End-Users Discuss Concerns at CFTC Roundtable

By Joanne Morrison

The Commodity Futures Trading Commission held a roundtable on April 3 to give energy companies, asset managers and other end-users a chance to vent their frustration with a number of Dodd-Frank requirements that affect their ability to use the futures and swaps markets.

The meeting was organized by Mark Wetjen, the CFTC's Acting Chairman, to give the agency a better idea of what changes could be implemented to address end-user concerns in addition to the steps already taken, such as extending the deadline for certain reporting requirements and easing the requirements for firms that do business with municipal utilities and other "special entities."

"Congress was crystal clear that commercial end-users, which make up the overwhelming majority of companies in America, did not cause the crisis," said CFTC Acting Chairman Mark Wetjen at the start of the day-long meeting. "Congress was equally clear that in putting in place the significant derivatives reforms contained in Dodd-Frank, the derivatives markets need to remain accessible to end-users who rely on these markets for hedging and price-discovery needs."

Recordkeeping for Commodity Interest and Related Cash or Forward Transactions

During the roundtable, participating end-user representatives questioned the benefit of Rule 1.35 and highlighted the costs associated with this rule. Rule 1.35 requires futures commission merchants, retail foreign exchange dealers, introducing brokers and members of designated contract markets and swap execution facilities to retain all records and data related to business dealing in commodity interest and related cash or forward transactions including text messages and telephone conversations. This applies to transactions conducted on both swap execution facilities and designated contract markets.

The regulation requires that records be kept on all electronic written communications including emails, chat rooms, mobile devices, other digital or electronic media or instant messages that are provided or received that led to the execution of a transaction in a commodity interest and related cash or forward transactions. A "commodity interest" includes futures, options, forwards and swaps based on physical commodities.

Several participants in the roundtable commented that the record-keeping requirement makes sense for intermediaries that do business with customers, such as futures commission merchants and introducing brokers, but complained that the requirements would also apply to end-users that have chosen to become members of SEFs and DCMs. They explained that the recordkeeping requirements of Rule 1.35, and in particular the requirement to record conversations that led to the execution of a trade, would be so burdensome that some end-users would avoid becoming members of these venues.

Todd Kemp, vice president of marketing at the National Grain and Feed Association, warned that the rules would create a bifurcated market where firms that are DCM members would be required to capture this data and non-DCM members would not. "We have some concerns about an uneven situation being created in the marketplace," he said.

Many of the participants agreed that they do not plan to conduct transactions on swap execution facilities because of the recordkeeping requirements. "The rule as written today is a disincentive to become a member of a DCM or SEF," said Jerry Jeske, head of compliance at Mercuria Energy Trading. "We have no interest in being part of a SEF at this point."

A number of panelists also questioned the need to establish these requirements for commodity trading advisors simply because they are a member of a SEF. "The legislative intent of 1.35 has never been to take in customers," said Robby Sen, counsel in the asset management area at Ameriprise Financial. "We had no idea that we would be subject to this requirement."

Stephen Waldman, managing director and deputy general counsel at Tudor Investment Corp. cautioned that the reporting requirement has "really turned into a substantive change as to how many of us are forced to conduct business."

In response to these concerns, the CFTC has decided to hold off on implementing the oral recordkeeping requirements for asset managers and commodity trading advisors that are members of SEFs and DCMs. Two weeks after the roundtable, the agency issued a no-action letter that extended relief from this part of Rule 1.35 until Dec. 31.

Treatment of Embedded Options

The panelists also raised concerns about the treatment of derivatives with option-like features embedded into the contracts. As several panelists pointed out, many utilities and other energy companies enter into forward contracts with embedded options to hedge the risk that they will be unable to provide sufficient power or gas at a particular moment in time. These "volumetric option" contracts allow them to change the amount of the underlying commodity that will be delivered at settlement.

A large number of the panelists expressed the concern that the CFTC's rules and guidance do not provide sufficient clarity on whether a contract with an embedded option has to be treated as a swap, which is covered by CFTC reporting requirements and other rules that apply to swaps, or as a trade option, which is subject to some of the CFTC's rules, or as a physical forward, which is exempt. As a result, many companies have found themselves unable to agree with their counterparties on whether the contracts are subject to the swap definition and in some cases they have chosen to avoid entering into these contracts because of the uncertainty, several panelists said.

The panelists added that this uncertainty also affects decisions on whether to exercise the options embedded in existing contracts. "There has been an impact on market liquidity," warned Susan Bergles, a lawyer at Northwest Natural, an Oregon utility, who spoke as a representative of the American Gas Association. She added that uncertainty over the treatment of these contracts has significantly reduced the number of counterparties willing to enter into these contracts.

"We can't make it work in a way that we can make clear to our clients," said David Perlman, a lawyer speaking on behalf of the Coalition of Physical Energy Companies. Perlman warned that this issue will not only hinder compliance with the CFTC's swap reporting requirements but also the CFTC's position limits when those are extended to swaps.

The panelists urged the agency to take action in two ways: by issuing interpretative guidance as an interim solution and by proposing a rule for comment to provide a more definitive solution. The panelists also urged the agency to go beyond providing additional examples of specific transaction types. "If you are going to give us interpretative guidance, it has to be something we can use," said James Allison, risk manager for North American gas and power at ConocoPhillips.

De Minimis Threshold Exemption for Transactions with Special Entities

The final topic discussed during the roundtable discussion covered the so-called *de minimis* threshold set by the CFTC to determine whether an entity must register as a swap dealer when dealing with "special entities" such as municipalities. This threshold is set at $25 million; any firm that executes more than $25 million of swaps with special entities has to register as a swap dealer.

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>
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> **SACRAMENTO, CA**
> **MUNICIPAL UTILITY DISTRICT**

On March 21, the CFTC revised its policy in this area. The agency issued a no-action letter that gives firms more freedom to enter into swaps with government owned gas or power utilities without triggering the swap dealer registration requirement.

During the roundtable, several panelists welcomed this decision, but warned that the CFTC's swap dealer rules had significantly reduced the number of counterparties available to enter into transactions with them.

"Half of our counterparties have stopped trading with us," said Jim Tracy of California's Sacramento Municipal Utility District.

The CFTC's Wetjen has indicated that the CFTC plans to propose rulemaking to amend the *de minimis* exception to address this issue. Panelists welcomed this move, noting that the no-action relief has already led to improvements in the number of counterparties available.

"We've already seen benefits from this policy change and applaud the Commission in its efforts to make it permanent in the announced rulemaking," said Terry Naulty of the Owensboro Municipal Utilities, the largest municipal electric and water system in Kentucky.

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