February 21, 2011

David A. Stawick, Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581

Re: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" (RIN 3038-AD06)

Dear Mr. Stawick:

On December 21, 2010, the Commodity Futures Trading Commission ("CFTC" or "Commission") published a notice of proposed rulemaking in the Federal Register (the "Proposed Rule") regarding the further definition of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant" and "eligible contract participant," as provided under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd- Frank Act").[1] Among other things, the Commission specifically requested comment on the application of the swap dealer definition to entities and transactions associated with agricultural commodities.[2]

The Gavilon Group, LLC ("Gavilon") appreciates the opportunity to provide the Commission with comments regarding the potential impact of the Proposed Rule on the swaps markets generally, and the agricultural markets in particular. Gavilon has a broad perspective as both an end-user that uses swaps to hedge commercial risk and as a trader of various commodity swaps, including swaps on agricultural products. Gavilon believes that this perspective will help the Commission develop a commercially practicable definition of "swap dealer" that, consistent with Congress' intent, will not subject commercial entities or proprietary traders to a regulatory scheme that was designed to apply to companies whose regular business is swap dealing.

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act") (to be codified as an amendment to the Commodity Exchange Act in various sections of 7 U.S.C. ch. 1); Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,174 (proposed Dec. 21, 2010) (to be codified in scattered subsections of 17 C.F.R. § 1.3). The Proposed Rule was prepared and issued jointly with the Securities and Exchange Commission, as required under Section 712(d) of the Dodd-Frank Act.

[2] 75 Fed. Reg. at 80,179 ("The CFTC requests comment on the application of the swap dealer definition to dealers, including potentially agricultural cooperatives, that limit their dealing activity primarily to swaps in agricultural commodities.").

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On October 28, 2010, Gavilon provided the Commission with comments in response to the Advance Notice of Proposed Rulemaking and Request for Comment regarding the treatment of swaps in an "agricultural commodity,"[3] and the Notice of Proposed Rulemaking regarding the definition of "agricultural commodity."[4] Gavilon believes that the comments it provided in its October 28, 2010 letter regarding the definition of "agricultural commodity" and the regulation of agricultural swaps continue to be relevant to the Commission's task of implementing the Dodd-Frank Act. Because many of the issues addressed in its October 28, 2010 letter also are raised in the Proposed Rule, on December 23, 2010 Gavilon re-filed the October 28, 2010 letter in response to the Proposed Rule.

I. Description of Gavilon and its Interest in the Proposed Rule

Gavilon is an active participant in the wholesale commodity markets, including the markets for agricultural and energy commodities. Gavilon's agricultural operations serve farmers, livestock producers, the commercial food industry, dairy producers, feed manufacturers and industrial users. Gavilon provides origination and distribution, physical merchandising, storage, transportation, and logistics services for a variety of agricultural and fertilizer products, including: (i) corn products, such as distillers dried grains with solubles, wet distillers grain, hominy, gluten feed and corn oil; (ii) wheat products such as wheat midds, midd pellets, red dog, wheat bran, wheat germ and second clear flour; (iii) animal products such as beef meal, pork meal, bone meal, blood meal, feather meal, edible and inedible tallow, edible lard, choice white grease and yellow grease; (iv) oilseed products such as whole cottonseed, cottonseed meal, cottonseed hulls, canola meal, soy meal and soy hulls; (v) oil products such as cottonseed oil, corn oil, palm oil, canola oil and soybean oil; and (vi) dairy products. In addition, Gavilon operates a large fertilizer distribution network and provides wholesalers with a wide array of bulk fertilizer products including nitrogen-based, phosphate-based and potash-based fertilizers. Gavilon's energy operations provide physical storage and transportation services at major North American hubs for crude oil, ethanol, natural gas and natural gas liquids, and provides a range of risk management and hedging services associated with inventory positions and forward contracts.

Gavilon uses swaps and other derivatives products to hedge the risk it incurs as a commercial participant in the agricultural and energy commodity markets, and to trade on a proprietary basis for a profit. In certain circumstances, Gavilon also provides its physical agricultural and energy market customers with ancillary hedging services related to their cash market business. For example, Gavilon may enter into a physical option with a natural gas customer to ensure that it will have a reliable supply of fuel during a period of time when resources may be limited. Similarly, Gavilon may enter into a physical option with a grain

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[3] Agricultural Swaps, 75 Fed. Reg. 59,666 (Sept. 28, 2010).

[4] Agricultural Commodity Definition, 75 Fed. Reg. 65,586 (proposed Oct. 26, 2010).

customer to set a "floor" on the price of a commodity to mitigate the impact of unexpectedly low prices on its customer's cash market business. These transactions, which naturally flow from and are ancillary to Gavilon's physical commodity businesses, help Gavilon's agricultural and energy market customers manage their commercial risk in an efficient and cost-effective manner.

Gavilon has a significant interest in how the Commission defines and interprets the key terms in the Dodd-Frank Act, particularly how those terms are applied to commercial end-users and traders of swaps. The definition of "swap dealer" could have a direct and significant impact on how (and to what extent) Gavilon and its physical commodity customers are able to manage their commercial risk. Similarly, this definition could adversely affect the ability of Gavilon and other proprietary traders to transact efficiently in the swap markets. Accordingly, Gavilon respectfully submits that if the Commission defines "swap dealer" and other key terms in the Dodd-Frank Act too broadly, it may inadvertently reduce liquidity and limit access to important hedging products and services that are used by farmers, agricultural cooperatives, food manufacturers, and other commercial entities to reduce their exposure to commodity price fluctuations.

II. Summary of Comments

- Consistent with Congress' intent, the Commission should adopt a well-tailored definition of "swap dealer" that applies only to those entities that regularly engage in swap dealing as part of a regular business. The definition should not inadvertently capture end-users that enter into swaps to hedge or mitigate commercial risk or to trade for a profit.

- In particular, the Commission should:

  - Clarify that swap activity that is ancillary to a cash market business is not swap dealing;

  - Adopt a meaningful *de minimis* exception that clearly and expressly exempts the swap activities of non-dealer commercial entities;

  - Clarify in the regulatory text that trading for profit does not constitute "dealing";

  - Clarify that an entity is not engaged in "dealing" merely because it proposes the terms for a transaction; and

  - Categorize swaps as hedges or speculative at the time of execution because the nature of a transaction relative to an entity's overall portfolio may change over time.

III. The Definition of "Swap Dealer"

Section 1a(49) of the Commodity Exchange Act, as amended by the Dodd-Frank Act ("CEA"), defines a swap dealer as any person who:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.[5]

In the Proposed Rule, the Commission expands upon the statutory definition by describing certain characteristics that may distinguish swap dealers from other market participants. For example, the Commission states that swap dealers:

- accommodate demand for swaps from other parties;
- are generally available to enter into swaps to facilitate other parties' interest in entering into those instruments;
- do not request that other parties propose the terms of swaps, but rather enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interests; and
- have the ability to arrange customized terms for swaps upon request, or to create new types of swaps on their own initiative.

Congress provided two express statutory exceptions from the definition of swap dealer. The first exception provides that the term "swap dealer" does not include any person that "enters into swaps for such person's own account, either individually or in a fiduciary capacity, *but not* as a part of a regular business."[6] The second exception exempts from designation as a swap dealer any entity that engages in a "*de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers."[7]

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[5] CEA § 1a(49).

[6] CEA Section 1a(49)(C) (emphasis added).

[7] CEA Section 1a(49)(D).

IV. The Commission Should Further Define the Term "Swap Dealer" in a Manner that is Consistent with Congress' Intent and the Purposes of the Dodd-Frank Act

Congress stated that the purpose of the Dodd-Frank Act is "to promote the financial stability of the United States by improving accountability and transparency in the financial system."[8] To achieve this goal, Title VII of the Dodd-Frank Act provides for comprehensive regulation of those entities that, because of their functional role or overall size, represent a significant risk to the stability and integrity of the U.S. banking system or financial markets. These new requirements include, among other things, registration requirements, capital and margin requirements, clearing and trade execution requirements (subject to certain exceptions), rigorous new recordkeeping and real-time reporting requirements, capital and margin requirements, and business conduct standards.

In contrast, Congress explicitly excepted commercial entities and other market participants that do not create systemic risk from most of the new requirements that apply to swap dealers and major swap participants. Congress recognized that subjecting certain non-financial entities to the same regulatory requirements as swap dealers and major swap participants would undermine the ability of those entities to operate and compete effectively. Moreover, such regulation would do little to advance the goals of the Dodd-Frank Act. Indeed, as Senators Blanche Lincoln and Christopher Dodd noted, Congress intentionally "narrowed the scope of the Swap Dealer and Major Swap Participant definitions" to avoid "inadvertently pull[ing] in entities that are appropriately managing their risk."[9]

Gavilon believes that the Commission can most effectively implement Congress' intent by drafting a well-tailored definition of "swap dealer" that: (1) applies only to those entities that regularly engage in swap dealing as part of a regular business; and (2) does not inadvertently capture end-users to the extent that they enter into swaps to hedge or mitigate commercial risk or to trade for a profit. Based on the plain language of the CEA and Congress' expressed intent, Gavilon believes that it will not be required to register as either a swap dealer or major swap participant. Nevertheless, Gavilon believes that the Commission should expressly clarify that proprietary trading and certain ancillary swap activities are not swap dealing. Gavilon is concerned that if the Commission does not clarify these important distinctions, the uncertainty will have a significant negative impact on the commodity markets and would be contrary to the express purpose of the Dodd-Frank Act.

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[8] Dodd-Frank Act preamble.

[9] 156 Cong. Rec. H5248 (Jun. 30, 2010) (Dodd-Lincoln Letter).

V. The Commission Should Clarify that Swap Activity that is Ancillary to a Cash Market Business is not Swap Dealing

The Dodd-Frank Act expressly excepts from the definition of swap dealer "a person that enters into swaps for such person's own account . . . but not as part of a regular business."[10] Accommodating demand for swaps in a manner that is ancillary to an entity's cash market business should not, by itself, cause a company to become a swap dealer because such activity is not part of an entity's "regular business." Many commercial entities, including Gavilon, occasionally enter into transactions with their physical commodity customers. These transactions are directly tied to the cash market businesses of both commercial entities, and are provided merely as an ancillary service for the convenience of the end-user customer.

For example, in the natural gas markets, utilities enter into agreements commonly referred to as "physical peaking services." These contracts typically are structured as physical options where the utilities pay a premium in exchange for the right to call for delivery of a given volume of gas at an index price (*i.e.*, the strike price floats with the market). Utilities purchase these options from marketing companies that have storage in their region to ensure they will have fuel when prices are high or supplies could be limited (*i.e.*, gas supply cuts). Although utilities could obtain comparable services from other market participants, it is often simpler and more economical for the utilities to work through their existing fuel suppliers (*i.e.*, a commercial entity, such as Gavilon). Absent Gavilon's physical business, Gavilon would not be a counterparty to this type of transaction. This ancillary activity is not "swap dealing" and should not cause Gavilon or other similarly situated entities to be regulated as swap dealers.

The Commission has stated that entities that "accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties" may be required to register as swap dealers. However, physical commodity market participants that provide ancillary hedges to their customers should not be required to register as swap dealers because such entities are not engaged in "dealing" as a "regular business." As Rep. Collin Peterson explained, "[i]n crafting the House bill and the conference report, [Congress] focused on creating a regulatory approach that permits the so-called end users to continue using derivatives to hedge risks associated with their underlying businesses . . . ."[11] Consistent with Congress' intent, the Commission should adopt rules that accommodate the many ways in which commercial entities hedge and mitigate risk. As a provider of risk management and hedging services associated with inventory positions and forward contracts, Gavilon respectfully requests that the Commission

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[10] CEA § 1a(49)(C) (emphasis added).

[11] 156 Cong. Rec. H5245 (daily ed. Jun. 30, 2010) (statement of Rep. Collin Peterson).

clarify that an entity will not be required to register as a swap dealer as a result of swap activity that is ancillary to or otherwise not a part of its "regular business."[12]

VI. The Commission Should Adopt a Meaningful *De Minimis* Exception that Clearly and Expressly Accommodates the Swap Activities of Non-Dealer Commercial Entities.

The Dodd-Frank Act provides an exemption from the definition of swap dealer for any entity that "engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers."[13] The Proposed Rule defines a *de minimis* quantity of swap dealing as satisfying *all* of the following conditions:

1. The aggregate effective notional amount (measured on a gross basis) of swaps entered into over the preceding 12 months in connection with dealing activities must not exceed $100 million;

2. The aggregate effective notional amount of swaps with "special entities" over the preceding 12 months in connection with dealing activities must not exceed $25 million;

3. The entity must not enter into swaps as a dealer with more than 15 counterparties over the prior 12 months; and

4. The entity must not enter more than 20 swaps as a dealer over the prior 12 months.[14]

Gavilon believes that the Commission should clarify in the regulatory text that swaps that an entity enters into for purposes other than dealing do not count toward the *de minimis* threshold. As the Commission correctly noted:

> "[t]he *de minimis* exemption specifically places limits on a person's *dealing* activity involving swaps or security-based swaps. Thus, these limits would not apply to swap or security-based swap activity that does not itself constitute dealing activity, *such as activity in which a person hedges or mitigates a commercial risk* of its business that is unrelated to a dealing business (*i.e.*, . . . when the person did not accommodate demand

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12 *See id.* Gavilon notes that because it, like most commercial entities, hedges risk on a portfolio basis, in some circumstances, even the swaps that it enters into with a customer to hedge the customer's commercial risk may, in fact, also hedge or mitigate its own commercial risk arising from other parts of its business.

13 CEA § 1a(49)(D).

14 75 Fed. Reg. at 80,212 (to be codified at 17 C.F.R. § 1.3(ppp)(4)).

> from the other party, respond to the other party's interest in swaps or security-based swaps, solicit the other party, propose economic terms, intermediate between parties, provide liquidity, or engage in other dealing activities)."[15]

However, because of the potentially ambiguous way in which dealing has been defined, there is some concern among market participants, including Gavilon, that the thresholds proposed by the Commission could be interpreted to apply to an entity's *entire* swap portfolio rather than just those swaps that constitute dealing activity.[16] For this reason, Gavilon respectfully requests that the Commission adopt regulatory text that expressly excludes swaps used to hedge or mitigate commercial risk and swaps that are the result of proprietary trading activity for purposes of determining whether an entity qualifies for the *de minimis* exception. These categories of swap activity do not constitute "dealing" in any commonly understood sense of the word; therefore, the Commission should clarify that they will not be regulated as such.

In addition, Gavilon believes that the Proposed Rule defines the threshold for *de minimis* swap dealing activity too narrowly to unambiguously exempt those entities for which regulation as a swap dealer would not be appropriate "in light of the limited nature of their dealing activities."[17] Although the Commission stated in the Proposed Rule that the scope of the *de minimis* exception "does not appear to readily translate into objective criteria," the proposed regulatory text relies on several discrete numerical thresholds to determine who will be eligible to claim the exception. Gavilon believes that this approach may inadvertently subject some small commercial entities to regulation as swap dealers even though such regulation is not reasonably warranted.

As a result, Gavilon urges the Commission to reassess its approach to the *de minimis* exception and reconsider a rule that is based on a market participant's swap dealing activity in the context of its overall business activity instead of using the same numerical cap as a litmus test for what constitutes material dealing activity in every possible scenario. In particular, Gavilon believes that the threshold for *de minimis* swap dealing activity should be defined in terms that are applicable to each major category of swap in proportion to the size of the relevant market. This approach will accomplish the Dodd-Frank Act's goals of "reduc[ing] risk . . . and promot[ing] market integrity within the financial system" without unnecessarily subjecting smaller, systemically insignificant entities to "a comprehensive new regulatory framework" that was intended to regulate only swap dealers and major swap participants.

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[15] 75 Fed. Reg. at 80,180 n.35 (emphasis added).

[16] Notably, the term "dealing" is not defined in the proposed regulatory text.

[17] 75 Fed. Reg. at 80,180.

However, if the Commission elects to adopt some form of quantitative thresholds as described in the Proposed Rule, Gavilon respectfully requests that it: (1) increase the overall threshold to reasonably reflect the level of most commercial entities' anticipated swap activity; and (2) simplify its approach to consider *only* an entity's aggregate gross notional amount of dealing activity. For example, in order for the *de minimis* exception to be effective, the Proposed Rule should take into account the fact that end-users may be active in the derivatives markets during one period of time (*e.g.*, in order to hedge a long-term supply agreement, or in response to uncharacteristic market volatility) and relatively inactive for other, extended periods of time. If the *de minimis* threshold is set too low, end-users may be required to register as swap dealers even though they only engage in sporadic swap activity.

Moreover, Gavilon believes that the proposed limitations based on the number of swaps, number of swap counterparties, or volume of transactions with "special entities" are not material to whether an entity functions as a swap dealer to a degree that would justify regulation under the Dodd-Frank Act.[18] Accordingly, Gavilon does not believe that the Commission should consider such criteria when determining whether an entity is engaged in a *de minimis* volume of dealing.

Gavilon also believes that any entity that is exempt from designation as a swap dealer should be *fully* exempt from the regulatory requirements that apply to swap dealers generally. Congress included a *de minimis* exception in the definition of swap dealer in order to provide entities that engage in only a small amount of dealing activity with relief from regulatory requirements that are meant to apply to larger, more active swap market participants. Limiting the scope of this relief would be inconsistent with Congress' intent in providing the *de minimis* exception. Such a limitation also would be unnecessary because, by definition, *de minimis* dealing activity does not implicate the market stability and integrity issues that the Dodd-Frank Act is meant to address.[19] Moreover, requiring entities that engage in only *de minimis* amounts of swap dealing to comply with some swap dealer requirements, but not others, could create an undue administrative burden for the Commission and an unclear regulatory framework for those entities subject to the exception.

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[18] For example, one entity may enter into a single swap with a gross notional amount just under the *de minimis* threshold. Even if the Commission concluded that the entity was engaged in "dealing" activity, it would not be required to register as a swap dealer because its activity is below the threshold. In contrast, another entity may enter into 100 very small transactions with its customers that, even when aggregated, have a gross notional amount that is only a fraction of the *de minimis* threshold. Even though the second entity's swap activity will have less of an effect on risk, transparency, and market integrity than the first entity's, the Proposed Rule could require the second entity to register as a swap dealer. Fixed numerical limits on the number of swaps and the number of counterparties simply do not correspond to the fundamental objectives that the Dodd-Frank Act was meant to serve.

[19] 75 Fed. Reg. 80,174, 80,181. (The Commission asked, "whether the *de minimis* exemption should excuse an entity from having to comply with certain regulatory requirements imposed on swap dealers or security-based swap dealers, while also mandating compliance with other dealer requirements").

Congress did not intend to limit the activities of commercial end-users of physical commodities when it enacted the Dodd-Frank Act. Rather, "Congress incorporated a *de minimis* exception to the swap dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk [(*i.e.*, end-users)] are not inadvertently pulled into additional regulation."[20] The Commission should adopt a final rule that is consistent with this intent.

VII. The Commission Should Clarify that Trading for Profit Does Not Constitute "Dealing"

Gavilon believes that the statutory definition of "swap dealer" and the Proposed Rule intend to distinguish proprietary trading from dealing. Nevertheless, to provide additional certainty for market participants that trade swaps for a profit, Gavilon requests that the Commission expressly clarify that proprietary trading is not "dealing" activity that falls within the definition of swap dealer. As the Commission knows, dealers and traders participate in the swap markets for different reasons and operate in a fundamentally different manner. For example, "dealers" ordinarily are willing to transact with both buyers and sellers because they are in the business of making a profit from the bid-ask price spread in each transaction. In other words, dealers accommodate whatever the market demands, regardless of whether a potential counterparty seeks to take a long or short position in the market. Although dealers may take speculative positions, they generally maintain a balanced portfolio of transactions so that long positions offset short positions and overall price risk is mitigated.

In contrast, "traders" acquire positions either to take an outright view on the direction of the market (*i.e.*, speculators) or to obtain exposure to either the price of a commodity or the value of the swap position itself (*i.e.*, investors). Traders' transactions, like those of dealers, provide market liquidity and enhance price discovery. However, unlike dealers, traders do not make markets, nor do they regularly accommodate demand for swaps without regard to their own perspectives on the value of a commodity or trends in the market. If their transactions meet another party's demand to execute a swap, that occurs only because the third party's demand happens to be consistent with the traders' proprietary view of the market.

The CFTC has recognized "trading" as a distinct category of market activity with respect to swaps in other contexts. For example, in the proposed rule implementing the end-user exception to the mandatory clearing of swaps, the Commission explained that, in contrast to swaps held to hedge or mitigate commercial risk, "swap positions that are held for the purpose of speculation or trading are . . . positions . . . 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." Similarly, the CFTC's September 2008 Staff Report on Commodity Swap Dealers and Index Traders (the "2008 Staff Report") described "traders" as entities that have traditionally

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[20] 156 Cong. Rec. S6192 (daily ed. July 22, 2010) (Statement of Sen. Blanche Lincoln), 156 Cong. Rec. H5248 (daily ed. June 30, 2010) (Statement of Rep. Barney Frank) ("Dodd-Lincoln Letter").

fallen into one of two sub-categories: commercial traders, who use derivatives to offset or hedge price risks in the cash market; and noncommercial traders, often referred to as speculators, who do not necessarily have physical risk exposure that needs to be offset. In contrast, the 2008 Staff Report described "dealers" as entities that offer swaps to third-parties and take on any price risks associated with those swaps, noting that, in practice, "there has been a natural tendency for financial intermediaries (*e.g.*, commercial banks, investment banks, insurance companies) to become swap dealers," because these entities have the capital and market expertise necessary to manage the price risks associated with their dealing activity.

Similarly, as part of its implementation of the Dodd-Frank Act, the Securities and Exchange Commission ("SEC") proposed a rule further defining "security-based swap dealer" that explicitly recognizes the difference between "dealing" and "trading." The SEC noted in its proposed rule that because "[t]he definition of 'security-based swap dealer' has parallels to the definition of 'dealer' under the [Securities] Exchange Act . . . [it] would consider the same factors that are relevant to determining whether a person is a 'dealer' under the [Securities] Exchange Act as also generally relevant to the analysis of whether a person is a security-based swap dealer."

Although there are certain differences between the markets for securities and commodities, Gavilon believes that the Commission should follow the same general approach as the SEC and expressly distinguish between "dealing" and "trading" in the definition of swap dealer.[21] Gavilon believes that such an approach is both commercially practicable and consistent with the framework provided by Congress.[22] If the Commission declines to expressly distinguish between dealers and traders, the uncertainty may inadvertently discourage a significant volume of beneficial trading activity. Many proprietary traders (far more than would be required to register as major swap participants) may limit their swap activity or elect to exit the marketplace rather than risk being deemed swap dealers. In either case, the markets would lose a valuable source of liquidity. Gavilon respectfully submits that the Commission should protect the current efficiency of the derivatives markets by expressly adopting a narrowly tailored definition of "swap dealer" that properly excludes traders and other entities that Congress did not intend to regulate as dealers.

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[21] Notably, multiple commodity swap market participants specifically requested that the Commission make this important distinction in the Proposed Rule; however, the Commission did not do so and provided no explanation as to why it declined to adopt a dealer-trader distinction with respect to swaps.

[22] Regulating traders as swap dealers is unnecessary and potentially inconsistent with plain language of the Dodd-Frank Act intent because, to the extent that Congress intended for traders to be subject to regulation, it provided clear and commercially practicable guidelines within the definition of major swap participant.

VIII. The Commission Should Clarify that an Entity is not Engaged in "Dealing" Merely Because it Proposes Terms for a Transaction

The Proposed Rule states that one of the characteristics that may distinguish swap dealers from other market participants is that swap dealers tend to propose and to enter into swaps on their own preferred terms, rather than requesting that their counterparty propose the terms of the swap.[23] The Commission should clarify that this characteristic is not dispositive, and that an entity will not be regulated as a swap dealer merely because it has the inclination and ability to set the terms of its transactions with counterparties. Gavilon, like many sophisticated end-users, actively negotiates with swap counterparties to secure mutually agreeable transaction terms. This is true whether a swap is intended to hedge or mitigate commercial risk or entered into for purely speculative purposes. Although swap dealers may prefer to set the terms of their transactions, this is not always the case. The Commission should clarify the proposed definition of swap dealer to ensure that sophisticated end-users are not inadvertently treated as swap dealers due to the way in which they negotiate and enter into swaps.

IX. The Commission Should Categorize Swaps as Hedges or Speculative at the Time of Execution

Gavilon agrees with the preliminary conclusion in the Proposed Rule that states that whether a swap hedges or mitigates commercial risk should be determined at the time of execution, not through a ongoing, periodic analysis of a transaction's continuing effectiveness or present purpose. As market values change, an entity's exposure also changes and hedges that were perfect (or nearly so) at one moment, may become less effective over time. However, the fact that a hedge may be imperfect or become less effective does not mean that is has ceased to serve its original intended hedging purpose.

For example, commercial companies that transact in the natural gas markets often secure cost-effective natural gas storage by using "spreads" (*i.e.*, buying storage for the front month and selling storage in the next month). When a market participant first buys the spread, the prices of the two contracts are different, but because the two contracts are correlated, each represents a partial hedge for the other. As time passes, the prices of both contracts may move. In some cases, prices will diverge and the spread will widen further and the hedge will become more valuable (and more effective). In other cases, prices could converge, narrowing the spread, decreasing the future value of the hedge, and making it less effective. In either case, the value and effectiveness of the hedge is not within the control of the end-user and, importantly, does not change the original purpose that the transaction was meant to serve.

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[23] 75 Fed. Reg. at 80,176.

Requiring an ongoing evaluation of hedge effectiveness would create an operational burden for end-users that does not presently exist for participants in the futures markets. Currently, the CFTC evaluates whether a futures transaction is a bona fide hedge at the time a transaction it is executed. This simple, one-time approach is consistent with the CFTC's long-established practices for examining hedges in regulated markets, and represents a commercially practicable assessment practice for the parties involved. Gavilon respectfully submits that a more complex, continuous evaluation process could be costly and time-consuming for market participants and is not necessary to carry out the purposes of the Dodd-Frank Act fully and effectively.

X. Conclusion

Gavilon commends the Commission's efforts to protect consumers by bringing more transparency and oversight to the over-the-counter derivatives markets generally and to agricultural markets specifically. Gavilon also recognizes the complexity involved in such significant reform and submits its comments to ensure that the Commission has the best understanding of how the commodities markets function in order to craft its implementing regulations in a way that will reduce unintended negative impacts on the markets. We welcome the opportunity to discuss these issues further with the Commission and its Staff. Please contact the undersigned at (402) 889-4026, if you have any questions regarding Gavilon's comments.

Respectfully submitted,

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