May 17, 2011

Mr. David A. Stawick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

*Via agency website*

**Re: Comment on Proposed Interpretive Order, "Antidisruptive Practices Authority"; 76 Fed. Reg. 14943 (March 18, 2011)**

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" or the "Commission") regarding its proposed interpretive order issued under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") entitled "Antidisruptive Practices Authority." We are glad to work with the CFTC to ensure that the interpretive order reflects legislative intent, while also limiting unnecessary restrictions that may impede the ability for end-users to efficiently and effectively manage their risks.

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.

## Introduction

Section 747 of the Dodd-Frank Act amends section 4c(a) of the Commodity Exchange Act, 7 U.S.C. § 1 *et seq*. ("CEA") to add a new section entitled "Disruptive Practices." The new section states:

> *It shall be unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that—*
>
> > *(A) violates bids or offers;*
> > *(B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or*
> > *(C) is, is of the character of, or is commonly known to the trade as, 'spoofing' (bidding or offering with the intent to cancel the bid or offer before execution).*

In addition, the Commission is given authority to promulgate rules that are "*reasonably necessary to prohibit the trading practices described in paragraph (5) and any other trading practice that is disruptive of fair and equitable trading.*"

The Coalition supports Congress's goal of protecting "fair and equitable trading." In charging the Commission with this task, Congress trusted that the Commission's expertise and good judgment would lead to rules striking the correct balance. We urge the Commission to interpret the statute's ambiguous elements in a manner that reflects this basic principle. As currently proposed, we believe certain elements of the interpretive order could have a detrimental impact on end-users' ability to hedge efficiently and effectively. The interpretive order unnecessarily diminishes or eliminates a company's ability to exercise discretion over its derivatives risk management activities. Therefore, the Coalition offers these comments to ensure important nuances of these risk management activities are taken into account.

**Applicability to End-User Transactions**

Generally, end-user transactions fall into two broad categories: (1) transactions eligible for the end-user clearing exemption, which will not be cleared and likely will be executed off-facility, and (2) transactions not eligible for the end-user clearing exemption, which will be cleared and likely will be executed on-facility. In each case, the application of the proposed interpretive order—and particularly the Commission's interpretation of section 4c(a)(5)(A) "*violating bids or offers*" —could adversely impact end-users' ability to exercise important discretion in the execution of its transactions. In some cases, the absence of such discretion could require an end-user to ignore factors that are important in assessing the most suitable party with whom to transact. Such factors, discussed in greater detail below, relate to margin, non-cash collateral, and default terms, each of which can be relevant to an end-user's choice of counterparties.

**Non-cleared transactions executed off-facility**

End-users that are hedging or mitigating commercial risks will qualify for the end-user exemption from clearing and trading requirements. These transactions generally would not be cleared and would be executed off-facility, which also makes them ill-suited to the Commission's interpretive order.

The Commission acknowledged this issue in its release by noting that comments were concerned about, and sought clarification on, how the prohibition against violating bids and offers applies in swap markets, open outcry pit trading environments and over-the-counter markets.[1] However, the proposed interpretive order is not clear on whether section 4c(a)(5)(A) is applicable to this category of transactions. Instead, using terms such as "*trading environment*," "*trading platforms*," "*trading venue*," and "*markets*," the interpretive order language is vague and could be interpreted as applying to <u>all</u> swap transactions, including end-user transactions. In doing so,

[1] 76 Fed. Reg. 14943, 14945 n. 31, 32, 33 (March 18, 2011).

the proposed interpretive order only increases ambiguity, rather than providing participants much needed clarity.

**Best execution must incorporate multiple factors:**

To understand the impact of applying section 4c(a)(5)(A) to non-cleared transactions executed off-facility, we have to understand how corporate treasurers have a fiduciary duty to optimize numerous factors — not solely the transaction price of a particular derivative — in achieving "best execution."

*Best execution must incorporate credit and legal terms*

Non-cleared transactions often incorporate important credit and legal terms. Different dealers offer different terms based on individualized credit assessments and banking relationships. These terms could include, but are not limited to, the following:

- the posting of variation margin when the mark-to-market value exceeds a defined and negotiated threshold;
- allowances for non-cash collateral, including illiquid forms of collateral such as property, and the ability to cross-collateralize swap and loan exposures;
- the posting of upfront collateral;
- relevant events of default;
- whether cross-default or cross-acceleration applies;
- the impact of defaults by affiliated entities; and
- the impact of defaults on other transactions.

In choosing a dealer counterparty to execute a product, an end-user will consider the most suitable combination of transaction price and transaction terms for its hedging or delivery needs. An end-user does not focus on transaction price alone. Doing so could require an end-user to take on legal and credit risks, items that ultimately could subject the end-user to significant costs. It is critical that end-users retain the ability to select the bank that provides the best terms, as judged from the perspective of the end-user. We therefore urge the Commission to clarify that an end-user is not required to focus exclusively, or even primarily, on transaction price when determining its own optimal terms.

*Best execution must manage counterparty credit exposure*

When executing non-cleared transactions, end-users minimize counterparty credit exposure by dispersing derivatives transactions across multiple swap dealer counterparties. This practice allows end-users to minimize their credit exposure to any single dealer. This practice is especially helpful if one swap dealer counterparty, because it consistently offers superior pricing, earns a disproportionate share of business. Such a situation can leave the end-user with disproportionate or concentrated counterparty exposure to that single bank. End-users may pay a premium to other banks in order to avoid the concentration of risk in a single counterparty relationship. The Commission's interpretive order should not dissuade end-users from prudently managing their risk in this way. Yet, the interpretive order inappropriately incentivizes dealers

to focus on price, , thereby creating increased concentration and credit risk in the market at large—a result surely not envisioned by Congress' passage of the Dodd-Frank Act.

*Best execution must manage overall banking relationship*

Rather than focusing exclusively on transaction price of a derivative, end-users optimize across banking products when assessing which banking transactions, in combination, are most economically beneficial. End-users must examine the entire banking relationship including derivatives (e.g., clearing and trade execution) and non-derivatives transactions, (e.g., lending and other services). For example, in borrowing floating-rate debt from a lender that is also a potential hedging counterparty, an end-user may want to optimize both the credit spread on the loan and the credit charge on the hedge to achieve best overall pricing. The Commission's interpretive order could preclude end-users from considering the most economically beneficial combination of transactions, ultimately working at cross-purposes to the objective of maximizing efficiency for the end-user.

In light of these multi-faceted considerations, an interpretation that precludes end-users from exercising discretion in its counterparty selection could force end-users to make sub-optimal decisions when determining the most suitable swap counterparty on a given transaction. Indeed, such a prescriptive approach could create conditions for end-users that increase legal and credit risks and that could disrupt an end-user's ability to achieve best overall pricing.

**Impact on bids and offers in the market:**

The Commission has sensibly set limits on the applicability of section 4c(a)(5)(A) to a single trading "environment," "platform," "market," or "venue":

> *The Commission recognizes that at any particular time the bid-ask spread in **one trading environment** may differ from the bid-ask spread in another trading environment. Accordingly, in the view of the Commission, section 4c(a)(5)(A) does not create any sort of best execution standard across multiple **trading platforms** and **markets**; rather, a person's obligation to not violate bids or offers is confined to the specific **trading venue** which he or she is utilizing at a particular time.*[2]

Therefore, a key question for end-users is whether an ad hoc off-facility auction to solicit multiple quotes would fall under the scope of these terms. If so, they would be inappropriately subjected to section 4c(a)(5)(A). In that situation, the regulatory litmus test must be altered, and one standard for consideration is whether "fair and equitable trading" within an ad-hoc auction is distorted by an end-user's execution decision. We believe no such distortion would occur.

The competing quotes and the winning quote are for the benefit of a single end-user. Dealers' quotes are unaffected and unaltered by the end-user's final execution choice since dealers would

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[2] 76 Fed. Reg. 14943, 14946 (March 18, 2011) (emphasis added).

have no knowledge of other dealers' quotes prior to or contemporaneously with the auction.[3] Therefore, all dealers will bid or offer at their normal price levels irrespective of what price the end-user ultimately accepts. In other words, end-user choice does not distort a dealer's incentive to bid or offer at its normal or best price.

While we do not believe that end-users' execution decisions will disrupt trading within short-lived ad hoc auctions or within the wider market, we note that, at a minimum, the Commission does not have sufficient information to set regulations based on the notion that counterparty determinations based on non-price factors would be market-distorting.

If transaction pricing disseminated through real-time reporting distorted other market participants' ability to discover the true market price, such a distortion could affect the wider market prospectively. However, several factors make it reasonable to believe that there is no prospective impact via the real-time reporting rule. First, we have already noted that end-users generally do execute at the best transaction price. Any decision to do otherwise is exceptional in the context of end-user transactions and even more exceptional in the context of the market as a whole. Second, we expect that once data is available from swap data repositories, it will reveal that end-users' transactions tend to be smaller in size than transactions between dealers, and therefore have less impact on price discovery. Third, end-users' transactions tend to be customized to their idiosyncratic commercial risks and are different from "benchmark" transactions that meaningfully contribute to price discovery. Taken together, it would stretch reason to conclude that this category of transactions could distort price discovery.
As we have discussed, end-user choice does not disrupt ad-hoc auctions or the wider market, either contemporaneously or prospectively. When taken together with the aforementioned benefits of end-user discretion, we believe the benefits of promoting such discretion are clear. We therefore respectfully ask that the Commission interpret the statute in a manner that promotes, rather than limits, end-user discretion.

**Cleared transactions executed on-facility**

Although many end-users will be exempted from the Dodd-Frank Act's clearing and trading requirements, there may be circumstances in which end-users may centrally clear trades and execute them on-facility. Such circumstances may arise, for example, if:

- the end-user is a financial end-user;
- the end-user has a subsidiary that is deemed a financial entity;
- the end-user chooses to centrally clear and execute on-facility because its working capital resources allow it to manage cash collateral requirements efficiently; or
- the end-user is incentivized to centrally clear because of potentially prohibitive costs on bilateral transactions as a result of, for example, heightened dealer capital requirements.

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[3] Real-time reporting will give them some ability to discern market pricing only immediately post trade.

Regardless of the reasons an end-user might centrally clear and execute on-facility, any prescriptive execution requirement could unnecessarily limit an end-user's discretion to exercise judgment and could have unintended consequences. As previously noted, end-users do typically execute at the best transaction price. Frequently, the best transaction price correlates to the best *overall, or true* price (i.e., when other factors are incorporated). However, flexibility and choice are important to allow end-users the ability to ensure optimal outcomes in all circumstances.

In the case of cleared transactions, this could mean taking the end-users' clearing and banking relationships into account in choosing swap counterparties. Because clearing members will incur non-trivial fixed costs in servicing end-users' clearing needs, end-users periodically may choose to execute with their clearing members to make the clearing relationship economically viable for both parties. By prescribing a restrictive interpretive order, the Commission may inadvertently make access to clearing services much more difficult for smaller end-users.

Finally, if a transaction submitted for clearing is not accepted by a clearinghouse, it is reasonable to expect the transaction to be conducted bilaterally under a master agreement. In such cases, the identity, credit quality, credit and legal terms of the swap dealer counterparty become important. In other words, while an end-user theoretically should be agnostic to its swap dealer counterparty for cleared transactions (because trades ultimately novate to a clearinghouse), in practice, the identity of end-users' execution counterparties will continue to be relevant. We urge the Commission to take such nuances into account by allowing market participants discretion in selecting its swap counterparty.

**Impact on bids and offers in the market:**

In most circumstances, end-users will execute at the best transaction price for cleared transactions on a trading facility, and will only do otherwise in limited circumstances. Therefore, such transactions constitute only a small part of the overall market. The Coalition believes that preserving end-user choice will not meaningfully skew or distort publicly available pricing information. Indeed, in a market that is expected to include many counterparties, the small quantity of transactions concerned should not prevent dealer counterparties from continuing to compete with their best bids and offers. However, we think this issue should be further examined after data submitted to swap data repositories has been evaluated and should be re-examined if significant quantities of transactions are not executed at the best transaction price.

**Conclusion**

We thank the Commission for the opportunity to comment on these important issues. The Coalition looks forward to working with the Commission 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 Commission to discuss these issues in more detail.

Sincerely,

Business Roundtable
Commodity Markets Council
National Association of Corporate Treasurers
National Association of Real Estate Investment Trusts
The Real Estate Roundtable
U.S. Chamber of Commerce