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

VIA ELECTRONIC MAIL

Re: *Comments on Clearing Exemption for Swaps Between Certain Affiliated Entities; RIN 3038–AD47*

Dear Mr. Stawick:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits these comments in response to the Commission's proposed rule: *Clearing Exemption for Swaps Between Certain Affiliated Entities* (the "**Proposed Rule**").[1] The Working Group appreciates the opportunity to provide the comments set forth herein and respectfully requests the Commission's consideration of such comments.

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

II. COMMENTS OF THE WORKING GROUP.

A. Treatment of Inter-Affiliate Swaps Generally

The Working Group agrees with the premise underlying the Proposed Rule that inter-affiliate swaps should not be subject to mandatory central clearing. The Working Group, however, respectfully suggests that the Commission use its authority under Section 4(c) of the Commodity Exchange Act (the "**CEA**") to unconditionally exempt all inter-affiliate swaps from

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[1] 77 Fed. Reg. 50,425 (August 21, 2012).

mandatory central clearing. At a minimum, inter-affiliate swaps should be unconditionally exempt from mandatory clearing when the affiliates are consolidated for accounting purposes.

Many commercial enterprises use a corporate structure with multiple entities and transactions, including swaps, between such entities for a number of business purposes such as to: (i) efficiently allocate risks and responsibilities among affiliated entities; (ii) optimize tax consequences; and (iii) comply with customs, licensing and other regulatory requirements for doing business in certain jurisdictions. In this context, inter-affiliate swaps serve legitimate business purposes, such as risk management, accounting, and treasury management.[2] Requiring the conditions in the Proposed Rule to be satisfied to avoid central clearing in certain circumstances or to require central clearing of inter-affiliate swaps in any circumstance would render what is often an internal management matter too costly for its intended purpose.

The Commission provides an example to justify subjecting certain inter-affiliate swaps to mandatory central clearing and the conditions to take advantage of the clearing exception in the Proposed Rule. The Commission states:

> Uncleared inter-affiliate swaps also may pose risk to other market participants, and therefore the financial system, if the treasury/conduit affiliate enters into swaps with third parties that are related on a back-to-back or matched book basis with inter-affiliate swaps…[for example] if A's failure to perform (for whatever reason) makes it impossible for B to meet its third-party swap obligations, then those third parties would be harmed and risk could spread into the marketplace.[3]

The simplistic example provided identifies one manner in which inter-affiliate swaps may be used and then uses that as justification to require the central clearing of certain inter-affiliate swaps and the conditions to take advantage of the clearing exception in the Proposed Rule. It is true that particular commercial enterprises coordinate the management of commercial risks through one or more central desks. These central desks are often separate legal entities and, in addition to entering into swaps with affiliates, may transact with third parties to manage such risk on an enterprise basis. This arrangement is common in the energy industry, where hedging and trading activities for affiliates holding generation, transportation, refining, storage or other commercial assets is often centrally coordinated through a central desk.

The use of inter-affiliate transactions, including swaps, is central to this arrangement. However, in practice, inter-affiliate relationships are often more complex than the example provided by the Commission. Requiring the use of the statutory end-user exception, the use of the exception in the Proposed Rule, or the central clearing of a swap introduces unnecessary restrictions on such relationships.

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[2] For additional comments on this concept please see comments submitted by the Commercial Alliance (filed July 21, 2011 – http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47876&SearchText=47876), Shell Trading (filed June 3, 2011 – http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1032), and Kraft Foods (filed February 11, 2011 – http://comments.cftc.gov/PublicComments/CommentList.aspx?id=933).

[3] *Proposed Rule* at 50,427.

In addition, the provided example is only one way in which the commercial entities use inter-affiliate swaps and should not serve as justification to require the central clearing of certain inter-affiliate swaps and the conditions to take advantage of the clearing exception in the Proposed Rule. In many circumstances, inter-affiliate swaps are entered into without a corresponding third-party trade. Often swaps will be used to transfer physical commodity exposure between affiliates or the risk associated with a cleared futures trade. The rationale underlying such transactions can range from compliance international tax laws, compliance with customs obligations, or to ensure that internal accounting allocations properly reflect the results of the commercial operations of the respective entities. The Commission should not use the simplistic example above as the reason for applying central clearing or the conditions in the Propose Rule to inter-company commercial transactions. There is a significant cost associated with central clearing of inter-affiliate swaps and the conditions to utilize the proposed clearing exception, but there is little to no concomitant benefit.

Limitations on the use of inter-affiliate swaps in commercial enterprises impose unnecessary costs on such businesses. For example, if such enterprises must use less efficient methods to mitigate commercial risk or conduct their business generally, there may be higher costs associated with such methods. Alternatively, at certain costs points, it may be an exercise of prudent business judgment to retain risk in less suitable or credit-worthy entities or to avoid certain business opportunities. In addition, if variation margin must be passed among affiliates on inter-affiliate swaps, such practice may represent inefficient use of cash resources among the enterprise and may come at meaningful financing costs. These costs may lessen a commercial enterprise's ability to use its resource on other legitimate business purposes, including capital expenditures and job creation.

B. Definition of Financial Entity

The application of certain provisions of the Proposed Rule is dependent on whether the parties to the swap are "financial entities" as defined in Section 2(h)(7)(C) of the CEA. While whether an entity meets certain provisions of that definition (*e.g.*, the entity is a swap dealer or major swap participant) is clear, the Commission has not provided guidance on what it means for an entity to be "predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956."[4]

The Working Group is unable to determine the applicability and scope of the Proposed Rule until the Commission provides further guidance as to what constitutes being predominantly engaged in activities that are financial in nature. Therefore, the Working Group respectfully requests that the Commission provide such guidance. In promulgating that guidance, the

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[4] The Commission intended to provide guidance on the similar, though not identical, definition of financial entity contained in the definition of "major swap participant". Specifically, the Commission attempted to exclude certain hedging affiliates of non-financial entities from the definition of "financial entity" in the major swap participant context. *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 77 Fed. Reg. 30,596 (May 23, 2012) (the "Final Entity Definitions") at 30,685. However, the language that was intended to be included in CFTC Regulation 1.3(ggg)(2) to that effect does not exist.

Working Group would ask the Commission to consider the comments in Sections II(B)(i)-(ii) below.

i. Treatment of Trading Subsidiaries as Financial Entities

There are a variety of genuine commercial reasons why a non-financial company would choose to conduct its swaps activity through an entity that solely engages in swap trading. For example, a company's board of directors may have determined that it is prudent and beneficial to shareholders to isolate distinct forms of risk in dedicated entities. Said another way, a company may not want to expose its swap trading relationships to the risks associated with the potential environmental liabilities associated with its pipelines or oil wells and, by the same token, the board of directors may not want to expose its physical assets to risks associated with swaps. In addition, there are often tax and other regulatory reasons why a non-financial company would elect to trade out of an entity that has a balance sheet comprised solely of trading positions.

The Commission's guidance in the Proposed Rule and the recently finalized final rule on the end user exception from mandatory clearing[5] appears to indicate that the Commission intends to treat trading entities within a non-financial enterprise as financial entities. That treatment is contrary to Congressional intent and has at least two serious commercial implications for non-financial entities that utilize central trading affiliates.

First, financial entity treatment eliminates the ability of such entities to utilize the end-user exception from central clearing when they function in the role of risk aggregator, even if such risk is accumulated through physical transactions, or market conduit for several non-financial affiliates.[6] In addition, in the event that two trading affiliates within a non-financial enterprise enter into a transaction and do not satisfy the overly restrictive requirements of the Proposed Rule, neither the proposed exception nor the end user exception would be available.

Second, when transacting with swap dealers and major swap participants, such entities, even when exercising the end-user exception on behalf of an affiliate, will be subject to the margin paradigm for financial entities.[7] Specifically, such entities cannot be afforded unsecured credit thresholds and must post cash or cash equivalents as margin.[8] Accordingly, the higher margin costs of the central trading affiliate will result in higher costs of funds for the entire commercial enterprise.

The treatment of trading entities in non-financial commercial enterprises as financial entities is contrary to Congressional intent. Congress intended to "protect end users from

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5 *End-User Exception to the Clearing Requirement for Swaps*. 77 Fed. Reg. 42,559 (July 19, 2012) ("End-User Rule").

6 A financial entity can only utilize the end user exception from mandatory clearing if it is acting as "agent" for a non-financial entity affiliate. *See* End-User Rule at 42,567.

7 Assuming the definition of "financial entity" in the CFTC's proposed Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,621 (Jul. 11, 2012,) remains identical to the definition in Section 2(h)(7)(C) of the CEA.

8 *Proposed Rule* at 50,442.

burdensome costs associated with margin requirements and mandatory clearing" and "specifically mandated that regulators permit the use of noncash collateral."[9] Congress "did not authorize the regulators to impose margin on end users."[10] Regulators were "charged with establishing rules for…margin requirements for all uncleared trades, but [such] rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction."[11] Therefore, the Working Group requests that the Commission treat trading entities within non-financial end-user enterprises as non-financial entities in order to give effect to Congressional intent. In addition, in the event that the Commission deems it necessary, the Working Group requests that the Commission use its authority under Section 4(c) of the CEA to do so.

ii. Trading of Physical Commodities is Not Financial Activity

The determination of whether an activity is "financial in nature" under the definition of "financial entity" in Section 2(h)(7)(C) of the CEA is made by reference to Section 4(k) of the Bank Holding Company Act of 1956 (the "BHC Act"). This language can reasonably be interpreted to include Regulation Y[12] as in existence at the time the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") became law.[13] Section 4(k) of the BHC Act and Regulation Y set forth a broad list of activities in which it is permissible for bank holding companies to engage, and then impose conditions under which bank holding companies are permitted to engage in such activities. The list is broad and includes a number of activities that are *not* commonly thought of as financial, such as providing management consulting services and providing career counseling services.[14] Regulation Y also addresses investing in commodity forwards and options, subject to the condition that such transactions require cash settlement or that the bank holding company "makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract." [15]

An expansive reading of the BHC Act and the resulting broad list of activities listed in Regulation Y was deemed necessary to allow bank holding companies and their affiliates to

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[9] *See* Letter from Chairman Christopher Dodd, Committee on Banking, Housing, and Urban Affairs, United States Senate, and Chairman Blanche Lincoln, Committee on Agriculture, Nutrition, and Forestry, United States Senate, to Chairman Barney Frank, Financial Services Committee, United States House of Representatives, and Chairman Colin Peterson, Committee on Agriculture, United States House of Representatives (June 30, 2010).

[10] *Id.*

[11] *Id.*

[12] 12 C.F.R. 225.28

[13] Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change. So too, where, as is the instant case, Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute. See *Lorillard, Div. of Loew's Theatres, Inc. v. Pons, 434 U.S. 575, 580-581 (U.S. 1978) (citing Albemarle Paper Co. v. Moody, 422 U.S. 405, 414 n. 8 (1975); NLRB v. Gullett Gin Co, 340 U.S. 361, 366 (1951); National Lead Co. v. United States, 252 U.S. 140, 147 (1920); 2A C. Sands, Sutherland on Statutory Construction § 49.09 (4th ed. 1973).*

[14] 12 C.F.R. 225.28

[15] *See Id.*, at (8)(ii)(B) and (C).

function in a commercially viable manner, not because the full list of activities was determined to be clearly financial in nature.[16] The conditions placed on the manner and degree to which a bank holding company can engage in the activities listed in Section 4(k) of the BHC Act and Regulation Y are to ensure that the activities do not threaten the safety and soundness of a subsidiary depository institution. By referencing Section 4(k) Congress clearly intended that the scope of companies which are "predominantly engaged in activities that are financial in nature" be properly circumscribed to include only those companies that are engaged in activities substantially similar to those of a bank holding company.

Therefore, the Working Group requests that the Commission, provide guidance as to what constitutes being "predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956," to clarify that this includes only those activities described in Section 4(k) and Regulation Y at the time of the enactment of Dodd Frank, and make clear that the trading of physical commodities is not financial in nature.

C. Practical Implications of the Proposed Rule

i. Implications of the Requiring Central Clearing of Inter-Affiliate Swaps

As stated above, the Working Group respectfully suggests that the Commission use its authority under Section 4(c) of the CEA to unconditionally exempt all inter-affiliate swaps from mandatory central clearing as the central clearing of inter-affiliate swaps is operationally impractical and burdensome and offers no concomitant benefit.

For example, requiring central clearing of certain inter-affiliate swaps would require each affiliate that would potentially enter into an inter-affiliate swap that would fall outside the clearing exception in Section 2(h)(7) of the CEA or the exception in the Proposed Rule to enter into its own relationship with a futures commission merchant (each an "FCM"). That is inefficient for a number of reasons.

First, each entity would have to negotiate its own clearing agreement, a resource intensive process. *Second,* each entity would have to dedicate resources to monitor and ensure it made its daily margin transfers. *Third*, each entity would have to post its own margin, resulting in duplicative and unnecessary margin being posted and a costly strain on working capital. *Fourth,* once a swap is cleared, there would be no inter-affiliate swap.

More importantly, many inter-affiliate swaps are not arms-length transactions. Forcing certain inter-affiliate transactions to be centrally cleared could introduce non-market prices into a clearing house, distorting the prices a clearing house provides to the market and its risk management. In addition, to avoid FCMs providing inaccurate information to the Commission

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[16] *See*, *e.g.*, *Bank Holding Companies and Change in Bank Control*, 68 Fed. Reg. 39,807 at 39,800 (Jul. 3, 2003) (expanding bank holding companies' ability to trade in physical commodities to allow them to "compete effectively with non-bank holding company participants in commodity derivatives markets.")

with regard to open interest and large trader reporting, FCMs would have to rebuild their systems to identify and segregate inter-affiliate swaps.

ii. Implications of the Requiring Exchange Execution of Inter-Affiliate Swaps

The CFTC does not consider the implications of the Proposed Rule in the context of the mandatory execution requirement. As the mandatory clearing requirements and the mandatory execution requirement are closely intertwined, the Working Group requests that the Commission do so and consider the following comments when it does.

As with the central clearing of inter-affiliate swaps, mandatory execution of inter-affiliate swaps on a designated contract market or swap execution facility is operationally impractical and burdensome. *First,* such a requirement would obligate each entity to establish its own FCM relationship, the inefficiencies of which are discussed above. *Second*, there would be a transaction cost associated with each swap. *Third,* in the circumstance where the two affiliated entities were able to transact directly with each other, they would either be forced to take a market price for the trade or execute at a non-market price. The first option could be deemed a wash trade and the second could be deemed disruptive or manipulative trading. *Fourth*¸ in the circumstance where the counterparties executed anonymously, the trade would no longer be an inter-affiliate swap. For these reasons, the Working Group respectfully suggests that the Commission use its authority under Section 4(c) of the Commodity Exchange Act (the "CEA") to unconditionally exempt all inter-affiliate swaps from mandatory central clearing.

iii. Requirement for Centralized Risk Management

The Proposed Rule would require a swap to be subject to a centralized risk management program that is reasonably designed to monitor and manage the risks associated with the swap in order for the proposed clearing exception to be available.[17] The Proposed Rule goes on to state "if at least one of the eligible affiliate counterparties is a swap dealer or major swap participant, this centralized risk management requirement shall be satisfied by complying with the requirements of §23.600."[18] It is unclear to the Working Group whether this proposed requirement would require two non-swap dealer or non-major swap participant counterparties to be subject to the same enterprise level risk management program or whether the proposed requirement just requires a counterparty to have a robust risk management program. The Working Group respectfully requests that the Commission clarify that it is the latter.

In the event the Commission intended the former, there are a number of commercially and legally valid reasons for not subjecting affiliated entities to centralized risk management. For example, the cost associated with establishing the information technology systems to allow for centralized risk management on two different continents may not justify the benefits of having such a program. In addition, there are anti-trust and other regulatory reasons that would prohibit certain affiliates from sharing the information necessary for effective risk

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[17] *Proposed Rule* at 50,442.

[18] *Id*.

management.[19] The Proposed Rule requires such entities to suffer an unnecessary commercial consequence in order to satisfy its other regulatory obligations. As such, the Working Group respectfully requests that the Commission replace this requirement with a requirement that both counterparties be subject to robust risk management programs.

D. Extraterritorial Implications of the Proposed Rule

The Commission should withdraw the condition on the proposed clearing exception that (a) both affiliates be located in the United States or in a country that has a clearing requirement that is comparable and comprehensive to the clearing requirement in the United States or (b) the non-United States counterparty is otherwise required to clear swaps with third parties in accordance with U.S. law or does not enter into swaps with third parties in order to utilize the proposed exemption.[20]

The effect of these two requirements would be to deny the proposed clearing exception to any transaction involving a Non-U.S. Person affiliate of a U.S. company. Specifically, the requirement that each counterparty "is required to clear swaps with non-affiliated parties in compliance with U.S. law", when combined with the requirement that both affiliates be in a country that has a clearing requirement that is comparable and comprehensive to the clearing requirement in the United States, renderers the proposed clearing exception unusable for transactions with any Non-U.S. affiliate.

For example the proposed clearing exception cannot be relied upon where a U.S. crude oil producer engages in a swap with its non-U.S. Person refining affiliate for two reasons. *First*, being a non-U.S. Person, the refiner is not required to clear swaps with other non-affiliated foreign companies "in compliance with U.S. law." *Second,* almost no other jurisdiction currently has a comparable clearing requirement, potentially subjecting a multitude of inter-affiliate swaps to mandatory clearing. As such, the Proposed Rule would impose an obligation on almost all non-U.S. Persons to comply with the U.S. clearing requirement in the event such entities wanted to engage in a non-hedge swap that was subject to mandatory clearing with a U.S. Person affiliate. It is not clear what public policy benefit accrues from extending the clearing requirement in this instance, when a similar transaction between affiliates of the same parent would be exempt if such affiliates were both located in the United States.

By effectively prohibiting non-U.S. persons seeking to enter into inter-affiliate swaps from utilizing the proposed clearing exception, the Proposed Rule extends the reach of U.S. law on non-U.S. persons far beyond the immediate clearing requirement. For example, in order to effectuate an inter-affiliate swap subject to mandatory clearing, certain non-U.S. persons would have to enter into an FCM agreement. That arrangement would require such non-U.S. persons to enter into a commercial relationship in the U.S., including posting capital in U.S. markets, which, among other things, subject those entities to U.S. Bankruptcy law. In short, the

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[19] For a more detailed discussion of such regulatory requirements see the comments of the Working Group filed with the Commission on June 29, 2012.

Available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58290&SearchText=

[20] Proposed Rule at 50,442.

unavailability of the proposed clearing exception to Non-U.S. Persons could extend the reach of a host of U.S. laws to foreign jurisdictions just because an entity enters into an inter-company transaction.

Even once most G-20 countries fulfill their clearing commitments, the Proposed Rule could be a significant impediment to multi-national enterprises. Many commercial energy firms have operations in foreign countries with less commercially robust financial markets than those in the United States. Thus, the requirement may place significant limitations on the ability of commercial enterprises to efficiently hedge risk associated with such operations. The inability to mitigate such risks might result in (a) a higher cost of doing business in such foreign countries or (b) the lessening of overall business activity by U.S. companies in such jurisdictions.

The Proposed Rule could result in a substantial commercial burden to certain multi-national enterprises and the Commission should not place blanket limitations on legitimate business activity. Therefore, the Working Group requests that the Commission remove the provisions of the Proposed Rule that implicate the domicile of an entity.

III. CONCLUSION.

The Working Group supports appropriate regulation that brings transparency and stability to the swap markets worldwide. The Working Group appreciates this opportunity to provide comments on the Proposed Rule and respectfully requests that the Commission consider the comments set forth herein as it develops its final rule regarding these matters.

If you have any questions, please contact the undersigned.

Respectfully submitted,

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

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