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Background

The FAA has been asked to provide a legal interpretation regarding the application of 14 CFR 135.263 and 135.267(d) to the following factual scenario.

An operator plans a flight that is anticipated to be completed within a 13.5-hour duty day. However, unanticipated delays (such as late passengers and late cargo) occur before the last leg of the flight, and these delays would extend the flight beyond a 14-hour duty day if the last leg is completed. The proposed interpretation would clarify whether the crew may take off on the last leg of the flight, knowing in advance that they will not receive the 10 hours of rest required in a 24-hour period by section 135.267(d).

Discussion of the Proposal

Section 135.267(d) of Title 14 of the Code of Federal Regulations requires that a flight assignment operating under section 135.267(b) and (c) must provide for at least 10 consecutive hours of rest during the 24-hour period that precedes the planned completion time of the assignment. Under this section, a duty day may not exceed 14 hours in a 24-hour period without infringing on the required rest time. However, section 135.267(d) works in conjunction with 14 CFR 135.263(d), which provides that:

A flight crewmember is not considered to be assigned flight time in excess of flight time limitations if the flights to which he is assigned normally terminate within the limitations, but due to circumstances beyond the control of the certificate holder or flight crewmember (such as adverse weather conditions), are not at the time of departure expected to reach their destination within the planned flight time.

In the 1990s, the FAA interpreted sections 135.263(d) and 135.267(d) to permit flight crewmembers to take off on flights that were scheduled to be completed within a 14-hour duty period even though circumstances beyond the crewmembers' control extended the actual duty time beyond the permissible 14-hour period. *See, e.g.*, Aug. 30, 1993, Letter to Mr. Ross from Donald P. Byrne, Assistant Chief Counsel for Regulations and Enforcement; Mar. 30, 1992, Letter to Kevin Wilson from Donald P. Byrne.

However, in 2000, the FAA issued a seminal interpretation of a section that

is nearly identical to section 135.263(d). That section, 14 CFR 121.471(g), states that:

A flight crewmember is not considered to be scheduled for flight time in excess of flight time limitations if the flights to which he is assigned are scheduled and normally terminate within the limitations, but due to circumstances beyond the control of the certificate holder (such as adverse weather conditions), are not at the time of departure expected to reach their destination within the scheduled time.

The FAA's 2000 interpretation stated that the language of section 121.471(g) created an exception to pilot flight time limitations, but did not provide an exception for pilot rest requirements. *See* Nov. 20, 2000, Letter to Captain Richard D. Rubin from James W. Whitlow, Deputy Chief Counsel ("Whitlow Letter"). The Whitlow Letter's validity was subsequently upheld by the U.S. Court of Appeals for the DC Circuit, and since that time, the FAA has consistently applied the Whitlow Letter in its interpretations of section 121.471(g). *See Air Transport Ass'n of America, Inc. v. F.A.A.*, 291 F.3d 49 (DC Cir. 2002) (upholding the validity of the Whitlow Letter). *See, e.g.*, Mar. 18, 2009, Letter to William E. Banks, Jr. from Rebecca B. MacPherson, Assistant Chief Counsel for Regulations (noting that section 121.471(g) does not provide an exception for rest requirements); Jan. 11, 2005, Letter to Jan Marcus from Rebecca B. MacPherson, Assistant Chief Counsel for Regulations (same).

The FAA has determined that it is illogical that the nearly-identical regulatory language in sections 121.471(g) and 135.263(d) is interpreted in two different ways. *See Air Transport Ass'n*, 291 F.3d at 51 n.1 (stating that "[t]he substance of the rules in Parts 121 and 135 is essentially the same and the rules are likewise interpreted"). As such, the FAA proposes to apply the Whitlow Letter's interpretation of 121.471(g) to sections 135.263(d) and 135.267(d). Because the Whitlow Letter and the subsequent interpretations based on the Whitlow Letter are more recent than the 1990s interpretations of sections 135.263(d) and 135.267(d), the Whitlow Letter line of interpretations best reflects the FAA's current understanding of the pertinent regulatory language. As such, the proposed application of the Whitlow Letter to sections 135.263(d) and 135.267(d) would supersede any contrary pre-Whitlow interpretations of these sections.

Under the proposed interpretation, section 135.263(d) would not create an exception for flight crewmember rest requirements. As such, if a flight

crewmember was to be aware at the time of departure on the last leg of the flight that he or she has not had the required rest, 14 CFR 135.267(d) would prohibit him or her from departing on the last leg of the flight.

Issued in Washington, DC, on December 17, 2010.

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COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 39

RIN 3038-AD10

End-User Exception to Mandatory Clearing of Swaps

AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed rule.

SUMMARY: The Commodity Futures Trading Commission ("CFTC" or "Commission") is proposing new requirements governing the elective exception to mandatory clearing of swaps available for swap counterparties meeting certain conditions under Section 2(h)(7) of the Commodity Exchange Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Commission is requesting comments on the proposed rule and related matters.

DATES: Comments must be received on or before February 22, 2011.

ADDRESSES: You may submit comments, identified by RIN number 3038-AD10, by any of the following methods:

- *Agency Web site, via its Comments Online process:* <http://comments.cftc.gov>. Follow the instructions for submitting comments through the Web site.
- *Mail:* David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.
- *Hand Delivery/Courier:* Same as mail above.
- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow instructions for submitting comments.

Please submit your comments using only one method. All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to <http://www.cftc.gov>. You should submit only information that you wish to make

available publicly. If you wish the Commission to consider information that is exempt from disclosure under the Freedom of Information Act, a petition or confidential treatment of the exempt information may be submitted according to the established procedures in § 145.9 of the Commission's regulations.¹ The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse, or remove any or all of your submission from <http://www.cftc.gov> that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

FOR FURTHER INFORMATION CONTACT: Lee Ann Duffy, Assistant General Counsel, (202) 418-6763, lduffy@cftc.gov, or Mark Fajfar, Assistant General Counsel, (202) 418-6636, mfajfar@cftc.gov, Office of General Counsel, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

SUPPLEMENTARY INFORMATION: The Commission is proposing § 39.6 to govern the elective exception to mandatory clearing of swaps available to swap counterparties meeting certain conditions. The Commission is requesting comments on all aspects of the proposed rules and related matters. The Commission will carefully consider any comments received and will respond as necessary or appropriate.

I. Introduction

The Commodity Exchange Act ("CEA" or "Act"),² as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "DFA"),³ establishes a comprehensive new regulatory framework for swaps, security-based swaps, and related instruments. The Dodd-Frank Act was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) Providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating rigorous

recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities over all registered entities and intermediaries subject to the Commission's oversight.

The Dodd-Frank Act amended the CEA to require that: (1) Swaps be cleared through a derivatives clearing organization ("DCO") if they are of a type that the Commission determines must be cleared, unless an exception from mandatory clearing applies; (2) swaps be reported to a registered swap data repository ("SDR") or the Commission; and (3) if a swap is subject to a clearing requirement, it be executed on a registered trading platform, *i.e.*, a swap execution facility or a designated contract market ("DCM"), unless no facility or market is available for execution of such swap.⁴

CEA Section 2(h)(1) provides that it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a DCO if the swap is required to be cleared.⁵ However, Section 2(h)(7) of the CEA also provides that a swap otherwise subject to mandatory clearing is subject to an elective exception from clearing if one party to the swap is not a financial entity, is using swaps to hedge or mitigate commercial risk, and 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 (the "end-user clearing exception").⁶

The Dodd-Frank Act provides the Commission with authority to adopt rules governing the end-user clearing exception and to prescribe rules, issue interpretations, or request information from persons claiming the end-user clearing exception necessary to prevent abuse of the exception. The Commission is also required to consider whether to except small banks, savings associations, farm credit system institutions, and credit unions from the

definition of "financial entity" contained in CEA Section 2(h)(7)(C)(ii).

The Commission is proposing § 39.6 to specify requirements for electing to use, and facilitating compliance with, the exception to mandatory clearing of swaps established by CEA Section 2(h)(7). The Commission is also requesting comments regarding the requirements that should apply to small banks, savings associations, farm credit system institutions, and credit unions that may wish to elect to use this clearing exception.

II. Description of Proposed Rule

A. Notification to the Commission

A non-financial entity⁷ that enters into a swap to hedge or mitigate commercial risk must notify the Commission how it generally meets its financial obligations associated with non-cleared swaps in order to use the end-user clearing exception. The CEA authorizes the Commission to establish the manner of notification and to prescribe such rules as may be necessary to prevent abuse of the end-user clearing exception. The Commission is proposing in § 39.6(b) to require non-financial entities to notify the Commission each time the end-user clearing exception is elected by delivering specified information to an SDR in the manner required by proposed rules for swaps data recordkeeping and reporting.⁸ The specified information would be

⁷ CEA Section 2(h)(7)(A)(i) limits availability of the end-user clearing exception to counterparties to the swap that are not a financial entity. The term financial entity is defined in CEA Section 2(h)(7)(C)(i), and includes the following eight entities: (i) A swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap participant; (v) a commodity pool as defined in CEA Section 1a(10); (vi) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)); (vii) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); or (viii) a person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)). Four of these terms, "swap dealer", "major swap participant", "security-based swap dealer" and "major security-based swap participant" are themselves the subject of current proposed joint rulemaking by the Commission and the SEC. See *Further Definition of Swap Dealer, Security-Based Swap Dealer, Major Swap Participant, Major Security-Based Swap Participant and Eligible Contract Participant*, approved by the Commission on December 1, 2010, to be published in the *Federal Register* on December 21, 2010.

⁸ See *Swap Data Recordkeeping and Reporting Requirements*, 75 FR 76573, December 8, 2010. The recordkeeping and reporting rules contemplate that this information may be delivered to the Commission directly in limited circumstances when an SDR is not available. When permitted, such delivery would also meet the end-user clearing exception notice requirement.

¹ 17 CFR 145.9.

² 7 U.S.C. 1 *et seq.*

³ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

⁴ The Dodd-Frank Act amends the Securities Exchange Act of 1934 ("Exchange Act") to provide for a similar regulatory framework for transactions in security-based swaps regulated by the Securities and Exchange Commission ("SEC").

⁵ See Process for Review of Swaps for Mandatory Clearing, 75 FR 67277 (Nov. 2, 2010).

⁶ When entering into a swap with a swap dealer or a major swap participant, non-financial counterparties are granted a right to forgo the exception and require clearing for a swap subject to a clearing mandate from the Commission. Non-financial counterparties are granted a similar elective right regarding clearing where a swap has been listed for clearing, but is not the subject of a Commission clearing mandate. See CEA Section 2(h)(7)(E). The choice to require or forgo clearing is solely at the nonfinancial counterparty's discretion. See CEA Section 2(h)(7)(B).

delivered to the SDR by the reporting counterparty defined in the swap data recordkeeping and reporting rules together with other information regarding the swap that is subject to the end-user clearing exception to form the central record of the swap held by the SDR.

Under the approach set forth in proposed § 39.6(b), whenever the end-user clearing exception is elected, ten additional items of information would be required to be provided to the SDR. If the counterparty electing to use the end-user clearing exception is an issuer of securities under Exchange Act Section 12 or required to file periodic reports with the SEC under Exchange Act Section 15(d), two further items of information would be required: the electing counterparty's SEC Central Index Key number, and whether the appropriate governing body of that counterparty has reviewed and approved the decision not to clear the swap.

1. Meeting Financial Obligations

A non-financial entity electing to use the end-user clearing exception must notify the Commission of "how it generally meets its financial obligations associated with non-cleared swaps" ("Financial Obligation Notice"). See CEA Section 2(h)(7)(A)(iii). A principal feature distinguishing cleared swaps from non-cleared swaps is that non-cleared swaps do not have a uniform method of mitigating counterparty credit risk.⁹ Proposed § 39.6(b)(5) would require a person relying on the end-user clearing exception to provide additional information regarding the methods used to mitigate credit risk in connection with non-cleared swaps. If more than one method is used by the person electing to use the end-user clearing exception, information must be provided for each of the methods being used.

a. Credit Support

Proposed § 39.6(b)(5)(i) requires an indication of whether a written credit support agreement is being used with respect to the non-financial entity or entities in connection with the non-cleared swap. For these purposes, the term credit support agreement may refer to any agreement, or annex, amendment or supplement to another agreement,

which contemplates the periodic transfer of specified collateral to or from another party to support payment obligations associated with the swap or a related portfolio, basket or other combination of securities, swaps and other instruments. Agreements of this kind are frequently used to mitigate the counterparty credit risk of swaps and other instruments that are not centrally cleared, but the use of such arrangements may be more or less common among certain types of counterparties and for certain types of swaps.¹⁰ The proposed notification would provide the Commission with information regarding the extent to which credit support agreements are used by non-financial entities to support their meeting financial obligations associated with non-cleared swaps.

b. Pledged or Segregated Assets

Proposed Rule 39.6(b)(5)(ii) requires an indication of whether payment of all or any portion of the financial obligations associated with the non-cleared swap are secured by collateral that has been pledged pursuant to a documented security arrangement not requiring the transfer of possession of collateral to the swap counterparty. Examples of this type of arrangement include, but are not limited to, agreements granting security interests over property of the non-financial entity, whether or not such security interests are perfected by the filing of a mortgage, financing statement or similar document, agreements to transfer assets to collateral agents or escrow agents acting pursuant to instructions agreed by both parties to a swap, or the posting or receiving of margin. While such arrangements may be somewhat less commonly used to mitigate credit risk associated with non-cleared swaps, the Commission preliminarily believes this method may have particular importance for certain categories of non-financial entities, such as enterprises with high levels of fixed assets relative to cash flows.¹¹ Accordingly, the Commission considers it appropriate to separately categorize this information in the data being collected.

c. Guarantee

Proposed § 39.6(b)(5)(iii) requires an indication of whether all or any portion of the financial obligations associated with the non-cleared swap are

guaranteed in writing by a person or entity other than the non-financial entity or entities that are party to the swap. The proposed notification would provide the Commission with information regarding the role that guarantees by third parties (such as parent companies, affiliated parties or others) play in meeting financial obligations associated with non-cleared swaps.¹²

d. Sole Reliance on Available Financial Resources

Proposed Rule 39.6(b)(5)(iv) requires an indication of whether the non-financial entity or entities that are party to the swap intend(s) to meet the obligations associated with the swap solely by utilizing available financial resources.¹³ Financial resources available to meet obligations associated with non-cleared swaps may include various liquidity sources, including existing assets, investments and cash balances, cash flow from operations, short-term and long-term lines of credit, and capital market sources of funding.

e. Other Means

Proposed § 39.6(b)(5)(v) requires an indication of whether the non-financial entity or entities that are party to the swap intend(s) to employ means other than those described in proposed § 39.6(b)(5)(i) through (iv) to meet the financial obligations associated with a swap. This item is intended to separately categorize all other methods that may be used in the markets today or that may develop in the future. The Commission anticipates many entities would meet their financial obligations through one of the specific methods listed in § 39.6(b)(5)(i) through (iv). The information collected pursuant to proposed § 39.6(b)(5)(v), however, together with other information collected, may allow the Commission to gain greater insight regarding whether additional data concerning methods used to mitigate credit risk should be collected in the future.

¹² See ISDA Collateralization Practices at 20 (identifying master cross-netting and cross-guarantee structures as common credit risk mitigation practices).

¹³ For a variety of reasons one or both of the counterparties to some non-cleared swaps may choose not to mitigate credit risk and instead rely on the general creditworthiness of their opposite counterparty, given the circumstances and financial terms of the transaction. See, e.g. Office of the Comptroller of Currency "Risk Management of Financial Derivatives" Comptroller's Handbook (Jan. 1997) at 50 (available at <http://www.occ.gov/static/publications/handbook/deriv.pdf>) (contemplating that evaluations of individual counterparty credit limits should aggregate limits for derivatives with credit limits established for other activities, including commercial lending).

⁹ See "ISDA Collateral Steering Committee, Market Review of OTC Derivative Bilateral Collateralization Practices (2.0)" (available at http://www.isda.org/c_and_a/pdf/Collateral-Market-Review.pdf) ("ISDA Collateralization Practices") (describing methods of risk mitigation used in connection with swaps and key legal foundations supporting collateralization).

¹⁰ See ISDA Collateralization Practices. See also "ISDA Margin Survey 2010" (available at http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf) ("ISDA Margin Survey 2010").

¹¹ See e.g. ISDA Margin Survey 2010 at 9 (noting types of non-ISDA collateral agreements used and frequency of use).

2. Preventing Abuse of the End-User Clearing Exception

The remaining items of information required by proposed § 39.6 are designed to confirm compliance with particular requirements of CEA Section 2(h)(7) or otherwise produce information necessary or useful to aid the Commission in its efforts to prevent abuse of the end-user clearing exception as contemplated by CEA Section 2(h)(7)(F).

a. Person Electing to Use the End-User Clearing Exception

Proposed § 39.6(b)(1) requires identification of which of the parties to the swap is electing to use the end-user clearing exception.

b. Financial Entity Status

Proposed § 39.6(b)(2) requires an indication of whether a person electing to use the end-user clearing exception is a financial entity as defined in CEA Section 2(h)(7)(C)(i). The exception to mandatory clearing of swaps under CEA Section 2(h)(7) is only available to persons that are not financial entities, or are affiliates of non-financial entities satisfying the requirements of CEA Sections 2(h)(7)(C)(iii) or 2(h)(7)(D).

c. Finance Affiliate Status

Proposed § 39.6(b)(3) requires an indication of whether a person electing to use the end-user clearing exception is an affiliate of another person qualifying for the exception under CEA Section 2(h)(7), and satisfies the additional requirements of CEA Sections 2(h)(7)(C)(iii) or 2(h)(7)(D). These sections of the CEA contain provisions specially designed for captive finance affiliates of persons qualifying for the end-user clearing exception.¹⁴ Given the

nature of these provisions, the Commission preliminarily believes it is appropriate to separately categorize swaps transacted by such finance affiliates in particular.

d. Hedging or Mitigating Commercial Risk

Proposed § 39.6(b)(4) requires an indication of whether a person electing to use the end-user clearing exception is using the swap being reported to hedge or mitigate commercial risk. The exception to mandatory clearing of swaps under Section 2(h)(7) of the CEA is only available to persons that use such swaps to hedge or mitigate commercial risk. The definition of “hedging or mitigating commercial risk” is discussed below in Section B.

e. End-User Board Approval

Proposed § 39.6(b)(6) requires all persons electing the end-user clearing exception to indicate whether they are an issuer of securities registered under Exchange Act Section 12 or required to file reports under Exchange Act Section 15(d) (“SEC Filer”).¹⁵ Under CEA Section 2(j), the exception to mandatory clearing of swaps under CEA Section 2(h)(7) is available to SEC Filers only if an appropriate committee of the issuer’s board or governing body has reviewed and approved the issuer’s decision to enter into swaps that are subject to the exception.¹⁶ When the person electing to use the end-user clearing exception is an SEC Filer, two additional items of information must be provided:

- Proposed § 39.6(b)(6)(i) requires an SEC Filer electing to use the end-user

the clearing requirement in CEA Section 2(h)(1), provided that the swaps in question are entered into to mitigate the risk of the financing activities. *See* CEA Section 2(h)(7)(D)(iii). Finally, excluded from the definition of financial entity are those entities (1) whose primary business is providing financing, and (2) who are using derivatives to hedge underlying commercial risks related to interest rate and foreign currency exposures, if 90% or more of those risks arise from the finance or lease of products, and if 90% or more of those products are manufactured by the parent company or another subsidiary of the parent. *See* CEA Section 2(h)(7)(C)(iii).

¹⁵ For these purposes, a counterparty electing to use the end-user clearing exception is considered to be an issuer of securities registered under Exchange Act Section 12 or required to file reports pursuant to Exchange Act Section 15(d) if it is controlled by a person that is an issuer of securities registered under Exchange Act Section 12 or required to file reports pursuant to Exchange Act Section 15(d). *See* Rule 1–02(x) of SEC Regulation S–X, 17 CFR § 210.1–02(x) (defining subsidiary for purposes of the financial statements required to be filed as part of registration statements under Exchange Act Section 12, and annual and other reports under Exchange Act Sections 13 and 15(d)).

¹⁶ *See* CEA Section 2(j). For these purposes, the Commission considers a committee to be appropriate if it is specifically authorized to review and approve the issuer’s decisions to enter into swaps.

clearing exception to specify its SEC Central Index Key number. Collection of this information will allow the CFTC to cross reference materials filed with the relevant SDR with information in periodic reports and other materials filed by the SEC Filer with the SEC.¹⁷

- Proposed § 39.6(b)(6)(ii) requires confirmation that an appropriately authorized committee of the board of directors or equivalent governing body of the SEC Filer has reviewed and approved the decision of the electing person not to clear the swap being reported, as required by CEA Section 2(j).¹⁸

Given the requirements of CEA Section 2(j) and its relationship to the end-user clearing exception, the Commission preliminarily believes collection of this information is appropriate to promote compliance with the requirements of the end-user clearing exception.

Request for Comment:

The Commission generally requests comments on all aspects of the proposed rules. Additionally, the Commission requests comments on the following specific issues:

- Is it sufficiently clear what information the Commission is requiring to be reported under proposed § 39.6? If not, why not? Is it sufficiently clear how information would be reported under proposed § 39.6 if a swap is between two non-financial entities both seeking to elect to use the end-user clearing exception? If not, why not? Are there clarifications or instructions the Commission could adopt that are useful for parties seeking to elect to use the end-user clearing exception? If so, what are they and what would be the benefits of adopting them?

- Would it be difficult or prohibitively expensive for persons to report the information required under the proposed § 39.6? If so, why?

- Is the information the Commission proposes to collect in connection with the Financial Obligation Notice sufficient? Is other information needed to achieve the purposes of the Dodd-Frank Act? For example, is it necessary or appropriate for the Commission to collect: Additional general information on the credit support agreement and the

¹⁷ *See* Item 305 of SEC Regulation S–K, 17 CFR 229.305.

¹⁸ For example, a board resolution or an amendment to a board committee’s charter could expressly authorize such committee to review and approve decisions of the electing person not to clear the swap being reported. In turn, such board committee could adopt policies and procedures to review and approve decisions not to clear swaps, on a periodic basis or subject to other conditions determined to be satisfactory to the board committee.

¹⁴ CEA Section 2(h)(7)(D)(i) provides that affiliates of persons qualifying for the end-user clearing exception will also qualify for the end-user clearing exception if the affiliate (1) acts on behalf of the person and as agent, (2) uses the swap to hedge or mitigate commercial risk of that person or another affiliate of that person that is not a financial entity as defined in CEA Section 2(h)(7)(C)(i), and (3) is not itself one of seven entities defined in CEA Section 2(h)(7)(D)(ii). The seven entities are: (i) A swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap participant; (v) an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3), but for paragraph (1) or (7) of subsection c of that Act (15 U.S.C. 80a–3(c)); (vi) a commodity pool; or (vii) a bank holding company with over \$50,000,000,000 in consolidated assets. *See* CEA Section 2(h)(7)(D)(ii). In addition, an affiliate, subsidiary, or wholly owned entity of a person that qualifies for an exception under CEA Section 2(h)(7)(A) and which is predominantly engaged in providing financing for the purchase or lease of merchandise or manufactured goods of the person shall be excepted from both the margin requirements described in CEA Section 4s(e) and

collateral practices under the agreement, such as the level of margin collateral outstanding (*e.g.*, less than or equal to a specified dollar amount, or greater than a series of progressively higher dollar amounts); the types of collateral provided (*e.g.*, cash, government securities, other securities, other collateral), or the frequency of portfolio reconciliation? Additional general information on specific terms of the credit support agreement, such as whether the collateral requirements are unilateral or bilateral provisions and whether there are contractual terms triggered by changes in the credit rating or other financial circumstances of one or both of the counterparties? Additional general information about the guarantor, such as whether or not the guarantor is a parent or affiliate of the person electing to use the end-user clearing exception? Additional general information regarding the assets pledged, such as the type of security interest or the type of property being used as collateral? Additional general information regarding the segregation arrangements, such as the identity of the collateral agent or other third party involved in the arrangement, and information regarding whether the arrangement involves a custodian, tri-party or different type of relationship? Additional general information regarding the adequacy of other means being used, or the adequacy of the financial resources available, to meet the financial obligations associated with the non-cleared swap?

- Should the Commission provide additional clarity to the terms used in CEA Sections 2(h)(7)(C)(iii) and 2(h)(7)(D) in proposed § 39.6 for affiliates electing to use the end-user clearing exception? Should the Commission adopt more specific requirements to implement the provisions of CEA Sections 2(h)(7)(C)(iii) and 2(h)(7)(D)? Is there need for the Commission to address the factors to be taken into account or the manner of calculating the percentage standards established in CEA Section 2(h)(7)(C)(iii)? Should the Commission provide further guidance on other terms used in these sections, such as the meaning of the term “predominantly engaged” in CEA Section 2(h)(7)(D)? If so, what specific rules or guidance should the Commission consider and what would be the benefits of adopting them?

- Should the Commission provide additional clarity to the requirements of CEA Section 2(j) to facilitate compliance with proposed § 39.6 by parties electing to use the end-user clearing exception? Should the Commission adopt more

specific requirements to implement the provisions of CEA Section 2(j)? If so, what specific rules should the Commission consider and what would be the benefits of adopting them?

- Should the Commission provide additional guidance as to the meaning of the term “issuer of securities” as used in CEA Section 2(j)?

- Should the Commission consider requiring parties electing to use the end-user clearing exception to report additional types of information, either in order to limit abuse of the exception or for other reasons? If so, what other information should be reported and what would be the benefit of requiring such information to be reported? What categories of information, if any, should not be required to be reported and why?

- What does it mean to abuse the clearing exception under CEA Section 2(h)(7)(F)? Will some types of swaps be more susceptible to such abuse than others? For example: Are large or small companies or other identifiable sub-categories of swap users more or less likely to abuse the end-user clearing exception than other persons? Are there certain swap products or counterparties that the Commission should monitor for abuse more closely than others?

- Are there different considerations for small companies or other identifiable categories of persons who may wish to elect to use the end-user clearing exception? If so, what are they and how should the Commission take these considerations into account?

3. Form of Notice to the Commission

Proposed Rule 39.6 provides that a person electing to use the end-user clearing exception for a swap shall satisfy the notice requirements of CEA Section 2(h)(7)(A)(iii) upon providing the information specified in proposed § 39.6 to a registered SDR or, if no registered SDR is available, the Commission, in the form and manner generally required for delivery of information specified under proposed swap data recordkeeping and reporting rules.¹⁹ Under this approach, rather than collecting information through a separate process established by the Commission for these purposes, the information delivered in compliance with the requirements of proposed § 39.6 and the proposed swap data

¹⁹ Proposed §§ 45.2 and 45.3 establish the recordkeeping and reporting requirements for swaps. See *Swap Data Recordkeeping and Reporting Requirements*, 75 FR 76573 (Dec. 8, 2010). The information required under proposed Rule 39.6 would be in addition to these requirements but would be delivered to the SDR by the reporting counterparty in the same manner as required by the proposed swap data recordkeeping and reporting rules.

recordkeeping and reporting rules would serve as the official notice of a swap covered by the end-user clearing exception.

The CEA, as amended by the Dodd-Frank Act, requires all swaps (whether cleared or non-cleared) to be reported to a registered SDR or, if no registered SDR is available, the Commission. See CEA Sections 2(a)(13)(G) (reporting of swaps to SDRs) and 4r (reporting alternatives for non-cleared swaps). As centralized recordkeeping facilities of swaps, SDRs are intended to play a critical role in enhancing transparency in the swap markets. SDRs will enhance transparency by having complete records of swaps, maintaining the integrity of those records, and providing effective access to those records to relevant authorities and the public in line with their respective information needs.²⁰ The Commission recently proposed a series of new rules relating to the SDR registration process, duties, and core principles to ensure that SDRs operate in the manner contemplated by the Dodd-Frank Act amendments to the CEA.²¹

The Commission is proposing to collect notice information for the end-user clearing exception through SDRs. This will permit detailed information on the use of the end-user clearing exception to be collected in conjunction with other swap information in a format well suited to analysis by the Commission and consistent with the development of straight-through processing for swaps. Using SDRs should also help to reduce the administrative burdens of the notice requirement because the information would be incorporated into a transaction record already required by the Dodd-Frank Act in connection with each swap and subject to standards designed to assure the accuracy of the information collected. The Commission anticipates that empirical data collected in this manner will aid its ability to evaluate how the end-user clearing exception is being used and encourage appropriate deliberation by counterparties prior to its use. The

²⁰ In the case of non-cleared swaps, CEA Section 21(c)(2) requires each SDR to confirm with both parties to the swap the accuracy of the data submitted to the SDR. CEA Section 4r(c) requires each party to a non-cleared swap to maintain records of the swaps held by such party in the form required by the Commission, and CEA Section 4r(d) provides that these records shall be in a form not less comprehensive than required to be collected by SDRs. These records are available for inspection by the Commission and other specified authorities under CEA Section 4r(c)(2).

²¹ See *Swap Data Repositories*, approved by the Commission on November 19, 2010, to be published in a forthcoming issue of the **Federal Register**.

Commission also preliminarily believes receiving notification and other information in connection with CEA Sections 2(h)(7)(A)(iii) and 2(h)(7)(F) through SDRs should allow monitoring for potentially abusive practices, and timely action to address abusive practices if they were to develop.²²

Request for Comment:

The Commission generally requests comments on all aspects of the proposed rules. Additionally, the Commission requests comments on the following specific issues:

- Is it appropriate for the Commission to require notification regarding use of the end-user clearing exception to be made through SDRs? What are the advantages or disadvantages of the Commission's proposal?

- Does collecting Financial Obligation Notice information through SDRs provide sufficient assurance that the end-user clearing exception will be available to non-financial entities wishing to use the exception? Are SDRs reliable enough to be used for these purposes?

- Is Financial Obligation Notice information different from other information collected by SDRs in any respect that makes use of SDRs for these purposes inappropriate? If so, how is the notice information different and why is it inappropriate to use SDRs to collect the information?

- Is there a more feasible and cost effective way for the Commission to receive notification regarding the use of the end-user clearing exception? If so, what is the better alternative and in what ways is it better?

- Do the CEA and the associated rules and proposed rules regulating SDRs and parties to swaps create sufficient assurance that notice information collected through SDRs will be accurate? Are there additional protections the Commission should establish to create greater assurance that the notice information collected will be accurate? If so, what are they and how will they improve the information collection process?

- Would the person reporting information to the SDR be in a position to have or be able to obtain, in all cases, the information the Commission is

requiring to be reported under proposed Rule 39.6. If not, why not? Are there special considerations in this regard when a swap is between two non-financial entities that are each seeking to elect to use this exception? Are representations and warranties and similar established market practices associated with documenting swaps adequate to ensure the person reporting information to the SDR can obtain such information when necessary?

- How long would it be expected to take for the person reporting information to the SDR to gather the information required under proposed § 39.6? Will the time needed to gather the required information disrupt the transaction process for swaps to any material extent?

- Should the Commission require persons electing to use the end-user clearing exception to follow additional compliance practices in some circumstances? For example, should the Commission require electing persons to create a record of the means being used to mitigate the credit risk of the swap? Would such a requirement be redundant or duplicative of other proposed recordkeeping requirements?

- Will collecting notice information together with other transaction information have the advantages expected by the Commission? For example, will it be useful to analyze information regarding use of the end-user clearing exception by product type and other transaction characteristics? Are there other advantages or disadvantages related to collecting notice information through SDRs that the Commission should consider? If so, what are they?

- Is there reason to believe that collecting information through SDRs will make it more or less difficult for the Commission to take action to prevent abuse of the clearing exception? If so, what Commission actions might be more or less difficult and what alternatives should the Commission consider?

- Does collecting notice information regarding use of the end-user clearing exception through SDRs create significantly greater burdens for some parties to swaps compared to others? For example, will parties who frequently enter into swaps face higher or lower burdens compared to parties that enter swaps less frequently? Will small companies face different burdens than large companies? Will non-financial entities that enter into swaps with other non-financial entities face different burdens? If so, what steps should the Commission consider taking to account for these differences?

- Are there international or cross-border issues related to the end-user exception that the Commission should address?

B. Hedging or Mitigating Commercial Risk

To qualify to use the end-user clearing exception with respect to a particular swap, CEA Section 2(h)(7)(A)(ii) requires that a non-financial entity must be using the swap to hedge or mitigate commercial risk. The Commission's proposal deems that the use of a swap is for hedging purposes in three circumstances. While the proposed definition in Proposed § 39.6(c) includes swaps that are recognized as hedges for accounting purposes or as bona fide hedging for purposes of an exemption from position limits under the CEA, the swaps included within the clearing exception are not limited to those two circumstances. *See* Proposed § 39.6(c)(1)(ii) and (iii). The proposal also covers swaps used to hedge or mitigate any of a person's business risks, as defined by six categories in the proposal, regardless of their status under accounting guidelines or the bona fide hedging exemption. *See* Proposed § 39.6(c)(1)(i). Proposed § 39.6(c)(2) further provides, however, that a swap is disqualified from the clearing exception if it is held for a speculative, investing, or trading purpose,²³ or if it hedges another swap unless that swap itself is held for hedging purposes.

The phrase "hedging or mitigating commercial risk" is the subject of current joint rulemaking by the Commission and the SEC.²⁴ Through this joint rulemaking exercise, the Commission is proposing a definition of "hedging or mitigating commercial risk"

²³ The Commission preliminarily believes that swap positions that are held for the purpose of speculation or trading are, for example, those positions that are held primarily to take an outright view on the direction of the market, including positions held for short term resale, or to obtain arbitrage profits. Swap positions that hedge other positions that themselves are held for the purpose of speculation or trading are also speculative or trading positions.

The Commission preliminarily believes that swap positions that are held for the purpose of investing are, for example, those positions that are held primarily to obtain an appreciation in value of the swap position itself, without regard to using the swap to hedge an underlying risk. In contrast, a swap position related to a non-swap investment (such as the purchase of an asset that a commercial enterprise will use to produce income or otherwise advance its commercial interests) may be a hedging position if it otherwise qualifies for the definition of hedging or mitigating commercial risk.

²⁴ *See Further Definition of Swap Dealer, Security-Based Swap Dealer, Major Swap Participant, Major Security-Based Swap Participant and Eligible Contract Participant*, approved by the Commission on December 1, 2010, to be published in the **Federal Register** on December 21, 2010.

²² The proposed notification method is supported by the recordkeeping requirements under CEA Section 4r, which will permit the Commission to review transaction information and take such action as may be necessary to prevent abuses of the end-user clearing exception. Such Commission action would be taken in a manner consistent with our review practices for other transaction information submitted to SDRs, rather than through a separate process developed for these purposes, thereby helping to maintain consistency of regulatory action in comparable areas.

that would govern for purposes of the major swap participant definition under CEA Section 1a(33). The Commission has determined to propose nearly identical regulatory language in Proposed § 39.6(c) to define the meaning of the phrase “hedge or mitigate commercial risk” as found in CEA Section 2(a)(7)(A)(ii) for purposes of the elective end-user clearing exception. This parallel approach should allow consistency of interpretation across the CEA as a whole and help provide for fair and equivalent treatment for similarly situated parties.²⁵

The Commission proposes an inclusive, multi-pronged definition that allows end users to qualify their hedging transactions in a manner that best fits their businesses. The Commission preliminarily believes that such an approach is appropriate, given the elective nature of this exception. While the line between speculation and hedging can at times be difficult to discern, the Dodd-Frank Act nonetheless requires such determinations to be made, and the Commission believes its rules proposal provides guidance and a measure of certainty in this regard.

Proposed § 39.6(c)(1)(i) takes a narrative approach similar to that used in § 1.3(z) of the Commission’s regulations, which defines what activities qualify as hedging when used in futures markets, by enumerating specific risk shifting practices that are deemed to qualify for purposes of the clearing exception. Proposed § 39.6(c)(1)(ii) and (iii) assure counterparties that if their swap qualifies for the bona fide hedge exemptions from positions limits, or if their swap qualifies for hedge accounting treatment under the FASB hedge accounting standards, the swap also qualifies for the clearing exception.

As a general matter, the Commission preliminarily believes that whether a position is used to hedge or mitigate commercial risk should be determined by the facts and circumstances at the time the swap is entered into, and should take into account the person’s overall hedging and risk mitigation strategies. The Commission expects that a person’s overall hedging and risk management strategies will help inform whether or not a particular position is

properly considered to hedge or mitigate commercial risk for purposes of the clearing exception. In this regard, the Commission preliminarily believes the question whether an activity is commercial should not be determined solely by an entity’s organizational status as a for-profit company, a non-profit organization, or a governmental entity. Instead, the determinative factor should be whether the underlying activity to which the swap relates is commercial in nature.

Request for Comment:

The Commission generally requests comments on all aspects of the proposed rules. Additionally, the Commission requests comments on the following specific issues:

- Should swaps qualifying as hedging or risk mitigating be limited to swaps where the underlying hedged item is a non-financial commodity? Commenters may also address whether swaps qualifying as hedging or risk mitigating should hedge or mitigate commercial risk on a single risk or an aggregate risk basis, and on a single entity or a consolidated basis. The Commission also invites comment on whether risks such as the foreign exchange, currency, or interest rate risk relating to offshore affiliates, should be covered; whether industry-specific rules on hedging, or rules that apply only to certain categories of commodity or asset classes, are appropriate at this time; whether swaps facilitating asset optimization or dynamic hedging should be included; and whether hedge effectiveness should be addressed. The Commission is interested in whether special considerations are warranted with respect to the use of non-cleared swaps by agricultural cooperatives as well as by non-profit, governmental, or municipal entities engaged in electric power or energy activities. Commenters are requested to discuss both the policy and legal bases underlying such comments.

- Should the Commission consider adopting a definition of “hedge or mitigate commercial risk” in proposed § 39.6(c) that is different from definition of “hedging or mitigating commercial risk” in the major swap participant definitions rule and is specifically designed to address the circumstances of the end-user clearing exception? If so, what are the specific considerations associated with the end-user clearing exception that make a separate definition desirable? What features would such a definition need in order to be effective and what would be the benefits of adopting them?

- Should the Commission consider adopting a definition of “hedge or

mitigate commercial risk” in proposed § 39.6(c) that is different from definition of “hedging or mitigating commercial risk” in the major swap participant definitions rule and is specifically designed to address the circumstances of the end-user clearing exception? If so, what are the specific considerations associated with the end-user clearing exception that make a separate definition desirable? What features would such a definition need in order to be effective and what would be the benefits of adopting them?

III. Consideration of a Clearing Exception for Small Banks, Savings Associations, Farm Credit System Institutions, and Credit Unions

Pursuant to CEA Section 2(h)(7)(C)(ii), the Commission is considering whether to except small banks, savings associations, farm credit systems institutions, and credit unions from the Act’s definition of financial entity, including specifically those with total assets of \$10,000,000,000 or less (“Small Financial Institutions”). This type of exception would permit Small Financial Institutions to use the end-user exception from the mandatory clearing requirement, which is otherwise unavailable to financial entities.

To inform its consideration of whether it would be appropriate for the Commission to grant any exception for Small Financial Institutions, the Commission requests comments on the following specific issues:

- Would such an exception be appropriate? If so, what terms and conditions should apply? Would it be better for the Commission to simply require Small Financial Institutions to follow the same practices as other financial institutions in the future? Would such an exception pose any risks to the swap markets or the financial system? Why or why not?

- How should the Commission take into account the supervisory regimes to which Small Financial Institutions are currently subject, and whether those regulatory regimes adequately mitigate any risks associated with an exception?

- Should the Commission consider treating different types of swaps differently when considering whether any exception should be available for Small Financial Institutions? If so, what specific distinctions should be considered by the Commission and what would be the benefits of adopting them?

- Should the Commission consider limiting the availability of any end-user clearing exception to only some Small Financial Institutions? Are there differences between Small Financial

²⁵ The Commission notes that the major swap participant definitional rule does not contemplate applying the definition of hedging or mitigating commercial risk to affiliates. CEA Sections 2(h)(7)(C)(iii) and 2(h)(7)(D) create certain additional requirements for affiliates of non-financial entities seeking to elect the end-user clearing exception, and these requirements must also be satisfied for the end-user clearing exception to be available.

Institutions that should lead to differences in the availability of the exception? If so, what specific distinctions should be considered by the Commission and what would be the benefits of adopting them? Would an across-the-board application of an exception to all Small Financial Institutions create any advantages or disadvantages for certain Small Financial Institutions? Would a differentiated application of an exception create any advantages or disadvantages?

- In CEA Section 2(h)(7)(C)(ii), Congress directed the Commission to consider whether to exempt small banks, savings associations, farm credit institutions, and credit unions, including those with total assets of \$10 billion or less. The Commission invites public comment on the \$10 billion total assets level. Are there measures other than total assets of \$10 billion, such as financial risk or capital, which could be used for determining whether an entity qualifies for an exception, and if so, what are the advantages or disadvantages of utilizing the alternative measures? Would utilizing these alternative measures create additional risks, and if so, should the Commission consider additional measures to address them?

IV. General Request for Comments

The Commission is requesting comments from all members of the public. The Commission will carefully consider the comments that it receives. The Commission seeks comment generally on all aspects of the proposed rules. In addition, the Commission seeks comment on the following:

- Should the Commission clarify or modify any of the definitions included in the proposed rules? If so, which definitions and what specific modifications are appropriate or necessary?

- Are there aspects of the CEA, the Investment Advisers Act of 1940 (15 U.S.C. 80), the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002), or the Bank Holding Company Act of 1956 (12 U.S.C. 184) that are incorporated in the definition that may need to be taken into consideration by the Commission to ensure the end-user clearing exception is available in appropriate circumstances? If so, what specific changes should the Commission consider and what would be the benefits of adopting them?

- Are the obligations in the proposed rules sufficiently clear? Is additional guidance from the Commission necessary?

- What are the technological or administrative burdens of complying with the rules proposed by the Commission?

- Should the Commission implement substantive requirements in addition to, or in place of, the policies and procedures required in the proposed rules?

- If an entity is designated as a swap dealer or a major swap participant with respect to only certain of its swaps or activities, should it be treated as a financial entity under CEA Section 2(h)(7)(C)(i) and thereby be disqualified from electing to use the end-user clearing exception with respect to its other swaps or activities? If so, why? If not, should the Commission require such an entity to separate those swaps or activities for which it is designated as a swap dealer or major swap participant from its other swaps or activities? If so, how? If not, why not?

In addition, the Commission seeks commenters' views regarding any potential impact of the proposals on non-financial entities expecting to elect to use the end-user clearing exception, SDRs, other market participants, and the public generally. The Commission seeks comments on the proposals as a whole, including their interaction with the other provisions of the Dodd-Frank Act. The Commission seeks comments on whether the proposals would help achieve the broader goals of increasing transparency and accountability in the swap market.

The Commission requests comment generally on whether its proposed actions today to govern the elective exception to mandatory clearing of swaps available under CEA Section 2(h)(7) are necessary or appropriate for those purposes. If commenters do not believe one or all such actions are necessary and appropriate, why not? What would be the preferred action?

Title VII requires that the Commission consult and coordinate to the extent possible with the SEC for the purposes of assuring regulatory consistency and comparability, to the extent possible, and states that in adopting rules, the Commission and SEC shall treat functionally or economically similar products or entities in a similar manner. Specifically, do the regulatory approaches under the Commission's proposed rulemaking under DFA Section 723(a) and the SEC's proposed rulemaking under DFA Section 763(a) result in duplicative or inconsistent efforts on the part of market participants subject to both regulatory regimes or result in gaps between those regimes? If so, in what ways do commenters believe that such duplication, inconsistencies,

or gaps should be minimized? Do commenters believe the approaches proposed by the Commission and the SEC to govern the elective exception to mandatory clearing of swaps and security-based swaps are comparable? If not, why? Do commenters believe there are approaches that would make the elective exception to mandatory clearing of swaps and security-based swaps more comparable? If so, what are they and what would be the benefits of adopting such approaches? Do commenters believe that it would be appropriate for us to adopt an approach proposed by the SEC that differs from our proposal? If so, which one? Are there further distinctions or clarifications that should be made by the Commission for purposes of the end-user clearing exception that are different from those being made in connection with the proposed joint rulemaking by the Commission and the SEC? If so, what are they and what would be the benefits of adopting them?

Commenters should, whenever possible, provide the Commission with empirical data to support their views. Commenters suggesting alternative approaches should provide comprehensive proposals, including any conditions or limitations that they believe should apply, the reasons for their suggested approaches, and their analysis regarding why their suggested approaches would satisfy the statutory mandate contained in DFA Section 723(a) governing the exception to mandatory clearing of swaps.

V. Related Matters

A. Cost-Benefit Analysis

Section 15(a) of the Act requires that the Commission, before promulgating a regulation or issuing an order, consider the costs and benefits of its action. By its terms, CEA Section 15(a) does not require the Commission to quantify the costs and benefits of a new regulation or determine whether the benefits of the regulation outweigh its costs. Rather, CEA Section 15(a) simply requires the Commission to "consider the costs and benefits" of its action.

CEA Section 15(a) specifies that costs and benefits shall be evaluated in light of the following considerations: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Accordingly, the Commission could, in its discretion, give greater weight to any of the five considerations and could, in its

discretion, determine that, notwithstanding its costs, a particular regulation was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

Costs

Proposed § 39.6 specifies requirements for using the elective end-user exception to the mandatory clearing of swaps established by CEA Section 2(h)(7). The proposal calls for a user-friendly, check-the-box approach to the Dodd-Frank Act's notification requirement. Proposed Rule 39.6 would simply require an indication of each method used to mitigate the credit risk associated with non-cleared swaps. Additional boxes would indicate whether finance affiliate or a SEC Filer is involved. The reporting counterparty would further be required to check a box in order to indicate whether the swap was being used to hedge or mitigate commercial risk, as defined by proposed § 39.6(c). These data elements would be provided as part of the overall package of swap-related information that must generally be submitted by reporting counterparties to SDRs under the Dodd-Frank Act.

With respect to costs, the Commission has determined that the notification requirement imposed by the rule proposal will present an increased cost. Currently, there is no requirement to notify the Commission of how a swap counterparty generally meets its financial obligations associated with its non-cleared swaps; therefore, the new notification requirement necessarily introduces a new cost to the system. While the Commission must be notified each time an election to forgo clearing is made, the cost incurred should be minimal since only general information must be included in the notification. In most cases, this check-the-box notification process will be performed by the swap dealer or major swap participant for whom such notification will represent only a small added cost to the overall cost of complying with its general reporting and recordkeeping obligations for swaps under the DFA. End users will provide the notification only for those swaps that do not involve a swap dealer or a major swap participant.

Benefits

With respect to benefits, the Commission has determined that the rule proposal should enhance the level of transparency associated with the OTC swap activity of non-financial entities, grant the Commission new insights into

the practices of non-financial entities, and help the Commission and other regulators in their efforts to reduce risk in the financial system.

Proposed § 39.6's collateralization reporting requirements should allow the Commission to identify the collateral activities of non-financial entities. The role of OTC swaps in the financial system came into focus in the aftermath of the financial crisis of 2007; instituting the proposed rule would strengthen the regulatory regime that governs OTC swaps, and provide a greater degree of transparency with regard to non-financial entities in general.

When non-financial entities report that they use alternative methods to meet their financial obligations related to OTC swaps, they would provide the Commission with a valuable insight into the practices of non-financial entities of various types. Although the Commission expects that most transactions rely on one of the specific methods listed in § 39.6(b)(5)(i), (ii), (iii), or (iv), the reporting of the use of alternative methods should help the Commission determine whether additional data collection could be needed in the future.

Finally, the rule proposal represents a more rigorous reporting regime, a stated goal of the Dodd-Frank Act. While the reporting requirements contained in the rule proposal might present increased costs to non-financial entities seeking to engage in OTC swaps, they provide the benefits of a greater body of information for the Commission to analyze.

Summary

In summary, the Commission, after considering the CEA Section 15(a) factors, finds that the incremental cost imposed by the proposed rules is outweighed by their expected benefit. Accordingly, the Commission has determined to propose the rules. The Commission invites public comment on its cost-benefit considerations. Commenters also are invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the proposed rules.

B. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA") requires federal agencies, in proposing regulations, to consider the impact of those regulations on "small entities."²⁶ The proposed rules detailed in this release would affect organizations including eligible contract participants ("ECPs")²⁷ and SDRs. The

²⁶ 5 U.S.C. 601 *et seq.*

²⁷ Under CEA Section 2(e), only ECPs are permitted to participate in a swap subject to the end-user clearing exception.

Commission has previously determined that ECPs are not "small entities" for purposes of the RFA.²⁸ Since SDRs are new entities to be regulated by the Commission pursuant to the Dodd-Frank Act, the Commission has not previously determined whether they are small entities for the purpose of the RFA. The Commission therefore has determined that SDRs are not small entities for purposes of the RFA. Specifically, the Commission has determined that SDRs should not be considered small entities based on the central role they will play in the national regulatory scheme overseeing the trading of swaps, similarly to DCMs and DCOs, which the Commission has previously determined not to be small entities on the same grounds.²⁹ Moreover, because they will be required to accept swaps across asset classes, SDRs will require significant operational resources.

Accordingly, the Commission does not expect the proposed rules to have a significant impact on a substantial number of small entities. Therefore, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed regulation would not have a significant economic impact on a substantial number of small entities. The Commission invites the public to comment on whether the entities covered by these proposed regulations should be considered small entities for purposes of the RFA.

C. Paperwork Reduction Act

1. Overview

The Paperwork Reduction Act ("PRA")³⁰ imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA. This proposed rulemaking would result in new collection of information requirements within the meaning of the PRA. The Commission therefore is submitting this proposal to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for this collection of information is "Rule 39.6 End-User Non-Cleared Swap Notification" (OMB control number [3038-NEW]). If

²⁸ See *Opting Out of Segregation*, 66 FR 20740 at 20743 (April 25, 2001).

²⁹ See *A New Regulatory Framework for Clearing Organizations*, 66 FR 45604 at 45609 (Aug. 29, 2001)(DCOs); *Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act*, 47 FR 18618 at 18618-18619 (April 30, 1982)(DCMs).

³⁰ 44 U.S.C. 3501 *et seq.*

adopted, responses to this collection of information would be mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. OMB has not yet assigned a control number to the new collection for proposed rule 39.6. The requirements of new rule 39.6 are not currently covered by any existing OMB control number.

Proposed Rule 39.6 would require non-financial entities to notify the Commission each time the end-user clearing exception is elected by delivering specified information to a registered SDR or, if no registered SDR is available, the Commission in the manner required by the proposed part 49 rules for swaps data recordkeeping and reporting. The notification will occur only once at the beginning of the swap life cycle. If one of the counterparties to the swap transaction is a swap dealer or a major swap participant, notification would be provided through that counterparty. The non-financial counterparty would provide notice only in the event its counterparty is not a swap dealer or a major swap participant.

The Commission estimates that there are approximately 30,000 end users who are counterparties to a swap in a given year. Of these end users, the Commission estimates that the majority will not be required to report under proposed § 39.6 because their counterparty is a swap dealer or major swap participant. In that case, as described above, the swap dealer or major swap participant is required to make the report on behalf of the end user. Also, end users who are counterparties to a swap entered into in a previous year will presumably have already made the notification under proposed § 39.6 and therefore will not be required to make further notifications under the rule in subsequent years. Reducing the number of annual end users by these factors, the Commission estimates that there are approximately 1,000 end users who must report in a given year.³¹ The Commission estimates that the report will require between approximately 10 minutes and one hour of burden, per end user per year.³² The number of burden hours per end user may vary depending on various factors, such as the number of swaps entered into by that end user in the given year. Therefore, the number of estimated

aggregate annual burden hours is between approximately 167 and 1,000 hours.

2. Confidentiality

The Commission protects proprietary information pursuant to the Freedom of Information Act and 17 CFR part 145, "Commission Records and Information." In addition, Section 8(a)(1) of the CEA prohibits the Commission, unless specifically authorized by the Act, from making public "data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers."³³ The Commission also is required to protect certain information contained in a government system of records pursuant to the Privacy Act of 1974, 5 U.S.C. 552a.

3. Information Collection Comments

The Commission invites the public and other federal agencies to comment on any aspect of the reporting burden discussed above. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Comments may be submitted directly to the Office of Information and Regulatory Affairs ("OIRA") in OMB, by fax at (202) 395-6566 or by e-mail at OIRAsubmissions@omb.eop.gov. Please provide the Commission with a copy of submitted comments so that all comments can be summarized and addressed in the final rule preamble. Refer to the Addresses section of this notice of proposed rulemaking for comment submission instructions to the Commission. A copy of the supporting statements for the collections of information discussed above may be obtained by visiting RegInfo.gov.

D. Antitrust Considerations

Section 15(b) of the CEA requires the Commission, before adopting a rule or

issuing an order, to take into consideration the public interest protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of the Act, as well as the purposes and policies of the CEA.³⁴ The Commission did not identify any means by which the proposed end-user exception could be implemented to achieve the objectives, purposes and policies of the CEA in a less anticompetitive manner. The Commission invites comments on all aspects of its rules proposal in this regard.

E. Consideration of Impact on the Economy

Under the Small Business Enforcement Fairness Act of 1996 ("SBREFA"), federal agencies are called upon to advise the Administrator of the OIRA in the OMB whether their proposed rules constitute "major" rules.³⁵ A rule is considered major where, if adopted, it results, or is likely to result, in: (1) An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease); (2) a major increase in the costs or prices for consumers, individual industries, federal, state, or local government agencies, or geographic regions; or (3) significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic and export markets.³⁶ If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review.

The Commission requests comment on whether its proposed rule would, if adopted, constitute a major rule under SBREFA. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

VI. Statutory Authority

Pursuant to the CEA, and particularly Section 2(h)(7) thereof, the Commission proposes new Rule 39.6, as set forth below, governing the exception to mandatory clearing of swaps established by CEA Section 2(h)(7).

³⁴ See also Section 6 of the Dodd-Frank Act.

³⁵ See Public Law 104-121 (March 29, 1996), as amended by Public Law 110-28 (May 25, 2007). The provisions governing congressional review of agency rulemaking are set forth in SBREFA Subtitle E, which is codified at 5 U.S.C. 801-808.

³⁶ See 5 U.S.C. 804(2).

³¹ The Commission requests public comment on this estimate.

³² The Commission requests public comment on this estimate.

³³ 7 U.S.C. 12(a)(1).

List of Subjects in 17 CFR Part 39

Business and industry, Reporting requirements, Swaps.

For the reasons stated in the preamble, the Commission proposes to amend 17 CFR part 39 as follows:

PART 39—DERIVATIVES CLEARING ORGANIZATIONS

1. The authority citation for part 39 is revised to read as follows:

Authority: 7 U.S.C. 2, 5, 6, 6d, 7a–1, 7a–2, and 7b, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

2. Section 39.6 is revised to read as follows:

§ 39.6 Electing to use the end-user exception to mandatory swap clearing.

(a) A counterparty to a swap (an “electing counterparty”) may elect to use the exception to mandatory clearing under section 2(h)(7)(A)(iii) of the Act if the electing counterparty is not a “financial entity” as defined in section 2(h)(7)(C)(i) of the Act, is using the swap to hedge or mitigate commercial risk as defined in § 39.6(c), and provides or causes to be provided to a registered swap data repository or, if no registered swap data repository is available, the Commission, the information specified in § 39.6(b). More than one counterparty to a swap may be an electing counterparty. If there is more than one electing counterparty to a swap, the information specified in § 39.6(b) shall be provided with respect to each of the electing counterparties.

(b) When an electing counterparty to a swap elects to use the exception to mandatory clearing under section 2(h)(7)(A)(iii) of the Act, one of the counterparties to the swap (the “reporting counterparty”) shall provide or cause to be provided the following information to a registered swap data repository or, if no registered swap data repository is available, the Commission, in the form and manner required for delivery of information specified under the Commission’s rules:

(1) The identity of the electing counterparty to the swap;

(2) Whether the electing counterparty is a “financial entity” as defined in section 2(h)(7)(C)(i) of the Act;

(3) Whether the electing counterparty is a finance affiliate meeting the requirements described in sections 2(h)(7)(C)(iii) or 2(h)(7)(D) of the Act;

(4) Whether the swap is used by the electing counterparty to hedge or mitigate commercial risk as defined in § 39.6(c) under the Act;

(5) Whether the electing counterparty generally expects to meet its financial obligations associated with its non-cleared swap by using:

(i) A written credit support agreement;

(ii) Pledged or segregated assets (including posting or receiving margin);

(iii) A written third-party guarantee;

(iv) Solely the electing counterparty’s available financial resources; or

(v) Means other than those described in § 39.6(b)(5)(i), (ii), (iii) or (iv); and

(6) Whether the electing counterparty is an entity that is an issuer of securities registered under section 12 of, or is required to file reports under 15(d) of, the Securities Exchange Act of 1934, and if so:

(i) The relevant SEC Central Index Key number for that counterparty; and

(ii) Whether an appropriate committee of the board of directors (or equivalent body) has reviewed and approved the decision not to clear the swap.

(c) For purposes of section 2(a)(7)(A)(ii) of the CEA and § 39.6(b)(4), a swap shall be deemed to be used to hedge or mitigate commercial risk when:

(1) Such swap:

(i) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from:

(A) The potential change in the value of assets that a person owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of business of the enterprise;

(B) The potential change in the value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise; or

(C) The potential change in the value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise;

(D) The potential change in the value of assets, services, inputs, products, or commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of business of the enterprise;

(E) Any potential change in value related to any of the foregoing arising from foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or

(F) Any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person’s current or anticipated assets or liabilities; or

(ii) Qualifies as bona fide hedging for purposes of an exemption from position limits under the Act; or

(iii) Qualifies for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133); and

(2) Such swap is:

(i) Not used for a purpose that is in the nature of speculation, investing, or trading; or

(ii) Not used to hedge or mitigate the risk of another swap or securities-based swap, unless that other swap itself is used to hedge or mitigate commercial risk as defined by this rule or the equivalent definitional rule governing security-based swaps promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934.

Issued in Washington, DC, on December 9, 2010, by the Commission.

David A. Stawick,

Secretary of the Commission.

Appendices to End-User Exception to Mandatory Clearing of Swaps—Commission Voting Summary and Statements of Commissioners

Note: The following appendices will not appear in the Code of Federal Regulations.

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Dunn and Chilton voted in the affirmative; Commissioners Sommers and O’Malia voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler

I support the proposed rule on the end-user exception. Congress decided that non-financial entities hedging or mitigating commercial risk will have a choice of whether to submit their transactions to clearinghouse.

In essence, the proposal says that, if a company is using a swap to hedge an asset, liability, input or service that it currently has or uses or anticipates having or using, it would qualify for the end-user exception. In addition, the proposal says that if the swap meets generally accepted accounting principles as a hedge or if it used for bona fide hedging, the transaction would qualify for the end-user exception. These non-financial entities would be able to hedge interest rate risk, currency risk, physical commodity risk or other types of risk.

The proposed rule does, however, say that if an entity is taking a position to speculate,

the transaction would not qualify for the end-user exception.

I also support the series of questions included in the proposal regarding small financial institutions. In the Dodd-Frank Act, Congress directed the commission to consider possible exemptions for small financial institutions. I look forward to hearing from the public on their views on this and what conditions would be appropriate for such exemptions.

[FR Doc. 2010-31578 Filed 12-22-10; 8:45 am]

BILLING CODE P

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

18 CFR Part 284

[Docket No. RM11-4-000]

Storage Reporting Requirements of Interstate and Intrastate Natural Gas Companies

December 16, 2010.

AGENCY: Federal Energy Regulatory Commission, DOE.

ACTION: Notice of inquiry.

SUMMARY: The Federal Energy Regulatory Commission is considering whether to revise regulations requiring interstate and intrastate natural gas pipelines to report semi-annually on their storage activities. This Notice of Inquiry will assist the Commission in determining what changes, if any, should be made to its regulations.

DATES: *Comment Date:* Comments are due February 22, 2011.

ADDRESSES: You may submit comments on the Notice of Inquiry, identified by Docket No. RM11-4-000, by one of the following methods:

- *Agency Web Site:* Documents created electronically using word processing software should be filed in native applications or print-to-PDF format, and not in a scanned format, at <http://www.ferc.gov/docs-filing/efiling.asp>.

- *Mail/Hand Delivery:* Commenters unable to file comments electronically must mail or hand deliver an original copy of their comments to: Federal Energy Regulatory Commission, Secretary of the Commission, 888 First Street, NE., Washington, DC 20426. These requirements can be found on the Commission's Web site; see, e.g., the "Quick Reference Guide for Paper Submissions," available at <http://www.ferc.gov/docs-filing/efiling.asp> or via phone from FERC Online Support at 202-502-6652 or toll-free at 1-866-208-3676.

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SUPPLEMENTARY INFORMATION:

Notice of Inquiry

December 16, 2010.

1. In this Notice of Inquiry, the Federal Energy Regulatory Commission (Commission) seeks comments on whether the Commission should modify the semi-annual storage reports required of interstate and intrastate natural gas companies pursuant to 18 CFR 284.13(e) and 284.126(c) of the Commission's regulations.¹ In particular, the Commission is interested in exploring whether it should modify the information currently collected in the semi-annual storage reports, whether there should be a standardized electronic format for the reports, and whether the storage reports must be public.

I. Background

2. Section 284.13(e) of the Commission's regulations requires interstate pipelines to file semi-annual storage reports at the end of each complete storage injection and withdrawal season. Section 284.126(c) requires similar reports by (1) intrastate natural gas pipelines providing interstate transportation service pursuant to section 311 of the Natural Gas Policy Act of 1978 (NGPA)² and (2) Hinshaw pipelines providing interstate service subject to the Commission's Natural Gas Act (NGA) section 1(c) jurisdiction pursuant to blanket certificates issued under 18 CFR

284.224.³ The reports by both sets of pipelines must include:

- (1) The identity of each customer injecting gas into storage and/or withdrawing gas from storage (including, for interstate pipelines, any affiliate relationship),
- (2) the rate schedule (for interstate pipelines) or docket number (for intrastate pipelines) authorizing the storage injection or withdrawal service,
- (3) the maximum storage quantity and maximum daily withdrawal quantity applicable to each storage customer,
- (4) for each storage customer, the volume of gas (in dekatherms) injected into and/or withdrawn from storage during the period,
- (5) the unit charge and total revenues received during the injection/withdrawal period from each storage customer (including, for interstate pipelines, any discounts), and
- (6) for intrastate pipelines, any related docket numbers under which the intrastate pipeline reported storage related injection/withdrawal transportation services.

The pipelines must file these reports within 30 days of the end of each complete storage injection and withdrawal season, and the reports must be signed under oath by a senior official. The Commission has not adopted any standardized electronic form for pipelines to submit the semi-annual storage reports. Nor has the Commission expressly required that the reports be public.

3. The Commission adopted the existing semi-annual storage reporting requirements for both interstate and intrastate pipelines in their current form in 1992 as part of Order No. 636,⁴ and there have been only minor modifications in the semi-annual storage reporting requirements since

³ Section 1(c) of the NGA exempts from the Commission's NGA jurisdiction those pipelines which transport gas in interstate commerce if (1) they receive natural gas at or within the boundary of a state, (2) all the gas is consumed within that state, and (3) the pipeline is regulated by a state Commission. This exemption is referred to as the Hinshaw exemption after the Congressman who introduced the bill amending the NGA to include section 1(c). See *ANR Pipeline Co. v. Federal Energy Regulatory Comm'n*, 71 F.3d 897, 898 (1995) (briefly summarizing the history of the Hinshaw exemption).

⁴ *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, Order No. 636, FERC Stats. & Regs. ¶ 30,939, order on reh'g, Order No. 636-A, FERC Stats. & Regs. ¶ 30,950, order on reh'g, Order No. 636-B, 61 FERC ¶ 61,272 (1992), order on reh'g, 62 FERC ¶ 61,007 (1993), *aff'd in part and remanded in part sub nom. United Distribution Cos. v. FERC*, 88 F.3d 1105 (DC Cir. 1996), order on remand, Order No. 636-C, 78 FERC ¶ 61,186 (1997).

¹ The FERC Form No. 549B reporting requirements in 18 CFR 284.13(e) are approved by the Office of Management and Budget (OMB) under OMB Control No. 1902-0169. The Form No. 549 reporting requirements in 18 CFR 284.126(c) are approved under OMB Control No. 1902-0089.

² 15 U.S.C. 3372.