minimized. I thank you for the opportunity to testify today, and I am happy to answer any questions that you may have.

The CHAIRMAN. Thank you. Mr. Field.

STATEMENT OF JAMES M. FIELD, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, DEERE & COMPANY, MOLINE, IL

Mr. FIELD. Good afternoon. My name is Jim Field. I am the Senior Vice President and Chief Financial Officer of Deere & Company, perhaps better known as John Deere.

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[5] Firms that are not eligible contract participants will only be permitted to enter into derivatives on regulated exchanges. In addition to other criteria, corporations and partnerships that have at least $10 million in assets or are hedging and have $1 million in net worth qualify as eligible contract participants under the Commodity Exchange Act.

[6] Certain firms have been able to enter into over-the-counter hedges if they meet the criteria set forth in the CFTC's 1989 Policy Statement Concerning Swaps Transactions.

I am pleased to have this opportunity to share our perspectives on the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

As with most major multinational companies, the new law will impact many aspects of our business, especially our captive finance business. Through our captive finance business, John Deere Financial Services, Inc., we provide literally tens of millions of dollars of liquidity into rural America each and every day. We provide essential financing to agricultural producers, construction contractors, commercial landscapers, and foresters seeking to purchase high-quality John Deere equipment. This source of financing is essential to our customers' success and directly contributes to the growth and prosperity of local economies across this country.

As the Committee knows, derivatives are an essential tool for companies like Deere to manage commercial risks inherent in our business, such as interest rate risk and foreign exchange risk. We do not use the derivatives for speculative purposes at Deere. The prudent use of derivatives supports our ability to provide high-quality products and services to U.S. farmers and other customers around the world.

John Deere worked closely with the Congress on the derivatives reform legislation and commends this Committee for its leadership on that important title. While we believe the statutory direction is generally clear, the current rulemaking process has not yet adequately settled several implementation issues and concerns. I would like to highlight several areas for the Committee, all of which are subject to ongoing rulemaking proceedings.

Congress provided an exception for captive finance companies from the *major swap* definition. This exception—often referred to as the 90:90 exception—is explicitly provided for in the statute. However, we are concerned that the statutory language is imprecise and could be interpreted in a manner to inadvertently preclude many end-users for whom this exception was or is intended.

We are currently seeking guidance to clarify the application of the captive finance provision to ensure it reflects how we operate and practice. For instance, as a captive finance company, we facilitate the sale of all products sold by the parent and its dealers, not just those manufactured by the parent or another subsidiary. For instance, we may finance an implement manufactured by another company, along with one of our tractors, as part of an entire sales package.

We also facilitate the financing for parts and services on John Deere equipment. For example, we provide financing for significant overhauls on Deere equipment. This work is done at a John Deere dealership for a John Deere customer using both Deere and non-Deere parts. A significant portion of the finance covers the labor cost or the technician's hours. We interpret the exception to include the full value of these notes, but others might interpret this differently.

We are seeking more clarity that reflects the legislative intent while not adding burdensome requirements. Regulations that provides either a broader exception or additional clarity reflecting ordinary business activities are necessary.

In addition to the *major swap participant* exemption for captive finance companies, the CFTC proposed a rulemaking to include an exemption for a captive finance company. We want to ensure that the definition of a *captive finance company,* as it applies to the clearing exemption, is consistent with the definition of a *captive finance company* as it applies to the major swap participant exemption.

A second area of concern relates to the exemption from mandatory clearing requirements for derivatives end-users such as Deere. While it appears that this exemption would apply to our trades, a regulatory requirement on swap dealers and major swap participants to collect margins from end-users could effectively eliminate the benefits of the clearing exemption. Hence, we strongly support a statutory provision that prohibits regulatory agents from requiring swap dealers or major swap participants to post or collect capital or margin on trades that are executed with a financial or non-financial end-user counterparty.

If John Deere is required to clear swaps, independently or post margin through our transactions with a major swap participant, we would need to divert working capital to comply with this requirement. Furthermore, the requirements of posting margin on a daily basis could create additional costs and administrative burdens.

We are also seeking clarification that unintended parties are not defined as a *swap dealer* or *major swap participant.* The CFTC and the SEC propose to consider the economic reality of transactions between wholly-owned affiliates, including whether the swaps and security-based swaps simply represent an allocation of risks within a corporate group. John Deere supports this interpretation and would note further that the regulator should not limit an interpretation of inter-affiliate transactions to those between wholly-owned affiliates.

Transactions between commonly controlled affiliates, as well as swap transactions done by one corporate treasury entity to hedge the commercial risk of another entity in the same corporate group, merely represent the shifting or hedging of risk within a corporate group, and do not pose any more or any less risk to the economy as a whole. Including such inter-affiliate swaps or affiliate risk-hedging swaps for purposes of calculating the major participant definitions would effectively "double count" the same swaps.

Last, John Deere wishes to emphasize the importance of getting this regulation right for all derivatives end-users. We recognize the substantial efforts being made by the regulatory agents to advance several concurrent rulemakings in order to meet the timelines provided by Congress. However, given the complexity of the business issues involved, the number of potentially affected market participants, and the potential disruption to legitimate risk mitigation strategies, we believe that an extension of the date by which the rules must be promulgated, as well as a workable implementation schedule, should be considered.

Let me again reiterate John Deere's appreciation for the opportunity to appear before this Committee today.

[The prepared statement of Mr. Field follows:]

PREPARED STATEMENT OF JAMES M. FIELD, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, DEERE & COMPANY, MOLINE, IL

Good afternoon.

My name is Jim Field, and I am Senior Vice President and Chief Financial Officer of Deere & Company.

I am pleased to have this opportunity to share Deere & Company's perspectives on the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Deere & Company is also a member of the Coalition for Derivatives End-Users who share our perspective. As with most major multi-national companies, the new law will impact many aspects of our business, especially our captive finance business.

Deere & Company is a leading global manufacturer of agricultural, construction, forestry and turf care equipment, and provides advanced products and services, including financial services, to customers whose work is linked to the land—those who cultivate, harvest, transform, enrich and build upon the land to meet the world's dramatically increasing need for food, fuel, shelter and infrastructure. We are headquartered in Moline, Illinois, with sales in over 100 countries and employing over 56,000 people. Since 1837, John Deere has delivered innovative products of superior quality built on a tradition of integrity.

Through our captive finance business, John Deere Financial Services, Inc., we provide literally tens of millions of dollars of liquidity into rural America each and every day. We provide essential financing to agricultural producers, construction contractors, commercial landscapers and foresters seeking to purchase high-quality John Deere equipment. This source of financing is essential to our customers' success and directly contributes to the growth and prosperity of local economies across the country.

My testimony today will focus on the impacts of Title VII on derivatives end-users and, in particular, the End-Use Exception and Captive Finance Provision that were added to the Commodity Exchange Act through the Dodd-Frank Act.

As the Committee knows, derivatives are an essential tool for companies like John Deere to manage commercial risks inherent in our business, such as interest rate and foreign exchange risks. We do not use derivatives for speculative purposes. The prudent use of derivatives supports our ability to provide high-quality products and services to U.S. farmers and to customers around the world.

We provide financing for our customers on a significant percentage of our sales in both good and bad economic times. Our financial services operations have over $25 billion in assets. We offer fixed and variable rate financing to meet the various long and short-term financing needs of our customers. We issue debt in the commercial paper, medium term note, and asset-backed securitization markets to fund our loan and lease portfolios. Institutional debt investors purchase the majority of our debt securities, and the demand for these securities varies as economic conditions change. Derivatives enable us to match the interest rate characteristics of the funding available in the capital markets with the financing needs of our customers. This was especially critical during the credit crisis. John Deere's volume of new loans to customers and dealers increased during the credit crisis as we were able to provide product financing when other financial institutions curtailed lending. During the crisis, we were able to issue long-term fixed rate notes in the capital markets and use interest rate swaps to match the fixed and floating rate loans and leases that we provided to our customers. We employ this strategy of issuing longer-termed debt even in good economic times to reduce our refunding risk.

For a swap to be effective, it must match the timing and amount of the cash flows of the hedged exposure. Therefore, the terms of our interest rate swaps are customized to match the terms of the debt we issue. They will match the currency, principal or notional amount, interest rates, and maturity dates. Standardized contracts with predetermined terms would be a far less effective tool for hedging our risk exposure.

Derivatives provide stability to our business. At the end of our most recent first quarter, John Deere had over $15 billion notional amount of derivative transactions outstanding. That is a large number, but it corresponds to the more than $25 billion of credit we have extended to our customers and dealers to purchase the equipment they need to help drive the economy. The fair value of these derivatives, which represents the price to terminate or settle the positions, was approximately $253 million, and was a receivable for John Deere—our counterparties would owe us that amount if we terminated the derivatives.

John Deere worked closely with the Congress on the derivatives reform legislation and commends this Committee for its leadership on that important title. While we believe the statutory direction is generally clear, the current rulemaking process has not yet adequately settled several implementation concerns. I would like to highlight several areas for the Committee, all of which are subject to ongoing rulemaking proceedings.

Congress provided an exception for captive finance companies from the major swap participant definition. This exception is defined as:

> "entities whose primary business is providing financing and use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company."

We are concerned that the statutory language is imprecise and could be interpreted in a manner to inadvertently preclude many end-users, for whom the exception is intended, from qualifying.

We are currently seeking guidance to clarify the application of the captive finance provision to ensure it reflects how we operate in practice. For instance, as a captive finance company we facilitate the sale of all products sold by the parent and its dealers, not just those that are manufactured by the parent or another subsidiary. We may finance an implement manufactured by another company along with one of our tractors as part of the entire sale. We also facilitate the financing for parts and service on John Deere equipment. For instance, we provide financing for significant overhauls on pieces of equipment. This work is done at a John Deere dealership, for a John Deere customer, using both Deere and non-Deere parts. A significant portion of the financing covers the labor costs. We interpret the full value of these notes to fall under the exception, but others might interpret this differently.

We are seeking further clarity that reflects Congress' intent while not adding burdensome requirements. Regulations that provide either a broader exception or additional clarity reflecting ordinary business activities are necessary.

In addition to the major swap participant exemption for captive finance companies, the Commodity Futures Trading Commission (CFTC) proposed a rulemaking to include a mandatory clearing exemption for a captive finance company. We want to ensure that the definition of a captive finance company as it applies to the mandatory clearing exemption is consistent with the definition of a captive finance company as it applies to the major swap participant exemption.

A second area of concern relates to the exemption from mandatory clearing requirements for derivatives end-users, such as John Deere. While it appears that the exemption would apply to our trades, a regulatory requirement on swap dealers and major swap participants to collect margin from end-users could effectively eliminate the benefits of the clearing exemption. Hence, we strongly support a statutory provision that prohibits regulatory agencies from requiring swap dealers or major swap participants to post or collect capital or margin on trades that are executed with a financial or nonfinancial end-user counterparty.

If John Deere is required to clear swaps independently or post margin through our transactions with a swap dealer or major swap participant, we would need to divert working capital to comply with this requirement. Furthermore, the requirements of posting margin on a daily basis could create additional costs and administrative burdens on an end-user engaged in derivatives primarily to manage risk.

We are also seeking clarification that unintended parties are not defined as a swap dealer or major swap participant. The CFTC and SEC propose to consider the "economic reality" of transactions between wholly-owned affiliates, "including whether the swaps and security-based swaps simply represent an allocation of risk within a corporate group." John Deere supports this interpretation and would note further that the regulators should not limit an interpretation of inter-affiliate transactions to those between wholly-owned affiliates.

Transactions between commonly-controlled affiliates, as well as swap transactions done by one corporate treasury entity to hedge the commercial risk of another entity in the same corporate group, merely represent the shifting or hedging of risk within a corporate group and do not pose any more or any less risk to the economy as a whole. Including such inter-affiliate swaps or affiliate risk-hedging swaps for purposes of calculating the major participant definitions would effectively "double-count" the same swaps, as swaps subsequent to the market-facing transaction simply transfer a swap's risk-mitigation qualities to affiliated entities.

We also have some concerns with potentially conflicting rules from the U.S. Department of Labor regarding utilization of swaps by pension plans that could, unintentionally, restrict the ability of ERISA-covered plans like John Deere's from utilizing derivative markets to manage risks.

Last, John Deere wishes to emphasize the importance of getting this regulation right for all derivative end-users. We recognize the substantial efforts being made by the regulatory agencies to advance several concurrent rulemakings, in order to meet the timelines provided by Congress. However, given the complexity of the business issues involved, the number of potentially affected market participants, and the potential disruption to legitimate risk mitigation strategies, we believe that an extension of the date by which rules must be promulgated, as well as a workable implementation schedule, should be considered.

Let me again reiterate John Deere's appreciation for this opportunity to appear before the Committee today. I would be pleased to answer your questions.

Thank you.

The CHAIRMAN. The gentleman has been very thorough.

Mr. McMahon.

STATEMENT OF RICHARD F. MCMAHON, JR., VICE PRESIDENT, FINANCE AND ENERGY SUPPLY, EDISON ELECTRIC INSTITUTE, WASHINGTON, D.C.; ON BEHALF OF AMERICAN GAS ASSOCIATION; ELECTRIC POWER SUPPLY ASSOCIATION

Mr. MCMAHON. Chairman Lucas and Members of the Committee, I am Richard McMahon, Vice President of Energy Supply and Finance for the Edison Electric Institute. I am testifying on behalf of EEI, AGA, and EPSA. Together, our members serve most of our nation's electric and gas consumers.

Thank you for this opportunity to discuss the role of OTC derivatives markets in helping our utilities and our customers, and specifically our implementation concerns with Title VII of the Dodd-Frank Act.

Our members' goal is to provide our customers with reliable and affordable electric and gas service. Therefore, it is essential to manage the significant price volatility inherent in wholesale commodity markets for natural gas and electricity. The derivatives market is an extremely effective tool in insulating our customers from this price volatility. Our members are the quintessential commercial end-users of swaps and in no way contribute to systemic risk.

Utilities and energy companies are financially stable and highly creditworthy. As a result, utilities and their customers get a significant cost-benefit from little or no margin collateral requirements for their OTC derivatives transactions.

Exchanges and clearinghouses demand expensive cash margin deposits from all participants, irrespective of their credit standing. A margin requirement on all OTC swaps for utilities would have an average annual cash flow impact of between $250 million and $400 million per company. If our members were forced to post margin on all their OTC swaps, or their transaction costs go up significantly for other reasons, we will have three equally undesirable choices—redirect dollars from our core infrastructure capital spending programs, or borrow the money and pass that cost through to our customers and rates, or curtail our derivatives hedging programs and pass the commodity price volatility through to our customers.

We were pleased to hear Chairman Gensler today regarding margin and end-users. It is essential that this approach be fully implemented. However, we are concerned that our transaction costs may go up significantly as a result of other aspects of Dodd-Frank implementation. For example, the yet-to-be-promulgated rulemaking on capital and margin requirements for bank and nonbank swap dealers could impose incremental capital requirements on those dealers that engage in non-cleared OTC swaps with end-users. Undoubtedly, swaps dealers would pass along this additional cost to end-users, thereby more or less nullifying any benefit of having an end-user exemption from clearing margin.

Dodd-Frank left many important issues to be resolved by regulators and set impractically tight deadlines on rulemakings. To further complicate matters, many of the complex issues raised by scores of rulemakings are interrelated. As a result, interested parties are unable to provide meaningful comments to the proposed rules because they do not know the full effect of the complete universe of proposed rules.

For instance, the CFTC has not yet issued the proposed rules on the definition of *swap*. This definition is critical to many of the current rulemakings of Dodd-Frank and could significantly expand the reach and impacts of these regulations.

For the end-user exception provision of the Dodd-Frank Act, the CFTC's proposed rule would require an end-user to report roughly a dozen items of information to the CFTC each and every time it elects to rely on the end-user clearing exemption for a swap. The CFTC does not need such representations from end-users about each and every one of their non-cleared swaps to prevent abuse of the end-user clearing exemption.

We request that the Committee emphasize to CFTC that it should implement the end-user clearing exemption by streamlining their proposed requirements in the following ways: by requiring end-users to represent to the CFTC, once, that they intend to rely on the end-user clearing exemption, and by informing the CFTC, once, how they generally intend to meet their financial obligations associated with entering into non-cleared swaps, and by maintaining a record showing that an appropriate committee of the board of directors—assuming they are a public company—has reviewed and approved their overall decision not to clear.

We are also concerned with how the CFTC plans to define *swaps dealer*. CFTC's proposed rule includes very expansive language about the types of activities that the CFTC views as dealing. At the same time, the Commission has proposed to implement the not as part of a regular business and *de minimis* exceptions in a very restrictive manner. The result could be that commercial end-users are inappropriately miscast as dealers.

Since the enactment of Dodd-Frank, the CFTC has promulgated dozens of proposed rules. Commercial end-users like our members have struggled mightily just to keep pace and have filed comments in more than 17 different Dodd-Frank rulemakings to date. We do not believe that the end-user clearing exemption was intended to result in this burdensome outcome.

We believe that under the current timetable, it is impossible for the CFTC to promulgate workable rules; therefore, we ask that the Congress extend the statutory deadline for the promulgation of derivatives rules of Dodd-Frank under Title VII. We also urge Congress to direct the regulatory agencies to promulgate those rules so that the basic definitions are issued prior to other rules that they rely upon.

I am happy to answer any questions. Thank you.

[The prepared statement of Mr. McMahon follows:]

PREPARED STATEMENT OF RICHARD F. MCMAHON, JR., VICE PRESIDENT, FINANCE AND ENERGY SUPPLY, EDISON ELECTRIC INSTITUTE, WASHINGTON, D.C.; ON BEHALF OF AMERICAN GAS ASSOCIATION; ELECTRIC POWER SUPPLY ASSOCIATION

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, thank you for this opportunity to discuss the role of over-the-counter (OTC) derivatives markets in helping utilities and energy companies insulate our customers from the volatility of commodity price risk, and specifically our implementation concerns regarding the entity and product classifications under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), about which there remains great uncertainty.

I am Richard McMahon, Vice President of Energy Supply and Finance for the Edison Electric Institute (EEI). EEI is the trade association of U.S. shareholder-owned electric utilities, with international affiliates and industry associates worldwide. EEI's U.S. members serve 95 percent of the ultimate electricity customers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the total U.S. electric power industry.

I also am testifying on behalf of the American Gas Association (AGA) and the Electric Power Supply Association (EPSA). AGA represents 199 local energy companies that deliver clean natural gas throughout the United States. There are more than 70 million residential, commercial and industrial natural gas customers in the U.S., of which 91 percent receive their gas from AGA members. EPSA is the national trade association representing competitive power suppliers, including generators and power marketers.

Utilities and Energy Companies Hedge Risk

Wholesale natural gas and electric power are, and have been historically, two of the most volatile commodity groups. Our members use natural gas extensively as a fuel to generate electric power, and distribute natural gas to consumers in their homes. Additionally, utilities generate and purchase wholesale electricity from generators and marketers to meet consumer demand.

The goal of our members is to provide their customers with reliable service at affordable and stable rates. Therefore, it is essential to manage the price volatility inherent in wholesale commodity markets for natural gas and electric power. Our members purchase fuel and sell power at thousands of delivery points throughout the U.S. They need the ability to use OTC swaps because existing futures contracts cover only a limited number of natural gas and electricity delivery points. The derivatives market has proven to be an extremely effective tool in insulating our customers from this risk and price volatility. Utilities and energy companies use exchange-traded and OTC natural gas and electric power swaps to hedge commercial risk. About 40% of our gas swaps and about ⅓ of our power swaps are traded on exchanges.

In sum, our members are the quintessential commercial end-users of swaps.

Why the Margin Issue Is Critically Important

Utilities and energy companies are financially stable and highly creditworthy. On average, EEI's members are rated BBB. As a result, utilities and their customers get a significant cost benefit from low- or no-collateral requirements for their OTC derivatives transactions. In some cases, our members provide a letter for credit or a lien on assets as collateral to support their obligations on swaps. Exchanges and clearinghouses are generally blind to the financial health of their participants and demand cash margin deposits, both initial and variation margin.

Our industry is in the midst of a major capital spending program to enhance the electric grid, make our generation fleet cleaner and bring new technologies to our customers. Last year, shareholder-owned electric utilities' capital expenditures (CAPEX) were $83 billion, while gas distribution utilities' CAPEX was $5 billion. We expect this pace of capital investment to continue throughout the decade. The capital investments of all of our members are contributing to our nation's economic recovery and job growth.

A margin requirement on all utility OTC swaps would have an average annual cash flow impact of between $250 million and $400 million per company for EEI members. This "dead capital" tied up in margin accounts at clearinghouses would need to be funded by our retail customers.

If our members are forced to post margin on all of our OTC transactions, we have three equally undesirable choices:

- Re-direct dollars from our core infrastructure capital spending programs to margin accounts at clearinghouses;
- Borrow the money to post in margin accounts and pass that cost through to our customers in rates; or
- Curtail our derivatives hedging programs and pass the commodity price volatility in natural gas and electricity through to our customers.

Because of these undesirable consequences, the National Association of Regulatory Utility Commissioners (NARUC) passed a resolution in support of the industry's goal of maintaining our ability to use OTC derivatives without cash margining requirements (see attached).

We were very pleased to hear Commodity Futures Trading Commission (CFTC) Chairman Gensler's recent testimony earlier this month before Congress in which he stated, "Proposed rules on margin shall focus on transactions between financial entities rather than those transactions that involve nonfinancial end-users." It is essential that this now unambiguous direction from the CFTC Chairman be carried through fully in implementation of the Dodd-Frank Act. We believe this was the clear intent of the Congress, and it was confirmed in the Dodd-Lincoln letter, which was drafted as part of the conference committee to clarify the intent of Congress to fully exempt end-users from margining and burdensome CFTC compliance obligations. (see attached).

However, there remains significant concern that our transaction costs may go up significantly as the result of Dodd-Frank implementation. For example, the yet-to-be promulgated rulemaking on capital and margin requirements for bank and nonbank swap dealers could impose incremental capital requirements on those dealers that engage in non-cleared OTC swaps with end-users. Undoubtedly, swap dealers would pass this additional cost along to end-users, thereby nullifying any benefit of having an end-user exemption from clearing margin.

Need for a Proper Sequencing and an Extension of the Implementation Timetable

We support the overarching goals of the Dodd-Frank Act to bring greater transparency and oversight to derivatives markets and to address systemic risk to the economy. Additionally, we compliment the CFTC Chairman, Commissioners and staff for their hard work and openness in seeking input from different market participants during the implementation process. But, like the CFTC and other market participants, we are overwhelmed by the pace and scope of rulemakings.

Since the enactment of Dodd-Frank, the CFTC has established 30 rulemaking teams and has promulgated dozens of proposed rules. Energy swaps are a small fraction of the more than $650 trillion swaps market. We believe that, under the current timetable, it is impossible for the CFTC to adequately understand the energy swaps market, the other segments of the commodity-based swaps (metals and agriculture) market, and the much larger other classes of swaps (rates and credit), and to promulgate workable rules.

Therefore, we ask that Congress extend the statutory deadline for the promulgation of derivatives rules set forth in section 712 of the Dodd-Frank Act. Also, we urge Congress to direct the regulatory agencies to promulgate these rules so that the basic definitions are issued prior to other rules that rely upon them.

The Dodd-Frank Act left many important issues to be resolved by regulators and set impractically tight deadlines on rulemakings by the agencies charged with implementation. To further complicate matters, many of the complex issues raised by scores of rulemakings are interrelated. As a result, interested parties are unable to comment on the proposed rules in a meaningful way, because they cannot know the full effect of the complete universe of proposed rules. For example, it is very difficult to comment on the proposed swap dealer definition, position limits, and record-keeping and reporting rules for swaps before the proposed definition of a swap has been issued.

Commercial end-users like our members have struggled mightily just to keep pace, and have been compelled, because of the aforementioned uncertainty, to file comments in more than 17 different Dodd-Frank rulemakings in the past 6 months. We do not believe that the end-user clearing exemption was intended to result in this burdensome outcome.

Concerns Regarding Entity Designation and Implementation Burdens on End-Users

In a provision of the Dodd-Frank Act known as the "end-user clearing exception," Congress gave our members and other end-users of swaps the flexibility to elect not to clear swaps that they use to hedge commercial risk.

The CFTC's proposed rule implementing this provision would require an end-user to report roughly a dozen items of information to the CFTC every time it elects to rely on the end-user clearing exception for a swap. The required information for each swap includes representations that:

- it is a nonfinancial entity,
- the swap is hedging commercial risk,
- it has certain credit arrangements in place, and
- in the case of publicly-traded companies like most of our members, that an appropriate committee of the board of directors (or equivalent body) has reviewed and approved its decision not to clear.

The CFTC does not need repeated representations from our members and other end-users about every one of their non-cleared swaps to prevent abuse of the end-user clearing exception. Our members and other end-users understand that knowingly providing the CFTC with inaccurate information is a very serious violation of the Commodity Exchange Act (CEA). That is more than sufficient incentive for end-users to rely on the end-user clearing exception only when they are authorized to do so.

We request that the Committee emphasize to the CFTC that it can implement the end-user clearing exception, consistent with Congress's intent, by requiring end-users to:

- represent once that they will only rely on the end-user clearing exception for swaps that hedge commercial risk;
- inform the Commission once how they *generally* meet their financial obligations associated with entering into non-cleared swaps (coupled with an obligation to provide notice of material changes); and
- in the case of publicly-traded companies, maintain a record that shows that an appropriate committee of the board of directors (or equivalent body) has reviewed and approved their decision not to clear.

In addition to our concerns about the CFTC's proposed implementation of the end-user clearing exception, we have serious concerns about how the CFTC plans to define "swap dealer." The CFTC's proposed rule includes very expansive language about the types of activity—including "accommodating" the demand of third parties for swaps—that the CFTC views as dealing activity. At the same time, the Commission has proposed to implement the "not as part of a regular business" and "*de minimis*" exceptions to the definition of "swap dealer" in a very restrictive manner. The result could be that commercial end-users are inappropriately miscast as swap dealers. If our members, who primarily engage in hedging activities, are caught within the definition of "swap dealer," they will face not only the costs of registration and margin requirements, but they also will be subject to additional capital requirements (not yet defined by the CFTC), cost of IT systems for additional record-keeping and reporting, and other costly requirements not appropriate for end-users.

The CEA, prior to the passage of the Dodd-Frank Act, excluded physical forward transactions from the CFTC's jurisdiction over futures contracts. The definition of swap in the Dodd-Frank Act includes options for the purchase or sale of commodities, but excludes "any sale of a nonfinancial commodity . . . so long as the transaction is intended to be physically settled." The CFTC has issued proposed rules on swap position reporting and commodity options that indicate the CFTC intends to regulate options that, when exercised, require the delivery or receipt of physical commodities as swaps or "swaptions." The end-user community is concerned about the CFTC's proposal because many contracts for the delivery of power in the electric industry, such as capacity and requirements contracts, include price, volume or other optionality. Including these end-user to end-user contracts in the definition of swap would greatly expand the scope of the CFTC's regulation over the electric utility industry, conflict with the jurisdiction of the Federal Energy Regulatory Commission, and potentially would subject end-users to a number of burdensome regulatory requirements. We urge Congress to restrain CFTC's regulatory authority in this critical area of our business.

Conclusion

Thank you for your leadership and interest in implementation of the Dodd-Frank Act. We appreciate your role in helping to ensure that shareholder-owned and community-owned utilities and energy suppliers can continue to use OTC derivatives to cost-effectively help protect our nation's consumers from volatile wholesale natural gas and power commodity prices. We ask that the Congress extend the statutory deadline for the promulgation of derivatives rules set forth in section 712 of the

Dodd-Frank Act. Also, we urge Congress to direct the regulatory agencies to promulgate these rules in a logical order so that the basic definitions are issued prior to other rules that rely upon them.

Again, I appreciate the opportunity to testify and would be happy to answer any questions.

ATTACHMENTS

Resolution on Financial Reform Legislation Affecting Over-the-Counter Risk Management Products and Its Impacts on Consumers

Whereas, There is a diverse group of end-users, consisting of electric and natural gas utilities, suppliers, customers, and other commercial entities who rely on over-the-counter ("OTC") derivative products and markets to manage electricity and natural gas price risks for legitimate business purposes, thereby helping to keep rates stable and affordable for retail consumers; *and*

Whereas, The United States Congress is considering financial reform legislation with the goal of ensuring that gaps in regulation, oversight of markets and systemic risk do not lead to economic instability; *and*

Whereas, Previous NARUC resolutions support Federal legislative and regulatory actions that fully accommodate legitimate hedging activities by electric and natural gas utilities; *and*

Whereas, The proposed legislation would, among other things, provide the Commodity Futures Trading Commission (CFTC) with oversight of OTC risk management products, including mandatory centralized clearing and exchange trading of all OTC products; *and*

Whereas, Mandatory centralized clearing of all OTC contracts will increase expenses associated with hedging activity, and ultimately end-user prices, due to increased margin requirements; *and*

Whereas, A report by the Joint Association of Energy End-Users stated that the effect of margin requirements resulting from mandatory clearing for electric utilities would have the unintended effect of reducing or eliminating legitimate hedging practices and could jeopardize or reduce investments in Smart Grid technology; and for natural gas utilities and production companies could reduce capital devoted to infrastructure and natural gas exploration; *and*

Whereas, The laudable goals of reform that ensure market transparency and adequate regulatory oversight can be accomplished by means other than mandatory clearing of OTC risk management contracts and the anticipated extra expense. For example, a requirement that natural gas and electric market participants engaging in legitimate hedging report all OTC derivative transactions to a centralized data repository, like the CFTC, provides sufficient market transparency without the costs associated with mandatory clearing; *and*

Whereas, Proposed reforms would cause regulatory uncertainty with regard to the oversight of Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs), where such uncertainty and/or overlapping jurisdiction can lead to negative impacts on liquidity, market confidence and reliability; *and*

Whereas, The Federal Energy Regulatory Commission (FERC), and the Public Utility Commission of Texas (PUCT) for Texas/ERCOT, as the regulators with the necessary expertise and statutory mandates to oversee electricity and natural gas markets to protect the public interest and consumers, should not be preempted by the financial reform legislation from being able to continue exercising their authority to ensure reliable, just and reasonable service and protect consumers; *and*

Whereas, Energy markets currently regulated by FERC or the PUCT (for Texas/ERCOT) under accepted tariffs or rate schedules should continue to be subject to FERC's and the PUCT's (for Texas/ERCOT) exclusive Federal jurisdiction, including jurisdiction over physical and financial transmission rights, and market oversight; and should themselves not be subject to CFTC jurisdiction as a clearinghouse due to the financial and other settlement services they provide those transacting in regional electricity markets; *now, therefore be it*

Resolved, That the Board of Directors of the National Association of Regulatory Utility Commissioners, convened at its 2010 Winter Committee Meetings in Washington, D.C., supports passage of financial reform legislation ensuring that electric and natural gas market participants continue to have access to OTC risk management products as tools in their legitimate hedging practices to provide more predictable and less volatile energy costs to consumers; *and be it further*

Resolved, That new financial legislation being considered by Congress should weigh the costs of potential end-user utility rate increases *versus* the benefits of new standards for the clearing of OTC risk management contracts used by natural gas and electric utilities for legitimate hedging purposes; *and be it further*

Resolved, That any Federal legislation addressing OTC risk management products should provide for an exemption from mandatory clearing requirements for legitimate hedging activity in natural gas and electricity markets; *and be it further*

Resolved, That any exemption to the mandatory clearing requirement for OTC derivatives be narrowly tailored as to not allow excessive speculation in natural gas and electricity markets; *and be it further*

Resolved, That the FERC, and the PUCT for Texas/ERCOT, charged with the statutory obligation to protect the public interest and consumers, should continue to be the exclusive Federal regulators with authority to oversee any agreement, contract, transaction, product, market mechanism or service offered or provided pursuant to a tariff or rate schedule filed and accepted by the FERC, or the PUCT for Texas/ERCOT; *and be it further*

Resolved, That NARUC authorizes and directs the staff and General Counsel to promote with the Congress, the Commodity Futures Trading Commission and other policymakers at the Federal level, policies consistent with this statement.

Sponsored by the Committee on Gas, Consumer Affairs, and Electricity Adopted by the NARUC Board of Directors February 17, 2010.

June 30, 2010

Hon. BARNEY FRANK,
Chairman,
House Committee on Financial Services,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Chairman,
House Committee on Agriculture,
Washington, D.C.

Dear Chairmen Frank and Peterson:

Whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool. Regulators, namely the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the prudential regulators, must not make hedging so costly it becomes prohibitively expensive for end-users to manage their risk. This letter seeks to provide some additional background on legislative intent on some, but not all, of the various sections of Title VII of H.R. 4173, the Dodd-Frank Act.

The legislation does not authorize the regulators to impose margin on end-users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs of end-user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end-users or impair economic growth.

Again, Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end-users, nor can the regulators require clearing for end-user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, but rules may not be set in a way that requires the imposition of margin requirements on the end-user side of a lawful transaction. In cases where a Swap Dealer enters into an uncleared swap with an end-user, margin on the dealer side of the transaction should reflect the counterparty risk of the transaction. Congress strongly encourages regulators to establish margin requirements for such swaps or security-based swaps in a manner that is consistent with the Congressional intent to protect end-users from burdensome costs.

In harmonizing the different approaches taken by the House and Senate in their respective derivatives titles, a number of provisions were deleted by the Conference Committee to avoid redundancy and to streamline the regulatory framework. However, a consistent Congressional directive throughout all drafts of this legislation, and in Congressional debate, has been to protect end-users from burdensome costs associated with margin requirements and mandatory clearing. Accordingly, changes made in Conference to the section of the bill regulating capital and margin requirements for Swap Dealers and Major Swap Participants should not be construed as changing this important Congressional interest in protecting end-users. In fact, the House offer amending the capital and margin provisions of Sections 731 and 764 expressly stated that the strike to the base text was made "to eliminate redundancy." Capital and margin standards should be set to mitigate risk in our financial system, not punish those who are trying to hedge their own commercial risk.

Congress recognized that the individualized credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management. That is why Congress specifically mandates that regulators permit the use of non-cash collateral for counterparty arrangements with Swap Dealers and Major Swap Participants to permit flexibility. Mitigating risk is one of the most important reasons for passing this legislation.

Congress determined that clearing is at the heart of reform—bringing transactions and counterparties into a robust, conservative and transparent risk management framework. Congress also acknowledged that clearing may not be suitable for every transaction or every counterparty. End-users who hedge their risks may find it challenging to use a standard derivative contracts to exactly match up their risks with counterparties willing to purchase their specific exposures. Standardized derivative contracts may not be suitable for every transaction. Congress recognized that imposing the clearing and exchange trading requirement on commercial end-users could raise transaction costs where there is a substantial public interest in keeping such costs low (*i.e.,* to provide consumers with stable, low prices, promote investment, and create jobs.)

Congress recognized this concern and created a robust end-user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk. These entities could be anything ranging from car companies to airlines or energy companies who produce and distribute power to farm machinery manufacturers. They also include captive finance affiliates, finance arms that are hedging in support of manufacturing or other commercial companies. The end-user exemption also may apply to our smaller financial entities—credit unions, community banks, and Farm Credit institutions. These entities did not get us into this crisis and should not be punished for Wall Street's excesses. They help to finance jobs and provide lending for communities all across this nation. That is why Congress provided regulators the authority to exempt these institutions.

This is also why we narrowed the scope of the Swap Dealer and Major Swap Participant definitions. We should not inadvertently pull in entities that are appropriately managing their risk. In implementing the Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in their ordinary course of business. Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business. For example, the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business. Congress incorporated a *de minimis* exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.

Just as Congress has heard the end-user community, regulators must carefully take into consideration the impact of regulation and capital and margin on these entities.

It is also imperative that regulators do not assume that all over-the-counter transactions share the same risk profile. While uncleared swaps should be looked at closely, regulators must carefully analyze the risk associated with cleared and uncleared swaps and apply that analysis when setting capital standards for Swap Dealers and Major Swap Participants. As regulators set capital and margin standards on Swap Dealers or Major Swap Participants, they must set the appropriate standards relative to the risks associated with trading. Regulators must carefully consider the potential burdens that Swap Dealers and Major Swap Participants may impose on end-user counterparties—especially if those requirements will discourage the use of swaps by end-users or harm economic growth. Regulators should seek to impose margins to the extent they are necessary to ensure the safety and soundness of the Swap Dealers and Major Swap Participants.

Congress determined that end-users must be empowered in their counterparty relationships, especially relationships with swap dealers. This is why Congress explicitly gave to end-users the option to clear swaps contracts, the option to choose their clearinghouse or clearing agency, and the option to segregate margin with an independent third party custodian.

In implementing the derivatives title, Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to "book-out" their physical delivery obligations under a forward contract.

Congress recognized that the capital and margin requirements in this bill could have an impact on swaps contracts currently in existence. For this reason, we provided legal certainty to those contracts currently in existence, providing that no contract could be terminated, renegotiated, modified, amended, or supplemented (unless otherwise specified in the contract) based on the implementation of any requirement in this Act, including requirements on Swap Dealers and Major Swap Participants. It is imperative that we provide certainty to these existing contracts for the sake of our economy and financial system.

Regulators must carefully follow Congressional intent in implementing this bill. While Congress may not have the expertise to set specific standards, we have laid out our criteria and guidelines for implementing reform. It is imperative that these standards are not punitive to the end-users, that we encourage the management of commercial risk, and that we build a strong but responsive framework for regulating the derivatives market.

Sincerely,

Chris Dodd

Hon. CHRISTOPHER DODD,
Chairman,
Senate Committee on Banking, Housing, and Urban Affairs;

Blanche L. Lincoln

Hon. BLANCHE L. LINCOLN,
Chairman,
Senate Committee on Agriculture, Nutrition, and Forestry.

The CHAIRMAN. Thank you.
Ms. Trakimas.

STATEMENT OF ANN E. TRAKIMAS, CHIEF OPERATING OFFICER, CoBANK, GREENWOOD VILLAGE, CO; ON BEHALF OF FARM CREDIT COUNCIL

Ms. TRAKIMAS. Thank you. Good afternoon, Chairman Lucas, Ranking Member Peterson, and Members of the Committee. Thank you for your leadership in overseeing the CFTC's implementation of the derivatives title of the Dodd-Frank Act and for the opportunity to testify today.

My name is Ann Trakimas and I am the Chief Operating Officer of CoBank. I am testifying today on behalf of the Farm Credit System. New derivatives regulation has the potential to affect the Farm Credit System's ability to offer cost-effective, dependable financing to farmers, farm-related businesses, rural home buyers and rural energy, water and communications companies.

Farm Credit supports Congress' goal of making the U.S. financial system safer and more transparent. We believe, however, that some of the new proposed regulations would impose unwarranted costs on Farm Credit institutions, ultimately increasing the cost of credit to our customers without making the financial system safer.

The provisions on derivatives in the Dodd-Frank Act were designed to reduce and control systemic risk in the financial system. In passing the Act, Congress made clear its view that Farm Credit institution derivative activities do not pose a systemic threat. As a result, we believe Congress' intent is for new regulation to be focused on institutions that engage in derivatives activity that do create systemic risk.

Farm Credit institutions should be exempt from the mandatory swap clearing requirements of the Act. System institutions are end-users and use them solely for hedging the risks inherent in making loans to their customers and in managing their liquidity and funding costs. Farm Credit institutions primarily use plain vanilla, fixed for floating interest rate, swaps and caps. We do not use swaps to speculate; we are not market makers, and we do not use the credit default swaps that contributed to the financial crisis.

The System's swaps are an extremely small portion of the overall derivatives market. We have robust procedures in place today, closely overseen by our Federal regulator, that ensures our swaps post no significant risk to us or to our counterparties.

The recent global financial crisis conclusively demonstrated that Farm Credit's strong risk controls effectively limited our exposure to financial stress resulting from derivatives activities. Congress recognized all of this in the Dodd-Frank Act when it directed CFTC to consider exempting small banks, credit unions, and Farm Credit institutions for mandatory swap clearing.

The CFTC's final regulations in this area should provide an exemption from mandatory swap clearing for derivatives activities that do not possess systemic risk.

In addition, no Farm Credit institution should be considered a swap dealer. Only one Farm Credit institution, CoBank, offers swaps to its customers.

CoBank does a limited number of these transactions each year, and all of these transactions are executed in conjunction with loans made to our customers. All of our customers' derivative transactions are nonspeculative, and we offset the risk associated with each. These customer transactions pose no systemic risk and are critical to helping our customers economically manage the risks inherent in their loans.

Additionally, because CoBank is the only lender to many of its borrowers, we may be the only counterparty able to enter into a swap with that customer, because we already hold the customer's collateral via our loan agreements.

Congressional intent in this area is clear: The Dodd-Frank Act specifically gives CFTC the authority to exclude these types of customer swap transactions from the *swap dealer* definition. CoBank's customer derivatives are the same as the customer derivatives that commercial banks provide to their customers, and Congress has exempted commercial banks from designation as a swap dealer.

There is no reason that the same exemption should not apply to the Farm Credit System.

On behalf of the members of the Farm Credit System, thank you for holding this hearing and for considering our views on this important topic.

The CHAIRMAN. Thank you.

Ms. TRAKIMAS. Can I just complete? Farm Credit institutions rely on the safe use of derivatives to manage our interest rate liquidity and balance sheet risks. These instruments in turn help us provide cost-effective, dependable financing to farmers, ranchers, ag co-ops and other farm-related and rural infrastructure businesses that serve rural America. It is essential that in implementing Dodd-Frank, the CFTC does not impose unwarranted, duplicative, and costly regulations on the Farm Credit System. Mandatory clearing or swap dealer regulation would increase our borrowers' financing costs.

We look forward to working with the Committee as well as the CFTC to strike the appropriate balance between improving the safety of the financial system and preserving rural America's access to credit.

Thank you, Mr. Chairman. And I would be very happy to answer any questions that you or the Committee have.

[The prepared statement of Ms. Trakimas follows:]

PREPARED STATEMENT OF ANN E. TRAKIMAS, CHIEF OPERATING OFFICER, COBANK, GREENWOOD VILLAGE, CO; ON BEHALF OF FARM CREDIT COUNCIL

Good afternoon, Chairman Lucas, Ranking Member Peterson, and Members of the Committee. I appreciate the opportunity to testify today on behalf of the Farm Credit System, and I commend the Committee for its leadership in overseeing the rulemaking process as the Commodity Futures Trading Commission ("CFTC") implements the derivatives title of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1]

I am the Chief Operating Officer of CoBank, a member bank of the Farm Credit System. Before joining CoBank, I served as a director of the Federal Farm Credit Banks Funding Corporation, the entity that issues debt securities that CoBank and other Farm Credit banks use to fund loans to farmers and ranchers, farm-related businesses, agricultural cooperatives, and rural electric, water, and communications providers.

As you know, the Farm Credit System provides 40% of agricultural lending in the United States. New derivatives regulation has the potential to affect the Farm Credit System's ability to offer cost-effective, dependable financing to farmers, farm-related businesses, and rural America. The Farm Credit System supports Congress's goal of making the financial system safer. We believe, however, that new regulation should not impose unwarranted costs on Farm Credit System institutions, which would ultimately raise the costs of loans to our member-borrowers and diminish rural America's access to credit, without making the financial system safer.

In explaining how proposed regulations will affect the Farm Credit System and what steps we believe the CFTC should take in implementing Dodd-Frank, I would like to make three points:

First, the Farm Credit System already has in place important protections for safety, soundness, and consumer protection. These attributes illustrate that many of Dodd-Frank's regulatory concerns do not apply with equal force to the Farm Credit System. In passing the Act, Congress concluded that the Farm Credit System did not pose a systemic threat and specifically excluded them from oversight by the new systemic risk regulatory agency.

Second, Farm Credit System banks and associations should qualify for the end-user exemption to Dodd-Frank's clearing requirement. Congress authorized and instructed the CFTC to consider exempting Farm Credit System institutions, regardless of size, from mandatory clearing since they do not pose a systemic risk to the financial system and they were not the cause of the problems that resulted in the recent financial crisis. Imposing higher costs, through unnecessary derivatives regulations, on Farm Credit System institutions ultimately leads to higher credit costs for farmers and ranchers, their agricultural cooperatives, rural infrastructure providers and others in rural America. While Dodd-Frank places special emphasis on exempting institutions with less than $10 billion in assets, Congress also made it clear that it should not be viewed as a limit by CFTC. If the CFTC adopts an asset

[1] Pub. L. No. 111–203, 124 Stat. 1376 (2010).

test, it must be applied in a manner that appropriately recognizes the unique cooperative structure of the Farm Credit System to "look through" Farm Credit Banks to the smaller Farm Credit associations that own them. Alternatively, the CFTC should adopt a risk-based approach to mandatory clearing in a manner similar to the definition of major swap participant.

Third, no Farm Credit System institution should be considered a swap dealer. Farm Credit System institutions enter into customer derivative transactions that are linked to the financial terms of the loans they issue. All customer derivative transactions are non-speculative in nature with risk immediately eliminated through appropriate risk management activities and controls. These customer derivative transactions pose no systemic risk to the financial system and are critical to helping our customers economically manage interest rate and foreign currency risk. In this way, the Farm Credit System's customer derivatives activity is the same as the same sort of customer derivatives activity of commercial banks, which Congress has exempted from designation as a swap dealer. There is no reason that the same exemption should not apply to the Farm Credit System.

Background

I would like to begin with an overview of the Farm Credit System, which comprises five banks and 84 cooperative lending associations. As you know, Congress created the Farm Credit System "to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations." [2] Congress also intended "to encourage farmer- and rancher-borrowers participation in the management, control, and ownership of a permanent system of credit for agriculture which will be responsive to the credit needs of all types of agricultural producers having a basis for credit." [3] Today, the Farm Credit System is safe, sound, and responsive to its customer-owners. This is due, in part, to the following aspects of the Farm Credit System.

The Farm Credit System uses safe, non-speculative swaps and already effectively addresses counterparty credit risk. Farm Credit System institutions primarily use plain vanilla, fixed-for-floating interest rate swaps, and virtually all of our derivatives qualify for hedge accounting treatment. Farm Credit System institutions do not use swaps to speculate, and do not use the credit default swaps that contributed to the financial crisis. And Farm Credit System institutions already effectively manage counterparty credit risk. We deal with counterparties that have an investment grade or better long-term credit rating, and we monitor the credit standing of and levels of exposure to individual counterparties. Substantially all of our derivative contracts are supported by credit support agreements requiring the two-way posting of collateral in the event certain dollar thresholds of exposure are reached. These thresholds are small relative to the Farm Credit System capital. As of December 31, 2010, the net uncollateralized exposure of Farm Credit System institutions to swap dealers was only $232 million. As of that same date, Farm Credit Bank capital stood at $12.3 billion.

Farm Credit System institutions are regulated by the Farm Credit Administration, an independent Federal agency that effectively mitigates the risk of Farm Credit System institutions to the United States financial system. The Farm Credit Act gives the Farm Credit Administration broad powers "for the purpose of ensuring the safety and soundness of System institutions." [4] These powers include suspending or removing directors or officers of Farm Credit System institutions who engage in unsafe or unsound practices, and the ability to place unsafe or unsound institutions in conservatorship or receivership.

The Farm Credit Administration also effectively oversees the capital adequacy and derivatives activity of Farm Credit System institutions. The Farm Credit Administration sets minimum capital standards and rates the safety and soundness of each Farm Credit System institution, and it requires Farm Credit System institutions to limit their exposure to single or related counterparties and to establish policies that ensure that counterparty risks are consistent with the institution's risk-bearing capacity.

The Farm Credit System is not so interconnected with other financial entities to raise systemic risk concerns. Because Farm Credit System institutions do not take deposits, Farm Credit System banks and associations cannot experience a "run on the bank." And the Systemwide Debt Securities used to fund the Farm Credit Sys-

[2] 12 U.S.C. § 2001(a).
[3] *Id.* § 2001(b).
[4] *Id.* § 2252(a)(10).

tem are (1) insured by the Farm Credit System Insurance Corporation, a government-controlled, independent entity, that administers a more than $3 billion insurance fund paid by premiums imposed on System institutions, and (2) issued by the five Farm Credit System banks, which are jointly and severally liable for these Systemwide debt obligations. In short, these layers of investor protection ensure that the Farm Credit System will not cause a run on the funding of other entities.

The Farm Credit System is a cooperative enterprise. Farm Credit System associations are cooperatives owned by their borrowers, and Farm Credit System banks are cooperatives primarily owned by their affiliated associations and other borrowers organized as cooperatives. Borrowers purchase equity in the institutions with which they do business, and Farm Credit System institutions return a portion of their earnings to their borrower-owners in the form of patronage distributions. Farm Credit Administration regulations further govern our standard of conduct, requiring, among other things, that Farm Credit System institutions monitor and avoid conflicts of interest.

Finally, Farm Credit System institutions are uniquely well suited to provide derivatives to their customers. To the extent that a System institution is a customer's only lender, that customer will likely be unable to enter into a swap with another party that would not have access to the loan collateral. New regulation would raise the costs of derivatives to the Farm Credit System's customers and could cause System institutions to stop offering these products. This would deprive some farmers, farm-related businesses, and rural America of the ability to manage risk, and drive others to Wall Street swap dealers that are less familiar with their unique needs.

In sum, Farm Credit System institutions are safe and sound, and they operate with high standards of conduct for their customers. Before determining that new regulation is warranted, regulators must therefore consider the Farm Credit Administration's effective current regulation of safety and soundness, the low risk profile of Farm Credit System institutions, and the unique relationship those institutions have with their borrower-owners.

With these principles in mind, I would like to discuss two significant areas of potential new regulation: (1) whether Farm Credit System institutions will qualify for the end-user exemption as we believe Congress, and this Committee, intended; and (2) whether Farm Credit System institutions will be designated as swap dealers, which we believe Congress, and this Committee did not intend and if it occurred would be unfair and unnecessary.

End-User Exemption

As you know, Dodd-Frank provides an exemption to mandatory clearing for end-users entering into swaps to hedge or mitigate commercial risk. Although Dodd-Frank generally defines end-users as nonfinancial entities, Congress also directed the CFTC to "consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions." [5] Because the Farm Credit System is already safe and sound, and because our derivatives are already collateralized, we believe Congress gave the CFTC broad authority to permit Farm Credit System institutions, including those with total assets of more than $10 billion, to use the end-user exemption. We have urged the CFTC to clarify in its final rules that Farm Credit System institutions will qualify for the end-user clearing exemption.

First, we have asked the CFTC to provide the maximum flexibility to adopt an equitable solution for exempting Farm Credit institutions from mandatory swaps clearing if they do not pose a systemic risk to the U.S. financial institutions. Consistent with what we believe to be Congress's intent, the Dodd-Frank Act authorizes CFTC to exempt any-sized Farm Credit System institution from mandatory clearing requirements, which is appropriate given Farm Credit System institutions' derivatives use does not pose a systemic risk to the financial system. More troubling to us is the CFTC may take a more narrow approach, particularly with respect to how it interprets the Dodd-Frank Act's reference to the $10 billion asset limit, which would make even more critical that it at least recognize the unique cooperative structure of the Farm Credit System where the cooperative district banks are generally owned by cooperative lending associations, which engage in most of the System's retail lending. Under this structure, the cooperative lending associations are smaller than their affiliated banks that provide them funding and use derivatives to manage liquidity and other balance-sheet risks. For example, AgriBank, FCB, is the largest district bank, and its assets exceed $10 billion. But the 17 associations that own 99% of AgriBank have average assets of $3.6 billion. This is well below

[5] Pub. L. No. 111–203, § 723(a)(3), 124 Stat. at 1680 (CEA § 2(h)(7)(C)(ii)).

the $10 billion threshold that some have suggested.[6] Congress did not intend the $10 billion as a size limitation for exempting Farm Credit institutions from mandatory clearing. If, however, CFTC decides to implement an exemption test that included size, the agency must then also recognize the unique cooperative structure of the Farm Credit System and "look through" Farm Credit Banks to the smaller Farm Credit associations that own them. One consequence of our unique structure is that each bank centrally funds loans for its district. Centralized funding enables the associations to benefit from lower administrative and operational costs. Swaps that hedge risk on behalf of Farm Credit System associations are executed by the district bank to gain hedge accounting, to minimize administrative costs, and to minimize counterparty credit risk and margin requirements via district-wide netting of offsetting exposures. This is more cost effective and strengthens the liquidity of the System. As a result, Farm Credit System associations have a lower risk profile than the small commercial banks.

We believe the increased costs of mandatory clearing will ultimately be borne by farmers and ranchers because of the higher cost of credit, and will put our cooperative lending associations at a disadvantage with respect to the small commercial banks with which they compete. The increased costs of mandatory clearing will be passed on from the banks to their associations, reducing their capital and liquidity, which in turn will either reduce the funds available for loans or increase borrowing costs. That result would be unfair and unnecessary given that Congress intended to give regulators maximum flexibility in implementing the end-user exemption.

Second, we have asked the CFTC to consider the risk of an institution's derivatives activity instead of simply its total assets. To the extent clearing is designed to address credit risk, large institutions may in fact be less risky than smaller institutions. Risk is a function of the type and amount of derivative activity after netting offsetting positions and collateral, not simply of total assets. Accordingly, we have urged the CFTC to consider a risk-based measure of which financial entities should be eligible for the end-user clearing exemption.

One such approach could draw on the framework proposed by the CFTC and the Securities and Exchange Commission ("SEC") for determining whether an entity has a "substantial position" in a major swaps category warranting regulation as a major swap participant. A similar test measuring uncollateralized current exposure or current exposure plus potential future exposure would also be appropriate for determining which financial institutions pose enough risk to warrant mandatory clearing. Specifically, we have proposed that current uncollateralized exposure of $2 billion in rate swaps and $1 billion in other categories of swaps—or current uncollateralized exposure and potential future exposure of $3 billion for rate swaps or $1 billion for other swaps—would be appropriate. These proposed thresholds, which are lower than the thresholds the CFTC has proposed for identifying major swap participants, would address risk among financial entities and would more accurately capture financial institutions whose swap exposure poses risk to the financial system. We are convinced that implementing a risk-based test using current and potential exposures is more equitable and appropriate way to determine when financial institution derivative activities, including Farm Credit System institutions, may pose a systemic risk to the financial system and, therefore, require mandatory clearing of derivative transactions.

Alternatively, the CFTC could adopt a test based on an institution's uncollateralized exposure to swaps as a percentage of capital. The Farm Credit System has suggested to the CFTC that appropriate risk limits would be current uncollateralized exposure to swaps of 10% of capital, or current uncollateralized exposure plus potential future exposure to swaps of 20% of capital. These limits would appropriately identify which small financial institutions pose systemic risk warranting mandatory clearing.

In the end, it is critically important that Farm Credit System banks, associations, and their members can make use of the end-user clearing exemption. Clearing will raise costs for Farm Credit System institutions that will ultimately be borne by our agricultural borrowers in the form of higher interest rates. We do not believe that new costs on agricultural borrowers are justified.

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[6] As the Farm Credit Council noted in its February 22 comment on the CFTC's proposed end-user exception rules, although the majority of Farm Credit System associations have assets of less than $10 billion, the few associations with greater assets do not present risk requiring mandatory clearing. Even the failure of a large association would have no material impact on the Farm Credit System's ability to meet its debt obligations because the five Farm Credit System banks are jointly and severally liable for the System's notes and bonds. Thus, no association is so large that it would impact System debt holders if it were placed in receivership. By contrast, if a standalone bank fails, its bondholders will likely face losses.

Swap Dealer Regulation

Finally, I would like to address the issue of whether any Farm Credit System institution will be defined as a "swap dealer" and therefore will be forced to register with the CFTC and comply with potentially costly new capital, margin, and business conduct standards.

Farm Credit System institutions do not use swaps speculatively and we are not market makers. CoBank does, however, enter into swaps with customers as a service that enables them to modify or reduce their interest rate and foreign currency risk related to their loans with the bank or its related associations. For example, a floating-rate loan agreement may require the customer to hedge fluctuations in interest rates. The most efficient way for the customer to do so is to enter into an interest rate swap or cap. By requiring the customer to hedge against changing interest rates and by providing the customer a swap for that hedge, CoBank reduces the risk that higher interest rates may cause excessive interest expense that the customer cannot afford. Thus, the hedging requirement mitigates risk for both the bank and the customer.

All of the Farm Credit System's customer derivatives transactions are non-speculative, and Farm Credit System institutions offset the risk associated with them. For example, CoBank concurrently enters into offsetting agreements with approved counterparties, and customer derivatives are secured under the related loan agreements with CoBank or its related association. CoBank's customers—which include agricultural cooperatives; rural energy, communications, and water companies; farmer-owned financial institutions including agricultural credit associations; and other businesses that serve rural America—depend on these swaps to hedge risk and allow them to access credit. Indeed, because CoBank is the only lender to many of its borrowers, it may be the only counterparty able to enter into a swap backed by the loan collateral.

We believe that Congress intended to clarify that "community banks aren't swap dealers or major swap participants" [7]—at least not when they enter into a swap with a customer that is linked to the financial terms of the customer's loan. To accomplish this objective, Dodd-Frank states that "in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." [8] Although the statute says "insured depository institution," we believe Congress intended to exclude swaps offered in connection with loans and did not intend to confer a peculiar market advantage on commercial banks. To effectuate the intent that community banks not be designated swap dealers, the members of the Farm Credit System have urged the CFTC to clarify that this exemption applies equally to Farm Credit System institutions when they offer derivatives to customers in connection with loans, even though our institutions do not accept deposits.

First, the Farm Credit System's customer interest rate derivatives are identical to swaps offered by community banks in connection with loans. For example, CoBank customizes customer swaps to match the terms of loans and to ensure that the customer is effectively hedged against changes in interest rates. Because the swaps are connected to the financial terms of the loan, CoBank's customer interest rate swaps are consistent with the CFTC's preliminary interpretation of the community banks exemption.

Second, Farm Credit System institutions are subject to similar regulatory requirements as insured depository institutions. As an example, the Farm Credit Administration uses the same FIRS, or CAMELS, rating system for Farm Credit System institutions that the Federal Deposit Insurance Corporation uses for commercial banks.

Third, although Farm Credit System institutions do not accept deposits, the Systemwide Debt Securities they use to finance loans are insured, just as deposits of commercial banks are insured. If a bank cannot pay principal or interest on an insured debt obligation, the investors are paid from an independently administered insurance fund supported by premiums paid by Farm Credit System institutions. In the event that the entire insurance fund is exhausted, investors have further re-

[7] 156 *Cong. Rec.* S5922 (daily ed. July 15, 2010) (statement of Sen. Lincoln) ("The definition of swap dealer was adjusted in a couple of respects so that a community bank which is hedging its interest rate risk on its loan portfolio would not be viewed as a Swap Dealer. In addition, we made it clear that a bank that originates a loan with a customer and offers a swap in connection with that loan shouldn't be viewed as a swap dealer. It was never the intention of the Senate Agriculture Committee to catch community banks in either situation. We worked very hard to make sure that this understanding came through in revised statutory language which was worked out during conference.").

[8] Pub. L. No. 111–203, § 721(a)(21), 124 Stat. at 1670 (adding CEA § 1a(49)(A)).

course to the five Farm Credit System banks, which are jointly and severally liable for Systemwide Debt Securities. All of the Farm Credit System's debt financing is insured in this manner.

Finally, unless Farm Credit System institutions were able to use it, the community bank exemption would give commercial banks an unwarranted competitive advantage in the market for agricultural lending. In determining whether an entity is a swap dealer, the rules currently proposed by the CFTC and the SEC do just that. The proposed rules exempt derivatives offered by commercial banks, while counting the same derivatives offered by the Farm Credit System, simply because System institutions do not accept deposits. This is unfair, and we do not believe that Congress intended this result in exempting community banks from additional regulation. Accordingly, we have urged the CFTC to provide this same exemption to the Farm Credit System in its final rules.

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On behalf of the members of the Farm Credit System, I thank the Committee for holding for this hearing and for considering our views on these very important issues. Farm Credit System institutions rely on the safe use of derivatives to manage interest rate, liquidity, and balance sheet risk. These instruments, in turn, help us to provide cost-effective, dependable financing to farmers, farm-related businesses, and rural America. It is essential that, in implementing Dodd-Frank, the CFTC does not impose unwarranted, duplicative, and costly regulation on the Farm Credit System. Mandatory clearing or swap dealer regulation would raise costs of financing for our borrowers. We look forward to working with the Committee, as well as with the CFTC, to strike the appropriate balance between improving the safety of the financial system and preserving rural America's access to credit. Again, I thank the Committee for its leadership on these important matters.

The CHAIRMAN. Thank you again.

I now recognize myself for 5 minutes.

Mr. Allison, if ConocoPhillips were no longer providing swaps to its physical customers because of the cost associated with regulation as a swap dealer due to that activity, how do you anticipate the demand for those swaps would be met? If you can't do it, what is going to happen?

Mr. ALLISON. The customers that were unable to acquire swaps from us would either have to increase the risk they were willing to bear, or they would go to an entity that I would think of—probably one of the big financial firms. The well-known financial firms are the biggest swap dealers in the energy space as in the other derivatives markets, and that would be the most likely firm to pick up any business that we weren't doing.

The CHAIRMAN. So they simply expose themselves to more risk, or they increase their cost by finding some entity that would?

Mr. ALLISON. Yes.

The CHAIRMAN. Mr. Fields, Mr. McMahon, how would you respond to the assertion that central clearing shifts the informational advantage from Wall Street to the end-users and that the result from end-users of a central clearing mandate would be better pricing? How do you respond to that comment by some people?

Mr. MCMAHON. I will start first. Our members utilize exchanges and central clearing for some of their transactions in electric swap transactions and electric power and natural gas. So it is not that we don't use clearing in exchanges, but only where it makes sense. Oftentimes there are a lot of customized transactions that need to be done that don't lend themselves to central clearing. So we need the ability to utilize all the options.

I think that for us, that is the key, having that flexibility and also where it makes sense; because of our credit standing, oftentimes we don't need to post any margin, and that benefit flows directly to our customers.

The CHAIRMAN. Mr. Field?

Mr. FIELD. I would reply to that in the sense that when we are bidding a transaction, we will have a very, very transparent and a very significant process where we are getting lots of market information from many different Wall Street banks. And so we feel that actually it is very, very transparent from our perspective today and we don't see that advantage. In fact, we see an advantage where oftentimes the banks are bidding very aggressively for our business, because they like a swap with a nonfinancial institution, a non-Wall Street bank. They like having us as the counterparty.

The CHAIRMAN. Mr. Cvrkel, Ms. Trakimas, as the bankers at the table, how is the credit profile of a potential borrower impacted by whether or not they are hedging their exposure to risk? I know it is a simple question but it is one of those things we need to point out and discuss in public.

Ms. TRAKIMAS. I guess I will start. Our customers typically borrow in the floating rate market, and essentially they use interest rate swaps to cap the interest rate risk on that floating rate loan. So to the extent that we do not offer this product because of increased costs and regulation, they will be increasing their risk profile to us and themselves. So it is a disadvantage.

Mr. CVRKEL. When we look at our customers, one thing we need to evaluate credit risk exposure is fixed-debt service cost so the cost will be consistent over the next 5 years or 10 years. If we are unable to offer those customers that fixed-rate debt service cost, chances are we would not make any loans greater than 10 years. That would be out. Lending would be shut off.

The CHAIRMAN. I suspected that was the case, and thank you for pointing that out.

Mr. Field, one last question. Does your pension fund engage in swaps and are you concerned about the CFTC's business conduct rules?

Mr. FIELD. Yes, we do engage in swaps and we are concerned about the rule. Let me, if you can indulge me for a minute.

The CHAIRMAN. Please.

Mr. FIELD. John Deere has a defined benefit plan that covers more than 40,000 participants. And we are very, very proud that we are able to provide a defined benefit plan in this environment; and in fact, as you all know, that is the minority of companies that do that anymore.

And we use swaps basically to discharge our fiduciary duty to reduce the risk to manageable levels. So we have a payment obligation to our beneficiaries that has a very long tail on it. And what we are trying to do is go out and get assets that match up against that long tail. And the only way that we can do that cost effectively is through the use of swaps. So we are very concerned about this.

The CHAIRMAN. It is an important issue.

My time has expired.

I now turn to the gentleman from Pennsylvania, Mr. Holden, and recognize him for 5 minutes.

Mr. HOLDEN. Thank you, Mr. Chairman.

Mr. Cvrkel and Ms. Trakimas, following up on the Chairman's question, basically if you are not exempted, the services you provide your customers now, you will not do in the future because of the regulation and because of the costs; or is more staff needed to comply.

Mr. CVRKEL. The way I look at it is we started swaps in 2007; we have done 54 transactions. And currently with the additional regulation come on us, we don't have the staff nor would I get the staff. So chances are we would stop using swaps to fix our debt service cost and help our customers. And that lending opportunity would go away.

Mr. HOLDEN. They would have to go to larger entities?

Mr. CVRKEL. That is correct.

Ms. TRAKIMAS. From our perspective, it is clear that the costs to our customers will increase and the potential negative there is that the availability of credit will also diminish. We would be looking at higher capital requirements and higher margin requirements.

The other issue to think about here is that our customers may not have access to another swap counterparty because our swaps are made in connection with the loans that we make to them and we hold the collateral against those loans. So from a collateral perspective, the customers posting to us collateral on our loan, which we also use to collateralize our swap position. So the marketplace is not prepared to, and our customers are not prepared to, technically and operationally post collateral to anyone else other than their lender.

Mr. HOLDEN. To the extent that such exemptions are granted, could such exemptions be based on the same standard regardless of the type of entity? Suppose the CFTC determines that an exemption is warranted for Farm Credit banks with less than $20 billion in assets, could the CFTC set a different threshold for small banks and credit unions?

Ms. TRAKIMAS. Yes. From our perspective, it is not the size of the institution that is the question; the question to us is what is the risk in the transaction. And also all swaps are not created equal. Some are more risky than others. And the type of swaps that we use are plain vanilla, interest-rate swaps that are risk mitigation tools.

And from our perspective, you could be a very large institution and have very small swap exposure. And I would probably put us in that category. We are a good-sized institution, but the size of our portfolio of swaps from a risk perspective is just very, very small.

On the other hand, you could be a small institution with a very, very high volatility swaps portfolio.

So to us, it is not necessarily the size that counts.

If I just might. To the extent that that is the way the rules will be written, however, we do—a lot of our lending associations are small. When you look at the System on a combined basis, we are large. So if it does come down to a numbers, a size perspective, we do think that we would appreciate a sizeable threshold so our lending associations could be excluded.

Mr. HOLDEN. Do you care to comment, Mr. Cvrkel?

Mr. CVRKEL. I think one thing you have to look at is even the size of the organization. For instance, for banks under $10 billion, they have .04 percent of the swap market; for banks of $30 billion and under, that goes up to .1 percent. The top five banks in the country have 96 percent of the notional value of the swap portfolio.

So the risk is not into smaller banks. It is not banks of $14 billion or $20 billion. That is not where the risk exposure is.

Also when you look at swap risk, I think it is somewhat misleading, everyone is looking at the big numbers of the $600 billion market; that is not the risk exposure. The risk exposure is the uncollateralized portion of that swap. When we do a swap, and if it is an asset to our counterparty, we have to post collateral. So the risk is the difference that is not posted.

And one thing, one comment I want to make, too, as I mentioned we made 54 transactions since 2007. When Lehman Brothers went bankrupt they had 900,000 transactions compared to 54. Why should we get regulated like them?

Mr. HOLDEN. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The chair now recognizes the gentleman from Illinois for 5 minutes, Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

Let me just say I don't expect any of you to comment on my comment, but the fact that you have to be here today and subject yourself not only to questions but also to this whole incredibly complicated labyrinthine process is an indication to me how Congress overreaches in regard to a problem and then causes innumerable problems as a result of it. So that is just my parenthetical. I don't expect Members of the Committee or you to respond, but this is a good example of bureaucracy run amok and over-regulation and over-legislation run amok. So take that as you will.

I wish Mr. Gensler were still here, but since he isn't let me direct this question to Mr. Cvrkel. And I don't mean—this is not an adversarial question to you. I remember in response to one of my questions, that he indicated that they hadn't received any public comment in regard to one particular area.

I am specifically now directing you—maybe you don't have awareness of this—to a letter of February 22nd of this year, in which at some point in the letter—this is a letter that Susquehanna signed and a number of other entities signed. I am quoting, "These low thresholds, especially when coupled with narrow interpretation of the statutory exclusion for IDIs, could have the effect of either subjecting many small banks to the substantial regulatory burden imposed on swap dealers or causing them to cease offering certain risk management services to customers."

I think I heard him correctly. The Chairman, maybe he overlooked this letter, indicated he hadn't received any input in that regard.

Would you agree with me that this is a pretty definitive letter from you and your coalition?

Mr. CVRKEL. That is correct.

Mr. JOHNSON. And that maybe the Chairman just overlooked this public input?

Mr. CVRKEL. Apparently he has.

Mr. JOHNSON. Mr. Field, you are a corporate citizen of my State of Illinois, and we are very happy and proud to have you, and I know Congressman Schilling who represents your district just does an extraordinary job of advocating on your behalf and your employees' behalf.

But let me just ask you specifically whether you think that the captive finance exemption that we have referenced in questions in response, was intended for a business like yours. And a follow-up question is: What would be the impact of your specific ability to lend to farmers and others if they don't qualify for that exemption?

Mr. FIELD. Well, first let me thank you for the comments about Deere, and I am very privileged to be here and represent Deere, and we are privileged to be in the great State of Illinois.

Mr. JOHNSON. Even though we are trying to tax you and Caterpillar and everybody else out of the state, in the state legislature. But that is another issue.

Mr. FIELD. Yes. We believe that the captive finance exemption is—and the legislative intent was clearly to capture companies like Deere. And as we mentioned, we were very active in the process. And the reason why we are active in the process is because this is a critically important offering for us and for our customers.

And the reason why it is critically important is because the farm sector isn't always the world's most favorite sector in the world. And neither is the construction sector. But we are there through thick and thin. We are in the finance business not to be in the finance business; we are in the finance business to help sell pieces of John Deere equipment. And if we did not have that exemption, well, one thing for sure is that there would be an increased cost, increased regulatory, burdensome requirements for us, and ultimately impacted in the wallets of our farmer customers, or through us by having to take costs out of the system somewhere else. Because we need to be in the finance business and we need to be there through thick and thin.

Mr. JOHNSON. Let me just encourage you to continue to communicate with us specifically through Congressman Schilling, who is your advocate here, and we hope to be responsive to what you want us to do.

One last question for Ms. Trakimas.

Ms. TRAKIMAS. Yes.

Mr. JOHNSON. Can you give me some examples, I have only about 20 seconds, so your 20 second examples of some of the particular swaps that you provide to customers, and why you think that should be distinguished from swaps dealing in general?

Ms. TRAKIMAS. Our swaps are what we call plain vanilla swaps fixed or floating, and caps. And essentially this is just to manage the interest rate risk that we as lenders have on our balance sheet. It helps us manage our liquidity and our costs. And we also provide these swaps to our customers. These are extremely low-volatility swaps and they are merely there to cap the interest rate risk that is either connected with our loans or our customers' loans.

Mr. JOHNSON. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The chair now recognizes the gentleman from Texas, Mr. Conaway, for 5 minutes.

Mr. CONAWAY. Thank you, Mr. Chairman. And, panel, thank you for sitting here all afternoon.

You all heard Chairman Gensler's comments to our questions, several different directions in trying to understand his idea of a swap dealer. Can any of you say with any degree of certainty how you are classified under these new rules? Just right down the list. Mr. Allison.

Mr. ALLISON. I don't think I can say with certainty how we ought to be classified. I think I know where Chairman Gensler thinks we are, but I don't know that that is the outcome necessarily dictated by the rules.

I will not claim to understand fully how all of the rules work. But, I know where Chairman Gensler thinks the answer is for us.

Mr. CONAWAY. Okay. Mr. Cvrkel.

Mr. CVRKEL. I think we would be considered a swap dealer.

Mr. CONAWAY. Okay. Mr. Field.

Mr. FIELD. I don't think we could say with a level of certainty that I would be comfortable answering.

Mr. CONAWAY. Mr. McMahon.

Mr. MCMAHON. I don't think any of our members should be classified as swaps dealers; but, again, there was a question asked about utilities, and the Chairman answered that question to say that most aren't, but some may be. So that would be my interpretation of what he said.

Ms. TRAKIMAS. We really have no idea. But to the extent that we are like commercial banks and our business is like commercial banks, we think we should be treated like commercial banks and be exempt.

Mr. CONAWAY. The point being is that that level of uncertainty and/or certainty is pervasive across the folks you represent, your members or whatever, and so that is a pretty telling indication that we don't have a lot of granularity yet. We made a big deal about the cost-benefit analysis that we think has not been done at CFTC. At least the comments included in their proposed rules are pretty cavalier with respect to the decision making process.

Can you comment on what the estimates that the CFTC has said you will bear in terms of cost *versus* your own internal analysis of what you think it is going to cost to comply as you understand the rules today, Mr. Allison?

Mr. ALLISON. In certain of the rulemakings, the Working Group has been able to do fairly detailed comparisons of our estimate *versus* the CFTC's estimate, and our perspective is that the costs we would expect to bear are very, very, very much larger than what the CFTC has.

Mr. CONAWAY. A factor of what?

Mr. ALLISON. Up to a factor of 100, depending on exactly what costs element you are looking at.

Mr. CONAWAY. Thank you. Mr. Cvrkel.

Mr. CVRKEL. Yes. As far as if it goes the way it is written now, we would be out of the swap business. We would not take on the added cost, and we would not be able to provide long-term fixed rate debt service cost to our customers.

Mr. CONAWAY. Okay. Mr. Field.

Mr. FIELD. We have not done a detailed analysis, but suffice to say that our presence here today is because we believe the cost is quite significant to Deere.

Mr. CONAWAY. Significant beyond what the estimate that the CFTC is providing?

Mr. FIELD. No. No. Not beyond.

Mr. CONAWAY. So you think the CFTC got it right as to what it would cost you?

Mr. FIELD. Let me get back to you on that.

Mr. CONAWAY. It is a leading question.

Mr. FIELD. We haven't done a comparison.

Mr. CONAWAY. Okay, thank you. Mr. McMahon.

Mr. MCMAHON. I am not aware of an estimate in terms of the impact on the utility industry. But what I will say, as I pointed out in my statement, is assuming that we are end-users, this transactional approach that they appear to be going in terms of the end-user exemption would be costly in and of itself, and it shouldn't be like that for end-users.

Mr. CONAWAY. But the information in the proposed rule, does it give you enough information to be able to—for your members to guess at what their implementation cost would be?

Mr. MCMAHON. Again, if some of them fall into this category of swaps dealer, it would be profound. And, we don't have all the information we will need at this point because there is reporting and a lot of different things and systems changes and governance changes. So there are a lot of issues.

Mr. CONAWAY. Any indication you have in the proposed rules that they are getting it right; or is it just a broad statement you think understated what the costs will be?

Mr. MCMAHON. We just feel that the costs are going to be very significant.

Mr. CONAWAY. Ms. Trakimas.

Ms. TRAKIMAS. We have attempted to make an estimate of the costs, but the rules are so vague that we, with no confidence or accuracy, can come up with a number. But it is clear that costs will go up, and credit availability to our customers will decline and farmers and ranchers will suffer.

Mr. CONAWAY. Okay. Just for the record, does anybody think those are good results, that costs go up and services go down? Just official.

Mr. ALLISON. For the record, no.

Mr. CONAWAY. Mr. Field?

Mr. Cvrkel?

Mr. CVRKEL. No.

Mr. CONAWAY. The transcriber can't put down nods of the head, so I need you to say in the record. Mr. Field.

Mr. FIELD. No.

Mr. CONAWAY. Mr. McMahon.

Mr. MCMAHON. No.

Ms. TRAKIMAS. No.

Mr. CONAWAY. Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman yields back the balance of his time. I now turn to the gentleman from Illinois, for 5 minutes, Mr. Schilling.

Mr. SCHILLING. Thank you, Chairman. First and foremost I would like to welcome you all here, and I am with Representative Johnson and we have a lot better things that we could be doing right now. And I am part of the freshman class, the 87 that were swept in, and I come here basically for the same reason that I believe that you folks might be here, is the over-regulating.

You know, I look at Mr. Field's company which is in the 17th Congressional District. It has been the backbone of our district for over 100 years. I believe we have close to 60,000 employees there. And the thing that we are finding in Illinois is because of over-regulating and overtaxing, we are losing lots of people from our great state. And people are finally rising up to that challenge.

But I just have a couple of questions for Mr. Field specifically. Could you just comment maybe on the timing sequencing and the analysis of the SEC and the CFTC on their proposed rulemaking?

Mr. FIELD. Yes. Maybe I will answer that question a little bit more from—contrast it with at least how we would approach it from a business perspective, because I can't sit here and be as presumptuous that I understand exactly all these regulatory processes as some of the folks that are very involved in it. But I would say from our perspective, when we are doing a product program, we always say never, ever put quality—put schedule, rather, ahead of quality. I think the analogy in this particular piece of legislation and rulemaking is dead-on.

I think what we would like to see is, first of all, that we come out with a quality product that has the appropriate level of public conversation, discussion, and exposure prior to going into adoption. I think it is vitally important that we settle on these definitions first and foremost, and then we can start to see how this mosaic comes together, because we understand what definitions apply to who and what, and where we are going to be in this whole process. Right now, it is a little bit like from our perspective; and from others' perspective, it is a little bit like trying to put your finger on a bead of mercury, because you might fall out of this one and then you are in here and then you are over here. So, getting buttoned down in aggregate and a holistic view of the definitions, so then we can start to understand what provisions apply to whom, would be very, very important.

Mr. SCHILLING. So basically you would say that just let us know what our environment is, what cards are on the table, so we know what we are doing.

Mr. FIELD. Yes. And let's not shortchange this. This is a very, very sweeping piece of legislation for corporate America and for all that are involved in the financial process. I think from our perspective, we think it would be a grave injustice to put schedule ahead of quality here.

Mr. SCHILLING. And then finally, and being one of the less senior people here, a lot of my questions get asked by the time it gets to me. So finally, do you think that the agencies will meet their 1 year deadline or even should meet the 1 year deadline?

Mr. FIELD. I think Chairman Gensler indicated that they most likely are not going to. And I would say that, from my perspective, is probably a good thing because at least it shows we are taking a little bit of time. But, having that 1 year deadline out there in terms of a sort of a backdrop is something that I think we might be better off if we were to remove that or suspend it.

Mr. SCHILLING. Thank you, Mr. Field, and thank you all for what you do for your communities. And I yield back my time.

The CHAIRMAN. The gentleman yields back. And the chair now recognizes the gentleman from Pennsylvania, Mr. Thompson, for the concluding 5 minutes.

Mr. THOMPSON. Thank you, Mr. Chairman. Thanks to the panel, everyone on the panel for your testimony and weighing in on this.

My first question actually really has to do more with the sequencing in the process by which the CFTC has used in rolling this out. And have the proposed rules impacted your ability to participate in the process, and how has it impacted your ability to evaluate how the proposed regulations will impact your business?

Mr. ALLISON. The sequencing has, in fact, had a detrimental effect on our ability to evaluate the rules and respond sensibly to the CFTC with comments on them. The Working Group had filed with the CFTC, before the rulemakings came out, a letter proposing an order for the rules. The CFTC followed a different order. And we recently filed another comment with the CFTC about the sequence we think they should use from here, and I would be happy to get those added into the record if that would be helpful.

Mr. THOMPSON. Thank you.

Mr. CVRKEL. As far as when we look at the proposal, in my job I have multiple tasks to do other than this. So to spend my time to understand all the proposed regulations and go down that road is—I just really don't have the time. The concern I have, it is going to affect our customers, and I believe if you are a bank you want to have good customer service, and that is how you keep your customers. And being defined as a *swap dealer,* we would have a disservice to our customers and also to economic growth in our region because credit will no longer be there for the long term.

Mr. THOMPSON. Thank you. Mr. Field.

Mr. FIELD. I think the sequencing has had an impact. I think, to my earlier comment, not having all the definitions as the starting point, speaks to that. I think earlier today a Member of Congress said, "You know, it would be nice to have all the pieces together so that we can see how this all interrelates rather than piecemeal at some point in time."

The CHAIRMAN. Mr. McMahon.

Mr. MCMAHON. I would concur. I think the sequencing has had an impact and a negative impact. I would suggest that we should start with the fundamental definitions, particularly with a swap, and work our way out. Our view kind of coming in was that we would mostly be, we would be end-users and that we would only be engaged in one or two of these rulemakings, not 17 as we have to this point. So, yes, it has.

Ms. TRAKIMAS. My response to your question is that I would encourage the CFTC to go back to what it was tasked with by Congress, and that is to ensure that systemic risk is reduced and controlled. How long that takes, if it is a year, clearly we don't think they should be bound by a time frame, but we would really ask them to focus on the main purpose of what we are doing here today, and that is to control and reduce systemic risk.

Mr. THOMPSON. I appreciate, actually, all of your thoughts not only on how it impacts your business, but specifically all the suggestions of how this could have been done in a better way to minimize negative impacts and the consequences.

Mr. Cvrkel, why should community and regional banks receive different treatment under Title VII, and why is your derivative use distinguishable from those that are the target of the new regulation under Dodd-Frank?

Mr. CVRKEL. I guess the way I look at it is, here again, banks like ours didn't cause the meltdown. We don't have any—the swaps we do are vanilla swaps. There is no additional risk exposure. And here again, there is some confusion on defining risk related to swaps. And the risks should be defined as the uncollateralized portion of that swap, not the notional. And under Dodd-Frank I don't believe under the proposals, opinions of banks our size and how we use bank swaps with our customers were taken into consideration.

Mr. THOMPSON. Very good. I would assume that most you would agree with the thoughts that this is actually a solution in search of a problem as it was proposed.

Thanks, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The time for all questions has expired.

Before we adjourn, I would like to thank our panel's participation. Many times in this body we become so focused on grandiose pieces of legislation that we forget that there are dramatic effects on you, your customers, your businesses, your pensioners, on the entire economy as a whole. And that is why we need to hear from you in the straightforward fashion that you have come today to discuss the potential impact.

With that, under the rules of the Committee, the record for today's hearing will remain open for 10 calendar days to receive additional material and supplemental written responses from the witnesses to any question posed by a Member.

This hearing of the Committee on Agriculture is adjourned.

[Whereupon, at 5:20 p.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUPPLEMENTARY MATERIAL SUBMITTED BY HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

21 March 2011

DAVID A. STAWICK,
Secretary,
Commodity Futures Trading Commission,
Washington, D.C.

Re: **Re: Risk Management Requirements for Derivatives Clearing Organizations—*Federal Register* Vol. 76, No. 13 3698 (January 20, 2011) RIN 3038–AC98**

Dear Mr Stawick:

The Financial Services Authority ("FSA") is submitting this letter in response to the request for comment in respect to the rule proposals by the Commodity Futures Trading Commission ("the Commission") regarding risk management requirements for derivatives clearing organisations ("DCOs").

The FSA supports the September 2009 G20 commitment to improving the over-the-counter ("OTC") derivatives markets and the clearing through central counterparties ("CCPs") of standardised OTC derivative contracts. Regulatory authorities need to consider how existing market infrastructures can best play a role in meeting these commitments in an environment where CCPs are becoming increasingly systemically important. There is a clear need for stronger international standards for CCPs and the FSA is contributing to the work currently underway in developing such standards through, for example, the CPSS–IOSCO[1] work on principles for financial market infrastructure.[2]

Risk management standards for CCPs must be anchored in the characteristics of the products being cleared, and the FSA recognises that different product types may require different clearing models. This can extend to participant eligibility in models where the clearing members are required to perform specific actions to assist in a member default, for example Interest Rate Swap clearing models that include an obligation to bid for, or be allocated, portfolios from the defaulting clearing member.

The Commission has requested comment on whether establishing a capital threshold on participants is an effective approach to promoting fair and open access to DCOs.[3] The FSA supports transparent and non discriminatory rules, based on objective criteria, governing access to CCPs. We note the CPSS–IOSCO proposed principle that CCPs should allow "fair and open access to its services . . . based on reasonable risk-related participation requirements".[4] However whilst capital thresholds or other participation eligibility threshold[5] limitations may be a potential tool to help ensure fair and open access to CCPs, to impose them on clearing arrangements for products that have complex or unique characteristics could lead to increased risk to the system in the short to medium term.

Participation requirements sometimes need to be tailored to take into account the types of products being cleared by a CCP. For example the less liquid derivative markets typically require more complex default management processes that impose more onerous obligations on the participants than the exchange traded futures market. The ability of the surviving clearing members to meet their obligations in relation to default management is important in mitigating systemic risk in the event of a clearing member default.

As noted by CPSS–IOSCO in its consultation, a CCP should ensure that its participants "have the requisite operational capacity, financial resources, legal powers, and risk-management expertise so that their activities do not generate unacceptable

[1] Committee on Payment and Settlement Systems (CPSS), International Organization of Securities Commissions (IOSCO).
[2] CPSS IOSCO Principles for financial market infrastructures—consultative report 2011.
[3] *Federal Register* Vol. 76, No. 13 page 3701.
[4] CPSS IOSCO Principles for financial market infrastructures—consultative report 2011, Principle 18, Key consideration 1.
[5] Such as the Commission's proposals 39.12(a)(1)(iv) "A derivatives clearing organization shall not require that clearing members must be swap dealers", *ibid* (v) "A derivatives clearing organization shall not require that clearing members maintain a swap portfolio of any particular size, or that clearing members meet a swap transaction volume threshold.", and *ibid* (2)(iii) "A derivatives clearing organization shall not set a minimum capital requirement of more than $50 million."

risk for the [CCP] and other participants".[6] Capital requirements, the "swap dealer" criteria and portfolio size or volumes have previously served as proxies for establishing that a clearing member meets these criteria. If such criteria are to be excluded, then CCPs must develop alternative membership criteria that ensure the CCP's own safety. Consideration should be given to the time required to develop such criteria.

CCPs must therefore set appropriate risk based membership criteria that test a clearing member's financial and operational ability to:

(i) manage the default of one of their own clients (*i.e.,* to hedge and liquidate positions); and

(ii) participate in the CCPs default management process without introducing risk to the system (for example bid accurately in a default auction, hedge any portfolios acquired in a default auction, or manage any risks presented by the forced allocation of a portfolio in a default process).

Potential clearing members who lack the requisite operational capacity, financial resources, legal powers or risk-management expertise to participate in a default management process might consider that they could source these capabilities from a more experienced third party in the event of a default. Outsourcing the clearing member responsibility to partake in the default management process to a third party could present additional risk to the system[7] and increase the cost for the participant.

A CCP may seek to reduce the relative impact of the default process on participants with lesser financial and operational ability by providing that their role in a default be proportional to the risk they introduce. As this would only limit the relative and not the absolute size of the risk (for example the size of portfolio that could be allocated to a clearing member in a default) this approach does not reduce the CCP's need to set the appropriate membership criteria needed to gauge the ability of the clearing member to engage fully in the default management process (including loss allocation).

Increasing the amount of margin called or contributions to the default fund does not compensate for the risk that a participant cannot participate in the default management process. Margin and default funds increase the time available to a CCP to liquidate its positions, but they do not directly assist the actual liquidation.

We note that the Commission proposes that CCPs may exclude or limit certain types of market participant if the CCP can demonstrate that "the restriction is necessary to address credit risk or deficiencies in the participants' operational capabilities that would prevent them from fulfilling their obligations as clearing members".[8] If capital requirements, the "swap dealer" criteria and portfolio size or volumes are to be subject to limitation as criteria then we believe the Commission's exclusion should specifically extend to address clearing members whose operational capabilities would prevent them from fulfilling their obligations to the CCP to participate in a default management process.

The FSA therefore requests that when the Commission finalises its rules it takes into account that access should be based on proportionate risk-related participation requirements and that risks may be introduced into the system by universally prohibiting certain participant eligibility criteria.

Yours sincerely,

ALEXANDER JUSTHAM,
Director, Market Division,
Financial Services Authority.

SUPPLEMENTARY MATERIAL SUBMITTED BY JAMES C. ALLISON, GAS AND POWER RISK MANAGER, NORTH AMERICA, CONOCOPHILLIPS, HOUSTON, TX; ON BEHALF OF WORKING GROUP OF COMMERCIAL ENERGY FIRMS

February 22, 2011

DAVID A. STAWICK,
Secretary,

[6] CPSS IOSCO Principles for financial market infrastructures—consultative report 2011, Principle 18, 3.18.1.

[7] As well as adding legal and operational complexity at a time market stress, there is the risk that third parties might act differently than clearing members acting for themselves, given their different incentives.

[8] *Federal Register* Vol. 76, No. 13 39.12(a)(1)(iii).

Commodity Futures Trading Commission,
Washington, D.C.

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

Dear Secretary Stawick:

I. Introduction

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP 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") Notice of Proposed Rulemaking, *End-User Exception to Mandatory Clearing of Swaps* (the "*Proposed Rule*"), published in the *Federal Register* on December 23, 2010,[1] which proposes to provide "non-financial entities," *i.e.,* commercial firms, with an exception from the mandatory clearing requirements ("End-User Exception") pursuant to new Section 2(h)(7) of the Commodity Exchange Act ("CEA"), as established by Section 723 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act").[2]

The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities. The Working Group appreciates the opportunity to provide these comments in response to the *Proposed Rule* and respectfully requests that the Commission consider the comments set forth herein. The Working Group looks forward to working with the Commission to further develop and define the End-User Exception prior to the effective date of Title VII.

II. Executive Summary

The Working Group strongly supports the goals of the Act to enhance transparency and reduce systemic risk in the swap markets. To that end, the Working Group submits for the Commission's consideration comments and recommendations it believes will assist the Commission in developing a final rule that preserves the integrity of the swap markets and serves the best interests of market participants. Specifically, the Working Group requests the Commission adopt the following recommendations:

1. Revise Proposed CFTC Rule 39.6(b) to Require a Single, Omnibus Annual Notification Filing. The Working Group submits that requiring notification to the Commission each time a non-financial entity elects to use the End-User Exception is inconsistent with Section 2(h)(7)(A) of the Act. Additionally, such requirement is overly burdensome and will disrupt the trade execution process. In light of the foregoing, the Working Group strongly suggests that the Commission require a single, omnibus annual filing that reports such notification in the same prospective, narrative, and comprehensive form as the Commission's current Form 40.

2. Recognize Discretion Granted to the Board in Meeting its Obligation to Review and Approve Election to Use End-User Exception. Contrary to new CEA Section 2(j), which permits an appropriate committee of the board of directors (or equivalent governing body) (collectively, the "Board") broad discretion in meeting its obligation to review and approve the use of the End-User Exception by an SEC Filer,[3] proposed CFTC Rule 39.6(b)(6)(ii) requires board review and approval on a transaction-by-transaction basis. As such, the Commission should reconcile the proposed rule with the clear and unambiguous new CEA Section 2(j) to permit the board (i) to adopt a single, continuing resolution approving any decision by an SEC Filer to use the End-User Exception and (ii) to delegate its obligation to appropriate supervisory personnel with direct knowledge and oversight responsibility of swap trading activities.

3. Adopt a Definition of "Hedging" or "Mitigating Commercial Risk" that Appropriately Reflects Commonly Used Practices In Energy Markets. Because the unambiguous language of the proposed definition of "commercial risk" eliminates the need to adopt regulatory text identifying transactions that fall outside of the scope of this definition, proposed CFTC Rule 39.6(c)(2)(i) should be struck from any final rule adopted in this proceeding. Further, commercial energy firms do not generally execute swaps transactions to hedge a particular underlying phys-

[1] *End-User Exception to Mandatory Clearing of Swaps,* Notice of Proposed Rulemaking, 75 FED. REG. 80747 (Dec. 23, 2010).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

[3] An "SEC Filer" refers to an issuer of securities that is registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781) or that is required to file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 780).

ical trade. Indeed, in order to mitigate commercial risk, commercial energy firms hedge their underlying physical positions dynamically and on a portfolio basis, which do not involve the matching of hedges to specific underlying physical positions. Thus, any definition of "hedging" adopted by the Commission must contemplate such market practices.

4. Exempt Inter-Affiliate Swap Transactions from Mandatory Clearing. Because inter-affiliate transactions do not have any bearing on, or reflection of, swap markets, these transactions should be exempt from the mandatory clearing requirements. At a minimum, the Working Group recommends that the Commission confirm that otherwise qualified non-financial entities may engage in uncleared swap transactions with a swap dealer or major swap participant affiliate.

III. Comments of the Working Group of Commercial Energy Firms

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. As commercial firms, the Working Group members function primarily as principals, not intermediaries, by transacting futures and energy-related derivatives on a daily basis, among other things, to mitigate or hedge the commercial risk associated with their core businesses of delivering electricity, heating oil, crude oil, natural gas, propane, gasoline, and other energy commodities to U.S. consumers.

The Working Group generally supports the intent of the *Proposed Rule* implementing new CEA Section (2)(h)(7). By exempting qualifying transactions involving "non-financial entities" from the mandatory clearing requirements, this exception permits the continuation of a well-established and long-standing practice in the energy markets of accommodating the unique credit profiles of certain market participants. Unlike centralized clearing arrangements that demand uniformity in credit support based upon each underlying exposure, current practice in energy markets is for market participants to extend credit based on fundamental analysis of the ability of each counterparty to continue as a going concern, or through the use of alternative collateral support.[4]

The ability to transact swaps on an uncleared basis provides a significant cost benefit by permitting commercial energy firms to preserve capital and operating cash flow. This is particularly critical in such firms' efforts to implement major capital spending programs designed to (i) enhance and expand energy infrastructure, (ii) develop and deploy technologies that promote energy independence, and (iii) comply with new environmental rules, regulations, and policies. More importantly, the ability of commercial energy firms to transact swaps on an uncleared basis is the most effective and efficient means to protect both themselves and consumers from the effects of volatility in physical energy markets.

In recognition of the above factors, the Working Group respectfully recommends that the Commission adopt the revisions proposed herein to ensure that any final rule will promote efficient and orderly energy markets while ensuring transparency in accordance with the requirements of new CEA Section 2(h)(7).

A. An Annual Filing Is Sufficient To Meet the Notice Requirement Regarding the Election To Use the End-User Exception

New Section 2(h)(7)(A) of the CEA provides counterparties to a swap an exception from mandatory clearing if one of the counterparties "(i) is a non-financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps." Proposed CFTC Rule 39.6(b) requires the "reporting counterparty" to provide notification of the manner in which the non-financial electing party expects to meet its financial obligations associated with the qualifying, non-cleared swap.

Specifically, such notification must be submitted to a swap data repository ("SDR") pursuant to the protocol for "reporting counterparties" set forth in the proposed rule for *Swap Data Recordkeeping and Reporting Requirements* (the "*Proposed General Reporting Rule*")[5] and must contain several items of information associated

[4] For instance, certain commercial firms in the energy sector use asset-based collateral arrangements (*i.e.,* first liens in generating facilities). These collateral arrangements are accepted in energy markets as an appropriate form of credit support for liabilities and derivatives exposures.

[5] *Proposed Rule* at 80748. *See Swap Data Recordkeeping and Reporting Requirements,* Notice of Proposed Rulemaking, 75 FED. REG. 76574 (Dec. 8, 2010).

with a non-financial entity's election to use the End-User Exception.[6] Where the counterparty electing to use the End-User Exception is an SEC Filer,[7] the notification must include two additional items of information: (i) the relevant SEC Central Index Key number for that counterparty; and (ii) whether the Board has reviewed and approved the decision not to clear the swap.

The *Proposed Rule* states that the submission of information required by proposed CFTC Rule 39.6(b) must be submitted to an SDR on a transaction-by-transaction basis.[8] Notwithstanding this requirement, the *Proposed Rule* requests comment on whether it would be difficult or prohibitively expensive for persons to report the information that must be included in the notification required by proposed CFTC Rule 39.6(b). The Working Group submits that it would be prohibitively expensive for persons to do so and suggests a much less burdensome approach.

1. A Single, Omnibus Annual Filing Is Consistent with, and in Furtherance of, the Statutory Objectives of New CEA 2(h)(7)(A)

To maximize efficiency, minimize administrative burdens and costs, and ensure consistency with the express language of new CEA Section 2(h)(7)(A), the Working Group submits that this notification only be submitted annually and recommends that such notification should be reported in the same manner and form as the Commission's current Form 40 applicable to large traders with reportable futures positions. Specifically, the Working Group envisions that the notification would be (i) prospective in nature (*i.e.,* for the forthcoming calendar year beginning on January 1), and (ii) provide all information required by proposed CFTC Rule 39.6(b) on a narrative and consolidated basis.

Proposed CFTC Rule 39.6(a) requires submission of the notification of the election of the End-User Exception to be on a transaction-by-transaction basis. Moreover, the *Proposed Rule* interprets this provision to require market participants to determine whether a swap qualifies for the End-User Exception at the time of execution. As noted below, these requirements conflict with the plain language of new CEA Section 2(h)(7)(A). This apparent conflict should be reconciled by the Commission in any final rule issued in this proceeding.

Proposed CFTC Rule 39.6(a) states, in relevant part:

> (a) A counterparty to a swap (an "electing counterparty") may elect to use the exception to mandatory clearing under section 2(h)(7)(A)(iii) of the Act if the electing counterparty is not a "financial entity" as defined in section 2(h)(7)(C)(i) of the Act, *is* ***using the swap*** *to hedge or mitigate commercial risk* as defined in § 39.6(c), and provides or causes to be provided to a registered swap data repository or, if no registered swap data repository is available, the Commission, the information specified in § 39.6(b) . . . .

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[6] *See* proposed CFTC Rule § 39.6(b). These items generally include: (1) the identity of the electing counterparty to the swap; (2) whether the electing counterparty is a "financial entity" as defined in new CEA Section 2(h)(7)(C)(i); (3) whether the electing counterparty is a finance affiliate meeting the requirements of new CEA Sections 2(h)(7)(C)(iii) or 2(h)(7)(D); (4) whether the swap is used by the electing counterparty to hedge or mitigate commercial risk as defined in proposed CFTC Rule § 39.6(c); (5) the method or mechanism by which the electing counterparty generally expects to meet its financial obligations associated with its non-cleared swaps; and (6) whether the electing counterparty is an issuer of securities registered under section 12 of, or is required to file reports under section 15(d) of, the Securities Exchange Act of 1934.

[7] Unlike the Act, the *Proposed Rule* defines an issuer of securities to include a counterparty that is controlled by a person that is an issuer of securities. See *Proposed Rule* at 80750 n. 15. That is, the *Proposed Rule* broadens the definition of an issuer of securities as set forth in the Act to include subsidiaries. The Working Group submits that there is no policy or purpose that supports the expansion of the definition of issuer of securities beyond that which is provided under the Act. Indeed, while the Working Group acknowledges the Commission's concern in ensuring proper Board oversight of a non-financial entity's swap trading activity, the Commission required such only for an SEC Filer. If the Commission were seeking to accomplish such an objective, then it should have imposed the requirement on all non-financial entities that use swap trades. Because it did not, the *Proposed Rule* results in unreasonable disparate treatment of market participants.

[8] In relevant part, the *Proposed Rule* states:

> The Commission proposes in § 39.6(b) to require non-financial entities to notify the Commission *each time the end-user clearing exception is elect*ed by delivering specified information to an SDR in the manner required by proposed rules for swaps data recordkeeping and reporting.

Proposed Rule at 80748 (emphasis added; footnote omitted).

(emphasis added).[9]

In contrast, new CEA Section 2(h)(7)(A) states:

> (A) IN GENERAL.—The requirements of paragraph (1)(A) shall not apply to a swap if 1 of the counterparties to the swap—
>
> (i) is not a financial entity;
>
> (ii) *is **using swaps** to hedge or mitigate commercial risk; **and***
>
> (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared ***swaps.***

(emphasis added).

The language of new CEA Section 2(h)(7)(A)(ii) and (iii), highlighted above, demonstrates a clear and unambiguous intent by Congress to permit a non-financial entity to make a general election to use the End-User Exception. Use of the singular form of the word "*swap*" in proposed CFTC Rule 39.6(a) is in direct conflict with the statutory use of "*swaps*" in CEA Section 2(h)(7)(A)(ii) and (iii). The conjunctive requirements of CEA Section 2(h)(7)(A) make clear that the election to use the End-User Exception will not be required on a transaction-by-transaction basis. That is, this language cannot be reasonably construed by the Commission to require market participants to identify or provide notification that a particular swap qualifies for the End-User Exception at the time it is entered into. Consequently, since the election is not on a transaction-by-transaction basis, notification cannot be on a transaction-by-transaction basis unless the statute indicates otherwise. As stated above, however, new CEA Section 2(h)(7)(A)(iii) references "swaps" in the plural, which does not contemplate notification on a transaction-by-transaction basis. Accordingly, although new CEA Section 2(h)(7)(A)(iii) provides the Commission with the discretion to prescribe the manner (*i.e.,* the form and format) in which such notification may be provided to it, the Commission must interpret this provision consistent with the express language of, and the Congressional intent underlying, new CEA Section 2(h)(7)(A)(ii) and (iii), which clearly permits the use of the Working Group's proposed annual omnibus notification in the form described above.

2. Notification Should be Submitted by the Non-Financial Entity Electing to Use the End-User Exception

The Working Group submits that it is not appropriate to impose an obligation on a "reporting counterparty," as that term is defined in the *General Reporting Rule,* to submit information to an SDR associated with a non-financial entity counterparty's election to use the End-User Exception.[10] In order to minimize the potential for administrative errors or conflicts between parties that could disrupt the trade execution process, proposed CFTC Rule 39.6(b) should be revised to require the counterparty electing to use the End-User Exception to submit any required information to an SDR, not the reporting counterparty.

To the extent that the Commission has concerns regarding possible abuse of this exception, new CEA Section 2(h)(7)(F) provides it with the authority to request information from any non-financial entity claiming the use of the End-User Exception. The Commission may also solicit such information by issuing a formal special call pursuant to CFTC Rule 21.[11] In addition, the Commission's broad statutory enforcement authority under the CEA, as enhanced by the enactment of Title VII, is a strong deterrent to situations in which the End-User Exception could be abused through the knowing and willful submission of false information.

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[9] Notwithstanding the statement in proposed CFTC Rule 39.6(a) that "a counterparty to a swap (the 'electing counterparty') may elect to use the exception to mandatory clearing under section 2(h)(7)(A)(iii) of the Act," new CEA Section 2(h)(7)(A) is drafted in the conjunctive and, therefore, should be read in its entirety as the End-User Exception. The Commission's reliance on new CEA Section 2(h)(7)(A)(iii) as the specific End-User Exception is misplaced. This interpretation effectively swallows the other statutory criteria that must be satisfied by a market participant to avail itself of the End-User Exception. The Working Group respectfully submits that new CEA Section 2(h)(7)(A)(iii) constitutes only the "notice" element of the End-User Exception that must be interpreted consistent with the express language of, and Congressional intent, underlying the other statutory elements.

[10] The Working Group believes that placing this obligation on the reporting counterparty is improper as it could create an inherent conflict of interest between the parties to a commercial transaction that should be avoided by the Commission.

[11] *See* 17 CFR § 21 (2010).

B. Board Review and Approval of Use of End-User Exception by an SEC Filer

As noted above, pursuant to proposed CFTC Rule 39.6(b)(6)(ii), the End-User Exception is only available to an SEC Filer if the Board has reviewed and approved its decision to enter into swap transactions subject to this exception. Further, this provision requires the notification submitted to an SDR relating to a counterparty's election to use the End-User Exception to include confirmation that the required Board review and approval has been obtained.

The scope and application of proposed CFTC Rule 39.6(b)(6)(ii) raises two concerns that should be addressed by the Commission in any final rule issued in this proceeding. First, the requirement for an SEC Filer to obtain Board review and approval each time a non-financial entity elects to use the End-User Exception is inconsistent with the statutory language of CEA Section 2(j) requiring a Board to review and approve the decision to enter into swaps, not each individual swap. Second, the *Proposed Rule* is not clear whether the Board review and approval requirement may be delegated to executive officers or other senior managers that have the direct corporate oversight responsibility for (i) stand-alone subsidiaries or affiliates of an SEC Filer engaged in swap trading activities, or (ii) functional business units of a corporate entity in which swap trading activities are organizationally housed. The Working Group's concerns are discussed separately below.

1. Board Review and Approval of an SEC Filer's Decision to Use the End-User Exception

Based upon the express language of proposed CFTC Rule 39.6(b)(6)(ii) and related interpretative guidance in the *Proposed Rule,* it appears that an SEC Filer must obtain on a transaction-by-transaction basis Board review and approval of each and every election to use the End-User Exception.[12] Specifically, proposed CFTC Rule 39.6(b)(6)(ii) states, in relevant part, as follows:

> (6) Whether the electing counterparty is an entity that is an issuer of securities registered under section 12 of, or is required to file reports under 15(d) of, the Securities Exchange Act of 1934, and if so:
>
> * * * * *
>
> (ii) Whether an appropriate committee of the board of directors (or equivalent body) has ***reviewed and approved the decision not to clear the swap.***

(emphasis added).

This language violates new CEA Section 2(j) which states:

> (j) COMMITTEE APPROVAL BY BOARD.—Exemptions from the requirements of subsection (h)(1) to clear a swap and subsection (h)(8) to execute a swap through a board of trade or swap execution facility shall be available to a counterparty that is an issuer of securities that are registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o) only if an appropriate committee of the issuer's board or governing body has ***reviewed and approved its decision to enter into swaps*** that are subject to such exemptions.

(emphasis added).

The use of the phrase "decision to enter into swaps," namely, the singular form of "decision" and plural form of "swaps," in new CEA Section 2(j) cannot be reasonably interpreted by the Commission to require Board review and approval of an SEC Filer's decision to elect the End-User Exception on a transaction-by-transaction basis. In contrast, such language actually requires only that a Board review and approve an SEC Filer's general decision to enter into multiple swaps qualifying for the End-User Exception. Accordingly, pursuant to new CEA Section 2(j), a Board of an SEC Filer may adopt a single, continuing resolution approving the decision to use the End-User Exception.

The Working Group's reading of new CEA Section 2(j) is supported by a statement in footnote 18 of the *Proposed Rule* that a "board committee could adopt policies and procedures to review and approve decisions not to clear swaps, on a periodic basis

[12] See *Proposed Rule* at 80748, 80757 § 39.6(b)(6)(ii) (stating that the Commission must be notified "*each time*" the End-User Exception is elected, and where the non-financial party is an SEC Filer, such notification must include confirmation that the Board has approved the decision not to clear the swap).

or subject to other conditions deemed satisfactory to the board committee."[13] Specifically, this statement demonstrates a recognition by the Commission that a Board may review and approve an SEC Filer's decision to use the End-User Exception at its discretion. A transaction-by-transaction review and approval process is not required. Recognizing the importance of appropriate and diligent corporate oversight as required by applicable state laws, the Board may modify the proposed resolution upon determining that a material change in circumstances warrants such action.

Accordingly, to eliminate any regulatory uncertainty created by the *Proposed Rule,* the Commission should reconcile and conform the language of proposed CFTC Rule 39.6(b)(6)(ii) with new CEA Section 2(j). In doing so, the Commission will ensure that proposed CFTC Rule 39.6(b)(6)(ii) is consistent with, and gives meaning to, the Congressional intent underlying new CEA Section 2(j).

2. Delegation of Board Review and Approval Obligation To Duly Authorized Personnel Should Be Permitted

The Commission should clarify that, for non-financial entities formed as a standalone subsidiary or affiliate of a parent holding company, the Board, for that subsidiary or affiliate, is permitted to review and approve the decision to use the End-User Exception. That is, Board review and approval for that non-financial entity is sufficient to meet the requirements of proposed CFTC Rule 39.6(b)(6)(ii), and such review and approval need not be obtained from the Board of the parent holding company.

The Commission should further clarify that, for any non-financial entity operating as a functional business unit within a single corporate entity, the obligation to review and approve the use of the End-User Exception under proposed CFTC Rule 39.6(b)(6)(ii) may be delegated by the Board to duly authorized executive officers or other senior managers with direct oversight responsibility for swap trading activities.

The delegation of the Board review and approval requirement in proposed CFTC Rule 39.6(b)(6)(ii) to such executive officers and other senior managers will ensure that duly authorized supervisory personnel with day-to-day knowledge of the operation of the relevant swap markets and their participants are in the position to review and approve a non-financial entity's use of the End-User Exception. Furthermore, such delegation is supported by statements in footnotes 16 and 18 of the *Proposed Rule*, which expressly contemplate the review and approval of an SEC Filer's decision to use the End-User Exception to be undertaken by duly authorized personnel.[14] The exercise of such delegated authority may be guided by internal policies and procedures adopted pursuant to proposed CFTC Rule 39.6(b)(6)(ii) or other conditions established by the Board itself.

C. Scope and Application of End-User Exception to Transactions Intended To Hedge "Commercial Risk"

The Working Group supports the Commission's proposed interpretation of the term "commercial risk" in proposed CFTC Rule 39.6(c)(1), and the consistency of this interpretation with the use of the same term in the pending joint rulemaking further defining "Major Swap Participant."[15] However, to ensure regulatory certainty, the Commission should (i) strictly limit this definition to identifying those swaps that hedge or mitigate "commercial risk," as defined in proposed CFTC Rule 39.6(c)(1); and (ii) strike proposed CFTC Rule 39.6(c)(2)(i) from any final regulations implementing this definition.[16] In addition, swaps that are executed to mitigate or hedge commercial risk on a dynamic or portfolio basis should unconditionally qualify for the End-User Exception.

1. The Proposed Definition of Commercial Risk Obviates the Need for Proposed CFTC Rule 39.6(c)(2)(i)

Proposed CFTC Rule 39.6(c)(2)(i) is unnecessary and excessive in light of the proper scope and specificity of the proposed definition of "commercial risk" in proposed

[13] *Proposed Rule* at 80750 n. 18.

[14] *See Proposed Rule* at 80750 nn. 16 & 18.

[15] *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"* 75 FED. REG. 80174 (Dec. 21, 2010).

[16] The Working Group supports proposed CFTC Rule § 39.6(c)(1)(iii), which provides that a swap transaction hedges or mitigates commercial risk if such swap "qualifies for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133)." Yet the Working Group submits that other accounting regimes exist and are used by market participants. As such, any final rule should include those in addition to the standards of the Financial Accounting Standards Board.

CFTC Rule 39.6(c)(1). Any transaction that does not fall within the definition "commercial risk" cannot, by definition and in any way, qualify for the End-User Exception. The Working Group is concerned that, if adopted, the broad and vague regulatory text in proposed CFTC Rule 39.6(c)(2)(i) will dilute and weaken the proposed definition of "commercial risk" in proposed CFTC Rule 39.6(c)(1).

In addition, the terms "investing" and "trading," set forth in proposed CFTC Rule 39.6(c)(2)(i) are beyond the scope of the CEA, as amended by Title VII of the Dodd-Frank Act. Moreover, these terms, as well as the term "speculation," are not defined and are widely used in swap markets in a variety of contexts.[17] In energy markets, for instance, the term "trading" is often used to describe activity involving both *bona fide* hedging as well as proprietary trading.[18] Notwithstanding that the regulation of "investing" and "trading" is beyond the scope of the CEA, the adoption of regulatory text containing such undefined, yet commonly used, terms will lead to conflicting interpretations regarding the scope and application of the End-User Exception. Confusion as to what constitutes investing, trading, and speculation will inject unnecessary and harmful uncertainty into swap markets.

The Working Group respectfully submits that such a result is neither in the public interest nor is it consistent with the Congressional intent underlying the new CEA Section 2(h)(7)(A). Because the clear and unambiguous language of the proposed definition of "commercial risk" eliminates the need to adopt regulatory text identifying transactions that fall outside of the scope of this definition, the Commission should strike proposed CFTC Rule 39.6(c)(2)(i) from the final regulations implementing the End-User Exception.

2. Swaps Used to Offset Risks Associated with Underlying Position in Physical Commodity Markets Hedge or Mitigate "Commercial Risk"

Interpretive guidance in the *Proposed Rule* creates uncertainty whether the Commission is attempting to create different categories of activity in physical commodity markets in order to distinguish whether a swaps transaction is hedging or mitigating commercial risk. Such uncertainty arises from interpretive guidance set forth in footnote 23 of the *Proposed Rule:*

> 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. Swap positions that hedge ***other positions*** that themselves are held for the purpose of speculation or trading are also speculative or trading positions.[19]

The Working Group seeks clarification that the highlighted language above is intended to apply to **other *swaps* positions** "that themselves are held for the purpose of speculation", and not any other position that would also include physical positions. Otherwise the Working Group is concerned that the Commission has adopted a preliminary view that certain exposures in physical commodity markets would not fall within the definition of "commercial risk" in proposed CFTC Rule 39.6(c)(1). This view is not supported by any policy rationale, is inconsistent with the proposed language under proposed CFTC Rule 39.6, and could lead to absurd results that would have material, adverse impacts on both physical commodity and swap markets. All physical market participants, from car manufacturers, to toy stores, to merchant energy companies, are in the business of trying to sell a commodity for more than the cost of producing or procuring the commodity. An energy company procuring supply in advance of the summer driving season, or a toy store stocking its shelves in advance of a holiday, are both arguably taking a position in a physical market to trade based on speculation that there will be increased demand. If the phrase "other positions" is interpreted as applying to physical market positions, it could have the perverse result of treating certain *bona fide* hedges of positions as

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[17] Nowhere in Title VII do the terms "speculation," "investing," or "trading" appear together. Further, there are open questions about what activity constitutes "investing" or "trading." Even if such terms were to be defined, it is unclear whether Title VII affords the same treatment for swaps used for investing and trading as it does for swaps entered into for speculation.

[18] The Working Group is particularly concerned that the word "trading" might impermissibly include the buying and selling of commodities by parties that are primarily in the business of producing, delivering, storing, marketing, and managing physical commodities. This is traditional "commercial activity." Yet, it may also come within the meaning of "trading." Swaps executed in connection with this trading likely would constitute *bona fide* hedging transactions. In other words, proposed CFTC Rule 39.6(c)(2)(i) would effectively nullify the force and effect of proposed CFTC Rule 39.6(c)(1)(ii), which cannot be the intention of the Commission.

[19] *Proposed Rule* at 80752 at n. 23.

outright speculative swap positions. This interpretation is not consistent with the Congressional intent underlying new CEA Section 2(h)(7)(A).

In light of the foregoing, the Working Group respectfully requests that the Commission clarify that the language in the interpretive guidance set forth in footnote 23 of the *Proposed Rule* is the result of imprecise drafting that should be corrected in any final rule issued in this proceeding. As long as a swap transaction is intended to (i) offset the types of risks, or (ii) meet other qualifying criteria, identified in proposed CFTC Rule 39.6(c)(1), it should be viewed as hedging or mitigating "commercial risk." To remedy the uncertainty created by the above-quoted text in footnote 23 of the *Proposed Rule,* the Working Group requests that the Commission clarify that the phrase "other positions" is intended to mean "other swap positions."

3. Swaps that Hedge Commercial Risk on a Portfolio or Dynamic Basis Should Qualify for the End-User Exception

The Working Group respectfully requests the Commission to recognize that, although participants in physical energy commodity markets use swaps and futures to hedge underlying physical positions, they do not, as a general matter, execute such transactions specifically for the purpose of hedging a specified underlying physical position only. With this in mind, the End-User Exception should not be interpreted by the Commission to implement a "one-size-fits-all" approach to hedging by requiring an entity claiming use of this exception to match a swap that hedges or mitigates commercial risk with a specified underlying physical commodity transaction only.

In physical energy markets, the predominant risk management practice used by commercial firms is to hedge underlying physical assets and related positions on a portfolio or aggregate basis. In order to effectively and efficiently mitigate commercial risk associated with underlying physical assets and related positions, commercial energy firms will dynamically hedge their aggregate exposures on a regular and on-going basis. A commercial firm will normally hedge these exposures utilizing physical transactions, futures, and swaps, the exact combinations of which will be determined by various characteristics which may be unique to such firm. A prescriptive one-to-one matching requirement of each swap to a specific physical transaction or an asset position is contrary to the statutory language, and is unnecessary and overly burdensome.

Another well-established practice used by commercial energy firms to mitigate commercial risk is to hedge dynamically to optimize the value of underlying physical assets or portfolios. A key aspect of dynamic hedging is the ability to modify the hedging structure related to the physical asset or positions when the relevant pricing relationships applicable to that asset change.[20] Dynamic hedging may involve leaving an asset or position unhedged when necessary to mitigate lost opportunity

[20] The following provides an example of dynamic hedging of natural gas and power prices by a commercial energy firm in over-the-counter swap markets. The dynamic hedging transactions relate to the sale of power from a gas-fired, electric generating facility (the "Asset"). The impact of the strategy set forth below is to hedge commercial risk associated with changing market conditions to (i) facilitate a cumulative improvement on the return of the Asset, and (ii) allow for a better economic allocation of the underlying physical commodities being used or generated by the Asset.

- *Step 1: Power Prices Exceed Gas Prices; Asset Hedged to Lock in Positive Margin.* The commercial energy firm purchases fixed price swaps to fix the prices for natural gas fuel supply and power output produced by the Asset ("Initial Hedges"). At the time the Initial Hedges are entered into, power prices exceeded natural gas prices. This strategy locks in a specified positive margin for the Asset.
- *Step 2: Power Prices and Gas Prices Reverse; Asset Unhedged to Capture Additional Positive Margin.* At a later date, the relative prices of natural gas and power reversed (*i.e.,* gas prices exceeded power prices to the point where the natural gas was worth more sold as gas than it would be if it was converted to electricity), the commercial energy firm bought back the Initial Hedges to maximize the positive margin on the Asset. The repurchase of the Initial Hedges left the Asset in an unhedged position. The repurchase of the Initial Hedges made economic sense because it would have been uneconomic from the physical commodity pricing perspective to run the Asset. Specifically, it allowed the commercial energy firm to earn an additional positive margin on the Asset under the then-existing market conditions by mitigating lost opportunity costs associated with holding gas positions that were worth more than the power it could have generated.
- *Step 3: Power Prices and Gas Prices Reverse Again; Asset Re-Hedged to Capture Additional Positive Margin.* As the relative prices of natural gas and power reverse again a few months later it becomes economical to produce output from the Asset and enter into new fixed price natural gas and power price hedges to lock in an additional positive margin on the Asset.

cost risk, which may require hedges to be established, unwound, and re-established on an iterative basis over time. The hedging of commercial risk should therefore include all hedging activity that maximizes the value of the asset.

Given the customary use of portfolio and dynamic hedging in energy markets, it would be impracticable, if not impossible, for the vast majority of energy market participants to link hedges with specified underlying physical positions for purposes of complying with the End-User Exception. Accordingly, the Working Group respectfully submits that, as long as these transactions meet the underlying requirements of new CEA Section 2(h)(7)(A) and proposed CFTC Rule 39.6(a), they should unconditionally qualify for the End-User Exception. In the alternative, the cost burdens would be drastic, and the potential effects on liquidity would be severe, without resulting benefits to participants or the markets.

D. The Applicability of the End-User Exception to Certain Affiliate Transactions Needs To Be Clarified

New CEA Section 2(h)(7)(D)(i) permits an affiliate of a non-financial entity to use the End-User Exception if that affiliate, "acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of" the non-financial entity or other affiliate that also qualifies as a non-financial entity. Notwithstanding this language, new CEA Section 2(h)(7)(D)(ii) prohibits an affiliate from using the End-User Exception if it is, among other things, a Swap Dealer or Major Swap Participant. These provisions are, however, silent with respect to swap transactions between affiliates within the same corporate family that are used to manage and allocate risk. The Commission should use the authority granted to it under new CEA Section 2(h)(2) to explicitly exempt such inter-affiliate swap transactions from mandatory clearing and, as applicable, the End-User Exception notification requirements set forth in proposed CFTC Rule 39.6(b).[21]

The Working Group respectfully submits that there is no benefit to the public interest or the Commission to require mandatory clearing or (as applicable) reporting of information pursuant to proposed CFTC Rule 39.6(b) with respect to inter-affiliate swaps that are used to manage and allocate risk within a holding company system or other organizational structure. Inter-affiliate swaps do not in any way enhance systemic risk, nor do they affect liquidity in swap markets. Information relating to such swap transactions is neither responsive to one of the central policy goals of Title VII of the Act—to enhance transparency in swap markets—nor is it necessary to prevent abuse.

Should the Commission decline to grant the requested explicit exception from mandatory clearing and End-User Exception notification requirements for inter-affiliate swaps, the Working Group requests that, at a minimum, it clarify that otherwise qualified non-financial entities are not prohibited from utilizing the End-User Exception when engaged in swap transactions with Swap Dealer or Major Swap Participant affiliates.

E. Presumption of Status as a Non-Financial Entity

As noted in other comments filed with the Commission by the Working Group, the framework adopted in Title VII for the regulation of over-the-counter swap markets is based upon the existence of distinct classes of market participants.[22] New CEA Section 2(h)(7) and provisions of the *Proposed Rule* implementing the End-User Exception recognize two distinct classes of market participants: (i) financial entities that are ineligible for this exception, and (ii) non-financial entities that are eligible for this exception upon compliance with certain conditions. In order to provide legal and regulatory certainty, and to be faithful to the intent of the Act, the Commission should not adopt any presumption that a "financial entity" as defined in new CEA Sections 2(h)(7)(C) and (D)(ii) for one kind of swap is also a financial entity for other kinds of swaps. Instead, market participants should be permitted to seek the exemption for each swap for which they are not registered as a swap dealer. Alternatively, the Commission should adopt a presumption that a market participant is a non-financial entity until proven otherwise.

[21] New CEA Section 2(h)(2) provides the Commission with the ability to determine whether a specific swap or group, category, type, or class of swaps should be required to be cleared.

[22] *See* Working Group, Comment Letter on Joint Notice of Proposed Rulemaking on Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," Notice of Proposed Rulemaking (Feb. 22, 2011).

F. The *Proposed Rule* Fails to Adequately Consider Anticipated Compliance Costs

Section 15(a) of the CEA requires the CFTC, before promulgating a rule, to "consider the costs and benefits of the action of the Commission."[23] The *Proposed Rule* does not, as a general matter, provide any empirical data regarding the specific costs and benefit analysis specific to the implementation of proposed CFTC Rule 39.6 by market participants.[24] The Working Group requests that the Commission (i) consider the costs and benefits associated with the *Proposed Rule* in the manner prescribed by CEA Section 15(a), (ii) issue a supplemental new rule in this proceeding setting forth empirical data supporting its conclusions regarding the costs and benefits of the *Proposed Rule*, and (iii) notice the supplemental rule in the *Federal Register* for public comment.

IV. Responses to Specific Requests for Comment

A. Specific Requests for Comment Addressing Notification to the Commission

Question: Are there clarifications or instructions the Commission could adopt that are useful for parties seeking to elect to use the end-user clearing exception? If so, what are they and what would be the benefits of adopting them?

Response: As stated under Part III.A, above, the Working Group believes the nonfinancial entity electing to use the End-User Exception should be required to submit any relevant information in the same manner and form as the Commission's current Form 40.

Question: Would it be difficult or prohibitively expensive for persons to report the information required under the proposed § 39.6? If so, why?

Response: As discussed under Part III.A, the Working Group believes that notification on a transaction-by-transaction basis will be prohibitively burdensome and expensive. Too many entities other than the traders would have to be involved in each deal if this cannot be handled on an aggregate basis. As such, the ability to hedge with an adequate price will be slowed due to data collection and additional employees needed to collect and report information.

Question: Is the information the Commission proposes to collect in connection with the Financial Obligation Notice sufficient? Is other information needed to achieve the purposes of the Dodd-Frank Act?

Response: The Working Group believes that no additional information is necessary to achieve the transparency objectives of new CEA Section 2(h)(7).

Question: Is it necessary or appropriate for the Commission to collect additional general information on the credit support agreement and the collateral practices under the agreement, such as the level of margin collateral outstanding (*e.g.,* less than or equal to a specified dollar amount, or greater than a series of progressively higher dollar amounts); the types of collateral provided (*e.g.,* cash, government securities, other securities, other collateral), or the frequency of portfolio reconciliation?

Response: The Working Group does not believe this additional information should be required, as such is not required by the CEA or the Act.

Question: Is it necessary or appropriate for the Commission to collect additional general information on specific terms of the credit support agreement, such as whether the collateral requirements are unilateral or bilateral provisions and whether there are contractual terms triggered by changes in the credit rating or other financial circumstances of one or both of the counterparties?

Response: The Working Group does not believe such additional information is necessary as such information provides no benefit to the Commission.

Question: Is it necessary or appropriate for the Commission to collect additional general information about the guarantor, such as whether or not the guarantor is a parent or affiliate of the person electing to use the end-user clearing exception?

Response: The Working Group does not believe such additional information.

Question: Is it necessary or appropriate for the Commission to collect additional general information regarding the assets pledged, such as the type of security interest or the type of property being used as collateral?

Response: The Working Group does not believe such additional information is necessary.

Question: Is it necessary or appropriate for the Commission to collect additional general information regarding the segregation arrangements, such as the identity of the collateral agent or other third party involved in the arrangement, and infor-

[23] 7 U.S.C. § 19.
[24] *Proposed Rule* at 80754–55.

mation regarding whether the arrangement involves a custodian, triparty or different type of relationship?

Response: The Working Group does not believe such additional information is necessary.

Question: Is it necessary or appropriate for the Commission to collect additional general information regarding the adequacy of other means being used, or the adequacy of the financial resources available, to meet the financial obligations associated with the non-cleared swap?

Response: The Working Group does not believe such additional information is necessary as such information provides no benefit to the Commission.

Question: Should the Commission consider requiring parties electing to use the end-user clearing exception to report additional types of information, either in order to limit abuse of the exception or for other reasons? If so, what other information should be reported and what would be the benefit of requiring such information to be reported? What categories of information, if any, should not be required to be reported and why?

Response: The Working Group does not believe additional information is necessary. As discussed under Part III.A.2, above, the Commission has adequate authority to limit abuses.

B. Specific Request for Comment Regarding Treatment of Affiliates

Question: Should the Commission provide additional clarity to the terms used in CEA Sections 2(h)(7)(C)(iii) and 2(h)(7)(D) in proposed § 39.6 for affiliates electing to use the end-user clearing exception?

Response: The Working Group submits its response to this question under Part III.D, above.

C. Specific Requests for Comment Addressing Board Approval Requirement

Question: Should the Commission provide additional clarity to the requirements of CEA Section 2(j) [board approval] to facilitate compliance with proposed § 39.6 by parties electing to use the end-user clearing exception?

Response: The Working Group submits its response to this question under Part III.B, above.

Question: Should the Commission adopt more specific requirements to implement the provisions of CEA Section 2(j)? If so, what specific rules should the Commission consider and what would be the benefits of adopting them?

Response: The Working Group submits its response to this question under Part III.B, above.

D. Specific Requests for Comment Addressing Notification of the Commission

Question: Does collecting Financial Obligation Notice information through SDRs provide sufficient assurance that the end-user clearing exception will be available to non-financial entities wishing to use the exception? Are SDRs reliable enough to be used for these purposes?

Response: The Working Group submits its response to this question under Part III.A, above.

Question: Is there a more feasible and cost effective way for the Commission to receive notification regarding the use of the end-user clearing exception? If so, what is the better alternative and in what ways is it better?

Response: The Working Group submits its response to this question under Part III.A, above

Question: Would the person reporting information to the SDR be in a position to have or be able to obtain, in all cases, the information the Commission is requiring to be reported under proposed Rule 39.6. If not, why not? Are there special considerations in this regard when a swap is between two non-financial entities that are each seeking to elect to use this exception?

Response: The Working Group submits its response to this question under Part III.A.2, above.

Question: Should the Commission require persons electing to use the end-user clearing exception to follow additional compliance practices in some circumstances? For example, should the Commission require electing persons to create a record of the means being used to mitigate the credit risk of the swap? Would such a requirement be redundant or duplicative of other proposed record-keeping requirements?

Response: The Working Group submits that no additional compliance practices are required. The transactions at issue are governed by the terms of industry standard bilateral master agreements, which incorporate negotiated credit terms.

E. Specific Requests for Comment Address the Hedging of Commercial Risk

Question: Should swaps qualifying as hedging or risk mitigating be limited to swaps where the underlying hedged item is a non-financial commodity?

Response: The Working Group supports the Commission's proposed definition of "commercial risk" in proposed CFTC Rule 39.6(c)(1). Non-financial commodities such as interest rate and foreign currency present risk that is central to the effective and efficient operations of a commercial enterprise. As such, swaps entered into to mitigate or hedge interest rate risk or currency risk should fall within the proposed definition of "commercial risk" and should be eligible for the End-User Exception (assuming the other qualifying requirements are satisfied).

Question: Commenters may also address whether swaps qualifying as hedging or risk mitigating should hedge or mitigate commercial risk on a single risk or an aggregate risk basis, and on a single entity or a consolidated basis.

Response: The Working Group submits its response to this question under Part III.C, above.

Question: Whether swaps facilitating asset optimization or dynamic hedging should be included; and whether hedge effectiveness should be addressed.

Response: The Working Group submits its response to this question under Part III.C, above.

V. Open Comment Period

Given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure over-the-counter derivatives markets, the Working Group respectfully requests that the Commission hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on proposed rules. The resulting comprehensive comments will allow the Commission to better understand how its proposed rules will impact swap markets.

VI. Conclusion

The Working Group supports appropriate regulation that brings transparency and stability to the energy swap markets in the United States. The Working Group appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein as it develops a final rule in this proceeding.

The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, please contact the undersigned.

Respectfully submitted,

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February 22, 2011

DAVID A. STAWICK,
Secretary,
Commodity Futures Trading Commission,
Washington, D.C.

Re: *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Dealer" and "Eligible Contract Participant"*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter in response to the Commodity Futures Trading Commission (the "CFTC") and Securities Exchange Commission (the "SEC," and together with the CFTC, the "Commissions") request for comment concerning the Commissions' Notice of Proposed Rulemaking on *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Dealer" and "Eligible Contract Participant"* (the "Proposed Rules").[1] This comment letter provides the Working Group's comments regarding the proposed definition of "major swap participant."

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. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") vests the Commissions with new and expanded authority to regulate a wide array of participants in swap markets. Swap dealers, security-based swap dealers, major swap participants and major security-based swap participants in particular, will be required to develop and implement comprehensive measures to assure compliance with both substantive and procedural requirements under the Commissions' new regulations set forth under the Act. Such regulations have been the subject of several key proposed rulemakings for which the Working Group has previously submitted comments. The Working Group anticipates submitting comments on the subjects of additional key proposed rulemakings.

The Working Group appreciates the opportunity to provide these comments in response to the Proposed Rules and respectfully requests that the Commissions consider the comments set forth herein. The Working Group looks forward to working with the Commissions to further define the term "major swap participant" prior to the effective date of Title VII of the Act. Because the Commissions have not finalized the regulatory definition of the terms that are the subject of the Proposed Rules, members of the Working Group have commented on proposed rulemakings applicable to swap dealers and major swap participants. They are concerned about the potential that one or more aspects of the proposed definitions, which are unclear in material respects, could be interpreted such that they are deemed to be swap dealers or major swap participants. The Working Group would also note that the comments supplied herein are incomplete. Without a definition of "swap," the Working Group is unable to provide complete comments on the proposed definition of "major swap participant."

I. Comments of the Working Group

The Working Group is generally supportive of the objective approach taken by the Commissions in further defining "major swap participant." The use of objective criteria and tests will provide swap market participants with needed clarity and regulatory certainty with regard to their status as a potential major swap participant. However, multiple aspects of the proposed definition of "major swap participant" are vague in material respects and must be clarified so market participants can properly and consistently apply these aspects of the proposed definition to their own swap positions and related business activities.

A. Proposed Definitions Must Reflect Congressional Intent To Capture Only Entities Presenting Significant Risk to the U.S. Financial System

Congress clearly intended the definitions of "major swap participant" and "major security-based swap participant" to cover entities with swap portfolios that result in such entities presenting risk to the United States financial system. The first prong of the definition of "major swap participant," as set forth in Commodity Exchange Act ("CEA") Section 1a(33)(A)(i), deems any entity that "maintains a substantial position in swaps," excluding, among other things, positions "held for hedging or mitigating commercial risk" of a major swap participant.[2] In CEA Section 1a(33)(B), Congress directed the Commissions to define the term "substantial position" at "the threshold that the Commission[s] determine to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States."[3] In general, this prong identifies as "major swap participants" those entities that have amassed speculative positions in swaps that are sufficiently large such that losses

[1] 75 *Fed. Reg.* 80174 (Dec. 22, 2010).

[2] CEA Section 1a(33)(A)(i).

[3] As discussed below, when determining whether a position is a "substantial position" if a position creates "substantial counterparty exposure," the following swaps should be excluded: (a) swaps that are centrally cleared, (b) swaps to the extent their market value is collateralized and (c) swaps entered into between affiliates. These swaps do not have any significance to the stability of the financial system of the United States or any such risk can be better addressed elsewhere, such as the regulation of derivatives clearing organizations and clearing agencies.

on these positions could have a materially adverse effect on the financial system of the United States.

The second prong of the definition of "major swap participant" set forth in CEA Section 1a(33)(A)(ii) defines a "major swap participant" as a party whose "outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets." Congress clearly intended this standard to be a *substantial* threshold. This prong addresses the risk that an entity could inject huge losses into the financial network by defaulting on its swap portfolio, whether or not the default is particular to swaps.[4] In contrast to the first prong of the definition, the second prong contemplates potential losses beyond those inherent with an entity's actual swap positions.

Implicit in both of these prongs of the definition of "major swap participant" is Congress' intent for the definition to capture those entities that are not swap dealers, but that pose a systemic risk as a consequence of their swap activities. An entity is systemically risky if its default would significantly impact the financial system. The degree of systemic risk an entity poses, therefore, is a function of (a) the potential size of its default, (b) the degree to which its default would be distributed through out the financial system, and (c) the probability of its default. Accordingly, any definition intended to capture systemically risky entities should take into account all of those factors.

The tests proposed by the Commissions in the definitions of "major swap participant" and "major security-based swap participant" only consider the size of an entity's swap portfolio and, to some extent, the degree to which its swaps are margined. To capture only those entities whose swap activities can significantly impact the financial system, the Commissions should also factor in (a) the assets an entity has available to cure any potential default on its swap portfolio and (b) the degree to which an entity's potential swap exposures are concentrated among systemically important market participants. Consideration of those factors might result in the application of any potential definitions of "major swap participant" and "major security-based swap participant" being more difficult for the Commissions and market participants. However, that additional burden is justified. If such definitions account for these additional factors, they will be less likely to unduly burden less risky entities than the proposed definitions.[5] Inclusion in the final rule of the additional factors would capture only entities that truly pose a systemic risk as a result of their swap activities.

1. Different Thresholds Across Categories Does Not Reflect Systemic Risk

The degree of systemic risk posed by an entity's swap activities generally is not a function of the markets or products in which it transacts. So, the threshold level of swap activities to determine whether an entity is a major swap participant should not be different for different markets or classes of swaps. An entity, for example, is not more systemically risky because it has $1 billion in current outward exposure in "other commodities" swaps rather than $1 billion in current outward exposure in "rate" swaps. However, under the *Proposed Rule*, in the first circumstance, the entity is treated as systemically important and in the second instance, it is not.

The Commissions might have made market-by-market distinctions in the Proposed Rules because Section 1a(33)(C) of the CEA and Section 3(a)(67)(C) of the Securities Exchange Act of 1934 contemplate that a person may be designated as a major swap participant or major security-based swap participant for one or more categories of swaps or security-based swaps without being classified as such for all classes of swaps or security-based swaps. Congress likely understood that an entity might be a systemically significant participant because of its activity in one category of swaps, but might enter into other types of swaps from time to time. Prudential regulation would be unnecessary with respect to the entity's truly ancillary swap activities. However, the need for regulation is triggered by the exposure inherent in an entity's portfolio, not which markets a portfolio might cover.

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[4] *E.g.,* a major swap participant that becomes insolvent upon suffering massive losses on its portfolio of residential mortgage investments.

[5] *See* proposed CFTC Rule 1.3(sss). The Commissions recommend a threshold of $3 billion of current unsecured outward exposure or $6 billion in current outward and potential future unsecured exposure for an entity to have a substantial position in rate swaps and $1 billion in current outward unsecured exposure or $2 billion in current and future potential future unsecured exposure for an entity to have a substantial position in each of the other swap categories. For an entity's swap positions to constitute a substantial counterparty exposure, the Commissions proposed a threshold of $5 billion of current uncollateralized exposure and $8 billion of current and potential future uncollateralized exposure.

Accordingly, the Working Group believes that the exposure thresholds for the determination of substantial positions should be the same for each swap category. Alternatively, if the thresholds differ across swap categories, the Commissions must provide sufficient rationale to support such differences and such reasons should be solely based on concerns about the risk to the U.S. financial system.

2. Proposed Thresholds Do Not Reflect Systemic Risk

The objective standards outlined in the current definitions, as set out in the Proposed Rules, likely will capture entities that do not present systemic risk. While the Working Group supports the use of objective standards, it respectfully submits that the objective standards associated with proposed definitional tests have been set too low and should not be set as a static number.

Though the Commissions conclude otherwise, the proposed thresholds used to determine whether an entity holds a substantial position or if its positions create substantial counterparty exposure do not fully reflect Congress' desire for major swap participants to be limited to only those entities that are "systemically important or can significantly impact the financial system of the United States." The Commissions state:

> The proposed thresholds are intended to be low enough to provide for the appropriately early regulation of an entity whose swap or security-based swap positions have a reasonable potential of posing significant counterparty risks and risks to the market that stress the financial system, while being high enough that it would not unduly burden entities that are materially less likely to pose these types of risks.[6]

The instruction of Congress to the Commissions in the Act was to set definitions for "major swap participant" and "major security-based swap participant" that capture entities that *are* systemically important. The definition was intended to capture those entities that (a) for the purposes of the substantial position test "are systemically important or can significantly impact the financial system of the United States" and (b) for the purposes of the substantial counterparty exposure test whose swaps and resulting exposures "could have serious adverse effects on the financial stability of the United States banking system or financial markets."[7] The Act does not establish visibility thresholds at which entities *might potentially be* systemically important. The Commissions should correct their interpretation of the Act to correctly reflect the statutory text and Congress' true intent. Otherwise, the Commissions might regulate entities as major swap participants or major security-based swap participants that do not have swap portfolios that present risks to the U.S. financial system. There is no evidence to show this was Congress's interest.

The Commissions offer no evidence to support why the above thresholds were selected. The proposed thresholds do not appear to have any direct relationship to systemic risk. There are numerous examples of entities sustaining losses well in excess of the proposed limits. These entities not only did not cause a financial crisis, but also, in some cases, survived such losses. For example, the collapse of Enron is cited as an example of a high profile default that did not have a substantial systemic impact.[8] Prior to its collapse, Enron had approximately $18.7 billion in derivatives exposure, which constituted approximately 3% of the notional outstanding in the global market for derivatives on "other commodities."[9] Enron's share of the market for derivatives on "other commodities" was more than ten times larger than the Commission's proposed threshold. Despite this scale, the collapse of Enron did not trigger any systemic failure in the U.S. financial system.

Another example of an entity sustaining massive losses in the energy derivatives markets, yet not causing the energy markets or U.S. financial system to collapse is Amaranth Advisors, LLC. On one trading day, September 14, 2006, Amaranth ex-

[6] *Proposed Rules* note 105.

[7] CEA Section 1a(33).

[8] *See, e.g.,* Darryl Hendricks, John Kambhu, and Patricia Mosser, *Systemic Risk and the Financial System,* Background Paper presented at Federal Reserve Bank of New York and the National Academy of Sciences Conference on New Directions in Understanding Systemic Risk, May, 2006 and James Bullard, Christopher J. Neely, and David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer,* 91 FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, Sep./Oct. 2009, Sec. 5, Part 1 at 403–17.

[9] Diana B. Henriques, *Enron's Collapse: The Derivatives Market That Deals in Risks Faces a Novel One,* N.Y. TIMES, Nov. 29, 2001. Available at : *http://www.nytimes.com/2001/11/29/business/enron-s-collapse-thederivatives-market-that-deals-in-risks-faces-a-novel-one.html*, and Bank of International Settlements Press Release: *The global OTC derivatives market at end—June 2001 Second part of the triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity,* December 20, 2001.

perienced losses of approximately $560 million in natural gas futures positions. Amaranth is believed to have experienced total losses in connection with such position in excess of $4.35 billion.[10]

The Commissions should adopt substantial position and substantial counterparty exposure tests that account for current conditions in swap markets. Setting thresholds that utilize static numbers will require the Commissions to revisit such thresholds over time in order to ensure they continue to reflect Congressional intent. For example, prices in energy markets are correlated to macroeconomic conditions. So, if the U.S. economy were to return to strong growth, the notional size of energy swap markets would grow as the prices of the underlying commodities rise. Though commercial energy firms' absolute positions will rise, their relative positions will remain constant. On the other hand, other factors, such as the use of portfolio compression, might shrink the notional size of a market while the actual market value increases. The recent trend in the credit default swap market is an example.[11] In short, rising energy prices could push many commercial energy firms over the proposed major swap participant determination thresholds or shrinking notional amounts in other markets could allow entities to avoid designation as a major swap participant. In both cases, those entity's relative positions in their markets will remain unchanged and the risk they pose to the financial system will generally remain constant as well.

The Working Group respectfully suggests that the Commissions set the following limits with respect to a substantial position in other commodities:

- a daily average aggregate uncollateralized outward exposure in excess of 1% of the gross market value of other commodity swaps; or
- a daily average aggregate uncollateralized outward exposure *plus* daily average aggregate potential outward exposure in excess of 2% of the gross market value of other commodity swaps.[12]

Such limits would better reflect Congress' desire for the "major swap participant" definition to capture entities whose swap activities pose a systemic risk and that those limits will not require frequent modification as they are a relative measure of an entity's systemic risk.

3. Speculation, Investing and Trading Are Different Concepts

Proposed CFTC Rule 1.3(ttt)(2)(i)[13] provides that any swap "held for a purpose that is in the nature of speculation, investing or trading" will not be considered a hedging transaction for purposes of the definitional tests.[14] The Working Group recommends that this provision be deleted in the final rule.[15]

Proposed subparagraph (ttt)(1),[16] the operative provision, describes certain hedging and credit mitigation activities. If a firm uses swaps for these activities, then such swaps are deemed to be held for "hedging or mitigating commercial risk" and excluded when determining whether a firm's swap portfolio constitutes a substantial position. As hedges, they are not speculative.

Proposed subparagraph (ttt)(2)(i) also should be deleted because it regulates swaps in connection with "investing or trading."[17] While Congress was clearly concerned with speculation, it showed no similar concern for investing or trading. In fact, no where in Title VII do the terms "speculation, investing, or trading" appear together. Also, the phrasing "investing or trading" does not appear in Title VII. The Commissions have not defined "investing" or "trading" in the Proposed Rules. Thus, there are open questions about what activity constitutes investing or trading. For example, even if such terms were to be defined, does Title VII require the same

[10] Ludwig B. Chincarini, *The Amaranth Debacle: A Failure of Risk Measures or a Failure of Risk Management?,* THE JOURNAL OF ALTERNATIVE INVESTMENTS, Winter 2007, at 93.

[11] *See* Nicholas Vause, *Counterparty risk and contract volumes in the credit swap market,* BIS QUARTERLY REVIEW, December 2010.

[12] The Working Group respectfully suggests that the Commissions base these determinations on the BIS' market size data until the Commissions determine the size of the swap markets they will regulate.

[13] *Proposed Rules* at 80215.

[14] Such categorization is also used in determining whether or not the end-user exception from the mandatory clearing requirement is available to certain market participants.

[15] The Working Group suggests that the CFTC adopt one provision in its regulations that defines when swaps are hedges or mitigate commercial risk. We note that the CFTC proposes a similar definition in proposed CFTC regulation 39.6.

[16] *Id.* at 80214–15.

[17] In the alternative, the Commissions should redraft it to read, "Not held for a purpose that is in the nature of speculation."

treatment for swaps done for investing and trading purposes as it does for swaps entered into for speculative purposes?

Trading and investing, as vernacular concepts, include both speculation and hedging. Use of such terms might suggest that hedging swaps, which constitute trading or investing activity, would not be afforded treatment as hedges under the definitional tests. This treatment of hedging swaps would effectively nullify the statutory provisions that exclude swaps for hedging purposes when determining whether a swap portfolio might constitute a "substantial position."

The Working Group also is concerned that the word "trading," in particular, might impermissibly include the buying and selling of commodities by parties that are primarily in the business of producing, delivering, storing, marketing and managing physical commodities. This is traditional "commercial activity." Yet, it might also come within the meaning of "trading." Swaps executed in connection with this trading likely would constitute *bona fide* hedging transactions. It would make no sense for language in the Commissions' regulations to disqualify such swaps from being hedges for purposes of the definitional tests.

4. The Commissions Should Not Reclassify Swaps That Hedge Non-Swap Speculative Positions

The Commissions, in the release to the Proposed Rules, introduced uncertainty as to the treatment of swaps entered into by a firm to hedge physical market positions. This may simply be a drafting issue, but the Working Group would respectfully request the Commissions to provide clarification.

In footnote 128 to the Proposed Rules,[18] the Commissions state that, "[s]wap positions that hedge **other positions** that themselves are held for the purposes of speculation or trading are also speculative or trading positions." (emphasis added). There is no clarity as to what the Commissions meant by "other positions." Perhaps it was an error, and the Commissions meant "other swap positions."

If the Commission intended to suggest that the hedge of a physical market position that is a "trading" position (*i.e.,* held as a merchant or merchandiser in the commodity) would not qualify for treatment as "hedging or mitigating commercial risk" under the MSP definition, this would have serious consequences to physical market participants. All physical market participants, from car manufacturers, to toy stores, to merchant energy companies, are in the business of trying to sell a commodity for more than the cost of producing or procuring the commodity. An energy company procuring supply in advance of the summer driving season or a toy store stocking its shelves in advance of a holiday are each arguably taking a position in a physical market to trade based on speculation that there will be increased demand. If the phrase "other positions" is interpreted as applying to physical market positions, it could have the perverse result of treating certain *bona fide* hedges of positions as outright speculative swap positions. Thus, firms would be unable to exclude these swaps from the exposure calculations.

On the other hand, if the footnote was intended to use the phrase "other swap positions," the sentence in question would be consistent with what the Working Group believes the Commission's intent to be.

Such an interpretation of footnote 128 also is consistent with proposed CFTC Rule 1.3(ttt)(2)(ii). This subparagraph, in describing swaps that are not hedging or mitigating commercial risk, reads:

> (ii) Not held to hedge or mitigate the risk of another swap or securities-based swap position, unless that other position itself is held for the purpose of hedging or mitigating commercial risk as defined by this rule of § 350.4s67–4 of this title.

In this subparagraph, "other position" clearly references another swap or security-based swap. Unlike footnote 128, subparagraph (ttt)(2)(ii) does not refer to swaps held to hedge "other position," just those to hedge swaps or securities-bases swaps.

Accordingly, the Working Group requests that the Commission clarify or correct (as appropriate) the phrase "other positions" in footnote 128 to mean "other swap positions."

Separately, the Working Group supports the inclusion of subparagraph (ttt)(2)(ii) in the Proposed Rules as it facilitates as firm's effective management of it hedge portfolio when that portfolio includes swaps entered into in connection with commercial activity (*e.g.,* the physical delivery of energy products). We note, however, that it prevents a swap intended to offset a speculative swap from being considered a hedge for purposes of the definitional tests. Yet, entering into an offsetting swap is a very common and efficient way in which market participants exit or limit a de-

[18] *Proposed Rules* at 80195. *See, also, Proposed Rules* footnote 131 at same.

rivatives position. When considered in the context of systemic risk mitigation, the Working Group believes that all hedges should be treated as hedges.

5. The Commissions Should Provide More Support for Their Conclusions With Respect to Administrative Law Matters

The Commissions, in the release to the Proposed Rules, largely conclude that the requirements under several administrative statutes are satisfied because the Proposed Rules only concern definitional matters. As the definitions covered by the Proposed Rules are the keystone for Title VII, this conclusory approach to applicable administrative statutes is wanting.

For example, the Commissions do not provide supporting discussion about the various thresholds contained in the *Proposed Rule*. There is no analysis as to why any particular threshold represents the best selection. There is no discussion of the impact to the U.S. economy from the selection of one threshold over another. These definitions simply cannot be made in a vacuum. Quantitative, economic analysis is required to understand how and why the Commissions fashioned the definitions as they appear in the *Proposed Rule*.

Title VII and the rules to be promulgated by the Commissions thereunder will fundamentally effect the U.S. financial system and the U.S. economy. In the energy markets, they will effect the cost of electricity, natural gas and heating oil received by nearly every U.S. tax payer. The definitions are central to derivatives reform. Without them, the other statutory and regulatory provisions largely are inoperative. To hold that the definitional rules have little or no associated costs or economic impact (perhaps on the theory that it is the other statutory provisions or rules that actually impose the obligations and constraints) is to truly subvert substance to legal finery.

Thus, among other things, the Working Group does not support the Commissions' conclusion under the Small Business Regulatory Enforcement Fairness Act of 1996 that the definitions do not constitute a "major" rule. The Commissions offer no support behind their conclusions that the Proposed Rules do not result in or are likely to result in the following:

- an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effect on competition, investment or innovation.

The Working Group believes that the Proposed Rules will cause each of the foregoing to occur.[19]

The Commissions should provide economic analysis as to the import of the definitions they have selected. This information, however, should not appear solely in the final rule. The Working Group therefore requests that the Commissions (i) consider the costs and benefits associated with the Proposed Rules in the manner prescribed by CEA Section 15(a), (ii) issue a supplemental rule in this proceeding setting forth empirical data supporting its conclusions regarding the costs and benefits of the Proposed Rules, and (iii) notice the supplemental rule in the *Federal Register* for public comment.

B. Suggested Improvements to Exposure Tests

The definitional tests in the Proposed Rules are highly technical. They also are more challenging to use than may appear at first glance. Given the potential complexity of and likely interpretive issues with any tests set forth under the final definitions of "major swap participant" and "major security-based swap participant," the Working Group requests that the Commissions solicit additional feedback from market participants prior to the issuance of a final rule. The Commissions also might request volunteers to walk-through the determination of whether they are a major swap participant or major security-based swap participant to ensure that the proposed tests actually function in practice.

Attached as *Exhibit A* is an exercise through which members of the Working Group attempted to perform the definitional tests for major swap participant. The

[19] The Working Group has given notice to Congress and the CFTC on several occasions of the potential impact to energy markets and the U.S. economy from reform of the energy swap markets. *See for example,* Comments of the Working Group on the CFTC's proposed rule on *Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant,* filed with the CFTC on January 18, 2011, Comments of the Working Group on the CFTC's proposed rule on *Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants,* filed with the CFTC on December 15, 2010, and January 24, 2011.

Proposed Rule, as described below, leaves certain matters open to interpretation or, in other cases, require entities to "fill in the blanks." Accordingly, *Exhibit A* reflects some subjective interpretation. Thus, it is possible that the exercise is not how the Commissions intended the definitional tests to apply. Accuracy, however, was not the primary point of the exercise. Instead, the Working Group wants to demonstrate by example the need for the Commissions to (a) build and run such models to assure the definitional tests work in practice, (b) establish a step-by-step procedure for applying the definitional tests and (c) publish a "worksheet," perhaps like *Exhibit A,* to facilitate the definitional analysis by market participants.

1. Clarifications Are Necessary for the Exposure Determinations

Certain aspects of the proposed definitional tests must be further clarified or revised to ensure proper and consistent application of these tests by market participants. As stated above, the definitions should be styled to provide a clear step-by-step method for evaluating any given swap portfolio and must include clear definitions of critical terms and related calculations.

There are several instances where descriptions of calculations related to the definitional tests are not clear. For example, proposed CFTC Rule 1.3(sss)(3)(ii)(A)(1), as currently styled, could be interpreted to require notional amounts be summed and then multiplied by the appropriate multiplier. However, when the entire regulation is read together, it appears that the notional amount of each swap is multiplied by the appropriate multiplier, a cap is applied with respect to credit default swaps, and then the products are summed. As another example, the adjustment for netting agreements in proposed CFTC Rule 1.3(sss)(3)(ii)(B) is not entirely clear. Is "NGR" (a) the net outward exposure (after netting) divided by gross outward exposure (before netting) or (b) the net exposure regardless of its direction divided by the gross exposures without regard to direction? (The detailed and technical nature of these examples underscores the need for active participation of industry representatives beyond submission of prose commentary.)

To further illustrate, in determining the aggregate potential outward exposure of a swap portfolio under the Proposed Rules, the aggregate notional amount of a class of swaps in the portfolio is multiplied by a factor depending on duration.[20] What is not clear from the text of the Proposed Rules is whether individual swaps spanning multiple time horizons should be bifurcated for reporting purposes so that the notional amount of the swap is split appropriately between applicable time horizons (as the Working Group believes would be appropriate), or if the entire notional amount of the swap should be reported only in the time horizon corresponding to the final maturity of the swap.

There are additional instances in which the Commissions must further define some of the more basic elements included in prescribed calculations. For example, the Proposed Rules do not define the terms "notional principal amount" or "notional amount," which appear to be used interchangeably and are integral to the calculation of potential outward exposure. Notional amounts for swaps, as understood by members of the Working Group, are not always established in dollars, but can also be established by reference to units of commodities. Thus, when determining an "aggregate notional amount" of a "notional principal amount" of swaps in a market participant's portfolio, some conversion is necessary to transform notional amounts measured in units of commodities to dollar amounts. In addition, the Commissions should clarify whether or not outward exposure includes unpaid amounts under a swap. The final rule further defining "major swap participant" should provide sufficient technical guidance to answer seemingly basic questions such as these and provide clarity on the specific mechanics and the order in which the calculations in the *Proposed Rule* 1.3(sss) are to be performed.

Exhibit B provides some specific recommendations of the Working Group with respect to language as it appears in the CFTC proposed Rule 1.3(sss).

2. The Commissions Should Afford Favorable Treatment of Cleared Swaps and Swaps Subject to Daily Margining

The Proposed Rules consider both cleared and daily margined swaps in the determination of potential outward exposure. The notional value of these swaps is effectively discounted by 80% when they are included in the potential outward exposure calculation to account for the risk mitigation benefits of central clearing and daily margining.[21] The Working Group applauds the Commissions for accounting for the risk mitigation benefits of central clearing and daily margining, although the pro-

[20] *Proposed Rule* at 80193.
[21] Proposed CFTC Rule 1.3(sss)(3)(iii).

posed 80% discount potentially overstates the risk posed by daily swings in the value of such swaps.

Cleared swaps, in particular, should not be considered in the determination of whether an entity is a major swap participant. Daily settlement of gains and losses on cleared swaps shortens the time horizon for exposure to changing market prices to a single day, and initial margin required by rules of derivatives clearing organizations ("DCOs") ensures that sufficient funds will be available for settlement of daily losses in almost any conceivable circumstance. If the Commissions are concerned about the potential risk posed by daily price swings of cleared swaps, then the proper place to address this concern is in the regulations pertaining to initial margin requirements for DCOs and clearing agencies.

Swaps that are subject to daily margining should also be discounted heavily in calculations of potential outward exposure. While the Proposed Rules state that "a swap shall be considered to be subject to daily mark-to-market margining if, and for so long as, the counterparties follow the daily practice of exchanging collateral to reflect changes in the current exposure arising from the swap," the Working Group believes that the existence of contractual margining provisions should be sufficient justification for the discount contemplated in the proposed rule in the absence of evidence that the applicable party has consistently chosen not to enforce margin provisions contained in its agreements. Absent such evidence, the Working Group believes that a discount of 98% is appropriate to account for the risk that a counterparty cannot meet its daily margin call.[22] [23]

3. Unused Unsecured Thresholds Should Not Be Included in Definitional Tests

The method for determining aggregate potential outward exposure, as set forth in proposed CFTC Rule 1.3(sss)(3), appears to account for a portion of the potential exposure twice.[24] The calculations require any uncollateralized threshold to be added to the aggregate uncollateralized outward exposure, which is then added to potential outward exposure to reach a representation of potential future exposure. It is entirely unclear why any unused unsecured threshold is equated to exposure, as it more accurately represents the absence of exposure. This proposed treatment is onerous and inconsistent with other standard financial measurements of exposure. For example, when calculating an entity's debt-to-equity ratio, the indebtedness component of the calculation does not incorporate undrawn portions of revolving credit facilities or other forms of available but undrawn debt. At best, any unused unsecured threshold is a reserve for potential outward exposure.

The unworkable nature of the proposed inclusion of unused unsecured thresholds is even more apparent when considered in the context of master agreements under which there are no trades in place in the calculation of potential outward exposure. Dormant master agreements represent an agreement as to the parameters that will govern any future trades between two parties. Such agreements do not represent an active credit relationship between the parties. Accordingly, unsecured thresholds contained in dormant master agreements should not be included in any measure of current or potential future exposure.[25] The Proposed Rules should be clarified to exclude any unsecured thresholds under dormant master agreements from the calculation of current or potential future exposure. Additionally, the Proposed Rules should not require the inclusion of any unsecured threshold amount in excess of calculated outward exposure.

The consideration of unsecured thresholds creates further complications in two other significant ways. *First,* for the purposes of determining whether an entity has a substantial position, positions entered into to hedge commercial risk are removed from the calculations. By including unused unsecured thresholds in the determination of substantial position, the CFTC is potentially reading the exclusion of hedge positions out of the Proposed Rules. If an entity has entered into both speculative and hedge positions under the same master agreement, how would an entity deter-

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[22] The Working Group notes that it is unable to fully evaluate the proper risk discount for swaps subject to daily margining without knowing the parameters of margin requirements imposed on major swap participants.

[23] This proposed discount is appropriate to address systemic risk concerns, particularly in respect of the energy swap markets. As discussed elsewhere, the Working Group does not know of an example of a default in energy swaps triggering a systemic event to the U.S. financial system.

[24] *Proposed Rule* at 80188.

[25] Inclusion of dormant trading relationship in the major swap participant definition would also serve as an incentive to terminate dormant master agreements. Master agreements are left in place even if there are no active trades between the counterparties, because, as the terms of the trading relationship are already in place, they allow the counterparties to enter into new trades quickly and efficiently.

mine what portion of any unused unsecured threshold should be allocated to hedge positions?

Second, commercial energy firms often enter into master agreements that cover both physical and financial positions. Including both in one agreement is done for efficiency purposes. Only one agreement must be negotiated, and more importantly, counterparties are able to net physical and financial exposures. If unused unsecured exposure is required to be included in the determination of whether an entity is a major swap participant, then it is uncertain how that unused unsecured threshold should be allocated between potential physical positions and potential swap positions. A more fundamental legal question is how physical positions that are outside the CFTC's jurisdiction should be considered.

The Commissions might have added unused unsecured thresholds to the definitional formulas to discourage the use of unsecured trading. The Working Group believes that the loss of unsecured trading will result in a diminution of liquidity in the overall market. Many commercial energy firms rely on some amount of unsecured trading, both for administrative considerations and for allocation of cash resources. If unsecured trading is removed or receives punitive treatment under the Commissions' regulations, then such firms might limit their trading or even exit the market all together. This would reduce liquidity for the entire market. Accordingly, the Working Group suggests that the Commissions not include unused unsecured thresholds in the definitional tests.

4. Initial Margin Should Be Deducted From Aggregate Potential Outward Exposure

In the release to the Proposed Rules, the Commissions specifically ask "if an entity currently has posted excess collateral in connection with a position, should the amount of that current over-collateralization be deducted from its measure of potential future exposure?"[26] The Working Group believes that such excess collateral should be deducted from potential outward exposure. In particular, any initial margin posted on a swap should be factored into the determination of aggregate potential outward exposure. If initial margin, as the CFTC's own definition of the term states, is "money, securities, or property posted by a party to a swap as performance bond to cover potential future exposures arising from changes in the market value of the position,"[27] then the risk mitigation effects of any initial margin should logically be considered in the calculation of aggregate potential outward exposure under the proposed definition of "major swap participant."

5. Adjustments for Netting Agreements in the Calculation of Aggregate Potential Outward Exposure Should Be Revised

The Proposed Rules provide an adjustment for netting in the calculation of aggregate potential outward exposure that relies on a specified formula referencing the ratio of net current exposure to gross current exposure derived from the calculation of aggregate uncollateralized outward exposure. The Working Group believes that this formula-based adjustment for netting is unnecessary because off-setting positions could be easily reflected directly in calculations of net total notional principal amount prior to application of conversion factors specified in the Table to § 1.3(sss)—Conversion Factor Matrix for Swaps.[28] This approach has been incorporated into example calculations provided in *Exhibit A.*

C. Collateral Considerations

The Working Group supports the broadest definition of collateral for determining whether an "out-of-the-money" swap is secured for purposes of the definition of "major swap participant." The Commissions should recognize in the Proposed Rules that collateral for a swap might be in forms such as liens on assets and parent guarantees.

Swaps that are secured by sufficient liens on property should be afforded the same discount as swaps subject to daily margining. Often, the value of collateral supporting the lien is several times greater than the exposure. Given the adequacy of this collateral, the Commissions should afford the same treatment to swaps collateralized in such a manner. Even if such swaps were subject to daily margining, the counterparty effectively would not be subject to delivery obligations because it had already delivered collateral far exceeding the exposure.

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[26] *Proposed Rules* at 80183.
[27] Proposed CFTC Rule 23.600.
[28] Proposed CFTC Rule 1.3(sss).

D. Treatment of Affiliates

1. Aggregation Across Enterprises

The Commissions state that it would be appropriate to attribute a majority-owned subsidiary's swap positions to a parent for the determination as to whether the parent is a major swap participant.[29] In many circumstances aggregation would not be consistent with "the concepts of 'substantial positions' and 'substantial counterparty exposure.'"[30] Positions of affiliates should not be aggregated to the extent that such affiliates are independently controlled and capitalized. Under these circumstances, the affiliate's trading is not being coordinated with swap activities of other entities and only the assets of that entity are at risk in the event of a default. If an entity is independently controlled it is unlikely that such entity was created in an attempt for a parent to evade classification as a major swap participant, and if an affiliate is independently capitalized then there is no recourse to the parent entity or another affiliate.

The market treats an independently controlled and capitalized entity as distinct from its parent and affiliates, so only its positions should be considered when attempting to determine if it is a major swap participant and should not be considered when determining if its parent company or affiliates are major swap participants. This approach is consistent with the treatment of affiliated companies under bankruptcy law where such companies are considered individually so as to not prejudice the rights of creditors to one entity by allowing recourse to the assets of such entity to creditors of an affiliate. This distinction allows subsidiaries to obtain favorable financing independent of any concerns of a corporate parent. The Commissions should give deference to the separateness of affiliates so long as they are managed as distinct entities.

If the Commissions choose to aggregate the swap portfolios of affiliated entities for the purposes of the major swap participant determination, the Working Group respectfully requests that the Commissions not aggregate the positions of an entity that on its own is a swap dealer or major swap participant with those of its affiliates. To do so would eliminate an enterprise's ability to segregate all of its regulated swap activities in one entity, and would thereby potentially subject that entire enterprise to prudential regulation. To the extent that an ultimate parent would be considered a major swap participant as a result of aggregation of positions of its subsidiaries, the designation should only apply to the parent itself and not to individual subsidiaries. Such designation should only apply to individual subsidiaries if the positions of such individual subsidiaries warrant such designation on a standalone basis.

If the Commissions elect to aggregate swap portfolios of affiliated entities, the Commissions should provide a clear process by which entities might petition one or both of the Commissions to permit the petitioning entities to not aggregate positions. The petitioner should be permitted to provide evidence to the applicable Commission that the swap portfolios of its affiliates do not reflect a scheme to avoid registration as a major swap participant. This approach is consistent with the CFTC's Notice of Proposed Rulemaking on Position Limits for Derivatives.[31] In that notice, the CFTC provided a mechanism by which certain non-financial entities can disaggregate certain positions if the parent company can demonstrate that the owned non-financial entity is independently controlled and managed. The Working Group will comment separately on specific aspects of the proposed rule on Position Limits.

Aggregation of swap portfolios also introduces issues with the extraterritorial application of the Commissions' jurisdiction.[32] Many of the Working Group members have affiliates that are not incorporated in and do not operate in the United States. These affiliates often trade in swaps outside of the United States. The Working Group recommends that the swap portfolios of such off-shore affiliates not be aggregated with swap portfolios of companies in the same enterprise that operate within the U.S.

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[29] *Proposed Rules* at 80202.

[30] The Working Group acknowledges that under certain unusual circumstances such aggregation would be appropriate. For example, it would be appropriate to aggregate positions of affiliated entities if an entity were attempting to evade registration as a major swap participant by trading swaps out of multiple subsidiaries under common control.

[31] 76 *Fed. Reg.* 4752 (January 26, 2011).

[32] The Working Group has submitted comments to the CFTC with respect to the extraterritorial application of its rules and regulation under Title VII of the Act. Working Group of Commercial Energy Firms comments to the CFTC's *Proposed Rule* on *Registration of Swap Dealers and Major Swap Participants,* filed with the CFTC on January 24, 2011.

2. Treatment of Inter-Affiliate Swaps

Inter-affiliate swaps should not be considered when determining if an entity is a major swap participant. Transactions between two affiliated entities result in the same corporate family taking both sides of the swap. The corporate family's net credit exposure from the trade is zero. Given that the net credit exposure is zero, consideration of inter-affiliate swaps when determining if an entity is a major swap participant would be counting swaps with no counterparty risk to the market in tests meant to arrive at some indication of the level of risk an entity poses to the U.S. financial system.

E. Legacy Portfolios

For many market participants, a large number of swaps in their portfolios were entered into prior to the enactment of the Act. These positions were entered into in the ordinary course of business before parties to these swaps could reasonably anticipate the possibility of being subject to prudential regulation because of these swap positions. The Working Group respectfully requests that the Commissions allow market participants whose current portfolios would make them a major swap participants to maintain their current positions and allow such positions to expire on their own terms without regulating the entities as major swap participants.[33]

Any entity that might be deemed a major swap participant should be permitted to not register as such if each of its relevant existing transactions expire according with their terms and such entity does not enter into any new swaps that would cause it to be deemed a major swap participant. This "grandfathering" of legacy portfolios would allow a smooth regulatory transition and would avoid any market disruption caused by entities closing-out a significant number of legacy positions in a short period of time to avoid being a major swap participant. We anticipate that any entity electing to grandfather a legacy portfolio would submit a brief petition to the applicable Commission.

F. Netting of Physical Positions

The Working Group strongly supports the Commissions' decision to consider the risk mitigation effects of netting agreements when determining whether an entity is a major swap participant. The Commissions recognized that because (a) swaps are not necessarily hedged with other swaps and (b) swaps are also used to hedge non-swaps exposure, certain other positions should be considered for netting purposes. The Commissions state:

> When calculating the net exposure the entity may take into account offsetting positions with that particular counterparty involving swaps, security-based swaps and securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements) to the extent that is consistent with the offsets provided by the master netting agreement.[34]

The Working Group respectfully requests that the Commissions consider the netting of physical positions in commodities and offsetting swaps when calculating net exposure for the purposes of the major swap participant definition. Specifically, master netting agreements that cover entire trading relationships, not just uncleared energy-based swaps and the other listed products, should be considered. It is common practice for commercial energy firms to enter into a transaction for a physical energy commodity and then enter into a related uncleared energy-based-swap transaction with the same counterparty as a risk mitigation tool. Any multi-transaction-netting agreement between the two counterparties will typically net obligations under both the physical energy transaction and the uncleared energy-based swap. Moreover, trades in physical energy commodities and uncleared energy-based swaps are often inextricably linked, and counterparties should be able to consider their entire trading relationship when determining net exposure for the purposes of the definition of major swap participant. If the Commissions were to exclude physical positions from the netting calculations under the proposed major swap participant definition, then the unsecured exposure of many commercial energy firms would be substantially overstated, potentially causing such commercial energy firms to incorrectly be deemed major swap participants.

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[33] For discussion of the treatment of legacy portfolios and how they should be considered with regards to registration as a major swap participant please see the Working Group's comments on the CFTC's proposed rule on *Registration Requirements for Swap Dealers and Major Swap Participants,* filed with the CFTC on January 24, 2011.

[34] *Proposed Rules* at 80189.

G. Limited Purpose Designations

Section 1a(33)(C) of the CEA clearly states and Congress intended that entities can be designated as a major swap participant for only one category of swaps. Proposed CFTC Rule 1.3(qqq)(2) requires entities to make an affirmative application to the CFTC to be treated as a major swap participant for less than all of the major categories of swaps. However, the statute expressly presumes that an entity may be deemed a major swap participant for one category of swaps without being considered a major swap participant for other categories, thus creating a presumption in favor of the market participant, meaning an entity deemed to be a major swap participant for a category of swaps should be presumed to be a major swap participant only for that particular category. The Commissions have effectively flipped the statute on its head, establishing a presumption in direct contrast to the express statutory language. As such, the Working Group respectfully requests the Commissions to abandon proposed CFTC Rule 1.3(qqq)(2).

If the Commissions choose to retain proposed CFTC Rule 1.3(qqq)(2), the Working Group believes that it will impose an unnecessary and potentially substantial burden on both (a) major swap participants that are clearly a major swap participant for one category of swap and (b) the Commissions which must process petitions to limit the scope of description. In the event that proposed CFTC Rule 1.3(qqq)(2) is retained, the Working Group respectfully suggests that the Commissions adopt a presumption that if 50% or more of a major swap participant's swaps fall within one category of swaps and that entity's swaps in other categories would not separately exceed any of the proposed thresholds, then that entity is a major swap participant for only that one category of swap. For example, the swap portfolios of many commercial energy firms that might be major swap participants are likely to be predominantly comprised of energy swaps, and the remainder of the portfolio are likely to be positions such as foreign exchange or interest rate swaps entered into to hedge commercial risk. Accordingly, such an entity should not have to file an application to have the scope of the application of the major swap participant definition limited.

By adopting the recommended presumption, the Commissions will avoid placing a costly and unnecessary burden on entities that are clearly only a major swap participant for one class of swaps. In addition, the presumption would eliminate the need for the Commissions to process applications that are likely a mere formality.

H. Timing Concerns

The Working appreciates that the Commissions recognize exogenous market conditions could temporarily force a potential major swap participant over a threshold during one quarter. Allowing an entity that exceeds a threshold by twenty percent or less in one quarter an additional quarter as a reevaluation period will avoid market disruptions that could result from deeming as major swap participants entities that, through factors beyond their control, temporarily exceed a given threshold.[35]

An entity that potentially meets the definition of a major swap participant should be given two quarters to register as such. As discussed more completely in the Working Group's comments to the CFTC's *Proposed Rule* on *Registration of Swap Dealers and Major Swap Participants,*[36] the determination of whether an entity is in fact a major swap participant will be a complex one. Further, coming into compliance with the regulatory obligations imposed on major swap participants will likely require a substantial expenditure of compliance and risk management resources and might require corporate restructuring as well as the restructuring of existing trading relationships. This compliance burden will be greatest for commercial entities that have never been subject to prudential regulation by a financial regulator. Accordingly, the Working Group believes that two quarters is the minimum amount of time an entity would need to register as a major swap participant.[37]

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[35] Proposed CFTC Rule 1.3(qqq)(4).

[36] Working Group of Commercial Energy Firms comments to the CFTC's *Proposed Rule* on *Registration of Swap Dealers and Major Swap Participants,* filed with the CFTC on January 24, 2011.

[37] The Working Group notes that this suggested time frame differs from the more extended time frame recommended in its comments to the CFTC's *Proposed Rule* on *Registration of Swap Dealers and Major Swap Participants.* The time frame suggested herein assumes that an entity becomes a major swap participant once the entire new regulatory regime imposed by Title VII of the Act is in place. Under these circumstances, an entity that is not a major swap participant from the outset can undertake some, but not all of the requirements imposed on major swap participants prior to exceeding the proposed thresholds.

I. Open Comment Period

As the Commissions have proposed the definitions contained herein towards the end of releasing proposed rules under Title VII of the Act, and have yet to propose a definition of "swap," market participants have not been able to offer fully informed comments on the CFTC's and SEC's proposed rules, especially comments regarding the cost implications of such rules. In addition, given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure over-the-counter derivatives markets, the Working Group respectfully requests that the Commissions hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on all of the proposed rules. The resulting comprehensive comments will allow the Commissions to better understand how their proposed rules will impact swap markets.

II. Conclusion

The Working Group supports appropriate regulation that brings transparency and stability to the swap markets in the United States. We appreciate the balance the Commissions must strike between effective regulation and not hindering the uncleared energy-based swap markets. The Working Group offers its advice and experience to assist the Commissions in implementing the Act. Please let us know if you have any questions or would like additional information.

Respectfully submitted,

DAVID T. MCINDOE;
MARK W. MENEZES;
R. MICHAEL SWEENEY, JR.;
Counsel for the Working Group of Commercial Energy Firms.

EXHIBIT A

Calculation of Aggregate Uncollateralized Outward Exposure

a.	*b.*	*c.*	*d.*	*e.*	*f.*	*g.*	*f.*
Counterparty	Current Mark-to-Market			Master Netting	Net Exposure	Posted Collateral	Uncollateralized Exposure
	Positive Value	Negative Value	Net Swap Value				
Example Portfolio:							
Counterparty 1	$15,000,000	**($20,000,000)**	**($5,000,000)**	$0	**($5,000,000)**	$0	**($5,000,000)**
Counterparty 2	$5,000,000	**($35,000,000)**	**($30,000,000)**	$5,000,000	**($25,000,000)**	$5,000,000	**($20,000,000)**
Counterparty 3	$35,000,000	**($5,000,000)**	$30,000,000	$0	$30,000,000	$0	$0
Counterparty 4	$1,000,000	**($16,000,000)**	**($15,000,000)**	$0	**($15,000,000)**	$0	**($15,000,000)**
Counterparty 5	$5,000,000	**($165,000,000)**	**($160,000,000)**	$10,000,000	**($150,000,000)**	$100,000,000	**($50,000,000)**
Aggregate Uncollateralized Outward Exposure							**($90,000,000)**

a. Legal entity that is contractual counterparty to swaps.

b. Sum of mark-to-market value for all individual swaps with a respective counterparty that have a positive mark-to-market value (in-the-money-swaps). Amount will be > = $0.

c. Sum of mark-to-market value for all individual swaps with a respective counterparty that have a negative mark-to-market value (out-of-the-money swaps). Amount will be < = $0.

d. Sum of mark-to-market value for all individual swaps with a respective counterparty.

e. Amount under valid master netting agreement with a respective counterparty available to offset negative net swap value reported in column d. Amount will be > = $0.

f. Net Exposure for a respective counterparty should be calculated as the lesser of $0 and the sum of columns d. and e.

g. Amount of collateral posted to a respective counterparty and available to offset negative net exposure reported in column f. Amount will be > = $0.

h. Uncollateralized Exposure for a respective counterparty should be calculated as the lesser of $0 and the sum of columns f. and g.

***Aggregate Uncollateralized Outward Exposure* equals the sum of column h. for entire portfolio of swap counterparties.**

Calculation of Potential Outward Exposure

Notional Principal Amount = notional underlying quantity in units (i.e., MWh, MMBtu, gallons, *etc.*) multiplied by current market price per unit.

a. Indicator (Y/N) of daily margining.

b. Applicable collateral threshold with respect to each counterparty. Amount will be < = $0

c. Collateral threshold less uncollateralized exposure.

d. Sum of Notional Principal Amount for all long swaps with a respective counterparty, categorized by applicable time period. For swaps that span multiple applicable time periods, report Notional Principal Amount that would be applicable for each time period. Amount reported will be > = $0.

e. Sum of Notional Principal Amount for all short swaps with a respective counterparty, categorized by applicable time period. For swaps that span multiple applicable time periods, report Notional Principal Amount that would be applicable for each time period. Amount reported will be < = $0.

f. Sum of amounts reported in ***d.*** and ***e.***

g. Product of amounts for each respective time period in column ***e.*** and factors in matrix presented in the proposed rule.

h. Absolute value of amount calculated for each counterparty in column ***g.***

i. Net Swap Value from Aggregate Uncollateralized Outward Exposure calculation.

j. Column ***hi.*** plus column ***h.***

k. Column ***i.*** minus column ***h.***

l. Lesser of $0 and minimum value from columns ***j.*** and ***k.***

m. Amount under valid master netting agreement with a respective counterparty available to offset negative net swap value reported in column ***l.*** Amount will be > = $0.

n. Amount of collateral posted to a respective counterparty and available to offset potential negative net exposure reported in column ***l.*** Plus additional collateral representing initial margin, independent amounts, and the like. Amount will be > = $0.

o. Margining Adjustment (see below).

p. Sum of columns ***l., m., n.,*** and ***o.*** Amount will be < = $0.

Margining Adjustment:				If Daily Margining = "Y" and Adjusted NSV (column ***l.***) < 0 Multiply the amount by which PFE Factor (column ***h.***) exceeds Available Threshold (column ***c.***) by 0.8 Net effect is that only the PFE factor that exceeds available unsecured credit gets discounted.

Calculation of Potential Outward Exposure

See calculation detail for Aggregate Uncollateralized Outward Exposure								***a.***	***b.***	***c.***
Counterparty	Current Mark-to-Market			Master Netting	Net Exposure	Posted Collateral	Uncollateralized Exposure	Daily Margining	Collateral Threshold	Available Threshold
	Positive Value	Negative Value	Net Swap Value							
Example Portfolio:										
Counterparty 1	$15,000,000	**($20,000,000)**	**($5,000,000)**	$0	**($5,000,000)**	$0	**($5,000,000)**	N	$0	$0
Counterparty 2	$5,000,000	**($35,000,000)**	**($30,000,000)**	$5,000,000	**($25,000,000)**	$5,000,000	**($20,000,000)**	Y	**($20,000,000)**	$0
Counterparty 3	$35,000,000	**($5,000,000)**	$30,000,000	$0	$30,000,000	$0	$0	Y	**($20,000,000)**	**($20,000,000)**
Counterparty 4	$1,000,000	**($16,000,000)**	**($15,000,000)**	$0	**($15,000,000)**	$0	**($15,000,000)**	Y	**($20,000,000)**	**($5,000,000)**
Counterparty 5	$5,000,000	**($165,000,000)**	**($160,000,000)**	$10,000,000	**($150,000,000)**	$100,000,000	**($50,000,000)**	Y	**($50,000,000)**	$0
	Aggregate Uncollateralized Outward Exposure						**($90,000,000)**			

Calculation of Potential Outward Exposure—Continued

d.			***e.***			***f.***		
Notional Principal Amount—Long Swaps			Notional Principal Amount—Short Swaps			Net Aggregate Notional Principal Amount		
< = One Year	1–5 Years	> 5 Years	< = One Year	1–5 Years	> 5 Years	< = One Year	1–5 Years	> 5 Years
$35,000,000	$20,000,000	$15,000,000	**($25,000,000)**	**($15,000,000)**	**($5,000,000)**	$10,000,000	$5,000,000	$10,000,000
$45,000,000	$25,000,000	$20,000,000	**($15,000,000)**	**($5,000,000)**	**($1,000,000)**	$30,000,000	$20,000,000	$19,000,000
$15,000,000	$5,000,000	$1,000,000	**($45,000,000)**	**($25,000,000)**	**($20,000,000)**	**($30,000,000)**	**($20,000,000)**	**($19,000,000)**
$250,000,000	$100,000,000	$50,000,000	**($25,000,000)**	**($10,000,000)**	**($5,000,000)**	$225,000,000	$90,000,000	$45,000,000
$950,000,000	$550,000,000	$450,000,000	$0	$0	$0	$70,000,000	$34,000,000	$15,000,000

Calculation of Potential Outward Exposure—Continued

g.				***h.***	***i.***	***j.***	***k.***	***l.***	***m.***	***n.***	***o.***	***p.***
0.1	0.12	0.15										
Converted Amount per Table to § 1.3(SSS)				PFE Factor	Net Swap Value (NSV)	NSV Plus PFE Factor	NSV Minus PFE Factor	Adjusted NSV	Master Netting	Posted Collateral	Margining Adjustment	Pot. Outward Exposure
< = One Year	1–5 Years	> 5 Years	Total									
$1,000,000	$600,000	$1,500,000	$3,100,000	$3,100,000	**($5,000,000)**	**($1,900,000)**	**($8,100,000)**	**($8,100,000)**	$0	$0	$0	**($8,100,000)**
$3,000,000	$2,400,000	$2,850,000	$8,250,000	$8,250,000	**($30,000,000)**	**($21,750,000)**	**($38,250,000)**	**($38,250,000)**	$5,000,000	$5,000,000	$6,600,000	**($21,650,000)**
($3,000,000)	**($2,400,000)**	**($2,850,000)**	**($8,250,000)**	$8,250,000	$30,000,000	$38,250,000	$21,750,000	$0	$0	$0	$0	$0
$22,500,000	$10,800,000	$6,750,000	$40,050,000	$40,050,000	**($15,000,000)**	$25,050,000	**($55,050,000)**	**($55,050,000)**	$0	$0	$28,040,000	**($27,010,000)**
$7,000,000	$4,080,000	$2,250,000	$13,330,000	$13,330,000	**($160,000,000)**	**($146,670,000)**	**($173,330,000)**	**($173,330,000)**	$10,000,000	$100,000,000	$10,664,000	**($52,666,000)**
	Aggregate Uncollateralized Outward Exposure—Continued											**($109,426,000)**

EXHIBIT B

Proposed Language Changes

Proposed CFTC Rule 1.3(sss)(2)

(2) *Aggregate uncollateralized outward exposure.*

(i) *In general.* Aggregate uncollateralized outward exposure in general means the sum of the current exposure, obtained by marking-to-market using industry standard practices, of each of the person's swap positions with negative value in a major swap category, less the value of the collateral the person has posted in connection with those positions.

(ii) *Calculation of aggregate uncollateralized outward exposure.* In calculating this amount the person shall, with respect to each of its swap counterparties in a given major swap category:

(A) Determine the dollar value of the aggregate current exposure arising from each of its swap positions with negative value (subject to the netting provisions described below) in that major category by marking-to-market using industry standard practices; and

(B) Deduct from that dollar amount the aggregate value of the collateral the person has posted with respect to the swap positions.

The aggregate uncollateralized outward exposure shall be the sum of those uncollateralized amounts across all of the person's swap counterparties in the applicable major category.

(iii) *Relevance of netting agreements.*

(A) If the person has entered into multiple swaps under a single master agreement with a particular counterparty, or has a master netting agreement in effect with a particular counterparty to provide for netting of positions entered into under multiple master agreements, the person may measure the current exposure arising from its swaps in any major category on a net basis, as applicable, applying the terms of ~~the~~ each respective agreement. Calculation of net exposure may take into account offsetting positions entered into with that particular counterparty involving swaps (in any swap category) as well as security-based swaps, ~~and~~ securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements), forward contracts, and any other qualified contracts to the extent these are consistent with the offsets permitted by the respective master agreement or master netting agreement , as applicable.

(B) Such adjustments may not take into account any offset associated with positions that the person has with separate counterparties.

Comments:

Calculations of aggregate outward exposure should reflect two types of netting:

First, current exposure should be calculated on a net basis for all swap positions entered into under the same master agreement with a particular counterparty.

Second, to the extent that the person has a master netting agreement in effect with a particular counterparty [as described in (iii)(A) above], current exposure for that counterparty should be calculated net of any potential offsetting positions under other agreements pursuant to the master netting agreement. The Commission should not limit the types of offsetting positions that may be taken into account to those specifically described in (iii)(A).

Proposed CFTC Rule 1.3(sss)(3)

(3) Aggregate potential outward exposure.

(i) *In general.* Aggregate potential outward exposure in any major swap category means the sum of:

(A) The aggregate potential outward exposure for each of the person's swap positions in a major swap category that are not subject to daily mark-to-market margining and are not cleared by a registered clearing agency or derivatives clearing organization, as calculated in accordance with paragraph (sss)(3)(ii); and

(B) The aggregate potential outward exposure for each of the person's swap positions in such major swap category that are subject to daily mark-to-market margining or are cleared by a registered clearing agency or derivatives clearing organization, as calculated in accordance with paragraph (sss)(3)(iii) of this section.

(ii) *Calculation of potential outward exposure for swaps that are not subject to daily mark-to-market margining and are not cleared by a registered clearing agency or derivatives clearing organization.*

(A) *In general.*

(1) For positions in swaps that are not subject to daily mark-to-market margining and are not cleared by a registered clearing agency or a derivatives clearing organization, potential outward exposure equals the total notional ~~principal~~ amount of those positions~~,~~ calculated on a net basis for swaps entered into under a single master agreement with a particular counterparty, adjusted by the following multipliers on a position-by-position basis reflecting the type of swap. For any swap that does not appropriately fall within any of the specified categories, the "other commodities" conversion factors are to be used. If a swap is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the swap is zero, the remaining maturity equals the time until the next reset date. In the same respect, if a swap is structured with periodic settlement periods that occur over the life of the swap, where the parties calculate a settlement amount applicable only to that specific settlement period, the total notional amount of such swap should be bifurcated in calculations such that each settlement period constitutes a residual maturity for the notional amount applicable to that settlement period.

Table To § 1.3(sss)—Conversion Factor Matrix for Swaps

Residual maturity	Interest rate	Foreign exchange rate and gold	Precious metals (except gold)	Other commodities
One year or less	0.00	0.01	0.07	0.10
Over one to five years	0.005	0.05	0.07	0.12
Over five years	0.015	0.075	0.08	0.15

Residual maturity	Credit	Equity
One year or less	0.10	0.06
Over one to five years	0.10	0.08
Over five years	0.10	0.10

(2) Use of effective notional amounts. If the stated notional amount on a position is leveraged or enhanced by the structure of the position, the calculation in paragraph (sss)(3)(ii)(A)(1) of this section shall be based on the effective notional amount of the position rather than on the stated notional amount.

Comments:

The Commission should clarify that "notional amount" simply means the product of the notional underlying quantity in units (*i.e.,* MWh, MMBtu, gallons, *etc.*) of the applicable commodity with respect to each swap multiplied by current market price per unit of the applicable commodity. The term "notional amount" should be used consistently throughout the description of calculations. Notional amount should be calculated on net basis among all swaps entered into with a particular counterparty under a single master agreement. Additionally, the Commission should clarify that, for a swap that spans multiple time horizons specified in the Table to § 1.3(sss)—Conversion Factor Matrix for Swaps, the total notional amount for that swap should be bifurcated among applicable time periods when calculating potential outward exposure and not simply reported in the last applicable time period.

(3) Exclusion of certain positions. The calculation in paragraph (sss)(3)(ii)(A)(1) of this section shall exclude:

(i) Positions that constitute the purchase of an option, such that the person has no additional payment obligations under the position; and

(ii) Other positions for which the person has prepaid or otherwise satisfied all of its payment obligations.

(4) *Adjustment for certain positions.* Notwithstanding paragraph (sss)(3)(ii)(A)(1) of this section, the potential outward exposure associated with a position by which a person buys credit protection using a credit default swap or index credit default swap is capped at the net present value of the unpaid premiums.

(B) *Adjustment for* master *(B) Adjustment for master netting agreements. Notwithstanding paragraph (sss)(3)(ii)(A) of this section, for positions subject to master netting agreements the potential outward exposure associated with the person's swaps with each counterparty* may be reduced by amounts applicable to offsets permitted by the respective master netting agreement. If such offsets represent physically settled forward contracts pertaining to a non-financial commodity or security for deferred shipment or delivery or similar such contract that is not a swap, total notional amount of those positions calculated on a net basis for such forward contracts entered into under a single master agreement with a particular counterparty, adjusted by the multipliers specified in the Conversion Factor Matrix for Swaps specified above, on a position-by-position basis reflecting the type of swap that would me most applicable to such forward contract. For any forward contract that does not appropriately compare to any of the specified categories for swaps, the ''other commodities'' conversion factors are to be used. The total notional amount of each forward contract should be bifurcated in calculations such that each delivery period constitutes a residual maturity for the notional amount applicable to that delivery period. For other permitted offsets, potential outward exposure may only be reduced by amounts in excess of amounts included in calculations of aggregate uncollateralized outward exposure. ~~equals a weighted average of the potential outward exposure for the person's swaps with that counterparty as calculated under paragraph (sss)(3)(ii)(A), and that amount reduced by the ratio of net current exposure to gross current exposure, consistent with the following equation as calculated on a counterparty-by-counterparty basis:~~

~~*PNet* = *0.4* * *PGross* + *0.6* * *NGR* * *PGross*~~

~~Note to paragraph (sss)(3)(ii)(B): *PNet* is the potential outward exposure, adjusted for bilateral netting, of the person's swaps with a particular counterparty; *PGross* is that potential outward exposure without adjustment for bilateral netting; and *NGR* is the ratio of net current exposure to gross current exposure.~~

Comments:

The proposed methodology for calculating offsets attributable to master netting agreements is overly simplistic and would not likely produce reasonable results. Because the most likely type of offset to swaps exposure applicable to a valid and enforceable master netting agreement will be exposure related to forward contracts, the proposed methodology would produce a more reasonable result.

(iii) *Calculation of potential outward exposure for swaps that are subject to daily mark-to-market margining or are cleared by a registered clearing agency or derivatives clearing organization.* For positions in swaps that are subject to daily mark-to-market margining or cleared by a registered clearing agency or derivatives clearing organization:

(A) Potential outward exposure equals the potential exposure that would be attributed to such positions using the procedures in paragraph (sss)(3)(ii) of this section multiplied by 0.2.

(B) For purposes of this calculation, a swap shall be considered to be subject to daily mark-to-market margining if, and for so long as, the counterparties follow the daily practice of exchanging collateral to reflect changes in the current exposure arising from the swap (after taking into account any ~~other financial positions addressed by a~~offsets related to a master netting agreement between the counterparties and the existence of any thresholds for which a party is not required to post collateral). If the person is permitted by agreement to maintain a threshold for which it is not required to post collateral, only the ~~total~~ amount of that person's potential outward exposure that, when added to the person's aggregate outward exposure (prior to deducting aggregate value of the collateral the person has posted) would exceed~~of~~ that threshold, ~~(regardless of the actual exposure at any time) shall be added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (sss)(1)(i)(B), (ii)(B), (iii)(B) or (iv)(B) of this section, as applicable~~multiplied by 0.2. In addition, i~~I~~f the minimum transfer amount under the agreement is in excess of $1 million, the entirety of the minimum transfer amount shall be added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (sss)(1)(i)(B), (ii)(B), (iii)(B) or (iv)(B), as applicable.

(C) For purposes of this calculation, the dollar amount the aggregate value of collateral the person has posted with respect to the swap positions in excess of aggregate outward exposure, including amounts that represent initial margin, independent amounts, and the like, may be deducted when calculating potential outward exposure.

Comments:

The proposed methodology for addressing master netting agreements should be revised to clarify that the lesser of (i) measured exposure related to swaps, and (ii) specified threshold amounts, will be included in calculations at 100%. Only measured exposure in excess of specified amounts will be afforded the 80% discount (0.2 multiplier). This would also clarify that threshold amounts with respect to dormant master agreements would not be included in calculations. The proposed methodology should also be revised to include a deduction for initial margin, independent amounts, and the like since these amounts would be available to offset potential future exposure on applicable swaps.

February 22, 2011

DAVID A. STAWICK,
Secretary,
Commodity Futures Trading Commission,
Washington, D.C.

Re: *Joint Notice of Proposed Rulemaking on Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," RIN 3038–AD06*

Dear Secretary Stawick:

I. Introduction

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP submits the following in response to the request for public comment set forth in the Joint Notice of Proposed Rulemaking, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" ("*Proposed Rule*") issued by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions") and published in the *Federal Register* on December 21, 2010,[1] proposing to further define the term "Swap Dealer."

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. The Working Group considers and responds to requests for public 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 appreciates the opportunity to provide these comments in response to the *Proposed Rule* and respectfully requests that the Commission consider the comments set forth herein. The Working Group looks forward to working with the Commissions to further define the term Swap Dealer prior to the effective date of Title VII. The comments herein specifically address the proposed further definition of Swap Dealer set forth in proposed CFTC Rule 1.3(ppp), pursuant to Section

[1] *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"* 75 FED. REG. 80174 (Dec. 21, 2010).

1a(49) of the Commodity Exchange Act ("CEA"), as established by Title VII, Subtitle A, Section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act").

II. Executive Summary

The *Proposed Rule* fails to consider the differences between the energy commodity markets and the financial swap markets. Energy commodity markets, in which parties enter into swaps with each other to ensure physical delivery and manage price risk, are different from the swap markets. The energy commodity markets comprise a minuscule portion of the total national notional amount of swap transactions. The Commissions' proposed "one-size-fits-all" rule fails to recognize the unique nature of these markets. Unlike major financial institutions, non-dealer commercial energy firms function primarily as principals by transacting futures and energy-related swaps on a daily basis to mitigate price risk associated with providing necessary electricity, heating oil, natural gas, propane, gasoline and other energy commodities at affordable prices.

The *Proposed Rule* incorrectly assumes that swap markets, including energy commodity swap markets, do not operate without the involvement of swap dealers. It is well recognized that non-dealer commercial energy firms routinely enter into swap transactions with other non-dealer commercial energy firms in over-the-counter ("OTC") markets. Further, the *Proposed Rule* directly contradicts other proposed rules recently issued by the CFTC that clearly contemplate swap transactions occurring between two non-Swap Dealer counterparties.

The proposed definition of Swap Dealer is over-broad and inconsistent with the statutory terms and Congressional intent. Congress intended to enhance substantially the regulation of those in the business of being Swap Dealers, not expand the definition to include almost any and all market participants in the swap markets. Congress expressly provided that the term Swap Dealer shall have a parallel meaning to the term "dealer" under the securities laws and as is otherwise set forth in the Act.

Congress specifically listed four statutory criteria for Swap Dealers, provided for a General Exception, and created a *de minimis* test for those small or inconsequential Swap Dealers. The Commissions' authority to further define Swap Dealer is limited to providing certainty as to those listed criteria, not creating new criteria or interpreting the definition contrary to the express terms or intent of Congress. Thus, the definition of Swap Dealer must be construed narrowly, based on commonly understood terms of dealing activity, and must account for the existence of other market participants. Yet the Commissions' proposed "core" criteria of accommodating demand, being available to enter into swaps, entering into swaps with their own standard terms, or arranging swaps at the request of others provides for a broad definition of Swap Dealer that is not based on commonly understood terms of dealing activity.

The Commissions' interpretation of "market making" is broad and inconsistent with the CFTC's own definition and interpretation of the term. Historically, "market making" is incident to dealing activity by those holding themselves out as and known in the market to be Swap Dealers. Swap Dealers are in the business of taking either side of a swap to effectuate the trade, regardless of price or commodity. They are not the producers or owners of commodities nor do they have obligations to buy or deliver commodities as their primary business, unlike non-dealer commercial firms. The *Proposed Rule* should be revised to expressly exclude activity legitimately incidental to the businesses of non-dealer commercial firms.

Rather than providing clarity on the General Exception to swap dealing set forth by Congress, the Commissions proposed interpretation actually uses the General Exception to redefine the statutory Swap Dealer definition. The *Proposed Rule* ties the General Exception to language in the Swap Dealer definition, referring to swap dealing activity "as an ordinary course of" a "regular business." However, the Commissions' interpret this provision to say that any market participant in the swap markets is doing so as part of its regular business and thus is a dealer and unable to avail itself of the General Exception. Clearly, Congress did not intend any user of swap markets to be deemed a Swap Dealer. A better interpretation of the General Exception is to exclude swaps entered into by producers, processors, or commercial users of physical energy or agricultural commodities used as prudent price and risk management tools as part of the business of such producers, processors or commercial users of such commodities.

The proposed *de minimis* exemption swallows the rule. Rather than determining which "mom and pop" or inconsequential Swap Dealers are eligible for the statutorily provided exemption from the enhanced regulatory regime for significant Swap Dealers, the *Proposed Rule* uses this exemption to determine who is a Swap Dealer.

The rule inexplicably provides that any entity who enters into more than twenty swaps, has more than fifteen counterparties, or holds more than $100 million in notional amount is a Swap Dealer regardless of its regular business. Such interpretation essentially makes every market participant in the swap markets a Swap Dealer and renders the express statutory definition superfluous. The Commissions should clarify that the *de minimis* exemption applies to those Swap Dealers that hold no more than one one-thousand of one percent (.001%) of the total notional amount of the U.S. swap markets. Such definition would capture Swap Dealers with an inconsequential position and activity in the markets.

Alternatively, the Commissions should reconsider its rejection of a "relative test" for applying the *de minimis* exemption. Because the statutory definition of the *de minimis* exemption refers to "customers," it is entirely appropriate that the Commissions consider a relative test measuring the ratio of a firm's "customer" swaps notional amount to its total swaps notional amount. If an entity's ratio is less than 25%, it should be exempt from regulation as a Swap Dealer.

The *Proposed Rule* should make clear that no affiliate transactions be considered dealing activity, including application of the *de minimis* criteria. Inter-affiliate transactions are used to manage and allocate risk within a company and do not present any risk to the markets or counterparties.

Consistent with the Commissions' practices, the *Proposed Rule* should provide a safe harbor and process for market participants to determine in good faith and with due diligence whether they need to register as a Swap Dealer.

Finally, the cost and benefit analysis provided by the Commissions in the *Proposed Rule* does not appear to be based on any empirical data and does not appear to be consistent with the expected costs of compliance anticipated by market participants. The Commissions should therefore issue a supplemental rule in this proceeding setting forth empirical data supporting its conclusions regarding the costs and benefits of the *Proposed Rule.*

III. Comments of the Working Group of Commercial Energy Firms

The Working Group generally supports the efforts of Congress and the Commissions to reform the derivatives markets to prevent abuses that led to the current fiscal crisis. However, for reasons discussed herein, the Working Group urges the Commissions to carefully construe the definition of Swap Dealer and proposed interpretational guidance so that it achieves the overarching policy goals of the Act without imposing unwarranted burdens on domestic energy markets and undue costs on the energy sector of the U.S. economy.

As drafted, the Commissions' proposed definition of Swap Dealer and associated interpretive guidance are fundamentally flawed. The proposed definition and guidance would implement a "one-size-fits-all" approach to commodities regulation, which fails to recognize the unique characteristics of the various OTC commodity markets in which swaps are traded, including energy markets. In this regard, the Commissions' overly broad definition and guidance will sweep in a wide array of market participants that do not hold themselves out as "dealers" or engage in what has traditionally been viewed as "dealer" activity.

Such a result runs counter to the statutory language and Congress' intent to limit application of the Swap Dealer definition to those market participants engaged in what has historically been understood as "dealing" activity. Although Congress intended to enhance substantially the regulation of such activity, Congress also envisioned a regulatory framework conducive to the continued participation of active non-dealer market participants. Without significant revision, however, the Commissions' proposed definition and guidance will thwart this effort and instead create unacceptable uncertainty, likely resulting in adverse impacts to energy markets and energy providers and their customers.

A. Application of the Definition of Swap Dealer Should Avoid Adversely Impacting Domestic Energy Markets

Final regulations and interpretive guidance further defining the term "Swap Dealer" should be appropriately construed to avoid adverse impacts to domestic energy markets. Indeed, in the *Proposed Rule,* the Commissions properly recognize that "the swap markets are diverse and encompass a variety of situations in which parties enter into swaps with each other," such as in energy commodities markets, including swap transactions involving oil and natural gas, and electricity generation and transmission.[2] The Commissions highlight the complexities and unique characteristics of such energy markets and correctly invite comment as to "any different or additional factors that should be considered in applying the swap dealer defini-

[2] *Proposed Rule* at 80183.

tion to participants in these markets."[3] In accordance with this request, and to assist the Commissions in finalizing an appropriate definition of Swap Dealer that will not unduly burden domestic energy markets, the Working Group provides these comments regarding the unique characteristics of energy markets and the participants operating within these markets.

Energy markets possess unique characteristics in terms of the instruments transacted, the market participants themselves, and the underlying products transacted, such as certain commodities that are not stored and are not capable of being stored.[4] Distinct from institutions in the banking and financial system, which play an intermediary role in financial markets, nondealer commercial energy firms typically do not play intermediary roles in financial markets, and their swap trading activity is generally related to their respective physical portfolios of energy commodities.[5]

Unlike major financial institutions, non-dealer commercial energy firms function primarily as principals by transacting futures and energy-related swaps on a daily basis, among other things, to hedge (*i.e.,* mitigate or off-set) the price risk associated with their core business of providing electricity, heating oil, natural gas, propane, gasoline and other energy commodities at competitive prices to satisfy current and future energy supply and demand. In this regard, the operation of assets and related trading activities of one non-dealer commercial energy firm are largely independent of other non-dealer commercial energy firms in the same product market. Should one party become unable to trade, its counterparties can easily enter the market to match the resulting open positions.

Although significant external events can adversely impact multiple energy firms at the same time, the failure of one energy provider has never led to the systemic failure of the energy markets. Moreover, the failure of a non-dealer commercial energy firm has neither resulted in, nor raised concerns about, triggering a collapse of the U.S. banking and financial system. The absence of any large scale, long-term disruption of the operation of financial and physical energy markets following the Enron and Amaranth failures provides clear evidence that OTC derivatives in energy commodities do not create systemic risk to the financial system or within the energy industry of the type and nature that the Act is intended to prevent.[6]

Moreover, non-dealer commercial energy firms have a significant incentive to manage their exposure to all counterparties and, therefore, such firms are not materially at risk in the absence of government assistance. If the credit risk management practices and policies of non-dealer commercial energy firms are inadequate, the impacts of any resulting failure would fall on the shareholders of such entities, as was the case in the Enron and Amaranth failures. In the case of a failure of a non-dealer commercial energy firm, the burdens and obligations of the affected company will be borne by shareholders and investors, not by the federal government or, ultimately, taxpayers.

In light of the above, applying the proposed definition of Swap Dealer and interpretive guidance to non-dealer commercial energy firms is inconsistent with Congressional intent and would result in the imposition of unnecessary and burdensome transactional, operating, and compliance costs.[7] In order to cover such costs, nondealer commercial energy firms will be forced to divert resources away from investment in innovation, infrastructure, growth and jobs. Further, this will adversely affect liquidity, competition, efficiency and price discovery in energy markets as market participants either withdraw or no longer participate to the same extent. This,

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[3] *Id.* at 80183–184.

[4] Such commodities are traded in markets typically regulated by other state and federal regulators and governed by well-understood market rules.

[5] Non-dealer commercial energy firms primarily transact swaps to support hedging and trading activity associated with their underlying, primary physical business operations and/or that of their affiliates. From a trading perspective, this business involves transactions executed in physical energy markets, as well as hedges (which are often undertaken on a portfolio basis) and proprietary price discovery transactions executed in swap markets for energy commodities.

[6] *See* Dodd-Frank Act Conference Report Summary, available at *http://banking.senate.gov/public/index.cfm?FuseAction=Issues.View&Issue_id=84d77b9f-c7ab-6fe2-4640-9dd18189fb23*. The summary explains that the goals of the Act, in part, are to "identify and address systemic risks posed by large, complex companies, products, and activities before they threaten the stability of the economy." *Id.*

[7] *See* Comments of the Working Group submitted to the CFTC on December 15, 2010 in response to the CFTC's request for comment concerning the cost-benefit analysis conducted pursuant to CEA Section 15. *See Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants,* 75 FED. REG. 71397 (Nov. 23, 2010). In those comments, the Working Group detailed the significant costs likely to be imposed on commercial energy firms should such firms be deemed Swaps Dealers.

in turn, will result in higher energy prices for commercial, industrial, and retail consumers.

B. The Application of the "Core" Swap Dealer Criteria to Energy Markets Is Not Consistent With the Statutory Language

It is the extensive experience of the Working Group members that non-dealer commercial energy firms and other "traders" routinely enter into swap transactions where both parties are holding a position to hedge or to benefit from a forward view of the market rather than holding themselves out as "dealers." However, under the broadly worded and subjective "core" Swap Dealer criteria proposed by the Commissions, such non-dealer commercial energy firms could be viewed as "accommodating demand" for these transactions—a key indicator of "dealing activity" in the *Proposed Rule.*[8] As described in Part III.C.2, below, this result is not consistent with the statutory definition of Swap Dealer or the Congressional intent underlying Title VII. Further, the mere fact that the terms and conditions are customized should not change the role of that counterparty from that of a commercial market participant to that of a Swap Dealer.

1. Energy Swap Markets Routinely Operate Without the Involvement of Swap Dealers

The Working Group believes that the Commissions' assertion that significant parts of the swap markets do not operate without the involvement of Swap Dealers is both unsupported and flawed when applied to energy markets. Specifically, instead of providing any analysis of the issue, the Commissions offer only the following unsupported opinion:

> Some of the commenters appeared to suggest that significant parts of the swap markets operate without the involvement of swap dealers. We believe that this analysis is likely incorrect, and that the parties that fulfill the function of dealers should be identified and are likely to be swap dealers.[9]

Further, when discussing transaction activity in swap markets, the Commissions contend that:

> in some markets, non-dealers tend to constitute a large portion of swap dealers' counterparties. In contrast, non-dealers tend to enter into swaps with swap dealers more often than with other non-dealers.[10]

As detailed herein, the Working Group respectfully submits that these conclusions (i) are inaccurate with respect to energy markets, and (ii) are not supported by empirical data developed by, or provided at the request of, the Commissions.

It is well recognized that non-dealer commercial energy firms routinely enter into swap transactions with non-dealer counterparties (*e.g.,* other commercial firms) in OTC markets. Such transactions take place (i) in bilateral markets directly between the counterparties or where counterparties are matched by voice brokers, and (ii) on electronic trading facilities operating as exempt commercial markets, such as ICE. Indeed, a significant number of the transactions executed on ICE are between two end-user counterparties or between other non-dealer market participants.

In other proposed rules issued pursuant to the Act, the CFTC expressly contradicts its assertion here that significant parts of the swap markets do not operate without the involvement of Swap Dealers. For instance, in the recently released notice of proposed rulemaking addressing the end-user exception from mandatory clearing requirements, the CFTC recognizes that in certain markets more than one counterparty to a swap may be qualified to elect to use the end-user exception from clearing.[11] Because only "non-financial entities" can elect to use this exception, the language proposed in the *End-User NOPR* supports the proposition that portions of swap markets, notably energy markets, operate without dealer involvement.[12]

With respect to energy markets, as detailed in the below examples, non-dealer commercial energy firms will agree to enter into the "other side" of a bilateral swap

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[8] *Proposed Rule* at 80176 (proposing that "dealers tend to accommodate demand for swaps . . . from other parties."). *See also* Part III.C.2.d., *infra,* discussing the proposed "core" Swap Dealer criteria.

[9] *Proposed Rule* at 80177 n. 18.

[10] *Id.* at 80177.

[11] *End-User Exception to Mandatory Clearing of Swap,* 75 FED. REG. 80747 (Dec. 23, 2010) ("*End-User NOPR*").

[12] *Id.* (proposed CFTC Rule 39.6(a)). *See also Real-Time Public Reporting of Swap Transaction Data,* 75 FED. REG. 76141 (Dec. 7, 2010) (the proposed rule imposes reporting obligations on non-Swap Dealers for transactions executed off-facility "if neither party is a swap dealer nor a major swap participant."); *Swap Data Recordkeeping and Reporting Requirements,* 75 FED. REG. 76574 (Dec. 8, 2010) (same).

transaction proposed by another non-dealer counterparty where both parties are hedging or taking a forward view of the market. In this instance, neither party is engaged in swap dealing. They do not enter into such transactions (i) as a "service" to, or for the benefit of, their counterparty, (ii) to collect a fee, or (iii) as a "service" to, or for the benefit of the market generally, *i.e.,* to enhance liquidity. Because they enter into such transactions to take a position for their own benefit, and not the benefit of their counterparty, this trading activity does not constitute swap dealing. Similarly, due to the unique characteristics of the underlying physical energy markets, non-dealer commercial energy firms often enter into swaps with customized terms and conditions. These terms are often highly negotiated and are intended to address the specific needs of the counterparties, *i.e.,* hedging bespoke commercial risk or price discovery.

2. Specific Examples of Transactions Occurring in Energy Markets Without Swap Dealer Involvement

To assist the Commissions in better understanding the non-dealer to non-dealer transactions described above, the Working Group provides the following examples of transactions between non-dealer commercial energy firms that are ancillary or as an incident to their business as producers, processors, commercial users, or merchants of physical energy commodities.

Example 1: Hedge Between Two Non-Dealer Commercial Energy Firms

The following example illustrates how two non-dealer commercial energy firms seeking to hedge commercial risk can "respond to the interest of others" without "dealing."

> Company A is a natural gas producer that sells into the natural gas spot market.
>
> Company B is a retail seller of natural gas that sells natural gas to its customers at fixed prices but purchases the natural gas it sells in the spot market.
>
> Company A desires to hedge its spot sales exposure by entering into a swap where it is the floating price payer and receives a fixed payment. Company B desires to hedge its spot purchase exposure by entering into a swap where it is the fixed price payer and receives a floating payment.
>
> Company A and Company B have established bi-lateral trading documents and agreed on credit terms. They are aware of each others' business needs and regularly communicate regarding the possibility of a mutually beneficial trade to hedge their respective commercial risks.
>
> Company A and Company B enter into a swap where Company A is the floating price payer and Company B is the fixed price payer. The swap is priced such that Company B makes a margin between the fixed price it receives from its retail customers and the fixed price it pays to Company A. The floating price is the spot natural gas price.
>
> Company A and Company B are not Swap Dealers. They are entering into a swap to hedge their commercial risk. Company A has fixed its output price. Company B has locked-in its margin and hedged its purchase price. While the companies could achieve the same result by using an intermediary such as a Swap Dealer, their transaction is more economic as they have "cut out the middleman."

Example 2: Structured Deals

The following illustrates an example of how structured deals do not constitute "dealing."

> Company A enters into a deal to purchase all of the power off-take from a power plant for a period of 10 years. Company A also enters into a 10-year natural gas swap with the power plant, allowing it to fix its margins. The combination of those two transactions allows the owner of the plant to secure financing. Company A is not engaged in "dealing."

C. The Definition of Swap Dealer: Scope and Application

1. The Definition of Swap Dealer and Interpretive Guidance Must Promote Legal and Regulatory Certainty

The definition of Swap Dealer is a critical element of the new framework for the regulation of swaps in OTC markets embodied in Title VII of the Act. Together with the proposed definition of Major Swap Participant ("MSP"), the definition of Swap Dealer is one of the "gateways" through which the Commissions may exercise the new and expanded regulatory oversight authority granted to them under Title VII. The successful implementation of a new framework for the regulation of swaps is tied, in large part, directly to the Commissions' ability to further define and apply Swap Dealer in a fashion that (i) promotes regulatory and legal certainty, (ii) is faithful to the statutory provisions and intent of Congress, and (iii) is consistent with the overarching objectives and structure of Title VII.

If adopted as proposed, the Working Group is concerned that the definition of Swap Dealer and related guidance could be interpreted in a manner that effectively (i) limits the concept of an end-user to that of a one-directional (*i.e.,* buy-side only) hedger, and (ii) leaves commercial market participants with active swap trading operations at risk of being designated as a Swap Dealer, including commercial energy firms that primarily transact swaps to hedge underlying physical commodity portfolios, assets, or positions. Such an interpretation is not faithful to the statute or Congressional intent, would create legal and regulatory uncertainty, and would be highly disruptive to the efficient operation of swap markets.

The regulations implementing the definition of Swap Dealer must include a clear methodology that will allow market participants to determine whether they, or the counterparties with whom they transact, fall within this definition. This clarity and guidance is vital to ensuring the legal certainty and stability necessary to facilitate an orderly transition to new regulation under Title VII and avoid disruptions to energy swap markets.

2. The Commissions Should Define and Interpret the Term Swap Dealer in a Manner That Gives Effect to the Statutory Language and Congressional Intent

a. Congress Intended the Definition of Swap Dealer to Capture Entities Engaged in Traditional Dealing Activity

The statutory language of new CEA Section 1a(49) establishes an unambiguous definition of Swap Dealer, including express exceptions and exemptions, to reflect Congress' intent to (i) capture only those entities engaged in sufficient "dealing" activities to necessitate regulation under the Act, and (ii) to avoid inadvertently sweeping in those entities that are responsibly managing commercial risk.[13] At the outset of Title VII of the Act, Congress expressly made clear that the term Swap Dealer shall have the same meaning as used in the Securities Exchange Act of 1934 ("1934 Exchange Act") and as amended by the Act.[14] In this regard, Congress intended not to entirely redefine the well-known and understood meaning of what constitutes a "dealer," but rather Congress provided specific meaning and context to the definition by drawing from the 1934 Exchange Act and principles of the Dealer/Trader Distinction Rule.

In setting forth the definition of a "Swap Dealer," Congress expressly used the word "means" immediately following the term it intended to define, "Swap Dealer."[15] Importantly, Congress did not use the word "includes" or "consists of," nor did Congress list additional activities as illustrative, meaning Congress said what it meant.[16] Any general authority Congress provided to the Commissions to further define Swap Dealer cannot exceed the bounds of the express definition or ignore the intent of Congress.[17]

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[13] *See* Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010) ("Lincoln-Dodd Letter") (explaining that "this is also why we narrowed the scope of the Swap Dealer and Major Swap Participant definitions. We should not inadvertently pull in entities that are appropriately managing their risk."). *See also* 156 CONG. REC. H5248 (daily ed. June 30, 2010) (statements of Rep. Frank and Rep. Peterson recognizing Lincoln-Dodd Letter and entering into Congressional Record).

[14] *See* Section 711 of the Act (stating that the term "Swap Dealer" shall have the "same meaning[] given the term[] in section 1a of the Commodity Exchange Act . . . ."). The "same meaning" is the meaning provided by Congress in setting forth the definition of Swap Dealer in new CEA Section 1a(49), which parallels the meaning of "dealer" under existing securities laws and precedent.

[15] *See, e.g., Wilson* v. *U.S. Parole Commission,* 193 F.3d 195, 198 (3d Cir. 1999) (explaining that "[a]s a rule, a definition which declares what a term means is binding.") (citing *National City Lines, Inc.* v. *LLC Corp.,* 687 F.2d 1122 (8th Cir. 1982); *see also Colautti* v. *Franklin,* 439 U.S. 379, 392–93 (1979) (explaining that "[a] definition which declares what a term 'means' . . . excludes any meaning that is not stated.") (citing 2A C. Sands, *Statutes and Statutory Construction* § 47.07 (4th ed., Supp. 1978).

[16] *See, e.g., United States* v. *Gertz,* 249 F.2d 662, 666 (9th Cir. 1957) (explaining that "the word 'includes' is usually a term of enlargement, and not of limitation."); *Federal Election Commission* v. *Massachusetts Citizens for Life, Inc.,* 769 F.2d 13 (1st Cir. 1985); *Argosy Ltd.* v. *Hennigan,* 404 F.2d 14 (5th Cir. 1968).

[17] The Commissions cite to Sections 712(d) and 721(b) of the Act as providing authority to redefine the term Swap Dealer.

Specifically, Congress set forth the statutory elements for determining whether a person is a Swap Dealer, explicitly providing that "the term 'swap dealer' *means* any person who":

(i) holds itself out as a dealer in swaps;

(ii) makes a market in swaps;

(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.[18]

Accordingly, any person engaged in activities consistent with the express statutory criteria shall be deemed a Swap Dealer, and be subject to the applicable compliance obligations established in the Act. As detailed below, however, the Commissions went well beyond the express language of the statute, instead establishing additional "core" and "secondary" Swap Dealer criteria that are wholly inconsistent with the express statutory definition of Swap Dealer.

As part of the definition of Swap Dealer, Congress also included a General Exception to the definition, providing that the term Swap Dealer "does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." [19] The inclusion of the General Exception again reflects Congress' intent to capture entities engaged in traditional "dealing" activities, and thus the proper interpretation and application of the General Exception will avoid capturing entities not intended to be regulated as Swap Dealers, particularly those entities transacting in swap markets but not as a part of a regular business. To ensure the final rule and interpretive guidance properly reflect the statutory language and the intent of Congress, the Working Group provides, in Part III.D.1, below, specific comments and alternatives to the Commissions' definition and interpretation of the General Exception and the term "regular business."

Further, pursuant to the *de minimis* exemption established by Congress, entities that meet the swap dealing criteria set forth in new CEA Section 1a(49)(A) will nevertheless be exempt from the regulations of the Act applicable to Swap Dealers because their dealing activities would be so minimal as to not warrant regulation as a Swap Dealer.[20] In contrast, the Commissions' interpretation of this exemption suggests that if an entity fails to satisfy the *de minimis* criteria proposed by the Commissions, such entity would be deemed a Swap Dealer. Thus, rather than further limiting the scope of entities subject to the Act's Swap Dealer regulations, as intended by Congress, such an interpretation establishes additional criteria by which to identify entities as Swap Dealers.

b. The Statutory Definition of Swap Dealer is Based on the Definition and Interpretation of "Dealer" Under the Securities Laws and Rules

All four elements contained in the definition of Swap Dealer set forth in new CEA Section 1a(49)(A) are based upon the definition of "dealer" set forth in Section 3(a)(5) of the 1934 Exchange Act [21] and upon key elements of the SEC's long-standing and well-known "Dealer/Trader Distinction Rule." [22]

The first two prongs of the statutory definition of Swap Dealer—holding oneself out as a dealer in swaps and making a market in swaps, respectively—were clearly relied upon by Congress in crafting the definition of Swap Dealer.[23] Specifically, the

[18] New CEA Section 1a(49)(A).

[19] New CEA Section 1a(49)(C).

[20] Specifically, new CEA Section 1a(49)(D) provides that the "Commission shall exempt from designation as a swap dealer an entity that engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers." *Id*.

[21] *See* 15 U.S.C. § 78c(a)(5).

[22] *See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934,* 68 FED. REG. 8685, Final Rule, SEC Release No. 34–47364 (Mar. 2003) ("*Dealer/Trader Distinction Rule*"); Definition of Terms in Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Proposed Rule, SEC Release No. 34–46745 (Dec. 2002).

[23] The SEC explained, in part, in the *Dealer/Trader Distinction Rule* that ". . . the dealer definition has been interpreted to exclude 'traders.' The dealer/trader distinction recognizes that dealers normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have a regular turnover of inventory (or participate in the sale

Dealer/Trader Distinction Rule provides, in part, that a dealer is someone who is "*holding itself out as a dealer or market maker* or as being otherwise willing to buy or sell one or more securities on a continuous basis." [24]

In relevant part, Section 3(a)(5) of the 1934 Exchange Act defines a "dealer" as "any person that is engaged in the business of buying and selling securities for its own account through a broker or otherwise." This definition has clear overlap with the third prong of the definition of Swap Dealer, particularly the key element of engaging in, or entering into, activities for one's "own account."

Additionally, the "Exception" from the definition of dealer provided in the 1934 Exchange Act provides that "[t]he term 'dealer' does not include a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." Importantly, this exception is virtually identical to the General Exception included in the definition of Swap Dealer in new CEA Section 1a(49)(C).

The above comparison illustrates that Congress, in drafting the definition of Swap Dealer, adopted specific language and principles from the definition of "dealer" under the 1934 Exchange Act. Notably, Congress also chose not to adopt other SEC statutory language or principles based on SEC precedent. Accordingly, Congress intended that, in interpreting and implementing the term Swap Dealer, such interpretation should be modeled after the SEC's Dealer/Trader Distinction Rule, taking into account applicable differences between swaps and securities markets. Consequently, in further defining the term Swap Dealer, the Commissions were required to fully consider the SEC's interpretive guidance of the term "dealer." [25] However, as discussed below, the Commissions did not thoroughly consider existing precedent, choosing instead to adopt unsupported "core" and "secondary" criteria, which resulted in a proposed definition and interpretation of Swap Dealer that fails to follow the statute or effectuate the intent of Congress.

Furthermore, the Working Group believes that the Commissions' decision in the *Proposed Rule* to adopt Dealer/Trader Distinction—like guidance for security-based swaps, but not for swaps traded in commodity markets, is unreasonable in light of the statutory language and Congressional intent. The Commissions attempt to justify their distinction, in part, by explaining that:

> The definition of swap dealer should be informed by the differences between swaps, on the one hand, and securities and commodities, on the other. Transactions in cash market securities and commodities generally involve purchases and sales of tangible or intangible property. Swaps, in contrast, are notional contracts requiring the performance of agreed terms by each party.[26]

This is not, however, an informed basis to justify the SEC and CFTC adopting diametrically opposed positions for security-based swaps and swaps traded in commodity markets.[27]

To be sure, the definitions of "Swap Dealer" and "Security-based Swap Dealer" set forth in the Act are virtually identical and, as discussed above, modeled in large part on existing SEC precedent.[28] Yet, with limited explanation, the Commissions reach opposite results. Thus, the distinction is contrary to the express statutory language and Congressional intent, which support definitions of Swap Dealer and Security-based Swap Dealer that are consistent with SEC precedent.

c. The Definition of Swap Dealer Must Account for the Existence of Other Market Participants

The Commissions should establish guidance interpreting the definition of Swap Dealer that appropriately recognizes the existence of other market participants transacting in different types of swap markets. The regulatory framework adopted in Title VII is based upon the existence of, at a minimum, four classes of market participants: (i) Swap Dealers; (ii) MSPs; (iii) non-financial end-users (*i.e.,* those eli-

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or distribution of new issues, such as by acting as an underwriter), and generally provide liquidity services in transactions with investors (or, in the case of dealers who are market makers, for other professionals)." *See Dealer/Trader Distinction Rule* at 8688 (citations omitted).

[24] *See Dealer/Trader Distinction Rule* at 8689 n. 26 (citing OTC Derivatives Dealers, Release No. 34–40594, Section II.A.1., n.61, 63 FED. REG. 59,362, 59,370 (Nov. 3, 1998)) (emphasis added).

[25] *See* note 14, *supra.*

[26] *Proposed Rule* at 80176.

[27] Notably, the SEC applies the Dealer/Trader Distinction Rule to options, which, like swaps, are a derivative for which there is no limitation on the quantity of the underlying asset and there is no requirement to hold inventory in order to be a dealer. Thus, the basis for the Commissions' distinction lacks a thorough understanding of the swaps and securities markets.

[28] *Compare* new CEA Section 1a(49) and new 1934 Exchange Act Section 3(a)(71).

gible to use the clearing exception); and (iv) all other market participants that are not Swap Dealers, MSPs, or non-financial end-users. Pursuant to the framework contemplated by Congress, the Commissions are required to further define Swap Dealer in a manner that gives meaning and effect to each distinct class of market participant.

The proposed definition of Swap Dealer and the interpretational guidance in the *Proposed Rule* are based upon a very broad reading of the four disjunctive prongs of new CEA Section 1a(49)(A)(i)–(iv). Rather than proposing interpretational guidance for each of the four disjunctive prongs of the statutory definition of Swap Dealer, the subjective identifying characteristics promoted by the Commissions appear to apply to all prongs. This approach to identifying Swap Dealers, as well as the qualified guidance interpreting the General Exception to the definition of Swap Dealer, creates uncertainty regarding the universe of market participants that must register as a Swap Dealer.

To minimize such uncertainty, to the greatest extent possible, concrete and objective fact-based guidance should be included in the final rule that clearly illustrates swap trading activity that falls either within (i) the definition of Swap Dealer or (ii) the General Exception. Because the *Proposed Rule* unequivocally places the obligation on market participants to self-select whether they must register as a Swap Dealer, this guidance is particularly important to mitigate potential non-compliance risk.

d. The Proposed "Core" Swap Dealer Criteria Do Not Distinguish Between the Roles of Different Swap Market Participants

Citing the unique characteristics of swap markets, the Commissions decline to adopt interpretive guidance distinguishing the activities of dealers from traders in swap markets.[29] In lieu of adopting such guidance, the Commissions propose certain "core" criteria for identifying Swap Dealers ("Core S/D Criteria"), as well as other additional criteria ("Secondary S/D Criteria").[30] As noted above, in order to demonstrate consistency with the express statutory definition, the underlying Congressional intent, and the regulatory framework embodied in Title VII, the guidance interpreting the definition of Swap Dealer should distinguish the roles of different swap market participants in a meaningful manner. Moreover, such guidance should recognize that, in certain instances, dealers and traders engage in overlapping types of conduct; however, this fact alone should not result in a trader being subject to dealer regulation.[31]

The proposed Core and Secondary S/D Criteria do not accomplish these objectives. To be sure, Congress intended for the CFTC to regulate only those swap market participants who engage in dealing, a concept well-understood and recognized in securities markets. The proposed Core and Secondary S/D Criteria instead provide only vague concepts that will potentially sweep in numerous other market partici-

[29] *Proposed Rule* at 80177–178.

[30] *Id.* at 80,176, 80,178. The Commissions' proposed Core S/D Criteria provide that:

- dealers tend to accommodate demand for swaps and security-based swaps from other parties;
- dealers are generally available to enter into swaps or security-based swaps to facilitate other parties' interest in entering into those instruments;
- dealers tend not to request that other parties propose terms of swaps or security-based swaps; rather, dealers tend to enter into those instruments on their own standard terms or terms they arrange in response to other parties' interest; and
- dealers tend to be able to arrange customized terms for swaps or security-based swaps upon request, or create new types of swaps or security-based swaps at the dealer's own initiative.

[31] It is instructive to look at the definitions of "swap dealer" and "producer/merchant/processor/user" set forth in the explanatory notes of the CFTC's *Disaggregated Commitment of Traders Report:*

> *Producer/Merchant/Processor/User:* An entity that predominantly engages in the production, processing, packing or handling of a physical commodity and uses the futures markets to manage or hedge risks associated with those activities.
>
> *Swap Dealer:* An entity that deals primarily in swaps for a commodity and uses the futures markets to manage or hedge the risk associated with those swaps transactions. The swap dealer's counterparties may be speculative traders, like hedge funds, or traditional commercial clients that are managing risk arising from their dealings in the physical commodity.

See Disaggregated Commitments of Traders Report, Explanatory Notes, available at *http://www.cftc.gov/MarketReports/CommitmentsofTraders/DisaggregatedExplanatoryNotes/index.htm.*

pants within the definition of Swap Dealer—a result clearly not contemplated by Congress given the distinct classes of market participants established by Title VII. Indeed, to avoid such an unintended result, Congress purposely based the definition of Swap Dealer on applicable SEC precedent in order to limit the term's application to only those market participants engaged in what has historically been understood as dealing activity.[32]

3. The Commissions Should Interpret "Market Making" Consistent With Existing CFTC Interpretation

The Working Group is concerned that the Commissions' interpretation of the "market making" language in new CEA Sections 1a(49)(A)(ii) and 1a(49)(A)(iv) is overly broad and inconsistent with CFTC precedent. The Commissions should therefore reconsider their interpretation and issue interpretative guidance in the final rule clarifying the meaning and scope of this language. Such guidance should clearly recognize that the activity of "market making" is an incident of dealing activity in swap markets.

Consistent with the CFTC's glossary definition of "Market Maker," "dealing activity" generally occurs when a party acts as an intermediary for others to access a market.[33] A hallmark of dealing activity is that a party's business is to continually stand ready, willing, and able to take either side of a transaction and trade with its customers in accordance with a "bid/ask" spread on its own account. In fact, the CFTC's definition of "Market Maker" connotes this "obligation" to buy or sell.[34] In general, a dealer seeks to remain neutral to price movements with respect to the swap at issue, as well as the underlying commodity. Dealers, in large part, profit from intermediation fees and ancillary services to their dealing activity (*e.g.,* providing investment advice), not from realizing changes in the value of the swaps transacted or the underlying commodities.

In contrast, a non-dealer commercial energy firm, on occasion, may take either side of any particular swap transaction, depending on its needs. This behavior is distinct from dealing activity as it is driven by the commercial energy firm's underlying commercial business operations, including specific customer-related obligations in physical markets. Given this direct nexus to the commercial energy firm's primary business operations in physical markets, such activity does not constitute "market making" and is not incident to dealing activity in swap markets.

The Commissions should interpret "market making" in a manner that is generally consistent with the CFTC's own glossary definition of "Market Maker." This may be accomplished by the development of enumerated criteria that identifies different activities that constitute "market making" in swap markets, *i.e.,* a person who has an obligation to buy when there is an excess of sell orders and to sell when there is an excess of buy orders.

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[32] *See* Part III.C.2.b., *supra,* discussing Congress' intent to base the definition of Swap Dealer on the 1934 Exchange Act definition of "dealer" and the Dealer/Trader Distinction Rule.

[33] The CFTC's online glossary, titled "A Guide to the Language of the Futures Industry," sets forth the Commission's own definition of the term "Market Maker." As highlighted below, the CFTC views a market maker as an entity that has an obligation to buy or sell when there is an excess of sell or buy orders (as the case may be):

> [P]rofessional securities dealer or person with trading privileges on an exchange *who has an obligation to buy when there is an excess of sell orders and to sell when there is an excess of buy orders.* By maintaining an offering price sufficiently higher than their buying price, these firms are compensated for the risk involved in allowing their inventory of securities to act as a buffer against temporary order imbalances. In the futures industry, this term is sometimes loosely used to refer to a floor trader or local who, in speculating for his own account, provides a market for commercial users of the market. Occasionally a futures exchange will compensate a person with exchange trading privileges to take on the obligations of a market-maker to enhance liquidity in a newly listed or lightly traded futures contract. (Emphasis added).

See https://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm.

[34] *See* note 33, *supra. See also* SEC online guidance interpreting a "Market Maker" as:

> a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price. You'll most often hear about market makers in the context of the NASDAQ or other "over the counter" (OTC) markets. Market makers that stand ready to buy and sell stocks listed on an exchange, such as the New York Stock Exchange, are called "third market makers." Many OTC stocks have more than one market-maker. Market-makers generally must be ready to buy and sell at least 100 shares of a stock they make a market in. As a result, a large order from an investor may have to be filled by a number of market-makers at potentially different prices.

See http://www.sec.gov/answers/mktmaker.htm.

The Commissions should not, however, treat "market making" activity as the sole measure of whether an entity engaged in such activity is a Swap Dealer. An occasional two-way trade made by a market participant, when offered for customary commercial purposes, such as to briefly test a market for price discovery purposes or as an adjunct to an underlying physical business, does not constitute the type of "continuous, ready, willing and able" trading activity that is a key indicium of a "professional" market maker.

4. The Working Group Offers a Proposed Alternative Definition of Swap Dealer

In light of the numerous statutory and policy concerns outlined above with respect to the Commissions' proposed definition of Swap Dealer and interpretive guidance, the Working Group offers the following alternative definition of Swap Dealer that will mitigate many of the identified concerns and bring the definition and its interpretation back within the limited scope originally intended by Congress:

17 CFR 1.3(ppp) Swap Dealer.[35]

(1) IN GENERAL. The term "*swap dealer*" means any person who:

(i) Holds itself out as a dealer in swaps;
(ii) Makes a market in swaps;

''Makes a market'' means regularly providing two-sided pricing:

(a) for a particular swap for execution for a person's own account; or
(b) pursuant to a contractual obligation.

(iii) Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
(iv) Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.

provided, however, that an entity shall not be considered to be a swap dealer to the extent that it offers to enter into, or enters into, a swap:

(a) to hedge or mitigate commercial risk;
(b) for the purpose of benefiting from future changes in the commodity reference price (*i.e.,* the price to which the floating leg of a swap is indexed);
(c) on a designated contract market or swap execution facility, unless suchentity is making a market in that swap; or
(d) that is a physical option that includes the obligation to deliver or receive a commodity if the option is exercised.
(d) to provide two-sided pricing in a market of limited or episodic liquidity for the purpose of:

(I) discovering a price for the swap or the underlying commodity, or
(II) eliciting bids and offers for the swap from other marketparticipants.

Given that the Commissions' have interpreted the principle "market making" in a broad fashion, the first proposed change is to provide specificity to the second prong of the Swap Dealer definition by expressly defining the term "makes a market" as regularly providing two-sided pricing: (i) for a particular swap for execution for a person's own account, or (ii) pursuant to a contractual obligation. As previously described, making a market often means a party continually stands ready, willing, and able to take either side of a transaction and trade with its customers in accordance with a "bid/ask" spread on its own account.[36] The proposed additional language will ensure the market making prong is applied narrowly so as to limit the scope of entities subject to regulation as Swap Dealers to those entities engaged in the sort of dealing activity intended to be regulated by Congress under the Act.

The additional language offered by the Working Group—proposed subsections (a)–(d)—would expressly exclude from the definition those activities historically under-

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[35] Note, proposed new language is underlined. This alternative definition revises only new CEA Section 1a(49)(A). The Working Group offers revised language to the General Exception and the *de minimis* exemption in Sections III.D.1 and 2, herein. See also *Attachment A,* attached hereto.

[36] *See* Part III.C.3, *infra,* discussing the need for a consistent interpretation of "market making." *See also* note 34, *infra,* regarding SEC online guidance interpreting a "market maker," in part, as: "a firm that stands ready to buy and sell *a particular stock on a regular and continuous basis* at a publicly quoted price" (emphasis added).

stood as *not* constituting dealing. Namely, the proposed language would exclude the following activities:

- *Swaps for Hedging Commercial Risk:* The Commissions should expressly exclude from the Swap Dealer definition swaps offered or entered into for purposes of hedging or mitigating commercial risk. The Working Group recognizes that this principle is generally accepted by the Commissions; however, providing express language to this effect in the final rule would provide greater certainty to market participants and would effectuate Congressional intent.[37]
- *Swaps for Making a Profit:* The Commissions should expressly exclude from the definition of Swap Dealer swaps offered or entered into for purposes of benefiting from a forward view of the market, such as profits sought from future changes in the price of the underlying commodity. Doing so will ensure that the definition of Swap Dealer captures only those market participants involved in "dealing" activities.
- *Swaps Traded On-Facility:* The Commissions should expressly exclude from the definition of Swap Dealer swaps offered or entered into on designated contract markets and swap execution facilities, unless the entity entering into or offering the on-facility swap is making a market in that swap. Such an exclusion will provide certainty that market participants who are anonymously matched on a swap execution facility are not accommodating demand. This scenario clearly should not be considered as accommodating demand and yet because the Commissions' Core S/D Criteria are broad, the Working Group believes an express exclusion would better serve the market.
- *Physical Options:* The Commissions should expressly exclude from the definition of Swap Dealer swaps offered or entered into that are physical options that include an obligation to deliver or receive a commodity if the option is exercised. Such an exclusion is consistent with the definition of "swap" in new CEA Section 1a(47), which, if interpreted properly, excludes these physical options. Thus, without evidence to the contrary, the Commissions have no authority to regulate physical market participants as Swap Dealers simply for transacting in physical commodity options.
- *Providing Two-Sided Pricing in Markets of Limited or Episodic Liquidity:* The Commissions should exclude from the definition of Swap Dealer swaps offered or entered to provide two-sided pricing in a market of limited or episodic liquidity either for the purpose of (i) discovering a price for the swap or the underlying commodity, or (ii) eliciting bids and offers for the swap from other market participants. Such activity is distinct from dealing activity because the fundamental purpose is price discovery. Nor is this "market making" given that the market participant is not functioning specifically for the purpose of being a liquidity provider, but rather the activity is intended to be in furtherance of its commercial business.[38]

D. The Commissions Must Provide Greater Clarity and Guidance Regarding the Proposed General Exception and the *De Minimis* Exemption

1. The General Exception

a. The Interpretive Guidance Explaining "Regular Business" Is Circular and Creates Uncertainty

The Working Group believes that the decision of the Commissions to tie prong three of the definition of Swap Dealer to the General Exception, *i.e.,* to entities that regularly enter into swaps for their own account, is inconsistent with the clear Congressional intent of the General Exception and will result in significant legal and regulatory uncertainty for market participants. Specifically, the *Proposed Rule* states that:

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[37] The phrase "hedge or mitigate commercial risk" could ultimately be tied to proposed CFTC Rule 1.3(ttt), but *only if* the Commissions adopt the framework recommended by the Working Group with respect to proposed CFTC Rule 1.3(ttt) in comments submitted contemporaneously with this comment letter on the Commissions' proposed definitions of "Major Swap Participant" and "End-User."

[38] For example, a natural gas company holds natural gas inventory when the natural gas markets are thin at a value it believes to be $4.00/MMbtu. It posts a bid price of $3.80 and an offer of $4.20 for a portion of its inventory. If the bid price hits and the offer lifted, it now knows the $4.00/MMbtu estimation was low and it is in a better position to sell its full physical inventory at the higher price. If the company wanted to hold its inventory but try to execute its hedge position, it would engage in similar behavior to discover a true market price.

> . . . clause [1a(49)](A)(iii) of the definition should be read in combination with the express exception in subparagraph (C) of the swap dealer definition, which excludes "a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." Thus, the difference between the inclusion in clause (A)(iii) and the exclusion in subparagraph (C) is whether or not the person enters into swaps as a part of, or as an ordinary course of, a "regular business."[39]

The Commissions continue, explaining that:

> We believe that persons who enter into swaps as a part of a "regular business" are those persons whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties. *Conversely, persons who do not fulfill this function should not be deemed to enter into swaps as a "regular business" and are not likely to be swap dealers.*[40]

As evidenced by the above excerpts, rather than developing an independent basis by which to interpret "regular business," the Commissions define the General Exception by simply citing to the definition of Swap Dealer, resulting in circular reasoning that does not assist market participants in determining whether their activities meet the exception. Said differently, the Commissions rely upon the Swap Dealer definition to define what "regular business" is *not,* which, given the broad interpretation of Swap Dealer proposed by the Commissions, will undoubtedly create significant legal and regulatory uncertainty. The Commissions should avoid this circular logic and instead develop clear guidance as to what constitutes "regular business."

Additionally, the Commissions attempt to provide further guidance as to how the CFTC will determine whether an entity is a Swap Dealer, explaining that:

> In sum, to determine if a person is a swap dealer, we would consider that person's activities in relation to other parties with which it interacts in the swap markets. If a person is *available* to accommodate demand for swaps from other parties, *tends to* propose terms, or *tends to* engage in the other activities discussed above, then the person is *likely* to be a swap dealer. Persons that *rarely* engage in such activities are *less likely* to be deemed swap dealers.[41]

The Working Group believes that this interpretation, and the use of a number of qualifiers, such as the terms "not likely," "available," "tends to," "likely," "less likely," and "rarely," creates significant uncertainty regarding the scope and applicability of the General Exception. Congress provided an exception for those entities that engage in swap dealing activities that are incidental to their non-swap dealing businesses. Congress recognized that many businesses use swap markets to manage their financial and physical delivery obligations and commercial risk. This use is incidental to their primary businesses and their use of the swap markets in this manner does not make them Swap Dealers. Thus, the Commissions should clarify this language in order to (i) help more clearly define the universe of market participants that fall within the definition of Swap Dealer, and (ii) provide the legal and regulatory certainty required for market participants to rely in good faith on the General Exception.

b. In the Alternative, the Commissions Should Provide a Commodity-Based Exception

Given the shortcomings of the Commissions' proposed interpretation of "as a part of a regular business," the Working Group recommends that the Commissions revise the proposed General Exception. In doing so, the Commissions should make it clear that swap transactions entered into for customary economic purposes relating to a market participant's primary underlying business as a producer, processor, commercial user, or merchant of a physical energy or agricultural commodity should not be considered part of an entity's "regular business" for purposes of the General Exception.

To this end, the Working Group proposes the following revised definition of "Exception" for the Commissions' consideration:

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[39] *Proposed Rule* at 80177.
[40] *Id.* (emphasis added).
[41] *Id.* (emphasis added).

17 CFR 1.3(ppp)(2).[42]

EXCEPTION. The term "swap dealer" does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

(i) The following swap transactions shall not be considered in determining a person's Regular Business:

(a) Swaps entered into by a producer, processor, or commercial user of, or a merchant handling a physical energy or agricultural commodity that are ancillary or as an incident to the person's business as a producer, processor, or commercial user of, or a merchant handling a physical energy or agricultural commodity.

(ii) ''Regular Business'' means a usual and significant business activity of a person as measured by, among other things, revenues, profits, volume, value-at-risk, exposure and resources devoted to the business.

*2. **De Minimis** Exemption*

a. Proposed Alternative Approach to the *De Minimis* Exemption

The Commissions' interpretation of the *de minimis* exemption suggests that if an entity fails to satisfy the *de minimis* criteria proposed by the Commissions, such entity would be deemed a Swap Dealer. In this manner, the Commissions' proposed definition effectively establishes additional criteria by which to identify entities as Swap Dealers. Such an application of the exemption was not the intent of Congress. The Working Group believes Congress intended the *de minimis* exemption to apply to those Swap Dealers who engage in limited amounts of swap dealing or whose notional amount of exposure is small.

Further, the Working Group recognizes the widely accepted reports that at least 92% of the total value of the notional amounts of the outstanding OTC swaps is held by the 25 largest bank holding companies.[43] Such entities are Swap Dealers and should be covered by the *Proposed Rule.* The *de minimis* exemption should therefore be crafted to distinguish the remaining notional exposure in the entire U.S. swap market. The Commissions' proposed *de minimis* definition does not accomplish this objective.

In this context, the Working Group offers the following alternative approach to the *de minimis* exemption:

17 CFR 1.3(ppp)(4).[44]

DE MINIMIS EXCEPTION.

(i) A person shall not be deemed to be a swap dealer for any major category of swaps as a result of swap dealing in connection with transactions with or on behalf of its customers if the notional amount of the swap positions connected with those activities did not exceed one one-thousandth of one percent (.001%) of the total notional amount of swaps in the United States. The total notional amount of swaps in the United States shall be determined by the Commission on an annual calendar basis.

(ii) For purposes of this section, the measure of the percent of the total notional amount of swaps in the United States during a calendar quarter shall equal the arithmetic mean at the close of each business day, beginning the first business day of each calendar quarter and continuing through the last business day of that quarter.

(iii) A person that is not registered as a swap dealer, and which does not qualify for the exception in Section 1.3(ppp)(2) above, but which exceeds the criterion in this section as a result of its swaps dealing will not be deemed to be a swap dealer until the earlier of the date on which it submits a complete application for registration as a swap dealer or two months after the end of the calendar quarter in which it first exceeds this criterion. Notwithstanding the previous sentence, if a person that is not registered as a swap dealer meets the criteria in this section to be a swap dealer but

[42] Note, proposed new language is underlined. *See also Attachment A,* attached hereto.

[43] *See Public Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the House Committee on Agriculture,* 112th Cong. (Feb. 10, 2011) (testimony of CFTC Chairman Gary Gensler explaining that the size of the U.S. swaps market is approximately $300 trillion and that "the largest 25 bank holding companies currently have $277 trillion notional amount of swaps."). Based on Chairman Gensler's figures, the largest 25 bank holding companies control approximately 92 percent of the U.S. swaps market. *See also* "Goldman Sachs, Morgan Stanley Would Be Least Affected by Swaps Proposal," *Bloomberg News* (June 23, 2010), available at *http://www.bloomberg.com/news/2010-06-23/goldmansachs-morgan-stanley-would-be-least-affected-by-swaps-proposal.html* (concluding that the five major U.S. commercial banks and their subsidiaries held 97 percent of the notional amount of outstanding derivatives in the fourth quarter of 2009).

[44] Note, proposed new language is underlined. *See also Attachment A,* attached hereto.

does not exceed the threshold in (ii) by more than twenty percent in that quarter that person will not be subject to the timing requirements unless and until at the end of the next fiscal quarter that person exceeds the criterion.[45]

(iv) A person that is deemed to be a swap dealer in this section shall continue to be deemed a swap dealer until such time that its swap positions in (i) do not exceed the criterion for four consecutive quarters.

The Working Group suggests the alternative language as it provides an appropriate threshold to identify swap dealing which is above a *de minimis* level. The Working Group respectfully submits that one one-thousandth of one percent of the total notional amount of swaps in the U.S. is by definition a *de minimis* amount. Further, the calculation, as set forth above, mirrors the Commissions' proposal for determination of a MSP.

b. Rejection of a Relative Test for Applying the *De Minimis* Exemption Is Not Based on Reasoned Decision-Making

The Working Group has concerns with the Commissions' rejection of proposals to apply the *de minimis* exemption using a test that measures the size of an entity's customer-facing, dealing activities relative to the size its overall swap trading operations.[46] As support for this decision, the Commissions take the view that the use of a "relative test" for applying the *de minimis* exemption would favor larger, more active traders over smaller, less active traders. Specifically, the *Proposed Rule* states that:

> Aside from the fact that the statute does not explicitly call for a relative test, *such an approach would lead to the result that larger and more active companies, which presumably would be more able to influence the swap markets, would be more likely to qualify for the exemption than smaller and less active companies.* Also, a relative test would require a means of measuring the person's dealing activities, but also would require a means of measuring the larger scope of activities to which its swap dealing or security-based swap dealing activities are to be compared, thus introducing unnecessary complexity to the exemption's application.[47]

Notwithstanding the Commissions' position that the adoption of a relative test would favor companies with larger, more active swap trading operations, the Working Group contends that the rejection of such a test actually could competitively disadvantage such companies. Moreover, the basis for qualifying for the *de minimis* exemption appears to be fundamentally different from the basis for determining whether an entity is a trader and thus the Working Group requests that the Commissions reconsider a relative test.

The statement in the *Proposed Rule* that use of a "relative test" would harm smaller companies with less active trading operations is flawed. Regardless of an entity's size, if a dominant portion of its overall trading activities involve customer-facing transactions and the entity otherwise meets the definition of "Swap Dealer," then that entity's functional role in swap markets should be viewed as that of a "dealer." If the Commissions do not wish to impose the onerous prudential, business conduct, record-keeping and reporting requirements applicable to Swap Dealers on smaller companies with less active trading operations, then the Commissions should establish an exemption from such regulatory requirements, rather than exempting them from Swap Dealer status.

In this context, the Working Group recommends the Commissions consider replacing the proposed mechanism to define the *de minimis* threshold with an approach that examines the ratio of a firm's "customer" swaps notional amount (on a delta-equivalent basis) to total swaps notional amount (delta-equivalent), and excludes from the Swap Dealer definition any entity for which this ratio is less than 25%.[48]

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[45] Please note that in comments on the definition of "Major Swap Participant" submitted contemporaneously with this comment letter, the Working Group recommends different registration timing for MSPs than the timing presented here for Swap Dealers (*i.e.,* two consecutive quarters vs. two months after the end of the calendar quarter). In this comment letter, the Working Group maintains the CFTC's proposed Swap Dealer registration timing requirements in order to demonstrate the framework analysis.

[46] *Proposed Rule* at 80180.

[47] *Id.* (emphasis added).

[48] A definitional distinction that is critical for this alternative metric is that between "customer" and "counterparty." This distinction is created by the statutory language—new CEA Section 1a(49)(A)(iii) of the Swap Dealer definition refers to "counterparties," while the *de minimis* provision in Section 1a(49)(D) refers to "customers." However, the statute itself provides no definitional guidance for this distinction. The concept of "customer" seems to imply some manner of relationship that extends beyond the bare terms of the particular transaction, as distinct from

For banks subject to the Volcker rule, the value for the proposed metric should never be less than 0.5. This is the value of the metric in a world in which (1) the bank's customer deals do not provide any diversification of risk, (2) the bank hedges all of the risk from the customer deals with non-customer deals, and (3) the bank does no other non-customer deals because they would be prohibited by the Volcker rule. To the extent customer deals hedge each other and the bank hedges only the residual with non-customer deals, the metric will approach one (1.0). As a result, the proposed critical value of 0.25 provides ample room to assure that entities properly viewed as swap dealers cannot resort to the *de minimis* exception.

c. The Proposed Aggregate Gross Notional Amount Is Unsupported and Unduly Restrictive

Should the Commissions forego adopting the Working Group's proposed alternative *de minimis* definition or a relative test and instead maintain their proposed framework, the Working Group submits that the proposed hard cap on aggregate notional amount of $100 million is unsupported and unduly restrictive. Indeed, under the Commissions' proposal, a non-dealer commercial firm or end-user that has, for example, four customer-facing swaps with an aggregate notional amount of over $100 million would be required to register as a Swap Dealer. Such a result is at odds with Congressional intent to regulate as Swap Dealers only those entities commonly understood to engage in dealing activity.

The Commissions attempt to justify this cap with an unsupported assumption that the average amount of a small swap transaction is $5 million.[49] The Commissions, however, fail to set forth in the *Proposed Rule* the underlying data to support this claim, and thus the Commissions' decision to set the cap at $100 million lacks a proper evidentiary foundation.

In a further attempt to justify the $100 million notional amount threshold, the Commissions explain that:

> given the customer protection issues raised by swaps and security-based swaps—including the risks that counterparties may not fully appreciate when entering into swaps or securities-based swaps—we believe that this notional amount reflects a reasonable limit for identifying those entities that engage in a *de minimis* level of dealing activity.[50]

This rationale, however, does not hold up to closer scrutiny. The Act expressly prohibits unsophisticated parties from entering into inappropriate derivatives transactions by limiting the types of counterparties that can participate in those markets.[51] As such, only eligible contract participants ("ECP") are eligible to participate in off-facility swap transactions. Given that ECPs are sophisticated parties that fully appreciate the attendant risks involved when engaging in swaps in physical markets, the Commissions' assertion that such parties require "customer protection" is contrary to the market participant framework contemplated by Congress and established by the Act.

Due to the current economic recession in the U.S., energy prices remain depressed compared to periods of strong and sustained economic growth. Consequently, commercial energy firms that presently meet the requirements of the *de minimis* exemption may no longer meet this exemption if the aggregate notional amount of their existing deals exceed the $100 million threshold simply due to rising energy prices. As such, the Commissions should increase the hard cap for aggregate notional amount of customer-facing transactions beyond the proposed $100 million threshold, or otherwise provide some form of flexibility to market participants. At a minimum, the Commissions should include in the final rule any data related to its determination that the average value of a small swap transaction is $5 million.

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the relationship of mere trading counterparties, where two entities have met in the market place and transacted, each for its own reasons. One element suggestive of a "customer" relationship might be a concept of "solicitation," in the sense that a counterparty would be an entity's customer if such entity solicits the counterparty to do a transaction on the grounds that it will be beneficial to the counterparty. This "solicitation" concept must be distinguished from a "Request for Proposal" or "Request for Quote" process, in which an entity solicits transactions, but for the purpose of benefiting the entity itself, rather than for the benefit of the solicited counterparty or counterparties. In addition, a counterparty would seem to be an entity's customer if such entity provided advice on the transaction that was material to the counterparty's decision to transact, or with whom.

[49] *Proposed Rule* at 80180. The *Proposed Rule* provides that "[w]e understand that in general the notional size of a small swap or security-based swap is $5 million or less . . . ." *Id.*

[50] *Id.*

[51] *See* new CEA Section 2(e).

d. The Commissions Should Revisit the Scope and Application of the Twenty Transaction Threshold

Based on guidance in the *Proposed Rule* interpreting proposed CFTC Rule 1.3(ppp)(3) as covering different "types, classes, and categories of swaps," [52] the Working Group believes that the twenty transaction threshold of the *de minimis* exemption is grossly insufficient and should be significantly higher. To be sure, market participants exceeding the twenty transaction threshold, including non-dealer commercial firms and end-users, will be deemed Swap Dealers simply for transacting in swap markets for their customary business purposes. Certainly Congress did not intend for such a far-reaching result. In the absence of any supporting data from the Commissions, the Working Group is unable to contemplate any justification for this number and requests the Commissions to identify their reasoning. To the extent the Commissions do not have a reasonable basis, the Working Group requests the Commissions to develop a more appropriate transaction threshold based on empirical swap market data.

Should the Commissions fail to significantly increase the proposed threshold in the final rule, the Working Group seeks clarification regarding the scope and application of the proposed threshold embedded in the *de minimis* exemption. In the energy context, it is not clear whether the twenty transaction threshold would apply to all energy commodities combined (*i.e.,* energy swaps or metals swaps), or on a commodity-by-commodity basis (*i.e.,* power swaps, natural gas swaps, silver swaps, *etc.*). If the Commissions apply the threshold to all energy commodities combined, a commercial energy firm that engaged in the following customer-facing swaps would be required to register as a Swap Dealer: (i) three customer-facing crude swaps, (ii) three fuel swaps, (iii) three heating oil swaps, (iv) three gasoline swaps, (v) three natural gas swaps, (vi) three natural gas liquids swaps, and (vii) two power swaps. Such a result is clearly not intended by Congress, as numerous commercial energy firms will surpass the twenty transaction threshold simply by engaging in swaps for customary business activities, unrelated to any dealing activity whatsoever. At a minimum, therefore, the Commissions should apply the threshold on a commodity-by-commodity basis.

E. The Proposed Limited Designation Requirement Creates a Presumption Contrary to the Statute

The Commissions' proposed limited designation requirement creates a presumption that a person who is a Swap Dealer "shall be deemed to be a swap dealer with respect to each swap it enters into regardless of the category of the swap or the person's activities in connection with the swap." [53] Accordingly, the CFTC intends to view an entity deemed a Swap Dealer for one category of swaps to be deemed a Swap Dealer for all other activities, unless and until such entity seeks and obtains CFTC approval that its Swap Dealer designation should be limited to certain activities.

This presumption, however, is contrary to the express statutory language of the Act, which provides that:

> A person may be designated as a swap dealer for a single type or single class or category of swap activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.[54]

The statute expressly presumes that an entity may be deemed a Swap Dealer for some activities without being considered a Swap Dealer for other activities, thus creating a presumption in favor of the market participant, meaning an entity deemed to be a Swap Dealer for a swap or category of swaps should be presumed to be a Swap Dealer only for that particular activity. The Commissions have effectively flipped the statute on its head, establishing a presumption in direct contrast to the express statutory language. As such, the Working Group respectfully requests the Commissions to abandon proposed CFTC Rule 1.3(ppp)(3) or, alternatively, to revise the rule to reflect the fact that entities designated as a Swap Dealer for one category of swaps shall not be deemed a Swap Dealer or any other financial entity (as defined under CEA 2(h)(7)(C)) for other swaps.

[52] *Proposed Rule* at 80182.
[53] Proposed CFTC Rule 1.3(ppp)(3).
[54] New CEA Section 1a(49)(B).

F. Additional Issues Requiring Clarification With Respect to the Proposed Definition of Swap Dealer

1. Issues Related to Affiliate Transactions

The Commissions invite comment with respect to how the Swap Dealer definition should be applied to swaps executed between members of an affiliated group. The Working Group generally supports the approach taken by the Commissions with respect to affiliate transactions, particularly the Commissions' recognition that transactions between affiliates are used for risk management purposes and that swaps between affiliates "may not involve the interaction with unaffiliated persons that we believe is a hallmark of the elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a dealer." [55]

However, given that transactions between affiliates are used for the "allocation of risk within a corporate group," the Working Group requests the Commissions to clarify that in no case shall any transactions between corporate affiliates be considered dealing activity for purposes of determining whether an entity is a Swap Dealer, including application of the *de minimis* criteria. As noted by the Commissions, inter-affiliate transactions do not carry any of the elements of dealing activity given that the transactions are used to manage and allocate risk within a holding company system or other organizational structure.

2. Safe Harbor for Good Faith Efforts To Comply With the ***Proposed Rule***

The *Proposed Rule*'s requirement that market participants self-select whether registration as a Swap Dealer is required raises significant compliance risks. Consequently, the Commissions should seek to facilitate compliance with the *Proposed Rule* and work with industry members as the definition of Swap Dealer becomes effective. Market participants that exercise due diligence and make good faith efforts to determine whether registration is required, but do not register, should not be subject to enforcement action. Thus, the CFTC should enhance relevant guidance, including the No Action Letter process, for providing comfort to market participants that enforcement would not be recommended under specific fact-based scenarios.

G. The Commission's Cost-Benefit Analysis Is Insufficient and Inconsistent With Anticipated Compliance Costs

Section 15(a) of the CEA requires the CFTC, before promulgating a rule, to "consider the costs and benefits of the action of the Commission." [56] As a general matter, the cost and benefit analysis specific to regulations regarding Swap Dealers does not appear to be based on any empirical data and does not appear to be consistent with the expected costs of compliance anticipated by market participants.[57] In particular, the Swap Dealer cost-benefit analysis does not evaluate the costs to be imposed on the numerous additional market participants likely to be swept into the Swap Dealer category as a result of the overly broad definition of Swap Dealer proposed by the Commissions.

If these market participants choose to exit the swap markets rather than absorb the costs of potential regulation as a Swap Dealer, such departures will adversely impact liquidity as remaining swap transactions become concentrated in a smaller number of market participants, notably financial institutions. Accordingly, the Commissions should perform a liquidity cost analysis that assesses the probability and impacts of such a result. Such an analysis also should consider the number of non-dealer market participants expected to be designated as Swap Dealers simply for exceeding the low thresholds set forth in the Commissions' proposed *de minimis* framework.

The Working Group therefore requests that the Commissions (i) consider the costs and benefits associated with the *Proposed Rule* in the manner prescribed by CEA Section 15(a), (ii) issue a supplemental rule in this proceeding setting forth empirical data supporting its conclusions regarding the costs and benefits of the *Proposed Rule,* and (iii) notice the supplemental rule in the *Federal Register* for public comment.

IV. Conclusion

The Working Group supports appropriate regulation that brings transparency and stability to the energy swap markets in the United States. The Working Group appreciates this opportunity to comment and respectfully requests that the Commis-

[55] *Proposed Rule* at 80183.
[56] 7 U.S.C. § 19(a).
[57] *Proposed Rule* at 80204.

sion consider the comments set forth herein as it develops a final rule in this proceeding. If you have any questions, please contact the undersigned.

Respectfully submitted,

MARK W. MENEZES;
R. MICHAEL SWEENEY, JR.;
DAVID T. MCINDOE;
Counsel for the Working Group of Commercial Energy Firms.

ATTACHMENT A

Proposed Revised Definition of Swap Dealer

17 CFR 1.3(ppp) Swap Dealer.[1]

(1) IN GENERAL. The term "*swap dealer*" means any person who:

(i) Holds itself out as a dealer in swaps;
(ii) Makes a market in swaps;
''Makes a market'' means regularly providing two-sided pricing:

(a) for a particular swap for execution for a person's own account; or
(b) pursuant to a contractual obligation.

(iii) Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
(iv) Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.

provided, however, that an entity shall not be considered to be a swap dealer to the extent that it offers to enter into, or enters into, a swap:

(a) to hedge or mitigate commercial risk; [2]
(b) for the purpose of benefiting from future changes in the commodity reference price (*i.e.,* the price to which the floating leg of a swap is indexed);
(c) on a designated contract market or swap execution facility, unless such entity is making a market in that swap;
(d) that is a physical option that includes the obligation to deliver or receive a commodity if the option is exercised; or
(e) to provide two-sided pricing in a market of limited or episodic liquidity for the purpose of:

(I) discovering a price for the swap or the underlying commodity, or
(II) eliciting bids and offers for the swap from other market participants.

(2) EXCEPTION. The term "*swap dealer*" does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

(i) The following swap transactions shall not be considered in determining a person's Regular Business:

Swaps entered into by a producer, processor, or commercial user of, or a merchant handling a physical energy or agricultural commodity that are ancillary or as an incident to the person's business as a producer, processor, or commercial user of, or a merchant handling a physical energy or agricultural commodity.

(ii) ''Regular Business'' means a usual and significant business activity of a person as measured by, among other things, revenues, profits, volume, value-at-risk, exposure and resources devoted to the business.

(3) SCOPE. [No proposed changes.]
(4) *DE MINIMIS* EXCEPTION.

(i) A person shall not be deemed to be a swap dealer for any major category of swaps as a result of swap dealing activity in connection with transactions with or on behalf of its customers if the notional amount of the swap positions connected with those activities did not exceed one one-thousandth of one percent (.001%) of the total notional amount

[1] Please note that the underscored text reflects the Working Group's proposed revisions.
[2] The phrase "hedge or mitigate commercial risk" could ultimately be tied to proposed CFTC Rule 1.3(ttt), but *only if* the Commissions adopt the framework recommended by the Working Group with respect to proposed CFTC Rule 1.3(ttt) in comments submitted contemporaneously with this comment letter on the Commissions' proposed definitions of "Major Swap Participant" and "End-User."

of swaps in the United States. The total notional amount of swaps in the United States shall be determined by the Commission on an annual calendar basis.

(ii) For purposes of this section, the measure of the percent of the total notional amount of swaps in the United States during a calendar quarter shall equal the arithmetic mean at the close of each business day, beginning the first business day of each calendar quarter and continuing through the last business day of that quarter.

(iii) A person that is not registered as a swap dealer, and which does not qualify for the exception in Section 1.3(ppp)(2) above, but which exceeds the criterion in this section as a result of its swap dealing activity will not be deemed to be a swap dealer until the earlier of the date on which it submits a complete application for registration as a swap dealer or two months after the end of the calendar quarter in which it first exceeds this criterion. Notwithstanding the previous sentence, if a person that is not registered as a swap dealer meets the criteria in this section to be a swap dealer but does not exceed the threshold in (ii) by more than twenty percent in that quarter that person will not be subject to the timing requirements unless and until at the end of the next fiscal quarter that person exceeds the criterion.[3]

(iv) A person that is deemed to be a swap dealer in this section shall continue to be deemed a swap dealer until such time that its swap positions in (i) do not exceed the criterion for four consecutive quarters.

March 22, 2011

DAVID A. STAWICK,
Secretary,
Commodity Futures Trading Commission,
Washington, D.C.

Re: *Rulemaking under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter to the Commodity Futures Trading Commission (the "Commission") to offer certain observations regarding the approach by which the Commission might implement regulations under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1]

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. The Working Group considers and responds to requests for public comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

Because the Commission has not finalized the regulatory definition of the terms such as "swap dealer," "major swap participant" and "swap," members of the Working Group have commented on proposed rulemakings applicable to swap dealers and major swap participants and offer their thoughts contained herein on requirements imposed on "swap dealers" and "major swap participants." While members of the Working Group have never considered themselves, or been viewed by others as swap dealers or major swap participants, they are concerned with the breadth and vagueness of the proposed rules and, thus, have commented on proposed rules imposing obligations on swap dealers and major swap participants.

I. Comments of the Working Group

Title VII of the Dodd-Frank Act places a substantial burden on the Commission. The Commission is tasked with constructing a new regulatory regime for swap markets based on the contours set forth in the Dodd-Frank Act. It is charged with com-

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[3] In comments on the definition of "Major Swap Participant" submitted contemporaneously with this comment letter, the Working Group recommends different registration timing for MSPs than the timing presented here for Swap Dealers (*i.e.,* two consecutive quarters vs. two months after the end of the calendar quarter). In this comment letter, the Working Group maintains the CFTC's proposed Swap Dealer registration timing requirements in order to demonstrate the framework analysis.

[1] This letter sets out general observations about the Commission's rulemaking process to date. The Working Group intends to submit a separate letter on the topic of sequencing the final rules and their implementation.

pleting this monumental task in less than a year with limited resources. The Commission must balance the timing requirements set forth by Congress with the need to construct rules that (1) accomplish the goals of the Dodd-Frank Act, (2) are enforceable by the Commission and (3) cause the least disruption in, and impose the lowest possible costs on swap markets.[2] The Working Group respectfully submits this letter to assist the Commission in satisfying these three goals.

A. Market Analysis

As a threshold matter, when proposing a rule, the Commission should conduct a careful analysis of the markets and market participants to which the rule will apply. Without a comprehensive understanding of the relevant market and its participants, the Commission will be unable to ensure that such proposed rule will meet the three goals set forth above. Further, analysis of the relevant market and its participants is necessary to satisfy the Commission's cost benefit obligations under Section 15(a) of the CEA. Such analysis is warranted particularly for swap markets that traditionally have not been regulated pervasively by the Commission, such as the energy swap markets.

The current approach taken by the Commission to the regulation of swap markets does not appear to have the benefit of such careful market analysis. For example, as Chairman Gensler has stated repeatedly, over $277 trillion in notional amount of domestic swaps are held by 25 bank holding companies.[3] Said another way, those 25 bank holding companies are party to 91–99% of domestic swaps. Despite these compelling statistics, the proposed definition of "swap dealer" appears to be based on the premise that the universe of swap dealers extends far beyond this group of financial institutions.[4] Drafting the definition of "swap dealer" in a manner that captures entities far beyond these 25 bank holding companies will have serious implications for swap markets. As noted above, in crafting rules, the Commission must take into account the costs of regulation. In this instance, the Commission must weigh (a) the costs of extending the comprehensive regulation imposed on swap dealers to entities beyond the 25 bank holding companies against (b) the potential benefits of this additional regulation. If the Commission extends the definition of "swap dealer" beyond such bank holding companies, it will impose substantial additional costs on consumers and the overall swap markets, while providing little or no benefit to the economy. Further, extending the designation of swap dealers beyond these core bank holding companies will not further the underlying intent of the Dodd-Frank Act.

B. The Commission Should Continue Its Principles-Based Approach

1. The Dodd-Frank Act Generally Allows the Commission To Adopt Principles-Based Regulations

The Commission has an established history of effective oversight through a principles-based approach to regulation. The Working Group believes that the Commission should remain squarely within this tradition. This tradition results in clear statements of the goals and requirements of regulation and is based upon the market participants' deep experience and knowledge of the swap markets to create efficient compliance solutions. It also reduces the burden on the Commission to craft and monitor compliance with granular criteria.

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[2] Satisfying these three goals would not only fulfill the Commission's obligation under Section 15(a) of the Commodity Exchange Act ("CEA") to consider and evaluate the costs and benefits of a proposed rule, but it would also adhere to the intent of President Obama's Executive Order on Improving Regulation and Regulatory Review. Exec. Order No. 13563, 76 *Fed. Reg.* 3821 (January 18, 2011) (the "Executive Order"). The Working Group acknowledges, that as an independent agency, the Commission is not subject to the Executive Order. However, the Working Group encourages the Commission to adhere to President Obama's intent.

[3] *See, Public Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act,* 112th Cong. (Feb. 10, 2011) (statement of Hon. Gary Gensler, Chairman, CFTC). Chairman Gensler stated that, based on OCC estimates, the largest 25 bank holding companies held $277 trillion in notional amount of swaps and that the domestic swap market was approximately seven times larger than the $40 trillion futures market. Based on those figures, the 25 largest bank holding companies would hold 99% of the domestic swap market. *See also,* Chairman Gensler's Budget Transmission Letter (Feb. 14, 2011). Chairman Gensler stated that, based on OCC estimates, the largest 25 bank holding companies held $277 trillion in notional amount of swaps and that some estimates placed the size of the U.S. swap market at "as big as $300 trillion." Based on those figures, the 25 largest bank holding companies would hold 91% of the domestic swap market.

[4] *See,* Gary Gensler, Chairman, CFTC, Remarks Before ISDA Regional Conference (Sept. 16, 2010). Chairman Gensler stated "initial estimates are that there could be in excess of 200 entities that will seek to register as swap dealers."

While the Dodd-Frank Act is prescriptive in many of the requirements that it imposes,[5] many of the rules proposed by the Commission have been prescriptive when the Dodd-Frank Act allows the Commission ample latitude to craft rules consistent with a principles-based approach. For example, Section 731 of the Dodd-Frank Act requires the Commission to set basic duties of, and business conduct standards for, swap dealers and major swap participants, including disclosure of material risks associated with swaps and having processes in place to ensure compliance with position limits. However, the rules proposed by the Commission to implement such duties and business conduct standards go well beyond setting a general compliance, risk management, and disclosure framework for swap dealers and major swap participants. The Proposed Rule on Duties of Swap Dealers and Major Swap Participants would codify a set of detailed aspirational "best practices," arguably appropriate only as guidance for financial entities, as legal requirements for all swap dealers and major swap participants. The Proposed Rule on Business Conduct Standards for Swap Dealer and Major Swap Participants with Counterparties would impose a suitability standard on swap dealers and major swap participants and also seeks to codify a set of detailed aspirational "best practices" intended as guidance for financial entities as legal requirements for all swap dealers and major swap participants.[6]

In these two rulemakings, among others, the Commission has taken an unnecessary prescriptive approach. This approach will not result in market participants taking the proper approach to compliance, *i.e.,* developing an organic "culture of compliance" within the company to constantly improve compliance as markets evolve and react to conditions. A prescriptive approach limits the judgment of entities and their personnel to essentially binary decisions, and, thus, leads to robotic compliance practices that seek only to assure compliance with the letter of the Commission's regulations and not the intent. Under such prescriptive approach, market participants might know what they can and cannot do but will not fully understand the policy behind the rules.

2. Overly Prescriptive Rules Will Limit Participation in Swap Markets

Adopting prescriptive rules for all market participants based on aspirational "best practices" for financial entities will limit competition in swap markets. Markets function best when there is a large and diverse group of participants. This is particularly true in the energy swap markets, where many large commercial energy firms are active traders. This activity brings liquidity to the markets, and it also helps disperse counterparty credit risk. As drafted, many of the proposed rules might not be workable for non-financial swap market participants and, even if they prove workable, they would likely impose substantial costs on such market participants.

A prescriptive approach to rulemaking might lead to a perverse result of promoting the further concentration of market activity and risk in certain swap markets to institutions that are "too big to fail." The consequence of being a swap dealer or a major swap participant for a non-financial entity, such as a commercial energy firm, is that it will be regulated as a financial entity. Accordingly, depending on the scope and compliance burden imposed under the final regulations, it is possible that non-financial entities will decrease or discontinue their participation in swap markets.

Only entities that can structure their businesses to meet the prescriptive requirements included in many of the Commission's proposed rules will have the ability to be central players in markets. The burdens of regulatory compliance as a swap dealer or major swap participant effectively will become a substantial barrier to entry to those non-financial entities looking to become active, sophisticated traders in swap markets. Non-financial entities that are currently active market participants will have to reevaluate their activity in the swap markets. Some may continue as major market participants. Others may not. In such cases, the relative role of financial firms in the operation of the swaps market will increase and, as other entities leave the market, liquidity will likely decrease and volatility will increase.

This concern is especially relevant in swap markets that currently rely on non-dealer market participants for a substantial amount of transaction volume. In energy swap markets, many parties trade directly without the involvement of a swap

[5] *See, for example,* the requirement in Section 731 of the Dodd-Frank Act for swap dealers and major swap participants to provide daily marks to counterparties on uncleared swaps.

[6] *See* Notice of Proposed Rulemaking on Business Conduct Standards for Swap Dealer and Major Swap Participants with Counterparties 75 *Fed Reg.* 81519 (Dec. 28, 2010), notes 47, 50, 52. The "best practices" upon which the Commission relies on in certain circumstances are the work of the Counterparty Risk Management Policy Group, which was comprised almost entirely of representatives from the largest banks.

dealer or other intermediary. An overly broad definition of "swap dealer" or rules that force all energy swaps to be done through swap dealers or other intermediaries likely will harm an otherwise mature and efficient market. Swaps between commercial energy firms where neither party plays the role of a dealer bring cost savings to the market and energy consumers, valuable liquidity to the market and help disperse credit risk among a wide number of market participants that are generally outside the core of the U.S. financial system. Without certainty that they will not be regulated like financial entities, commercial energy firms will be reluctant to enter into swaps with each other. The end result will be a market dominated by financial firms that are "too big to fail," a loss of liquidity, a possible increase in consumer energy prices and a loss of market expertise.

C. Elective Rule Makings

As noted above, by requiring the Commission to issue numerous rulemakings in a short period of time, the Dodd-Frank Act tasks the Commission with a substantial undertaking. Given these mandatory obligations, the Working Group advises the Commission to postpone the consideration of any proposed rules not explicitly required by the Dodd-Frank Act ("Elective Rulemakings") until all of the required rulemakings have been completed, and more importantly, until the effects of the required rulemakings on swap markets are known.[7]

Delaying the consideration of the Elective Rulemakings would have multiple advantages. *First,* delaying these rulemakings will allow the Commission and market participants to dedicate their limited resources to only those undertakings required by Congress. *Second,* by waiting until the regulatory paradigm set forth by Title VII of the Dodd-Frank Act is in place, the Commission can determine if the Elective Rulemakings are in fact necessary. *Third,* if the Commission finds that the Elective Rulemakings are necessary, the delay will enable the Commission to focus on the Elective Rulemakings. Delay and subsequent consideration will ensure that the Elective Rulemakings further the intent of the Dodd-Frank Act, will work in swap markets, and will accomplish the desired result without imposing undue burdens on the Commission and swap market participants. In this light, the Working Group respectfully requests that the Commission postpone all Elective Rulemakings until the entire mandatory Dodd-Frank Act regulatory paradigm is in place.

D. Working Group Recommendations

In light of the difficulties that the Commission faces in creating rules that (1) accomplish the goals of the Dodd-Frank Act, (2) are workable for the Commission and market participants and (3) accomplish these two goals while limiting the negative impacts on swap markets, the Working Group has the following three suggestions.

First, the Working Group suggests that the Commission limit the scope of the definition of "swap dealer" in a manner that captures only those 25 bank holding companies that hold over 90% of the notional value of domestic swaps.[8] Doing so will accomplish the intent of the Dodd-Frank Act in that it will capture the overwhelming majority of the U.S. swap market and will do so in a manner that limits the costs to market participants. Adopting such a definition will allow the Commission to focus its limited resources on a small number of market participants and will allow traders who are not thought of by the market as swap dealers to remain active market participants. Setting a definition of swap dealer that captures the remaining minimal percentage of the market will impose substantial marginal costs on the Commission and on the many market participants that will be captured. Therefore, to do so, the Commission should determine that there is a compelling benefit to the market that outweighs the additional costs.

Second, where possible, the Commission should retain its traditional principles-based approach to regulation. The Dodd-Frank Act is prescriptive in some specific areas, but it generally does not limit the Commission's ability to write rules that provide discretion to market participants to design and implement compliance measures. Such adaptability is necessary to allow a diverse community of active traders to remain in swap markets so that such markets remain liquid and well functioning. Permissive rules will allow market participants to put in place compliance and risk

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[7] Elective Rulemakings include, but are not limited to, proposed rules on portfolio compression, portfolio reconciliation, the suitability standard for non-swap dealer and non-major swap participant counterparties and the provision of scenario analysis.

[8] The Working Group is not suggesting that the definition of "swap dealer" be constructed to capture these 25 bank holding companies because they are large bank holding companies. The definition should focus on the role played in the market by potential "swap dealers" and should be calibrated to capture these 25 bank holding companies because they are party to a vast majority of domestic swaps. The Commission, of course, has the authority to expand the definition if it is necessary with regards to the post-Dodd-Frank Act market structure.

management infrastructure that is most efficient for their individual circumstances. Issuing permissive rules will also allow the Commission to easily adapt such rules to changing market conditions. Said differently, prescriptive rules will likely be too rigid to adapt to changing market conditions, and it is probable that the Commission will have to reissue such rules to account for such changes. Finally, if the Commission issues permissive rules, it will allow market participants to approach compliance from a holistic perspective. Market participants will be able to construct compliance and risk management programs that encourage self-governing and self-reporting and create a culture of compliance rather than the "check-the-box" approach that is the logical outgrowth of prescriptive rules.

If the Commission elects to retain its traditional principles-based approach, the Working Group respectfully submits that the Commission develop a formal policy statement with respect to compliance under the rules it proposes under the Dodd-Frank Act. The statement should identify the policy objectives for the overall regulatory effort, the proper design of regulations to support those policy objectives and the factors by which the Commission will determine if its proposed regulations adhere to Congress' intent. This statement would be the "blueprint" for effective regulation of swap dealers and major swap participants. Adopting a policy statement will send a clear message to market participants of the Commission's policy goals and expectations, which will facilitate regulatory certainty as well as uniform and orderly enforcement of the existing and new rules and regulations adopted by the Commission.[9]

Third, the Working Group respectfully suggests that the Commission prioritize drafting sound and functional regulations over promulgating rules within a certain time period. Rulemaking should be a deliberate, methodical and iterative process. If the Commission, in its attempt to satisfy Congressionally mandated deadlines, issues rules that leave significant legal uncertainty, are unworkable or impose substantial unnecessary costs on swap markets, then it is likely that the Commission will have to revisit a number of rulemakings. If this is the case, not only would the Commission have to expend additional resources to do so, but swap markets will be confronted with an extended period of legal uncertainty.

Thankfully, Congress provided the Commission with two tools with which it can take the time necessary to draft regulations that (1) accomplish the goals of the Dodd-Frank Act, (2) are enforceable by the Commission and (3) satisfy these latter two goals while causing the least disruption in and imposing the lowest possible costs on swap markets, without departing significantly from the timing requirements set forth in Title VII of the Dodd-Frank Act.

Section 754 of the Dodd-Frank Act provides "the provisions of this subtitle shall take effect on the later of 360 days after the date of the enactment of this subtitle or, to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after the publication of the final rule or regulation implementing such provisions of this subtitle." Section 754 would allow the Commission to delay the effective date of any final rule promulgated under Title VII of the Dodd-Frank Act until the Commission determines the market is ready to comply. In addition, Section 723 of the Dodd-Frank Act grants the Commission the authority to allow market participants to remain subject to current Section 2(h) of the CEA for up to a year after the Dodd-Frank Act becomes effective.[10] The Working Group respectfully submits that by using the authority granted to it under Sections 754 or 723 of the Dodd-Frank Act, the Commission can take the time necessary to construct sound rules without violating Congress' required time frame.

II. Conclusion

The Working Group supports tailored regulation that brings transparency and stability to the swap markets in the United States. We appreciate the balance the Commission must strike between effective regulation and not hindering the

[9] There is a good amount of academic writing supporting the Working Group's suggestion for an integrated, principles-based regulatory paradigm. *See,* John S. Moot: *Compliance Programs, Penalty Mitigation and the FERC,* 29 ENERGY LAW JOURNAL 547 (2008); Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law,* 2002 COLUM. BUS. L. REV. 71 (2002); Kimberly D. Krawiec, *Corporate Decisionmaking: Organizational Misconduct: Beyond the Principal-Agent Model,* 32 FLA. ST. L. REV. 571 (2005); and Jennifer Arlen and Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes,* 72 N.Y.U.L. REV. 687 (1997).

[10] If the Commission elects to use the 2(h) extension in Section 723 to help phase in Title VII of the Dodd-Frank Act's compliance requirements, it is possible that the implementation dates for certain rules will be extended beyond the maximum one year 2(h) extension period. In such an event, the Working Group suggests that the Commission use its existing statutory authority to address any gaps in the regulatory treatment of swaps and swap market participants.

uncleared energy-based swap markets. The Working Group offers its advice and experience to assist the Commission in implementing the Act. Please let us know if you have any questions or would like additional information.

Respectfully submitted,

DAVID T. MCINDOE;
R. MICHAEL SWEENEY, JR.;
MARK W. MENEZES;
ALEXANDER S. HOLTAN;
Counsel for the Working Group of Commercial Energy Firms.

March 23, 2011

DAVID A. STAWICK,
Secretary,
Commodity Futures Trading Commission,
Washington, D.C.

Re: *Sequencing of Release of Final Rules under the Dodd-Frank Act*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter regarding the order in which the Commodity Futures Trading Commission (the "Commission") might issue final rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Working Group appreciates the opportunity to share its views with the Commission.

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. The Working Group considers and responds to requests for public comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

In developing the suggestions contained herein, the Working Group has focused on what it believes are the best interests of the swap markets, the Commission, other regulators, market participants, and the U.S. economy. The suggestions are based on the Working Group's experience in the energy markets, but can be applied to all swap markets. The ideas expressed herein are not intended to promote the interests of any one group. We firmly believe that the well-being of any market participant benefits the swap markets as a whole.

I. General Comments

The Working Group fully supports the Commission's focus on the sequencing of its rules under Title VII of the Dodd-Frank Act and the solicitation of input from market participants. A considered approach to the release of the final rules will greatly assist the transition of many market participants to the new regulatory paradigm, particularly for participants in swap markets such as the energy swaps market that the Commission largely has not regulated previously. If the Commission releases final rules, sets effective dates and sets implementation dates in a logical manner, market participants will have a meaningful opportunity to review such rules, evaluate their compliance obligations under such rules, and design and implement measures to meet such obligations in a reasonably efficient manner.[1]

The Working Group urges the Commission to not sacrifice sound reasoning for expediency and to take the time necessary to implement Title VII of the Dodd-Frank Act properly.[2] The Working Group recommends the Commission not release rules

[1] The use of different effective dates (the date on which a rule becomes effective) and implementation dates (the date on which market participants must comply with the relevant rule) will allow the Commission to gradually phase-in the regulatory requirements imposed by Title VII of the Dodd-Frank Act while providing the market with regulatory certainty as to regulatory obligations.

[2] A similar request was made by Senator Stabenow, Chairman of the Senate Committee on Agriculture, Nutrition and Forestry. Senator Stabenow stated "We must consider how new rules will fit together in a way that makes sense for the markets; whether that is phasing-in implementation or carefully sequencing the rules, . . . We must make sure the market infrastructure is in place, the technology is ready, and that market participants are able to meet the requirements of this law. The new accountability and transparency we have created is clearly in the public interest and the most important thing is to get it right, not do it quickly." *Implementation*

under title VII of the Dodd-Frank Act before such rules, taken in related subject matter groups, are fully developed. The market place is far better served if the Commission considers all of the final rules in a comprehensive and organized fashion. Doing so promotes consistency in terms and the overall design across the rules. Thus far, the rulemaking process has occurred piecemeal and not in a logical order, creating significant uncertainty in swap markets. A significant challenge in commenting on the rules proposed thus far is the impossibility for any market participant to understand how all of the rules fit together.[3] It will be substantially burdensome and costly if market participants must design and implement regulatory compliance and risk management programs without knowing all of the requirements of the Commission's regulations issued under the Dodd-Frank Act. The burden and cost are amplified as market participants face compliance deadlines that are too close in time.

A comprehensive review of the Commission's proposed rules shows that additional rulemakings are likely needed to further define key requirements and terms and how they will impact market participants.[4] In certain cases it might be appropriate for the Commission to reissue substantially revised versions of a proposed rule as comments received might demonstrate the need for significant changes from the initial proposed rule. Also, under established principles of administrative law, final rules are susceptible to challenge if (a) they did not provide parties with sufficient notice that the proposed rule might apply to them, thereby providing that person with a meaningful opportunity to comment or otherwise participate in the rulemaking process, or (b) do not constitute a logical outgrowth of the proposed rule. The Working Group encourages the Commission to facilitate continued public comment as it develops regulations.

At the close of the comment period of the last rule to be proposed under Title VII of the Dodd-Frank Act, the Commission should allow market participants a period of time to consider all of the rules proposed under Title VII of the Dodd-Frank Act in the aggregate.[5] Following the review period, the Commission should provide a period in which market participants can comment on all of the rules. These comments would not only address the merits and impacts of the rules on a holistic basis, but also the ultimate cost of implementation and the time it will take to comply with all requirements. The comments will no doubt be substantiality more informed and complete as market participants will have the benefit of placing each rule within the overall context of the Commission's new regulatory regime.

II. Market Participants Need Ample Time To Comply With Proposed Rules

Market participants have not had sufficient time to prepare to comply with rules to be issued by the Commission under Title VII of the Dodd-Frank Act. Title VII is a fundamental redesign of the derivative markets, particularly for the energy swap market. Title VII by itself did not provide an adequate basis for market participants to foresee all the implications of the market redesign. Uncertainty continues as to certain key definitions, such as the definition of "swap" and the definition of "swap dealer." Under the many proposed rules, entities face a myriad of potential requirements, many of which are interrelated and potentially redundant. While it might be reasonable to expect an entity to be in a position to quickly comply with one rule, it is not reasonable to expect an entity to be in immediate or almost immediate compliance with a substantial number of new rules at the same time or in rapid succession.

III. Two Important Observations About the Rules and the Marketplace

When considering the order in which the Commission might issue rules and the dates by which such rules become effective, the Commission should consider two concepts.

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of Title VII of the Wall Street Reform and Consumer Protection Act, Senate Committee on Agriculture, Nutrition and Forestry, 112th Cong. (Mar. 3, 2011) (statement of Senator Stabenow).

[3] The Working Group also is concerned that the proposed rules released to date mandate requirements that do not work well together. For example, in the proposed rule on *Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants* (76 FED. REG. 6715 (Feb. 8, 2011)), all documentation must be completed before or contemporaneous with trade execution, including the confirmation. (Proposed CFTC Rule § 23.504). However, in the proposed rule on *Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants* (75 FED. REG. 81519 (Dec. 28, 2010)), confirmations are done after trade execution. (Proposed CFTC Rule § 23.501).

[4] For example, the term "processed electronically" as used in proposed CFTC Rule 23.501 (swap confirmation) and the term "notional amount" as used in the proposed definition of "major swap participant" in proposed CFTC Rule 1.3(qqq) also must be further defined.

[5] We note that the Commission has informally continued to accept comments even though stated deadlines have passed. The Working Group proposes an official "open comment period."

First, the Commission's regulations can be structured as building blocks, one set of rules providing the necessary foundation for subsequent rules. Said a bit differently, the Commission should issue final rules in a manner that allows an entity to allocate resources, hire personnel and design and test systems to meet the requirements of one rule that then prepares such entity to address the requirements of a subsequent rule. For example, entities should be able to first hire a chief compliance officer who should have a reasonable period of time in which to write, test and implement policies and procedures that, in turn, allow that entity to provide compliant disclosure to its counterparties. In addition, many of the requirements imposed by the Dodd-Frank Act depend on the existence of other new regulatory entities. For example, the reporting requirements largely depend on swap data repositories being fully operational.

Second, not all entities that come within the definitions of "swap dealer" and "major swap participants" are the same or even similar. Some will have large swap portfolios and a substantial market share, presenting unique risks to the U.S. financial system. As these entities likely have been subject to prudential regulation by a financial regulator, their compliance and risk management infrastructure might be easily modified to meet the new requirements imposed by the Commission. Thus, compliance with the Commission's rules may be a minor incremental cost.[6] In contrast, many entities that might come within the definitions of "swap dealer" and "major swap participant," particularly those never subject to prudential regulation by a financial regulator, will likely have to make substantial or wholesale changes to their corporate structure and their compliance and risk management infrastructure. For these entities, the requirements of the Dodd-Frank Act and the Commission's rules represent a fundamental redesign of their operations and, in some cases, their business. In particular, many commercial energy firms still do not know if they are, and do not anticipate being, swap dealers. However, if they are deemed as such, this will be the first time many of them will be subject to prudential regulation and coming into compliance will be a costly, time consuming process.

Recognizing that all entities potentially designated as swap dealers are not similar: the Commission should concentrate its attention and resources to overseeing compliance by market participants previously subject to prudential regulation by a financial regulator, and that are commonly known today as swap dealers. The Commission should allow other entities that come within the definitions of "swap dealer" and "major swap participant" a longer period to meet their compliance obligations.

There is no standard test for determining which market participants are traditionally recognized as swap dealers. However, the Commission might focus on those bank holding companies that hold a vast majority of the market share in the swap markets. In his testimony before the House Committee on Agriculture, Chairman Gensler noted that 25 bank holding companies in the United States are a party to $277 trillion notional in swaps, which constitutes over 90% of domestic swaps.[7] In addition, these bank holding companies are already subject to some degree of prudential regulation by a financial regulator. If the Commission concentrates on those 25 bank holding companies first, the Commission will capture a vast majority of U.S.-based swap activity as an initial matter and will likely be imposing regulation on those entities most prepared to comply in short order.

While the Dodd-Frank Act and the Commission's regulations place most compliance obligations on swap dealers and major swap participants, many requirements will fall on entities that are not swap dealers or major swap participants. The Working Group recommends the Commission, to the greatest extent possible, impose compliance obligations on these market participants last, and only if necessary. Said differently, a swap dealer should come into compliance ahead of the end-users with which it trades swaps.

Even after the definitions of "swap dealer" and "major swap participant" are finalized, some entities still might not have a clear understanding if they are covered by the definitions and will need to seek guidance from the Commission as to their status or attributes of about their businesses. Such a consultation process should be developed in light of the vague and overly broad definitions that have been proposed.

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[6] For example, if the Commission adopts capital and margin requirements modeled after those imposed on banks, a vast majority of such institutions are banks and will likely have systems in place to comply with such capital and margin requirements with minimal modifications.

[7] *Public Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act,* House Committee on Agriculture, 112th Cong. (Feb. 10, 2011) (statement of Hon. Gary Gensler, Chairman, CFTC).

IV. Recommended Implementation Process

As alluded to above, each of the Commission's rules have at least three dates that the Commission should coordinate in the sequencing of the final rules it issues under the Dodd-Frank Act: (a) the date the rule is issued; (b) the date the rule is effective and (c) the implementation date(s) on which the compliance obligations must be satisfied. The distinction between these dates is important. The Commission should issue final rules with sufficient notice and, by careful structuring of effective dates and compliance deadlines, provide ample time for entities to come into compliance. As an alternative, the Commission could make the implementation date of one or more rules contingent on the implementation date of other rules that should logically come first in the series of rulemakings.

The Working Group recommends that the Commission issue final rules and set their effective and related compliance dates as set forth in *Exhibit A. Exhibit A* is comprehensive, but not exhaustive, list of all of the rules the Commission has proposed under the Dodd-Frank Act. In constructing *Exhibit A,* the Working Group first determined the major goals of the Dodd-Frank Act, such as putting in place a mandatory clearing requirement and reporting regime. The Working Group then determined which rules must be in place to reach that goal and put such rules in groups for sequencing purposes. The Working Group next determined the order in which such rule groups should be implemented in order to allow the market to adapt and continue to function. Finally, the Working Group combined the implementation plans for each individual goal into a macro-implementation plan, or critical path for implementation, which is reflected in *Exhibit A.*

The Working Group developed its recommendations based on the observation above that the rules work together in an iterative, building block manner. Accordingly, the Commission should first release the definitional rules, including the definition of swap, (with ample periods to facilitate entities engaging with the Commission to resolve uncertainties and otherwise reorganize or restructure their businesses). The definitional rules will allow parties to make critical determinations about their regulatory status and the derivatives transactions into which they enter. In addition, the Commission should issue final rules for the institutions, such as swap data repositories and derivatives clearing organizations, that will lay the ground work for the new regulatory regime as soon as practicable. Three months after issuing the final definitions, the Commission should issue the registration rules. This will allow the Commission to identify those entities that warrant immediate and longer term regulatory oversight. About the same time or shortly thereafter, the Commission should release rules for governance and internal business conduct standards. Swap dealers and major swap participants should have a period of time to organize and develop their systems and personnel to comply with regulations that do not entail counterparty interface. Only after swap dealers and major swap participants have their corporate structure, systems, policies and procedures in place should the Commission's rules governing transactions with counterparties become effective. Finally, rules that may place compliance obligations on entities that are not swap dealers or major swap participants should become effective.

It is our expectation that, once all of the regulatory requirements are known, entities will immediately begin working to implement measures in an attempt to comply with all rules applicable to them. However, it would be unreasonable to expect entities to implement all of these measures at the same time. Time is needed to allow thoughtful design and preparation. In addition, a phased-in approach will allow entities to incur costs over time.[8]

Finally, where a proposed rule requires substantial changes to existing information technology infrastructure or the creation of new information technology infrastructure, the Working Group requests that the Commission adopt a "beta testing" period coupled with a good faith safe harbor. During the beta testing period, market participants should be required to attempt to comply with the rule in question. However, if a market participant attempts to comply with such rule and fails because the relevant technology fails, the market participant should not face any sanction.

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[8] The Working Group of Commercial of Energy Firms, in its comments to the Commission's *Proposed Rules on Real-Time Public Reporting of Swap Transaction Data, Swap Data Recordkeeping and Reporting Requirements, and Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants,* all filed with the Commission on February 7, 2011, suggested a phase-in approach for the multiple reporting and record keeping requirements that might serve as a model for an overall phase-in approach.

V. Chairman Gensler's Suggested Approach to Implementation

In his speech before the Futures Industry Association, Chairman Gensler set forth a three group approach to the implementation of the final rules implementing Title VII of the Dodd-Frank Act.[9] The Working Group sees value in the Chairman's suggested approach. However, there are three issues about which the Working Group disagrees with the Chairman's plan.

First, the definition of "swap" should be issued at the beginning of the implementation process along with all other definitions. For many market participants, the scope of the definition of "swap" will be a substantial factor in the determination of whether they are a swap dealer or major swap participant. For example, without knowing which derivatives will be included in the definition of "swap," market participants will be unable to perform the tests necessary to determine whether they are a major swap participant. Waiting to the end of the implementation process to issue the final definition of "swap" will introduce significant uncertainty into the swap markets.

Second, the rules that address the institutions that will serve as the foundation of the post Dodd-Frank Act market infrastructure should be introduced as soon as practicable. Without those rules in place, market participants might be required to put in place expensive, though temporary, changes to systems in order to comply with the Dodd-Frank Act requirements.[10] The Chairman's proposed implementation plan would place many of these rules in the middle group. The Working Group suggests that these rules be addressed as a threshold matter.

Third, the Chairman's proposal anticipates being able to issue all final rules within the next six months. The Working Group believes that Commission staff will need a substantial period of time to consider market participants comments on many rules and will need additional time to make necessary changes to such rules. The Chairman's suggested timing would severely limit Commission staff's ability to draft well reasoned and sound final rules.

VI. Statutory Support for Extended Compliance Periods

Congress gave the Commission discretion in designing and implementing rules under the Dodd-Frank Act. In particular, Section 723 of the Act provided that the Commission, upon petition by market participants, could continue the availability of the exclusion of Section 2(h) of the CEA with respect to certain commodity transactions for up to one year after the general effectiveness of Title VII of the Dodd-Frank Act. Several entities applied to the Commission for the continued application of Section 2(h). The Commission might provide such continuation of Section 2(h) to facilitate an orderly transition to a new regulatory regime under the Dodd-Frank Act.[11] In addition, Section 754 of the Act allows the Commission to set effective dates for rules required under Title VII to be set at no earlier than sixty days after the publication of such rules. The authority granted to the Commission under Sections 723 and 754 of the Act should allow the Commission to provide the time necessary for market participants to come into compliance with the requirements of the new regulatory regime.

VII. Conclusion

The Working Group supports regulation that brings transparency and stability to the swap markets in the United States. The Working Group appreciates the balance the Commission must strike between effective regulation and not hindering the swap markets. Please let me know if you have any questions or would like additional information, including a working version of *Exhibit A.* In addition, members of the Working Group can be made available to meet with Commissioners or Commission staff to further discuss how the recommendations contained herein were reached.

Respectfully submitted,

DAVID T. MCINDOE;

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[9] CFTC Chairman Gary Gensler, *Implementing the Dodd-Frank Act,* Remarks before the Futures Industry Association's Annual International Futures Industry Conference, Boca Raton, Florida (Mar. 16, 2011).

[10] For example, if there are no SDRs in place, market participants could be required to put in place technology to report swaps directly to the Commission. Once SDRs come online, market participants will be required to put in place technology to report to SDRs.

[11] If the Commission elects to use the 2(h) extension in Section 723 to help phase in Title VII of the Dodd-Frank Act's compliance requirements, it is possible that the implementation dates for certain rules will be extended beyond the maximum one year 2(h) extension period. In such an event, the Working Group suggests that the Commission use its existing statutory authority to address any gaps in the regulatory treatment of swaps and swap market participants.

MARK W. MENEZES;
R. MICHAEL SWEENEY, JR.;
ALEXANDER S. HOLTAN;
Counsel for the Working Group of Commercial Energy Firms.

EXHIBIT A

Sequencing of Issuance of Final Rules Under the Dodd-Frank Act

This chart shows the order in which the Working Group suggests the Commission issue final rules.

The suggested schedule for the issuance of final rules does not include a hard start date. The Working Group recommends that the Commission start releasing the final rules in the sequence set forth below when each group of rules is ready to be considered.

Month	0	1	2	3	4	5	6	7
Definitions	Propose Definition of Swap and Reopen Comment Period on Other Definitions		Comment Period Closes for All Definitions		Issue Final Rules			
Duties						Reopen Comment Period	Comment Period Closes	Issue Final Rules
Capital and Margin	Propose Rules		Comment Period Closes		Issue Final Rules			
Institutions			Issue Final Rules Before the End of This Period					
Mandatory Clearing			Issue Final Rules Before the End of This Period					
Position Limits			Reissue Proposed Rule	Comment Period Closes		Issue Final Rules		
Reporting			First TAC Meeting*	Second TAC Meeting*	Third TAC Meeting*	Reopen Comment Period	Comment Period Closes	Issue Final Rules
Market Practices					Issue Final Rules			

Definitions—Given that the definition of "swap" has yet to be proposed and the comment period is closed on all other definitions, the Working Group requests that the Commission reopen the comment period for the other definitions upon proposing a definition of "swap," with such comment period for all such proposed rules closing in 60 days.

Duties—After all the final definitions are issued, market participants will have a clearer picture as to which entities the definitions cover. Market participants, armed with knowledge of the scope of the definitions, should be given an opportunity to comment on the proposed rules that might impose duties on them. Therefore, the Commission should reopen the comment period on those rules that impose duties on swap dealers and major swap participants after the final definitions have been published.

Capital and Margin—Capital and margin requirements should be made final (though not effective) on about the same day the definitions are finalized.

Institutions—The Working Group urges the Commission to issue final rules for market institutions as soon as practicable. The existence of entities such as SDRs and SEFs is integral to the new regulatory framework for swap markets. These institutions must be in place before market participants can begin to comply with requirements such as mandatory clearing and reporting.

Mandatory Clearing—As with market institutions, mandatory clearing rules should be finalized as soon as possible. The Commission should determine which swaps will be subject to the mandatory clearing requirements soon as possible. To make this process efficient, the Working Group recommends the Commission, as an initial matter, address only those swaps currently being cleared.

Position Limits—The Working Group, as discussed in its forthcoming comments on the proposed rule on position limits, anticipates that certain parts of the proposed position limits rules will have to be amended to such a degree that the proposed rule will have to be reissued. Once reissued, market participants should have at least an additional 30 days during which to comment on that proposed rule.

Reporting—Reporting will be a complex logistical undertaking. As a threshold matter, to even begin this process, an SDR must be registered for the relevant class of swaps. The Working Group recommends the Commission hold multiple Technology Advisory Committee meetings to walk through implementation issues with regard to the proposed reporting rules. After those meetings, market participants should be given the chance to file additional comments on such proposed rules.

Market Practices—Market practice rules should be issued by July 21, 2011, as required by Section 753 of the Act.

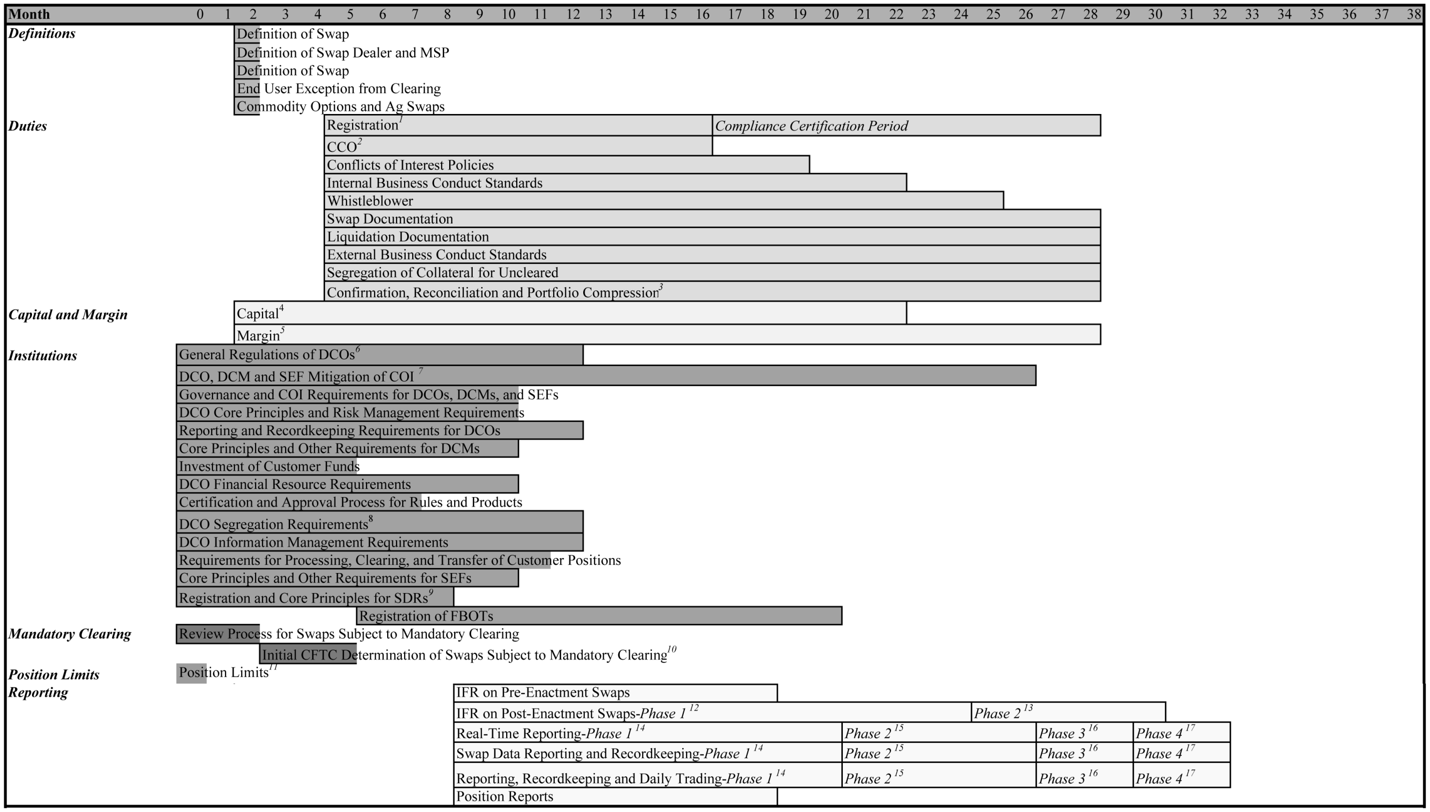
**Assuming there is an SDR.*

Sequencing of Implementation Dates for Rules Under the Dodd-Frank Act

Box Opening = Final Rule Released (or operation begun).

Box Closing = Implementation Date

The Implementation Date represents the time at which market participants must be in compliance with the relevant rule. For example, on the Implementation Date for the proposed rules on Registration and Core Principles for SDRs, any potential SDRs would have to be operational. The suggested implementation process does not include a hard start date. The Working Group recommends that the Commission start the suggested process when the final rules are ready to be issued in the sequenced manner suggested by the Working Group.


Month
0 1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30 31 32 33 34 35 36 37 38
Definitions
Definition of Swap
Definition of Swap Dealer and MSP
Definition of Swap
End User Exception from Clearing
Commodity Options and Ag Swaps
Duties
Registration[1]
Compliance Certification Period
CCO[2]
Conflicts of Interest Policies
Internal Business Conduct Standards
Whistleblower
Swap Documentation
Liquidation Documentation
External Business Conduct Standards
Segregation of Collateral for Uncleared
Confirmation, Reconciliation and Portfolio Compression[3]
Capital and Margin
Capital[4]
Margin[5]
Institutions
General Regulations of DCOs[6]
DCO, DCM and SEF Mitigation of COI [7]
Governance and COI Requirements for DCOs, DCMs, and SEFs
DCO Core Principles and Risk Management Requirements
Reporting and Recordkeeping Requirements for DCOs
Core Principles and Other Requirements for DCMs
Investment of Customer Funds
DCO Financial Resource Requirements
Certification and Approval Process for Rules and Products
DCO Segregation Requirements[8]
DCO Information Management Requirements
Requirements for Processing, Clearing, and Transfer of Customer Positions
Core Principles and Other Requirements for SEFs
Registration and Core Principles for SDRs[9]
Registration of FBOTs
Mandatory Clearing
Review Process for Swaps Subject to Mandatory Clearing
Initial CFTC Determination of Swaps Subject to Mandatory Clearing[10]
Position Limits
Position Limits[11]
Reporting
IFR on Pre-Enactment Swaps
IFR on Post-Enactment Swaps-Phase 1 [12]
Phase 2 [13]
Real-Time Reporting-Phase 1 [14]
Phase 2 [15]
Phase 3 [16]
Phase 4 [17]
Swap Data Reporting and Recordkeeping-Phase 1 [14]
Phase 2 [15]
Phase 3 [16]
Phase 4 [17]
Reporting, Recordkeeping and Daily Trading-Phase 1 [14]
Phase 2 [15]
Phase 3 [16]
Phase 4 [17]
Position Reports

Sequencing of Implementation Dates for Rules Under the Dodd-Frank Act—Continued

[1] *In its comments to the Commission's proposed rule on the registration of swap dealers and major swap participants, the Working Group recommended that the Commission allow market participants a one year period in which they could determine if they would have to register as a swap dealer or major swap participant. Following the registration period, the Working Group suggests a phased in approach to the certification of compliance for rules applicable to swap dealers and major swap participants.*

[2] *The Working Group recommends that the Commission require market participants first hire a CCO, then allow the CCO to put in place internal business conduct standards and then put in place business conduct standards for interaction with counterparties.*

[3] *The Working Group recommends that the Commission delay issuing any rules regarding portfolio compression and reconciliation until after the compliance deadline for all rules required under Title VII of the Dodd-Frank Act have been issued. If the Commission chooses to issue such rules, the Working Group estimates that the compliance deadline for such rules would be up to 12 months after what is currently depicted given the likely intensive IT modifications that will be required to comply.*

[4] *Capital Requirements may be one of the most costly regulatory requirements under Title VII. Market participants should be afforded the opportunity to review these rules prior to making elections as to whether to continue trading that results in such entity being designated a swap dealer or major swap participant. Such entities should also be afforded ample time to take corporate actions necessary to meet the capital requirements.*

[5] *The implementation of margin requirements will require documentation standards to be in place.*

[6] *The Working Group suggests that DCOs be operational within ten months of the effective date of the Dodd-Frank Act. Such a time frame will allow the Commission to complete action to effect the mandatory clearing requirement as soon as practicable.*

[7] *The Working Group realizes that this proposed rule might require existing DCOs to alter their current ownership structure, so the implementation time period is set at 26 months. However, rules that are not affected by the ownership structure of the DCO should be implemented earlier.*

[8] *The Working Group realizes that the Commission has not issued a proposed rule on this topic. To allow market participants to understand the implications of central clearing of swaps, segregation requirements for DCOs must be in place prior to the mandatory clearing requirement.*

[9] *SDRs would have to be operational on this date to allow market participants to begin to comply with reporting requirements in a timely fashion.*

[10] *This short implementation period assumes that (a) the Commission only initially reviews swaps that are currently cleared to determine if they should be subject to the mandatory clearing requirement and (b) the DCOs clearing these swaps will quickly be able to comply with the requirements imposed on DCOs by the Dodd-Frank Act. Those swaps should be deemed submitted to the Commission on the effective date of Dodd-Frank and the Commission should review them within the statutorily required 90 day period. The proposed timeline would allow the Commission to start the implementation process as late as June of 2012 and still meet the G20 goal of clearing all standardized derivatives by the end of 2012.*

[11] *The Working Group is still reviewing the Commission's Proposed Rule on Position Limits and will provide comment on the implementation timing in comments on that proposed rule.*

[12] *All traditional swap dealer reporting parties previously subject to prudential regulation by a financial regulator ("Traditional Swap Dealers").*

[13] *All other reporting parties.*

[14] *All swaps executed on facility or cleared through a DCO.*

[15] *All standardized swap executed off-facility and not centrally cleared entered into by Traditional Swap Dealers.*

[16] *All other standardized swap executed off-facility and not centrally cleared and all non-standardized swaps executed off-facility and not centrally cleared entered into by Traditional Swap Dealers.*

[17] *All other non-standardized swaps executed off-facility and not centrally cleared.*

Rule Categories

Definitions	Duties	Capital and Margin	Institutions	Mandatory Clearing	Position Limits	Reporting	Market Practices	Other
Definition of Swap	NOPR on Swap Trading Relationship Documentation for SDs and MSPs	Capital Requirements	NOPR on Core Principles and Other Requirements for SEFs	NOPR on Process for Review of Swaps for Mandatory Clearing	Position Limits	IFR on Reporting of Pre-Enactment Swaps	ANOPR on Disruptive Trading Practices	JNOPR on Reporting by Investment Advisors to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF
NOPR on Further Definitions of SD, MSP and ECPs	JNOPR on Orderly Liquidation Termination Provisions in Swap Trading Relationship Documentation for SDs and MSPs	Margin Requirement	NOPR on Governance and Additional COI Requirements for DCOs, DCMs, and SEFs	NOPR on Requirements for Processing, Clearing, and Transfer of Customer Positions		IFR on Reporting of Post-Enactment Swaps	NOPR on Prohibition of Market Manipulation	NOPR on Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations
NOPR on End-User Exception to Mandatory Clearing	NOPR on Designation and Duties of Chief Compliance Officer		NOPR on Core Principles and Risk Management Requirements for DCOs			NOPR on Real-Time Public Reporting of Swap Transaction and Pricing Data		NOPR on Conforming Amendments to Regulations Applicable to Commodity Pool Operators and Commodity Trading Advisors
NOPR on Commodity Options and Agricultural Swaps	NOPR on Conflict of Interest Policies for SDs & MSPs		NOPR on Reporting and Recordkeeping Requirements for DCOs			NOPR on Swap Data Reporting and Recordkeeping Requirements		NOPR on Removing References to Credit Ratings from Commission Regulations
NOPR on Definition of Agricultural Commodity	NOPR on Internal Business Conduct Standards for SDs and MSPs		NOPR on Registration of Intermediaries			NOPR on Reporting, Recordkeeping and Daily Trading Records for SDs & MSPs		NOPR on Business Affiliate Marketing and Disposal of Consumer Information Rules
	NOPR on Registration of Swap Dealers and Major Swap Participants		NOPR on Requirements for DCOs, DCMs, and SEFs Regarding the Mitigation of Conflicts of Interest			NOPR on Position Reports for Physical Commodity Swaps		NOPR on Privacy of Consumer Financial Information
	NOPR on Protection of Collateral of Counterparties to Uncleared Swaps		NOPR Regarding Investment of Customer Funds and Credit Ratings					NOPR on Conflict of Interest Policies for FCMs
	NOPR on Whistleblower Provisions		NOPR on Financial Resources Requirements for DCOs					

	NOPR on Business Conduct Standards with Counterparties		NOPR on Provisions Common to Registered Entities (Certification and Approval Procedures for New Products, Rules and Rule Amendments Submitted to the CFTC by Registered Entities)					
	NOPR on Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants		ANOPR on Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies					

March 28, 2011

DAVID A. STAWICK,
Secretary,
Commodity Futures Trading Commission,
Washington, D.C.

Re: *Position Limits for Derivatives,* RIN 3038–AD15 and 3038–AD16

Dear Secretary Stawick:

I. Introduction

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP 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") Notice of Proposed Rulemaking, *Position Limits for Derivatives* (the "*Proposed Rule*"), published in the *Federal Register* on January 26, 2011,[1] which establishes position limits for certain physical commodity derivatives pursuant to newly amended Section 4a(a) of the Commodity Exchange Act ("CEA"), as established by Section 737 the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act").[2]

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. The Working Group considers and responds to requests for public comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

II. Executive Summary

The Working Group strongly supports the goals of the Act to enhance transparency and reduce systemic risk in the swap markets. The Working Group appreciates the opportunity to provide the comments set forth herein and requests the Commission's consideration of such comments in order to adopt, if at all, position limits that are effective and workable for market participants.

As an initial matter, and as discussed in Part III.A, below, the Working Group submits that, prior to establishing and imposing speculative position limits in any specific market, the CEA requires the Commission to analyze the relevant markets and find that such position limits are indeed necessary. If implemented without sufficient study, speculative position limits will disrupt today's highly efficient energy commodity markets by (i) reducing liquidity, (ii) impairing price discovery, and (iii) preventing market participants from effectively and efficiently hedging their commercial risk exposure.

Additionally, as set forth in Part III.A, below, the Commission's proposal for Phase II single-month and all-months-combined ("AMC") position limits are entirely unnecessary, and accordingly, should be rejected. The Working Group submits that such limits could have significant adverse impacts on derivatives markets. As such, the Working Group strongly urges the Commission to use the discretion afforded to it pursuant to new CEA Section 4a(a) and decline the adoption of single-month and AMC position limits in any final rule issued in this proceeding at this time.

As discussed in Part III.B, below, the Working Group believes that there are several flaws in the proposed definition of a *bona fide* hedging transaction that could disrupt the efficient operation of energy commodity markets. In failing to provide a vehicle for market participants to apply for, and receive, an exemption from speculative position limits for "non-enumerated hedges," the Commission, contrary to the intent of Congress, has eliminated several important classes of transactions from the definition of a *bona fide* hedging transaction that are routinely undertaken in energy markets to hedge or mitigate commercial risk. The Working Group provides in Parts III.B.1, below, several examples of such excluded transactions. As illustrated by these examples, this proposed definition simply does not reflect the hedging practices generally used in commodity markets, especially energy markets. Specifically, as discussed in Part III.D, below, to qualify for a *bona fide* hedging exemption, the proposed definition appears to require market participants to match on a one-to-one basis a swap transaction to a specific physical transaction. Participants

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[1] *Position Limits for Derivatives,* Notice of Proposed Rulemaking, 76 FED. REG. 4752 (Jan. 26, 2011).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

in energy commodity markets, however, frequently enter into swaps and futures to hedge underlying physical assets on a portfolio or aggregate basis. The Working Group submits that any final rule adopted by the Commission in this proceeding must preserve the ability of commercial energy firms to effectively and efficiently hedge their commercial risk exposure.

The Working Group further requests in Part III.C, below, that the Commission provide certainty to market participants as to how the process will work for applying for exemptions from speculative position limits should the Commission adopt one in any final rule. As written, the *Proposed Rule* provides an insufficient application process for exemptions and instead requires market participants to file daily reports on their cash market commodity activities upon exceeding any position limit. The Working Group submits that this creates not only an unnecessary compliance burden on market participants but also a significant burden on the Commission who will have to review and evaluate daily such position reports. Should the Commission adopt an application process in any final rule, the Working Group strongly suggests that it provide market participants an opportunity to comment on such process.

As discussed more thoroughly in Part III.F, below, the Working Group believes the Phase I spot-month position limits must (i) be reconsidered in many respects and (ii) more appropriately accommodate the hedging needs of market participants. As recommended in Part III.F.1, below, the process for determining deliverable supply must be fully transparent and provide market participants the opportunity to comment on the DCM estimates of deliverable supply and any Commission proposal for spot-month position limits. Further, as set forth in Part III.F.2, below, with respect to the proposed spot-month position limits for cash-settled contracts, the Working Group submits that (i) the Commission's proposal to set the limit for cash-settled contracts equal to the level for physically-settled contracts is not grounded in a sound regulatory foundation, (ii) the proposal unduly restricts the position of cash-settled referenced contracts that may be held by market participants, and (iii) the proposed conditional exemption for cash-settled contracts inappropriately requires market participants to hold no physically settling futures contracts in order to qualify for such exemption. In Part III.F.3, below, the Working Group recommends that the Commission initially identify the universe of referenced paired contracts based only on those contracts that are cleared, and after such initial identification, identify which swaps constitute a referenced paired contract during its process for determining whether a swap must be mandatorily cleared pursuant to the Act.

Regarding the proposed visibility levels and related reporting requirements, the Working Group submits in Part III.G, below, that such are unnecessary in light of the transparency created by the Act and the Commission's existing special call authority. The Working Group believes that such requirements will result in a substantial and disproportionate burden on *bona fide* hedgers without providing any benefit to the markets.

Moreover, as discussed in Part III.I, below, the Working Group generally supports the proposed aggregation rules and disaggregation exemption as applied to "owned" non-financial entities. Yet it respectfully requests that the Commission (i) provide guidance on the required showing a market participant must make in demonstrating independent control, (ii) permit market participants discretion in using internal or external personnel to make any assessments relating to the independence of its owned non-financial entities, and (iii) confirm that the positions of owned non-financial subsidiaries or affiliates demonstrating independent control will not be aggregated with a parent financial entity.

Finally, and not of least importance, as discussed in Part III.J, below, the Working Group strongly recommends that the Commission conduct a thorough cost-benefit analysis of this *Proposed Rule,* which should include the costs presented in the Paper Reduction Act section of the *Proposed Rule.*

III. Comments of the Working Group of Commercial Energy Firms

A. The Commission Has Not Established the Foundation for the Imposition of Federal Speculative Position Limits for Exempt and All Agricultural Commodities

As a threshold matter, the Working Group respectfully submits that Congress did not mandate the establishment of speculative position limits for exempt and all agricultural commodities or authorize the Commission to so impose them without an analysis and finding of the need for, or appropriateness of, speculative position limits in any specific market.[3] This issue has been addressed in comment letters filed in response to the Commission's January 26, 2010 Notice of Proposed Rulemaking, *Federal Speculative Limits for Referenced Energy Contracts and Associated Regulations,*[4] and in pre-rulemaking comments filed in connection with the potential implementation of speculative position limits under Dodd-Frank.[5] Moreover, the Working Group is informed that other interested parties will address this issue in their comments submitted in this rulemaking proceeding. The Working Group supports the principle that the CEA requires additional analysis before the Commission can finalize a speculative position limit rule for exempt and all agricultural commodities.

In Section III.F, below, the Working Group presents its concerns regarding the proposed spot-month limits for referenced contracts should the Commission move forward and implement such limits using the phased approach outlined in the *Proposed Rule.* In addition to its concerns regarding the proposed Phase I spot-month limits, the Working Group submits that imposing position limits for non-spot months and AMC could result in significant, unintended adverse impacts on derivatives markets, particularly markets for energy commodities.

The *Proposed Rule* fails to provide any verified, empirical data, or cost-benefit analysis justifying the imposition of Phase II non-spot-month and AMC limits that can be reviewed and commented upon by interested parties—even on a prophylactic basis. Notwithstanding this lack of analysis, non-spot month and AMC position limits are unnecessary if the Commission develops appropriate spot-month limits. As such, the Working Group strongly recommends the Commission use the discretion afforded under new CEA Section 4a(a) and forego the implementation of Phase II non-spot month and AMC position limits in any final rule issued in this proceeding.

The comments that follow are submitted by the Working Group to address concerns with respect to specific provisions in the *Proposed Rule* so that a final rule, if one is ultimately adopted, will contain the clearest and most workable provisions.

B. The Proposed Definition of a *Bona Fide* Hedging Transaction Is Seriously Flawed

The Working Group submits that there are several, very specific and somewhat technical, flaws in the proposed definition of a *bona fide* hedging transaction that threaten its utility for commercial energy firms. As such, the Working Group provides the following comments addressing its concerns with specific provisions of the *Proposed Rule* and respectfully requests that the Commission address each of them prior to the adoption of any final rule. Doing so will ensure that any final rule adopted by the Commission in this proceeding will be clearer and more workable (*i.e.,* commercially practicable).

1. There is No Basis for the Elimination of "Non-Enumerated" Hedges

Without much explanation, the Commission excluded from proposed CFTC Rule 151.5 provisions that would define "non-enumerated hedges" or provide a vehicle for a commercial energy firm to apply for, and receive, an exemption from speculative position limits for "non-enumerated hedges."[6] In contrast, the *Proposed Rule* provides that the only transactions or positions that would be recognized as *bona fide* hedges would be those described under proposed CFTC Rule 151.5(a)(2) as "enumerated hedges." Specifically, the proposed rule states, in relevant part:

> "[N]o transactions or positions shall be classified as *bona fide* hedging for purposes of § 151.4 unless . . . the provisions of paragraph (a)(2) of this section have been satisfied."[7]

In taking this position (hereinafter referred to as the "Enumerated Hedges Only" provision), the Commission has eviscerated the general definition of *bona fide* hedging transactions or positions as set forth in proposed CFTC Rule 151.5(a)(1), which came directly from CEA Section 4a(c)(2), as amended by Dodd-Frank. Significantly,

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[3] *See* CEA Sections 4a(a)(2)–(5) (requiring that the Commission establish position limits "as appropriate").

[4] *See Federal Speculative Limits for Referenced Energy Contracts and Associated Regulations,* Notice of Proposed Rulemaking, 75 FED. REG. 4144 (Jan. 26, 2010); *The Futures Industry Association, Inc.,* Comment Letter (Mar. 8, 2010); *International Swaps and Derivatives Association, Inc.* ("ISDA"), Comment Letter (April 16, 2010); *Working Group of Commercial Energy Firms,* Comment Letter (April 26, 2010).

[5] *See CME Group,* Pre-Rulemaking Position Limit Comments (Oct. 25, 2010); *The Futures Industry Association, Inc.,* Pre-Rulemaking Position Limit Comments and Recommendations ("FIA Pre-Rulemaking Comments") (Oct. 1, 2010).

[6] The analogs in existing Commission regulations are Sections 1.3(z)(3) and 1.47. Under the *Proposed Rule,* Section 1.3(z) would not apply to speculative position limits for exempt and agricultural commodities and Section 1.47 would be deleted altogether.

[7] Proposed CFTC Rule 151.5(a)(1).

the Commission has effectively eliminated from the *bona fide* hedging definition numerous classes of transactions that Congress intended to include.[8] The Working Group identifies and describes several of these transactions in subparts III.B.1.i–III.B.4, below.

The Working Group respectfully submits that it is neither in the public interest nor is it in the Commission's interest as a market regulator to structure a rule that eliminates its flexibility to allow hedge exemptions based on "non-enumerated hedging transactions." Markets are dynamic. Many of the proposed rules being implemented by the Commission pursuant to Dodd-Frank, particularly this *Proposed Rule,* may have the result of diminishing liquidity in certain markets. Thus, the Working Group submits that the Commission should preserve its ability to allow exemptions based upon non-enumerated transactions.[9]

Accordingly, in order to ensure consistency with the statutory language of new CEA Section 4a(c) and avoid harmful impacts to markets for Referenced Contracts, the Working Group suggests that the Commission (i) strike the last clause in proposed CFTC Rule 151.5(a)(1)(iv)(B)—"and the provisions of paragraph (a)(2) of this section have been satisfied;" and (ii) revise the lead-in language of proposed CFTC Rule 151.5(a)(2) to add following the word "includes" the phrase ", but is not limited to,". Specifically, the Working Group proposes the following revisions:

§ 151.5 Exemptions for referenced contracts.

(a) *BONA FIDE* HEDGING TRANSACTIONS OR POSITIONS.

(1) Any trader that complies with the requirements of this section may exceed the position limits set forth in § 151.4 to the extent that a transaction or position in a referenced contract:

* * * * *

(iv) Reduces risks attendant to a position resulting from a swap that—

* * * * *

(B) Meets the requirements of paragraphs (a)(1)(i) through (a)(1)(iii) of this section. Notwithstanding the foregoing, no transactions or positions shall be classified as *bona fide* hedging for purposes of § 151.4 unless such transactions or positions are established and liquidated in an orderly manner in accordance with sound commercial practices ~~and the provisions of paragraph (a)(2) of this section have been satisfied.~~

(2) ENUMERATED HEDGING TRANSACTIONS. The definition of *bona fide* hedging transactions and positions in paragraph (a)(1) of this section includes, <u>but is not limited to,</u> the following specific transactions and positions: . . .

Subparts III.B.1.i–III.B.4, below, address the identified flaws with the Commission's current proposal for the definition of a *bona fide* hedge, and support the Working Group's recommendation to revise the proposed language of the *bona fide* hedging transaction definition.

i. Hedges Relating to Assets That a Person Anticipates Owning or Merchandising Would Not Constitute *Bona Fide* Hedges Under the *Proposed Rule*

Proposed CFTC Rule 151.5(a)(1) includes as a *bona fide* hedge the anticipated *ownership,* production, manufacture, processing, or *merchandising* of an exempt or agricultural commodity.[10] Yet proposed CFTC Rule 151.5(a)(2), which sets forth "Enumerated Hedging Transactions," does not contain a parallel provision. Indeed,

[8] In addition, the Commission's proposal simultaneously establishes and eliminates the availability of the so-called "pass-through" exemption identified in proposed CFTC Rule 151.5(a)(1)(iv)(A) and CEA Section 4a(c)(2)(B). To be certain, proposed CFTC Rule 151.5(a)(1)(iv)(A) is nearly identical to the discretionary pass-through provision in new CEA Section 4a(c)(2)(B). As such, the Commission clearly sought to establish a pass-through exemption. And yet the Commission's proposed CFTC Rule 151.5(a)(2) would eliminate the use of any such exemption. The Working Group believes that the Commission likely did not intend such a result.

[9] This does not mean that the Commission is compelled to grant exemptions—it will retain its discretion on a case-by-case basis based on the market's ability to support it, among other things. What it does mean, however, is that if the Commission believes an exemption may be warranted to add liquidity to a particular market at a particular time it would not be forced to promulgate an amendment to Part 151.5 in order to do so.

[10] *See* analogous new CEA Section 4a(c)(2).

only "unsold anticipated production"[11] and "unfilled anticipated requirements," including requirements for "processing, manufacturing, and feeding"[12] qualify as enumerated hedges. Thus, as a result of the Enumerated Hedges Only provision, certain transactions entered into to hedge anticipated ownership or merchandising of an exempt or agricultural commodity would not qualify as *bona fide* hedging transactions under the *Proposed Rule*.[13] The Working Group provides two such examples.

Example 1.

At 8:00 a.m. commercial energy firm X becomes aware of the availability of a spot cargo of heating oil moving from Europe to the United States. Firm X believes that it can acquire the cargo over the next few hours or days, manage the discharge of the product at the end of the voyage, and re-sell the heating oil to a distributor in the northeast at the end of the month. While Firm X begins negotiations to purchase and re-sell the cargo, it is not concerned about upward price risk during the period of its purchase negotiations but is seriously concerned about downward price risk between now and the time it establishes its sale price. It sells New York Mercantile Exchange ("NYMEX") heating oil futures contracts for its expected delivery month. Under the Commission's proposal, this transaction would not qualify as a ***bona fide*** *hedge.*

Example 2.

Utility X periodically issues requests for proposals ("RFP") looking to obtain fixed price electricity supply for groups of its customers. For example, it may be looking for a fixed price for electricity for a term of three (3) years for its commercial customer class. In its RFP, Utility X requires that Bidders provide firm electricity at a fixed price and at designated locations on its electrical system. As it is for Full Requirement, Bidders must ensure that enough electric supply is delivered to Utility X so that it can meet the load requirements of its commercial customers. Actual deliveries of electricity are equal to actual usage of electricity by Utility X's commercial customers and results in physical delivery of electricity. Finally, the RFP requires that the fixed price offer be provided on or before the close of business, March 31, and be left open; that is, the price quoted must remain firm while Utility X evaluates and then selects the winning bidder on April 3.[14]

Power Marketer Y is preparing to respond to Utility X's RFP. It believes it can arrange for a physical supply of electricity supply on competitive terms. However, Power Marketer Y is concerned that prices in the electricity market will increase while it is holding open its fixed price for Utility X and then completing the transaction for the physical supply. Power Marketer Y enters into an electricity swap to protect against increases in prices while it leaves open the bid during the three day evaluation period and thereafter completes negotiations for the physical electricity purchase if Utility X accepts its price quote. Under the Commission's proposal, the electricity swap transaction would not qualify as a ***bona fide*** *hedge. If Power Marketer Y faces position limit restrictions in this situation, it would have to raise its fixed price quote to Utility X to account for the risk of the price moving and this could result in higher costs to Utility X's customers.*

The Working Group notes that the variance in the treatment of marketing or merchandising activities and the treatment of producers or processors in the *Proposed Rule* is remarkably similar to the differential treatment of cash market "trading" positions provided in footnotes 23 and 128 of the proposed rules implementing the End-user Exception and further defining the term Major Swap Participant, respectively, and upon which the Working Group commented in the relevant proceedings.[15] The Working Group's concern was that in those proposed rules, the Commission appeared to take the position that a marketer or merchandiser that acquired a commodity for resale (*i.e.,* a cash market "trading" position) would not be

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[11] Proposed CFTC Rule 151.5(a)(2)(i)(B).

[12] Proposed CFTC Rule 151.5(a)(2)(ii)(C).

[13] To the extent that language in the enumerated hedging section of the proposal parallels language in the enumerated hedging section of current Rule 1.3(z), the Working Group submits that the impact is different as a result of the elimination of the availability of an exemption for non-enumerated hedges.

[14] Often times, commercial energy firms competing to serve load under similar RFP arrangements have been required to leave in place fixed price quotes longer than the four (4) day window set forth in the example above.

[15] *End-User Exception to Mandatory Clearing of Swaps,* Notice of Proposed Rulemaking, 75 FED. REG. 80747 (Dec. 23, 2010) ("Proposed End-User Exception Rule"); *Working Group of Commercial Energy Firms,* Comment Letter (Feb. 22, 2011); *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"* 75 FED. REG. 80174 (Dec. 21, 2010); *Working Group of Commercial Energy Firms,* Comment Letter (Feb. 22, 2011).

entitled to treat a hedge of that position as "mitigating or reducing commercial risk" in order to avail itself of the end-user exception or certain calculations in connection with the definition of Major Swap Participant.

As in the instant proceeding, such differential treatment in those proposed rules wouldeffectively eliminate "merchant," [16] "merchandiser," [17] or "middlemen" [18] from the litany of commercial parties historically recognized as part of the chain from the production to the consumption of commodities. These parties own physical commodities and bear significant price risk as a result. The Working Group respectfully submits that this result is contrary to the CEA and that the use of derivatives by these firms to hedge that risk should qualify as *bona fide* hedges and as "hedging and mitigating commercial risk" under the Commission's rules.

ii. Hedges of Services Would Not Constitute *Bona Fide* Hedges Under the *Proposed Rule*

Proposed CFTC Rule 151.5(a)(1) would include as a *bona fide* hedging transaction "services that a person provides or purchases, or anticipates providing or purchasing." [19] However, proposed CFTC Rule 151.5(a)(2), which sets forth Enumerated Hedging Transactions, does not contain a parallel provision. Thus, under the Enumerated Hedges Only provision, hedges of the potential change in value of services would not constitute as *bona fide* hedging under the Commission's proposal. The Working Group provides the following two examples to illustrate such hedges.[20]

Example 1.

Commercial energy firm Z is a wholesale marketer of natural gas. It has an opportunity to acquire one year of firm transportation on Natural Gas Pipeline ("NGPL") from the Texok receipt point to the Henry Hub delivery point for an all-in cost of $.30/mmbtu. The "value" of that service at that time is $.33/mmbtu, measured as the difference between the price at which one can sell the natural gas at the delivery point minus the price at which one can purchase the gas at the receipt point. At that time, commercial energy firm Z can enter into a swap locking in the calendar 2012 strip at Texok at a price of $4.00/mmbtu and sell a calendar strip of NYMEX Henry Hub natural gas futures contracts locking in a sale price at a weighted average of $4.33/mmbtu. Entering into those two separate transactions without having actually purchased or sold natural gas to transport has allowed commercial energy firm Z to hedge the value of the firm transportation service that it holds or can acquire.[21] *However, under the Commission's proposal, the transaction would not qualify as a* ***bona fide*** *hedge transaction.*

Example 2.

Natural Gas Producer X has new production coming on line over the next few years in the Gulf of Mexico. The production is located near Point A on Pipeline Y's interstate natural gas pipeline system. Producer X has the desire to sell gas to customers in Region B as the price for natural gas in Region B is significantly higher than at Point A, where natural gas would currently be delivered into Pipeline Y's system. Producer X contacts Pipeline Y and negotiates a Precedent Agreement with the pipeline under which Pipeline Y will build new transportation capacity from Point A to Region B. Under the Precedent Agreement, Producer A is obligated to pay demand charges to the pipeline for a term of 5 years from the date the pipeline goes into commercial operation, if Pipeline Y is able to complete a successful open season and obtains the necessary permits to construct and operate the new section or expansion of its pipeline system from Point A to Region B. The open season is designed to attract

[16] *See* 17 CFR § 32.4(a) (2010) ("a producer, processor, or commercial user of, or a *merchant handling,* the commodity" may be an offeree of an option under the trade option exemption) (emphasis added).

[17] *Exemption for Certain Contracts Involving Energy Products,* 58 FED. REG. 21286 (Apr. 20, 1993) (granting exemptive relief in response to an application filed by a group of entities which represented that each was a producer, processor and/or *merchandiser* of crude oil, natural gas and/or crude oil and natural gas products, or was otherwise engaged in a commercial business in these commodities).

[18] *See* Section 4a(c) of the CEA ("producers, purchasers, sellers, *middlemen,* and users of a commodity or product derived therefrom" should be eligible for hedge exemptions) (emphasis added).

[19] *See* analogous new CEA Section 4a(c)(2).

[20] Without impacting their illustrative value, these examples have been simplified, and certain factors, such as the time value of money, have been eliminated.

[21] Note that this "value" exists whether commercial energy firm Z ever owns or intends to own the physical commodity. In some circumstances, the firm might choose to release the capacity to a third-party and realize the value of the transportation service from the capacity release transaction.

commitments from other potential shippers to help support the cost of building and operating the pipeline expansion. The schedule calls for a completion of construction and commercial operation of the pipeline expansion on March 31, 2013.

Producer X is concerned that the natural gas price differential between Point A and Region B could collapse and is fairly confident the expansion project will be completed. In order to manage the risk associated with the 5-year financial commitment to Pipeline Y, ***i.e.,*** *pipeline demand charges, Producer X enters into swaps at Point B for a term of April 1, 2013 to March 31, 2018, to lock-in the price spread between Point A and Region B. Under the Commission's Proposed Rule*, the swap transactions would not qualify as ***bona fide*** *hedges. In this case, the expansion of the pipeline system that would afford customers in Region B more access to lower priced gas might not occur without the ability to count the swaps associated with this transaction as a* ***bona fide*** *hedge.*

Example 3.

Commercial energy firm A is an electric utility that owns coal-fired generation facilities. Firm A enters into contracts with major railroads to transport coal from producing regions to its various generating facilities. One or more of these contracts are subject to a fuel surcharge, whereby rates paid by firm A to transport coal are indexed to the price of diesel fuel. As prices for the diesel fuel rise, the rate paid by firm A to transport coal also rises. To mitigate this risk, firm A could enter into a long position in futures contracts or swaps for the diesel fuel, whereby gains realized on these instruments should prices rise would off-set any increase in the rate paid by firm A to transport coal. Under the Proposed Rule, however, these transactions would not qualify as ***bona fide*** *hedge transactions since they would be entered into as a hedge of services—in this case, coal transportation services.*

2. Spreads and Arbitrage Positions Would Not Qualify as ***Bona Fide*** *Hedges Under the* ***Proposed Rule***

Section 4a(a) of the CEA both before and after the passage of Dodd-Frank authorizes the Commission to "exempt[] transactions normally known to the trade as 'spreads' or 'straddles' or 'arbitrage' or from fixing limits applying to such transactions or positions different from limits fixed for other transactions or positions." Under the regimes for speculative position limits currently administered by both NYMEX and the IntercontinentalExchange ("ICE"), exemptions from speculative position limits are available for arbitrage, intra-commodity spread, inter-commodity spread, and eligible option/option or option/futures spread positions.[22] Under the *Proposed Rule,* these classes of transactions would not qualify for an exemption.

Arbitrage and spread positions create a limited risk of causing sudden or unreasonable fluctuations or unwarranted changes in the price of a commodity. In fact, they are universally recognized as transactions that limit unwarranted changes in price by tying the price of one instrument to another, creating a market efficiency that reduces the risk of aberrational pricing. The Working Group submits that there has never been an issue of sudden or unreasonable fluctuations or unwarranted changes in price attributable to arbitrage or spread positions that would justify the elimination of exemptions for such transactions at this time.

The Working Group respectfully suggests that the fact that these positions currently exist in the market and may be the basis for an exemption from limits on both NYMEX and ICE requires that the Commission consider the potential negative impact on liquidity if such positions were no longer to be permitted such treatment. Therefore, as provided for under CEA Section 4a(a), the Commission should permit exemptions from position limits for transactions such as spreads or arbitrage.

3. Cross-Commodity Hedges Would Not Be Permitted To Be Carried Into the Spot Month

Proposed CFTC Rule 151.5(a)(2)(v) would permit cross-commodity hedges "provided that the positions shall not be maintained during the five last trading days of any referenced contract." This would result in transactions, such as the one set forth in the following example, being excluded from treatment as a *bona fide* hedging transaction.

Example.

Commercial energy firm J supplies jet fuel to airlines at a variety of airports in the United States, including Houston Intercontinental Airport. It has a fixed-price contract to purchase jet fuel from a refinery on the gulf coast during early June. Because there is no liquid jet fuel futures contract, commercial energy firm J uses the

[22] *See* NYMEX Rule 559.C and *ICE OTC Regulatory Rulebook for Significant Price Discovery Contracts,* Rule 1.17 ("ICE OTC Rule 1.17").

June NYMEX physically-delivered WTI crude oil futures contract to hedge its price risk. Under the ***Proposed Rule,*** *commercial energy firm J would be required to liquidate its hedge during the last five trading days of the June contract and either remain unhedged or replace its June hedge with a contract that represents a completely different delivery period and, therefore, a different supply/demand and pricing profile.*

4. The Working Group Questions the Phraseology Used in the ***Proposed Rule*** *that Would Treat as* ***Bona Fide*** *Hedges "Purchases of Referenced Contracts" on the One Hand, and "Sales of Any Commodity Underlying Referenced Contracts" on the Other*

The purpose and effect of the distinction presented in proposed CFTC Rule 151.5(a)(2) are unclear to the Working Group. Specifically, the lead-in language to proposed subpart 151.5(a)(2)(ii) states that "purchases of *referenced contracts*" may qualify as *bona fide* hedges provided certain conditions are met. In contrast, the lead-in language to proposed subpart 151.5(a)(2)(i) states that "sales of *any commodity underlying referenced contracts*" may qualify as *bona fide* hedges provided the right conditions are met. Nowhere in the *Proposed Rule* does the Commission explain the purpose behind this distinction. Under the analogous provisions of Section 1.3(z) of the Commission's current regulations,[23] purchases and sales are treated equally—that is, purchases or sales of futures contracts (and not the underlying commodity) may qualify as *bona fide* hedging transactions. Thus, it appears that the phrase "any commodity underlying" ought not to be included in proposed CFTC Rule 151.5(a)(2). The Working Group respectfully requests that in any final rule issued in this proceeding the Commission either (i) harmonize the two provisions in the *Proposed Rule,* or (ii) clarify the intent and purpose behind the distinction should the Commission adopt such language.

C. The Process for Applying for, and Receiving, Exemptions From Speculative Position Limits Is Also Flawed

1. The ***Proposed Rule*** *Unnecessarily Abandons the Current Energy Market Process of Applying in Advance for Exemptions From Speculative Position Limits*

Current practice on both NYMEX and ICE permits a commercial energy firm to apply, in advance, for an exemption from speculative position limits. With the exception of exemptions for "anticipated unsold production" and "anticipated unfilled requirements,"[24] the *Proposed Rule* abandons that construct. The Working Group respectfully submits that such an approach is flawed for the reasons set forth below.

i. The *Proposed Rule* Creates Uncertainty for Market Participants

Under current practice, a market participant would apply for an exemption from speculative position limits that would allow it to hold positions subject to the exemption up to a stated quantity. Such practice provides commercial energy firms with certainty and precise knowledge as to what the exchange (*i.e.,* NYMEX) or exempt commercial market ("ECM") with significant price discovery contracts (*i.e.,* ICE), as applicable, will permit. Unlike current practice, the *Proposed Rule* leaves the upper limit of an exemption undefined.[25] Unless the Commission is proposing that there is no upper limit for *bona fide* hedge transactions, which is highly doubtful, then the proposed process leaves a market participant without any knowledge as to when its positions will be deemed by the Commission to be "too much."

By way of example, assume the speculative position limit for an energy commodity is 1,000 contracts, and a commercial energy firm with significant inventory could justify an exemption to allow it to hold 6,000 contracts. In NYMEX's view, however, the market could support an exemption only to a level of 3,000 contracts. Under cur-

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[23] 17 CFR § 1.3(z).

[24] *See* proposed CFTC Rule 151.5(c) (with respect to hedging anticipated unsold production or anticipated unfilled requirements, a trader must submit to the Commission a 404A filing at least ten days in advance of the date that such transactions or positions would exceed the applicable position limits). *See also* proposed CFTC Rule 151.5(c)(1)(ii), (iv), and (v) (each subsection contains the phrase "which may not exceed one year"). This restriction, however, should only be applied to referenced agricultural commodities. The Working Group is also concerned that this proposed rule could be read to effectively restrict the ability of participants in exempt commodity markets to hedge exposure to price volatility for transactions that are more than one year in duration. The Commission should clarify and, as necessary, rectify, the language of proposed CFTC Rule 151.5(c)(1)(ii), (iv), and (v) to avoid such a result.

[25] The Commission would be fully justified under the CEA to make such a determination to leave the upper limit of an exemption undefined. *See* CEA Sections 4a(a)(2)(A) and 4a(a)(5)(A). If that was the Commission's intention behind this proposed exemption process, the Working Group would fully support it.

rent practice, the commercial energy firm would know, in advance, that the potential acquisition of additional cash market risk would not result in additional room to hedge on NYMEX and could make a considered decision to make, or not make, the acquisition, knowing it might have to hold it unhedged.

In contrast, the *Proposed Rule* does not provide a market participant the opportunity to know in advance what the Commission would determine to be the upper limit that the market could support. Pursuant to the *Proposed Rule,* a market participant must make the required filings with the Commission upon reaching the position limit of 1,000 contracts. In accordance with its internal policies and business practice, a market participant would continue to increase its position and make the corresponding required filings without ever knowing when and at what level the Commission would say "enough."

The Working Group believes that, at some point, the Commission would say "enough" on the same basis that NYMEX currently limits exemption levels even when they would be fully justified based upon a participant's cash market exposure. Yet the *Proposed Rule* makes no provision for when or how the Commission would establish an upper bound, and fails to state whether a market participant would be required to liquidate or offset positions established in good faith before an upper bound was communicated. Commercial energy firms cannot afford to operate under this process, or lack thereof, as it creates a high level of uncertainty.

ii. The Commission Should Provide Clear Guidance on the Application Process for Hedge Exemptions Should It Adopt One in Any Final Rule Issued in the Proceeding

Should the Commission adopt an application process for *bona fide* hedge exemptions in any final rule issued in this proceeding, the Working Group suggests that the Commission provide clear guidance on such process and permit market participants an opportunity to comment.[26] Any application process adopted by the Commission should require market participants to apply for exemptions only once. Currently, market participants seek exemptions from the exchanges. Yet, under any final rule adopted by the Commission, market participants should not be required to apply for exemptions from both the CFTC and the exchanges. Such a requirement would impose significant burdens on market participants.[27]

iii. Daily Reporting of Cash Market and Other Positions Is Burdensome and Unnecessary

Under current practice on both NYMEX and ICE, a party with a hedge exemption is not required to make regular filings with the exchange or ECM. Nevertheless, a market participant remains subject to inquiry by NYMEX or ICE[28] and the requirement to justify the use of the exemption. Additionally, the market participant remains subject to the special call authority of the CFTC[29] and an enforcement action if such market participant used an exemption to hold speculative positions in excess of the position limit.

Under the *Proposed Rule,* a party will be required to submit ***daily*** reports itemizing the following information with respect to such position: (1) the cash market commodity hedged, the units in which it is measured, and the corresponding referenced contract that is used for hedging the cash market commodity; (2) the number of referenced contracts used for hedging; (3) the entire quantity of stocks owned of the cash market commodity that is being hedged by a position in a referenced contract; (4) the entire quantity of open fixed price purchase commitments in the hedged commodity outside of the spot month of the corresponding referenced contract; (5) the entire quantity of open fixed price purchase commitments in the hedged commodity in the spot month of the corresponding referenced contract; (6) the entire quantity of open fixed price sale commitments in the hedged commodity outside of the spot month of the corresponding referenced contract; and (7) the entire quantity of open fixed price sale commitments in the hedged commodity in the

[26] The Working Group notes that in a prior rulemaking to establish federal speculative position limits, the Commission sought to establish an application process for *bona fide* hedge exemptions. *See Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations,* Notice of Proposed Rulemaking, 75 FED. REG. 4144 (Jan. 26, 2010).

[27] In addition to providing market participants with the ability to provide comments on the application process in the context of the instant rulemaking, the Working Group suggests that the Commission also host a technical conference or other forum to permit market participants to interface with the Commission and make recommendations. Upon issuance of a proposed application process, the Commission should then provide an appropriate opportunity for comment.

[28] *See* NYMEX Rule 559; ICE OTC Rule 1.16.

[29] *See* 17 CFR § 18.05; 21 (2010).

spot month of the corresponding referenced contract.[30] Building the system to perform such reporting will be a significant and unnecessary expense, and the management and execution of the system to satisfy the daily reporting obligation an unnecessary burden.

iv. Daily Review of Positions Is a Burden that the Commission Does Not Need To Impose Upon Itself

In order to manage the speculative limit regime that the Commission is proposing to establish, CFTC staff will be required to review and evaluate daily the positions of all market participants that exceed the speculative position limits. First, as described in Part III.C.1.i, above, CFTC staff will need to do so to determine when to say "enough" to a *bona fide* hedger with legitimate hedging needs that may be greater than the market for a particular instrument can bear. Second, staff will also need to do so to verify the veracity of a market participant's claim of eligibility for a hedge exemption, something that is currently only done on a periodic basis. The Working Group respectfully submits that the monitoring and verification obligations placed on CFTC staff will require the expenditure of considerable Commission resources and are unnecessary, especially at a time of significant budgetary constraint.

D. The Proposed Framework for *Bona Fide* Hedge Exemptions Should Reflect the Hedging Practices of Commodity Markets

In addition to the Working Group's specific concerns regarding the technical flaws with the proposed definition of the *bona fide* hedging exemption and the process of applying for an exemption, the Working Group respectfully requests the Commission to recognize that, although market participants in physical energy commodity markets use swaps and futures to hedge underlying physical positions, they frequently do not execute such transactions specifically for the purpose of hedging a specified underlying physical position (*i.e.,* on a one-for-one basis). Prudent risk management practices generally involve hedging underlying physical assets and related positions on a portfolio or aggregate basis.[31] A commercial firm will normally hedge these exposures utilizing physical transactions, futures, and swaps, the exact combinations of which will be determined by various characteristics that may be unique to such firm.

Further, in order to effectively and efficiently mitigate commercial risk associated with underlying physical assets and related positions, commercial energy firms will also dynamically hedge their aggregate exposures on a regular and on-going basis to optimize the value of underlying physical assets or portfolios. A key aspect of dynamic hedging is the ability to modify the hedging structure related to the physical asset or positions when the relevant pricing relationships applicable to that asset change. Dynamic hedging may involve leaving an asset or position unhedged when necessary to mitigate the risk of lost opportunity costs, which may require hedges to be established, unwound, and re-established on an iterative basis over time.

In this context, the concept of *bona fide* hedging should include all hedging activity that maximizes the value of the asset. The adoption of a prescriptive one-to-one matching requirement of each swap to a specific physical transaction or an asset position is inconsistent with the hedging practices of many participants in commodity markets, particularly energy markets, and is thus unnecessary and overly burdensome.[32] As such, the Working Group requests that the Commission modify

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[30] *See* proposed CFTC Rule 151.5(b).

[31] The Working Group notes that, in the CFTC's proposed rule on the end-user exception from mandatory clearing, the Commission recognizes that whether a position is used to hedge or mitigate commercial risk should be determined by the facts and circumstances at the time the swap is entered into, and should take into account the person's overall hedging and risk mitigation strategies. *See Proposed End-User Exception Rule,* at 80753. In relevant part, the Proposed End-User Exception Rule states:

> As a general matter, the Commission preliminarily believes that whether a position is used to hedge or mitigate commercial risk should be determined by the facts and circumstances at the time the swap is entered into, and should take into account the person's overall hedging and risk mitigation strategies. The Commission expects that a person's overall hedging and risk management strategies will help inform whether or not a particular position is properly considered to hedge or mitigate commercial risk for purposes of the clearing exception.

The Working Group respectfully submits that the Commission should take this same approach herein and recognize that the determination of what is a *bona fide* hedge transaction is informed by a market participant's overall hedging and risk management strategy.

[32] For example, a commercial energy firm may enter into several swap transactions to hedge a single physical position. This approach is used to spread out risk among different

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its hedge exemptions and their related reporting requirements to reflect more appropriately the actual hedging practices of participants in energy markets in any final rule it adopts in this proceeding.

E. The Pass-Through Provision Is Not Required, and Therefore, the Commission Should Adopt an Alternative Approach: Permit Risk Management Exemptions From Position Limits

As amended by Title VII of the Act, new CEA Section 4a(c)(2)(B) permits the pass-through of a *bona fide* hedge exemption from speculative position limits to swap dealers taking the other side of a hedge transaction from an end-user. In relevant part, new CEA Section 4a(c)(2)(B) states:

> (2) For the purposes of implementation of subsection (a)(2) for contracts of sale for future delivery or options on the contracts or commodities, the Commission shall define what constitutes a *bona fide* hedging transaction or position as a transaction or position that—
>
> * * * * *
>
> (B) reduces risks attendant to a position resulting from a swap that—
>
> (i) was executed opposite a counterparty for which the transaction would qualify as a *bona fide* hedging transaction pursuant to subparagraph (A); or
>
> (ii) meets the requirements of subparagraph (A).

This discretionary provision effectively allows a swap dealer to "step into the shoes" of a commercial firm or end-user counterparty for purposes of being exempted from applicable speculative position limits.

1. The Pass-Through Is No Longer Required; the Concerns Over Risk Management Exemptions Have Been Ameliorated

The Working Group submits that the transparency created in exempt commodity markets by Title VII of the Act, together with the Commission's exemptive authority under new CEA Section 4a(a)(7), render this pass-through provision unnecessary.

The Working Group supports pre-rulemaking comments submitted by other interested parties [33] recommending that the Commission continue its practice of granting arbitrage and risk management exemptions from position limits for positions that serve the same or similar function as a *bona fide* hedge position, but do not fall squarely within the definition of a *bona fide* hedge.[34] Risk management exemptions from position limits are essential to the risk management practices of commercial energy firms; however, such exemptions had come under scrutiny because they allowed a swap dealer to get a hedge exemption to hedge the risk of swaps opposite speculative traders whose swap positions were unknown to the Commission and were subject to neither position limit nor accountability rules. Under Dodd-Frank, those concerns are no longer present. That is, virtually all swap transactions will be reported to swap data repositories ("SDRs"), prices will be reported to the public, and the parties will be subject to large trader reporting rules. Accordingly, the Commission may grant risk management exemptions on the basis of a party's need, ability to manage the positions, and the ability of the market to support the positions, all without concern that it has enabled a "dark market" with attendant risks of "excessive speculation."

Section 4a(a)(7) provides the Commission with broad authority to exempt any persons or transactions from speculative position limits that it sets under Section 4a. The Working Group respectfully submits that the Commission exercise its exemptive authority to grant exemptions in appropriate circumstances rather than establish a pass-through exemption, the need for which has been significantly diminished given the transparency created in exempt commodity markets by the Act.

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counterparties and to obtain the best overall pricing possible for the hedge. Given the dynamic and volatile nature of energy markets, it is very difficult for a commercial energy firm or any other market participant to assert on an intra-day, real-time basis or at a later point in time whether a particular swap or futures transaction is functioning as a hedge. Under this example, it would be difficult, if even possible, for a swap dealer to step into the shoes of its commercial counterparty on a transaction-by-transaction-basis for purposes of applying the pass-through provisions of CEA Section 4a(c)(2)(B).

[33] *See* FIA Pre-Rulemaking Comments at 8; *Morgan Stanley,* Position Limits Pre-Rule Proposal Comments and Recommendations, at 10 (Oct. 25, 2010).

[34] Section 4a(a) of the CEA states: "[N]othing in this section shall be construed to prohibit the Commission from . . . exempting transactions normally known to the trade as 'spreads' or 'straddles' or 'arbitrage.' "

2. If Adopted, the Pass-Through Provision Raises Significant Compliance Concerns

To the extent the Commission declines the Working Group's recommendation to eliminate the pass-through provision in favor of risk management exemptions, the Working Group submits that the implementation of such provision in energy markets would create several practical concerns. Importantly, for the reasons described below, the resulting burdens and cost impacts of a pass-through provision will be disproportionately borne by those commercial firms, including energy firms, that presently manage risk through hedging practices.[35]

i. The *Proposed Rule* Contemplates One-for-One Hedging

For example, the Working Group is concerned that market participants will be required to engage in a transaction-by-transaction analysis for purposes of determining whether a particular trade is in fact a *bona fide* hedge. As discussed in Part III.D, above, such an approach is inconsistent with the routine hedging practices employed by many participants in commodity markets, particularly energy markets. Specifically, these market participants determine their aggregate underlying exposures in physical markets and match hedges to those physical positions rather than hedging on a one-to-one basis.

With this in mind, the pass-through of *bona fide* hedge exemptions as contemplated in the *Proposed Rule* is unworkable as it would require hedgers claiming the use of a *bona fide* hedge exemption to match a swap that hedges or mitigates commercial risk with a specified underlying physical commodity transaction. To the extent the Commission uses its discretion to retain the pass-through of *bona fide* hedge exemptions, the Working Group suggests that the Commission maintain the approach currently used by DCMs and ECMs with significant price discovery contracts—which is to focus on market participants' overall physical exposures and match hedges to the physical position.[36]

ii. Written Trade-by-Trade Representations and Acknowledgements Are Not Practical in Dynamic, Fluctuating Markets

Proposed CFTC Rule 151.5(g) requires that a party relying on the *bona fide* hedging exemption provide a written representation verifying that the particular swap qualifies as a *bona fide* hedging transaction under proposed Rule 151.5(a)(1)(iv).[37] Given the discretionary nature of new CEA Section 4a(c)(2)(B), the Working Group believes that such written representation should be optional, not mandatory (understanding that absent a representation, there would be no pass-through). It is impracticable to require a trader to make a determination at the time of the trade on the nature of the transaction, particularly, whether the swap is a hedge or speculative in nature.[38] Moreover, as stated above, it would be impracticable, if not impossible, for the vast majority of market participants to link hedges with specified underlying physical positions for purposes of complying with the pass-through requirements in proposed CFTC Rule 151.5(g).

iii. The Requirement that Parties Verify the Ongoing Nature of a Hedge Is Not Workable

The Working Group is also concerned with proposed CFTC Rule 151.5(j)(2), which permits a party to exceed a position limit only "to the extent and in such amounts that the qualifying swap directly offsets, and continues to offset, the cash market commodity risk of a *bona fide* hedger counterparty." This provision is problematic as it implies that a hedger must monitor and track the status of a each transaction it represented to its counterparty as a *bona fide* hedge and continually inform and represent to the counterparty that such swap continues to be a *bona fide* hedge. Such requirement would result in significant and costly burdens on hedgers.

[35] The Working Group submits that the *Proposed Rule* will impose costs for monitoring compliance associated with the Commission's proposed pass-through provision. *See infra* Part III.J, discussing the Commission's costs and benefit analysis.

[36] *See, e.g.,* ICE OTC Rule 1.16.

[37] Proposed CFTC Rule 151.5(g)(1) states: "The party not hedging a cash market commodity risk, *or both parties to the swap if both parties are hedging* a cash market commodity risk . . . ." The Working Group submits that if both counterparties are hedging, there is no need to pass through their respective hedge exemptions and thus fails to understand the provision as written.

[38] The Commission also recognizes the difficulty in discerning between speculation and hedging. *See* End-User Exception Rule, at 80753.

F. Problems With the Proposed Spot-Month Limits

1. The Determination of Deliverable Supply Should Be Fully Transparent and Subject to Public Notice and Comment

Pursuant to proposed CFTC Rule 151.4(c), DCMs that list referenced physical delivery contracts would be required to submit estimates of deliverable supply for those physical commodities to the Commission on an annual basis. The *Proposed Rule* notes that the Commission will rely on a DCM's estimate of deliverable supply unless it "determines to rely on its own estimate." Given the overwhelming importance of the determination of deliverable supply for a Referenced Contract in establishing workable spot-month position limits under the framework set forth in the *Proposed Rule,* this process should be fully transparent,[39] and the Commission should provide public notice and permit comment by interested parties. In furtherance of this process, the Working Group suggests the following approach:

- *November 30—DCM Estimate Submissions.* DCMs submit to the Commission deliverable supply estimates for each physical delivery referenced contract that is subject to a spot-month limit and listed or executed pursuant to the rules of such DCMs. This submission is immediately noticed by the Commission for public comment.
- *Mid-December—Comment Deadline on DCM Estimates.* Interested parties would have 15 days to submit comments to the Commission providing their views on the DCM's deliverable supply estimates.
- *Mid-January—CFTC Issues Proposed Position Limits.* Approximately 30 days following the submission of comments on the DCM deliverable supply estimates, the Commission would publish (or post on its website) proposed position limits for each referenced contract.
- *February 1—Comment Deadline on Proposed Position Limits.* Interested parties would have 15 days to submit comments on the Commission's proposed position limits for each referenced contract.
- *March 1—CFTC Issues Final Position Limits.* The CFTC would release (or post on its website) final position limits for each referenced contract.
- *April 1—New Position Limits Become Effective.* Affected market participants would receive approximately 30 days to come into compliance with the new position limits. The new position limits would remain in effect until March 31st of the following year.

Finally, the Working Group strongly recommends that the Commission grandfather any position put on in good faith prior to the effective date of any final position limit set by Commission rule, regulation, or order.

2. The Proposed Spot-Month Position Limits for Cash-Settled Contracts Should be Reconsidered

i. The Working Group Respectfully Submits that the Limit for Cash-Settled Contracts Does Not Need to Equal the Limit for Physically-Settled Contracts

In the first transitional phase, proposed CFTC Rule 151.4 would apply spot-month position limits separately for physically-delivered contracts and all cash-settled contracts, including cash-settled futures and swaps. The Commission has proposed to set the limit for cash-settled contracts at the same level as the level for physically-settled contracts, a level which is established as 25% of deliverable supply. While the Working Group notes that the establishment of identical spot-month limits for cash- and physically-settled contracts has been the practice in recent years, it respectfully submits that the practice is not grounded in a sound regulatory foundation. Cash-settled contracts have substantially different potential impacts on pricing. Although deliverable supply is an important component for establishing position limits, if any, for physically-delivered contracts, its importance is greatly diminished with respect to cash-settled contracts. The Working Group respectfully submits that the Commission reconsider this approach and establish a much higher, more appropriate spot-month limit, if any, on cash-settled contracts.

ii. As Applied to Cash-Settled Referenced Contracts, the *Proposed Rule* Significantly Reduces a Trader's Permitted Position

The Working Group submits that such approach inappropriately cuts in half position limits on cash-settled referenced contracts. For example, a NYMEX Henry Hub

[39] The Working Group supports proposed CFTC Rule 151.4(c)(3) requiring estimates submitted by a DCM to be accompanied by a description of the methodology used by the DCM and any supporting data.

Natural Gas (NG) physically-settled futures contract has a spot-month limit of 1,000. As a result, NYMEX (NN) cash-settled futures and an ICE HH LD1 swap each have a spot-month limit of 1,000. By separating the spot-month limits into "physically-delivered" and cash-settled," and setting each spot-month limit at 1,000, a market participant is effectively forced to add its NN position to its HH LD1 position, and whereas it previously could have held 1,000 in each (2,000 in total), it can now only hold 1000 cash-settled contracts in total. Such a result will likely constrict liquidity in the NYMEX NN and ICE HH LD1 markets. This is contrary to two of the express policy goals of CEA Section 4a(a): (i) ensuring sufficient market liquidity, and (ii) ensuring that the price discovery function of the underlying market is not disrupted.

Post Dodd-Frank position limits also will include swaps that previously were traded over-the-counter ("OTC") and not subject to limits. As a result, the imposition of limits on cash-settled positions will be even more constraining, as positions previously excluded from a market participant's position will now be required to be included, while the levels will be reduced in some circumstances. Thus, the Working Group respectfully requests that the Commission reconsider its spot-month position limits and modify them accordingly.

iii. Conditional Exemption for Cash-Settled Contracts Should Permit Market Participants To Hold Physically-Settled Futures Contracts

In order to promote liquidity and efficient price discovery, proposed CFTC Rule 151.4(a)(2) provides for a conditional spot-month limit. A trader would be permitted to acquire positions that are five times the spot-month limit if such positions are exclusively in cash-settled contracts, and the trader holds physical commodity positions that are less than or equal to 25 percent of the estimated deliverable supply of a physical commodity.[40] However, to qualify for the conditional exemption, market participants may not hold any physically-settled futures contracts.

The Working Group believes the condition requiring market participants to hold no physically settling futures contract is contrary to the statutory goals of CEA Section 4a to promote transparency, protect price discovery, and ensure the efficiency of markets. To the extent a hedger wants to avail itself of the conditional spot-month limit, it would be required to move out of physically settled futures, which would reduce liquidity and price discovery in the physically settled futures markets. The Working Group is concerned that the diminution in liquidity could negatively impact price convergence in the core physical delivery contract.

Accordingly, to accommodate more appropriately the hedging needs of market participants, the Working Group suggests an approach wherein cash-settled position limits are set as a multiple of physically-settled position limits, and so long as a market participant is not in violation of any position limit, their physical positions should not be limited in any manner.

3. The Commission Should Identify All Referenced Paired Contracts Subject to Spot-Month Position Limits

Without clear guidance from the Commission, the broad and vague language defining referenced paired contracts could lead to subjective and inconsistent interpretations by market participants seeking to identify the universe of referenced paired contracts. As such, the Working Group requests that the Commission identify the universe of futures contracts, option contracts, swaps, or swaptions that constitute referenced paired contracts and provide market participants the opportunity to comment on any Commission determination. Because the Commission cannot identify uncleared contracts until they are executed, it should limit referenced paired contracts to only those that are cleared.[41]

Further, after the Commission's initial identification, the Working Group suggests that, in its process for determining whether a swap must be cleared pursuant to the Act, the Commission should also determine whether such swap constitutes a ref-

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[40] Specifically, the conditional exemption for cash-settled contracts would apply if (i) such positions are exclusively in cash-settled contracts, and (ii) a trader holds physical commodity positions that are less than or equal to 25 percent of the estimated deliverable supply. With regard to the second condition, a trader may not hold or control (a) positions in cash-settled contracts in the spot month that exceed the level of any single month position limit, (b) any positions in the physical delivery referenced contract based on the same commodity that is in such contract's spot month, and (c) cash or forward positions in the referenced contract's spot month in an amount that is greater than one-quarter of the deliverable supply in the referenced contract's underlying commodity. *See* proposed CFTC Rule 151.4(a)(2).

[41] The Commission should not be concerned about excluding uncleared contracts because as soon as they become large or material for limit purposes, the Commission can make them subject to mandatory clearing.

erenced paired contract. New CEA Section 4a(a)(7) provides the Commission with broad authority to exempt swaps from speculative position limits it establishes pursuant to Section 4a. If a swap is not required to be cleared pursuant to the mandatory clearing requirements of the Act, it should not be included for purposes of determining position limits.

G. The Proposed Position Visibility Levels Will Impose a Disproportionate Burden on Hedgers

Notwithstanding the absence of any mandate from the Act, the Commission proposes to establish position visibility levels for referenced contracts other than agricultural contracts,[42] and establishes reporting requirements for all traders exceeding those levels in all months or in any single month, including the spot month.[43] Traders with positions above visibility levels in these referenced contracts would be required to submit statements containing additional information about their cash market and derivatives activity, including data relating to substantially the same commodity (*i.e.,* commodities that are different grades or formulations of the same basic commodity).[44]

These visibility and consequent reporting requirements are unnecessary given the transparency provisions that currently exist under the CEA and those being implemented under Title VII of the Act. For example, transparency is provided under: (i) the Large Trader Reporting System for futures markets; and (ii) reporting requirements adopted under Title VII applicable to large swap traders and registered entities, including derivative clearing organizations ("DCO"); and (iii) reporting requirements of uncleared OTC transactions to SDRs or the Commission itself. Further, to the extent that the Commission seeks specific information regarding the hedge exposures of a large market participant (or group of large market participants), it can exercise its special call authority set forth in Rule 18.05 of the Commission's Regulations.[45]

Further, the *Proposed Rule* fails to address and analyze adequately the compliance costs of meeting such visibility requirements and articulate any material benefits accruing to swap or futures markets.[46] The Working Group submits that, in contrast to speculators, compliance with the proposed visibility levels will result in a substantial and disproportionate burden on *bona fide* hedgers, as hedgers will be required to produce voluminous data.

Therefore, in light of the transparency created by Title VII of the Act and the Commission's ability to request data from market participants pursuant to its existing special call authority, the Working Group submits that the imposition of position visibility levels and periodic reporting requirements for hedge exposures is unwarranted. Such requirements will unnecessarily impose a substantial compliance burden for all markets participants and would not provide any benefit that justifies the costs.

H. Transactions Between Affiliates Should Not Be Counted for Position Limit Compliance Purposes

Inter-affiliate transactions that merely shift risk between one corporate affiliate and another (*i.e.,* a book transfer) should not be counted for purposes of complying with position limits. Indeed, inter-affiliate swaps do not in any way enhance systemic risk, nor do they affect liquidity in swap markets. Specifically, inter-affiliate transactions do not add to concentration in the market and therefore cannot lead to an attempt by a market participant to corner the market through excessive speculation. Consequently, the Working Group submits that there is no benefit in including affiliate transactions in any position limit.

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[42] The core referenced futures contracts in the energy sector that are subject to position visibility levels are: NYMEX Light Sweet Crude Oil (22,500 contract level); NYMEX NY Harbor Gasoline Blendstock (7,800 contract level); NYMEX Henry Hub Natural Gas (21,000 contract level); and NYMEX NY Harbor No. 2 Heating Oil (9,900 contract level).

[43] *See* proposed CFTC Rule 151.6. The Working Group notes that the visibility limits are below, and in some cases, significantly below, the all months combined and any month position limits.

[44] These statements must include: (i) the date the trader's position initially reached or exceeded the visibility level; (ii) gross long and gross short positions on an all-months-combined basis; (iii) the contract month and the trader's gross long and gross short positions in the relevant single month (if visibility levels are reached or exceeded in any single month); and (iv) if applicable, certification no positions subject to the additional reporting requirements set forth in the *Proposed Rule* are held.

[45] 17 CFR § 18.05.

[46] *See infra* Part III.J, discussing the Commission's costs and benefit analysis.

I. Aggregation of Positions

The Working Group generally supports the proposed aggregation rules and disaggregation exemption as applied to "owned" non-financial entities. However, the Working Group respectfully requests clarification on the scope and application of the indicia of independent control. Specifically, the Commission should (i) clarify the type of showing a market participant must make to demonstrate independent control; (ii) provide reasonable flexibility for market participants to address specified indicia through alternative, yet functionally equivalent, measures; and (iii) confirm that the positions of a non-financial subsidiary or affiliate that meet the applicable independent management and trading requirements will not be aggregated with a parent financial entity.

The Working Group submits that employees such as attorneys, accountants, and risk management personnel may be shared between two affiliate companies without violating the independence requirements under proposed CFTC Rule 151.7, so long as they do not actively and personally perform day-to-day trading activities and engage in day-to-day trading decisions. The Working Group further submits that risk management systems may also be shared between affiliated companies without violating the independence requirements under proposed CFTC Rule 151.7, so long as appropriate security mechanisms are in place to prevent each company from gaining access to information or data about its affiliated companies' positions, trades, or trading strategies.

Although the Working Group generally supports the proposed aggregation rules and disaggregation exception, it fails to understand certain aspects of proposed CFTC Rule 151.7(g). Specifically, subpart (g)(1)(ii) requires that, in any application for a hedging exemption, a market participant must provide an "independent assessment report" as described in proposed CFTC Rules "151.9(c)(1)(iii) and 151.9(f)(3)." The Working Group notes that these cross-references do not exist and believes this discrepancy is the result of a typographical error that should be corrected. Notwithstanding these errors, the Working Group requests that the Commission provide market participants flexibility in meeting the requirements of proposed CFTC Rule 151.7(g). Specifically, the Working Group respectfully requests that the Commission permit market participants discretion in using internal or external personnel to make assessments relating to the independence of its owned non-financial entities.

Finally, the Working Group recommends that the Commission treat the application for exemption from aggregation requirements for non-financial entities required by proposed CFTC Rule 151.7(g) as a self-certification requirement that is effective immediately upon filing. In addition, the Commission should provide a safe harbor for market participants that submit such applications in good faith to promptly correct inadvertent errors or make adjustments in an orderly manner to comply with newly implemented regulatory requirements under Title VII of the Act.[47]

J. Meaningful Comment on the Anticipated Costs and Benefits of the *Proposed Rule* Is Not Possible at This Time

The Working Group respectfully submits that it cannot meaningfully respond to the costs unless a comprehensive and complete view of all Dodd-Frank rulemakings are known. In particular, the Commission has not yet issued a proposed or final rule further defining the term "swap," as set forth in new CEA Section 1a(47)(A). As such, the Working Group and other market participants are unable to ascertain the universe of transactions that may be subject to Commission oversight as "swaps" and, thus, subject to the requirements of the *Proposed Rule.* This guidance is critical to the efforts of affected market participants to identify and understand the scope and impact of the *Proposed Rule* and effectively comply with it.

The reporting requirements proposed by the Commission as discussed above are commercially impractical and if implemented would create substantial and perhaps irreparable costs to the market and market participants. Further, it is difficult, if not impractical, to meaningfully analyze the costs to traders applying for, and reporting pursuant to, the *bona fide* hedge exemption because it is unclear how the reporting obligations would fit at this time with the many other reporting requirements proposed by the Commission for market participants. Therefore, the Working Group respectfully reserves the right to comment at a later date on the costs from the *Proposed Rule*, when those costs can be better understood and quantified. However, the Working Group offers analysis on several issues regarding the Commission's discussion of costs in the *Proposed Rule.*

[47] Such safe harbor protection is required to permit certain market participants to communicate internally to determine how they must comply with the proposed aggregation requirements and ensure that they do not violate the Commission's proposed rules or the rules and regulations of other federal regulators with jurisdiction over their operations.

The *Proposed Rule*'s analysis of requirements under the Paperwork Reduction Act address three main areas of costs that commercial firms can anticipate: (i) *bona fide* hedge related reporting requirements, (ii) record-keeping requirements for traders applying for *bona fide* hedge exemptions, and (iii) costs arising from the visibility level reporting obligations. The *Proposed Rule* states that the costs related to the reporting of *bona fide* hedges are anticipated to be $37.6 million in the aggregate. This equates to $188,000 per market participant. The record-keeping requirements for traders applying for *bona fide* hedge exemptions are anticipated to be an additional $10.4 million in the aggregate for annualized start up and capital costs and annual operating costs, which equates to $65,000 per market participant.[48] In addition, the *Proposed Rule* estimates that the costs to implement the position visibility levels is approximately $29.7 million in the aggregate, which equates to $212,000 per market participant. The costs associated with those market participants that exceed the visibility levels and need to seek a *bona fide* hedge exemption are estimated to be approximately $465,000 per market participant.

The costs set forth in the Paperwork Reduction Act analysis are not considered in the cost-benefit analysis set forth in the *Proposed Rule*. The costs outlined in the Paperwork Reduction Act section, along with the additional costs imposed by the *Proposed Rule* on *bona fide* hedgers, should be subject to a thorough cost-benefit analysis of any final rule issued in this proceeding. For example, should the Commission exercise its discretion and adopt the pass-through provision, additional costs not considered by the *Proposed Rule* are the costs associated with monitoring compliance with the pass-through provision set forth in proposed CFTC Rule 151.5(a)(1)(iv) that will be imposed on entities relying on the *bona fide* hedge exemption.

The *Proposed Rule* does not offer any empirical evidence as to the criteria for selecting, or process for identifying, the universe of market participants likely to be impacted by this rulemaking. For example, the Commission anticipates that on an annual basis, 140 market participants would be subject to the visibility level reporting obligations, and 200 would be subject to the reporting requirements applicable to *bona fide* hedging transactions. Given that visibility limits are to be set at a substantially lower level than the proposed position limits, the Working Group respectfully submits that it would be reasonable to assume that the number of entities impacted by the visibility limits would be greater than those which would need to seek a *bona fide* hedge exemption. However, the *Proposed Rule* espouses an opposite view.

Further, the cost estimates for wage and salary have been estimated from the Securities Industry and Financial Markets Association ("SIFMA") information. Internal data collected and analyzed by members of the Working Group suggest that the average cost per hour is approximately $120, much higher than SIFMA's $78.61, as relied upon by the Commission.[49] In addition, many commercial firms, including members of the Working Group, are not staffed with the expertise to build the systems that will be required to comply with the various reporting provisions of the *Proposed Rule*. The Working Group anticipates that its members will be utilizing the expertise of consultants to create and implement the information technology systems required by the *Proposed Rule*. Firms will be seeking these services at a time when consultants are in high demand and even before the implementation of Dodd-Frank requirements are at capacity. Thus, the cost estimates offered in the *Proposed Rule* regarding anticipated wage and salary impacts may be significantly below the costs of consultants.

IV. Open Comment Period

Given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure OTC derivatives markets, the Working Group respectfully requests that the Commission hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the en-

[48] The Commission does not provide a breakdown between annualized capital and start up costs and annual total operating and maintenance costs in the discussion of costs in the Paperwork Reduction Act analysis. Therefore it is not possible to ascertain the operating and maintenance costs noted in the *Proposed Rule,* and discussed herein, which the impacted market participants can expect to bear on an annual basis.

[49] For a complete discussion regarding the Working Group's cost estimates of the CFTC's proposed rules, *see* the Comments of the Working Group submitted in response to the CFTC's proposed rule regarding the duties of swap dealers and MSPs, filed on January 24, 2011. *Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants,* 75 FED. REG. 71,397 (Nov. 23, 2010).

tire new market structure and the interconnection between all proposed rules when drafting comments on proposed rules. The resulting comprehensive comments will allow the Commission to better understand how its proposed rules will impact swap markets.

V. Conclusion

The Working Group supports appropriate regulation that brings transparency and stability to the energy swap markets in the United States. The Working Group appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein as it develops a final rule in this proceeding.

The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, please contact the undersigned.

Respectfully submitted,

R. MICHAEL SWEENEY, JR.;
MARK W. MENEZES;
DAVID T. MCINDOE;
Counsel for the Working Group of Commercial Energy Firms.

SUBMITTED QUESTIONS

Response from Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission

Questions Submitted by Hon. Collin C. Peterson, a Representative in Congress from Minnesota

Question 1. Your testimony suggests that regulations may be applied to some asset classes before others. Which asset classes do you think would see regulation first, and what qualities about these asset classes make them ripe for regulation as opposed to others?

Answer. The Commission proposed a rule to establish a process for the review and designation of swaps for mandatory clearing. One of the primary goals of the Dodd-Frank Act was to lower risk by requiring standardized swaps to be centrally cleared. The process set out in the proposed rule is consistent with the Congressional requirement that derivatives clearing organizations (DCOs) be eligible to clear the swaps and that before a swap becomes subject to mandatory clearing, the public gets to provide input on the contract or class of contracts. The proposed rule would provide a process to implement the Dodd-Frank Act requirement that a DCO that plans to accept a swap (or group, category, type, or class of swaps) for clearing to submit the swap to the Commission for review. The proposed rule also includes a process to implement the Dodd-Frank requirement for Commission-initiated review of swaps, including by class. The Commission sought public comment on all aspects of the review process. In addition, DCO submissions and Commission-initiated reviews would be subject to public comment under the proposed rule's processes.

Question 2. There have been a number of concerns raised about the Commission's proposed definition of swap execution facility (SEF) and its requirement that participants must request price quotes from multiple participants. In contrasts the SEC and European regulators appear to be willing to allow one-to-one price quotations, similar to what occurs in over-the-counter markets today.

(a) Explain the reasoning behind the Commission proposal. How will the multiple bid requirement benefit market participants?

(b) Given that the legislative language for SEFs and security-based SEFs are virtually identical, is it possible for both the CFTC's and the SEC's very different proposals to be in compliance with the law? If so, what is a rationale for living with the differences?

(c) Assuming the Commission and the EU continue down their separate paths on this issue, what is to prevent business from moving overseas to what may be viewed as a more favorable trading venue?

Answer. The CFTC's proposed SEF rule will provide all market participants with the ability to execute or trade with other market participants. It will afford market participants with the ability to make firm bids or offers to all other market participants. It also will allow them to make indications of interest—or what is often referred to as "indicative quotes"—to other participants. Furthermore, it will allow participants to request quotes from other market participants. These methods will provide hedgers, investors and Main Street businesses both the flexibility to execute and trade by a number of methods, but also the benefits of transparency and more market competition. The proposed rule's approach is designed to implement Congress' mandates for transparency and competition where multiple market participants can communicate with one another and gain the benefit of a competitive and transparent price discovery process.

The proposal also allows participants to issue requests for quotes, whereby they would reach out to a minimum number of other market participants for quotes. It also allows that, for block transactions, swap transactions involving non-financial end-users, swaps that are not "made available for trading" and bilateral transactions, market participants can get the benefits of the swap execution facilities' greater transparency or, if they wish, would still be allowed to execute by voice or other means of trading.

In the futures world, the law and historical precedent is that all transactions are conducted on exchanges, yet in the swaps world many contracts are transacted bilaterally. While the CFTC will continue to coordinate with the Securities and Exchange Commission (SEC) to harmonize approaches, the CFTC also will consider matters associated with regulatory arbitrage between futures and swaps. The Commission has received public comments on its SEF rule and will move forward to consider a final rule only after staff has had the opportunity to summarize them for consideration and after Commissioners are able to discuss them and provide feedback to staff.

As the Commission works to implement the derivatives reforms in the Dodd-Frank Act—with regard to execution requirements as well as all other areas—we are actively coordinating with international regulators to promote robust and consistent standards and avoid conflicting requirements in swaps oversight. The Commission participates in numerous international working groups regarding swaps, including the International Organization of Securities Commissions Task Force on OTC Derivatives, which the CFTC co-chairs with the SEC. The CFTC, SEC, European Commission and European Securities Market Authority are coordinating through a technical working group.

Question 3. Most estimates place the world's 25 largest banks as a party to more than 90% of the world's swaps. When you testified here last, you suggested that 200 entities would likely register as swap dealers and that most of them would be affiliates of the large banks, who are being required to spin off parts of their swap business under other provisions of Dodd-Frank. Assuming the CFTC's proposed definition of swap dealer remains, of these 200 entities, how many do you believe will not be affiliates of these 25 large banks and who generally would make up these non-affiliated swap dealers?

Answer. In the first week of December 2010, the CFTC and the SEC jointly issued a proposed rulemaking to further define the term "swap dealer." To date, there are more than 200 comments responding to the proposal. Many of the commenters addressed why the definition of swap dealer should or should not encompass particular types of companies. The particular characteristics and activities that would require a company to register as a swap dealer will be addressed in the final rule, after taking the comments into account.

Question 4. In his testimony for the next panel, Mr. McMahon with Edison Electric Institute appears to not want regulators to impose capital or margin requirements on swaps entered into strictly between swap dealers and major swap participants because of potential costs. Given that you think the risks involved with swaps between end-users and financial players do not merit margin requirements, what are your thoughts about Mr. McMahon's idea to do the same for dealer to dealer swaps?

Answer. In passing the Dodd-Frank Act, Congress recognized the different levels of risk posed by transactions between financial entities and those that involve non-financial entities, as reflected in the non-financial end-user exception to clearing. The CFTC also has recognized this, for example, in its proposed rule regarding margin requirements for swap dealers and major swap participants. For any transaction involving a non-financial end-user engaged in hedging or mitigating commercial risk, neither party is required to post margin.

In the joint rulemaking to further define the term "swap dealer," the SEC and the CFTC proposed factors for the *de minimis* exemption based on the aggregate effective notional amount of an entity's trades, its level of trading activity with special entities, the number of counterparties it transacts with and the number of swaps it trades.

Before the Commission proceeds to final rules, Commission staff will read and summarize all submitted public comments, and Commissioners will have the opportunity to review comments and provide feedback.

Question 4a. In his testimony for the next panel, Mr. McMahon with Edison Electric Institute worries that his members' "accommodating" the demand of third parties for swaps are being viewed by the CFTC as dealing activity and such activity could get his members listed as swap dealers.

(a) Have you heard about this "accommodating" swap activity that his members have engaged in and what do you see are the similarities and differences between it and a dealer's swap activity?

(b) Although it would not qualify now under the proposed rules, isn't such "accommodating" swap activity a likely reason why Congress included a *de minimis* exception to the definition of swap dealer?

(c) Assuming this activity does classify one of his members as a swap dealer:

(i) Would the full scope of regulation under the proposed rules apply to all his swap activity or just this "accommodating" activity?

(ii) If his counterparties to these "accommodating" swaps were end-users, wouldn't such swaps still be eligible for the clearing exception and an exception from margin, as you envision it?

Answer. The CFTC and SEC jointly issued a proposed rule to further define the terms "swap dealer," "securities-based swap dealer," "major swap participant" and "major securities-based swap participant." The Commissions specifically sought public comment regarding the appropriate clarifications to the detailed definition included in the statute. While the *de minimis* exemption may apply in particular relevant circumstances, the Commissions sought specific comment with regard to additional factors to be considered where the *de minimis* exemption level may be exceeded. The Commission has received substantial public comment in response. Staff will analyze, summarize and consider public comments before the Commission proceeds further.

Question Submitted by Hon. Randy Hultgren, a Representative in Congress from Illinois

Question. As you know, the Committee has expressed concerns that the Commission is not conducting adequate cost-benefit analysis, and as a result does not know the impact the wave of proposed regulations will have on the economy and our markets. For example, you've received public comments that calculations of the costs of proposed rules by stakeholders have far surpassed those calculated by the Commission—by as much as 20 times, 63 times and even 4,000 times.

- As you hit the "natural pause" in rulemaking and review the "whole mosaic of rules and how they interrelate," do you intend to review the costs and benefits of the rules when applied comprehensively?
- If no—Don't you think that's the critical component to understanding whether the rules will have a negative impact on the economy and jobs?
- If yes—Do you intend to improve the cost-benefit analysis that you're conducting so that your estimates are not 4,000 times below those calculated by stakeholders?

Answer. The CFTC has endeavored to include well-developed considerations of costs and benefits in each of its proposed rulemakings. Relevant considerations are presented not only in the cost-benefit analysis section of the CFTC's rulemaking releases, but additionally are discussed throughout the release in compliance with the Administrative Procedure Act, which requires the CFTC to set forth the legal, factual and policy bases for its rulemakings.

In addition, Commissioners and staff have met extensively with market participants and other interested members of the public to hear, consider and address their concerns in each rulemaking. CFTC staff hosted a number of public roundtables so that rules could be proposed in line with industry practices and address compliance costs consistent with the CFTC's obligations to promote market integrity, reduce risk and increase transparency as directed in Title VII of the Dodd-Frank Act. Information from each of these meetings—including full transcripts of the roundtables—is available on the CFTC's website and has been factored into each applicable rulemaking.

With each proposed rule, the Commission has sought public comment regarding costs and benefits.

With the substantial completion of the proposal phase of rule-writing, the public in recent weeks has had the opportunity to review the whole mosaic of proposed rules. To facilitate this review, the CFTC reopened or extended comment periods for most of our proposed rules for an additional 30 days—allowing the public to submit any comments they may have after seeing the entire mosaic at once, including comments about potential compliance costs as well as phasing of implementation dates to help the agency as we go forward with finalizing rules. In addition, in May CFTC and SEC staff held a 2 day roundtable to hear from the public on implementation dates for final rules. The Commission also offered a 60 day public comment file to hear specifically on this issue. This comment period allowed for presentation of information regarding the costs and benefits of the rules on a comprehensive basis. Final rules will be developed only after staff can analyze, summarize and consider comments; after the Commissioners are able to discuss the comments and provide feedback to staff; and after we consult with fellow regulators on the rules.

Question Submitted by Hon. Christopher P. Gibson, a Representative in Congress from New York

Question. At a time when our economy is struggling to recover, I remain particularly concerned with our international competiveness. Technology and expertise have allowed the futures industry to spread throughout the globe. I understand the CFTC has been working closely with the European Commission, the European Central Bank, new European Securities and Markets Authority and other regulators overseas. I appreciate those efforts, and I hope the close consultations will continue. In a speech you delivered last month, you discussed the importance of "harmonizing oversight" of the swaps market. My question gets back to process and the speed at which the CFTC is moving, as well as the lack of clarity and definitions. Given the pace of the proposed rules, do you believe the CFTC is in danger of moving ahead of the EU and others? How is it possible to "harmonize oversight" if our rule making preempts theirs?

Answer. Regulators across the globe continue to work together towards achieving common goals including the G20 agreement of September 2009 that: all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of2012 at the latest. OTC derivative contracts should be reported to trade repositories. And non-centrally cleared contracts should be subject to higher capital requirements.

Japan is now working to implement its reforms. In September of last year, the European Commission (E.C.) released its swaps proposal. The European Council and the European Parliament are now considering the proposal. Asian nations, as well as Canada, also are working on their reform packages.

As we work to implement the derivatives reforms in the Dodd-Frank Act, we are actively coordinating with international regulators to promote robust and consistent standards and avoid conflicting requirements in swaps oversight. The Commission participates in numerous international working groups regarding swaps, including the International Organization of Securities Commissions Task Force on OTC Derivatives, which the CFTC co-chairs with the Securities and Exchange Commission (SEC). The CFTC, SEC, European Commission and European Securities Market Authority are intensifying discussions through a technical working group.

As we do with domestic regulators, we are sharing many of our memos, term sheets and draft work product with international regulators. We have been consulting directly and sharing documentation with the European Commission, the European Central Bank, the UK Financial Services Authority, the new European Securities and Markets Authority, the Japanese Financial Services authority and regulators in Canada, France, Germany and Switzerland.

The Dodd-Frank Act recognizes that the swaps market is global and interconnected. It gives the CFTC the flexibility to recognize foreign regulatory frameworks that are comprehensive and comparable to U.S. oversight of the swaps markets in certain areas. In addition, we have a long history of recognition regarding foreign participants that are comparably regulated by a home country regulator. The CFTC enters into arrangements with our international counterparts for access to information and cooperative oversight. We have signed Memoranda of Understanding with regulators in Europe, North America and Asia.

Questions Submitted by Hon. William L. Owens, a Representative in Congress from New York

Question 1. Will the Commission fully exempt end-users, including utilities, to hedge their commercial risks without having to clear those swaps and without the parties having to post margin?

Answer. In passing the Dodd-Frank Act, Congress recognized the different levels of risk posed by transactions between financial entities and those that involve non-financial entities, as reflected in the non-financial end-user exception to clearing. The CFTC has recognized this in its proposed rule regarding margin requirements for swap dealers and major swap participants. For any transaction involving a non-financial end-user engaged in hedging or mitigating commercial risk, neither party is required to post margin.

Before the Commission proceeds to final rules, Commission staff will read and summarize all submitted public comments, and Commissioners will have the opportunity to review comments and provide feedback.

Question 2. The business conduct rules established for governmental entities could potentially affect the access to and cost of swaps for public power utilities. What is the Commission doing in its rulemaking to ensure that governmental entities, like public power systems, continue to have access to swaps without the imposition of new burdensome and costly requirements?

Answer. The Commission's proposed business conduct standards rules track the statutory directive under the provisions of the Dodd-Frank Act that create a higher standard of care for swap dealers dealing with Special Entities, which include governmental entities. The proposed rules were designed to enable swap dealers to comply with their new duties in an efficient and effective manner. The Commission is reviewing the comments it has received on the proposed rules to ensure that the final rules achieve the statutory purpose without imposing undue costs on market participants. The proposed rulemaking release specifically asked that the public provide comment regarding associated costs and benefits.

Question 3. As you note in your testimony, the CFTC has yet to issue any guidance on what constitutes a "swap", and has yet to issue final rules on who's a "swap dealer", or a "major swap participant." How has this process impacted the SEC–CFTC Working Group's ability to participate in the rulemaking process, and, perhaps more importantly, how has it impacted the ability of members of the Working Group to evaluate how the CFTC's proposed regulatory regime will impact business operations?

Answer. The joint CFTC–SEC proposed rule to further define the terms "swap," "security-based swap," "mixed swap" and "security-based swap agreement" was published in the *Federal Register* on May 23, 2011.

Question 4. As you know, the CFTC is mandated under Dodd-Frank to have final rules issued by mid-July 2011. Can you provide a timeline on an appropriate strategy or timeline by which the CFTC should make effective its final rules in a manner that will provide entities, such as those in the SEC–CFTC's Working Group, adequate time for compliance? If applicable, please describe any potential implementation phase-ins, delaying of effective dates, or order by which certain final rules should be issued or become effective.

Answer. In enacting title VII of the Dodd-Frank Act, Congress gave the CFTC latitude with respect to the effective dates of particular requirements. In May, the Commission re-opened many of its comment periods that had closed and extended some existing comment periods so that the public could comment in the context of the entire mosaic of proposed rules. This opportunity was available with respect to all relevant proposed rules, giving the public and market participants the opportunity to comment on compliance costs and to make recommendations regarding the schedule of implementation. That extended comment period closed on June 3, 2011. In addition, on May 2 and 3, CFTC and SEC staff held roundtable sessions to obtain public input on implementation dates of the various rulemakings. Prior to the roundtable, on April 29, CFTC staff released a document that set forth concepts that the Commission may consider with regard to the effective dates of final rules for swaps under the Dodd-Frank Act. We also offered a 60 day public comment file to hear specifically on this issue. The roundtable and resulting public comment letters will help inform the Commission as to what requirements can be met sooner and which ones will take a bit more time.

Question 5. If subject to the regulatory requirements associated with being a swap dealer or major swap participant, you've testified that energy firms would face significant compliance costs. Could you briefly describe for this Committee how regulation as a swap dealer or major swap participant would impact additional compliance costs on energy companies?

Answer. The Dodd-Frank Act requires that swap dealers comply with rules establishing capital requirements, margin requirements, and business conduct standards. For non-bank swap dealers, the CFTC is responsible for issuing regulations establishing those requirements. The Commission has endeavored to include well-developed considerations of costs and benefits in each of its proposed rulemakings. Relevant considerations are presented not only in the cost-benefit analysis section of the CFTC's rulemaking releases, but additionally are discussed throughout the release in compliance with the Administrative Procedure Act, which requires the CFTC to set forth the legal, factual and policy bases for its rulemakings.

In addition, Commissioners and staff have met extensively with market participants and other interested members of the public to hear, consider and address their concerns in each rulemaking. CFTC staff hosted a number of public roundtables so that rules could be proposed in line with industry practices and address compliance costs consistent with CFTC obligations to promote market integrity, reduce risk and increase transparency as directed in Title VII of the Dodd-Frank Act. Information from each of these meetings—including full transcripts of the roundtables—is available on the CFTC's website and has been factored into each applicable rulemaking.

With each proposed rule, the Commission has sought public comment regarding costs and benefits.

Question 6. You mentioned in your testimony that the CFTC is reviewing the *de minimis* exception for swap dealers. What do you believe would be an appropriate *de minimis* exception?

Answer. In the joint rulemaking to further define the term "swap dealer," the SEC and the CFTC proposed factors for the *de minimis* exemption based on the aggregate effective notional amount of an entity's trades, its level of trading activity with special entities, the number of counterparties it transacts with and the number of swaps it trades. Specifically, to qualify for the *de minimis* exemption under the proposed rule, the entity's total notional swap activity must not exceed $100 million in a 12 month period, the notional amount of transactions with special entities must not exceed $25 million, it must not enter into swaps with more than 15 counterparties, and must not enter into more than 20 swaps as a dealer in a 12 month period. The Commissions specifically requested that the public provide comments regarding the proposal with respect to the *de minimis* exemption.

Question 7. Congress directed the CFTC to "consider whether to exempt small banks, savings institutions, farm credit system institutions, and credit unions." Will the Commission clarify in its final rules that farm credit system institutions, credit unions and small banks with under $10 billion in assets will qualify for the end-user clearing exemption?

Answer. The Dodd-Frank Act specifically provides for an exception from the clearing requirement for non-financial end-users hedging or mitigating commercial risk. It also requires the CFTC to consider whether to exempt farm credit system institutions, depository institutions and credit unions with total assets of $10 billion or less from the clearing mandate. The CFTC issued a proposed rulemaking with respect to the end-user exception from the clearing requirement that also requested comment regarding such small financial institutions. The Commission has received substantial public comment in response. Staff will analyze, summarize and consider public comments before the Commission proceeds further.

Response from James M. Field, Senior Vice President and Chief Financial Officer, Deere & Company

Question Submitted by Hon. Randy Hultgren, a Representative in Congress from Illinois

Question. I'm concerned about the impact of Title VII on pension plans. Can you tell me if Deere's pension plan engages in swaps? What would be the impact for Deere retirees if the plan were no longer able to engage in swaps or if they became prohibitively expensive?

Answer. The John Deere Pension Trust maintains trading positions in derivative contracts to implement asset allocation, investment strategies, and for risk management. Interest rate swaps are used for asset/liability surplus risk management. Currency spots and forwards are used to mitigate foreign exchange risk for investments held in currencies other than the U.S. dollar. Commodity total return swaps are used as a liquid alternative for implementing commodity exposures. If the pension trust was no longer able to engage in swaps, or swaps became prohibitively expensive due to Title VII or other regulations, the plans would incur higher transactions costs and experience higher volatility and surplus risk. This is clearly not in the best interest of plan beneficiaries nor the corporate plan sponsor, and ultimately could impact the level of benefits provided to plan participants, including the possibility of freezing, closing or termination of the plans.

Response from Ann E. Trakimas, Chief Operating Officer, CoBank, Greenwood Village, CO; on behalf of Farm Credit Council

Question Submitted by Hon. Christopher P. Gibson, a Representative in Congress from New York

Question. I remain extremely concerned about potential effects on my family farms and coops in my district. Falling under the definition of a swap dealer could significantly harm the ability of my farmers, who already face financial challenges, to hedge risk. On a related note, I am troubled over the testimony on Farm Credit Institutions. In your written testimony you address the potential for the CFTC to take a narrow approach to the $10 billion asset limit. What might an overly narrow interpretation of the asset limit mean for the Farm Credit System? Additionally, what could collateral and mandatory clearing mean to farm credit in my district?

Answer. Attached is a copy of the comment letter we submitted June 3 to the CFTC regarding the costs associated with both mandatory clearing and swap dealer regulation. Also attached is an earlier comment letter (Feb 22, 2011) we submitted to the CFTC regarding the "swap dealer" definition and "end-user" exception.

As you will note it is difficult to precisely estimate the costs of collateral and mandatory clearing, both in general as well as with respect to your Congressional District. We do note that the as a cooperative system, the costs of compliance become part of the operating rate that borrowers are ultimately responsible to bear. All farmers, ranchers and their cooperatives in your district would share proportionately in those costs.

We hope this additional information is responsive to your inquiry. If we can provide further assistance, please let us know.

ATTACHMENT 1

June 3, 2011

By Electronic Submission

Mr. David A. Stawick,
Secretary,
Commission Commodity Futures Trading Commission,
Washington, D.C.

Re: Entity Definitions (RIN 3038–AD06, RIN 3235–AK65) End-User Clearing Exception (RIN 3038–AD10)

Dear Mr. Stawick:

The Farm Credit Council, on behalf of its members, submits further comments on rules issued by the Commodity Futures Trading Commission (the "Commission") to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] As you know, on February 22, 2011, we submitted comments on the notices of proposed rulemaking concerning both the further definition of "swap dealer" and the end-user clearing exception.[2] We appreciate the opportunity to supplement these comments in light of the comprehensive regulatory framework that the Commission has now proposed.[3]

The Farm Credit Council is the national trade association for the Farm Credit System, a government instrumentality created "to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations."[4] Today, the Farm Credit System comprises five banks and 87 associations, which together provide 40% of agricultural lending in the United States. To provide tailored financing products for farmers and farm-related businesses, Farm Credit System institutions rely on the safe use of derivatives to manage interest rate, liquidity, and balance sheet risk, primarily in the form of interest rate swaps. These non-speculative swaps are backed by collateral. **Specifically, as of March 31, 2011, the Farm Credit System's total derivatives exposure, net of collat-**

[1] Pub. L. No. 111–203, 124 Stat. 1376 (2010).

[2] *See* End-User Exception to Mandatory Clearing of Swaps, 75 *Fed. Reg.* 80747 (proposed Dec. 23, 2010) (to be codified at 17 CFR pt. 39); Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 *Fed. Reg.* 80174 (proposed Dec. 21, 2010) (to be codified at 17 CFR pts. 1 & 240).

[3] *See* Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 *Fed. Reg.* 25274 (May 4, 2011).

[4] 12 U.S.C. § 2001(a).

eral ($204 million), represented approximately 11 to 12 basis points of the System's total loan volume ($177.5 billion). Respectfully, we would advocate that such a limited FCS exposure does *not* rise to current concerns related to systemic risk and/or interconnectivity.

As we have previously explained, Congress intended Farm Credit System institutions to qualify for the end-user exception to mandatory clearing. In this regard, we urged the Commission to clarify that it will consider (1) the average assets of that bank's affiliated lending organizations, and (2) risk-based factors to determine whether a financial institution's derivatives activity should be subject to mandatory clearing. Further, we have explained that no Farm Credit System institution should be regulated as a swap dealer. In this regard, we have urged the Commission to clarify that, like the commercial banks with which they compete, Farm Credit System institutions will be exempt from swap dealer regulation for swaps entered into in connection with originating customer loans.

Mandatory clearing or swap dealer regulation would raise the costs of risk management for Farm Credit System institutions and their borrowers. These new costs would reduce liquidity, discourage effective risk management, and frustrate the Farm Credit System's congressionally endorsed mission of providing financing to rural America. Having had more time to evaluate the consequences of these proposed regulations, the Farm Credit Council can now provide a clearer estimate of the costs that would result from mandatory clearing or swap dealer regulation. Although proposed requirements for margin on uncleared swaps will impose still additional costs on Farm Credit System institutions, the Farm Credit Council will address those proposed rules in separate comment letters.

I. Costs of Mandatory Clearing

We estimate that, conservatively, mandatory clearing would impose new costs on Farm Credit System institutions ranging from $6 million to $27.2 million, per year. This estimate depends on the direction and volatility of interest rates, which in some scenarios, may require Farm Credit System institutions to post additional margin and thereby incur costs exceeding even the high end of our estimate. For example, our estimate would have to be raised if exchanges were to increase initial margin requirements in response to changes in interest rates.

Our estimate represents the incremental costs that would result from moving the Farm Credit System's current bilateral interest rate swaps to major clearinghouses. First, we estimate that clearing would impose millions of dollars annually in transaction and operational costs. Specifically, Farm Credit System institutions would have to pay new fees to clearinghouses, futures commission merchants, and swap execution facilities. Additionally, Farm Credit System institutions would have to incur the cost of developing new systems to process cleared trades.

More significantly, Farm Credit System institutions would incur financing costs associated with posting initial and variation margin at clearinghouses. These financing costs are more difficult to predict because they depend on both the value of the Farm Credit System's swap positions, which may trigger variation margin requirements, and the level of interest rates, which will govern the cost of meeting margin calls. In fact, the negative carry associated with financing margin calls could easily exceed the assumptions we used to arrive at our estimates, pushing the annual cost of mandatory clearing above $27 million.

Finally, in addition to the up to $27 million in new annual costs discussed above, mandatory clearing will require Farm Credit System institutions to post funds as margin that they could otherwise lend to farmers and farm-related businesses. The largest two Farm Credit System banks estimate that they will likely have to post $250 million and $50 million in initial margin annually. In an adverse scenario, Farm Credit System institutions will have to post even larger amounts in variation margin. To be sure, the Farm Credit System currently posts—and collects—collateral from its bilateral swap counterparties, and Farm Credit System institutions carefully manage counterparty credit risk. To the extent that more margin is required at a clearinghouse, however, those funds will no longer be available for loans to farmers, ranchers, and farm-related businesses.

Accordingly, we continue to believe that, especially given the costs it would impose, mandatory clearing is not warranted for the Farm Credit System, which poses little risk to the United States financial system.

II. Costs of Swap Dealer Regulation

The costs of swap dealer regulation are more difficult to quantify. Currently, one Farm Credit System bank, CoBank, provides swaps to its customers, most commonly in the form of interest rate swaps tied to the financial terms of the loans it issues. If CoBank did not qualify for the exception granted to insured depository institutions providing swaps in conjunction with loans to a customer or the *de minimis* exception to the swap dealer definition, compliance risks and new regulation would force CoBank to cease activity causing it to be a swap dealer. This would impose costs on both CoBank and its member associations.[5]

As we explained in our February 22 letter, CoBank manages the risk of customer default by requiring certain customers to enter into swaps that hedge fluctuations in interest rates. This way, if interest rates rise—thereby raising the cost of loan payments—the customer will be hedged. CoBank usually has between $2 to $3 billion in these risk-reducing customer transactions. Eliminating the ability to help customers hedge changes in interest rates would increase credit risk to CoBank on this portion of its loans.

If CoBank ceased its customer derivatives activity, CoBank's affiliated associations would also face additional costs. These associations use swaps provided by CoBank to position their equity over a medium-term timeframe to earn a consistent return on equity. A consistent return on equity is important because, unlike commercial banks, cooperative Farm Credit System associations return their profits to their borrower-members in the form of patronage distributions. The consistent return therefore allows the associations to pay a consistent level of patronage distributions to the farmers and ranchers that borrow from them. We estimate that losing the ability to invest their equity over a longer time horizon would cost CoBank's affiliated associations an estimated $5 to $15 million in funds that are currently returned to borrower-members in patronage distributions.

Accordingly, we continue to believe that no Farm Credit System institution warrants regulation as a swap dealer. To the contrary, the risk-reducing products that CoBank offers actually make the bank safer and provide benefits to the Farm Credit System's member-borrowers.

III. Conclusion

For the reasons set forth above, the Farm Credit Council continues to urge the Commission to clarify both that Farm Credit System institutions will: (1) be eligible for the end-user clearing exemption, such as looking through each Farm Credit Bank to the average size of its affiliated associations, and (2) that Farm Credit System institutions will not be regulated as swap dealers to the extent they enter into swaps in connection with originating customer loans. Mandatory clearing or swap dealer regulation would raise costs—and increase risk—to the Farm Credit System and the farmers and ranchers that rely on it as a source of financing. Because Farm Credit System institutions are already safe and sound, and because they responsibly manage their derivatives exposure, we do not believe they pose systemic risk warranting these costly new regulations.

The Farm Credit Council appreciates the opportunity to comment. If you have any questions or we can provide other information, please do not hesitate to contact us. As always, we would welcome the opportunity to work with the Commission in developing the final rule.

Sincerely,

ROBBIE BOONE,
Vice President, Government Affairs,
Farm Credit Council.

CC:

Honorable GARY GENSLER, *Chairman;*
Honorable MICHAEL DUNN, *Commissioner;*
Honorable JILL E. SOMMERS, *Commissioner;*
Honorable BART CHILTON, *Commissioner;*
Honorable SCOTT D. O'MALIA, *Commissioner.*

ATTACHMENT 2

February 22, 2011

By Electronic Submission

[5] Consistent with the Farm Credit Act's "objective . . . to encourage farmer- and rancher-borrowers['] participation in the management, control, and ownership of a permanent system of credit for agriculture," 12 U.S.C. § 2001(b), Farm Credit System banks are cooperatives primarily owned by their affiliated associations, and Farm Credit System associations are cooperatives owned by their borrowers.

Mr. David A. Stawick,
Secretary,
Commission Commodity Futures Trading Commission,
Washington, D.C.

Re: End-User Exception to Mandatory Clearing of Swaps (RIN 3038–AD10)

Dear Mr. Stawick:

The Farm Credit Council, on behalf of its members, submits these comments on the Notice of Proposed Rulemaking ("NOPR") issued by the Commodity Futures Trading Commission ("Commission") concerning the end-user exception to mandatory clearing under Section 723 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1]

The Farm Credit Council is the national trade association for the Farm Credit System, a government instrumentality created "to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations."[2] Fulfilling this mission, the Farm Credit System's five banks and 87 associations currently account for 40% of agricultural lending in the United States. To provide tailored financing products for farmers and farm-related businesses, Farm Credit System institutions rely on the safe use of derivatives to manage interest rate, liquidity, and balance sheet risk, primarily in the form of interest rate swaps. Because we believe Congress intended the end-user exception to preserve our ability to provide dependable financing to farmers, farm-related businesses, and rural America, the Farm Credit Councilappreciates the opportunity to comment.

I. Summary of Comments

The Farm Credit Council supports Dodd-Frank's goal of making the derivatives market safer, and appreciates that mandatory clearing of swaps entered into by risky Wall Street institutions will provide important protections for the market. But clearing would also make the derivatives that the Farm Credit System safely and effectively uses to manage risk more expensive. These new costs would reduce liquidity, discourage effective risk management, frustrate the Farm Credit System's congressionally endorsed mission, and diminish rural America's access to credit. Congress did not intend, and the Commission should not endorse, such a result. Accordingly, the Commission should permit all Farm Credit System institutions to use the end-user clearing exception.

Specifically, our comments address the following issues:

- Dodd-Frank does not limit eligibility for the end-user exception to institutions with total assets of $10 billion or less, and any such limit would be particularly inappropriate for the Farm Credit System.
- In order to preserve competition for agricultural lending, the Commission must "look through" Farm Credit System banks to the smaller associations that own them and that benefit from the banks' derivatives activity. Otherwise, Farm Credit System associations would have to bear the cost of mandatory clearing, while competing commercial banks would not.
- Because the Farm Credit Administration effectively regulates Farm Credit System institutions; because Farm Credit System institutions only enter into safe, non-speculative swaps backed by collateral; and because the Farm Credit System is not interconnected with other financial entities, the Farm Credit System's derivatives activity does not warrant mandatory clearing.
- Alternatively, the Commission should adopt a risk-based approach to mandatory clearing, similar to the proposed definition of major swap participant, that would exempt small financial institutions whose current uncollateralized exposure and potential future exposure fall below certain thresholds.

II. Dodd-Frank Does Not Impose an Asset Limit on Which Farm Credit System Institutions May Qualify for the End-User Clearing Exception

Dodd-Frank requires the Commission to "consider whether to exempt . . . farm credit system institutions, . . . including . . . farm credit system institutions with

[1] End-User Exception to Mandatory Clearing of Swaps, 75 *Fed. Reg.* 80747 (proposed Dec. 23, 2010) (to be codified at 17 CFR pt. 39). Section 723 of Dodd-Frank, Pub. L. No. 111–203, 124 Stat. 1376, 1675–82 (2010), amends Section 2 of the Commodity Exchange Act ("CEA"), 7 U.S.C. § 2.

[2] 12 U.S.C. § 2001(a).

total assets of $10,000,000,000 or less." [3] The Farm Credit Council urges the Commission to clarify that this language does not set an asset limit on which institutions the Commission may exempt from mandatory clearing.

In fact, Congress gave the Commission broad authority to permit Farm Credit System institutions, including those with total assets of more than $10 billion, to use the end-user exception. The following colloquy between Representatives Holden and Peterson of the House Agriculture Committee makes this clear:

> Mr. HOLDEN. . . . Mr. Speaker, I now would like to enter into a colloquy with the chairman of the Agriculture Committee.
>
> Mr. Chairman, the conference report includes compromise language that requires the Commodity Futures Trading Commission to consider exempting small banks, Farm Credit System institutions and credit unions from provisions requiring that all swaps be cleared. We understand that community banks, Farm Credit institutions and credit unions did not cause the financial crisis that precipitated this legislation. While the legislation places a special emphasis on institutions with less than $10 billion in assets, *my reading of the language is that they should not in any way be viewed by the Commodity Futures Trading Commission as a limit on the size of the institution that should be considered for an exemption.*
>
> Mr. Chairman, would you concur with this assessment?
>
> Mr. PETERSON. Yes, I fully agree. The language says that institutions to be considered for the exemption shall include those with $10 billion or less in assets. It is not a firm standard. *Some firms with larger assets could qualify,* while some with smaller assets may not. The regulators will have maximum flexibility when looking at the risk portfolio of these institutions for consideration of an exemption.[4]

Senator Lincoln made a similar statement in the Senate. She observed that "small financial entities, such as banks, credit unions and farm credit institutions below $10 billion in assets—*and possibly larger entities*—will be permitted to utilize the end-user clearing exemption with approval from the regulators." [5]

In giving the Commission the authority to exempt institutions with assets exceeding $10 billion, Congress sought to avoid imposing new, clearing-related costs on the Farm Credit System. As Senators Dodd and Lincoln explained, "These entities did not get us into this crisis and should not be punished for Wall Street's excesses. They help to finance jobs and provide lending for communities all across this nation. That is why Congress provided regulators the authority to exempt these institutions." [6]

Further, as Representative Holden described in detail, mandatory clearing would have no benefit as applied to Farm Credit System institutions because they already effectively manage risk:

> Farm Credit System institutions are regulated and examined by a fully empowered independent regulatory agency, the Farm Credit Administration, which has the authority to shut down and liquidate a system institution that is not financially viable. In addition, the Farm Credit System is the only GSE that has a self-funded insurance program in place that was established to not only protect investors in farm credit debt securities against loss of their principal and interest, but also to protect taxpayers.
>
> These are just a few of the reasons why the Agriculture Committee insisted that the institutions of the Farm Credit System not be subject to a number of the provisions of this legislation. They were not the cause of the problem, did not utilize TARP funds, and did not engage in abusive subprime lending. We have believed that this legislation should not do anything to disrupt this record of success.[7]

Although Farm Credit System associations have, on average, total assets that are well under $10 billion, all of the five Farm Credit System banks have total assets exceeding $10 billion. If, despite the Commission's broad authority to exempt all Farm Credit System institutions, the end-user exception were confined to institutions with total assets of $10 billion or less, no Farm Credit System bank would qualify, and the bulk of the System's derivatives activity would be subject to a costly

[3] Pub. L. No. 111–203, § 723, 124 Stat. at 1680 (CEA § 2(h)(7)(C)(ii)).
[4] 156 *Cong. Rec.* H5246 (daily ed. June 30, 2009) (emphasis added).
[5] 156 *Cong. Rec.* S5921 (daily ed. July 15, 2010) (emphasis added).
[6] *See* Letter from Sens. Dodd and Lincoln to Reps. Frank and Peterson, *in* 156 *Cong. Rec.* S6192 (daily ed. July 22, 2010).
[7] 156 *Cong. Rec.* H5246 (daily ed. June 30, 2009) (statement of Rep. Holden).

new clearing requirement. As the legislative history demonstrates, the Commission can and should avoid this result. Accordingly, the Farm Credit Council urges the Commission to permit all Farm Credit System institutions—regardless of their total assets—to use the end-user clearing exception.

III. If the Commission Adopts an Asset Test, It Should Look Through Farm Credit System Banks to the Small Associations Whose Risk They Hedge With Derivatives

If the Commission adopts an asset-based test for which financial institutions qualify for the end-user exception, it should clarify that it will look through Farm Credit System banks and consider the average assets of their affiliated associations. As explained below, any other approach would give commercial banks an unfair competitive advantage in the market for agricultural lending.

Consistent with Congress's "objective . . . to encourage farmer- and rancher-borrowers['] participation in the management, control, and ownership of a permanent system of credit," [8] the Farm Credit System has a unique structure. Farm Credit System banks are cooperatives primarily owned by their affiliated associations.[9] The Farm Credit Act authorizes the banks "to make loans and commitments to eligible cooperative associations." [10] Farm Credit System associations are, in turn, authorized to make loans to *bona fide* farmers and ranchers, rural residents, and persons furnishing farm-related services.[11] Put simply, Farm Credit banks lend to Farm Credit associations, which lend to farmers, and farmers own the Farm Credit associations, which own the Farm Credit banks.

Accordingly, Farm Credit System banks are larger than their affiliated associations. For example, AgriBank, FCB, is the largest district bank, and its assets exceed $10 billion. But the 17 associations that own 99% of AgriBank have average assets of $3.6 billion, well below the $10 billion threshold suggested in Dodd-Frank.

Unique among agricultural lenders, the Farm Credit System's legal structure places the funding function for each district with the district bank. Centralized funding, in turn, enables the associations to benefit from lower administrative and operational costs. Swaps are executed by the district bank to gain hedge accounting, to minimize administrative costs, and to minimize counterparty credit risk and margin requirements via district-wide netting of offsetting exposures. This is more cost effective and strengthens the liquidity of the System. As a result, Farm Credit System associations have a lower risk profile than the small commercial banks with which they compete.

If the Commission adopted a $10 billion asset limit, this structure would place Farm Credit System associations at a competitive disadvantage with respect to commercial banks. Absent a "look through" provision for Farm Credit System institutions, small commercial banks would be eligible for the end-user exception on a standalone basis, while Farm Credit System associations would have to bear the costs of mandatory clearing. Clearing costs would, in turn, be passed on to farmers and ranchers in the form of higher effective interest rates on loans. Community banks eligible for the end-user clearing exception would therefore be able to gain market share by offering lower interest rates. Even banks that do not qualify for the end-user exception would benefit from spreading the costs of clearing across their entire business, including segments outside agriculture.

Although the majority of Farm Credit System associations have assets of less than $10 billion, the few associations with greater assets do not present risk requiring mandatory clearing. Even the failure of a large association would have no material impact on the Farm Credit System's ability to meet its debt obligations because the five Farm Credit System banks are jointly and severally liable for the System's notes and bonds. Thus, no association is so large that it would impact System debt holders if it were placed in receivership. By contrast, if a standalone commercial bank fails, its bondholders will likely face losses.

As noted, Congress gave the Commission "maximum flexibility" to adopt an equitable solution for which small financial institutions will qualify for the end-user exception.[12] The Farm Credit Council believes that the fair way to compare the hedging activities that benefit Farm Credit System associations with the hedging activities of their competing commercial banks is to consider the average assets of Farm Credit System associations in a particular district. If the Commission does not adopt

[8] 12 U.S.C. § 2001(b).

[9] *See id.* § 2124(c) (providing that "[v]oting stock may be issued or transferred and held only by . . . cooperative associations eligible to borrow from the banks").

[10] *Id.* § 2128(a).

[11] *See id.* § 2075.

[12] 156 *Cong. Rec.* H5246 (daily ed. June 30, 2009) (statement of Rep. Peterson).

such a "look through" approach, small Farm Credit System associations would be forced to raise interest rates for farmers and ranchers, and they would be placed at a competitive disadvantage in the market for agricultural lending.

IV. Farm Credit System Institutions Should Qualify for the End-User Clearing Exception

The Commission requested comment on, among other issues, whether an exception for Farm Credit System institutions would be appropriate.[13] As we describe more fully below, an exception is appropriate because the non-speculative, collateralized derivatives activity of comprehensively regulated Farm Credit System institutions does not pose risk to the United States financial system warranting mandatory clearing. Further, imposing a costly new clearing requirement on Farm Credit System institutions would frustrate Congress's equally important mission of providing a dependable source of financing for rural America.

A. Farm Credit System Institutions Do Not Cause Systemic Risk Warranting Mandatory Clearing

1. Comprehensive Regulation by the Farm Credit Administration Adequately Mitigates the Risk of Farm Credit System Institutions

The Farm Credit Council agrees that the Commission should "take into account the supervisory regimes to which Small Financial Institutions are currently subject, and whether those regulatory regimes adequately mitigate any risks associated with an exception[.]"[14] Farm Credit System institutions are regulated by the Farm Credit Administration, an independent federal agency that adequately mitigates any risks associated with permitting Farm Credit System institutions not to clear derivatives.

First, the Farm Credit Act authorizes the Farm Credit Administration to exercise broad powers "for the purpose of ensuring the safety and soundness of System institutions."[15] Those powers include:

- Bringing cease and desist proceedings against any institution or institution-affiliated party that has engaged, is engaging, or is about to engage in an unsafe or unsound practice;[16]
- Suspending or removing directors or officers of Farm Credit System institutions who engage in unsafe or unsound practices;[17] and
- Assessing civil monetary penalties against institutions or individuals thatviolate provisions of the Farm Credit Act or Farm Credit Administrationregulations.[18]

Further, if the Farm Credit Administration determines that a System institution is in an "unsafe or unsound condition to transact business," the Farm Credit Administration may place that institution in conservatorship or receivership.[19]

Second, the Farm Credit Administration effectively oversees the capital adequacy of System institutions. By regulation, the Farm Credit Administration ensures that institutions meet minimum capital requirements and establish written capital adequacy plans reviewed by that agency.[20] Specifically, each Farm Credit System institution must maintain permanent capital of at least 7% of its risk-adjusted asset base.[21] The Farm Credit Administration also rates the safety and soundness of each System institution using the uniform Financial Institutions Rating System, or CAMELS.[22] At the end of 2009, 82% of Farm Credit System banks and direct lending associations earned a score of one or two, out of five, on the CAMELS scale, with a score of one indicating that the institution is "sound in every respect."[23] Indeed, more than 90% of System assets are currently housed in institutions rated one or two.

Third, the Farm Credit Administration adequately oversees derivatives activity. By regulation, Farm Credit System institutions must adopt policies that mitigate

[13] NOPR, 75 *Fed. Reg.* at 80753.
[14] *Id.*
[15] 12 U.S.C. § 2252(a)(10).
[16] *See id.* § 2261.
[17] *See id.* §§ 2264–2265.
[18] *See id.* § 2268.
[19] *See id.* § 2183.
[20] *See* 12 CFR §§ 615.5200–615.5215.
[21] *See id.* § 615.5205.
[22] The name CAMELS derives from the rating's focus on six factors: capital, assets, management, earnings, liquidity, and sensitivity to market risk.
[23] Farm Credit Administration, 2009 Annual Report on the Farm Credit System 42, available at *http://www.fca.gov/Download/AnnualReports/2009AnnualReport.pdf.*

risk, including credit risk, by limiting their exposure to single or related counterparties, geographical areas, industries, or obligations with similar characteristics.[24] The Farm Credit Administration has further directed each Farm Credit System institution "to establish a policy with appropriate limits to ensure that counterparty risks are consistent with the institution's risk-bearing capacity."[25] In reviewing institutions' policies on exposure to counterparty credit risk, the Farm Credit Administration considers:

- Criteria for appropriate due diligence including processes for measuring and managing counterparty risk;
- Criteria for selecting and maintaining relationships with counterparties, which may include credit ratings;
- Controls that limit the exposure of capital to single counterparties expressed as a percent of the institution's capital base;
- Periodic reporting and monitoring of counterparty exposures to the board;
- Periodic reporting to the board on each counterparty's financial condition, including an assessment of its ability to perform on agreements and contracts executed with the institution; and
- Actions to mitigate an institution's exposure in the event the financial condition of a counterparty deteriorates and doubts arise about its ability to perform in accordance with the relevant agreements or contracts.[26]

Together, these comprehensive regulatory requirements effectuate the Farm Credit Administration's mission of ensuring a safe, dependable source of credit for agriculture and rural America. The Commission should not add a costly, unnecessary clearing requirement when the Farm Credit Administration's regulation and oversight already effectively mitigate risk to the financial system.

2. Farm Credit System Institutions Primarily Use Fixed-for-Floating Interest Rate Swaps and Effectively Manage Counterparty Credit Risk

The Farm Credit Council further agrees that the Commission should "consider treating different types of swaps differently when considering whether any exception should be available."[27] Because the Farm Credit System uses safe, non-speculative interest rate swaps and already effectively addresses counterparty credit risk, clearing should not be required.

Farm Credit System institutions primarily use plain vanilla, fixed-for-floating interest rate swaps, and materially all of our derivatives qualify for hedge accounting treatment. Farm Credit System institutions do not use swaps to speculate, and do not use the credit default swaps that caused the financial crisis. As the Commission determined in setting a higher substantial position threshold in the rate swaps category for purposes of identifying major swap participants, interest rate swaps are less risky than more complex or speculative instruments.[28]

Further, Farm Credit System institutions already effectively manage counterparty credit risk. To minimize the risk of credit losses from derivatives, Farm Credit System institutions deal with counterparties that have an investment grade or better long-term credit rating from a nationally recognized statistical rating organization, and further monitor the credit standing of and levels of exposure to individual counterparties. System institutions enter into master netting agreements that govern all derivative transactions with a counterparty. Substantially all derivative contracts are supported by credit support agreements requiring the bilateral posting of collateral in the event certain dollar thresholds of exposure are reached. These thresholds are small relative to the bank's capital. Accordingly, as of September 30, 2010, the net exposure of Farm Credit System institutions to swap dealers was only $252 million.[29]

[24] See 12 CFR § 615.5133.

[25] Memorandum from Roland E. Smith, Director, to Chairman, Board of Directors, Chief Executive Officer, All Farm Credit Institutions Regarding Counterparty Risk (Oct. 21, 2003), available at *http://www.fca.gov/apps/infomemo.nsf* (click on "Counterparty Risk").

[26] *Id.*

[27] NOPR, 75 *Fed Reg.* at 80753.

[28] *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 *Fed. Reg.* 80174, 80187–94 (proposed Dec. 21, 2010) (to be codified at 17 CFR pts. 1 & 240).

[29] *See* Federal Farm Credit Banks Funding Corporation, *Third Quarter 2010—Quarterly Information Statement of the Farm Credit System* 26 (Nov. 10, 2010) (hereinafter "Third Quarter 2010 Information Statement"), available at *http://www.farmcredit-ffcb.com/farmcredit/financials/quarterly.jsp*.

B. The Farm Credit System Is Not Interconnected with Other Financial Institutions

The Farm Credit Council recognizes that the determination of whether Farm Credit System institutions should be exempted from mandatory clearing depends not only on their safety and soundness, but also on the extent to which they are interconnected with other financial entities. As Chairman Gensler has recognized, "[t]he risk of a crisis spreading throughout the financial system is greater the more interconnected financial companies are to each other." [30] Farm Credit System institutions are not so interconnected with other financial entities to raise this concern.

First, based on their unique funding structure, Farm Credit System institutions neither borrow from nor lend to commercial banks. As a result, Farm Credit System institutions' primary credit relationships with other financial entities include (1) derivatives counterparty relationships and (2) federal funds investments. As described above, Farm Credit System institutions carefully manage derivatives counterparty relationships with bilateral collateral agreements, so that the System's exposure to counterparties is at low levels relative to capital. Federal funds investments, which are primarily overnight, can be unwound on any day with no transaction costs should credit concerns arise.

Second, because Farm Credit System institutions do not take deposits, Farm Credit System banks and associations cannot experience a "run on the bank." To the extent the concern about interconnectedness involves the consequences of declining depositor confidence, it does not apply to the Farm Credit System because the System does not rely on depositors for funding.

Finally, the Systemwide Debt Securities used to fund the Farm Credit System are insured by the Farm Credit System Insurance Corporation, a government-controlled, independent entity, that administers an insurance fund. As of September 30, 2010, the assets in the insurance fund totaled $3.193 billion, or roughly 2% of the Farm Credit System's aggregate insured obligations.[31] If a bank cannot pay principal or interest on an insured debt obligation, the Insurance Corporation must pay investors from the fund. In the event that the entire insurance fund is exhausted, investors have further recourse to the five Farm Credit System banks, which are jointly and severally liable for Systemwide Debt Securities. Accordingly, even though most investors in Systemwide Debt Securities are professional money managers, not banks, these layers of investor protection make sure that the Farm Credit System will not cause a run on the funding of other entities.

C. Imposing a Costly, New Clearing Requirement Would Frustrate the Farm Credit System's Mission of Providing Financing to Rural America

Although mandatory clearing would not make the Farm Credit System's derivatives activity safer, it would substantially raise the costs of derivatives for our members. For example, our members would incur significant negative carry costs on investments or cash posted to meet new initial margin requirements. Furthermore, if the clearing alternatives do not offer end-users interest on initial and variation margin, the Farm Credit System's costs could easily increase by tens of millions of dollars.

Market volatility, the direction of interest rates, and the maturity term of outstanding swaps also affect the amount of margin required. If market volatility returned to the levels observed after the Lehman Brothers bankruptcy in September 2008, the initial margin requirement for the Farm Credit System's derivatives could be expected to at least triple, and the projected negative carry expense on this component would easily exceed $2 million annually.

At September 30, 2010, the majority of the System's derivative positions had positive market value, so on an aggregate basis, the System was not required to provide a material amount of collateral or variation margin to our derivative counterparties. If, however, interest rates increase, the derivative exposure would swing in favor of our counterparties, and System institutions would then be required to provide variation margin, in addition to required initial margin. In this scenario, negative carry on variation margin is expected to be a significant cost. To minimize negative carry, it is especially important that clearing rules provide a mechanism for end-users of over-the-counter swaps to earn interest on the variation margin provided to our counterparties. On top of these costs would be new account fees paid to clearing members, which we estimate could easily reach $1.5 to $2.5 million each year.

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[30] Testimony of Chairman Gary Gensler before the House Committee on Agriculture (Feb. 10, 2011), available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-68.html*.

[31] *See* Third Quarter 2010 Information Statement 32 (Nov. 10, 2010).

These millions of dollars in new costs would make derivatives less attractive for risk management. To the extent new costs discourage Farm Credit System institutions from safely entering into derivatives to hedge or mitigate risk, mandatory clearing would actually make the Farm Credit System less safe. These new costs also represent millions of dollars that the Farm Credit System could otherwise lend to farmers and farm-related businesses, and new costs the Farm Credit System will have to offset with higher interest rates to farm-related businesses. In this way, mandatory clearing would frustrate the Farm Credit System's mission of providing safe, dependable financing to rural America.

In deciding which institutions should be eligible for the end-user exception, the Commission should consider that the Farm Credit System's mission is also federal policy. Congress created the System "to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them." [32] Dodd-Frank does not alter this congressional goal. To the contrary, Congress "insisted that the institutions of the Farm Credit System not be subject to a number of the provisions of [Dodd-Frank]." [33]

V. Alternatively, the Commission Should Adopt a Risk-Based Approach for Determining Which Small Financial Institutions Will Be Exempt From Mandatory Clearing

The Commission requested comment on whether "measures other than total assets of $10 billion, such as financial risk or capital, . . . could be used for determining whether an entity qualifies for an exception." [34] The Farm Credit Council believes that systemic risk created by derivatives is not a function of an institution's asset size; it is a function of the type and amount of derivative activity after netting offsetting positions and collateral. Put simply, small financial institutions entering into many risky trades pose greater risk to the financial system than larger institutions that carefully manage their derivatives portfolio. Accordingly, the Commission should focus on risk instead of asset size.

The Commission has already proposed such a risk-based framework for determining when an entity has a "substantial position" in a major swaps category warranting regulation as a major swap participant.[35] The Farm Credit Council proposes that a similar test measuring uncollateralized current exposure or current exposure plus potential future exposure would be appropriate in determining which small financial institutions pose enough risk to warrant mandatory clearing. Specifically, we believe that current uncollateralized exposure of $2 billion in the rate swaps category and $1 billion in other categories—or current uncollateralized exposure and potential future exposure of $3 billion for rate swaps or $1 billion for other swaps—would be appropriate. These proposed thresholds, which are lower than the thresholds the Commission has proposed for identifying major swap participants, would both address risk among financial entities and more accurately capture financial institutions whose swap exposure poses risk to the financial system.

Alternatively, the Commission could adopt a test based on an institution's exposure to swaps as a percentage of capital. The Farm Credit Council suggests that appropriate risk limits would be current uncollateralized exposure to swaps of 10% of capital, or current uncollateralized plus potential future exposure to swaps of 20% of capital. We believe these limits would appropriately identify which small financial institutions pose systemic risk warranting mandatory clearing. We believe that mandatory clearing would not be justified for institutions with less exposure to swaps as a percentage of capital. A test of current uncollateralized swap exposure as low as 5% of capital would, however, allow most of the Farm Credit System's risk management activities to survive without a costly new clearing requirement.

VI. Conclusion

For the reasons described above, the Farm Credit Council urges the Commission to exercise its ample authority to permit all Farm Credit System institutions—including those with total assets exceeding $10 billion—to use the end-user clearing exception. Because Farm Credit System banks use derivatives on a district-wide basis to manage risk for much smaller associations, the Commission should look through the banks to the average asset size of their affiliated associations. Otherwise, mandatory clearing would put small Farm Credit System associations at a competitive disadvantage with respect to competing commercial banks. This ap-

[32] 12 U.S.C. § 2001(a).
[33] 156 *Cong. Rec.* H5246 (daily ed. June 30, 2009) (statement of Rep. Holden).
[34] NOPR, 75 *Fed. Reg.* at 80754.
[35] *See* Further Definition, *supra* note 28, at 80188–94.

proach is appropriate because safe, sound Farm Credit System institutions do not need an additional, redundant layer of regulation. And new clearing regulation would impose costs that would both discourage Farm Credit System institutions from mitigating risk and diminish the availability of credit for farmers and rural America.

The Farm Credit Council appreciates the opportunity to comment. If you have any questions or we can provide other information, please do not hesitate to contact us. As always, we would welcome the opportunity to work with the Commission in developing the final rule.

Sincerely,

ROBBIE BOONE,
Vice President, Government Affairs,
Farm Credit Council.

CC:

Honorable GARY GENSLER, *Chairman;*
Honorable MICHAEL DUNN, *Commissioner;*
Honorable JILL E. SOMMERS, *Commissioner;*
Honorable BART CHILTON, *Commissioner;*
Honorable SCOTT D. O'MALIA, *Commissioner.*