June 3, 2011

By Electronic Submission

David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 25274 (May 4, 2011)

Dear Mr. Stawick:

Gavilon, LLC ("Gavilon") submits this letter in response to the Commodity Futures Trading Commission's ("CFTC" or "Commission") notice reopening and extending the comment period for many of its proposed rulemakings to implement the provisions of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). We appreciate the additional time the Commission has provided to market participants to comment on the comprehensive new framework for the regulation of swaps. Gavilon is a signatory to other specific comment letters relating to definitions (RIN 3038-AD06), end user exemption (RIN 3038-AD10), and transition exemptions for agricultural options that are being submitted as part of your extended comment period. Because many of these proposed rules will, in Gavilon's view, create serious practical and technical problems, including significant market disruptions and dislocations, Gavilon additionally submits these comments.

For the Commission's convenience, we summarize our comments and recommendations below:

- In developing its implementing regulations, the Commission should eschew attempting to implement a transaction-by-transaction regulatory approach, but instead recognize that the hedging needs of end users and the commercial risk they are hedging through derivatives transactions are rarely perfectly matched on a transaction basis, but are instead managed on a portfolio basis.

- The Commission should recognize that commodity merchants that are engaged in the business of buying and selling commodities and managing the associated risks are not in the business of dealing in swaps. The Commission should clarify that neither swap activity that is ancillary to a cash market business nor proprietary trading constitutes swap dealing.

- Gavilon respectfully recommends that the Commission revise its proposed rules (at a minimum, the end user exemption, swap dealer definition, and bona fide hedging portion of position limits) in a consistent manner that will eschew the approach of evaluating each derivative transaction in favor of a categorical approach whereby commercial entities are able to continue their current risk management and trading activities.

I. Gavilon's Commercial Commodity Operations

Gavilon is a leading commodity management firm that connects producers and consumers of food and energy commodities through its global supply chain network. Our operations currently include more than 1,800 employees at 300 locations on six continents. This scale enables Gavilon to be a leading provider of essential commodities and related services across the globe. For example, Gavilon:

- distributes approximately 30 million metric tons of grain and 8 million metric tons of ingredients;
- manages origination and transportation of fertilizer products from over 20 countries;
- has capacity to store 5 million barrels of crude oil, 14 billion cubic feet of natural gas, and 300,000 barrels of refined products;
- markets one billion cubic feet of natural gas per day and 1.6 million gallons of renewable fuels per day.

Gavilon manages the commercial risks it incurs in connection with the purchase and sales of these commodities with exchange-traded and over-the-counter ("OTC") derivatives. Because many of these commodities do not have a directly related exchange-listed futures contract, Gavilon relies on the OTC swaps markets to meet its many of it hedging requirements. Gavilon also uses a wide variety of swaps in many areas of our business to help manage risk. For example, we enter into swaps with both producers and processors of dairy products to manage the price risk associated with the transaction for both us and our customer. To take another example, Gavilon owns natural gas transportation capacity. In order to hedge this capacity, Gavilon will enter into natural gas basis swaps. A major factor in determining whether to use futures or swaps for Gavilon is liquidity—effective hedging requires efficient markets, which in turn require liquidity. Sometimes, the liquidity is in futures markets (wheat, corn, crude oil), but other times the liquidity is in the swaps markets (dairy).

II. The Proposed Regulatory Framework Appears to be Commercially Unworkable

Gavilon respectfully submits that the Commission appears to be attempting to implement Dodd-Frank provisions through a transaction-by-transaction regulatory approach that will be

commercially unworkable and will have a negative impact on commercial activity. For example, the proposed End-User Exception to Mandatory Clearing of Swaps requires that a non-financial entity notify the Commission each time it elects to rely on the end-user clearing exception.[1] Also, the proposed Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant" states that swaps "that are held primarily to take an outright view on the direction of the market including positions held for short term resale" do not fall within the definition of *bona fide* hedge and, therefore, may not qualify to be excluded from the calculation of a "substantial position."[2] And the proposed Position Limits for Derivatives limits *bona fide* hedge exemptions to "enumerated hedging transactions."[3]

In order for this approach to be commercially workable, markets would have to be comprised only of perfectly-hedged end users and swap dealers who have perfectly matched requirements in terms of tenor, quantity, and location and who have direct relationships with perfectly matched transaction agreements. However, in the real world the needs of market participants and the available risk management contracts are not so neatly matched. Gavilon buys and sells a wide variety of products for which there is no corresponding futures product (wheat byproducts, products derived from crude oil and natural gas), meaning that our hedging will necessarily be imperfect. For example, when we own physical wheat that is going to be used for livestock feed, we will hedge that using corn futures, which are the best correlated for the feed market. Or, we will use a short heating oil futures position to hedge risk associated with purchases of biodiesel.

Gavilon submits that the Commission's approach does not take into account a large category of commodity market participants – commercial companies, of which Gavilon is one, who serve as "middlemen," also known as "merchants," "merchandisers," or "marketers." These commercial market participants provide a necessary economic function by standing between and matching the disparate needs of buyers and sellers in both the physical and financial commodity markets. In the physical market, they store and transport commodities which helps to smooth the peaks and valleys of supply and demand due to the seasonality of many commodity markets, such as agriculture and energy. Their ownership of these commodities comes with the attendant risks and costs which they manage in a portfolio of positions that includes futures, options, and swaps contracts. These position portfolios cannot be dissected transaction-by-transaction to reveal one-to-one physical to hedge position relationships. Risk management in the real world simply does not work that way.

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1 *See* 75 F.R. 80747 at 80748

2 *See* 75 F.R. 80174 at 80195, n.128

3 *See* 76 F.R. 4752 at 4771

Commodity merchants, as well as producers and processors, use derivatives to optimize their returns on their commodity purchases and sales and to capitalize on trends in supply and demand market fundamentals. In order to accomplish this, they may buy the physical commodity when they already have a sales commitment or they may buy and store the commodity in anticipation of a future sale. Or conversely, they may sell the commodity and wait to buy it when, in their estimation, supply fundamentals indicate lower prices are likely. Among these decisions, is the decision on when and how, or even whether, to hedge these positions. These position portfolios are dynamic and can change on a daily, or even intra-day basis. Many commodities do not have perfectly correlated futures or swaps contracts. Therefore, transactions today may be intended to capitalize on a trend in the market, but may become fully hedged tomorrow, and positions that were fully hedged today may not be tomorrow. But overall, the goal is to manage a portfolio that has minimal risk associated with the positions.

For these reasons, we urge the Commission to take into consideration when issuing the final regulations the overall business of a market participant, rather than considering whether each transaction should be attributed to a "Swap Dealer," a "Major Swap Participant," or an "End-User." We do not believe that Congress intended for the business of commercial entities, like Gavilon, to be excluded from the definition of "hedger" or to be included in the definition of "Swap Dealer." The Dodd-Frank Act specifies that a Swap Dealer is one who engages in the activity of "regularly entering into swaps . . . with counterparties as an ordinary course of business for one's own account," but is not someone who enters into swaps "for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business."[4] Commodity merchants, such as Gavilon, are engaged in the business of buying and selling commodities and managing the associated risks; they are not in the business of dealing in swaps.

In evaluating the proposed rulemakings that are the subject of this extension, we believe that the Commission should carefully weigh an issue that is associated with a number of them—the important distinction between entities that regularly engage in swap dealing as part of a regular business and those that enter into swaps to hedge or mitigate commercial risk or for proprietary purposes. That is, the Commission should distinguish between trading and hedging on the one hand and dealing on the other. In enacting the Dodd-Frank Act, Congress did not seek to sweep within the concept of dealing swap activity that is simply ancillary to a cash market business. Indeed, it expressly sought to avoid "inadvertently pull[ing] in entities that are appropriately managing their risk."[5] Likewise, Congress did not seek to sweep within the concept of dealing proprietary trading where, for example, a merchandiser declines to hedge a physical position in order to take a proprietary view in the market. Rather, Congress sought to

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4 *See* CEA Sections 1a(49)(A) and 1a(49)(C)

5 156 Cong. Rec. H5248 (Jun. 30, 2010) (Dodd-Lincoln Letter).

regulate as swap dealer activity, activity that is generically regarded as "dealing," such as making a market in swaps as part of a firm's "ordinary course of business for its own account or regularly entering into such transactions to accommodate a generalized demand for swaps."[6]

In our case, Gavilon uses swaps and other derivatives products primarily to hedge the risks we incur as a commercial participant and as a merchandiser in the agricultural and energy commodity markets, as well as to trade on a proprietary basis for a profit. In none of these capacities, do we serve as a dealer as that term is commonly understood in the industry or used by Congress. When we act as a counterparty to our physical agricultural and energy market customers, we are providing an ancillary service for the convenience of such customers that is related to their cash market business. This ancillary activity, which allows our customers to hedge or mitigate their commercial risks, is not "swap dealing" that falls within the definition of that term because we are neither are accommodating demand for swaps in general or as a part of our regular business, nor making a market in such transactions in order to profit from the bid-ask price spread.

Likewise, when we enter into swaps to hedge or mitigate some or all of our risks as a merchandiser or to take an outright view on the direction of the market, or even to obtain market exposure, we are acting not as dealers, but as traders.[7] These ancillary activities are discretionary on our part—we do not have to do them, and indeed would probably stop doing so if such activities would make us a "swap dealer." Ironically, we would note that an outcome where Gavilon and other similarly-situated commercial entities stop entering into swaps and options with our customers would concentrate the swaps business in the hands of the fewer number of dealers, and reduce the amount of risk management entered into generally by commercial entities and end users.

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[6] CEA § 1a(49).

[7] While we are concerned that the Commission appears to be taking an expansive view of what constitutes swap dealing, we are also concerned with what appears to be an equally expansive view of what qualifies as a position that is held for the purpose of speculation or trading (and conversely an unduly narrow view of what qualifies as "hedging or mitigating commercial risk"). *See e.g.*, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Dealer," and "Eligible Contract Participant," Joint Proposed Rule*, 75 F.R. 80,174 at 80,195 n.128 (Dec. 21, 2010) ("Joint Proposed Rule") (clarifying that swap positions that hedge other positions that themselves are held for the purpose of speculation or trading are also "speculative or trading positions"). As a middleman or merchandiser in the physical marketing chain, Gavilon engages in transactions in the physical or financial derivatives markets that Commission under the proposed rules would likely regard as "trading" positions notwithstanding the fact that such positions are directly related to our merchandising activities and the fact that we hold significant price risk with respect to such positions. It seems implausible that Congress intended to treat transactions that hedge or mitigate price risk arising from such merchandising activities as those pursued for speculative or trading purposes. We believe that it is important that the Commission not exclude such "trading" positions especially those holding an uncommitted physical position, from the definition of commercial risk.

The CFTC has recognized the distinction between trading and dealing as well as between accommodating risk management needs and dealing with respect to swaps in other contexts. For example, the CFTC's September 2008 Staff Report on Commodity Swap Dealers and Index Traders distinguished between "traders" who use derivatives either to offset or hedge price risks in the cash market or for speculative purposes with "dealers" who offer swaps to third-parties and take on any price risks associated with those swaps, noting that, in practice, "there has been a natural tendency for financial intermediaries (e.g., commercial banks, investment banks, insurance companies) to become swap dealers," because these entities have the capital and market expertise necessary to manage the price risks associated with their dealing activity.[8] We believe that it is important to apply that general distinction here.

In categorizing swap activity of merchant firms like ours, we believe that it is important not to confuse our negotiations with our counterparties to secure mutually agreeable terms with the way a dealer sets terms in such transactions. We also believe that any swaps that we enter into be categorized *ex ante* or at the time they are entered into rather than *ex post,* since the purpose of a transaction in a dynamically changing market is determined at the initiation and does not change as a result of market fluctuations that may ensue. Either error could inadvertently result in treating Gavilon as a swap dealer due to the way we negotiate and enter into swaps or to the way those transactions become change in value after they are entered into.

Finally, we believe that the regulatory framework being considered for applying for hedge exemptions from position limits is also commercially impractical. Currently, market participants engaged in hedge transactions are allowed to apply for hedge exemptions *in advance* of their anticipated need for such exemptions. This approach has the benefit of allowing market participants to plan and manage their current and anticipated hedging needs in advance. The approach contemplated by the proposed rules, by contrast, would require traders that exceed position limits to wait until they exceed such limits and then file detailed reports to the Commission *daily* for every day on which they exceed the limit. We believe that the current approach is superior to the one contemplated in the proposed rules, which would look at each transaction in a portfolio individually and subject positions in portfolios whose hedging characteristics change as a result of market forces to being called into question by the CFTC. The proposed approach would foster uncertainty and make planning more difficult in a dynamically changing market. Alternatively, we would support the views of industry groups

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[8] *Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations*, CFTC at 8-9 (Sept. 2008). Similarly, as part of its implementation of the Dodd-Frank Act, the Securities and Exchange Commission ("SEC") proposed a rule further defining "security-based swap dealer" that explicitly recognizes the difference between "dealing" and "trading." The SEC noted in its proposed rule that because "[t]he definition of 'security-based swap dealer' has parallels to the definition of 'dealer' under the [Securities] Exchange Act . . . [it] would consider the same factors that are relevant to determining whether a person is a 'dealer' under the [Securities] Exchange Act as also generally relevant to the analysis of whether a person is a security-based swap dealer." Joint Proposed Rule, 75 F.R. at 80177.

urging the Commission to consider a less onerous process for collecting information needed to perform market surveillance responsibilities.[9]

In conclusion, we respectfully request that the Commission make clear that entities like Gavilon that enter into swaps to accommodate the commercial risk management needs of their physical customers or to profit from trends in the market not be regulated as swap dealers when it issues the final swap dealer definition. We also support the recommendation of several industry groups that the Commission provide market participants with the opportunity to comment more meaningfully on the proposed new regulatory structure, including:

- re-proposing the Proposed Rules in a manner that reflects, as appropriate, the incorporation of prior public comments;
- allowing for a final comment period of at least 60 days for all the rules in their entirety that runs from the date of the last proposed rule; and
- waiting to be informed by additional data before proceeding with market data-driven rules.

Again, we appreciate this opportunity to submit these comments as part of the extended comment period. If you wish to discuss this or our other submissions, please contact the undersigned at 402-889-4026 and we will arrange a mutually convenient time.

Respectfully submitted,

Lance Kotschwar
Senior Attorney

[9] *See e.g.*, FIA Comment Letter, Position Limits for Derivatives (RIN 3038-AD15 and 3038-AD16) at 20-21 (Mar. 25, 2011).