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The Honorable Debbie Stabenow
Chairwoman
Committee on Agriculture, Nutrition
and Forestry
United States Senate
328A Russell Senate Office Building
Washington, DC 20510

The Honorable Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition
and Forestry
United States Senate
328A Russell Senate Office Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran,

The American Petroleum Institute ("API") appreciates the opportunity to respond to your request for input on the reauthorization of this year's version of the Food, Conservation and Energy Act, especially as it applies to implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), as implemented and enforced by the Commodity Futures Trading Commission (the "CFTC").

The implementation of Title VII has proven to be significantly more challenging, complex, and costly than anticipated, affecting end-users transacting in energy commodity and energy-related commodity markets, as well as the CFTC itself. This is evidenced by the delays provided by the CFTC for multiple compliance deadlines and the piecemeal issuance of no-action relief and staff interpretive guidance. A number of critical CFTC rulemakings implementing Title VII that will have a direct impact on end-users have not been finalized as of the date hereof. In the case of position limits for futures and swaps, the CFTC must reissue a proposed notice of rulemaking *in toto* because its previously issued final rule was vacated by a federal court ruling in September 2012.[1] In addition, several interpretive issues regarding the scope and applicability of key definitions, including the definition of "swap," set forth in Title VII remain unresolved.

The regulatory and commercial uncertainty created by the "one-size-fits-all" regulatory framework established under Title VII of the Dodd-Frank Act has disrupted the efficient operation of swap markets, particularly those related to energy commodities. Moreover, in light of the complexities imposed by the CFTC's implementation of Title VII, IntercontinentalExchange, Inc. ("ICE") converted a large number of widely-traded, liquid and standardized energy swaps offered as part of its over-the-counter market to financially-settling futures in October 2012. Since that time, there has been a continued and distinct migration of derivatives activity involving energy commodities from swap markets to futures markets. In API's view, the futurization of swaps calls into question the overall need

[1] *Position Limits for Futures and Swaps,* Final Rule and Interim Final Rule, 76 Fed. Reg. 71,626 (Nov. 18, 2011), vacated and remanded, *International Swaps and Derivatives Association, et al. v. United States Commodity Futures Trading Commission*, Memorandum Opinion, Civil Action No. 11-cv-2146 (RLW) (Sept. 28. 2012).

for, and effectiveness of, Title VII of the Dodd-Frank Act as applied to energy markets. At a minimum, it highlights the need for specific, targeted reforms to Title VII that should be addressed by Congress as part of this year's reauthorization process.

Set forth below are several key issues relating to the implementation of, and compliance with, Title VII of the Dodd-Frank Act that API, on behalf of its membership, urges the Committee on Agriculture, Nutrition and Forestry (the "Committee") to consider:

### A. OPTIONS AND FORWARD CONTRACTS WITH EMBEDDED VOLUMETRIC OPTIONALITY THAT PHYSICALLY SETTLE SHOULD BE EXCLUDED FROM THE DEFINITION OF "SWAP."

Under the CFTC's current guidance on the scope and applicability of the definition of "swap" set forth in Section 1a(47) of the Commodity Exchange Act ("CEA"), both (i) options that result in the physical delivery of a commodity when exercised and (ii) forward contracts with embedded volumetric optionality are generally subject to regulation under Title VII the Dodd-Frank Act as "swaps." Forward contracts involve two parties in the commercial marketing chain. These transactions ensure the efficient delivery of nonfinancial commodities to end-users, thereby enabling them to conduct their core businesses. These transactions are entered into with the express intent to physically settle when the options are exercised and, in the energy sector, are used to mitigate the price and supply risks associated with end-users' core businesses of producing, processing, merchandising or consuming energy commodities.

Notwithstanding any embedded volumetric optionality, physical delivery forwards do not pose a systemic risk or offer any other basis for the application of the comprehensive regulatory regime for swaps. Accordingly, Congress should amend CEA Section 1a(47)(B)(ii) to clarify that both physical forwards with embedded volumetric optionality and physically delivered options should be excluded from the definition of "swap." Such clarification would be entirely consistent with the intent underlying the current forward contract exclusion for swaps established by Congress in CEA Section 1a(47)(B)(ii).

### B. END-USER FIRMS SHOULD NOT BE SUBJECT TO MARGIN REQUIREMENTS.

The imposition of mandatory margin and capital requirements as part of the Title VII regime is daunting to markets. Of particular concern is how the imposition of mandatory margin and capital requirements on swap dealers ("SDs") and major swap participants ("MSPs") will affect transactions with nonfinancial end-user counterparties. Although nonfinancial end-users are exempt from mandatory capital and margin requirements, there is a significant likelihood that SDs and MSPs may require nonfinancial end-users to margin transactions as a condition of transacting business. In addition, it is anticipated that SDs and MSPs will attempt to cover their own mandatory capital and margin costs by passing through such costs to their nonfinancial end-user counterparties. The imposition of margin requirements on nonfinancial end-users by their counterparties, as well as the pass through of SD or MSP capital and margin costs, will significantly increase transaction costs for nonfinancial end-users, particularly those in the energy sector, and could impair liquidity in these markets.

As a consequence, API urges Congress to amend CEA Section 4s(e) to state that nonfinancial end-user counterparties, even when transacting with SDs and MSPs, are exempt from swap margin rules promulgated by the CFTC and Prudential Regulators.[2] Further, Congress should affirmatively state that the CFTC and Prudential Regulators may not place limitations on the forms of collateral SDs and MSPs can accept from nonfinancial end-users if they voluntarily agree to collateralize a swap as a commercial matter.

### C. CONGRESS SHOULD REQUIRE AFFIRMATIVE ACTION BY THE CFTC TO RESET THE *DE MINIMIS* EXCEPTION FROM THE DEFINITION OF "SWAP DEALER."

Pursuant to CFTC Regulation 1.3(ggg)(4)(ii)(C), the CFTC is required to reassess the level of the *de minimis* exception from the definition of "swap dealer" in early 2016 and determine whether the *de minimis* exception should (i) decrease from its current level of $8 billion to $3 billion or (ii) via a public rulemaking process, be set at a different level altogether. In the event that the CFTC fails to address this issue on a proactive basis, the *de minimis* exception will automatically reset to $3 billion in 2018.

API respectfully submits that such a significant change in the *de minimis* exception level will have a material impact on the market structure for swaps in the United States. Moreover, the prospect of a change in the level of the *de minimis* exception because of the CFTC's failure to proactively and transparently address this issue will create substantial uncertainty and undermine market confidence. As such, Congress should amend CEA Section 1a(49)(D) to require that any undertaking by the CFTC to change to the level of the *de minimis* exception must be undertaken as part of a formal rulemaking proceeding and subject to public notice and comment.

### D. FEDERAL POSITION LIMITS SHOULD ONLY BE IMPOSED BY THE CFTC AFTER A FINDING OF NEED AND EFFECTIVENESS FOR A SPECIFIED CONTRACT.

Section 4a(a) of the CEA is clear that the Commission may only implement federal speculative position limits to prevent excessive speculation. Despite the Commission's concerns that unreasonable and abrupt price movements may result from the liquidation of large concentrated positions, the CFTC to date has not presented any empirical, quantifiable evidence that large position concentrations harm liquidity or the pricing of energy commodities.

With this in mind, Congress should amend CEA Section 4a(1) to require the CFTC to make an affirmative finding that the imposition of federal position limits for a particular energy commodity are a necessary and effective method to prevent, diminish, or eliminate excessive speculation. Further, Congress should direct the CFTC to conduct substantive cost-benefit analysis (i) establishing the need for the federal speculative position limits for a given derivatives contract, and (ii) discussing the effects that such limits may have on the markets for such contract(s). This cost-benefit analysis should be submitted

[2] API requests that that such clarification also extend to a financial entity acting on behalf of an entity that is a nonfinancial entity.

to Congress as part of a public report and published in the *Federal Register* for public notice and comment.

## E. CONGRESS SHOULD CLARIFY THE SCOPE AND APPLICABILITY OF EXEMPTIONS FOR *BONA FIDE* HEDGE TRANSACTIONS OR POSITIONS TO ENSURE THAT THEY COVER CURRENT RISK-REDUCING PRACTICES.

Section 4a(c) of the CEA directs the CFTC to provide an exemption from position limits for derivatives transactions that qualify as *bona fide* hedge transactions or positions (each, a "*Bona Fide* Hedge"). Congress adopted a broad *Bona Fide* Hedge definition specifically for the purpose of allowing producers, processors, merchandisers and consumers of physical commodities to properly hedge their exposure to price risk, including anticipated price risk.[3] In prior reauthorizations, Congress has unequivocally supported the use of anticipated hedges by end-users as an efficient means of hedging price risk associated with underlying physical commodity operations, whether for merchandising, the purchase or sale of services or other purposes.

Based on the CFTC's recently vacated final rule on position limits, API is concerned that there is a significant risk that the CFTC will adopt an unduly narrow interpretation of the statutory definition of *Bona Fide* Hedge. Such a narrow interpretation will place significant limitations on end-users' ability to efficiently and effectively hedge or mitigate exposure to price risk. API understands that the potential adoption of an overly narrow interpretation of definition of *Bona Fide* Hedge by the CFTC is driven by concerns that a broader reading of this statutory definition could create regulatory loopholes that could be abused by market participants, particularly non-commercial, financial entities transacting in energy markets. However, the CFTC has not presented any empirical evidence supporting these concerns and, thus, they are purely hypothetical in nature. More importantly, the adoption of such a narrow interpretation of this definition is not consistent with clear language of CEA Section 4a(c) and API's understanding of Congressional intent underlying this provision – which is to facilitate end-users' ability to engage in derivatives transactions that mitigate their exposure to price risk in an effective, practical manner.

API urges Congress to use the reauthorization process to clarify (i) the full scope and applicability of the statutory definition of *Bona Fide* Hedge, and (ii) it's clear support of the use of anticipated hedges by end-users in order to reduce price risk associated with the operation of underlying physical commodity businesses. Specifically, API supports the CFTC's *bona fide* hedge exemption under existing CFTC Regulation 1.3(z), as adopted and implemented by the CFTC prior to the promulgation of the Dodd-Frank Act. Existing CFTC Regulation 1.3(z), *inter alia*, allows for positions to be classified as *bona fide* hedges so long as they normally represent a substitute for a cash market transaction or positions to be taken at a later time in a physical market channel. CFTC Regulation 1.31(z) also incorporates both enumerated and non-enumerated hedging transactions. API supports this

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[3] In relevant part, CEA Section 4a(c)(1) unequivocally states that the definition of *bona fide* transaction or position "may be defined to permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange."

version of the definition of *Bona Fide* Hedge, which takes into account the realities of mitigating risk in the commercial energy sector.

### F. Congress should Clarify That the Definition of "Financial Entity" Does Not Include End-Users with "Central Desks."

The definition of term "financial entity" set forth in CEA Section 2(h)(7)(C)(i) and implementing CFTC regulations refers, in part, to provisions of federal banking law that currently includes the trading of physical commodities and the trading of related derivatives as "financial activity." Many end-users in the energy sector and in other commodity markets have separate affiliates that face the market on behalf of the entire company to trade commodities and derivatives, but such affiliates have no other assets and conduct no other activities.[4] As a consequence, such companies that effectively function as a central trading desk for the corporate enterprise likely fall in definition of "financial entity."

Because the current definition of "financial entity" treats end-users with "central desks" in the same manner as hedge funds, Congress's careful protections for end-users in Title VII of the Dodd-Frank Act are significantly undermined. In order to alleviate this situation and ensure end-users the fullest protections available, Congress should amend CEA Section 2(h)(7)(C) to clarify that an entity whose primary business is entering into swaps or other transactions on behalf of affiliates that are not "financial entities" does not fall within the definition of "financial entity" set forth in CEA Section 2(h)(7)(C)(i).

### G. Congress Should Clarify that Financial Entities May Utilize the End-User Exception to Mandatory Clearing When Transaction on Behalf of an Affiliate That is a Nonfinancial Entity.

CEA Section 2(h)(7) allows financial entities to exercise the end-user exception on behalf of non-financial affiliates if they act "on behalf of and as an agent of the nonfinancial affiliate." The CFTC has interpreted this phrase to require an actual agency agreement to be in place and to require that the nonfinancial end-user enter into the swap as principal. The narrow reading of this phrase vitiates Congress' intent that market-facing financial entities should be able to take advantage of the end-user exception if they are acting on behalf of nonfinancial affiliates. Requiring the nonfinancial end-user to enter into the swap as principal effectively eliminates the benefits realized by using central hedging affiliates and effectively renders futile financial entities' ability to exercise the end-user exception on behalf of nonfinancial affiliates. Congress should amend CEA Section 2(h)(7)(D)(i) by striking existing language requiring that a financial entity affiliate act "on behalf of a person and as an agent."

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4 Depending on their unique corporate structure, certain end-users in the energy sector may utilize (i) a single trading desk (*i.e.*, a centralized trading desk), or (ii) multiple trading desks. In either scenario, the trading activity of such end-users is generally subject to the oversight and monitoring of internal risk management and compliance personnel ("Risk Management Function"). Frequently, the Risk Management Function of an end-user will have responsibilities for the entire corporate enterprise. Given its separate and distinct role from trading, a Risk Management Function with enterprise-wide responsibilities should not fall within the definition of "financial entity."

## H. The Cross-Border Application of Title VII of the Dodd-Frank Act by the CFTC Should Not Hinder U.S. Interests Abroad.

In light of the global operations of many U.S.-based energy companies, the effective and efficient implementation of Title VII outside of the U.S. is of critical interest to API's membership. API urges Congress to use the reauthorization process as means for ensuring that the cross-border application of the CFTC's rules and regulations (i) does not place U.S. companies at a disadvantage when transacting abroad and (ii) does not raise unnecessary barriers for non-U.S. companies seeking to trade in U.S. markets. Specifically, Congress should direct the CFTC to allow U.S. persons and their affiliates to comply with transaction-level regulation of the relevant nation when doing business abroad, as long as such regulations are consistent with the G-20's derivatives reform principles. In addition, non-U.S. persons that transact in the U.S. markets, to the extent applicable, should be permitted to comply with their home country's entity-level regulations as long as such regulations are consistent with the G-20's derivatives reform principles. Finally, given the significance of the CFTC's approach to cross-border regulation of derivatives markets, Congress should require the Commission to publish any cross-border guidance as part of an actual rulemaking process so a public notice and comment period is permitted and a proper cost-benefit analysis is performed.

## I. Swaps Between Affiliates in the Same Corporate Family Should be Exempt from CFTC Regulation.

Currently, the final and proposed rules issued by the CFTC generally treat inter-affiliate swaps in the same manner as swaps transacted between unaffiliated third-parties. Consequently, under certain circumstances, companies transacting swaps between affiliates must report swaps to a swap data repository or the CFTC (as applicable). In addition, companies must submit such swaps to central clearing unless the end-user hedging exception set forth in CEA Section 2(h)(7) applies or complex criteria for the inter-affiliate clearing exception issued by the CFTC recently are met. The CFTC has provided relief in the form of no-action letters, but the no-action letters do not provide adequate relief in many circumstances. Because these regulations impose significant costs upon end-users and inter-affiliate swaps have little to no impact on swap markets, API urges Congress to amend the CEA and exempt swaps between affiliates within the same corporate enterprise – whether directly, indirectly, wholly or partially owned – from CFTC regulation.

If you have any questions regarding this letter, or if we can be of further assistance, please contact Shane Skelton at (202) 682-8172 or skeltons@api.org

Respectfully submitted,

/s/Shane Skelton
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