Coalition for Derivatives End-Users

February 22, 2010

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Via agency website

Re: Entity Definitions / File Number S7-39-10

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 joint proposed rule entitled "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' Major Security-Based Swap Participant,' and 'Eligible Contract Participant'" under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act"). The Coalition appreciates that the Commissions took note of its comment letter regarding the Advance Notice of Proposed Rulemaking ("ANPR") on the same topic.[1]

The Coalition represents companies that employ derivatives predominantly to manage risks. Hundreds of companies have been active in the Coalition throughout the legislative and regulatory process, and our message is straightforward: The Coalition seeks to ensure that financial regulatory reform measures promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users, who did not contribute to the financial crisis, would create more economic instability, restrict job growth, decrease productive investment, and hamper U.S. competitiveness in the global economy.

We are glad to continue working with the CFTC and SEC to ensure that that the final rules appropriately define "major swap participant," "major security-based swap participant" (collectively, with "major swap participant," "major participant"), "swap dealer," "security-

[1] "ANPR Comment," *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26181&SearchText=

based swap dealer," and "eligible contract participant" ("ECP") so that end-users are able to continue to efficiently manage their business risks, invest in our economy, and create jobs.

Introduction

The Commissions urged commenters to discuss the interplay of substantive requirements and the effects of the swap dealer, security-based swap dealer, and major participant designations.[2] The proposed rule accurately notes that:

> whether the definition of a major participant [or swap dealer] is too broad or too narrow may well depend in part on the substantive requirements applicable to such entities, and whether those substantive requirements are themselves appropriate may in turn depend in part on the scope of the . . . definitions.[3]

The numerous rules proposed thus far indicate that swap dealers, security-based swap dealers, and major participants will have to invest significant amounts of time and resources to comply with the new regulatory regime. It is imperative, therefore, that the definitions of these entities be carefully crafted so as not to capture entities that do not pose systemic risks and that do not have the resources to comply with all of the requirements being proposed for swap dealers, security-based swap dealers, and major participants. The Coalition believes further clarification and modification of these definitions may be beneficial and provide a greater degree of certainty for end-users and market participants.

Major Swap Participant and Major Security-Based Swap Participant

The Coalition supports the Commissions' focus on the risk posed by an entity to the entire economic system in its major participant definitions.[4] As we noted in our ANPR Comment, focus on systemic risk comports with the Dodd-Frank Act's[5,6] legislative history.[7]

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[2] 75 Fed. Reg. 80175 n.8 (2010).

[3] *Id*.

[4] The proposal refers to major participants as non-swap dealer entities "whose swap or security-based swap activities . . . could pose a high degree of risk to the U.S. financial system generally." 75 Fed. Reg. 80185 (Dec. 21, 2010). The proposal also notes that "the tests of the major participant definitions use terms—particularly 'systemically important,' 'significantly impact the financial system' or 'create substantial counterparty exposure'—that denote a focus on entities that pose a high degree of risk through their swap and security-based swap activities."

[5] The Dodd-Frank Act sets out three tests to determine which entities will be categorized as a major participant. Major participants include any person who is not a swap dealer or security-based swap dealer and:

[Footnote continued on next page]

While developing the final rule concerning the major participant definitions, the Commissions should keep in mind the intent of the Dodd-Frank drafters to focus on systemic risk. In a colloquy after the bill's passage, Chairman Dodd and Chairman Lincoln agreed that "*few end users will be major swap participants*."[8] We believe that end-user protections should be provided to any company or business entity within a company, regardless of the parent company's primary business or the business of any other affiliated entity, that employs swaps predominantly to hedge the risks associated with its business and that do not pose systemic risk. The Coalition urges the Commissions to define "major swap participant" and "major security-based swap participant" so that no end-users are captured by the terms and subjected to bank-like regulation.

[Footnote continued from previous page]

1) maintains a "substantial position" in swaps or security-based swaps for any of the "major swap categories," excluding "positions held for hedging or mitigating commercial risk" and positions held by employee benefit plans to hedge or mitigate risk;

2) whose outstanding swaps or security-based swaps create "substantial counterparty exposure that could have serious adverse effects" on the U.S. banking system or financial stability; or

3) is a "financial entity" that is "highly leveraged relative to the amount of capital it holds" and not subject to Federal banking regulation and "maintains a substantial position" in outstanding swaps or security-based swaps. 7 U.S.C. § 1a(33) (Dodd-Frank Act Sec. 721(a)(16)); 15 U.S.C. § 78c(a)(67) (Dodd-Frank Act Sec. 761(a)(6)).

[6] Additionally, the "major swap participant" (but not "major security-based swap participant") definition provides an exception for captive finance companies. CEA Sec. 1a(33)(D). Those 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, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company."

[7] *See* colloquy between Senators Lincoln and Hagan emphasizing that the major participant definitions should be focused on "risk factors that contributed to the recent financial crisis." 156 CONG. REC. S 5907 (daily ed. July 15, 2010) (statement of Senators Hagan & Lincoln); Obama Administration White Paper focusing on the "combination" of three factors—"size, leverage, and interconnectedness." *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.

[8] 156 CONG. REC. S 5904 (daily ed. July 15, 2010) (emphasis added).

Major Participant Definition 1: "Substantial Position" and "Hedging or Mitigating Commercial Risk"

The first major participant definition includes non-swap dealer entities that maintain a "substantial position" in swaps or security-based swaps for any of the "major swap categories," excluding "positions held for hedging or mitigating commercial risk" and positions held by employee benefit plans to hedge or mitigate risk. Below, we discuss the terms "substantial position" and "hedging or mitigating commercial risk."

Substantial Position

In our ANPR Comment, the Coalition explained that the Commissions should look to the actual risk an entity's position poses to determine whether the entity holds a "substantial position." We suggested that there not be a quota for end-users, whether financial or non-financial, nor a numerical threshold based on size or notional value over which end-users would mechanically fall into the major participant regulation. We also suggested that there should be a presumption against imposing the panoply of bank-like regulations on end-users.

We also encouraged the Commissions to account for netting of offsetting positions to ensure that the amount of risk would not be overstated, and suggested that the net credit exposure created by a party's derivatives portfolio would be the best characterization of the actual credit risk created by the portfolio.

Finally, we cautioned the Commissions against considering net credit exposure in isolation, and suggested that a party's positions should be understood in the context of the firm's equity and liquid assets, and the extent to which a default on derivatives would impact that firm's viability.

The Commissions have proposed that whether an entity maintains a "substantial position" in swaps or security-based swaps should be determined by one of two tests—a current collateralized exposure test and a current plus future collateralized exposure test.

Under the current collateralized exposure test, the Commissions propose to look at the marked-to-market current uncollateralized exposure in each of the major swap or security-based swap categories, excluding positions held for hedging or mitigating commercial risk and netting out offsetting positions. The daily average limit would be $1 billion for all major swap and security-based swap categories, except the threshold for the rate swap category would be $3 billion.[9]

Under the current plus future collateralized exposure test, the Commissions propose to look at an entity's "aggregate potential outward exposure," which would account for the entity's current future exposure plus potential future exposure by multiplying the total notional principal amount of the entity's positions by risk factor percentages, discounting the amount of positions subject to master netting agreements by a factor depending on the effects of the agreement, and discounting

[9] 75 Fed. Reg. 80188-90 (Dec. 21, 2010).

swaps by 80 percent if they are cleared or subject to daily mark-to-market margining.[10] The thresholds would be $2 billion in daily average current uncollateralized exposure plus potential future exposure in all the major swap and security-based swap categories, except the threshold for the rate swap category would be $6 billion.

Coalition Position

The Coalition generally supports the Commissions' proposed tests for determining "substantial position." In particular, the Coalition supports (i) the accounting consideration of the exposure reducing and risk-mitigating effects of netting in accordance with current industry practice and posting of collateral in determining "aggregated uncollateralized outward exposure" and (ii) the adjustments for netting agreements and daily mark-to-market margining or clearing by a registered clearing agency or derivatives clearing organization in determining "aggregate potential outward exposure."

The Coalition recommends the following:

- The Commissions should explicitly establish a presumption against imposing major participant and swap dealer regulations on end-users. As Congress and the Commissions have made clear, very few end-users should be caught up in these definitions.

- The Commissions should clarify in the text of the rule that non-cash collateral may be considered in the calculation to determine aggregate uncollateralized outward exposure. The types of collateral commonly posted by end-users can vary from cash and liquid securities to accounts receivable for physical assets such as real estate, equipment, inventory, and intellectual property. End-users frequently choose to post the latter forms of collateral when available as these are often already securing loan facilities that derivatives are hedging. Cross-collateralization is a well-accepted and understood practice because it poses no demands on a posting end-user's liquidity.

- The Commissions direct that if swaps are subject to a credit support agreement ("CSA") threshold, the CSA threshold in its entirety should count toward the potential future exposure calculation.[11] This could vastly overstate an entity's future exposure. For example, if the actual potential future exposure is $1 million, but the CSA threshold is $100 million, the potential future exposure would be required to be calculated at $100 million, even though it is in fact much lower. We believe it would be more appropriate to use the calculated future exposure amount, unless the calculated amount exceeds the CSA threshold, in which case, the CSA threshold should be used.

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[10] 75 Fed. Reg. 80191-93 (Dec. 21, 2010).

[11] 75 Fed. Reg. 80192 n.13 (Dec. 21, 2010).

- The Commissions should index the thresholds to the appropriate measure of inflation. Failure to index the thresholds could lead to more and more entities being regulated as major participants over time, even as the economy and the banking sector grow in their ability to absorb counterparty losses.

Hedging or Mitigating Commercial Risk

The major participant definition excludes non-swap dealers who maintain a substantial position in swaps, but hold those positions for "hedging or mitigating commercial risk." As the Coalition stated in its ANPR Comment, the definition of "hedging or mitigating commercial risk" should be interpreted broadly to incorporate all risks associated with entities' operations, including, but not limited to, interest rate risk, currency risk, credit risk, equity price risk, and risks arising from the purchase, ownership, production, storage, sale, financing, or transportation of commodities. In a 2009 survey, the Bank for International Settlements found that the top risk hedged with over-the-counter ("OTC") derivatives is foreign currency risk, followed by interest rate risk.[12] It is imperative that all of these forms of hedging are excluded from the substantial position calculation in the first major participant definition, as well as protected by the end-user exemption from clearing requirements.

This reading is consistent with both the Dodd-Frank Act's legislative history and text. Chairmen Lincoln and Dodd emphasized in a letter to Chairmen Frank and Peterson 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 employ the end-user exemption for their hedging activities.[13] This reading harmonizes with subparagraph D of the "major swap participant" 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 . . . ."[14] By describing hedging by end-users linked to their financing activities 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.[15] With respect to the first major participant definition, the Commissions determined that the nature of the entity—whether it be a financial entity or non-financial entity—does not matter with respect to which entities' activities are excluded under the hedging

[12] *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.

[13] 156 CONG. REC. S 6192 (daily ed. July 22, 2010, letter from Senators Lincoln & Dodd to Representatives Frank & Peterson).

[14] Dodd-Frank Sec. 721(a)(16) (emphasis added).

[15] *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").

exclusion. Instead, the exclusion would look to "whether the underlying activity to which the swap relates is commercial in nature."[16]

The CFTC has proposed a "facts and circumstances" test to determine when a swap qualifies as "hedging or mitigating commercial risk" for the "major swap participant" definition. The test would be based on the conditions at the time the swap was entered, taking into account the entity's "overall hedging and risk mitigation strategies." Swaps used for speculation would not be excluded from the major swap participant tests. The proposal "covers swaps hedging or mitigating any of a person's business risk, regardless of their status under accounting guidelines or the bona fide hedging exemption."[17]

For the "major security-based swap participant" definition, the SEC has taken a slightly different tack. The SEC has proposed that "hedging or mitigating commercial risk" would require that a security-based swap position be "economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise."[18]

Coalition Position

The Coalition agrees with the Commissions' assessment that "positions established to hedge or mitigate commercial risk may qualify for the exclusion, regardless of the nature of the entity—*i.e.*, whether a financial entity (including a bank) or a non-financial entity."[19] We also agree with the premise that "whether an activity is commercial should not be determined solely by the person's organizational status as a for-profit company, a non-profit organization or a governmental entity" and that the "determinative factor should be whether the underlying activity to which the swap relates is commercial in nature."[20]

The Coalition appreciates the CFTC's interpretation that "hedging or mitigating" risk includes bona fide hedging, hedging for accounting purposes, and all other hedging and mitigating of business risks, regardless of their status under the accounting guidelines or bona fide hedging definition.

The Coalition agrees that "economically appropriate" is the correct standard and urges the SEC not to adopt hedge accounting as the standard, or to require companies to undertake effectiveness testing in order to demonstrate economic appropriateness. With more than 1,000 pages of

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[16] 75 Fed. Reg. 80194 (Dec. 21, 2010).

[17] 75 Fed. Reg. 80195 (Dec. 21, 2010).

[18] 75 Fed. Reg. 80195 (Dec. 21, 2010).

[19] 75 Fed. Reg. 80194 (Dec. 21, 2010).

[20] *See* 75 Fed. Reg. 80194 (Dec. 21, 2010).

accounting guidance, the hedge accounting standard is complicated and burdensome, and swaps can be and are used for commercial risk mitigation without meeting this standard. Private companies do not apply hedge accounting. Public companies apply it only when necessary and may choose not to apply it in certain circumstances. Because of the rigors associated with the hedge accounting standard, however, the Coalition agrees that if swaps do meet the standard, they automatically should be treated as hedges for the purpose of Dodd-Frank Title VII.

The Coalition does not agree, however, with the Commissions' position[21] that the use of the word "mitigating" within the major participant definitions was not intended to mean something significantly more than "hedging." We are not advocating for a radical expansion, but we do believe that Congress used the additional word for a reason and thus it needs to be given meaning in interpreting this statutory language. There are long-established risk-reduction strategies for end-users that may not be clear hedges but are certainly intended to mitigate risk. If this concept is too narrowly drawn, then uncertainty will be created, which will impair the swap markets as well as the ability of end-users effectively to use swaps to control risk. Such uncertainty could lead to inefficiencies that will increase costs or risks, without providing any protections to the markets.

The Coalition recommends:

- That the availability of the exclusion for swaps entered into to hedge or mitigate commercial risk should not rely on a significant documentation burden. End-users should be given flexibility to adopt internal procedures to substantiate that swaps were entered into to hedge or mitigate commercial risk.

- That the Commissions adopt a final definition of "commercial risk" similar to the one which we understand to include, among other things, interest rate risk, currency risk, credit risk, equity price risk, and risks arising from the purchase, ownership, production, storage, sale, financing, or transportation of commodities, as well as "risks associated with financing activities engaged in by end-users." Furthermore, the CFTC should adopt the SEC's view that commercial operations include activities incidental to those that arise out of the ordinary course of an entity's commercial operations.[22]

- That the Commissions clarify that hedging risks in the aggregate would fall under the definition of hedging or mitigating commercial risks. Often, the commercial risks faced by companies are too small to hedge individually (*e.g.* small cash flows) in a cost effective way as dealer counterparties often have to pass on certain fixed operational costs associated with handling each transaction even if the transaction is small. Therefore, companies may choose to aggregate smaller risks together in order to hedge with a larger transaction. In such cases, the transactions are hedging and mitigating

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[21] 75 Fed. Reg. 90194 n.127 (Dec. 21, 2010).

[22] *See* 75 Fed. Reg. 80195 n.130.

commercial risks and are economically appropriate in the aggregate. Conversely, companies may choose to hedge a portion of a particular risk or enter into multiple swaps to hedge a single risk. Each of these hedging strategies should be treated as "hedging or mitigating commercial risk."

- That hedging for affiliates be treated as "hedging or mitigating commercial risk." It is often the case that an end-user's hedging will be centralized in one or more treasury entities that face third-party swap dealers. In these instances, a treasury hedging entity will enter into a swap with a third-party swap dealer to hedge or mitigate a risk of an affiliated company. In some cases, there will be a transfer of risk through an internal swap with the affiliated entity that holds the risk being hedged. These treasury hedging entities should be permitted to treat swaps entered into to hedge an affiliate's risk as "hedging or mitigating commercial risk." Further, as many end-users have global operations, these treasury hedging entities may hedge the risks of both U.S. and non-U.S. affiliates. Assuming the treasury hedging entity and the affiliates in which the risks arises consolidate for accounting purposes and result in reduced risk for the consolidated parent company, it should not matter, for purposes of determining whether a risk should be excluded from the first major swap participant definition, whether the risks arise in an offshore or an onshore affiliate.

- That the hedging of commercial risks not be limited to hedging of non-financial commodities. The Commissions requested comment on whether the risk mitigation exclusion should be limited to non-financial commodities. Companies unequivocally believe this would be inappropriate, and contrary to congressional intent. Given that non-financial commodities represent a significant minority of the types of transactions end-users do, we believe such an exclusion would effectively eliminate the end-user exemption for many companies and could lead to end-users unintentionally falling within the first major participant definition.

- That the Commissions clarify for purposes of the hedging exemption short-dated (*e.g.*, quarterly) foreign exchange forwards which are used to hedge operational cash flows. These transactions do not use hedge accounting because they expire at or prior to the end of each accounting quarter. Nonetheless, these short-dated forwards are used to hedge and mitigate commercial risk.

- That the Commissions provide for a transition period. Many of the requirements that depend on these key definitions will require companies to undertake significant preparation. Companies are not yet in a position to even start those preparations because the market has not evolved to implement Dodd-Frank's mandates. The Coalition encourages the Commissions to extend the implementation timelines for many of their proposed rules to be commensurate with the affected entities' ability to comply.

Major Participant Definition 2: "Substantial Counterparty Exposure"

The second major participant definition includes non-swap or security-based swap dealers whose outstanding swaps or security-based swaps create "<u>substantial counterparty exposure</u> that could have serious adverse effects" on the U.S. banking system or financial stability.

"Substantial Counterparty Exposure"

As the Coalition suggested in its ANPR Comment, it is important to recognize that a portfolio's size alone is not indicative of whether a firm's derivatives use poses systemic risk. We believe that the Commissions 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, including physical asset holdings, and collateral); (ii) whether the trades are for the purpose of hedging or speculation; and (iii) the interconnectedness of the firm.

The proposed rule would account for all of a person's current swap or security-based swap positions and potential future exposure, without reference to "major" categories and without excluding hedging positions or ERISA plan positions. The rule would set the major swap participant thresholds at $5 billion of current uncollateralized exposure and potential future exposure of $8 billion, across all swap positions. For major security-based swap participants, the thresholds would be set at $2 billion of current uncollateralized exposure and potential future exposure of $4 billion, across all security-based swap positions.[23]

Coalition Position

It is imperative to keep in mind the Dodd-Frank Act's overarching goal—to reduce systemic risk. A counterparty's true exposure and the risk it poses to the system only can be determined by looking at offsetting positions and collateral, the purpose behind its trades, and the potential it has to affect other parties in the system.

The Coalition recommends:

- Just as the Commissions understand the term "substantial position" to focus on a swap participant's net position, the Commissions should understand "substantial counterparty exposure" as referring to net exposure likely to create systemic risk. The Act does not provide guidance on the definition of "substantial counterparty exposure," but in its guidance regarding "substantial position," it states that the Commissions "may take into consideration the value and quality of collateral held against counterparty exposure." We applaud the Commissions for doing so in the proposed rule.

- The Commissions should differentiate between swaps held for hedging and mitigating risk versus swaps used as speculative trades when determining "substantial counterparty exposure," as they do not pose the same degree of risk. While the Commissions acknowledge, "we would expect [certain hedging positions] to pose fewer risks to counterparties and to the markets as a whole than positions that are not for purposes of hedging," the Commissions nonetheless treat hedging positions the same as speculative

[23] 75 Fed. Reg. 80197-98 (Dec. 21, 2010).

positions for purposes of determining major participant status under the "substantial counterparty risk exposure" test.[24] By definition, hedges and risk mitigation strategies are used to reduce risk, while speculative trades are used to take on risk. Swaps held for hedging do not affect a firm's enterprise value—when its hedges are down, the underlying hedged item is up, and vice versa. The Coalition believes that the Commissions should exercise their discretion to exempt hedging positions from the "substantial counterparty exposure" calculation for the reasons stated in the rulemaking notice and repeated above. If a counterparty directly or indirectly actually holds a physical asset position, by definition, there are fewer risks. If the goal is to mitigate systemic risk, then the proposed test could be overreaching in including hedges of commercial risks.

- The CFTC and SEC should adopt a uniform definition of "speculation." Currently footnotes 128 and 131 of the release offer two different interpretations of what constitutes "speculation." If the Commissions adopt both interpretations, market participants will have to comply with both standards, which will create confusion and inefficiencies. The Commissions should consider the interconnectedness of a swaps entity when defining "substantial counterparty exposure." Chairman Gensler himself has emphasized the importance of interconnectedness, remarking, "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."[25] A major participant with concentrated exposures against a few systemically significant counterparties would potentially pose greater systemic risk than a major participant with diversified exposures spread against many counterparties.

- The Commissions should take into account the following when defining "substantial counterparty exposure":

  - The Commissions should exclude hedges of commercial risks, ERISA hedging positions, and swaps that offset physical asset holdings from the calculation of "substantial counterparty exposure" recognizing that these positions have an offsetting underlying risk such that the combination of the hedge and the underlying risk would not result in substantial counterparty exposure.

  - The Commissions should consider the interconnectedness of the swap participant.

  - The Commissions should index the thresholds to the appropriate measure of inflation. Failure to index the thresholds could lead to more and more entities being regulated as "major swap participants" over time even as the economy and the banking sector grows in their ability to absorb counterparty losses.

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[24] 75 Fed. Reg. 80198 (Dec. 21, 2010).

[25] Gary Gensler, *Clearinghouses are the Answer*, WALL ST. J., April 21, 2010.

Major Participant Definition 3: "Highly Leveraged"

The third major participant definition captures any non-swap dealer that is a "financial entity," "highly leveraged relative to the amount of capital it holds," and not subject to Federal banking regulation and that "maintains a substantial position" in any "major" category of swaps or security-based swaps.[26] Such "highly leveraged financial entities" would not be able to exclude positions held for hedging or employee benefit plan positions for purposes of the "substantial position" calculation.

Highly Leveraged

The proposed rule offers two possible ratios of total liabilities to equity to use to determine when an entity is "highly leveraged"—8 to 1 or 15 to 1.[27]

Coalition Position

For two reasons, the Coalition recommends that the Commissions adopt the 15 to 1 standard.

First, we believe the definition of "highly leveraged" should be consistent with the authority granted the Federal Reserve Board of Governors in the provisions of Dodd-Frank Title I to establish the Financial Stability Oversight Council ("FSOC"). Specifically, Section 165(j) requires the Board of Governors to impose a leverage limit of 15 to 1 on any bank holding company or any nonbank financial company it supervises if the FSOC determines that the "company poses a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States."[28]

Following the logic of the drafters of Dodd-Frank that a leverage limit of 15 to 1 is appropriate to mitigate the risk created by an entity that could pose a "grave threat" to the U.S. financial system, the Coalition believes that it would be unreasonable to propose a stricter leverage threshold under the major participant test for nonbank financial end-users. This is especially true for nonbank financial end-users that primarily enter into derivatives to hedge or mitigate their own commercial risks and that are not designated as systemic by the FSOC. Second, while a leverage ratio of 8 to 1 may be appropriate for some nonbank financial firms during normal market conditions, periods of market stress could cause a company that comfortably fits under that threshold to suddenly exceed it. At a time of market stress, sudden designation as a major participant could seriously hinder a company from meeting its obligations. The company would

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[26] See discussion above, under the first major participant definition, regarding the term "substantial position" and the "major" categories of swaps and security-based swaps.

[27] 75 Fed. Reg. 80199 (Dec. 21, 2010).

[28] Dodd-Frank Act Sec.165(j)(1).

need to use precious resources to meet capital and collateral requirements, even when those resources might otherwise serve as an important buffer against deteriorating market conditions.

As such, of the two proposed options, we urge the Commissions to use the 15 to 1 standard. This ratio would reflect other provisions of Dodd-Frank intended to contain systemic risk. It would also provide an adequate cushion for a market-stress related increase in leverage unrelated to a company's balance sheet management, but solely a function of market declines in the equity value of the company.

Major Swap Participant Captive Finance Exception

The "major swap participant" (but not "major security-based swap participant") definition provides an exception for captive finance companies—those 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, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company."[29]

Coalition Position

Manufacturers for whom this exception was designed are concerned that this provision could be interpreted in a manner that would unintentionally preclude them from qualifying for the exception. These manufacturers, in addition to selling products that they produce, also sell products that they do not manufacture, but that are intimately connected to the sale and to their core mission of facilitating sales of the manufactured product. Several examples serve to illustrate the issue:

- Most of these companies sell implements that are used with their product. For example, the captive finance unit of a tractor manufacturer might finance a rake or a backhoe as part of its overall sale and financing package. The sale and financing of the implement is essential to the sale of the tractor itself, especially given that one could not reasonably be used without the other.

- In order to facilitate a sale of a new car, a car manufacturer might purchase the buyer's used car. The car manufacturer may then sell and finance that used car. In such situations, though the captive finance unit is financing items that it did not manufacture, doing so is critical to the sale of its own manufactured goods, as the purchaser may not otherwise have sufficient resources to pay for the new car if indeed they are unable trade-in their existing car.

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[29] CEA Sec. 1a(33)(D).

- When a manufacturer of boat engines finances the purchase of an engine, it is required as a matter of maritime law to finance the purchase of the entire vessel. Though it did not manufacture the vessel, its financing is intimately tied to the sale of the engine itself.

- A manufacturer of products that consist of many components (*e.g.*, airplanes and cars) may source these components from other manufacturers. In so doing, it becomes difficult to precisely define what percentage is manufactured by the parent company. A common sense approach would imply that the final product is in fact wholly manufactured by the manufacturer regardless of the sources of parts, components, and accessories.

In each of the examples above, the financing offered by these captive finance units is essential to the sale of their manufactured goods.

We urge the Commissions to clarify that such ordinary business activities do not preclude a company from utilizing the captive finance exception. We also urge that the Commissions clarify that the captive finance company exemption applies to finance companies that have been purchased in the last three years. The Commissions should provide that they meet the "primary business" test by looking at their current financing activities and not their legacy activities, because their old financing activities necessarily would not relate to the products or services of their new parent and affiliates.

Major Participant Limited Designation

Similar to the proposed "swap dealer" and "security-based swap dealer" definitions, under the major participant proposal, an entity meeting the definition of a major participant would be designated a major participant for all categories of swaps or security-based swaps. To be designated a major participant for only a limited number of categories, the entity would have to apply to the appropriate Commission for relief.[30]

Coalition Position

The Coalition believes that it would be more appropriate, and more in line with the intent of the Dodd-Frank Act, to designate major participants, swap dealers and security-based swap dealers as such for each category of swap or security-based swap, rather than requiring designated entities to apply for a limited designation. Doing so would ease a potential regulatory burden, while not at all diminishing the objective of containing systemic risk.

Affiliate Issues

Major Participant Control Relationship Aggregation

The Commissions request comment regarding whether the Commissions should aggregate positions when one entity controls another entity, and if so, how "control" should be defined for

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[30] 75 Fed. Reg. 80200 (Dec. 21, 2010).

that purpose, and whether aggregation should apply only when the controlling company provides guarantees for its subsidiaries.[31]

Coalition Position

The Dodd-Frank Act relies on the Federal Deposit Insurance Act's definition of control[32]: "(2) Any company has control over a bank or over any company if—(A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company; (B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or (C) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company."[33]

The Act cautions, however, that if "context otherwise requires," then the term "control" should be interpreted differently than in the FDI Act.[34] In this instance, "control" should be interpreted more narrowly than under the FDI Act. If Entity A owns only twenty-five percent of Entity B, it would be inappropriate to impute all of the risk of Entity B's swaps positions on Entity A when calculating Entity A's overall position. In this context, it makes more sense to attribute Entity B's positions to Entity A only when Entity A owns all of Entity B, or at least when Entity B is consolidated with Entity A for accounting purposes, and exercises actual control over Entity B, both in terms of ownership and management. Only in that circumstance will Entity A actually take on increased risk.

The Coalition urges the Commissions to regulate carefully in this area and to avoid aggregating the positions of affiliates unless there is actual control both in terms of ownership and management.

Joint Ventures

The Coalition also requests that the Commissions clarify that for calculating "substantial positions" and "substantial counterparty exposures," the Commissions will not aggregate the

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[31] 75 Fed. Reg. 80201-02 (Dec. 21, 2010). Note that, if positions are aggregated when a parent is the majority owner of a subsidiary entity for the "substantial position" and "substantial counterparty exposure" analyses, questions would be raised regarding which entity should bear the burden of clearing, trade execution, reporting, capital, margin, and business conduct requirements.

[32] Dodd-Frank Act, Sec. 2(18).

[33] 12 U.S.C. § 1841(a)(2).

[34] Dodd-Frank Act Sec. 2.

positions of entities with non-consolidated joint ventures. In such cases, a non-consolidated joint venture typically enters into its own swaps and the joint venture swaps are not reflected on the balance sheet of the minority-holder in the joint venture.

Pension Funds

Also, the Coalition urges the Commissions explicitly to clarify that the swap positions of a pension fund (and the advisers to a fund, if such advisers are affiliated with the sponsor) are not to be aggregated with the swap positions of the sponsoring entity when making major participant calculations, as mandated by Title VII.

Application of Major Participant Definitions to Individual Entities within Affiliated Group

The Coalition suggests that the Commissions apply the major participant designations in a targeted manner, designed to avoid regulation of end-user trades. A corporation with multiple affiliated entities may be designated as a major participant, but also include other non-financial entities performing discrete functions that engage in swaps activities solely to hedge their commercial risk or their affiliated entities' commercial risk. Assuming that a control relationship is found to exist between that larger entity and affiliates, the Coalition believes that it would be appropriate to exempt from major participant regulation those affiliates that would otherwise qualify for the end-user clearing exemption. Similarly, entities in a corporate group used by the parent corporation to hedge the commercial risks of other affiliates in the same corporate group also should qualify for the end-user exemption.

The notice of proposed rulemaking contemplates an exemption for certain affiliates of a major participant. The notice states that, even where a subsidiary's positions are attributed to a parent for purposes of major participant calculations, "there still may be questions as to whether the requirements applicable to major participants—*e.g.*, capital, margin and business conduct—should be placed upon the parent or the subsidiary."[35] We agree with the Commissions' determination to question the applicability of these requirements to certain subsidiaries or affiliates and urge the Commissions not to subject end-users to such regulation simply because of the corporate group in which they reside. By looking beyond corporate form to the substance of an entity and the nature of the hedging positions it takes, the Commissions can establish a more equitable distribution of the burdens of regulation, will tie up less working capital that can be put toward job creation, and will promote systemic stability by allowing those affiliate entities that only use swaps to mitigate their risk to continue to do so without increased costs.

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[35] 75 Fed. Reg. 80202 (Dec. 21, 2010).

Application of Major Participant Definitions to Inter-Affiliate Swaps and Security-Based Swaps

The Commissions propose to consider the "economic reality" of transactions between wholly-owned affiliates, "including whether the swaps and security-based swaps simply represent an allocation of risk within a corporate group."[36] The Coalition supports this interpretation, except that it believes that the Commissions should not limit an interpretation of inter-affiliate transactions to those between wholly-owned affiliates. There are legitimate business and regulatory reasons that an affiliate may not be wholly-owned by a parent company. Accordingly, the Coalition urges the Commissions to define inter-affiliate transactions as those between commonly-controlled entities.

Transactions between commonly-controlled affiliates, as well as swap transactions done by one corporate treasury entity to hedge the commercial risk of another entity in the same corporate group, merely represent the shifting or hedging of risk within a corporate group and do not pose any more or any less risk to the economy as a whole. Including such inter-affiliate swaps or affiliate risk-hedging swaps for purposes of calculating the major participant definitions would effectively "double-count" the same swaps, as swaps subsequent to the market-facing transaction simply transfer a swap's risk-mitigation qualities to affiliated entities.

Such an interpretation would acknowledge that a company's corporate structure should not subject it to additional regulatory burdens, especially if that structure does not increase risk to the financial system. This issue is a concern for numerous companies that centralize hedging activities within their treasury divisions using one or more market-facing entities. Such centralization allows companies to concentrate hedging expertise within a corporate treasury function or one or more entities within a corporate group.

Centralization of market-facing swaps through one or more hedging entities allows a corporate group to maximize netting benefits, use collateral efficiently and leverage risk management expertise. For example, if "XYZ Corp." has a subsidiary entity, "XYZ Subsidiary," that has a commercial risk, rather than entering into a swap between XYZ Subsidiary and a financial counterparty, XYZ Corp. (or another designated risk-hedging subsidiary of XYZ Corp.) can enter into the hedge with the financial counterparty. XYZ Corp. (or its designated risk-hedging subsidiary) would also enter into an offsetting hedge with XYZ Subsidiary to transfer the position to the entity that has the risk being hedged. Rather than counting both transactions—the one between XYZ Subsidiary and XYZ Corp. (or its designated risk-hedging subsidiary) and the one between XYZ Corp (or its designated risk-hedging subsidiary) and its financial counterparty—each as separate derivatives for the purposes of the major participant tests, only the market facing transaction—that between XYZ Corp. and its financial counterparty—should be counted.

[36] 75 Fed. Reg. 80202 (Dec. 21, 2010).

The Coalition believes that, for the above-stated reasons, swaps between commonly-controlled entities should not be subject to requirements applicable to major participants, as well as mandatory clearing, mandatory execution on a swap execution facility or designated contract market, real-time reporting, reporting and margin requirements.

Additionally, the Coalition believes that positions held by end-user affiliates that rely on credit support from a major participant parent when entering into a hedge should not be attributed to the parent for purposes of the major participant definition, specifically where such affiliates should still qualify as an end- user if they are entering into the hedges for commercial reasons, to hedge legitimate business risks, and that do not create systemic risk as a result of these hedging activities. Corporate groups may choose to use parental credit support to support an affiliate's obligations under its hedges rather than tie up valuable liquidity resources by providing collateral. . This process can significantly reduce the costs for both the affiliate and the corporate group. At the same time, any credit support provided is not adding systemic risk to the parent, whether or not it is a major participant, because the affiliate could pledge collateral (a very common practice) and presumably qualify for the end user exception, but has chosen not to in order to reduce hedging costs. Hence, such parental credit support should not transform a transaction that otherwise would qualify for the end-user clearing exception into one that does not due to imputation of the transaction to a parent entity. Accordingly, we urge the Commissions to clarify that positions supported by such parental credit support should not be attributed to the parent for purposes of the major participant definitions solely by virtue of the this credit support.

Bankruptcy Issues

The Coalition also requests that the Commissions provide clarity regarding the functioning of the major participant designations in the event of bankruptcy. Many end-users depend on entities that likely will be designated as major participants for credit. Those entities will be reluctant to lend to end-users if they believe there is a chance that, should they foreclose on their end-user borrowers, taking on the end-user's swap positions will force them to post collateral and raise capital. For example, if Major Participant Lender loaned funds to End-User Airline, which used swaps to hedge its fuel costs, and then Major Participant Lender had to foreclose on End-User Airline, currently, it is unclear whether Major Participant Lender would have to post collateral and raise capital for End-User Airline's swap positions until Major Participant Lender could divest itself of End-User Airline and/or its positions.

If the major participant lender does have to raise capital and post collateral once it acquires the end-user's swap positions, major participants will be reluctant to lend to end-users, which will raise the cost of capital for end-users and slow innovation and job creation significantly. To ensure that end-users may continue accessing major participants' capital, the Coalition recommends that the Commissions offer major participant lenders who foreclose on end-users a grace period to divest themselves of the end-user and/or its swap positions, or that the Commissions define an orderly liquidation process that does not force major participants to take on these incremental costs to foreclose on end-user borrowers.

Exclusions

The Commissions ask whether "certain types of entities should be excluded" from the major participant definitions' application.[37] The Coalition suggests that ERISA plans should be excluded from the "major participant" definitions. It is hard to contemplate a counterparty that is less of a risk to the financial stability of the United States or any dealer than ERISA plans. ERISA plans have met their swap obligations to dealers despite the bankruptcy of Fortune 500 plan sponsors, the market crash of 2008, and every other significant financial event since the adoption of ERISA in 1974. There are a number of reasons for the uniqueness of ERISA plans:

- ERISA plans are required to be prudently diversified. In entering into swaps for plans, ERISA requires that plan fiduciaries act solely in the interest of the plan's participants and beneficiaries and with the care, skill, prudence, and diligence that a prudent person familiar with such matters would use.[38]

- "Investment managers" for ERISA plans are required to be regulated entities (registered investment advisers, banks, or insurance companies) that are (1) subject to the highest standard of care under U.S. law; (2) liable for significant financial penalties for failure to comply with relevant provisions of ERISA; and (3) liable in many instances for the acts of other fiduciaries.[39]

- ERISA plan assets are required to be held in trust for future payment, subject to the oversight of a trustee which is typically a U.S. regulated bank.[40]

- Because of the regulatory structure that applies to ERISA plans, subject to one narrow exception, it would be rare—if it occurs at all—for plans to be highly leveraged.[41] It is for this reason that whenever adverse market conditions result in a demand that a plan post collateral (typically high-quality collateral) on its swap or security-based swap, the assets in the plan's portfolio are available to meet that demand.

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[37] 75 Fed. Reg. 80186 (Dec. 21, 2010).

[38] ERISA section 404(a)(1)(B).

[39] ERISA sections 3(38) (investment manager requirements), 404(a) (fiduciary standards), 405 (co-fiduciary liability), 409 (fiduciary liability), 502 (ERISA enforcement).

[40] ERISA section 403(a).

[41] Although not flatly prohibited, plans generally do not borrow (outside of special very narrow circumstances regarding loans used to acquire employer securities in certain types of defined contribution).

- ERISA plans are financially transparent: they typically have third-party custodians report their net asset value to dealers on a monthly basis and are required by law to report their holdings annually to the Department of Labor.[42]

- ERISA plans are not operating entities subject to business-line risks and competitive challenges.

- There is no provision under any law for ERISA plans to file for bankruptcy or reorganization to avoid their financial obligations to counterparties. Even the filing of bankruptcy by an ERISA plan sponsor or the involuntary termination of the plan does not relieve a plan of its financial obligations to counterparties. In fact, in an involuntary termination, the counterparty has a priority claim with respect to the plan's obligation to it.

Because of the foregoing factors, many dealers treat ERISA plans as if they were AAA-rated entities for credit analysis purposes. The low-risk nature of ERISA plans has been reflected in prior CFTC regulations.[43] To date, the CFTC has relied on ERISA's "pervasive" regulation of plans and plan fiduciaries as the reason it does not need to regulate these plans.[44] Regulating ERISA plans as major participants could, at best, result in duplicative regulation, and more likely, result in conflicting regulation that could cause confusion and harm to plans.[45]

Swap Dealer and Security-Based Swap Dealer

The Coalition is concerned that the Commissions' interpretation of the "swap dealer" and "security-based swap dealer" definitions could sweep a large number of derivatives end-users into those categories.[46] The breadth of the proposed definitions and the unreasonably small *de*

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42 *See* Form 5500.

43 *See, e.g.*, CFTC Rule 4.5.

44 *See* 50 Fed. Reg.15868, 15869, 15873 (1985); 58 Fed. Reg. 6371, 6373 (1993).

45 Our comments are limited to ERISA-regulated plans, unless specifically noted otherwise. We are not speaking for governmental plans

46 Title VII of the Dodd-Frank Act 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 definition for "security-based swap dealer" parallels the "swap dealer" definition. The definitions exclude entities that engage in a *de minimis* amount of swap or security-based swap dealing activity in connection with transactions with or on behalf of its

[Footnote continued on next page]

minimis exception could—and likely would—cause end-users to be subject to numerous requirements meant to regulate systemically significant entities which, in fact, could destabilize the economy rather than ensure its proper functioning.

At least three issues relating to the "swap dealer" definition concern end-users:

- First, end-users are concerned that the definition could be read (though we think this is the wrong reading) to deem entities that engage in affiliate trades as "swap dealers."
- Second, the CFTC and SEC's varying interpretations of the term "dealer" create regulatory uncertainty. The CFTC should follow the SEC's lead and interpret the term "dealer" using the traditional dealer/trader distinction that Congress clearly had in mind when drafting these terms.
- Third, the *de minimis* exception is unreasonably low and will not protect end-users generally from being regulated in the same way as true dealers.

Affiliate Transactions

Regarding the first concern, the Coalition appreciates the Commissions' preliminary belief that "swaps and security-based swaps between persons under common control may not involve the interaction with unaffiliated persons that [the Commissions] believe is a hallmark of the elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a

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customers. 7 U.S.C. § 1a(49) (Dodd-Frank Act Sec. 721(a)(21)); 15 U.S.C. § 761(a)(6) (Dodd-Frank Act Sec. 761(a)(6)).

The proposed rule would interpret the term with a loose, "functional" definition, based on an examination of whether an entity fits certain characteristics of a dealer, including: Accommodation of demand for swaps and security-based swaps from other parties; availability to enter into transactions to facilitate other parties' interest in entering those transactions; entering into instruments on their own standard terms or terms arranged in response to another party's interest; and arranging customized transactions upon request or creating new products. 75 Fed. Reg. 80176 (Dec. 21, 2010).

The proposed "security-based swap dealer" would look to the definition of "dealer" under the Exchange Act to identify entities that qualify as "security-based swap dealers," and would take into account the dealer-trader distinction. The proposal notes that dealers typically have a regular clientele, hold themselves out as transacting in securities at a regular place, provide general liquidity services, receive customer property, and furnish incidental advice regarding transactions. 75 Fed. Reg. 80177 (Dec. 21, 2010).

dealer."[47] We further appreciate the Commissions' approach of considering the "economic reality of any swaps and security-based swaps it enters into with affiliates (*i.e.*, legal persons under common control with the person at issue), including whether those swaps simply represent an allocation of risk within a corporate group."[48] We support the Commissions' analysis in this regard, as we think it essential in ensuring that an end-user's corporate structure does not unwittingly categorize it as a swap dealer.

We also believe this is consistent with the legislative intent behind the "swap dealer" provisions in Dodd-Frank articulated by then-Senate Banking Committee Chairman Dodd and Senator Collins:

> Senator Collins: The definition of a swap dealer in the bill includes an entity that "regularly enters into swaps with counter parties 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.
>
> Chairman 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**.[49]

Therefore, the Coalition recommends that the Commissions clarify in the rule's text that inter-affiliate transactions and transactions entered into by one or more centralized hedging entities with its affiliates would not be considered dealing activities so that end-users would not face any ambiguity regarding the treatment of these transactions. Inter-affiliate swap transactions commonly occur when a parent corporation or one or more centralized hedging entities in a corporate group enter into swap transactions with third-party swap dealers for the benefit of other affiliated members in the same corporate group which hold the risk being hedged and then enter into inter-affiliate swap transactions with such affiliated members. Inter-affiliate swap transactions of this nature pose no material risk to the U.S. financial system. It is therefore

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[47] 75 Fed. Reg. 80183 (Dec. 21, 2010).

[48] *Id*.

[49] Colloquy between Senator Collins and Chairman Dodd, 156 Cong. Rec. S 5907 (daily ed. July 15, 2010) (emphasis added).

appropriate to exclude inter-affiliate swap transactions from consideration in the determination of whether an entity's swap positions cause it to be a swap dealer.[50]

The Dealer-Trader Distinction

The Coalition suggests that the CFTC and SEC apply the dealer-trader distinction consistently under the "swap dealer" and "security-based swap dealer" definitions. The proposed rule would apply the dealer-trader distinction to security-based swap dealers, but not swap dealers. Applying the dealer-trader distinction consistently to both definitions would comport with the statutory language and congressional intent and would provide clarity to market participants regarding the application of the rule.

First, it is a basic rule of statutory construction that the same terms used in different parts of an act are presumed to mean the same thing.[51] The language in Dodd-Frank defining "swap dealer" and "security-based swap dealer" is substantially identical, and, thus, should be interpreted similarly.

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50 The Commissions should clarify that the key in determining whether a swap or security-based swap transaction qualifies as an inter-affiliate swap or security-based swap transaction over its lifetime is whether the parties to the swap or security-based swap transaction were affiliated at the time the transaction was originally entered.

51 *Atlantic Cleaners & Dryers v. United States*, 286 U.S. 427, 433 (1932).

Second, both definitions are modeled in part on the definition of "dealer" under the 1934 Securities and Exchange Act ("'34 Act"), evidencing Congress's intent that the CFTC and SEC rely on the established securities law to inform their interpretation of "swap dealer" and "security-based swap dealer." For example, the four elements contained in the "swap dealer" definition set forth in new CEA Section 1a(49)(A) are based upon the definition of "dealer" in Section 3(a)(5) of the '34 Act.[52] In particular the CEA section 1a(49)(C) exception for persons that trade "for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business" is nearly identical to the exception from the definition of "dealer" contained in the securities law.[53] As noted in the proposal, that exception informs the analysis as to who is a "market maker" and provides the groundwork for the "dealer/trader" distinction.[54]

As the proposal states, not all the elements of the securities law definition of "dealer" are directly applicable to the swap market. Nevertheless, the core concept, namely whether a party stands ready and willing to accommodate customer demand by making a two way market in securities, is analogous. The Coalition urges the Commissions to issue an internally consistent final rule, following the SEC's approach.

***De Minimis* Exemption**

The Coalition has urged the Commissions to consider the important role systemic risk mitigation plays in the definition of "swap dealer." Congress's overriding intention when drafting the Dodd-Frank Act was to reduce systemic risk, and this should be taken into account when determining whether an end-user should be deemed a "swap dealer" and subject to bank-like regulation. The *de minimis* exemption[55] should be broad enough to exclude swap dealing

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[52] Because except for the words "security-based" the "swap dealer" and "security-based swap dealer" are identical, each comment referring to "swap dealer" can be read to apply equally to "security-based swap dealer."

[53] Section 3(a)(5)(B) of the '34 Act states that "[t]he term 'dealer' does not include a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business."

[54] As noted in the proposal, at 8688: "[T]he dealer definition has been interpreted to exclude 'traders.' The dealer/trader distinction recognizes that dealers normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have a regular turnover of inventory (or participate in the sale or distribution of new issues, such as by acting as an underwriter), and generally provide liquidity services in transactions with investors (or, in the case of dealers who are market makers, for other professionals)."

[55] The Dodd-Frank Act requires that entities conducting a *de minimis* amount of dealing activity be exempted from the swap dealer and security-based swap dealer definitions. 7 U.S.C.§ 1a(49) (Dodd-Frank Act Sec. 721(a)(21)); 15 U.S.C. § 761(a)(6) (Dodd-Frank Act Sec. 761(a)(6)).

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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.

The Coalition believes that the *de minimis* exemption is too low and can be set higher without posing any systemic risk, while still reasonably meeting a common sense understanding for what would constitute a *de minimis* quantity.

It may be instructive to compare the proposed *de minimis* thresholds with the activities of those who are generally considered "dealers" by the market: In a 2010 ISDA Operations Benchmarking Survey,[56] the average respondent had an "event volume"[57] of close 297K

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The proposed rule would look at several factors to determine whether an entity's activities are "*de minimis*," including: (1) "the aggregate effective notional amount, measured on a gross basis, of swaps or security-based swaps that an entity enters into over the prior 12 months in connection with its dealing activities could not exceed $100 million;" (2) "the aggregate effective notional amount of . . . swaps or security-based swaps, in which the person's counterparty is a 'special entity' . . . that an entity enters into over the prior 12 months could not exceed $25 million; and (3) the entity could not have entered into swaps or security-based swaps . . . as a dealer with more than 15 counterparties, other than security-based swap dealers, over the prior 12 months" (counterparties that are members of an affiliated group would count as one counterparty); and (4) the entity could not have entered into more than 20 swaps or security-based swaps . . . as a dealer during the prior 12 months. 75 Fed. Reg. 80180 (Dec. 21, 2010).

The proposed rule states that when determining which counterparties are members of an affiliated group, the CFTC will look toward groups of entities under "common control" and that report information or prepare financial statements on a consolidated basis. 75 Fed. Reg. 80180 n.43 (Dec. 21, 2010).

[56] 2010 ISDA Operations Benchmarking Survey, *available at* http://www.isda.org/c_and_a/pdf/ISDA-Operations-Survey-2010.pdf.

[57] *Id*. "Event volume" is defined as the number of actions relating to OTC derivatives trades sent to the operations groups for processing which includes: new trades, amendments, terminations, and novations. Importantly, though, it excludes credit events, internal, intra-company, and intra-group trades, or terminations arising from portfolio compression.

annually.[58] If an extremely conservative haircut were made to the number because some of the respondents are large dealers and may be acting on behalf of their own account, 0.10% of the average respondents' event volume still would yield close to 300 transactions a year, or 15 times the threshold being proposed. Alternatively, if we ignore the large and medium size respondents who have tens of thousands of transactions a year and only examine the small size respondents, the latter group still processes over ten thousand events a year, or 500 times the proposed threshold.

It may be worthwhile to perform other comparisons to the current OTC derivatives market, whether by the number of transactions, or by counterparties, or by notional amount. We believe the proposed thresholds are arbitrarily set very low by any common sense understanding of *de minimis* quantity, and would unnecessarily classify many companies, including end-users, as swap dealers. The Coalition recommends that the Commissions consider the costs and benefits of subjecting many counterparties to the substantial regulatory compliance burden of being a swap dealer and the whether the benefit to mitigating systemic risks would be realized through such low thresholds.

Novation

The Commissions appropriately acknowledged that amendments to swaps in which the counterparty remained the same and the underlying item remained substantially the same should not count as a new swap under the *de minimis* tests. The Coalition also recommends that novations of swaps not be considered a new swap for determining how many swaps a party has entered over the prior 12 months.

Swap novations occur when a party transfers an existing swap from one counterparty to another. For example, if an end-user transacts only with those parties to its corporate credit agreement and one of those parties exits the credit agreement, that party also typically desires to exit other parts of the credit relationship, including swaps. In such situations, end-users may agree to novate, or transfer, the swap to a third party bank that remains party to the credit agreement. These transfers simply establish the same swap, but with a different counterparty. In such cases, the key economic features of the swap typically remain the same. In some cases, the pricing of the swap may be adjusted to adequately compensate the new counterparty for the incremental credit exposure. Both the transfer of the swap to a new party and appropriate pricing adjustments

[58] Weighted average of all respondents' activities in Interest Rate, Credit, Equity, Currency Options, Commodity OTC derivatives.

Average Respondent:	monthly	annually
IR	4,752	57,021
Credit	7,868	94,414
Equity	1,470	17,639
Currency Options	3,982	47,786
Commodity	6,731	80,771
		297,632

related thereto, should not be considered new swap transactions for purpose of the *de minimis* exemption.

Application of Introducing Broker and Commodity Trading Advisor Definitions to Certain Affiliate Swap and Security-Based Swap Transactions

During the Coalition's December 21, 2010 meeting with CFTC staff, we discussed several questions raised by the rule proposal pertaining to how certain affiliate transactions will be treated under the "swap dealer" definition. We discussed (1) how the CFTC will treat entities that execute swaps for affiliates under an umbrella entity, and (2) how the CFTC will regard back-to-back trades in which the benefits are transferred to the affiliated entity, or Commodity Trading Advisors.

In certain circumstances, some companies will execute transactions between subsidiary entities and swap dealer counterparties. In such cases, the corporate treasury office of an end-user will often coordinate execution of the transaction, and may participate in or be integral to the hedging strategy. In such situations, the corporate treasury office may be subject to regulation as an Introducing Broker ("IB") or Commodity Trading Advisor ("CTA"), when in fact, it is simply managing risk of the corporate group of which the subsidiary is a part. In some cases, these affiliated entities are wholly owned by the entity within which the corporate treasury office resides. In other cases, the subsidiary may not be wholly owned. In such cases, the affiliated, but not wholly owned subsidiary, relies on the expertise of the corporate treasury in order to prudently manage its risk exposures. The corporate treasury office often readily offers such expertise, because the corporate treasury office bears some portion of the risk exposure of the affiliated entity. In such situations, we urge the Commissions to avoid subjecting the corporate treasury office to regulation as an IB or CTA. Such designations should be isolated to situations in which the corporate treasury office offers advice to entities that are altogether unaffiliated with the entity that ultimately serves as counterparty to the swap.

We also urge that the clearing, margin, and capital requirements of Title VII should not apply to "behind the scenes" affiliate transactions.

Limited Designation

The Dodd-Frank Act provides that entities may be classified as swap dealers or security-based swap dealers for one or more types of swaps or security-based swaps. The Commissions propose that entities must apply for a limited designation; otherwise, swap dealers and security-based swap dealers will be considered as such for all categories of swaps or security-based swaps.[59]

The Coalition believes that it would be more appropriate, and more in line with the intent of the Dodd-Frank Act, to designate swap dealers and security-based swap dealers as such for each

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[59] 75 Fed. Reg. 80182 (Dec. 21, 2010).

category of swap or security-based swap, rather than requiring designated entities to apply for a limited designation.

Eligible Contract Participant

Under the Dodd-Frank Act, no person "other than an eligible contract participant" may enter a swap transaction unless it is exchange-traded.[60] The Coalition reiterates its request from its ANPR Comment that the CFTC use its authority under subparagraph (C) of the ECP definition[61] to further define "ECP" to permit smaller firms to continue to engage in OTC derivatives transactions under the Dodd-Frank Act.

While the Coalition understands the need to prevent the marketing of OTC derivatives to unsophisticated users, we strongly encourage the CFTC to permit smaller, sophisticated firms with legitimate hedging needs to continue to engage in OTC derivatives transactions under the Dodd-Frank Act. Many of these firms have successfully used OTC derivatives prior to Dodd-Frank to manage risks related to their businesses. Given that they have shown themselves to be competent users of OTC derivatives and that they rely on such products to address business risks, we would like the Commissions to consider allowing smaller firms to retain the ability to access the OTC derivatives market.

Access to the OTC derivatives market is important for many firms that do not meet the ECP definition.[62] While it is theoretically possible for these smaller firms to move their hedging activities to exchanges, it is practically unfeasible because they lack the substantial amounts of liquid collateral that exchanges require. Moreover, these small businesses often require individually tailored hedges that are not available on exchanges. Finally, many of these smaller firms are owned by larger, more sophisticated entities, but due to the common business structures in particular industries, it may not be possible or appropriate for the larger entities to manage the risks. In these cases, the smaller firms should be considered as sophisticated a user as the parent companies and allowed to enter into OTC derivatives transactions.

In the past, companies that did not meet the ECP criteria were able to rely upon the 1989 CFTC Policy Statement Concerning Swaps Transactions (the "Policy Statement") to access the OTC derivatives market. The Policy Statement allowed for certain OTC swap transactions to be executed on a bilateral basis, provided the transactions met specified criteria. As a result, smaller companies that do not meet the definition for ECP have been able to efficiently manage their risk

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[60] 7 U.S.C. § 2(e) (Dodd-Frank Act Sec. 723(a)).

[61] Under Subparagraph (C) of the ECP definition, the CFTC has 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 that person."

[62] The ECP definition requires a firm to have a minimum of $10 million in assets or $1 million in net worth.

through OTC derivatives. The ability to rely on this exemption was affirmed by the CFTC's decision in *Khorram Properties v. McDonald* in 2005.[63]

In order to ensure that end-users of all sizes will be able to participate in the OTC derivatives market, we request again that the CFTC affirm the "Policy Statement" by adopting 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.[64]

The Coalition supports the Commissions' assertion that "persons who qualified for exclusions or exemptions to enter into bilateral, off-exchange swaps prior to the Dodd-Frank Act will still qualify to do so with respect to non-standardized swaps under the Dodd-Frank Act."[65] This comment by the Commissions supports the continued validity of the Policy Statement cited above.

If the Commission chooses not to reaffirm the Policy Statement at this time, we would urge the Commission, when considering whether a subsidiary qualifies as an ECP, to look through to the sophistication, assets, and net worth of the majority owner or controlling entity of the subsidiary.

Finally, the Coalition would like to express its support for the Commissions' determination to grandfather pre-existing entities for the "eligible contract participant definition." We recommend, however, that the CFTC look at how grandfathering might be extended to real estate entities whose legal names change in certain transactions, but to which grandfathering should apply in the same way.

Policy

The Coalition was concerned to see that the Commissions stated that "it is appropriate to incentivize the use of central clearing and daily mark-to-market margining as practices for helping to control risks."[66] Throughout the debate on the Dodd-Frank Act and the regulatory

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[63] CFTC Docket No. 04-R045 (Oct. 13, 2005).

[64] *See* the CFTC's Policy Statement Concerning Swap Transactions, 54 FR 30694 (July 21, 1989).

[65] 75 Fed. Reg. 80184 (Dec. 21, 2010).

[66] 75 Fed. Reg. 80174, 80183 (Dec. 21, 2010).

implementation process, the Coalition has emphasized that it is neither an appropriate exercise of authority nor a necessary one to use mechanisms within the legislation as means of disincentivizing companies from engaging in uncleared OTC swap transactions. Over-the-counter transactions allow market participants to hedge very specific risks and long-dated transactions that they might not be able to address otherwise.

Though central clearing likely will attract many market participants because of its liquidity, security, and transparency benefits, and OTC transactions will be subject to margining requirements to offset their risks, the Commissions should not seek to burden market participants who choose to use OTC transactions with margin requirements past the point of risk reduction in order to drive them to clearing. Further, the Commissions' policy should acknowledge that end-user hedging activity does not meaningfully contribute to systemic risk. Such an acknowledgment is consistent with Title VII, as evidenced by the very existence of the end-user clearing exemption. Importantly, a policy that creates disincentives to using uncleared OTC derivatives will decrease market stability because some market participants simply will choose not to hedge their risks at all rather than face the increased costs or liquidity burden of cleared transactions, ultimately defeating the market-stabilizing purposes of the Dodd-Frank Act.

Timing

Finally, the Coalition has urged Congress to extend the deadline for the implementation of the Dodd-Frank Act. Given the complexity and sheer number of rules that must be written, the Coalition is concerned that the rulemaking process will not benefit from the attention that is deserved from stakeholders and the Commissions. The Dodd-Frank Act prescribes an entirely new regulatory system for derivatives transactions that ninety-seven percent of end-user companies rely on to manage risk.[67] More time is needed to allow regulators and the public to fully understand the implications of each rule proposal, to offer meaningful comment, and to write rules that will provide clarity and stability to the financial system, and at the same time, promote economic growth and innovation.

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[67] Keybridge Research, *An analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives* at 3, Feb. 11, 2011, available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Coalition-for-Derivatives-End-Users-OTC-Derivatives-Survey_Final-Version-2-11-11.pdf

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,

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