HUNTON& WILLIAMS

CMC COMMODITY MARKETS COUNCIL

July 21, 2011

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC SUBMISSION

Re: *Commercial Alliance Comments on Inter-affiliate Swaps and other Consideration of Affiliates in the Application of the Commission's Proposed Rules*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group")[1] and the Commodity Markets Council ("CMC")[2] (collectively, the "Commercial Alliance"),[3] Hunton & Williams LLP[4] submits the following to supplement its comments on a number of the Commodity Futures Trading Commission's (the "CFTC" or the "Commission") proposed rules. Specifically, the comments set forth below address the application of the Commission's proposed rules issued in accordance with Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act") to inter-affiliate swaps and entities affiliated with a swap dealer or major swap participant (together "Covered Swap Entities").[5]

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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.

2 CMC is a trade association bringing together commodity exchanges with their industry counterparts. The activities of our members represent the complete spectrum of commercial users of all futures markets including agriculture. Specifically, our industry member firms are regular users of the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Kansas City Board of Trade, Minneapolis Grain Exchange, and New York Mercantile Exchange.

3 The Commercial Alliance is a combined effort among commercial agriculture and energy companies to address significant issues under the Commission's rulemakings to implement derivatives reform under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

4 Please note that Hunton & Williams LLP is not counsel to CMC.

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

The Commercial Alliance applauds the Commission for providing swap market participants an additional period to submit comments on its proposed rules.[6] The recently expired 30-day period, among other things, allowed swap market participants to provide the Commission with helpful insights on subjects that apply to several of the Commission's proposed rules. The 30-day period, however, was too short and did not afford commenters with sufficient time to address the many potential subjects in adequate detail. The Working Group and CMC submitted a number of comment letters during the 30-day period. However, certain topics were complex enough to require time beyond the 30-day period in order to be properly addressed. As the Commission will benefit in its rulemakings with the receipt of more in-depth analysis, the Commercial Alliance trusts the Commission will consider the comments set forth herein.

The Commercial Alliance submits these comments to highlight certain issues being considered by the Commission that could have a direct and substantial impact not only on commercial firms in energy and agriculture markets, but swap markets as a whole.

I. COMMERCIAL FIRMS AND INTER-AFFILIATE TRANSACTIONS.

Many commercial enterprises have large corporate families comprised of multiple affiliated companies. Each affiliate has a separate role. Some companies hold assets like power plants or mineral rights. Other companies provide services to affiliate companies like technology and back-office services. Many commercial enterprises use swaps between its corporate entities to efficiently allocate risks and responsibilities among affiliated entities. These inter-affiliate transactions serve legitimate business concerns, such as accounting and treasury management.

Commercial enterprises often coordinate the management of commercial risks through a single entity or group of entities which may transact with third parties to manage such risk on an enterprise basis. This is common in the energy industry, where hedging activities for affiliates holding generation, transportation, refining, storage or other commercial assets is often centrally coordinated through a single entity or subset of entities.

Energy companies and other commercial firms often trade physical commodities through the same affiliate that serves as the central desk for trading. This affiliate may also engage in price discovery or other proprietary trading in the commodity for which it has expertise. Affording proper regulatory treatment to the many different functions handled by the same entity, and commonly the same trading desk, has been a key challenge in the Commission's development and implementation of regulations under Title VII of the Act.

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[6] *Reopening and Extension of Comment Periods for Rulemaking Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 76 Fed. Reg. 25,274 (May 4, 2011).

II. GENERAL SUPPORT OF LETTERS BY KRAFT FOODS, INC. AND SHELL TRADING.

Kraft Foods, Inc. ("Kraft Foods") submitted a letter to the Commission on February 11, 2011,[7] discussing issues under the Commission's proposed rule that might adversely affect large non-financial companies that have many affiliates, particularly those non-financial companies that coordinate derivatives activity for the entire enterprise by trading through one or more subsidiaries. The Commercial Alliance generally agrees with the comments of Kraft Foods. In particular, we agree that the intermediation role of a company on behalf of its affiliates (which Kraft Foods calls, "centralized hedging centers") should not cause it to be deemed a "financial entity" as a result of that activity.[8] We agree with Kraft Food's argument that characterizing such enterprise-related intermediation activity as "swap dealing" could result in a perverse outcome where a central desk of a non-financial corporate family is, in effect, foreclosed from using the end-user exception to the mandatory clearing requirement and is subject to regulation as a Covered Swap Entity. A non-financial commercial enterprise should not have to choose between (i) having a Covered Swap Entity with the attendant costs and requirements just to efficiently manage risk on an enterprise level through an affiliate with risk mitigation expertise or (ii) requiring various affiliates to independently mitigate and manage risks. Such a result would be quite harmful to American and international businesses.

Shell Trading (US) Company and Shell Energy North America (US), L.P. (collectively, "Shell Trading") submitted a letter to the Commission on June 3, 2011 regarding the regulatory consideration of inter-affiliate swaps as commonly used in large commercial enterprises.[9] The Commercial Alliance believes that Shell Trading's recommendations have merit.

Shell Trading is one of many commercial energy firms that use inter-affiliate swaps to allocate risks to central desks. These entities also enter into physical transactions with affiliates and transact with third parties in the physical and financial energy markets. As Shell Trading explains, this consolidation of trading and hedging activities offers operational and risk management efficiencies to corporate groups. In addition, it allows commercial firms to operate in an integrated fashion, taking knowledge in one area to manage related business in another. It is vitally important to commercial energy companies that the Commission consider and afford proper treatment under its rules to inter-affiliate transactions.

The consequences of the Commission not affording proper regulatory treatment to affiliate issues extends beyond the regulation of a particular company as a Covered Swap Entity. It may cause commercial firms to entirely restructure their business, causing notable inefficiencies in the use of personnel and other resources and disaggregation of internal controls

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[7] *See* comments of Kraft Foods filed with the Commission on February 11, 2011 available at: http://comments.cftc.gov/PublicComments/CommentList.aspx?id=933.

[8] The Commercial Alliance also supports Kraft Food's argument that the distinction between "legal agency" and mere intermediation should not be important for regulatory characterization of a firm as a Covered Swap Entity.

[9] *See* comments of Shell Trading filed with the Commission on June 3, 2011 available at: http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1032.

into separate business lines. As such, the Commercial Alliance believes that further discussion is warranted on (a) inter-affiliate transactions and (b) consideration of swap activity of a company's affiliates with regard to the application of the Act and the Commission's rules to a swap market participant.

III. INTER-AFFILIATE SWAP TRANSACTIONS.[10]

Title VII of the Act and the Commission's proposed rules are relatively silent as to the treatment of inter-affiliate swaps.[11] Yet, how the Commission elects to treat such swaps will have important implications for many swap market participants. The regulatory treatment of inter-affiliate swaps will affect the determination of whether firms are Covered Swap Entities as well as certain operational aspects in transacting such swaps. The Commercial Alliance submits that the Commission should conclude that, outside of incidents of fraud, evasion or price manipulation, inter-affiliate swaps are not subject to the requirements of Title VII of the Act. Importantly, the Commission will continue to have the ability to request access to internal business records related to swaps transactions, including inter-affiliate deals. Thus, there is little regulatory transparency risk posed by these transactions.

Furthermore, inter-affiliate swaps are not significant for purposes of Title VII. Swap transactions with affiliates are entered into to allocate risk, mitigate risk and realize operational efficiencies.[12] They do not present systemic risk concerns. Transactions between two affiliated entities result in the same corporate enterprise taking both sides of the swap. The corporate enterprise's net credit exposure from the trade, if any, is minimal and there is no interaction with the relevant swap market. Moreover, such swaps do not affect the orderly operation of swap markets. By definition, such swaps are not between third-parties. Thus, there are no disparities in information or sophistication between trading parties that warrant regulatory oversight.

If the Commission elects to subject inter-affiliate swaps to the requirements of Title VII of the Act, then many of its proposed rules will impose significant and unnecessary costs and hardship on Covered Swap Entities and other swap market participants. For example, requiring

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[10] For purposes of this discussion the Commercial Alliance is defining "inter-affiliate swaps" to be swaps between two entities that would be consolidated at the parent level for financial reporting purposes.

[11] In Subtitle A of Title VII of the Act, the term "affiliate" appears in Section 716 (limitation of prohibition on federal assistance does not apply to certain affiliates of insured depositing institutions), Section 723 (open access for clearing if swap executed on a non-affiliate designated contrast market) (end-user exception pass through), Section 725 (fitness standards for affiliates of derivatives clearing organizations, Section 726 (conflicts of interest for DCO and SEF), Section 728 (SDR must establish systems to monitor use of end-user exception by affiliates), Section 735 (core principles for DCM on governance fitness standards), and Section 741 (enforcement authority over conduct of affiliates of Swap Dealers and Major Swap Participants).

[12] Inter-affiliate swaps can also limit market risk and offer pricing efficiency. For example, in commercial energy firms with multiple trading arms, circumstances can arise when one trading group would like to exit a certain position that another trading group would like to enter into. Instead of looking to the market to execute their trading strategy, the two trading groups can enter into a swap to accomplish both goals. Such a swap would avoid the same corporate enterprise taking on market risk and paying both sides of the bid-ask spread on a transaction that should be costless and riskless.

inter-affiliate swaps to be reported under the Act will likely distort market prices and market size. It is for these reasons that the Federal Energy Regulatory Commission expressly does not include inter-affiliate swaps in natural gas reporting under Form 552.[13] Therefore, the Commercial Alliance respectfully recommends that the Commission adopt the following positions with respect to inter-affiliate swap transactions.

a. Covered Swap Entity Determinations.

As instruments with little regulatory importance, inter-affiliate swaps should not be considered when a firm determines whether it is a swap dealer or major swap participant. This would be consistent with the Commission's acknowledgment that inter-affiliate swaps represent an "allocation of risk within a corporate group" and therefore need not be considered with regards to the determination of whether an entity is a swap dealer because such transactions "may not involve the interaction with unaffiliated persons that [the Commission] believe[s] 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."[14]

b. Margin Requirements

Requiring Covered Swap Entities to post collateral with regards to inter-affiliate swaps is unnecessary. Again, inter-affiliate swaps are generally risk allocation tools and do not increase a corporate enterprise's outward counterparty risk exposure. Posting margin on such swaps would have little to no risk mitigation benefits and would be an extremely inefficient and costly use of resources.

c. Clearing and Swap Execution Facility Execution

The Commercial Alliance respectfully requests that the Commission clarify that inter-affiliate swaps are not subject to the Act's mandatory clearing and exchange execution requirement pursuant to Section 2(h) of the Commodity Exchange Act (the "CEA") (the "End User Clearing Exception").[15] If the Commission requires inter-affiliate swaps to be subject to the mandatory clearing requirement, it will increase transaction costs and increase capital costs with no risk mitigation benefit from clearing.[16] Also, the net effect of requiring inter-affiliate swaps to be centrally cleared would be the provision of cash to clearing houses without any material benefit to the trading parties. Commercial firms have many other activities that can be

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[13] FERC Order 704, pg 74.

[14] *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. 80,174 at 80,183 ("Proposed Definitions").

[15] Inter-affiliate swaps should not be subject to the mandatory clearing requirement regardless of whether they are entered into by one affiliate for speculative or hedging purposes.

[16] In fact, risk may actually increase slightly. In the event a derivatives clearing organization defaults it would default on both legs of the trade. The inter-affiliate swap would have to be replaced, introducing a degree of risk that was previously absent.

pursued if cash is not locked up in clearing houses, such as capital improvements that can create jobs.

Applying the mandatory execution requirement of Section 2(h)(8) of the CEA to inter-affiliate swaps would also be unworkable. In an inter-affiliate swap, the identity of the counterparties is the motivating factor behind entering into the swap. Requiring exchange execution would effectively prohibit the ability of two affiliates' to enter into a swap between themselves. In addition, if the Commission requires inter-affiliate swap transactions to be cleared, it should allow for any transaction that may come into the end user exception to be governed by an omnibus board resolution. It would be highly inefficient if separate authorizing resolutions were necessary for different affiliates or on a swap-by-swap basis.

d. Reporting Requirements

Inter-affiliate swaps should not be subject to any reporting requirements under the Act. As stated above, these transactions do not introduce risk into the market and may not reflect market prices. The reporting of inter-affiliate swap transactions might even cause price distortions or overstatement of the volume of transactions in a given market, giving a false sense of liquidity. Thus, reporting of such swaps, in real-time or otherwise does not fulfill any policy goals that underlay Title VII of the Act or the Commission's proposed rules. Also, requiring reporting of inter-affiliate swaps might require many swap market participants to make even greater investments in systems and technology than those currently required by Title VII of the Act.[17]

e. Recordkeeping Requirements

As inter-affiliate transactions are not entered into with external counterparties, there is little utility in requiring such transactions to be subject to the Act's many business conduct recordkeeping requirements, such as recordkeeping regarding suitability determinations and pre-trade communications. The analysis of suitability and the nature of communications related to inter-affiliate swaps is not the same as that appropriate for swaps between unaffiliated entities. Even if such records were created, the records would not provide any insight to regulators. Nevertheless, the Commercial Alliance recognizes that the Commission will need basic trading records to understand the swap positions of any market participant. Covered Swap Entities should only be required to retain the records necessary to evidence the existence and primary economic terms of the inter-affiliate swap. The Commercial Alliance recommends this set of data be limited to the economic terms currently captured by companies for their inter-affiliate transactions under their present business practices.

[17] Subjecting inter-affiliate transactions to be reported would likely increase the number of end user to end user swaps and would put such end users in the position of reporting a non-trivial number of swaps, even though the Act's reporting requirements were structured to avoid such an outcome.

f. Documentation Requirements and Business Conduct Standards

The Act's documentation requirements and business conduct standards ensure that Covered Swap Entities memorialize transactions in a certain manner, make appropriate disclosures and conduct themselves in a certain way to avoid one party with superior market knowledge taking advantage of any disparities in sophistication. Inter-affiliate swaps, by definition, are between related parties, so the principals do not require any market protections. Both are accountable to the larger commercial enterprise. Thus, imposing documentation and business conduct requirements on inter-affiliate swaps would be unnecessary and costly and offer no benefits to the affiliates or the market as whole. Instead, the Commission should clarify that documentation for internal transactions should be fit for the purpose of and as required by a company's document retention program.

IV. CONSIDERATION OF AFFILIATES FOR OTHER REGULATORY PURPOSES.

Several affiliates within a commercial firm may separately trade swaps with third parties. The Commission generally should regulate the swap activity of an entity without regard to the swap activity of its affiliates. In doing so, the Commission will not interfere in the operational structure of commercial firms. However, the separate regulatory treatment of affiliates with respect to their trading of swaps with third parties should not preclude commercial firms from taking advantage of certain operational efficiencies and legal benefits of belonging to a larger corporate enterprise. The Commercial Alliance discusses below how certain of the Commission's proposed rules might affect swap trading activity of affiliates.

a. End User Clearing Exception

Clarification as to the manner in which the End User Clearing Exception pass-through provisions in CEA Section 2(h)(7)(D)(i) will work in practice will greatly assist firms as they explore the various options available for coming into compliance with the Act.

The Commission should clarify that mere affiliation with a Covered Swap Entity should not remove the availability of the "pass-through" of the End User Clearing Exception for affiliates that are not Covered Swap Entities. With regard to market-facing transactions with third parties, the Commercial Alliance interprets Section 2(h)(7)(D) of the CEA as allowing a "pass-through" of the end-user exception to mandatory clearing if an entity intermediates a swap transaction for an affiliate that could avail itself of the exception directly, provided that the intermediating entity is not a financial entity.[18] Said differently, although a Covered Swap Entity cannot avail itself of the clearing exception, even when transacting on behalf of an end user affiliate, an end user affiliate may avail itself of the clearing exception directly (or on behalf

[18] CEA Section 2(h)(7)(D)(i) provides that affiliates of persons qualifying for the end user clearing exception will also qualify for the end user clearing exception if the affiliate (1) acts on behalf of the person and as agent, (2) uses the swap to hedge or mitigate commercial risk of that person or another affiliate of that person that is not a financial entity as defined in CEA Section 2(h)(7)(C)(i), and (3) is not itself one of seven entities listed in CEA Section 2(h)(7)(D)(ii).

of another end user affiliate), even if such entity is affiliated with a Covered Swap Entity. Commercial firms would benefit if the Commission provides guidance that CEA Section 2(h)(7)(D) has the meaning that Commercial Alliance believes it does.

Finally, a central desk that is not a Covered Swap Entity, should be able avail itself of the End User Clearing Exception if it is hedging a net exposure resulting from the aggregation of all of its trades with affiliates. As mentioned earlier, a central desk may conduct hedging and swap trading on behalf of multiple non-financial affiliates. In such a circumstance, the central desk will pool all of the exposures of the non-financial entities through the use of inter-affiliate swaps. The swap trading would first offset inter-affiliate swaps as appropriate, leaving a net exposure. The swap trading entity would then, if it chooses to, hedge that risk with third parties on an aggregate and not a swap-by-swap basis (*i.e.*, the hedging transactions could not be linked to a specific position or inter-affiliate swap). The Commercial Alliance requests that the Commission clarify that the pass-through under CEA Section 2(h)(7)(D)(i) is available if a swap entity is hedging on behalf of its non-financial affiliates in the aggregate or if it is hedging on behalf of a non-financial affiliate on a portfolio basis.

b. Position Limits

The Commercial Alliance supports the conceptual approach of the Commission's proposed disaggregation exemption as applied to "owned" non-financial entities in the context of position limits. Such an approach accurately reflects how commercial entities treat separate accounts among their affiliates. Commercial firms often have many affiliates that are not wholly-owned and are independently operated, particularly with respect to their swap activities. We support the Commission viewing these accounts as separate.

We are concerned, however, with the Commission's proposal to eliminate the current and long-standing aggregation policy for eligible entities set forth in Part 150 without providing supporting evidence for public review and comment. The Commission also offers no basis for limiting the exemption to non-financial entities. We believe there is no reasonable basis to treat one class of companies differently than another similarly situated class of companies.[19]

c. Capital, Margin and Netting

The Commercial Alliance strongly advocates that the Commission give commercial enterprises maximum flexibility to organize their operations to comply with the Act and the Commission's rules. Capital, margin and netting are all important factors in a firm's selection of a corporate structure. The Commercial Alliance believes that corporate parents and creditworthy affiliates should be able to effectively capitalize an affiliate that registers as a Covered Swap

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[19] *See* CMC's and the Working Group's comment letters on the Commission's proposed rule on "Position Limits for Derivatives" 76 Fed. Reg. 4,752 (Jan. 26, 2011) for further discussion of this issue.

Available at: http://comments.cftc.gov/PublicComments/CommentList.aspx?id=965;
http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=33861&SearchText=; and
http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=44705&SearchText=sweeney.

Entity through the provisions of inter-company guarantees or other similar instruments. This affiliate support, however, should not place the corporate parent or affiliates at risk of characterization as a Covered Swap Entity.

The ability of counterparties to net exposures across and among affiliated entities is unclear under the Commission's proposed margin rules. The Commission should permit swap market participants to elect cross-entity netting. Doing otherwise will likely increase the cost of both cleared and uncleared swaps and will likely reduce capital efficiency.[20]

d. Chief Compliance Officers

The Commission's proposed rule on the duties of chief compliance officers is unclear as to whether a chief compliance officer can fulfill that role for multiple affiliated entities. The Commercial Alliance respectfully requests that the same individual should be permitted to serve as chief compliance officer for multiple affiliated entities and should be permitted to report to an appropriate senior officer or director in both entities or a senior officer or director located in an affiliated entity that controls both entities.

It is also critical that the Commission clarify that any requirement for audited financial statements be limited to the trading entity and not the consolidated enterprise or affiliate financials in the case of inter-affiliate transactions. In addition to potentially revealing proprietary and confidential information of businesses that are not themselves registered entities, it would be unreasonable to ask individuals to certify the financials of companies other than those for which he or she serves as compliance officer. The Commission should provide clear guidance that non-registered affiliates or parents of a trading entity will not be required to file financial statements with the CFTC.

e. Major Swap Participant

In its release to the proposed rule further defining "major swap participant," the Commission states 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.[21] In many circumstances, aggregation would not be consistent with "the concepts of 'substantial positions' and 'substantial counterparty exposure.'"[22] Positions of affiliates should not be aggregated to the extent that such affiliates are independently controlled. 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.

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20 The Commercial Alliance will discuss netting issues under the Commission's proposed margin requirements more completely in its comments thereto.

21 *Proposed Definitions* at 80,202.

22 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.

The market treats an independently controlled 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. The Commission should give deference to the separateness of affiliates so long as they are managed as distinct entities.

In addition, the Commission should not aggregate positions of an entity or its affiliated entities for the purposes of the major swap participant determination if those positions fall outside the jurisdiction of the Commission. The swaps will be outside U.S. swaps markets and as such should factor into whether an entity should be deemed a major swap participant.

V. CONCLUSION.

The Commercial Alliance supports tailored regulation that brings transparency and stability to the energy swap markets in the United States. The Commercial Alliance appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein prior to the adoption of any final rule implementing Title VII of the Act.

The Commercial Alliance expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, please contact the undersigned

Respectfully submitted,

/s/ David T. McIndoe

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on behalf of the Commercial Alliance