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To: EndUser <EndUser@CFTC.gov>
Subject: End User Clearing Exception
Attach: End User Clearing Exception Submission 1-21-11.pdf

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January 21, 2011

VIA ELECTRONIC SUBMISSION

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

Re: Submission on Treatment of Affiliates Under Dodd-Frank Act and CFTC Proposed Rulemakings [End-User Clearing Exception]

Dear Mr. Stawick:

Shell Trading (US) Company and Shell Energy North America (US), L.P. (collectively, "Shell Trading") respectfully submit the following comments addressed to the potential impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act") on affiliated entities. Shell Trading's comments are related to, but also extend beyond, the proposed rulemakings on (1) the end-user clearing exception ("End-User Exception") found in Section 723 of Title VII of the Dodd-Frank Act (RIN 3038-AD10) and (2) the extraterritorial application of the registration of swap dealers and major swap participants pursuant to Section 722(d) of the same (RIN 3038-AC95).[1] Shell Trading submits these comments consistent with the Notice of Acceptance of Public Submissions issued by the U.S. Commodity Futures Trading Commission ("Commission" or "CFTC") on August 26, 2010.[2]

As the CFTC recognized, swap transactions among affiliated entities often "represent an allocation of risk within a corporate group . . . [and] may not involve the interaction with unaffiliated persons that [the Commission] believe[s] is a hallmark of the elements of the definition that refer to holding oneself out as a dealer or being commonly known as a dealer."[3] Shell Trading therefore believes that regulation of transactions between affiliates will not further the stated goals of Congress to reduce risk, increase transparency, and promote market integrity within the financial system. For this reason, Shell Trading believes that it is important and

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

2 Acceptance of Public Submissions on the Wall Street Reform and Consumer Protection Act and the Rulemakings that will be proposed by the Commission, 75 Fed. Reg. 52,512 (Aug. 26, 2010).

3 *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 (Dec. 21, 2010) (to be codified at 17 C.F.R. Parts 1 and 240) (Dec. 7, 2010).

appropriate that transactions among affiliated entities be deemed outside the Dodd-Frank Act's requirements, including mandatory clearing, margin and capital requirements, recordkeeping and reporting, and aggregation for position limit purposes.

Despite the CFTC's public acknowledgment of the unique relationship between affiliated entities, the proposed rulemakings referenced above suggest that the CFTC is considering whether swap transactions among affiliated entities may fall within the strictures of the regulations implementing the Dodd-Frank Act. As noted above, Shell Trading is concerned about several aspects of how inter-affiliate swaps might be treated in the CFTC's regulations; however, it submits these comments to highlight for the Commission two specific concerns: (1) what it considers to be the potential for an unwarranted dichotomy in the treatment of transactions between end-users and their *affiliated* swap dealers and major swap participants versus transactions between end-users and *unaffiliated* swap dealers and major swap participants, and the harmful consequences to end-users and the market at large that likely would follow, and (2) what Shell Trading believes to be the appropriate reach of the swap dealer / major swap participant registration requirements to entities located outside the United States. Shell Trading does not believe that it or its affiliated entities will be designated as swap dealers or major swap participants. However, its role in the markets for energy commodities gives it a unique perspective on the affiliate issues raised by the End-User Exception and the extraterritorial application of the Dodd-Frank Act's registration requirements. Shell Trading hopes that these comments will prove useful to the Commission.

I. Description of Shell Trading

Shell Trading (US) Company ("STUSCO") and Shell Energy North America (US), L.P. ("Shell Energy") are indirect subsidiaries of Royal Dutch Shell, plc ("Shell"). Shell Energy markets and trades natural gas, electricity and environmental products, including the natural gas produced by its affiliates. STUSCO trades various grades of crude oil, refinery feedstocks, bio-components and finished oil-related products, including such commodities that are produced, manufactured or imported by affiliates. Both entities actively participate in the U.S. energy derivatives markets. Together they manage risk and optimize value across physical and financial, exchange-traded and over the counter markets.

Commodity merchants like Shell Trading typically use "trading desks" to manage the entity's overall physical position by understanding the risk to which the entity is exposed through its overall physical and financial position. Given the dynamic nature of physical supply and demand positions coupled with price volatility, a trading desk is best situated to limit the risk to the entity's portfolio as a whole, rather than try to match physical supply to financial hedges on a transaction by transaction basis. Much like a trading desk in a commodity merchant firm, STUSCO and Shell Energy are available to provide supply and hedging functions for affiliated companies in the United States. When called upon, STUSCO and Shell Energy centralize and manage the risk that otherwise resides in the various Shell end-user subsidiaries, like Shell Chemical Company.

As an adjunct to its physical marketing and trading activities and the hedging of certain of Shell's physical exposures, Shell Trading takes proprietary positions in response to internal

forecasts of supply and demand to position itself ahead of foreseeable physical movements. It also enters into swap transactions related to energy commodities with a variety of counterparties, including other Shell affiliates, to offset its risks, including credit risks, and to facilitate physical transactions.

II. End-User Exception

Congress' intent in including Section 723 in the Dodd-Frank Act, among other things, was to exempt end-users who use the derivatives markets primarily to manage commercial risk associated with their physical businesses from the financial and other obligations imposed on swap dealers and major swap participants. Congress recognized that "clearing may not be suitable for every transaction or every counterparty . . ." and the Dodd-Frank Act reflects this reality by providing a "robust end-user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk."[4] Despite Congress' well-documented intention to except end-users from the clearing requirements and more general acknowledgment that clearing may not be suitable for every transaction, Shell Trading is concerned that the language of the End-User Exception, absent clarification by the Commission, may be misconstrued to carve out only certain swaps entered into by end-users with their affiliates. Shell Trading does not believe that the Dodd-Frank Act provides for this result, and will have the unintended consequence of subjecting many of the market structures that end-users currently employ to manage their commercial risk most efficiently and economically to the clearing and potentially margin requirements under the Act.

A. Scope of End-User Exception

The clearing and exchange trading requirements generally applicable to "swaps" under the CEA, as amended by the Dodd-Frank Act,[5] do not apply if one of the counterparties is an "end user." Under the Dodd-Frank Act, an end-user is a commodity market participant that:

(i) is not a financial entity;[6]
(ii) is using swaps to hedge or mitigate commercial risk; and

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4 156 Cong. Rec. H5248 ("Dodd-Lincoln Letter").

5 CEA § 2(h)(1)(A), § 2(h)(8).

6 Section 2(h)(7)(C) of the CEA provides that, for the purposes of the End-User Exception, the term "financial entity" means, in relevant part—

(I) a swap dealer;
(II) a security-based swap dealer;
(III) a major swap participant;
(IV) a major security-based swap participant; . . .
(VIII) a person 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. *Id.*

(iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.[7]

The Dodd-Frank Act allows affiliates of end-users to qualify for the End-User Exception if the affiliate: (i) is acting on behalf of the end-user, and (ii) uses the swap to hedge or mitigate the commercial risk of the end-user or other non-financial entity affiliate of the end-user.[8] However, this extension of the End-User Exception to affiliates does not apply if the affiliate is, among other things, a swap dealer or a major swap participant.[9] Thus, commercial end-users who manage their risk through affiliated swap dealers or major swap participants may be limited in their ability to transact in this manner, notwithstanding that the affiliate is acting as an extension of the end-user to hedge or mitigate risk. Indeed, by using an affiliate that is designated as a swap dealer or a major swap participant, the end-user is ultimately subjected to the clearing and potentially the margin requirements applicable to swap dealers or major swap participants.

In addition to the separate treatment of different types of end-user affiliates, the language of the End-User Exception, for reasons that are unclear, provides for separate treatment of affiliated versus unaffiliated swap dealers and major swap participants. In particular, if an end-user mitigates its commercial risk by facing the market directly, it benefits from the clearing exception and neither it nor the third parties with whom it transacts, regardless of whether they are swap dealers or major swap participants are required to clear the transaction unless the end-user so elects. In contrast, if the end-user mitigates the risk through an affiliated swap dealer or major swap participant, the swap transacted by the affiliate cannot qualify for the clearing exemption despite performing the same function as a transaction entered into directly by the end-user. Of even greater importance to Shell Trading, absent clarification by the Commission, there is the potential that Section 723 may be misinterpreted to also carve out from the clearing exception the initial transaction between the end-user and an affiliated swap dealer.

As described in further detail below, interpreting Section 723 to exclude swaps entered into with affiliated swap dealers[10] and major swap participants[11] from the End-User Exception likely will

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7 Dodd-Frank Act § 723(a)(3) (to be codified as CEA Section 2(h)).

8 Section 2(h)(D)(i) of the CEA provides that "[a]n affiliate of a person that qualifies for [the end user exception] ... may qualify for the exception only if the affiliate, acting on behalf of the person..., uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity." CEA § 2(h)(7)(D)(i).

9 CEA § 2(h)(7)(D)(ii).

10 Section 1a(49) of the CEA provides that a "swap dealer" means any person who—

(i) holds itself out as a dealer in swaps;
(ii) makes a market in swaps;
(iii) regularly enters into swaps with counterparties as ordinary course of business for its own account; or
(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps... *Id.*

result in the elimination of vital and effective risk management structures regularly employed by end-users like several of Shell Trading's affiliates.

B. Impact of Overly Restrictive End-User Exception on End-Users

The legislative history accompanying the Dodd-Frank Act, coupled with the plain language of the statute, make it clear that Congress provided the End-User Exception because end-users need access to cost-effective risk management tools. End-users have an established track record of using derivatives, including swaps, in a manner that does not create systemic risk. As Representative Colin Peterson explained on the House floor, "[Congress] 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."[12]

End-users manage their commercial risk in many different ways. For example, one end-user may manage its hedging activities by directly facing external counterparties; while another might use a centralized hedging affiliate ("Hedging Affiliate") to execute and manage all hedges; while yet another end-user might use multiple Hedging Affiliates to execute different types of hedges. Regardless of how the end-user's business or particular hedging transactions are structured, in each of these cases the end-user is hedging or mitigating its commercial risk.

For those end-users that manage their commercial risk through one or more Hedging Affiliates, the Hedging Affiliate's trading acumen, dynamic market knowledge, and efficient, enterprise-wide risk management affords the end-users with access to expertise that they might not be able to achieve on their own. This is particularly true for global energy companies that manage a variety of separate, but related, commodities across multiple continents and countries, and at various points along the commodities' production and marketing chain (*i.e.*, upstream, midstream and downstream). In addition, the availability of a centralized Hedging Affiliate allows the end-user to minimize or avoid much of the internal infrastructure that is necessary to support a trading function (*e.g.*, credit facilities, trading agreements). Another source of savings

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[11] Section 1a(33) of the CEA provides that a "major swap participant" means any person who is not a swap dealer, and –

(i) maintains a substantial position in swaps for any of the major swap categories determined by the Commission, excluding –

(I) positions held for hedging or mitigating commercial risk; and

(II) position maintained by any employee benefit plan…;

(ii) 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; or

(iii) (I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is subject to capital requirements established by an appropriate Federal banking agency; and

(II) maintains a substantial position in outstanding swaps in any major swap category as determined by this Commission. *Id.*

[12] 156 Cong. Rec. H5245 (daily ed. Jun 30, 2010) (statement of Rep. Peterson).

is the fact that large trading companies often pay lower fees to exchanges and clearing houses than end-users who do not regularly trade on the exchanges.

A clearing requirement for swaps entered into between end-users and their Hedging Affiliates will require the use of large amounts of capital to margin deposits for both sides of the transaction for what would be basically a riskless position at the clearing house. Draining already constrained working capital from a company of any size will reduce its ability to invest in its sector, slowing economic growth.

Use of a designated entity within a corporate family for this purpose can also allow some the exposures of the end-user affiliates to be offset internally, reducing the number of swaps that have to be executed with third parties. For example, the price risk associated with the production of crude oil by one affiliate could be offset by the price risk faced by an affiliated refiner that desires to hedge the cost of the crude oil that it purchases. This offset is only possible if hedging is handled on a centralized basis.

Consequently, the use of one or more Hedging Affiliates to manage an end-user's commercial risk reduces transaction costs, increases operating efficiency, conserves working capital, and minimizes the net exposure that affiliated companies need to hedge, whether on or off-exchange, without increasing systemic risk. Despite these benefits both to end-users and the markets generally, the End-User Exception creates barriers to the use of a Hedging Affiliate for the purposes of risk management because, if the Hedging Affiliate is designated as either a swap dealer or a major swap participant under the Dodd-Frank Act, the end-user is prohibited from fully taking advantage of the End-User Exception.

C. Congress Did Not Intend to Discourage End-Users From Managing Their Commercial Risk Through Affiliated Entities.

1. The End-User Exception's Exclusion of Affiliated Swap Dealers and Major Swap Participants Could Force End-Users to Rely on Less Efficient Market Practices and Business Structures.

Congress made clear that it did "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."[13] The fulfillment of this intent should not be conditioned upon how an end-user has structured its business. There are many, varied ways that end-users have devised to structure their business to manage their commercial risk effectively and efficiently, and the End-User Exception should be implemented in a manner that permits them to continue to manage this risk with minimal disruption to the end-user's commercial activities, however structured.

Depending on how the Commission interprets and applies the End-User Exception, the agency could significantly impede certain end-users' ability to continue their commercial activities as their business is currently structured. Shell Trading is concerned that, absent clear guidance by

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[13] *Id.*

the Commission, end-users that centralize their risk management through a Hedging Affiliate that is designated a swap dealer or major swap participant could find themselves unable to benefit fully from the End-User Exception. As a result, many end-users could be forced to restructure their businesses and risk management techniques, thereby losing the many benefits of centralized hedging. Such a loss might require taking on additional risk or being forced to transact with third parties. Clearly Congress did not intend this result or to so burden end-users as to disrupt their established and effective risk management methods and strategies. In the Dodd-Lincoln Letter, Senators Christopher Dodd and Blanche Lincoln warned regulators to "carefully consider the potential burdens that Swap Dealers and Major Swap Participants may impose on end user counterparties – especially if those requirements will discourage the use of swaps by end users or harm economic growth."[14]

As reflected in these comments, Shell Trading encourages the Commission to weigh heavily the harm that will result from misreading Section 723 to subject the swaps entered into by end-users with Hedging Affiliates to clearing and margin requirements where these Hedging Affiliates are deemed to be swap dealers or major swap participants. Given the likely adverse impact, Shell Trading urges the Commission to implement the End-User Exception in a manner that does not infringe on Congress' intent to encourage end-user's management of commercial risk. The consequences of frustrating the ability of end-users to hedge using swaps with affiliated swap dealers would be to cause the end-users to develop the expertise required to enter into swaps with third parties and bear substantial additional costs. In the some cases, the time and costs associated with transacting with third parties may lead the end-user to forgo hedging adding risk to both the business and the economy.

2. The Extension of the End-User Exception to Swap Dealers/Major Swap Participants Should be Based on the Function of the Entity.

Given the above, Shell Trading encourages the Commission to confirm that the End-User Exception applies to a swap transaction between an end-user and its Hedging Affiliate based upon the function being performed by the Hedging Affiliate (*i.e.* hedging or mitigating commercial risk), and not the Hedging Affiliate's designation (*i.e.* swap dealer / major swap participant). Consistent with the language of Section 723 and the intent of Congress, if a Hedging Affiliate of an end-user is engaged in activities to hedge or mitigate an end-user's commercial risk, then the exception should apply to the transaction regardless of the Hedging Affiliate's designation as a swap dealer or major swap participant. Indeed, the Commission recently acknowledged as much:

> In determining whether a particular legal person is a swap dealer or security-based swap dealer, we preliminarily believe it would be appropriate for the person to consider the economic reality of any swaps it enters into with affiliates…including whether those swaps and security-based swaps simply represent an allocation of risk within a corporate group. [footnote omitted] Swaps and security-based swaps between persons under

[14] 156 Cong. Rec. H5248 (Dodd-Lincoln Letter).

> common control may not involve the interaction with unaffiliated persons that we believe is a hallmark of the elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a dealer.[15]

Senator Collins stated on the Senate floor, "it is not Congress' intention to capture as swap dealers end users that primarily enter into swaps to manage their business risks, including risks among affiliates."[16] The activities performed by Hedging Affiliates are precisely the activities that Congress did not intend to curtail or subject to the greater regulatory oversight applicable to swap dealers and major swap participants. Confirmation of this functionality consideration by the Commission in determining whether the End-User Exception applies to a transaction between and end-user and its Hedging Affiliate would uphold the legislative intent of the End-User Exception and maintain the immense benefit to both the market and consumers that is provided by inter-affiliate hedging.

Without careful crafting of the rules implementing the End-User Exception, end-users' ability to hedge or mitigate their commercial risk through affiliated entities may be impaired. This would result in higher costs to both end-users and consumers, reduced liquidity in the market, and greater compliance risks and costs for end-users. None of these results would benefit market integrity or the public at large. Moreover, such an outcome would directly contravene Congress' express intent to protect end-users from just such a result. Shell Trading therefore encourages the Commission to make clear that the End-User Exception applies to swaps entered between an end-user and its affiliates, regardless of whether the affiliate is designated as a swap dealer or major swap participant.

III. Extraterritorial Application of the Swap Dealer Registration Requirement

On November 23, 2010, the Commission published a proposed rule addressing the registration of swap dealers and major swap participants ("Registration Rulemaking").[17] In Section E of the proposed rule, the Commission invites the public to comment upon the appropriate reach of the Dodd-Frank Act, and specifically the swap dealer and major swap participant designation and registration, based on conduct outside the United States.[18] Among other things, the Commission asks, "when [does] swap dealing activity with or by non-U.S. affiliates of U.S. persons ha[ve] a 'direct and significant connection with activities in, or effect on' U.S. commerce?"[19]

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[15] 75 Fed. Reg. 80,174 at 80,183 (Dec. 21, 2010). Perhaps tellingly, it is not just the CFTC that views transactions among affiliates as lacking the "hallmark" elements of swap dealing. Market participants themselves separate out inter-affiliate transactions. As but one example, participants typically do not report, and are discouraged from reporting, inter-affiliate transactions to companies that compile price indices.

[16] 156 Cong. Rec. S.105 (Thursday, July 15, 2010) (statement of Senator Collins).

[17] 75 Fed. Reg. 71,379 (Nov. 23, 2010).

[18] *Id.* at 71,382.

[19] *Id.* Shell Trading wholly supports the Commission's conclusion that registration of an entity located outside the United States as a swap dealer or major swap participant would not be triggered solely by (1) the use of a

(continued...)

Shell Trading would have significant concerns regarding any application of the CFTC's authority that was premised merely on the existence of an affiliation with a "U.S. person." Through its trading subsidiaries, Shell has trading operations around the world that are in place to support and facilitate Shell's global, commercial operations. Much like STUSCO and Shell Energy, Shell's non-U.S. trading entities are available to act as central trading desks for Shell's commercial operations outside the United States. While these non-U.S. trading entities are affiliated with STUSCO and Shell Energy, their businesses are driven largely by physical operations located outside the United States, including Shell's activities in Europe, the Middle East and Asia. Similarly, their trading is largely conducted in markets outside the United States. And, to the extent that these entities enter into swap transactions that arguably touch a U.S. market, these hedging activities are always or virtually always undertaken through STUSCO or Shell Energy. Much like transactions between Shell end-users and Shell Trading, these inter-Hedging Affiliate transactions do not face the market. They further minimize Shell's transaction costs and help to focus the company's risk management function for each commodity into a single legal entity. Thus, these activities, too, do not implicate the "hallmark" elements of swap dealing activities – namely, holding oneself out as a dealer in interactions with unaffiliated persons or being commonly known as a dealer to the external market.[20]

Given this "economic reality", to find that swap dealing activity with or by non-U.S. entities has a "direct and significant connection with activities in, or effect on" U.S. commerce based on the mere existence of an affiliation with a U.S. person would be impractical, inefficient and, arguably, beyond that which Congress intended when it set out to protect the integrity of markets in the United States.

U.S. registered swap execution facility, designated clearing organization or designated contract market in connection with swap dealing activities; or (2) the reporting of swaps to a U.S. registered swap data repository.

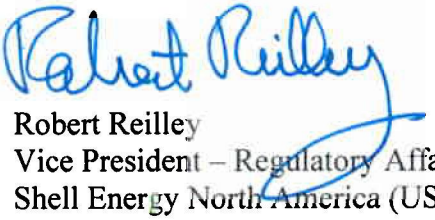
[20] 75 Fed. Reg. at 80,183.

IV. Conclusion

Shell Trading appreciates the opportunity to provide these comments. We would be pleased to provide additional information regarding our views on the regulation of affiliates. We would similarly welcome the opportunity to work with the Commission to develop an approach to meeting the mandate of Congress as it applies to affiliate access to the End-User Exception and the extraterritorial application of the Dodd-Frank Act's provisions to entities located outside the United States.

Please contact me at (713) 767-5632, if you have any questions regarding these comments.

Respectfully submitted,



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Shell Energy North America (US), L.P.

cc: Chairman Gensler
Commissioner Dunn
Commissioner Chilton
Commissioner Sommers
Commissioner O'Malia
Daniel Berkovitz, General Counsel