PHILIP MORRIS INTERNATIONAL INC.

February 22, 2011

**<u>Via E-Mail</u>**

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

**Re: Proposed Rules – End-User Exception to Mandatory Clearing of Swaps (RIN 3038-AD10); Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" (RIN 3235-AK65)**

Dear Mr. Stawick:

This comment letter is submitted on behalf of Philip Morris International Inc. ("PMI"), a Virginia holding company whose stock is listed on the New York Stock Exchange. PMI appreciates the opportunity to comment on several aspects of the Commodity Futures Trading Commission's ("CFTC" or the "Commission") proposed rule regarding the end-user exception to the mandatory clearing of swaps (the "end-user clearing exception"), as well as on the Commission's proposed "swap dealer" and "major swap participant" definitions, all of which are promulgated under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act").

In this letter, PMI focuses on the need to clarify several points that could undermine the public policy of encouraging sound risk management and the promotion of cost efficiencies for non-financial companies like PMI that operate on a global basis and use subsidiaries to hedge the commercial risks of their corporate groups as a whole. Such subsidiaries cannot be considered banks or financial entities since they focus exclusively on activities with group companies and do not accept deposits from the public.

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## Summary of Comments

PMI and its affiliates hedge or mitigate their foreign currency risks through foreign exchange ("FX") forwards and swaps entered into primarily by Philip Morris Finance SA ("PMF"). PMF is a wholly-owned treasury subsidiary of PMI whose key purpose is to hedge or mitigate the overall foreign currency risks of the entire PMI corporate group. PMF does not enter into swaps for speculative or trading purposes.

It is unclear under the end-user clearing exception whether PMF would be deemed the sort of affiliate acting as an "agent" of PMI and its other affiliates that qualifies for the end-user clearing exception. If PMF is not such an affiliate, PMF could potentially be ineligible for the end-user clearing exception, which would: (i) severely limit PMI's ability to effectively hedge or mitigate commercial risks across the entire family of PMI affiliates, (ii) result in increased costs, and (iii) negatively affect the ability of the entire PMI corporate group to effectively manage its working capital as well as its exposures and risks. Such results would run counter to the Dodd-Frank Act's intent.[1]

PMI is concerned that swap transactions entered into by PMF and other wholly-owned treasury subsidiaries of large non-financial companies, with their affiliates on the one hand and traditional swap dealers on the other, will not be considered "hedging or mitigating commercial risk" under the proposed rules. In addition to causing such subsidiaries to be ineligible for the end-user clearing exception,[2] it could, as discussed below, also cause them to be unintentionally classified as "major swap participants." Such swap transactions would clearly fall within the definition if they were entered into by the holding company or operating affiliates directly. For example, the FX forward transactions that PMF enters into on behalf of its affiliates would qualify as "hedging or mitigating commercial risk" if they were entered into directly between PMI or its operating affiliates and traditional swap dealers. Since PMF's primary purpose is to effect the risk management policies of PMI with respect to the entire PMI corporate group and because PMF does not enter into FX transactions for speculative or trading purposes, the FX forward transactions entered into by PMF should also qualify as "hedging or mitigating commercial risk." PMI therefore urges the CFTC to clarify that swap transactions entered into by the wholly-owned treasury subsidiaries of a corporate group, to hedge or mitigate their affiliates' commercial risks, will be considered "hedging or mitigating commercial risk" under the proposed rules.

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[1] Lawmakers have recognized that the Dodd-Frank Act is not intended to impede commercial end-users' ability to hedge or mitigate their commercial risk through the use of swaps. *See, e.g.*, Letter from Senators Dodd and Lincoln to the Chairs of the U.S. House of Representatives Financial Services and Agriculture Committees (June 30, 2010) ("Whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool."). *See also* Gary Gensler, Chairman, Commodity Futures Trading Comm'n, Remarks at U.S. House of Representatives Agriculture Committee Public Hearing (February 10, 2010) ("Congress recognized the different levels of risk posed by transactions between financial entities and those that involve non-financial entities, as reflected in the non-financial end-user exception to clearing. Transactions involving non-financial entities do not present the same risk to the financial system as those solely between financial entities.").

[2] The CFTC indicates in its notice of proposed rulemaking that its use of the phrase "hedging or mitigating commercial risk" for purposes of the end-user exception is intended to be nearly identical to the use of that phrase in the proposed "major swap participant" definition. 75 Fed. Reg. 80,747, 80,752-80,753 (Dec. 23, 2010) (to be codified at 17 C.F.R. pt. 39). PMI believes that the adoption of a consistent definition is appropriate. PMI's comments with respect to the "hedging or mitigating commercial risk" definition are presented in the "Major Swap Participant" section below (p. 5-6).

## I. Company Background and Derivatives Activities

PMI's subsidiaries, affiliates and licensees are engaged in the manufacture and sale of cigarettes and other tobacco products in approximately 180 countries outside the United States of America.

As a result of its global operations, PMI currently uses FX forwards and swaps to manage its foreign currency exposures arising from its business, which is transacted in multiple currencies.[3] Although PMI engages in swap transactions to hedge or mitigate its commercial risks directly (at the holding company level), the bulk of PMI's FX swap transactions ("FX swaps") are undertaken by PMI's wholly-owned subsidiary, PMF, which performs a centralized treasury function.[4]

PMF mainly enters into FX swaps to hedge its own currency risks, which arise from inter-company loans put in place to optimize funding and liquidity needs within the PMI group of companies. Typically, excess cash positions in foreign PMI subsidiaries are lent to PMF and are subsequently lent to other PMI subsidiaries in different jurisdictions and currencies to meet respective working capital requirements. These inter-company loans across different currencies are managed by PMF and, unless they are hedged by corresponding FX swaps, would cause PMF to suffer unwanted currency risks.

PMF also hedges the foreign currency risks of its PMI affiliates. PMF enters into FX forwards (which fall within the definition of a swap contained in §721(a) of the Dodd-Frank Act) with PMI affiliates and then enters into offsetting FX forwards with traditional swap dealers, almost all of which are commercial banks with whom PMI and/or its affiliates have separate credit relationships for the benefit of such respective PMI entities. Unlike the FX swaps mentioned in the preceding paragraph, the FX forwards that PMF enters into with external parties do not hedge the risks of PMF directly, but rather hedge the currency risks of PMI affiliates, *e.g.*, transactional exposure arising from international manufacturing and sales activities, as well as investments in foreign operations.

Structures like this, where a large, non-financial company with global operations centralizes its treasury operations in a subsidiary, are common in the marketplace and offer significant economic benefits. Such centralization also allows for greater efficiency and lower exposure to counterparties due to netting across affiliates, promotes prudent risk management and controls at a company-wide level, and results in the better allocation of resources.

## II. The End-User Clearing Exception

The end-user clearing exception is available to non-financial entities that use swaps to hedge or mitigate their commercial risks. PMI believes that, to the extent that it enters into swap transactions directly, it qualifies for the end-user clearing exception, because PMI is not a financial entity (as the term is defined in the proposed

[3] PMI believes that FX forwards and swaps are distinct from other swaps. As such, PMI has submitted a letter to the Secretary of the Treasury supporting the exemption of FX forwards and swaps from regulation as "swaps" under the Dodd-Frank Act.
(*available at* http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480ba8b3c). Nonetheless, PMI believes that the Commission's proposed rule pertaining to the end-user clearing exception, as well as the Commission's proposed "swap dealer" and "major swap participant" definitions, require clarification, particularly with respect to the treatment of large companies with global operations that engage in swap transactions, through their wholly-owned treasury subsidiaries, for the purpose of hedging or mitigating commercial risk,

[4] As discussed in the "Major Swap Participant" section below (p. 5-6) it is PMI's position that foreign currency risk falls, and should continue to fall, within the definition of "commercial risk" for purposes of the "hedging or mitigating commercial risk" definition. Accordingly, the terms "foreign currency risk" and "commercial risk" are used interchangeably throughout this letter.

rule)[5] and its use of swaps is limited to hedging or mitigating commercial risks.[6] PMI is concerned, however, that the Commission's proposed rule may exclude the activities of wholly-owned treasury subsidiaries like PMF.

Under the end-user clearing exception, an affiliate of a person that qualifies for the end-user clearing exception qualifies for the exception as well, so long as (i) it is acting *on behalf* of the person (or its affiliate) *and as its agent*, and (ii) the swaps it enters into are for the purpose of hedging or mitigating the commercial risk of the person that qualifies for the exception (or its affiliate). PMI believes that it and its operating affiliates qualify for the end-user clearing exception to the extent that they enter into swap transactions directly. Accordingly, PMF should also qualify for the exception, to the extent that it enters into FX forwards for the purpose of hedging or mitigating its PMI affiliates' commercial risks. However, the proposed rule is unclear as to whether entities like PMF qualify for the exception. Although PMF enters into FX forwards *on behalf of* its PMI affiliates to hedge or mitigate their commercial risks, it can potentially be viewed as not acting as an agent under §2(h)(7)(D)(i) of the CEA, as amended by §723(a) of the Dodd-Frank Act. PMF acts as a *de facto* agent for its affiliates: PMF enters into FX forwards pursuant to its affiliates' needs to hedge or mitigate *their* commercial risks, but PMF itself remains in a neutral position between its PMI affiliates and traditional swap dealers.

PMI believes that in acting as a *de facto* agent on behalf of its PMI affiliates, PMF is acting as an agent under the affiliate exemption provided in the Dodd-Frank Act. Therefore, PMI urges the CFTC to adopt an interpretation of the term "affiliate" that accounts for entities acting as *de facto* agents on behalf of persons that are eligible for the end-user clearing exception (and their affiliates). Doing so will ensure that the public interest is served by allowing non-financial corporate groups the flexibility to develop a risk management structure that best promotes prudent and effective hedging strategies, cost efficiencies and is consistent with the public policy goals of the Dodd-Frank Act. Otherwise, the proposed rule may unintentionally interfere with the internal risk management arrangements of non-financial corporate groups, a result which would be contrary to the purpose and goals of the Dodd-Frank Act.[7]

PMI is also concerned that treasury subsidiaries like PMF could fall within the definition of a "financial entity,"[8] because their activities could be deemed "financial in nature."[9] PMI requests that the CFTC expressly exclude the wholly-owned treasury subsidiaries of non-financial companies from the "financial entity" definition, to the extent that they solely engage in swap transactions to hedge or mitigate the commercial risks of an entire corporate group. As demonstrated by the carve-out for certain captive finance entities from the

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[5] The term "financial entity" is defined in §2(h)(7)(C)(i) of the Commodity Exchange Act ("CEA"), as amended by §723(a) of the Dodd-Frank Act, and includes the following eight entities: (i) a swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap dealer; (v) a commodity pool as defined in CEA § 1a(10); (vi) a private fund as defined in §202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)); (vii) an employee benefit plan as defined in paragraphs (3) and (32) of §3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); or (vii) a person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in §4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 843(k)).

[6] *See supra* note 2.

[7] *See supra* note 1.

[8] *See supra* note 5.

[9] *Id.* Activities that are "financial in nature" include, but are not limited to, (i) lending, exchanging, transferring, and investing for others; safeguarding money or securities, (ii) providing financial, investment or economic advisory services, or (iii) *engaging in any activity that the Federal Reserve Board deems to be "financial in nature."* *See* 12 U.S.C. 843(4)(k)(A),(C) and (F).

“financial entity” definition,[10] the Dodd-Frank Act does not intend to regulate entities merely because they engage in financial activity. We believe the Dodd-Frank Act intends that swap transactions entered into by the treasury subsidiaries of non-financial companies to hedge or mitigate commercial risks are eligible for the end-user clearing exception.

## III. The Major Swap Participant Definition

### a. *The First Test*

The first test for determining “major swap participant” status captures entities that maintain a “substantial position” in swaps. The Commission proposes to further define “substantial position” by implementing a mark-to-market $1 billion threshold in each major category of swaps ($3 billion for rate swaps) in current uncollateralized exposure plus potential future exposure. Swap transactions entered into solely for the purpose of hedging or mitigating commercial risk are excluded from the “substantial position” definition.

Given its past and expected positions in derivatives, PMI believes that the CFTC’s proposed thresholds will appropriately identify those entities that Congress intended to regulate as “major swap participants.” With respect to the definition of "hedging or mitigating commercial risk," PMI strongly agrees with the CFTC’s proposed rule implementing a broad interpretation of “hedging or mitigating commercial risk” that does not limit the types of swaps that may be used to hedge or mitigate commercial risks by reference to specific classes of underlying hedged items (*e.g.*, non-financial commodities), hedging rules specific to an industry, commodity or asset class or by reference to hedge effectiveness.[11] PMI believes that the determination of whether a swap hedges or mitigates commercial risk should be based on the facts and circumstances at the time the swap is entered into, as well as on the entity’s overall hedging and risk management strategies. A broad definition of “hedging or mitigating commercial risk” is consistent with this interpretation. PMI believes that the current definition is sufficiently broad to encompass swaps primarily used to mitigate commercial risks, while excluding swaps that could be used for speculative, trading or other non-hedging purposes. Consistent with this view, PMI believes that foreign currency risk constitutes "commercial risk" (as the term is used in the proposed definition), and that PMF's entering into FX swaps and/or forwards is an appropriate means of hedging this risk.

### b. *The Second Test*

The second test for “major swap participant” status captures entities 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. The CFTC proposes to further define “substantial counterparty exposure” by implementing an aggregate $5 billion threshold for current uncollateralized exposure and $8 billion of current uncollateralized exposure plus potential future exposure. Given its past and expected positions in derivatives, and based on our understanding of the calculation of potential future exposure, PMI believes that these thresholds will appropriately identify those entities that Congress intended to be regulated as “major swap participants.”

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[10] CEA §2(h)(7)(C)(iii) (as amended by §723(a) of the Dodd-Frank Act).

[11] 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, 80,195 (to be codified at 17 C.F.R. pt. 240).

### c. *The Third Test*

The third test for "major swap participant" status captures an entity that is (i) a "financial entity," (ii) is "highly leveraged" relative to the amount of capital it holds, (iii) is not subject to capital requirements established by an appropriate Federal banking agency, and (iv) maintains a "substantial position" in outstanding swaps in any major swap category. The CFTC proposes to define "highly leveraged" as a ratio of total liability to equity of 8:1 or 15:1. The proposed definition of "financial entity" is identical to that contained in the end-user clearing exception proposed rule (discussed above).

PMI urges the Commission to expressly exclude wholly-owned treasury subsidiaries of non-financial multinational companies from the "financial entity" definition, to the extent that such entities solely engage in swap transactions to hedge or mitigate the commercial risk of an entire corporate group. Although the activities of treasury subsidiaries may exceed proposed leverage ratios under this third test, for credit evaluation purposes, entities such as PMF are generally evaluated as wholly-owned subsidiaries of the corporate group that do not require additional credit support, *e.g.*, parent guarantees or collateral.

## IV. The Swap Dealer Definition

Under the CFTC's proposed rule, a person may be deemed a swap dealer if it (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 one's own account, or (iv) engages in activity causing oneself to be known in the trade as a dealer or market maker in swaps.[12] Persons that enter into swaps for their own account, either individually or in a fiduciary capacity, but not as a part of their regular business, are excluded from the "swap dealer" definition.[13] In determining if a person is a swap dealer, the CFTC proposes to consider that person's activities in relation to the other parties with which it interacts in the swap markets.

PMI does not believe that the swap transactions that it (or other similarly situated non-financial multinationals, for that matter) enters into directly will cause it to be classified as a swap dealer, as these transactions hedge PMI's own commercial risks and are not entered into as part of its ordinary course of business. PMI is concerned, however, that the manner in which PMF engages in FX forward transactions may cause PMF to be inappropriately classified as a swap dealer.

PMF does not hold itself out as a dealer in swaps, does not make a market in swaps, and does not engage in activity that would cause it to be known in the trade as a dealer or market maker in swaps. The offsetting FX forward transactions that PMF enters into with traditional swap dealers may be technically viewed as for PMF's own account, however. PMI believes that these transactions are not of the type contemplated of swap dealers by the Dodd-Frank Act; in entering into offsetting transactions with traditional swap dealers, PMF acts as a *de facto* agent for its affiliates, and solely for the purpose of hedging or mitigating *their* commercial risks. Further, such transactions would clearly be excluded from the swap dealer definition if PMI or PMF's affiliates were to enter into them directly. As such, PMI urges the CFTC to clarify that, for purposes of the third core test of swap dealer status, wholly-owned treasury subsidiaries of non-financial companies, to the extent that they only enter into transactions to hedge or mitigate the commercial risks of the entire corporate group, do not enter into transactions for their own account.

Classifying wholly-owned treasury subsidiaries (such as PMF) as "swap dealers" would likely cause many large companies with complex corporate structures to decentralize their hedging activities. This would

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[12] *Supra* note 11. at 80,175.

[13] *Id.* at 80,176.

increase complexity and risk due to the inefficiency of managing and controlling transactions and risks directly entered into through multiple entities, as well as the inability to net exposures of multiple entities to dealer counterparties. This result is clearly contrary to the Dodd-Frank Act's intent of reducing systemic risk to the financial markets and promoting prudent risk management policies.

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In summary, PMI believes that its method of internal risk management whereby it uses PMF to centralize hedging transactions between PMI affiliates and traditional swap dealers is a prevailing practice for many end-users. This practice reduces the complexity and risks of such transactions to the benefit of the PMI group of companies. The Dodd-Frank Act clearly does not contemplate interference with the internal risk management structure of end-users such as PMI and subjecting end-users to the requirements of "swap dealers," "major swap participants," or mandatory clearing of swap transactions engaged in for the purpose of hedging or mitigating commercial risks. PMI respectfully requests that the Commission clarify that end-user affiliate groups, such as PMI and its subsidiaries, are not "swap dealers," "major swap participants" or "financial entities."

We thank you for considering our perspective on these matters and welcome any questions you may have.

Respectfully submitted,

Marco Kuepfer
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Philip Morris International Inc.

cc: James M. Cain, Esq.
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