

Coalition for Derivatives End-Users

September 20, 2010

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Re: Advanced Notice of Proposed Rulemaking, File No. S7-16-10, Release No. 34-62717, Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act (August 13, 2010)

The Coalition for Derivatives End-Users (the “Coalition”) is pleased to respond to the request for comments by the U.S. Commodity Futures Trading Commission (“CFTC”) and the U.S. Securities and Exchange Commission (“SEC”) (collectively, the “Commissions”) regarding their Advanced Notice of Proposed Rulemaking (“ANPR”) pertaining to Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The Coalition’s comments distill to a simple premise: end-users should not be subject to bank-like regulation that may be appropriate for swap dealers, but that would undermine the ability of main street businesses of all sizes to efficiently manage the risks they face as they invest in our economy and create jobs, and that would divert capital from productive use without appreciably reducing systemic risk.

The Coalition represents thousands of companies across the United States that employ derivatives to manage risks they face in connection with their day-to-day business. Throughout the legislative process to reform our financial regulatory systems, the Coalition advocated for a strong derivatives title that reduces systemic risk, increases transparency in the over-the-counter (“OTC”) derivatives market, imposes thoughtful new regulatory standards and provides a strong, unambiguous exemption for end-users from the bill’s clearing, trade execution, margin, and capital requirements. In short, the Coalition worked to achieve a new regulatory structure that

Coalition for Derivatives End-Users

would enhance the stability of the financial system while not unduly or unnecessarily burdening the components of that system that allow U.S. companies to manage their risks, to make investments, and to create jobs.

While a new regulatory framework for derivatives is needed, so is a strong, clear exemption for end-users. Without such an exemption, we believe many end-users of derivatives would be forced to divert working capital away from productive use to margin accounts.¹ They might also have to move their hedging practices overseas in order to stay competitive, or forgo hedging altogether—leaving them exposed to the volatility and price uncertainty that OTC derivatives have effectively helped mitigate. Moreover, end-users, who did not contribute to the financial markets crisis, should not be subjected to the same regulatory structure as swap dealers and those who do not use derivatives to reduce risks associated with their businesses.

The Commissions' interpretation of the terms set out in the ANPR, such as “swap dealer” and “major swap participant,” and auxiliary terms such as “substantial counterparty exposure” and “commercial risk,” could affect Coalition members' businesses significantly. At stake is the liquidity of the end-user community, as margin requirements could tie up billions of dollars of funds that otherwise could be put to productive use. According to a 2010 Business Roundtable survey, without an exemption, a 3% initial margin requirement would require publicly-traded BRT companies that are not predominantly financial to set aside \$33.1 billion in aggregate collateral—approximately \$269 million per firm. If applied to the S&P 500 companies, the study estimated that the initial margin requirement could reduce capital spending by \$5 to \$6 billion per year, causing a loss of 100,000 to 120,000 jobs.² Significantly, the survey's assumptions were conservative—they did not contemplate the effects of a requirement to post variation margin, which would significantly increase the amount of funds required to be set aside to meet margin calls, likely resulting in even greater job losses. Indeed, the Natural Gas Supply Association and the National Corn Growers Association estimated that the costs of mandating

¹ Indeed, the drafters of the Dodd-Frank derivatives title have worked to clarify that this was never the intended result. Chairmen Dodd and Lincoln entered a letter to Chairmen Frank and Peterson into the Congressional Record stating, “If regulators raise the costs of end user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.” 156 CONG. REC. S 6192 (daily ed., July 22, 2010).

² See Business Roundtable survey, located at http://www.businessroundtable.org/publication/analysis_business_roundtable%E2%80%99s_survey_overthecounter_derivatives, at 2.

Coalition for Derivatives End-Users

central clearing and margining across the entire OTC derivatives market could reach as high as \$900 billion.³

While the Coalition supports transparent and well-regulated derivatives markets, we urge the SEC and CFTC to define terms carefully to avoid imposing unnecessary burdens on the businesses that drive America's economy without adding to systemic risk.

The Coalition offers comments on the following key definitions: "major swap participant," "substantial position," "substantial counterparty exposure," "commercial risk," "swap," "swap dealer," and "eligible contract participant."

Major Swap Participant

The term "major swap participant" ("MSP") should be applied judiciously because it could subject end-users to the full range of derivatives regulation that will be applied to swap dealers. Yet, it is clear that end-users, which engage in swaps transactions in order to hedge risks associated with their businesses, do not pose *through their derivatives use* the same gravity of risk that is introduced into our financial system by derivatives speculation through dealing and otherwise. Indeed, derivatives use by end-users actually *reduces* risk within companies and redistributes it more efficiently through the financial system as a whole.

The derivatives title of the Dodd-Frank Act generally applies in full force to swap dealers and MSPs. To the extent that end-users of derivatives do not, through their derivatives use, create systemic risk, they should not be regulated as MSPs under the legislation. A contrary interpretation of Dodd-Frank would be both harmful to the economy and punitive toward end-users. A non-bank determined to be an MSP under the Act would be subjected to the same capital, margin, clearing and exchange trading requirements as the largest swap dealers, and this irrespective of the fact that the swap dealer enjoys a lower cost of capital and engages in swap transactions for speculation or market-making, not merely hedging and risk management. These differences between end-users and swap dealers call for different regulatory treatment.

As emphasized by Senators Lincoln and Hagan in a floor colloquy on the bill, the definition of "MSP" is and should be focused on "risk factors that contributed to the recent financial crisis."⁴ When drafting its White Paper outlining its reasoning and goals for financial regulatory reform, the Obama Administration recognized that firms pose systemic risk due to the

³ See press release and letter at <http://www.ngsa.org/Assets/docs/2010%20press%20releases/16-corn%20growers%20join%20drumbeat%20against%20mandatory%20clearing.pdf>

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156 CONG. REC. S 5907 (daily ed. July 15, 2010) (statement of Senators Hagan & Lincoln).

Coalition for Derivatives End-Users

“combination” of three factors—“size, leverage, and interconnectedness.”⁵ These factors are meant to determine whether the failure of a company could pose systemic risk and should be considered when defining key terms in the MSP definition.

The MSP definition has three components. It is defined in section 721(a)(16) of the Dodd-Frank Act as any person “who is not a swap dealer, and”:

1. maintains a substantial position in swaps in any major swap category but excluding (a) positions held for hedging or mitigating commercial risk or (b) risk associated with the operation of an ERISA plan;
2. “whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets”; or
3. “is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established” by banking regulators and “maintains a substantial position in outstanding swaps in any major swap category.”

These three definitions contain key terms that will determine the scope of the MSP definition. They are discussed in the subsections below.

Substantial Position

Under Title VII, the term “major swap participant” includes any non-swap dealer who “maintains a substantial position for any of the major swap categories” Both the text and legislative history of the Dodd-Frank Act indicate that the key factor in determining what constitutes a “substantial position” in swaps is the risk posed by a person’s positions. The Dodd-Frank Act’s text emphasizes this point by instructing the CFTC to “consider the person’s relative position in uncleared as opposed to cleared swaps” and authorizing it to “take into consideration the value and quality of collateral held against counterparty exposures.” During a floor colloquy meant to clarify the text, Senator Lincoln reiterated those same terms, stating,

Just as collateral can mitigate the risks posed by uncleared swaps, offsetting swap positions also mitigate a swap participant’s risk. Thus, considering a swap participant’s net position provides a much better indicator of the risk that that

⁵ *Financial Regulatory Reform: A New Foundation* at 10 (see also pages 19, 20, 21, 22, 23, and 37 for reiteration of the importance of those three factors taken together), Department of the Treasury, http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

Coalition for Derivatives End-Users

participant poses to the system as a whole and is the appropriate understanding of the term “substantial position.”⁶

During another floor colloquy on the subject, Chairmen Dodd and Lincoln clarified the Dodd-Frank Act’s intent that the MSP definition should capture “few” end-users.⁷ The Coalition notes that there should not be a quota for end-users, nor a numerical threshold based on size or notional value alone over which end-users mechanically fall into the MSP definition and, with it, bank-like regulation. With regard to both their swap positions and their net counterparty exposures, end-users should be judged on the extent to which their swap portfolios could have serious adverse effects on the financial system. Moreover, there should be a presumption *against* imposing the panoply of bank-like regulations on end-users.

Some have suggested that size alone, as determined by the gross aggregate notional value of a company’s derivatives portfolio, should determine whether or not it is an MSP. But this methodology is flawed for several reasons.

First, aggregate notional value is calculated, as one would expect from the term, by adding the notional values of each swap in the portfolio. However, as the Office of the Comptroller of the Currency has noted, “The notional amount of a derivative contract is a reference amount from which contractual payments will be derived, but it is generally not an amount at risk.”⁸ For example, a \$10 billion option will never have a negative value to its purchaser.⁹ Meanwhile, a \$10 billion credit default swap could have a substantial negative value. However, that value would be more or less depending on the terms of the swap, including

⁶ 156 CONG. REC. S 5907 (daily ed. July 15, 2010, Statement of Senator Lincoln).

⁷ Senator Lincoln: “It is also important to note that few end users will be major swap participants, as we have excluded ‘positions held for hedging or mitigating commercial risk’ from being considered as a ‘substantial position’ under that definition. I would ask Chairman Dodd whether he concurs with my view of the bill.”

Senator Dodd: “I agree with the Chairman’s assessment.”

156 CONG. REC. S 5904 (daily ed. July 15, 2010, Statement of Senators Lincoln & Dodd).

⁸ See Office of the Comptroller of the Currency’s Quarterly Report on Bank Trading and Derivatives Activities at 3, located at <http://www.occ.treas.gov/ftp/release/2010-71a.pdf>.

⁹ To show an extreme example, a dealer could sell an interest rate cap with a notional amount of \$600 trillion and maturity date in one day that is set to pay out when 3 month LIBOR exceeds 30%. The notional amount is \$600 trillion, but the cap poses no systemic risk because it is worthless.

Coalition for Derivatives End-Users

the fixed rate, index, time to maturity and numerous other terms. Relying on notional amount as a measure of risk ignores important factors.

Second, failure to observe netting in this context could result in a significant overstatement of risk. For example, if a party had two offsetting positions with the same counterparty, failure to account for netting would result in a doubling of the position between the two parties when, in fact, these positions should not count at all. Notably, in its proposal released on September 15, 2010, the European Commission stated that it would consider the “**systemic relevance** of the sum of **net** positions and exposures” when determining the threshold for clearing.¹⁰

The net credit exposure created by a party’s derivatives portfolio is the best characterization of the actual credit risk that portfolio creates. Net credit exposure is a quantitative measure of the fair market value of the positions and is calculated in the same manner (but typically using different market values) as the amounts due to each party as a result of one party’s default, after considering legally enforceable netting and collateralization agreements. In this regard, we note that the form of Credit Support Annex (“CSA”) to the ISDA Master Agreement that is commonly used by most derivatives market participants provides for the provision of collateral only with respect to the net exposure that one party incurs to the other as a result of transactions entered into between them. That is because, due to the netting of all transactions entered into under an ISDA Master Agreement, one party can never owe the other party more than the net amount resulting from the liquidation of all open transactions. This amount, therefore, is the maximum amount of the exposure.

Third, even the net credit exposure attributable to the size of a firm’s derivatives portfolio should not be considered in isolation. A large derivatives portfolio and the credit risk related thereto can be understood only in the context of the amount of the firm’s equity and liquid assets, and the extent to which a default on the derivatives would impact the viability of that firm. For example, a \$1 billion exposure might be extraordinary for a firm that has only \$100 million in net capital, but would be small for a firm that has \$100 billion in net capital. As such, looking solely at the derivatives portfolio prevents regulators from considering the magnitude of derivatives exposure in the context of the company’s overall financial health and risk profile.

It is also important to note that, by the terms of the statute, whether a company’s derivatives portfolio constitutes a “substantial position” is determined only by those swaps that are not “held for hedging” or held to “mitigate[e] commercial risk.” In short, any legitimate hedging activity must be subtracted from a firm’s swaps portfolio before it is judged as

¹⁰ See *Proposal for a Regulation of the European Union and the Council on OTC derivatives, central counterparties, and trade repositories*, Article 7, paragraph 2, at 28 (available at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf) [hereinafter, “European Commission Report”].

Coalition for Derivatives End-Users

constituting a “substantial position.” To this end, it is important to note that the enterprise value of a firm that enters into swaps only for the purposes of hedging—as opposed to speculation—is not impacted by its use of derivatives. When its hedges are down, the underlying hedged item is up, and vice versa, leaving the value of the firm unchanged from an economic perspective.

The Commissions must not presume that the notional value of a company’s derivatives portfolio constitutes a “substantial position” or, for that matter, creates “substantial counterparty risk.” Indeed, it is possible, if not likely, that no end-users that use derivatives solely for hedging purposes would fit within either category.

Substantial Counterparty Exposure

Title VII of the Dodd-Frank Act also defines MSPs as non-swap dealers “whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. . . .” Since the beginning of the debate on derivatives regulation in 2008, the primary impetus for establishing a strong new regulatory system has been to reduce systemic risk. As Senate Banking Committee Chairman Chris Dodd said during the floor debate on the bill: “[O]ver-the-counter derivatives would be regulated by the Securities and Exchange Commission and the Commodities Futures Trading Commission. [Title VII] includes the Banking Committee’s tough requirements for central clearing, exchange trading, capital margin, and reporting that are critical to reducing systemic risk”¹¹ Senate Agriculture Chairman Blanche Lincoln agreed, noting: “In the underlying bill we have come to agreement with Chairman Dodd on, we lower the systemic risk by requiring mandatory trading and clearing [of swaps]”

The size of a portfolio alone is not indicative of whether a firm’s use of derivatives poses systemic risk. Indeed, size is but one of several factors that should be considered when contemplating the MSP definition, and, in particular, the application of terms such as “substantial position” and “substantial counterparty exposure.” Regulators should take a substantive, as opposed to a mechanical, approach to determining what constitutes “substantial counterparty exposure” and should consider at least the following factors: (i) the net credit exposure, as calculated by market participants under their existing agreements (which includes consideration of offsetting positions and collateral); (ii) whether the trades are for the purpose of hedging or speculation; and (iii) the interconnectedness of the firm.

Just as the Commissions should understand “substantial position” to focus on a swap participant’s net position, the Commissions should regard the term “substantial counterparty exposure” as referring to net exposure likely to create systemic risk. The text of the title supports this commonsense approach. While the Act does not include a subsection dedicated to guidance on the definition of “substantial counterparty exposure,” guidance on the definition of “substantial position” states that the Commissions “may take into consideration the value and

¹¹ 156 CONG. REC. S 3601 (daily ed. May 12, 2010) (Statement of Senator Dodd)

Coalition for Derivatives End-Users

quality of collateral held against counterparty exposure.” In the face of this statutory language, it would defy logic (and economic reality) for the Commissions to ignore collateral as well as other indicia of risk, such as the intended purpose behind such swaps, in determining what constitutes “substantial counterparty exposure.”

When determining whether a firm’s use of derivatives creates “substantial counterparty exposure,” the Commissions should not view hedges and speculative trades as posing the same degree of risk. By definition, hedges are used to reduce or eliminate risk, while speculative trades are used to take on risk. As stated above, the enterprise value of a firm that enters into swaps only for the purposes of hedging—as opposed to speculation—is not impacted by its use of derivatives. When its hedges are down, the underlying hedged item is up, and vice versa, leaving the value of the firm unchanged from an economic perspective. European regulators appear to share the view that hedges do not pose the same risk as speculative trades. In its proposal, the European Commission stated that “OTC derivative contracts entered into by a non-financial counterparty that are objectively measurable as directly linked to the commercial activity of that counterparty shall not be taken into account” when determining whether a firm has breached the clearing threshold.¹² We note that the European Commission has not defined the term “commercial activity,” which is a key determinant of what hedging is and, therefore, is not to be considered “in calculating the positions for the clearing threshold.”¹³ The Coalition urges the Commissions to adopt the formulation in the subsection of this comment letter on “commercial risk” in making such determinations.

In addition to differentiating between hedges and non-hedges, the Coalition suggests that the Commissions consider interconnectedness when defining what constitutes “substantial counterparty exposure.” On the importance of interconnectedness, Chairman Gensler wrote earlier this year, “A central lesson of [Long Term Capital Management], AIG and the financial crisis of 2008 is that not only do we have institutions that have become ‘too big to fail’—but also that some have become too interconnected to fail.”¹⁴ Excessive interconnectedness is not a condition that afflicts end-users. Indeed, most end-users face a very limited number of counterparties, so their default would have little impact across the market. Compare a typical end-user, with its principal counterparties in the low double-digits, to Lehman Brothers, which transacted with 8,000 or more counterparties upon its demise. Empirically, as well, the default of an end-user on its hedges has not led to the downfall of a swap dealer counterparty. This relative lack of “interconnectedness” makes it highly unlikely that end-users would be the source of systemic “contagion.” Hence, there is no reasonable likelihood that an end-user default could set in motion a chain reaction of default, rippling through entities interconnected with the end-user or its counterparties, that could cause significant risk to the financial system.

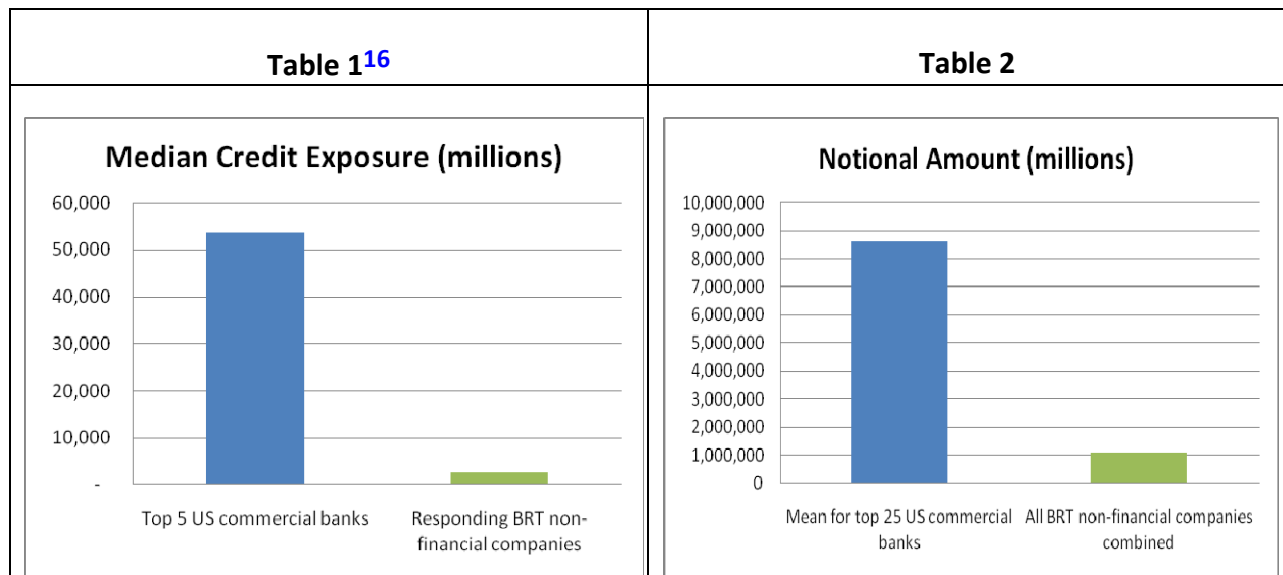
¹² See European Commission Report, Article 7, paragraph 4, at 28.

¹³ European Commission Report at 8.

¹⁴ Gary Gensler, *Clearinghouses are the Answer*, WALL ST. J., April 21, 2010.

Coalition for Derivatives End-Users

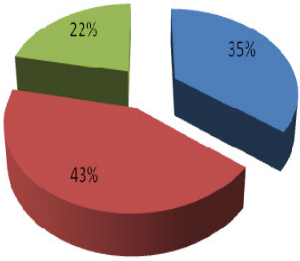
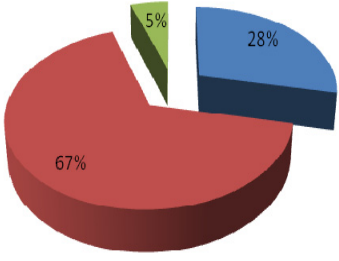
The bottom line is that end-user hedges do not create risk that demands and justifies the type of regulation imposed upon swap dealers. As the tables below illustrate, whether one focuses on notional value (which we think is not the appropriate measure) or credit exposure, end-users barely register on a relative scale. Table 1 shows the median credit exposure for the top 5 banks that use derivatives, from quarterly reports issued by the Office of the Comptroller (“OCC”), and compares it to the median credit exposure of the 27 non-financial companies that responded to the Business Roundtable survey.¹⁵ Table 2 compares the **average** notional held at the top 25 banks that use derivatives, according to the OCC study, and compares it to the estimated aggregate notional held at **all** of the non-financial companies in the Business Roundtable—more than 140 of the largest non-financial firms in the United States. Even when the notional held at **all** of the non-financial companies in the BRT is added together, it is a fraction of the **average** notional held at the top 25 U.S. banks. Tables 3 and 4 show that trades between dealers and non-financial customers comprise a relatively small portion of the gross market value in the overall market, whether one is looking is at FX derivatives (22%) or interest rate derivatives (8%).



¹⁵ Thirty-four Business Roundtable companies reported certain data relating to their usage of OTC derivatives in response to the survey. Of these, 27 are firms that may have significant financial businesses or operations, but are not predominantly financial. As shorthand, the 27 firms are referenced in this letter (as well as in the survey) as “non-financial.”

¹⁶ For Tables 1 and 2, see the OCC’s quarterly report on derivatives and the Business Roundtable’s survey results and paper at http://www.businessroundtable.org/publication/analysis_business_roundtable%E2%80%99s_survey_overthecounter_derivatives.

Coalition for Derivatives End-Users

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Commercial Risk

The MSP definition excludes non-swap dealers who “maintain[] a substantial position in swaps” but hold those positions for “hedging or mitigating commercial risk.” The Coalition urges that the Commissions interpret the terms “hedging” and “commercial” risk broadly to incorporate all risk associated with entities’ operations, including, but not limited to, interest rate risk, currency risk, credit risk, equity price risk and risks arising from purchase, ownership, production, storage, sale, financing or transportation of commodities. The definitions of “hedging” and “commercial risk” should be broad enough to accommodate the use of security-based swaps for hedging—for instance, by entering into a credit derivative to hedge the credit risk associated with a supplier’s customer that must satisfy a significant future obligation.

This interpretation of the “hedging” and “commercial risk” definitions comports with the drafters’ intent and the plain text of the derivatives title. Senators Lincoln and Dodd wrote a letter to Representatives Frank and Peterson, which was submitted into the Congressional

¹⁷ For Tables 3 and 4, please see *OTC Derivatives Market Activity in the Second Half of 2009*, Bank for International Settlements, May 2010, www.bis.org/publ/otc_hy1005.pdf?noframes=1.

Coalition for Derivatives End-Users

Record, clarifying that the hedging of both financial and non-financial risk should be included in the end-user exemption, noting that financial firms such as credit unions, community banks, and farm credit institutions could avail themselves of the end-user exemption for their hedging activities.¹⁸ That reading is consistent with the language of subparagraph D of the MSP definition, which excludes entities “whose primary business is providing financing, and use[] derivatives for the purpose of hedging underlying *commercial risks* related to interest rate and foreign currency exposures. . . .” § 721(a)(16) (emphasis added). By describing hedging linked to financing as hedging of “commercial risks,” this provision clearly indicates that “commercial risks” are *not* limited to non-financial risks. That interpretation applies with equal force to the use of the term “commercial risk” in subparagraph A. See *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 479 (1992) (noting the “basic canon of statutory construction that identical terms within an Act bear the same meaning”).

As a practical matter, the Coalition suggests that the Commissions define “hedging” and “commercial risk” to include hedging of the types of business-related risks noted above, using a similar formulation based on one already employed by the CFTC in its definition of “bona fide hedging transaction” supplemented by CFTC letter rulings and board of trade practice applying the concept of “bona fide hedging” to changing market conditions,¹⁹ and not based on whether the swaps qualify for hedge accounting treatment under Statement of Financial Accounting Standards No. 133, “Accounting for Derivative Instruments and Hedging Activities.” The “bona fide hedging transaction” definition seeks to separate hedging transactions from speculative transactions in the same way that the Commissions seek to protect the markets from speculators, while allowing end-users to manage their risks through hedging transactions in the Dodd-Frank Act. We suggest that the Commissions adopt a formulation that would define “commercial risk” as risks:

in the conduct and management of a business enterprise or not-for-profit organization, and where they arise from:

- (i) The potential change in the value of assets which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising,
- (ii) The potential change in the cost or value of liabilities which a person owns or anticipates incurring, or
- (iii) The potential change in the cost or value of goods or services which a person provides, purchases, or anticipates providing or purchasing.

¹⁸ 156 CONG. REC. S 6192 (daily ed. July 22, 2010, letter from Senators Lincoln & Dodd to Representatives Frank & Peterson).

¹⁹ 17 C.F.R. § 1.3(z).

Coalition for Derivatives End-Users

In a 2009 survey, the Bank for International Settlements found that the top risk hedged with OTC derivatives is foreign currency risk, followed by interest rate risk.²⁰ It is imperative that all of these forms of hedging be protected by the end-user exemption from the clearing and margining requirements. Importantly, the Commissions should note that the “hedging” and “commercial risk” definitions would not necessarily include an end-user’s hedging against risks unrelated to its business activities, such as investments held by the end-user. Below, we provide several examples of how these forms of risk management protect end-users’ businesses. Please note that this is not intended to be an exhaustive list:

Example I: Interest Rate Derivatives

A manufacturer needs to fund the construction of a new plant and the subsequent long-term financing once the construction is complete. A bank offers the manufacturer a floating rate loan because its own funding is based on short-term floating rates (e.g., deposits). The manufacturer is concerned that rising interest rates could cause its interest payments to exceed expected income from the plant’s operations (which it has forecasted). The manufacturer enters into an interest rate swap with the bank—a separate contract—where it pays a fixed rate of interest to the bank and receives a floating rate of interest from the bank. The floating rate on the loan is offset by the floating rate on the swap, leaving the manufacturer with a fixed rate. The manufacturer has eliminated the interest rate risk, and now has a fixed rate that is acceptable given the projected income from the plant’s operations.

Example II: Interest Rate Derivatives

A firm’s finance arm funds itself by borrowing money at a fixed rate of interest; however, it lends money to commercial customers at a floating rate of interest. Because of this mismatch, it is subject to the risk that interest rates will decrease or remain at low levels, in which case it will earn less (i.e., its net interest margin will be lower). To hedge this risk, the firm enters into an interest rate swap where it pays a floating rate of interest and receives a fixed rate of interest. The floating rate of interest on the swap offsets the floating rate of interest paid by its borrowers, eliminating the interest rate risk.

Example III: Foreign Exchange Derivatives

A United States-based firm expects to sell a plant in Europe in the future at a sales price that is denominated in EUR. Concurrent with the sale in the future, the firm will repatriate the funds to the United States, converting the EUR to USD. Because the EUR-USD exchange rate will fluctuate between now and the point of sale in the future, the firm is subject to the risk that the EUR will weaken against the USD, thereby yielding less USD in exchange for the EUR (i.e., the EUR depreciates and buys fewer USD). To hedge this risk, the firm enters into an FX forward in which it fixes the rate at which it will convert the EUR to USD. As a result, a

²⁰ *OTC Derivatives Market Activity in the Second Half of 2009* at 1, Bank for International Settlements, May 2010, www.bis.org/publ/otc_hy1005.pdf?noframes=1.

Coalition for Derivatives End-Users

reduction in the sales price of the plant that results from changes in the exchange rate will be offset by a gain in the forward contract, thereby eliminating the effect of a changing currency exchange rate.

Example IV: Foreign Exchange Derivatives

A United States-based firm based owns real estate in Europe. The value of the firm's investment in the real estate asset—which is reported in USD—depends in part on the fluctuation in the EUR-USD exchange rate. The value of the real estate asset decreases if the EUR-USD exchange rate decreases (i.e., EUR depreciates and buys fewer USD). To hedge against a decrease in the firm's real estate investment, the firm enters into an FX forward in which it fixes the EUR-USD exchange rate, thereby eliminating this FX risk. Any decrease in the value of the real estate asset due to a change in the EUR-USD exchange rate would be offset by an increase in the value of the forward contract, thereby leaving the firm's equity position unchanged.

Example V: Commodity Derivatives

An ocean freight company's charge for transporting freight for a firm includes a fuel surcharge known as a "bunker charge;" therefore, while the firm does not purchase the marine fuel, it has exposure to the risk that marine fuel prices at various locations will rise, thereby causing the bunker charge to increase. To hedge this risk, the firm would enter into a forward or swap contract to fix the price(s) of the marine fuel, or purchase an option contract that puts a cap on the price of the marine fuel.

Example VI: Credit Derivatives

A supplier has agreed to deliver materials to a customer and receive payment for those materials at a later date (i.e., the supplier has a cash receivable from the customer). After delivering the materials to the manufacturer, the supplier might enter into a credit default swap to hedge or mitigate the risk that it would not receive payment from the customer.

Example VII: Equity Derivatives

An end-user decides to benefit its shareholders by leveraging the strength of its balance sheet to repurchase an amount of its common stock. The company enters into an accelerated share repurchase agreement to retire a certain number of shares. The agreement operates such that, at settlement in 9 months, the company will pay the difference between the initial purchase price and the average purchase price over the pricing period. At the same time, the company enters into an equity derivative in order to reduce the price risk associated with the share repurchase. In essence, the company, through the derivative, has managed to lock in a repurchase price.

The common thread running through these examples is the hedging of risk related to the conduct of managing an organization—including financing relating to such conduct. The Commissions should resist artificial distinctions that are not found in text of the Dodd-Frank Act and that would discourage legitimate hedging activities by subjecting firms that engage in them to costly regulations.

Coalition for Derivatives End-Users

Swap Dealer

Title VII defines “swap dealer” as “any person who— (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.”

The third portion of the swap dealer definition has the potential to reach end-users if read too broadly. An expansive reading of that term could disqualify end-users from the exemption if they hedge business risks in the ordinary course of business. The Commissions should clarify that the term “swap dealer” does not include end-users when they are hedging their own risks. Senators Dodd and Collins made this intent of the bill clear in a floor colloquy. Senator Collins stated, and Senator Dodd agreed, that “it is not Congress’ intention to capture as swap dealers end users that primarily enter into swaps to manage their business risks, including risks among affiliates.”²¹

The text of Dodd-Frank, however, does not match unequivocally the intent of Congress to exclude from the “swap dealer” definition in-house swap execution arms. The Commissions should clarify that the term “swap dealer” does not include an in-house swap execution arm that enters into swaps on behalf of or with its parent company or its commonly-controlled affiliates primarily to hedge business risks and does not hold itself out as a dealer or make a market in swaps. We do not believe that it was the intent of either the House or Senate to regulate in-house swap execution arms as “swap dealers.” Nor do we believe that swap transactions between commonly-controlled affiliates were meant to be regulated the same as swap transactions

²¹ Senator Collins: “The Wall Street Transparency and Accountability Act will regulate ‘swap dealers’ for the first time by subjecting them to new clearing, capital and margin requirements. ‘Swap dealers’ are banks and other financial institutions that hold themselves out to the derivatives market and are known as dealers or market makers in swaps. The definition of a swap dealer in the bill includes an entity that ‘regularly enters into swaps with counterparties as an ordinary course of business for its own account.’ It is possible the definition could be read broadly and include end users that execute swaps through an affiliate. I want to make clear that it is not Congress’ intention to capture as swap dealers end users that primarily enter into swaps to manage their business risks, including risks among affiliates. I would ask the distinguished chairman whether he agrees that end users that execute swaps through an affiliate should not be deemed to be ‘swap dealers’ under the bill just because they hedge their risks through affiliates.”

Senator Dodd: “I do agree and thank my colleague for raising another important point of clarification. I believe the bill is clear that an end user does not become a swap dealer by virtue of using an affiliate to hedge its own commercial risk.”

156 CONG. REC. S 5907 (daily ed., July 15, 2010, Statement of Senators Collins & Dodd).

Coalition for Derivatives End-Users

between two unaffiliated entities. We urge the Commissions not to regulate internal swaps as they do not create any counterparty exposure.

De Minimis Exception

The Commissions should consider the important role systemic risk mitigation plays in the definition of “swap dealer”. Although not stated with the same language as appears in the MSP definition, it is clear Congress intended that the degree of systemic risk of a firm should be a material consideration as to whether an end-user will be deemed to be a “swap dealer” and, hence, must submit to bank-like regulation. The de minimis exception to “swap dealer” registration should therefore be defined broadly to exclude swap dealing activities that do not rise to the level of systemic significance, either because of the adequate collateralization of the party, the relative lack of leverage of the company, or the lack of inter-connectedness of the type commonly associated with financial dealer firms.

Swap

It has long been market practice that companies with numerous affiliates will use primarily one affiliated company as an in-house swap execution arm to hedge the net business risk of their commonly-controlled affiliates directly to the market. Under this practice, one affiliate of a company trades with external dealer counterparties, while the other affiliates of the company trade directly with the in-house swap execution arm. This use of a centralized hedging facility by a group of affiliated companies diminishes the internal demands on financial liquidity and resources while promoting efficient risk management and maximizing the benefits of netting arrangements with external dealer counterparties. In turn, this reduces both enterprise risk to the group and systemic risk to the financial system. However, without a clear exemption from the new regulatory regime for intra-group transactions between affiliates, these transactions could be subject to clearing, trade execution, margin and capital requirements—as well as public reporting and recordkeeping requirements—that would have a negative impact on companies’ liquidity resources and would increase hedging costs without any additional reduction in systemic risk to the financial system. These affiliates will be forced to go directly to the market to hedge their risk, even though their affiliates might be better capitalized. Such a result is squarely inconsistent with the goals of the Dodd-Frank Act to reduce systemic risk and should be guarded against.

The Coalition urges the CFTC to clarify that the definition of “swap” will not capture swap transactions between commonly-controlled affiliates, ensuring that internal swap transactions between affiliates will not be subject to the new regulatory requirements, while all swap transactions between an in-house swap execution arm and external dealer counterparties would be subject to the applicable regulatory requirements of Dodd-Frank. By doing so, we believe that the CFTC will avoid imposing unnecessary regulatory burdens on and will provide legal certainty to market participants that rely on an internal hedging structure.

Coalition for Derivatives End-Users

For many end-users, forward agreements constitute a routine means of arranging physical transactions. In some cases such contracts may result in financial, rather than physical, delivery. Following the decision in *Transnor Ltd. v. BP North America Petroleum*²², the CFTC took steps to reassure commercial operators that routine forward agreements would continue to be excluded from the application of the commodities laws. Clarifying that such treatment is intended to continue would greatly reassure end-users and avoid disruption of vital transactional agreements. The Commissions should clarify that the meaning of “intended to be physically settled” excludes all physical forwards, including those that generally settle financially (including for example the Brent, Forties, Oseberg and Ekofiske fields contracts).

Eligible Contract Participant (“ECP”)

The ECP definition in the Commodity Exchange Act, as amended by Dodd-Frank, contains criteria that certain types of firms and individuals must meet in order to be deemed ECPs that are able to enter into a larger universe of derivatives trades than the retail public. These include minimum asset and net worth requirements for corporations, proprietorships, organizations, trusts and other entities. Such firms are required to have a minimum of \$10 million in assets or a minimum of \$1 million in net worth if that entity is entering into the trade in connection with the conduct of the entity’s business or to hedge a risk related to the entity’s business. Notwithstanding these specific requirements, subparagraph (C) of the ECP definition provides the CFTC with somewhat broad authority to define an ECP as “[a]ny other person that the Commission determines to be eligible in light of the financial or other qualifications of the person.”

Page 300 of the Dodd-Frank Act contains a Limitation of Participation section that states that, “It shall be unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market under section 5.” In short, any non-ECP is prohibited from entering into swaps over-the-counter. Such non-ECP firms would be limited to entering into exchange-traded hedges that would, as a practical matter, require the posting of substantial and variable amounts of cash in the form of initial and variation margin.

Just as larger firms rely on the use of individually tailored over-the-counter derivatives to precisely offset risks they face in the course of managing their organizations, so do smaller firms. Indeed, many such firms place an equal and, perhaps, even greater importance on these customized hedges because even a minimal loss in revenue or increase in costs could prove especially damaging to a smaller firm. Many of the customized trades that smaller firms require for risk management may not be available on exchange. Moreover, even if these hedges were available on exchange, many smaller firms will be unable to divert precious working capital to

²² 738 F. Supp. 1472 (S.D.N.Y. 1990).

Coalition for Derivatives End-Users

post as cash to meet the onerous initial and variation margin requirements attendant to exchange-traded hedges.

Given the vital function that hedging plays in the management of many smaller firms, and considering the essential role that small businesses play in our economy, we would urge the Commissions to further define “ECP” to continue to permit these smaller firms to enter into hedges over-the-counter, providing that they meet specific criteria previously established by the CFTC. Indeed, these guidelines have been adhered to by smaller market participants for more than twenty years. Specifically, we would urge the Commissions to adopt the following amendment to subparagraph (C) of the ECP definition:

“provided, however, notwithstanding clause (v) of subparagraph (A) above, a corporation, partnership, proprietorship, organization, trust, or entity other than an entity referred to in clause (iv), (vi) or (vii) of subparagraph (A) above shall be deemed to be an eligible contract participant to the extent it enters into swaps that meet the specific criteria referred to in the Commission's Policy Statement Concerning Swap Transactions.”²³

Such a definition would provide much-needed certainty for smaller firms while also protecting against the marketing of certain trades that may not be suitable for the larger retail public. Indeed, in the Policy Statement Concerning Swap Transactions, the CFTC specified that, “Swap transactions eligible for safe harbor treatment may not be marketed to the public. This restriction reflects the institutional and commercial nature of the existing swap market and the Commission’s intention to restrict qualifying swap transactions to those undertaken as an adjunct of the participant’s line of business.”

²³ See the CFTC’s Policy Statement Concerning Swap Transactions, 54 FR 30694 (July 21, 1989).

Coalition for Derivatives End-Users

Conclusion

We thank the Commissions for the opportunity to comment on these important issues. We also want to express our appreciation for the willingness of Commission officials to meet with us in order to share perspectives on implementation of the derivatives title.

The Coalition looks forward to working with the Commissions to help implement rules that serve to strengthen the derivatives market without unduly burdening business end-users and the economy at large. We are available to meet with the Commissions to discuss these issues in more detail.

Sincerely,

Agricultural Retailers Association
Business Roundtable
Financial Executives International
National Association of Corporate Treasurers
National Association of Manufacturers
National Association of Real Estate Investment Trusts
The Real Estate Roundtable
U.S. Chamber of Commerce