10-012
COMMENT
CL-00011

From: Doyle, Mary <Mary.Doyle@bg-group.com>
Sent: Monday, September 20, 2010 2:10 PM
To: dfadefinitions <dfadefinitions@CFTC.gov>
Cc: secretary <secretary@CFTC.gov>
Subject: BG Americas Comments in Docket 10-012 Definitions in Dodd-Frank Act
Attach: BGA Definition Comments FR 10.012 FINAL.pdf

Attached are comments filed by BG Americas & Global LNG in Docket No. 10-012, *Advanced Notice of Proposed Rulemaking, Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.*

Please contact me if there are questions related to these comments.

Regards,

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<<BGA Definition Comments FR 10.012 FINAL.pdf>>

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September 20, 2010

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Re: Docket No. 10-012
Advanced Notice of Proposed Rulemaking
Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Mr. Stawick:

BG Americas & Global LNG ("BGA") is a business unit of BG Group plc ("BG"), a global natural gas company based in the United Kingdom and a major producer and supplier of natural gas to the United States. BGA is responsible for all of BG Group's operations in North and South America, the Caribbean, BG's global marine operations and BG's global liquefied natural gas ("LNG") operations. BG's subsidiary, BG Energy Merchants, LLC, ("BGEM") is a major marketer of natural gas and electricity in the United States.

BGA is submitting comments in response to the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC" or "Commission") request for comments in the Advanced Notice of Proposed Rulemaking ("ANOPR") on Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1] BGA's comments are directed to the CFTC and how it will define the referenced terms in a future rulemaking.

1. Executive summary

In enacting the Dodd-Frank Act, Congress was attempting to establish a legislative and regulatory framework designed to specifically prevent another financial collapse and ensuing crisis like the one that took place in 2008. One of the contributors to the financial collapse was the extensive use of derivatives without any regulatory oversight. Title VII of the Dodd-Frank Act, in particular, was designed to take derivatives out of the financial "closet" and bring them into the open. Congress wanted to increase transparency and

[1] 75 Fed. Reg. 161 (Aug. 20, 2010).

thus, reduce systemic risk. It believed that requiring derivatives to be traded and cleared on exchanges could accomplish both.

Title VII creates two categories of entities who deal in derivatives, the swap dealer and the major swap participant ("MSP"), and requires them to transact and clear on exchanges. At the same time, the Dodd-Frank Act carves out an exception for end-users from these requirements but they are not allowed to escape all regulatory oversight. The Dodd-Frank Act requires end-users to report swaps to a depository and, even more significantly, requires them to notify the Commission on how they will meet their financial obligations. As designed by Congress, no entity who transacts swaps will escape the reaches of the legislation.

In adopting and refining the definitions and rules that will implement the Dodd-Frank Act, the Commission should recognize and focus on this Congressional intent. In fact, in a letter to Congressional leadership, Senators Dodd and Lincoln emphasized that "[C]ongressional directive throughout all drafts of this legislation, and in Congressional debate, has been to protect end-users from burdensome costs associated with margin requirements and mandatory clearing."[2] Congress had a clear intent to create a class of end-users under the Dodd-Frank Act and distinguish them from swap dealers and MSPs.

BGA's suggested definitions, outlined below, of "swap dealer", "MSP" and "swap" are consistent with Congressional intent and will allow the Commission to fulfil its mandate of increasing transparency of the derivative market and reducing systemic risk.

2. Swap dealer

Section 721(a)(21)(49) of the Dodd-Frank Act defines swap dealer as follows:

> (A) In general —The term 'swap dealer' means 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, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a

[2] Letter from Senators Dodd and Lincoln to Honorable Chairmen Barney Frank and Colin Peterson, June 30, 2010 ("Dodd-Lincoln Letter")

swap with a customer in connection with originating a loan with that customer.

BGA is concerned that part (iii) of the swap dealer definition could be interpreted too broadly by the Commission. More specifically, we are concerned that speculative traders, including hedge funds, and traditional commercial clients, including end-users could be classified by the Commission as swap dealers, which was not the intent of the Dodd-Frank Act.

BGA believes that swap dealers are primarily financial institutions engaged in the buying and selling of uncleared swaps off exchange with counterparties as their primary business. The word counterparties in part (iii) is important since, unlike bilateral swaps, cleared swaps are not transacted with counterparties, but on exchanges. In contrast to bilateral swaps, cleared swaps are transparent and create very little systemic risk.

In the past, the SEC and the CFTC have not viewed typical traders and end-users as swap dealers. For example, under SEC precedent, the definition of a "swap dealer" is based upon the definition of a "[securities] dealer" in Section 3(a)(5) of the Securities and Exchange Act of 1934 ("Exchange Act"). Generally speaking, a "swap dealer" is a person:

(i) engaged "in the business" of buying and selling swaps as principal, including through a broker, but

(ii) not a person who does not do so as part of a "regular business."

The exclusion for those entering into transactions "not as part of a regular business" is, in the securities laws, commonly known as the "trader" exemption."[3] The general exception to the definition of swap dealer set forth in new Commodity Exchange Act ("CEA") Section 1a(49)(C) is virtually identical to the trader exception set forth in Section 3(a)(5) of the Exchange Act. If this exception is interpreted in the Dodd-Frank Act in a manner that is generally consistent with the Exchange Act,[4] it would serve to exclude from the swap dealer definition most speculative traders and end-users.[5] This

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[3] Importantly, the SEC has developed well-established interpretational guidance that is intended to facilitate the rational application of the definition of "dealer" and the "trader exemption" under Section 3(a)(5) of the Exchange Act. This guidance is known as the "Dealer/Trader Distinction." *See Definition of Terms in Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Final Rule, SEC Release No. 34-47364 (Mar. 2003); *Definition of Terms in Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Proposed Rule, SEC Release No. 34-46745 (Dec. 2002).

[4] *See* 15 U.S.C. § 78c(a)(5).

[5] The SEC's Dealer/Trader Distinction highlights the benefits that similarly structured interpretive guidance focused specifically on swap markets could provide in helping to

result honors the Congressional intent underlying Title VII of the Dodd-Frank Act.

The Commission should also consider how it has historically defined swap dealers. In a 2008 Staff Report, a swap dealer was described in the following way:

> The swap dealer, which is often affiliated with a bank or other large financial institution, has emerged to serve as a bridge between the OTC swap market and the futures markets. Swap dealers act as swap counterparties both to commercial firms seeking to hedge price risks and to speculators seeking to gain price exposure. In essence, swap dealers function as aggregators or market makers, offering contracts with tailored terms to their clients before utilizing the more standardized futures markets to manage the resulting risk.[6]

Furthermore, in its explanatory notes to the *Disaggregated Commitment of Traders Report*, the Commission set out definitions for "swap dealer" and "producer/merchant/processor/user" among others. It is instructive to look at these two definitions:

> Producer/Merchant/Processor/User – is an entity that predominantly engages in the production, processing, packing or handling of a physical commodity and uses the futures markets to manage or hedge risks associated with those activities.
>
> Swap Dealer – is an entity that deals primarily in swaps for a commodity and uses the futures markets to manage or hedge the risk associated with those swaps transactions. The swap dealer's counterparties may be speculative traders, like hedge funds, or traditional commercial clients that are managing risk arising from their dealings in the physical commodity.[7]

It is evident that the Commission currently does not classify speculative traders or end-users as swap dealers. Likewise, it is clear that the Commission currently views the swap dealer's primary business as taking on bilateral credit risk from counterparties, acting as an intermediary between those counterparties and central exchanges.

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facilitate an appropriate and rational interpretation of (iii) of the definition of swap dealer with the general exception set forth in new CEA Section 1a(49)(C).

[6] Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations (2008)

[7] *See* Disaggregated Commitments of Traders Report, Explanatory Notes. http://www.cftc.gov/MarketReports/CommitmentsofTraders/DisaggregatedExplanatoryNotes/index.htm

Not only does Commission precedent support a narrow reading of part (iii) of the Dodd-Frank Act's definition of swap dealer, but other definitions in the Dodd-Frank Act do as well. Notably, Congress took great care in defining an MSP in the Dodd-Frank Act. The Dodd-Frank Act expressly and unequivocally states that an MSP cannot be a swap dealer. If the definition of swap dealer were misinterpreted to include all entities that deal in swaps, there would be no reason for the MSP definition to exist at all, since that definition specifically excludes anyone who is a swap dealer.[8]

Finally, Senators Dodd and Lincoln remarked that: "Congress does not intend to regulate end-users as major swap participants or swap dealers just because they use swaps to hedge or manage the commercial risks associated with their business."[9] End-users will have their own obligations under the Dodd-Frank Act to report swaps to a depository and to notify the Commission on how they will meet their financial obligations. Therefore, defining swap dealer to exclude end-users will not impact Congress' goal of ensuring transparency in the swap market.

Recommendation: The Commission should define the term swap dealer in a precise and narrow manner that specifically excludes speculative traders, including hedge funds, and traditional commercial clients, including end-users.

3. Major Swap Participant

Section 721(a)(21)(33) of the Dodd-Frank Act contains the MSP definition:

> ''(A) In general —The term 'major swap participant' means any person who is not a swap dealer, and —
>
> ''(i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding —
>
> ''(I) positions held for hedging or mitigating commercial risk; and
>
> ''(II) positions maintained by any employee benefit plan (or any contract held by such a 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) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

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[8] *See Consumers Union of the United States v. Sawhill*, 512 F.2d 1112, 1126 (Temp. Emer. Ct. App. 1975) (emphasizing that "Congress will not be presumed to have done a useless, ineffective, or absurd thing.").

[9] Dodd-Lincoln letter, p. 3.

"(ii) 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

"(iii)(I) 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 an appropriate Federal banking agency; and "(II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission.

The first part of the definition is the most relevant to non-swap dealers. Under this part, one of the keys to determining whether a person is an MSP is considering whether it maintains a "substantial" position in swaps after subtracting positions held for hedging or mitigating commercial risk. When defining substantial position, the Dodd-Frank Act instructs the Commission to take into account a threshold necessary for the Commission to prudently monitor, manage and oversee entities that are systemically important or can have a significant negative impact on the US financial system.

What is a systemically important entity? It seems logical that a systemically important entity is one that could create systemic financial risk. There are many definitions for systemic financial risk, but one developed by the Group of Ten Countries in 2001 is, "[s]ystemic financial risk is the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy."[10] The Commission should address and answer whether or not there are energy end-users who are systemically important or have the ability to adversely impact the financial system of the US?

A Federal Reserve of New York paper discussing systemic risk as defined above noted that:

> Significantly, a run on an individual firm alone might not be enough to create systemic risk according to the definition outlined above unless the liquidation of assets by the firm or an associated reduction in the firm's underwriting activities were to have a material impact on economic growth. For example, in 2001, Enron suffered what amounted to a run on its short-term liabilities in the period immediately preceding its bankruptcy filing, but there appeared to be very limited systemic contagion to

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[10] Group of Ten. 2001. Consolidation in the Financial Sector. Available at www.bis.org/publ/gten05.html.

other energy-trading firms and very little impact on the broader economy.[11]

A more recent article by the Federal Reserve Bank of St. Louis explained why the failures of financial firms are more likely to pose systemic risks than the failures of nonfinancial firms.[12] This paper also cited the example of Enron and why its sudden collapse did not cause system risk. The authors pointed to three reasons why financial firms can cause systemic risk and non-financial firms do not:

- one, is the interconnectedness of large commercial and investment banks;
- two, unlike nonfinancial firms, banks and other financial firms are highly leveraged and fund a substantial portion of their assets by issuing debt as opposed to selling equity; and
- three, financial institutions are more likely to finance their relatively illiquid long-term assets holdings with short-term debt.[13]

It is instructive that both articles point out that when Enron, the largest energy trader at the time, went bankrupt that event was not significant enough to cause a major disruption in the energy sector, let alone in the US economy. The CFTC's focus should be on those entities that conduct such large amounts of business off exchange that, if they fail, that failure could cascade and create systemic risk, *e.g.* AIG. In the energy sector, no entity that is not a swap dealer could create that level of systemic risk. In fact, swaps related to exempt commodities[14] make up a very small part of the notional value of outstanding global over-the-counter ("OTC") derivatives – approximately four tenths of one percent (0.4%).[15] Furthermore, as the legislation specifically discusses the impact on the US financial system, the Commission should not read systemically important to mean important to any one sector of the economy, but rather systemically important to the entire economy.

Even Chairman Gensler testifying before the Senate Agriculture Committee on November 18, 2009 acknowledged that he thought the MSP definition was

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[11] Darryl Hendricks, John Kambhu, and Patricia Mosser, *Systemic Risk and the Financial System*, Background Paper presented at Federal Reserve Bank of New York and the National Academy of Sciences Conference on New Directions in Understanding Systemic Risk, May, 2006.

[12] James Bullard, Christopher J. Neely, and David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, 91 FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, Sep./Oct. 2009, Sec. 5, Part 1 at 403-17.

[13] *Supra* at 408-409.

[14] Exempt commodities include natural gas and electricity.

[15] Table 19 of Bank for International Settlements semi-annual OTC derivatives statistics at end-December, 2009, http://www.bis.org/statistics/derstats.htm.

intended to capture the "next AIG" or someone who "is almost like a swap dealer" or "someone with a significant book of business with counterparties." He testified that it was not meant to pick up the hundreds or even thousands of end-users. He testified that MSPs were companies where many counterparties would be at risk if they failed.[16] That is not the case with energy traders

The Commission is also instructed to consider the person's uncleared vs. cleared swap positions and the value and quality of collateral held against counterparty exposure when determining substantial position. Like the test for swap dealer, exchange cleared swaps should not contribute to an entity becoming a major swap participant. Again, this is because these swaps do not contribute to systemic risk, as they are on an exchange backed with a posted margin.

The Commission should not confuse *substantial position* with *position limits*. Position limits apply to individual markets or commodities while substantial position pertains to the entire US financial system. Position limits in the energy swaps market already greatly reduce the risk of any non swap dealer posing significant systemic risk on the US financial system. New position limits outlined in the Dodd-Frank Act will all but eliminate this risk. The Commission should recognize that, due to position limits, any non swap dealer in the energy markets is unlikely to pose significant systemic risk on the US financial system.

Furthermore, an extraordinarily high position in a commodity can have implications for that market, but that rarely extends beyond the reaches of that particular market. For example, assuming a market participant who is not a swap dealer had a position that equaled the Commission's recently proposed all month combined limit for NYMEX Henry Hub Natural Gas of 132,700 contracts[17] and liquidated that position at $5 out of the money, the total loss would be just over $6.6 *billion*. Therefore, it does not seem reasonable to assume this amount, in a multi *trillion* dollar economy, would have a dramatic negative impact on the entire US financial system.

Recommendation: When defining substantial position, the Commission should recognize that energy swaps do not pose a systemic risk to the US financial system.

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[16] *Reforming U.S. Financial Market Regulation: Hearing of U.S. Senate Agriculture Committee* (November 18, 2009, Videotape min. 41:59) (Statement of Gary Gensler, Chairman, Commodities Futures Trading Commission).

[17] *See* 75 F.R. 4143, *Federal Speculative Position Limits for Referenced Energy Contracting and Associated Regulations*, Commodity Futures Trading Commission (January 26, 2010).

4. Process for determining if an entity is a swap dealer or an MSP

The definitions as proposed by the Commission need to provide clear guidance to industry. The Commission must provide a process that is transparent for determining whether an entity is a swap dealer or an MSP. A lack of certainty could translate into companies exiting the trading business, leading to increased costs and a decrease in market liquidity. Not only is it necessary for a company to know whether it is a swap dealer or an MSP but it should also be relatively straightforward whether the counterparties it deals with also fall into these categories.

5. Swap

The Dodd-Frank Act provides that the term "swap" does not include "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[18] This exclusion is broadly written and must be clarified by the Commission. The exclusion definition should be consistent with the forward exclusion that is currently based upon CEA Section 1a(19) and prior Commission interpretations including those situations where commercial parties agree to "book-out" their physical obligations under forward contracts. The Commission should adopt a presumption that any contract that contains an enforceable physical obligation should meet this exclusion and is not a swap. The Commission should also confirm that prior practice (*e.g.*, counterparties frequently close out or financially settle certain types of physical transactions before final delivery) of a particular deal should not prejudge future consideration.

If the Commission does not provide clear guidance, the Commission and market participants will be faced with the same type of litigation associated with "forward intent" that occurred prior to passage of the Commodity Futures Modernization Act. During those years, the Commission and the Courts were continually forced to address intent of the parties to make or take delivery in connection with forward contracts. A return to this type of litigation will result in the disruption of swap markets, increased price volatility in underlying physical commodity markets and likely result in consumers paying increased prices for physical commodities, such as natural gas, oil and electricity. Such a result is clearly not in the public interest.

Recommendation: The Commission should clarify that any contract that contains an enforceable physical obligation should meet this exclusion and is not a swap.

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[18] Act, Section 721(a)(21)(47).

6. Conclusion

BGA supports the goals of this legislation and offers these comments on the ANOPR in order to assist the Commission's development of these critical definitions. BGA looks forward to providing further comments on the Commission's initiatives in connection with the Dodd-Frank Act.

Respectfully submitted,

__________/s/___________

Matt Schatzman
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