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Re: Response of the International Energy Credit Association ("IECA") to Commodity Futures Trading Commission ("CFTC") Notice of Proposed Rule ("NOPR") respecting End-User Exception to Mandatory Clearing of Swaps (17 CFR §39.6, RIN 3038-AD10, Federal Register December 23, 2010) pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")

Ladies and Gentlemen:

The CFTC by the above-referenced NOPR requests public comment on the proposed rule and other matters. This letter responds to the NOPR.

I. Introduction.

IECA is the leading global organization focused on credit-related issues in the energy industry. The IECA and its members have wide and deep experience in developing improved metrics, documentation, and tools to assess, manage, and mitigate credit risk. Its members come from more than 500 companies, representing every facet of the energy complex from producers and processors to generators, transporters and end-users. Most of these companies execute privately negotiated over-the-counter derivatives in commodities, interest rates, or currencies.

Derivatives are essential to the business of many of these companies, as well as their suppliers, customers and counterparties. Among other things, derivatives are used for purposes of:

- Protecting against increases in costs;
- Protecting against a decline in the value of the goods they sell;
- Managing cash flow, working capital, and liquidity;
- Maximizing the value of their assets;

- Meeting the needs of their customers; and,
- Complying with the terms of their financing arrangements, which frequently require the hedging of interest rate and foreign exchange risk.

The Dodd-Frank Act will have an enormous impact on working capital requirements, the costs of hedging, and earnings volatility - all critical credit-related issues. By increasing the cost, reducing the availability, and sometimes mandating the clearing of derivatives, the Dodd-Frank Act will introduce or enhance systemic risk by degrading the creditworthiness of companies in, or heavily dependent on, the energy sector.[1]

In view of these concerns, the IECA, for the first time in its history, is commenting in a series of rule-making proceedings. The purpose of these comments is to shape the rules in a way that will achieve more certainty for market participants, maximize the potential for bilateral credit relationships, limit the scope of mandatory clearing, and preserve as much competition and flexibility as possible.

Correspondence with respect to these comments should be directed to the following individuals:

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II. Comments

1. The Reporting and Corporate Governance Requirements in the NOPR Are Much More Frequent Than the Requirements of the Statute.

The Proposed Rules in the NOPR seem to require publicly traded end-users[2] relying on the end-user exemption to both report and to obtain board approval for each and every swap transaction. Specifically, Proposed Rule §39.6(b)(6)(ii) requires disclosure of "[w]hether an appropriate committee of the board of directors (or equivalent body) has reviewed and approved the decision not to clear the swap" (emphasis supplied).

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1 *See* "Evaluating Limits on Participation and Transactions in Markets for Emissions Allowances," Congressional Budget Office (Dec. 2010), p. 25 (stating that Dodd-Frank "increase[s] the cost of OTC transactions in the hope that participants would shift them to exchanges or clearing houses" and "Historical evidence suggests that higher capital requirements cause [those faced with such requirements] to shift toward riskier investments . . . to compensate for the higher costs imposed by those requirements.")

2 In fact, this requirement applies not only to publicly traded companies, but to every "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".

As currently written, this Proposed Rule seems to require board action for every uncleared swap and needlessly encumbers ordinary business practices. Boards generally meet too infrequently for an "each time" requirement to be practical. Moreover, the legal role of a board is setting the direction of their companies, not managing individual decisions.

End-users may execute many swaps a day. Due to systems limitation or for other reasons, the parties may choose to enter a twelve month strip as twelve one month transactions instead of a single one year transaction or to enter a spread option or a collar as two transactions rather than one. Generally, pursuant to their ISDA agreements, parties exchange authorizing documents, including board resolutions noting authorization of the applicable party to transact certain classes or types of swaps/derivatives. This is done at the outset of the relationship – when the ISDA Master Agreement is executed – and such authorization is satisfactory for the life of the relationship. A similar approach should be acceptable here.

Companies that continue to hedge using bilateral swaps will likely incur higher costs for such bilateral swaps as a result of the Commission's various regulations under Dodd-Frank. Imposing additional costs by requiring an "each time" authorization would further corrode the viability of over-the-counter (bilateral) swaps.

Companies that continue to hedge using bilateral swaps will likely have fewer counterparties to choose from, particularly if swap providers, with relatively minimal energy commodity swap portfolios, choose to cease that part of their regular business, rather than incur the costs of registration, capital, margin and reporting requirements associated with registered Swap Dealer status. Similarly, companies that continue to hedge using bilateral swaps will likely incur greater costs for such swaps as the remaining swap providers seek to pass through to end-users the higher costs they incur as registered Swap Dealers. Alternatively, companies that continue to hedge, but do so through cleared instruments would face still higher costs and in most cases greater working capital requirements, than the historical level of costs incurred to hedge using bilateral swaps. Finally, companies that reduce or discontinue hedging will absorb greater risk and therefore increase the risk of loss faced by their shareholders, creditors, suppliers, customers, and counterparties.

Adding an "each time" authorization requirement will only further increase those costs without any offsetting benefit. Furthermore, this high frequency governance requirement is not required by the statute. Therefore,

> **§39.6(b)(6)(ii) should say, "Whether an appropriate committee of the board of directors (or equivalent or superior authority) of the end-user or a direct or indirect parent of the end-user has <u>authorized</u> the decision not to clear <u>the respective swap or swaps</u>."**

Similarly, the Proposed Rule provides that a reporting counterparty notify a registered swap data repository or, in its absence, the Commission of how the end user "expects to meet its financial obligations associated with <u>its non-cleared swap</u> ... " (emphasis added) (Part 39.6(b)(5)). The Commission should correct the impression that high frequency, "each time"[3]

[3] NOPR FR p. 80748 col. 3 (Dec. 23, 2010).

data reporting is required. Rather than requiring "each time" data reporting, Dodd-Frank simply requires that the electing end-user "notif[y] the Commission ... how it generally meets its financial obligations associated with entering into non-cleared swaps" (emphasis added).[4]

Accordingly, the Commission should correct the impression that high frequency, "each time"[5] data reporting is required and explicitly authorize end-users to file with the Commission a one-time or periodic election to invoke the end-user exemption not to clear swaps that meet the requirements of §39.6(c).

A one-time or periodic report is more consistent with the requirement to notify the Commission "how it generally meets its financial obligations associated with entering into non-cleared swaps", since the manner in which a company "generally meets its financial obligations" is not likely to change from swap to swap. The IECA submits that a one-time report is all that should be required in order to comply with the statutory requirements of Dodd-Frank. Therefore,

> **§39.6(b)(5) should say, "Whether the electing counterparty generally expects to meet its financial obligations associated with its non-cleared swap or swaps by using (which obligation may be satisfied for all non-cleared swaps between a reporting party and an electing counterparty by a one-time election provided by either the reporting party or the electing counterparty): ..."**

2. Counterparty Governance Requirements Should be Clarified to Relate to the Counterparty Itself While Permitting Authorization By Parent Entities or Shareholders

Equity holders can generally authorize actions that would otherwise require board approval.[6] In large corporate families with intermediate parents, the practice of authorizing action by unanimous written shareholder consent is commonplace. In addition, the organizational structure of end-users can vary substantially. For example, in some cases an end-user may be directly held by the ultimate equity-holder(s), while in other cases the end-user may have one or more entities between it and the ultimate equity-holder(s).

In footnote 16 of the NOPR,[7] the Commission recognized the flexibility that boards need to conduct their business. The Proposed Rules should be clear that the "appropriate committee of the board of directors" is of "the board of directors (or appropriate committee) of the counterparty", not an affiliate. There should be no question that the governance required is at the board of the transacting entity, and not at a higher parent level board review. Therefore,

> **§39.6(b)(6)(ii) should be further revised to say, "Whether an appropriate committee of the board of directors (or equivalent or superior authority) of the end-user or a direct or indirect parent of the end-user has authorized the decision not to clear the respective swap or swaps."**

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4 CEA §2(h)(7)(A)(iii).

5 NOPR FR p. 80748 col. 3 (Dec. 23, 2010).

6 See, e.g., Delaware Corp. Code § XYZ (2010).

7 NOPR FR p. 80750 col. 2 (Dec. 23, 2010).

3. The Rule Should Specify That The Election Not To Clear, Once Made, Is Irrevocable Without The Consent Of Both Parties To The Swap.

An election not to clear a swap, once made, should be irrevocable as to that transaction, unless the parties subsequently and mutually agree otherwise. Otherwise, the other party will remain indefinitely exposed to the possibility of the fees and margining required by a clearinghouse. Counterparties will expect to be paid for the uncertainty and risk, resulting in wider bid-ask spreads, meaning either higher costs for over-the-counter swaps and the need for higher working capital reserves, or a reduction in hedging. Either way, counterparty profitability and viability suffer – potentially resulting in an increase in systemic risk. Therefore,

> **"Any election by a counterparty to use the exception to mandatory clearing is irrevocable without the consent of both parties to the swap." should be added to the end of §39.6(a).**

4. Reporting Exemption for End-user to End-user Transactions.

Section 39.6(a) of the Proposed Rule explicitly contemplates the possibility of End-user to End-user transactions. Such End-user to End-user transactions are, however, significant to the energy industry. At the same time, the CFTC has stated that End-user to End-user transactions do not constitute a significant portion of the overall derivatives market.[8] Accordingly, because End-user to End-user transactions are a systemically insignificant fraction of the overall swaps market, the Commission should find that such transactions do not present systemic risk and exempt them from reporting. Therefore, the last sentence of § 39.6(a) should be deleted and replaced with the following:

> **If more than one but less than all parties to a swap are electing counterparties, the information specified in § 39.6(b) shall be provided with respect to each of the electing counterparties. If all parties to a swap are electing counterparties, no report is required.**

5. The "User-Friendly, Check-the-Box Procedure" Discussed in a Related Commission Release Should be Provided in the Rules.

The document entitled "Q&A – End-User Exception to Mandatory Clearing of Swaps"[9] published by the CFTC proximate to the issuance of the NOPR states that the rulemaking "is to provide an easy-to-use process for end-users .... The end-user must provide notice that it is using the exception to mandatory clearing. This notice is a user-friendly, check-the-box procedure spelled out in the rule."[10] The NOPR, however, does not spell out a check the box procedure, but rather six categories and seven additional subcategories of information to be

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8 *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," RIN 3038-AD06, Federal Register 80174, 80177, fn 18 (Dec. 21, 2010).

9 Available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/eue_qa.pdf.

10 Id.

submitted "in the form and manner required for delivery of information specified under the Commission's Proposed Rules."[11] The IECA recommends that the rules actually provide the "easy-to-use ... check-the-box" form, rather than defer the form to a future rulemaking. Therefore,

> **the form of document sought by the Commission, with check boxes, should be included in the Rule, in place of the list at the end of §39.6(b).**

6. The Rule Should Provide a Safe Harbor to the Reporting Counterparty.

The NOPR asks whether "the person reporting information [would] . . . be in a position to have or be able to obtain, in all cases, the information the Commission is requiring to be reported .... If not, why not?"[12] In most cases, the end-user will not be reporting this information on its own behalf; rather the reporting counterparty will be an unaffiliated company, such as a Swap Dealer, Major Swap Participant or another end-user. In those situations, the reporting counterparty's ability to independently verify the veracity of the putative end-user's status and information will be quite limited.

If a reporting counterparty carries the risk of (a) having the transaction unexpectedly cleared, (b) having the transaction deemed void or voidable, (c) facing civil penalties for violating the Dodd-Frank Act or the Commission's implementing regulations and/or (d) a criminal prosecution for filing false information with the government, few companies will be willing to provide that service, the due diligence they will require will be substantial, and the availability of over-the-counter derivatives will be reduced while their cost will rise substantially. The net effect will be less hedging, lower credit quality, and higher systemic risk. To prevent this result, the Commission should declare that to the extent the putative end-user is the source of the information reported by the reporting counterparty and the reporting counterparty reasonably believes the information to be accurate, then (1) the reported information will be deemed to have been filed by the putative end-user and not by the reporting counterparty, and (2) the swap shall not be subject to clearing and shall not be void, voidable, or unenforceable.[13] Therefore, a new § 39.6(b)(7) should be added, as follows:

> " **(7) If a reporting counterparty reports information relating to a counterparty purporting to be an electing counterparty, then to the extent the electing counterparty is the source of the information reported by the reporting counterparty and the reporting counterparty reasonably believes the information to be accurate, then (1) the reported information will be deemed to have been filed by the putative end-user and not by the reporting counterparty, and (2) the swap shall not be subject to clearing and shall not be void, voidable, or unenforceable."**

7. The Rule Should Not Discourage Use of Other Risk-Mitigation Tools.

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[11] Proposed §39.6(b).

[12] NOPR p. 80752, 1st column, last bullet.

[13] This is analogous to the protection provided to Eligible Contract Participants under analogous to 7 U.S.C. § 25(a)(4).

The NOPR asks whether the Commission should "clarify or modify any of the definitions included in the proposed rules?"[14] The IECA respectfully requests a clarification to the definition of "financial entity."

Many participants in energy commodity physical and derivative transactions have provided in their master agreements representations that they are "financial institutions" as that term is defined in the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").[15] The purpose of invoking FDICIA is to ensure netting across over-the-counter derivatives between the parties.[16] As Congress noted in enacting FDICIA, "such netting procedures would reduce systemic risk within . . . financial markets . . . ."[17] For purposes of FDICIA, "financial institution" is a term of art, and is not limited to banking or lending institutions.[18]

> A person qualifies as a financial institution for purposes of sections 401-407 of the Act if it represents, orally or in writing, that it will engage in financial contracts as a counterparty on both sides of one or more financial markets and either—
>
> (1) Had one or more financial contracts of a total gross dollar value of at least $1 billion in notional principal amount outstanding on any day during the previous 15-month period with counterparties that are not its affiliates; or
>
> (2) Had total gross mark-to-market positions of at least $100 million (aggregated across counterparties) in one or more financial contracts on any day during the previous 15-month period with counterparties that are not its affiliates.

In the Dodd-Frank context, there is a defined term "financial entity."[19] Because of the implications of being labeled a "financial entity" under Dodd-Frank, end-users are increasingly reluctant to represent that they are a "financial institution" for purposes of FDICIA, even when it is clear that as a factual matter, they meet the definition. By clarifying that a "financial institution" for purpose of FDICIA is not necessarily a "financial entity" for purposes of Dodd-Frank the Commission can advance the goal of systemic risk reduction shared by both FDICIA and Dodd-Frank. As a suggestion, the Commission could amend Proposed Rule § 39.6(a) by inserting the following parenthetical after the phrase "is not a 'financial entity' as defined in section 2(h)(7)(C)(i) of the Act" and before ", is using the swap to hedge or mitigate":

> **(determined without regard to whether such entity believes itself to be, or in fact constitutes, a 'financial institution' within the meaning of FDICIA).**

8. End-Users Should be Allowed to Elect not to Clear Swaps that Hedge Commodity Purchases.

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[14] NOPR p. 80754, 1st column, 2nd bullet.
[15] 12 U.S.C. § 4401 et seq.
[16] Id. § 4401.
[17] Id. § 4401(4).
[18] 12 C.F.R. § 231.3.
[19] 7 U.S.C. § 2(h)(7)(C)(i) (as amended by Dodd-Frank Act).

End-users hedge not only commodity sales, but also hedge commodity purchases. For example, an airline might wish to hedge the potential change in the value of jet fuel which it purchases. Proposed Rule §39.6(c)(1)(i) allows hedging of purchased services in §39.6(c)(1)(i)(C), but does not provide for hedging of purchased assets or commodities. Therefore,

> **"purchases" and "purchasing" should be added after "owns, produces, manufactures" and "owning, producing, manufacturing", respectively, in each of Proposed Rule §39.6(c)(1)(i)(A) and §39.6(c)(1)(i)(D).**

9. "Trading" Does Not Mean "Speculating".

Since swaps are "traded" and can appear on balance sheets, the prohibition on swaps being "used for a purpose that is in the nature of ... investing, or trading" is not appropriate. The prohibition on the use of swaps for "speculation" is sufficient to distinguish the swap from a non-end-user transaction if the elements of Proposed Rule §39.6(c)(1) are met. Therefore,

> **the words "investing, or trading" should be deleted from Proposed Rule §39.6(c)(2)(i),**

and perhaps replaced with "for example, held primarily to take an outright view of the market", using the explanatory phrase in footnote 23 of the NOPR.

III. Responses to Commission Requests in the NOPR.

1. To Elect the End-User Clearing Exception, Dodd-Frank Requires Compliance Reporting, not Credit and Accounting Reporting.

The Commission asks in the NOPR whether electing counterparties should report "the frequency of portfolio reconciliation" and "general information on specific terms of the credit support agreement ... such as whether there are contractual terms triggered by changes in the credit rating or other financial circumstances of one or both of the counterparties". The Commission should not require such information. Information such as this is properly within the purview of accounting functions and creditworthiness estimation functions, neither of which are within the purview of, nor required by the language of the statute, which seeks only an explanation from an electing end-user of "how it generally meets its financial obligations associated with entering into non-cleared swaps."[20]

2. End-Users Hedge Both Nonfinancial Commodity and Financial Commodity Risks.

The Commission asks in its NOPR whether "swaps qualifying as hedging or risk mitigating be limited to swaps where the underlying hedged item is a nonfinancial commodity?"[21] The answer is "no," since end-users must often hedge risks and exposures to financial commodities. Most end-users have credit facilities that supply working capital. In

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[20] CEA §2(h)(7)(A)(iii).

[21] NOPR p. 80753 col. 2.

facilities with floating interest rates the lenders commonly require the borrower to hedge a significant portion of its exposure to rises in interest rates. Similarly, to the extent an end-user's ability to repay its credit lines depends materially on revenues generated in a currency other than the currency of the loan, the lenders will often require the counterparty to hedge its foreign exchange risk. Thus, end-users have a real and compelling need to hedge exposures to what might be regarded as financial commodities.

3. Collection of Additional General Information on Credit Support Agreements and Collateral Practices.

The Commission asks in the NOPR (at F.R. 80750-51 carryover sentence): "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," etc. The IECA submits that the answer is "no" because such information is not required by the Dodd-Frank Act and, accordingly, such a requirement would result in further burdensome regulatory requirements that are not required by the statute and would not serve any necessary purpose under the statute.

IV. Conclusion.

The IECA appreciates the opportunity to provide the foregoing comments and information to the Commission. The IECA is pleased to make available to the Commission experienced credit and derivatives professionals for further discussion and information upon request.

This letter represents a submission of the IECA, and does not necessarily represent the opinion of any particular member thereof.

Yours truly,
INTERNATIONAL ENERGY CREDIT ASSOCIATION

/s/ Phillip G. Lookadoo

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