

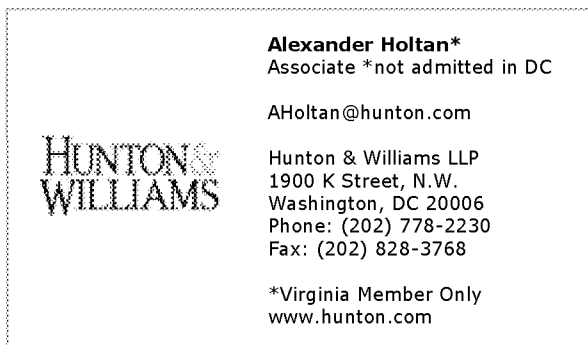
From: Holtan, Alexander S. <AHoltan@hunton.com>
Sent: Friday, November 5, 2010 6:56 PM
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Subject: Working Group of Commercial Energy Firms Comments on the Definition of "Commercial Risk"
Attach: CFTC Letter for the Definition of Commercial Risk-(filed version)_(32897667)_(7).pdf

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms, Hunton & Williams LLP submits for your consideration this letter concerning the definition of "commercial risk" under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. If you have any questions, please contact David McIndoe at (202) 955-1947, Michael Sweeney at (202) 955-1944, or Mark Menezes at (202) 419-2122. Thank you for your consideration.

Respectfully,

Alexander Holtan



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November 5, 2010

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

VIA ELECTRONIC MAIL

Re: *The Definition of “Commercial Risk” under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the “Working Group”), Hunton & Williams LLP respectfully submits the following pre-rulemaking comments concerning the definition of “commercial risk” under Section 721(b) of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”).

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 public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

The comments herein specifically address the definition of “commercial risk” under Section 721(b) of the Act and that term’s application in the definition of “Major Swap Participant” under new Commodity Exchange Act (the “CEA”) provision 1a(33) and its application with regard to the end user exemption from mandatory clearing under new Section 2(h)(7)(A) of the CEA. The Working Group appreciates the opportunity to submit these comments and looks forward to working with the Commodity Futures Trading Commission (the “Commission”) to define the term “commercial risk” as part of the formal rulemaking process for implementing this and other key definitions contained in Title VII.

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I. RECOMMENDATIONS OF THE WORKING GROUP.

A. GENERAL.

1. DEFINITION OF “COMMERCIAL RISK.”

The term “commercial risk” is used in the Act in two contexts. *First*, when determining whether a firm holds a “substantial position” under the first prong of the definition of Major Swap Participant, Swap transactions that hedge “commercial risk” are removed from the analysis.¹ *Second*, in order for a Swap to qualify for the end user clearing exemption in new CEA Section 2(h)(7), the Swap must be used to “hedge or mitigate commercial risk.”

While the Act does not require the Commission to define the term “commercial risk,” the Commission should use its authority to define what constitutes “commercial risk” to give entities legal certainty as to which transactions are included in the “substantial position” determination and which transactions qualify for the exemption from the mandatory clearing requirement.²

The Commission should adopt a meaning of “commercial risk” that is consistent with Congress’ intent to regulate over-the-counter Swap transactions that might pose risk to the financial system of the United States. Given such Congressional intent, the Working Group recommends the following definition of “commercial risk”:

Commercial Risk. This term means any risk that a person incurs, or anticipates incurring, in connection with the ownership, procurement, production, manufacture, processing, merchandising, marketing, transportation, transmission, storage, or distribution, of a commodity, any byproduct of a commodity, or a product or service related to a commodity, including, but not limited to: market risk; credit risk; interest rate risk; currency risk; operational and operating risk; and liquidity risk.

In both provisions in which it is used, the term “commercial risk” is used in the context of hedging risk associated with a company’s business operations. Thus, the definition

¹ New CEA Section 1a(33)(A)(i)(I).

² Section 721(b) of the Act gives the Commission the authority to define “commercial risk.”

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of “commercial risk” adopted by the Commission should capture those risks commonly understood to be risks inherent in the operation of a commercial enterprise. The Working Group’s suggested definition of “commercial risk” encompasses all such risks, from the price risk associated with extracting commodities or purchasing raw materials to the interest rate risk associated with issuing long-term debt to finance the construction of a power plant. Such a definition is consistent with both a functional definition of “substantial position” and a “robust end user clearing exemption.”³

The Working Group does not advocate a definition of “commercial risk” that is broad enough to allow nearly every Swap to be a potential hedge transaction. The definition above establishes a direct link between a firm’s core commercial business and the risk it is hedging. There are other risks that might affect a business, but which have little direct correlation to the day-to-day operation of that business. For example, sovereign events, acts of war, technological innovation, and macro-economic phenomena are all things outside the scope of the definition of “commercial risk” proposed by the Working Group.

2. DEFINITION OF “COMMERCIAL RISK” IN THE CONTEXT OF MAJOR SWAP PARTICIPANT.

When determining whether a firm holds a “substantial position” under the first prong of the definition of Major Swap Participant, Swap transactions that hedge “commercial risk” are removed from the analysis.⁴ This provision was included by Congress to ensure “that few, if any, end users will be major swap participants, as we have excluded ‘positions held for hedging or mitigating commercial risk’ from being considered as a ‘substantial position.’”⁵ The suggested construction of the term “commercial risk” will allow the Commission to accurately assess whether an entity does in fact have a “substantial position” in Swaps that rises to the level of systemic importance.

The suggested construction of the term “commercial risk” would not cause the definition of “Major Swap Participant” to be under-inclusive. Certain systemically important

³ See Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010).

⁴ New CEA Section 1a(33)(A)(i)(I).

⁵ See, Floor colloquy between Congressman Frank, Chairman, Committee on Financial Services and Congressman Peterson, Chairman, Committee on Agriculture in response to the letter from Sen. Dodd and Sen. Lincoln. 156 Cong. Rec. H 5248 (daily ed. June 30, 2010) (statement by Cong. Peterson).

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entities that hedge a vast majority of their “commercial risk” may not be captured under the first prong of the definition of Major Swap Participant if “commercial risk” were to be defined as proposed. However, the remaining two prongs of the definition of Major Swap Participant include Swaps entered into to hedge commercial risk in their analysis and are structured to capture such an entity if their Swaps create substantial counterparty exposure or if they are a highly leveraged financial entity.⁶

3. DEFINITION OF “COMMERCIAL RISK” IN THE CONTEXT OF MANDATORY CENTRAL CLEARING.

As noted above, Congress intended to create a “robust end user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk.”⁷ They did so because “Congress recognized that imposing the clearing and exchange trading requirement on commercial end-users could raise transaction costs where there is a substantial public interest in keeping such costs low (*i.e.*, to provide consumers with stable, low prices, promote investment, and create jobs.)”⁸ To implement what Congress intended, the Commission must adopt a definition of “commercial risk” that would allow those entities that qualify to use the end user clearing exemption to do so when hedging all of their legitimate commercial business risks.

In addition, the suggested definition of commercial risk would not allow the clearing exemption to be used in a way that would allow financial firms to avoid mandatory clearing for their hedges on speculative positions. Congress recognized the risk of this possible abuse and responded by explicitly prohibiting financial entities from using the clearing exemption.⁹

⁶ For a more detailed discussion of the definition of “Major Swap Participant” please see the Working Group’s Comment Letter on the definition of “Major Swap Participant” submitted to the Commission on September 20, 2010.

⁷ See Dodd Lincoln letter, *supra*. note 2.

⁸ *Id.*

⁹ The prohibition on use of the clearing exemption by financial entities was introduced in the Senate Committee on Agriculture, Nutrition, and Forestry’s Wall Street Transparency and Accountability Act of 2010, which passed on April 21, 2010. The legislation was never formally filed with the Senate, but was combined with Title VII of S. 3217 as passed by the Senate Committee on Banking, Housing, and Urban Affairs on March 25, 2010, which did not limit the clearing exemption to only nonfinancial firms.

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4. **HEDGING.**

In both contexts in which the term “commercial risk” is used, it is used in context of hedging commercial risk. The term “hedge” should be construed in a manner to cover any transaction entered into to mitigate commercial risk, including transactions entered into to mitigate risk associated with the price of physical commodities and transactions entered into to hedge financial risk associated with the operation of a commercial business.¹⁰ The term *bona fide* hedge is defined in new CEA Section 4a(c) and its application is extended to cover Swaps as well as futures.¹¹ This definition is largely a codification of the definition of “*bona fide* hedge” in CFTC Regulation 1.3(z).

When defining what it means to hedge commercial risk, the Commission, consistent with both its current practice and Congressional intent, should include any transaction entered into by a commercial end user of Swaps to mitigate physical or financial risk

¹⁰ The Commission should again note the direct link it established between hedging and commercial transactions and speculative and non-commercial transactions when determining what qualifies as a hedge of commercial risk. *See* note 5 *supra*.

¹¹ New CEA Section 4a(c)(2) states: “the Commission shall define what constitutes a bona fide hedging transaction ...—

“(A)(i) represents a substitute for transactions made or to be made ... in a physical marketing channel;

“(ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and

“(iii) arises from the potential change in the value of—

“(I) assets that a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;

“(II) liabilities that a person owns or anticipates incurring; or

“(III) services that a person provides, purchases, or anticipates providing or purchasing; or

“(B) reduces risks attendant to a position resulting from a swap that—

“(i) was executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction pursuant to subparagraph (A); or

“(ii) meets the requirements of subparagraph (A).”

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associated with the operation of a commercial business. The Commission has applied the definition of “*bona fide* hedge” to transactions in which a party was hedging risk associated with a physical commodity. The Commission has also recognized that *bona fide* hedging transactions are a valid activity of financial entities.¹² Congress also recognized that hedging transactions by commercial end users of Swaps should include transactions that mitigate physical or financial risk. Senators Dodd and Lincoln, in their June 30, 2010 letter to Congressmen Frank and Peterson, state: “whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool.”¹³

Energy market participants enter into a wide variety of customized Swaps to hedge the risks inherent in operating a commercial energy firm, and all of these Swaps should be considered hedges of commercial risk. Such Swaps vary in purpose and complexity. For example, a commercial energy firm will often engage in basic Swaps such as an interest rate Swap to hedge the risk associated with issuing long-term bonds to finance the construction of a power plant or pipeline or a Swap to fix the price of natural gas delivered to a specific location. Commercial energy firms will also enter into more complex and customized Swaps such as weather Swaps to hedge demand volatility associated with unanticipated volatility in the temperature. Thus, given the wide range of risks associated with the operation of a commercial energy firm, the Commission should adopt a view of hedging commercial risk that encompasses the Swap transactions entered into to mitigate such risks.

B. OPEN COMMENT PERIOD.

Given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure over-the-counter derivatives markets, the Working Group respectfully requests that the Commission hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on proposed rules. The resulting comprehensive comments will allow the Commission to better understand how their proposed rules will impact Swap markets.

¹² See CFTC Interpretive Letter 94-21, January 24, 1994, CFTC Interpretive Letter 95-27, February 16, 1995, and CFTC Interpretive Letter 97-30, April 21, 1997.

¹³ See Dodd Lincoln letter, *supra*. note 2.



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II. CONCLUSION.

The Working Group supports tailored regulation that brings transparency and stability to the energy Swap markets in the United States. We appreciate the balance the Commission must strike between effective regulation and not hindering the energy Swap markets. The Working Group offers its advice and experience to assist the Commission in implementing the Act. Please let us know if you have any questions or would like additional information.

Respectfully submitted,

/s/ David T. McIndoe

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