CLIENT UPDATE

CFTC EXCLUDES CERTAIN SWAPS WITH UTILITY SPECIAL ENTITIES FROM SWAP DEALER DE MINIMIS CALCULATION

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On September 26, 2014, the Commodity Futures Trading Commission (the "CFTC") published in the Federal Register a final rule (the "Final Rule") permitting a person to exclude utility operations-related swaps with utility special entities from the determination of whether the aggregate gross notional amount of its swap dealing positions exceeds the *de minimis* threshold from swap dealer ("SD") registration.

The Final Rule will become effective October 27, 2014.

BACKGROUND – SWAP DEALER DE MINIMIS THRESHOLDS

Section 1.3(ggg)(4)(i) of the CFTC regulations provides a *de minimis* exception (the "De Minimis Exception") from SD registration for any person that enters into swaps positions connected with its swap dealing activities, the aggregate notional amount of which does not exceed either of the two thresholds. The two thresholds are:

- $3 billion, subject to an initial phase-in level of $8 billion (the "General De Minimis Threshold"); and

- $25 million with regard to swaps in which the counterparty is a "special entity" as defined in section 4s(h)(2)(C) of the Commodity Exchange Act [1] (the "Special Entity De Minimis Threshold").

NO-ACTION LETTERS

On October 12, 2012, the Division of Swap Dealer and Intermediary Oversight of the CFTC ("DSIO") issued a no-action letter [2] (the "Original No-Action Letter") granting temporary relief from the requirement to include certain "utility commodity swaps"[3] in determining whether the aggregate gross notional amount of swaps connected with a person's swap dealing activity exceeds the Special Entity De Minimis Threshold.

The Original No-Action Letter was issued in response to a petition (the "Petition") requesting that section 1.3(ggg)(4) be amended to exclude from the Special Entity De Minimis Threshold the notional amounts of swaps to which certain "utility special entities" are counterparties and which are related to their utility operations. Subsequent to the issuance of the Original No-Action Letter, the same petitioners claimed that the requirements in that letter (e.g., the requirements that the utility special entity be using the swap to hedge a physical position in an exempt commodity and that the counterparty seeking relief not be a financial entity) imposed administrative costs or created legal uncertainty such that potential counterparties were dissuaded from entering into relevant swaps. The petitioners then renewed their request for the relief sought in their Petition.

In response to these concerns, DSIO issued another no-action letter (the "Current No-Action Letter"), [4] which superseded and broadened the relief provided in the Original No-

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1 The term "special entity" is defined to include: a federal agency; a state, state agency, city, county, municipality or other political subdivision of a state; any employee benefit plan as defined in the Employee Retirement Income Security Act of 1974 ("ERISA"); any government plan as defined under ERISA; and any endowment. Section 23.401(c) of the CFTC regulations adds to this definition "any instrumentality, department, or a corporation of or established by a State or subdivision of a State."

2 CFTC Letter No. 12-18, Staff No-Action Relief: Temporary Relief from the De Minimis Threshold for Certain Swaps with Special Entities. See also our client memorandum, "CFTC Grants Temporary Relief from Inclusion of Certain Transactions in Determining SD, MSP, CPO or CTA Status," October 19, 2012 http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=b390dae8-7d56-4263-875f-92e8ebf87a85.

3 The Original No-Action Letter defined "utility commodity swap" as any swap satisfying all of the following conditions: (1) a party to the swap is a utility special entity; (2) such utility special entity is using the swap in the manner described in Section 1.3(ggg)(6)(iii) (which provides for the exclusion of certain types of swaps used to hedge a physical position from the analysis of whether a person is a swap dealer); and (3) the swap is related to an exempt commodity (generally an energy or metal commodity) in which both parties to the swap transact as part of the normal course of their physical energy businesses.

4 CFTC Letter No. 14-34, "Staff No-Action Relief: Revised Relief from the De Minimis Threshold for Certain Swaps with Utility Special Entities," March 21, 2014, available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-34.pdf.

action Letter. The Current No-Action Letter grants relief from SD registration to a person that does not include (or whose affiliate does not include) "utility operations-related swaps" [5] with "utility special entities" [6] in determining whether it has exceeded the Special Entity De Minimis Threshold as long as the swaps connected with its dealing activities do not exceed (1) the General De Minimis Threshold or (2) the Special Entity De Minimis Threshold (not counting the utility operations-related swaps). On October 27, 2014 (the effective date of the Final Rule), the relief available under the Current No-Action Letter will terminate, except with respect to swaps entered into in reliance on that Letter prior to such date (for which a person may continue to rely on the relief provided in that Letter).

PROPOSED RULE

On June 2, 2014, the CFTC published for comment a proposal to amend section 1.3(ggg)(4) of the CFTC regulations to permit a person to exclude "utility operations-related swaps" transacted with "utility special entities" in calculating the aggregate gross notional amount of the person's swap positions, solely for purposes of the Special Entity De Minimis Threshold (the "Proposed Rule"). These utility operations-related swaps would still be subject to the higher General De Minimis Threshold.

The Proposed Rule would have required a person relying on this exclusion to maintain records (in accordance with section 1.31) substantiating its eligibility to rely on the exclusion. Additionally, under the Proposed Rule, a person relying on this exclusion would have been required to file a one-time notice with the National Futures Association (the "NFA"), representing that it meets the criteria for the exclusion.

FINAL RULE

The Final Rule provides that, solely for purposes of determining whether a person's swap dealing activity has exceeded the Special Entity De Minimis Threshold, a person may exclude "utility operations-related swaps" where the counterparty is a "utility special entity." Note that a person would still have to include these swaps in its determination of whether it has exceeded the higher General De Minimis Threshold.

The Final Rule defines "utility operations-related swap" as a swap that meets the following conditions:

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5 The definition of "utility operations-related swaps" in CFTC Letter 14-34 is generally similar to the definition in the Final Rule, but there are some differences discussed below.

6 The definitions of "utility special entity" in CFTC Letter 14-34 and the Final Rule are identical.

- A party to the swap is a utility special entity;[7]
- A utility special entity is using the swap to hedge or mitigate commercial risk as defined in section 50.50(c) of the CFTC regulations;[8]
- The swap is related to an exempt commodity (as defined in section 1a(20) of the Commodity Exchange Act) or to an agricultural commodity insofar as such agricultural commodity is used for fuel for generation of electricity or is otherwise used in the normal operation of the utility special entity; and
- The swap is (1) an electric energy or natural gas swap or (2) is associated with:
  - The generation, production, purchase or sale of natural gas or electric energy, the supply of natural gas or electric energy to a utility, or the delivery of natural gas or electric energy service to utility customers;
  - Fuel supply for the facilities or operations of a utility special entity;
  - Compliance with an electric system reliability obligation; or
  - Compliance with an energy, energy efficiency, conservation, or renewable energy or environmental statute, regulation or government order applicable to a utility.

A person seeking to rely on the exclusion in the Final Rule may rely on the written representations of the utility special entity that it is a utility special entity and that the swap is a utility operations-related swap, unless it has information that would cause a reasonable person to question the accuracy of the representation. The Final Rule requires a person relying on such written representations to maintain such representations in accordance with the recordkeeping requirements in section 1.31 of the CFTC regulations.

Like the Current No-Action Letter and the Proposed Rule, the Final Rule does not include a requirement (like the one in the Original No-Action Letter) that a person relying on the exclusion must not be a financial entity.

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7 The Final Rule, like the Proposed Rule and CFTC Letter No. 14-34, defines "utility special entity" as any special entity that owns or operates electric or natural gas facilities or operations (or anticipated facilities or operations), supplies natural gas and/or electric energy to other utility special entities, has public service obligations (or anticipated public service obligations) under federal, state or local law or regulation to deliver electric energy or natural gas service to utility customers, or is a federal power marketing agency under Section 3 of the Federal Power Act (16 U.S.C. 796(19)).

8 The Proposed Rule would have required that a utility special entity be "using the swap in the manner described in [section] 50.50(c) of [the CFTC regulations]." In response to commenters' concerns that this requirement could be misinterpreted to mean that a utility operations-related swap must be used to invoke an exception to the mandatory clearing requirement in order to qualify for the proposed exclusion, the CFTC revised this requirement to specify that the utility special entity must be using the swap "to hedge or mitigate commercial risk" as defined in section 50.50(c). As is the case in the context of the exception from the clearing requirement in section 50.50(a), qualification as a bona fide hedge does not require hedges, once entered into, to remain static; rather, the CFTC recognizes that entities may update their hedges periodically when pricing relationships or market factors applicable to hedges change.

Lastly, the Final Rule does not require a person to file a notice with the CFTC in order to rely on the exclusion for utility operations-related swaps. However, the CFTC notes in the Adopting Release that it has directed its staff to assess possible amendments to the CFTC regulations that would provide the CFTC with information regarding whether counterparties to utility special entities are relying on the exclusion in the Final Rule (to avoid SD registration) and generally how the exclusion is affecting the markets for utility operations-related swaps.

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Please do not hesitate to contact us with any questions.

October 2, 2014