From: Trent, Aaron <ATrent@eei.org>
Sent: Monday, October 11, 2010 10:00 AM
To: OTCDefinitions <OTCDefinitions@CFTC.gov>
Subject: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51429 (August 20, 2010)
Attach: Edison Electric Institute - Definitions Contained in Title VII of Dodd-Frank Act.pdf

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Dear Sir or Madam:

The Edison Electric Institute submitted these comments on the subject Advance Notice of Proposed Rulemaking on September 20. They were posted to the appropriate Federal Register comment file (10-012). Could you please also post them to the Rulemakings page for definitions:

http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC_2_Definitions.html

Thank you,
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September 20, 2010

VIA E-MAIL: dfadefinitions@cftc.gov

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581

Re: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51429 (August 20, 2010)

Dear Mr. Stawick:

The Edison Electric Institute ("EEI") respectfully submits these comments in response to the Commodity Futures Trading Commission's ("Commission" or "CFTC") and Securities and Exchange Commission's August 20, 2010, Advance Notice of Proposed Rulemaking (the "Advance Notice") regarding key definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1]

As the agencies begin the process of implementing the Dodd-Frank Act through an unprecedented series of complex and interrelated rulemakings, EEI appreciates the opportunity to provide the CFTC in particular with its views on the impact that certain key definitions, including the definitions of "swap," "swap dealer," and "major swap participant," potentially will have on the business operations of physical energy companies and other commercial end users of commodity swaps. Because EEI's members use, process, produce and market energy commodities, our comments focus primarily on the commodity-related aspects of the key definitions. EEI respectfully requests that the Commission define these key terms in a manner that, consistent with Congress's intent, exempts end users and their hedging transactions from additional regulatory requirements that could materially increase the costs that they and their customers will incur.

I. Description of EEI and its Interest in the Advance Notice

EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry.

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[1] Pub. L. No. 111-203 (2010) (to be codified as an amendment to the Commodity Exchange Act in scattered sections of 7 U.S.C. ch. 1 (the "Commodity Exchange Act" ("CEA")) ("Dodd-Frank Act").

EEI also has more than 65 international electric companies as Affiliate members, and more than 170 industry suppliers and related organizations as Associate members.

Organized in 1933, EEI works closely with all of its members, representing their interests and advocating equitable policies in legislative and regulatory arenas. EEI provides public policy leadership, critical industry data, market opportunities, strategic business intelligence, conferences and forums covering all aspects of the electricity industry, and various products and services to serve the needs of our members and other participants in the electricity industry.

As end users of commodity swaps that are used to hedge commercial risk, EEI's members have a significant interest in how the Commission defines all of the key terms listed in its Advance Notice, but particularly the definitions of "swap," "swap dealer," and "major swap participant." EEI's members are not financial entities. Rather, the typical EEI member is a medium-size electric utility with relatively low leverage and a conservative capital structure.[2] Nevertheless, the way in which the CFTC defines and interprets the key definitions will have a direct and substantial impact on how our members manage their commercial risk. Regulations that make effective risk management options more costly for end users of swaps will make providing consumers with reliable energy more expensive throughout the country.

II. Definition of a "Swap"

A. The Commission Should Interpret the Exclusion from the Definition of a "Swap" and the Forward Contract Exclusion Consistently

The Dodd-Frank Act excludes from the definition of a swap any "sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[3] This exclusion parallels the long-standing Commodity Exchange Act ("CEA") exclusion of "any sale of any cash commodity for deferred shipment or delivery" from the definition of "future delivery," commonly known as the forward contract exclusion.[4]

Although there is no definitive list of the elements of a physical commodity forward contract, the Commission and the courts have identified the following important characteristics of a forward contract:

- The contract must be between two commercial parties (*e.g.*, a producer, processor, merchandiser, or commercial user of the commodity) that incur risks related to the underlying physical commodity;

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2 Many EEI members are subject to substantial state regulatory requirements that impose, among other things, significant leverage limitations and minimum capital requirements.

3 Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(47)(B)(ii)). The exclusion from the definition of a swap in the Dodd-Frank Act refers to the "sale of a nonfinancial commodity." *Id.* Although "nonfinancial commodity" is not defined in the CEA or the CFTC's regulations, EEI presumes that this term is synonymous with commodities that underlie physically settled transactions (*e.g.*, exempt commodities and agricultural commodities).

4 CEA § 1a(19) (2010). The CEA grants the Commission exclusive jurisdiction over, among other contracts, "transactions involving contracts of sale of a commodity for future delivery." *Id.* § 2(a)(1)(A). However, the CEA limits the Commission's jurisdiction by defining the term "future delivery" to exclude forward contracts.

- The parties to the contract must have the capacity to make or take physical delivery of the underlying commodity;
- The material economic terms (*e.g.*, price, delivery point, duration, credit support, etc.) of the contract must be individually negotiated; and
- The contract must contain a binding delivery obligation.[5]

The commercial and physical characteristics of forward contracts distinguish them from swaps.[6] Therefore, to provide to provide the same legal certainty for physical energy and other commodity contracts in the new regulatory regime, the Commission should interpret the statutory exclusion from the definition of swap and the forward contract exclusion consistently.

Congress plainly intended the Commission and the courts interpret and apply the statutory exclusion from the definition of swap consistently with long-established precedent regarding the forward contract exclusion in the definition of future delivery. In a letter addressed to Representatives Barney Frank and Collin Peterson, Senators Christopher Dodd and Blanche Lincoln, Chairmen of the Senate banking and agricultural committees and principal drafters of the derivatives title (the "Dodd-Lincoln Letter"), confirmed that Congress intended for these two exclusions be interpreted in the same way:

> 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*.[7]

In other words, Congress intended that there be a single legal standard for identifying which forward contracts are excluded from the Commission's jurisdiction, and that the single standard be based upon existing precedent under the forward contract exclusion.

Without legal certainty as to the regulatory treatment of their forward contracts, EEI's members and other end users who rely on the forward contract exclusion likely will face higher transaction costs due to greater uncertainty. These increased transaction costs may include: (i) more volatile or higher commodity prices; and (ii) increased credit costs, in each case caused by changes in market liquidity as end users change the way they transact in the commodity

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5 *See*, *e.g.*, Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21,286, 21,294 (Apr. 20, 1993); Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188, 39,192 (Sept. 25, 1990); Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. 39,656 (Sept. 30, 1985) (Interpretive Statement of the Office of the General Counsel, CFTC).

6 For example, a standardized physical transaction, such as a sale of around-the-clock firm (LD) electricity executed in the wholesale power market, is not a swap.

7 156 Cong. Reg. H5249 (daily ed. Jun. 30, 2010) (Letter from Sen. Christopher Dodd and Senator Blanche Lincoln to Rep. Barney Frank and Rep. Collin Peterson ("Dodd-Lincoln Letter")) (emphasis added).

markets.[8] A single regulatory approach that uses the same criteria to confirm that a forward contract is excluded from the Commission's jurisdiction over swaps and futures will reduce this uncertainty and the associated costs to end users.

B. The Commission Should Clarify that Forward Contracts will not be Characterized as Swaps Solely Because the Parties Subsequently "Book-Out" Their Delivery Obligations for Commercial Efficiency and Convenience

A "book-out transaction" is a second agreement between two commercial parties to a forward contract that find themselves in a delivery chain or circle at the same delivery point.[9] When commercial parties "book out" a transaction, they agree to settle their delivery obligations (but not their other obligations) by exchanging a net payment (based on price differences).[10] By allowing the parties to a forward contract to financially settle their delivery obligations to one another rather than actually making or taking delivery of the physical commodity, book-outs eliminate the often substantial transaction costs associated with physical settlement. Significantly, no party to a forward contract is required to agree to book-out a transaction.[11] As a result, the parties to a forward contract retain all of the risks and obligations associated with making or taking delivery of a physical commodity until either a book-out is agreed or physical settlement occurs.[12]

Prior to the passage of the Dodd-Frank Act, the CFTC made clear that the forward contract exclusion encompasses booked-out forward transactions.[13] The CFTC recognized that an evolving commercial landscape necessitated more sophisticated forward contracts that "serve the same commercial functions as the forward contracts which originally were the subject of the [forward contract exclusion] notwithstanding the fact that, in specific cases and as separately agreed to between the parties, the transactions may ultimately result in performance through payment of cash as an alternative to actual physical transfer or delivery of the commodity."[14]

In its 1990 Statutory Interpretation, the CFTC explained that in the case of a book-out transaction, if the original contract is entered into between commercial participants in connection with their businesses and imposes specific delivery obligations on the parties, the forward

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8 Wholesale forward contracts for electricity and natural gas are already subject to pervasive regulation by the Federal Energy Regulatory Commission ("FERC") or the Electric Reliability Council of Texas. *See e.g.*, 16 U.S.C. §§ 825f and 825j. By interpreting the forward contract exclusions from the definitions of swap and future delivery consistently, the Commission will promote the efficient and predictable functioning of these physical markets.

9 Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. at 21,294; Interpretation Concerning Forward Transactions, 55 Fed. Reg. at 39,192.

10 Paul Horsnell and Robert Mabro, OIL MARKETS AND PRICES: THE BRENT MARKET AND THE FORMATION OF WORLD OIL PRICES 41 (1993).

11 Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. at 39,192.

12 *See id.*

13 *See* Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. at 21,294; Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. at 39,192.

14 *In re* Bybee, 945 F.2d 309, 314 (9th Cir. 1991).

contract exclusion still applies.[15] The CFTC emphasized the creation of an enforceable delivery obligation, noting that "any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party or parties in the chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts."[16] Because of this delivery obligation and the fact that subsequent book-out transactions are individually-negotiated, separate agreements, the CFTC has consistently concluded that booked-out forward contracts are excluded from its jurisdiction.[17]

Like the CFTC, the Federal Energy Regulatory Commission ("FERC") treats book-outs as physical transactions. Consistent with the CFTC's precedent, FERC has defined a book-out transaction as "the offsetting of opposing buy-sell transactions" where "[t]he buyer, seller, price, quantity and other agreement details in such agreements *are indistinguishable from those in any other [physical] power sale agreement*."[18] As with all other "sales for resale" of electricity in interstate commerce, FERC requires all sellers of wholesale power to report book-out transactions on their Electronic Quarterly Reports. According to FERC, unlike "purely financial transactions," book-outs (and the transactions that underlie them) are subject to its jurisdiction because they are agreements that "obligate the parties to deliver power at a specified price and, but for the subsequent offsetting power sales, transmission of power would be made."[19] In other words, whether or not they are booked-out, wholesale power forward contracts are sales of a non-financial commodity for deferred shipment or delivery.

Consistent with Commission precedent and commercial practice, Congress specifically intended for book-outs to continue to be treated as forward contracts and, therefore, excluded from the definition of swap. Notably, Representative Collin Peterson, Chairman of the House Committee on Agriculture, explained that with respect to forward contracts and book-outs, Congress intended *for nothing to change*:

> My interpretation of the exclusionary provision from the definition of swap … is that the exclusion would apply to transactions in which the parties' delivery obligations are booked-out…. The fact that the parties may subsequently agree to settle their obligations with a payment based on a price difference through a bookout does not turn a forward contract into a swap. Excluding physical forward contracts, including book-outs, is consistent with the CFTC's longstanding view that physical forward contracts in which the parties later agree to book-out their delivery obligations for commercial

15 Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. at 39,192.

16 *Id.*

17 *See*, *e.g.*, CFTC Staff Letter Re: Contract Market Resignation, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. ¶ 27,970 (CFTC Dec. 16, 1999); Exemption for Certain Contracts Involving Energy Products; 58 Fed. Reg. at 21,294; Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. at 39,192.

18 Revised Pub. Utility Filing Requirements, Order No. 2001, 67 Fed. Reg. 31,043, at 31,062, FERC Stats. & Regs. ¶ 31,127 (2002) (emphasis added).

19 *Id.* at 31,063.

convenience are excluded from its jurisdiction. *Nothing in this legislation changes that result with respect to commercial forward contracts.*"[20]

Forward contracts are neither futures nor swaps, and, therefore, should remain excluded from the CFTC's jurisdiction. Regulating forward contracts that are subsequently booked-out as swaps would result in significant uncertainty and instability in the physical commodity markets. For example, if forward contracts somehow are transformed into swaps the moment they are booked out, the parties to the swap could potentially (and retroactively) become subject to registration, capital, margin, reporting and other requirements that will be difficult to satisfy, particularly if a considerable amount of time has passed since the original forward contract was executed. Although these regulatory requirements may be appropriate for mitigating risk among financial institutions, they are unnecessary and incompatible with the structure and operations of most commercial enterprises. Congress excluded forward contracts, including those in which the delivery obligations of the parties later are booked-out, from the definition of swap precisely to avoid this result.[21]

C. The Commission Should Clarify that Option Contracts that Settle into Forward Contracts are not Swaps

Commodity option contracts that settle into physically-settled spot contracts or forward contracts are not swaps because, if exercised, they are contracts for the "deferred shipment or delivery" of a commodity that contain binding physical delivery obligations. Like forward contracts, options that settle into spot or forward contracts are used widely by commercial end users to manage price and supply risk. The only material difference between physically-settled options and forward contracts is that, in an option contract, only the option holder has the right (but not the obligation) to require the other party to make or take physical delivery. This difference is not sufficient to justify distinguishing forward contracts and options on forward contracts for purposes of the definition of swap, particularly given the similar ways in which commercial end users use these closely related transactions in practice.

Forward contracts and options that settle into spot or forward contracts provide end users with valuable tools for managing the price risk and other uncertainties associated with their commercial operations. For example, a power marketing company may acquire the capacity of a power plant by purchasing a call option that gives it the right (but not the obligation) to require the writer of the option to deliver energy from the plant at a specified price at any time before the option expires. If the power marketer never exercises its call rights, it has made a payment with no resulting physical delivery of a product, but the option remains a fundamentally physical transaction. At any time before the option expires, the option holder has the absolute right to call for physical delivery of energy. The right to call for physical delivery is consistent with the forward contract exclusion. The Commission should exclude both types of transactions from the definition of swap to ensure that they remain viable risk management tools for end users.

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20 156 Cong. Rec. H5247 (daily ed. Jun. 30, 2010) (statement by Rep. Peterson) (emphasis added).

21 *See id.*

III. End Users Should be Excluded from the Definitions of "Swap Dealer" and "Major Swap Participant"

EEI urges the Commission to ensure that the definitions of swap dealer and major swap participant exclude end users of derivatives. In the text of the Dodd-Frank Act and in numerous statements made by members during the legislative debate, Congress made clear that end users should not be regulated as swap dealers or major swap participants. Notably, the Dodd-Lincoln Letter explained:

> 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.[22]

End users rely on cost-effective swaps to hedge and manage the commercial risk associated with their business activities. If end users are categorized as swap dealers or major swap participants, they will be subject to extensive new regulatory requirements, including the requirement to clear virtually all of their swap transactions, including swaps that they use to hedge or mitigate commercial risk.[23] The increased costs of clearing and complying with other new regulatory requirements would substantially reduce the ability of most end users to manage their commercial risk efficiently and economically.

Congress excluded end users from the definitions of swap dealer and major swap participant because they do not contribute to systemic risk and because it would be inappropriate to subject end users to the same the regulatory requirements as swap dealers and major swap participants. Consistent with Congress's intent, the Commission should clearly exclude end users from the definitions of swap dealer and major swap participant.

A. The Definition of "Swap Dealer" Should Exclude End Users

The Dodd-Frank Act defines a swap dealer broadly to include any entity that holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties in the ordinary course of business for its own account, or is commonly known as a swap dealer.[24] The Commission should propose a definition of swap dealer that unambiguously excludes end users. Unlike a traditional "dealer" that typically is willing to take either side of a

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22 156 Cong. Rec. H5248 (Dodd-Lincoln Letter) (emphasis added).

23 Many end users are pervasively regulated by FERC and subject to credit provisions and business conduct standards set forth in FERC's regulations and each entity's governing tariff.

24 Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(49)).

swap in an effort to profit from the trade itself, most end users only "trade" swaps in order to hedge commercial risks associated with an underlying physical commodity position.[25] The Commission has distinguished between "dealing" and "trading," recognizing that each activity is undertaken by market participants for a different purpose and each has a fundamentally different impact on the operation and integrity of the market itself.[26] The Commission should make this same distinction here and exclude end users that predominantly use swaps to hedge the commercial risk associated with their businesses from the definition of swap dealer.

1. "Holds Itself Out"

The Commission should clarify that an end user (or an affiliate of an end user) that uses swaps to hedge or mitigate its own (or an affiliate's) commercial risk does not "hold itself out" as a swap dealer for any class of swaps unless it *actively and continuously* markets itself as a dealer to the general public. The Commission has addressed the meaning of "holding oneself out" in the context of the definition of "commodity trading advisor," explaining that an entity "holds itself out" if it engages in outward marketing activities, including: promoting itself through mailings, directory listings, and stationery, or otherwise initiating contacts with prospective clients.[27] The Commission similarly should limit the definition of a swap dealer to entities that affirmatively market themselves as dealers.

2. "Makes a Market"

"Market making" activity is generally a hallmark of a "dealer." The Commission should clarify that an end user (or an affiliate of an end user) that uses swaps to hedge or mitigate its own (or an affiliate's) commercial risk does not "make a market" for any class of swaps unless it *actively and continuously* offers to buy and sell swaps.

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25 An energy end user is primarily a "trader" in commodity derivatives, engaging in swaps transactions in order to hedge underlying business risks associated with a physical commodity. In contrast, a "dealer" will take the opposite side of a swap transaction with an end user customer as a service to that customer and as part of its core business model. The dealer will typically "flatten" the position incurred in the transaction with the end user customer via an offsetting swap or futures transaction. Therefore, dealers are usually indifferent as to whether they are long or short in a particular market. Notably, the Commission recognized the unique nature of dealing activities recently in the July 2010 Traders in Financial Futures Report ("TFF Report") (available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/tfmexplanatorynotes.pdf). The TFF Report separates large traders into four classifications, one of which is "Dealer/Intermediary." In describing the Dealer/Intermediary, the Commission states in the TFF Report that they "design and sell various financial assets to clients," and that they "tend to have matched books or offset their risks across markets and clients." End users fall outside of this description.

26 For example, the TFF Report distinguishes between "Dealer/Intermediary" activities, such as selling financial products, capturing bid/offer spreads, and otherwise accommodating clients, and all other market activities, which include investing, hedging, managing risk, speculating, and changing the term structure or duration of assets.

27 Interpretive Letter No. 91-9, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,189 (CFTC Dec. 30, 1991). The Division of Trading and Markets has consistently continued to employ this view. *E.g.*, No-Action Letter No. 02-59, Comm. Fut. L. Rep (CCH) ¶ 29,063 at *17 n.22 (CFTC May 17, 2002); Interpretive Letter No. 97-26, Comm. Fut. L. Rep. (CCH) ¶ 27,026 at *2 (CFTC March. 26, 1997); Interpretive Letter No. 96-72, 1996 CFTC Ltr. LEXIS 123 at *2 (CFTC Oct. 15, 1996); No-Action Letter No. 95-38, Comm. Fut. L. Rep. (CCH) ¶ 26,379 at *3 (Dec. 5, 1994).

The fact that an entity both buys and sells commodity swaps consistent with the economics of its commercial business should not be sufficient to treat such an entity as "making a market." For example, owners of electric generating assets in markets that are not overseen by a regional transmission organization often manage price risk associated with future purchases and sales on a portfolio basis. Because some generating assets are more efficient than others, and because a single power plant is more efficient at certain levels of output, such assets can be modelled and risk-managed according to their marginal (*i.e.*, per-unit of electricity) cost of production. Typically, at any given level of expected production (which corresponds to its forecast of customer demand), each unit of additional electricity produced is more expensive than the preceding unit.

Generators can minimize their total costs (and the overall price of electricity paid by their retail customers) by either buying from or selling to the market when doing so is economical. In this example, a generator can reduce its overall operating costs by: (1) buying power from the market (including the market for financially-settled electricity swaps) when the market price is lower than its marginal cost to increase production;[28] and (2) selling power into the market when the market price is higher than its marginal cost to decrease production. As a direct result of its variable marginal costs and demand obligations, a generator is commonly willing to "buy low and sell high" due to changes in its portfolio of positions or to optimize the value of its assets.

In order to protect their retail customers against volatile prices, EEI's members and other power and gas producers must be able to buy and sell swaps based on notional quantities of power, gas and other fuels in order to manage their production costs. Such practical use of derivatives does not constitute "making a market" or "dealing" in swaps, and should not cause energy companies to fall within the definition of swap dealer.[29]

3. "Regularly Enters into Swaps with Counterparties as an Ordinary Course of Business for its Own Account"

The Commission should clarify that an entity "regularly enters into swaps with counterparties as an ordinary course of business for its own account" only if its primary business is "dealing" in swaps, as that term is commonly known in the commodity trade. As the Commission has explained in the context of power marketers in the electric power industry: "[a dealer] *does not in the normal course of business hedge or speculate in electricity markets*… [but rather] routinely engage[s] in both buying and selling, including with other [dealers and] power marketers."[30] End users enter into swaps for precisely the *opposite* purpose. Accordingly, the Commission should define swap dealer to explicitly exclude an end user (or an affiliate of an end user) that primarily uses swaps to hedge or mitigate its own (or an affiliate's) commercial risk.

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28 In this case, the generator would actually buy from the spot market, but receive a fixed price from its swap counterparty over the life of the swap.

29 This is true even in less liquid markets where commercial entities may represent a significant percentage of the overall swap activity. Even though an end user may buy and sell in such a market, it is not "making a market," and therefore, should not automatically be characterized as a swap dealer.

30 CFTC No-Action Letter No. 99-67, Comm. Fut. L. Rep (CCH) ¶ 27, 970 (CFTC Dec. 16, 1999).

If the Commission reads this provision literally and treats *any* entity that regularly enters into swaps as part of its business as a swap dealer, without regard as to whether an entity is in fact "dealing" in swaps, virtually every end user that uses swaps primarily to hedge or mitigate commercial risk will be forced to register as a swap dealer. Such an overbroad interpretation would make other provisions of the Dodd-Frank Act meaningless, especially the end user clearing exception. Congress made clear that it did not intend this result.[31]

For the same reason, an entity that, for operational efficiency or convenience, regularly enters into swaps to hedge or mitigate the commercial risk of an end user affiliate should not be treated as a swap dealer.[32] For example, a centralized hedging affiliate that primarily acts as the counterparty to an affiliated end user's hedge transactions, and then enters into a back-to-back swaps with third-parties (whether through a portfolio of positions or otherwise) should not be regulated as a swap dealer solely due to that activity.

The Commission should clarify that an entity that regularly enters into swaps with counterparties as an ordinary course of business for its own account is only a swap dealer if its business is actually "dealing" in swaps such that it also satisfies one of the other three prongs of the swap dealer definition. End users that use swaps to hedge or mitigate commercial risk, even if they do so as an ordinary course of their business, should not be characterized as swap dealers.

4. "Engages in Activity that Causes the Person to be Commonly Known in the Trade as a Dealer or Market Maker in Swaps"

Under the fourth prong of the swap dealer definition, a person is a swap dealer if it engages in activity that causes it "to be commonly known in the trade" as a dealer or market maker in swaps. The concept of a person or a transaction being "commonly known" in or to the trade appears in several sections of the CEA.[33] Consistent with its prior precedent, the Commission should determine whether a person is "commonly known in the trade" as a swap dealer based upon the understanding of current dealers, market-makers and other participants in, as well as other persons who have substantial and demonstrable experience with or knowledge about, the market for the relevant class or category of swaps.[34] If the "commonly known"

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31 156 Cong. Rec. H5248 (Dodd-Lincoln Letter).

32 Moreover, for the same reason, such an entity should not be construed as "regularly enter[ing] into swaps with counterparties as an ordinary course of business for its own account." Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(49)(A)(iii)).

33 *See* Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(47)) (definition of "swap"); CEA § 1a(36) (definition of "option"); CEA §§ 2(a)(1)(A), 2(a)(1)(C)(ii), and 2(a)(1)(D)(i) (jurisdiction of the Commission); CEA §§ 4c(a)(2), 4c(a)(5), and 4c(b) (prohibited transactions); CEA §§ 9(c) and (d) (violations of the CEA); CEA § 19(a) (leverage contracts).

34 In *In re First National Monetary Corp. and Monex Int'l, Ltd.*, the Commission rejected, on appeal, an administrative law judge's determination that only those witnesses who were currently affiliated with the leverage transaction industry at the time of the adjudication could be considered to be members of that trade. *In re* First National Monetary Corp. and Monex Int'l, Ltd., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 at *8 (CFTC Aug. 7, 1985). The Commission determined that, in addition to the testimony of several persons currently affiliated with entities that were members of the leverage industry, the testimony of an economics professor and a professor of law who specialized in the economics of futures trading could be considered in the determination of whether a transaction was "commonly known to the trade" as a leverage transaction under the CEA. *Id.*

standard is properly applied, few, if any, end users should fall within this prong of the swap dealer definition.

5. The Commission Should Propose a De Minimis Exception which Excludes Entities that Engage in Limited Swap Dealing with or on Behalf of their Customers

Assuming that a company otherwise falls within one of the four prongs of the swap dealer definition for one or more categories of swaps, Congress nevertheless provided the Commission with the authority to exempt any entity that engages in "a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers" from the definition of swap dealer.[35] The purpose of the de minimis exception is, among other things, to except from the regulatory requirements that apply to companies whose principal business is swap dealing, those entities whose swap "dealing" activities are sufficiently small that they do not contribute to systemic risk. As Senators Christopher Dodd and Blanche Lincoln explained prior to enactment of the Dodd-Frank Act, "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."[36]

Congress charged the Commission with promulgating regulations that identify the "factors" that the Commission will consider in determining whether swap dealing activities are de minimis and, therefore, should be exempted from the definition of swap dealer. EEI is still considering the factors that the Commission should look to in making this determination. At a minimum, those factors should be transparent, objective and measurable, and yet sufficiently flexible so that the Commission can exempt a variety of dealing-type activities which end users and other companies engage in "with or on behalf of their customers" that Congress did not intend to capture in the definition of swap dealer.

In the energy markets, end users sometimes provide services with what some might call dealing attributes to other companies that are their customers for a variety of services. A common example is acting as counterparty to a financial hedge as an "add-on" risk management service provided to a large physical commodity customer or supplier. As long as this type of activity comprises only a small portion of a company's overall business activity, it should not cause a company that is primarily an end user of swaps to hedge commercial risk to be designated as swap dealer. Continuing with this example, to determine whether the de minimis exception applies, the Commission could measure a person's customer-oriented dealing activity against that person's entire portfolio of swap transactions, including swaps used to hedge or mitigate commercial risk. Regardless of the factors that the Commission adopts, the de minimis threshold should be large enough to exclude the swap dealing of end users that is either incidental to providing services to their customers, or a small portion of their business activity.

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35 Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(49)(D)).

36 156 Cong. Rec. H5248 (Dodd-Lincoln Letter).

B. The Definition of "Major Swap Participant" Should Exclude End Users

1. The Definition of "Substantial Position" Must Exclude Transactions that Are Used to Hedge or Mitigate Commercial Risk

The Dodd-Frank Act defines a major swap participant as any person who is not a swap dealer and who maintains a "substantial position" in swaps (excluding positions held for hedging or mitigating commercial risk), whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets, or is a highly leveraged financial entity that holds a substantial position is swaps.[37] The plain language of the definition of major swap participant makes clear that the definition of "substantial position" must exclude transactions that are used to hedge or mitigate commercial risk.

In addition, the Dodd-Frank Act further provides that:

> [T]he Commission shall define by rule or regulation the term 'substantial position' at the threshold that the Commission determines 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*. In setting the definition under this subparagraph, the Commission shall consider the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.[38]

In connection with defining "substantial position," the Commission should define the meaning of "positions held for hedging or mitigating commercial risk," and, consequently, define "commercial risk." Section 721(b) of the Dodd-Frank Act provides that the Commission "may adopt a rule to define … the term 'commercial risk;' and … any other term included in an amendment to the Commodity Exchange Act." The term "commercial risk" is an important part of the definition of "major swap participant" and the end user clearing exception. Without a definition of commercial risk, the definition of major swap participant (and other important provisions of the Dodd-Frank Act) will be ambiguous.

The proposed definition of "commercial risk" should accommodate the risk-shifting activities of commercial enterprises and be consistent with related provisions in the CEA, including the end user clearing exception. EEI respectfully suggests that the Commission define commercial risk as follows:

> ***Commercial Risk***. This term means any risk that a person or governmental entity incurs, or anticipates incurring, related to or in connection with a commodity, or any product or byproduct of a commodity, including, but not limited to: market risk; credit risk; operating risk; transportation and storage

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[37] Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33)(A)). EEI does not believe that any of its members are "highly leveraged financial entit[ies] that hold a substantial position is swaps." *Id.*

[38] Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33) (emphasis added).

risk; liquidity risk; financial statement risk; and any other risk that can be hedged or mitigated with a swap.[39]

2. "Commercial Risk" Should Have the Same Meaning Throughout the CEA

The term "commercial risk" appears in several sections of the CEA, as amended by the Dodd-Frank Act.[40] The Commission should propose a single definition of "commercial risk" that will have the same meaning everywhere the same words are used in the statute. As a general rule of statutory interpretation, when Congress uses the same words in a single statute it should be presumed, absent evidence to the contrary, that it intended for those words to be given the same meaning wherever they are used.[41] EEI is not aware of any evidence which suggests that Congress intended the meaning of the term "commercial risk" to vary depending upon where it appears in the CEA.

As practical matter, a single, consistent definition of commercial risk is necessary to implement a commercially practicable and coherent regulatory system. For example, if commercial risk is defined more broadly for the purpose of the end user exception than for the definition of major swap participant, a company could face the following "Catch-22:" it would be permitted to rely on the clearing exception for swaps that hedge or mitigate its commercial risk, except that if such swaps cause the company to fall within the definition of major swap participant, it will be disqualified from relying on the clearing exception. This is an unreasonable result that plainly would be contrary to Congress's intent.

3. Substantial Position Should be Defined Qualitatively, Not Quantitatively

The Commission should define what constitutes a "substantial position" in swaps in terms of the risk and counterparty exposure associated with a portfolio of swap positions.[42] The Dodd-Frank Act explicitly excludes positions in swaps used "for hedging or mitigating commercial risk" from the definition of substantial position for non-financial entities.[43] Congress excluded hedging activity because it determined that transactions which hedge or

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[39] Hedging and mitigating commercial risk does not include activity undertaken to assume the risk of changes in the value of a commodity.

[40] CEA § 1a(19) (definition of "excluded commodity"); Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33) (definition of "major swap participant")); *Id.* § 723(a) (to be codified at CEA § 2(h)(7)(A) (general requirements of the end user clearing exception)); *Id.* § 723(a) (to be codified at CEA § 2(h)(7)(D) (treatment of affiliates under the end user clearing exception)).

[41] Powerex Corp. v. Reliant Energy Servs., 551 U.S. 224 (2007) ("A standard principle of statutory construction provides that identical words and phrases within the same statute should normally be given the same meaning.").

[42] As Representative Collin Peterson stated, the effect of this provision is that, "[f]ew, if any, end users will be major swap participants, as we have excluded 'positions held for hedging or mitigating commercial risk' from being considered as a 'substantial position' under that definition." 156 Cong. Rec. H5248 (daily ed. Jun. 30, 2010) (statement of Rep. Peterson); *see also*, 156 Cong. Rec. S5904 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln)

[43] Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33)).

mitigate commercial risk are *not* associated with the risk factors that contributed to the recent financial crisis.[44]

The Commission should similarly exclude all other collateralized swaps that do not significantly increase systemic risk. As Senator Blanche Lincoln noted prior to enactment of the Dodd-Frank Act, "[b]ilateral collateralization and proper segregation *substantially reduces* the potential for adverse effects on the stability of the market. Entities that are not excessively leveraged and have taken the necessary steps to segregate and fully collateralize swap positions on a bilateral basis with their counterparties should be viewed differently."[45] Treating all swaps as equal, regardless of the quality of their counterparties and supporting collateral would result in an over-broad definition of major swap participant that might force many companies to comply with additional regulation that does little to enhance the stability or integrity of the financial system.

4. Inter-Affiliate Transactions Should Be Excluded from the Determination of Whether a Person Maintains a Substantial Position in Swaps

Inter-affiliate transactions should be excluded when determining whether a company maintains a substantial position in swaps. Many end users hedge their commercial risk through affiliated entities for operational efficiency or convenience. The end user clearing exception recognizes this common commercial practice by expressly permitting end users to enter into swaps through affiliated non-financial entities while still relying on the clearing exception.

The Commission should clarify that inter-affiliate transactions that are associated with the hedging and management of commercial risk are similarly excluded from the determination of whether a person maintains a substantial position in swaps. If hedging transactions entered into through an affiliate are included when determining whether an end user or its affiliate maintains a substantial position in swaps, end users potentially will be subject to radically different regulatory requirements based solely on how their operations happen to be structured. Congress did not intend for the Dodd-Frank Act (or the Commission) to make such an arbitrary distinction.

5. End Users are not "Systemically Important" and Cannot Significantly Impact the Financial System of the United States

The Dodd-Frank Act also defines a major swap participant as any person 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."[46] End users are objectively small participants in the swap markets who use swaps to transfer rather than to assume risk. End users *cannot* contribute significantly to systemic risk or have a "serious adverse affect" on the stability of the financial markets. As Representative Peterson stated in the

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44 *See* 156 Cong. Rec. H5245 (daily ed. Jun 30, 2010) (statement of Rep. Peterson) (noting through colloquy that Congress drafted the Dodd-Frank Act with the intent of continuing to allow end user hedging).

45 156 Cong. Rec. S5907 (daily ed. Jul. 15, 2010) (statement of Rep. Lincoln) (emphasis added).

46 Dodd-Frank Act § 721(a)(16) (to be codified at CEA §1a(33)).

Congressional record, Congress did not intend to limit the hedging activities of end users when it enacted the Dodd-Frank Act:

> In crafting the House bill and the conference report, we focused on creating a regulatory approach that permits the so-called end users to continue using derivatives to hedge risks associated with their underlying businesses, whether it is energy exploration, manufacturing, or commercial activities. End users did not cause the financial crisis of 2008. They were actually the victims of it.[47]

The Commission should clarify that end users do not contribute to systemic risk, and should expressly exclude them from the definition of major swap participant under the Dodd-Frank Act.

IV. Conclusion

EEI commends the Commission for its commitment to safeguarding the hedging and trading activities of end users of physical commodities and swaps, and looks forward to working with the Commission throughout the Dodd-Frank Act rulemaking process. As explained herein, we encourage the Commission to define the Dodd-Frank Act's key terms to exclude commercial end users. We welcome the opportunity to discuss these issues further with the Commission and its Staff.

Please contact me at (202) 508-5571, or Aaron Trent, Manager, Financial Analysis, at (202) 508-5526, if you have any questions regarding EEI's comments.

Respectfully submitted,

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SEC File Number S7–16–10

47 156 Cong. Rec. H5245 (daily ed. Jun 30, 2010) (statement of Rep. Peterson).