August 27, 2012

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

Via agency website

Re: "Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act" / RIN number 3038-AD57

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comments by the Commodity Futures Trading Commission (the "Commission" or the "CFTC") regarding its proposed interpretive guidance and policy statement under the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] (the "Dodd-Frank Act") entitled *Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act* (the "Proposal").

I. Introduction

The Coalition represents end-user companies that use 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: Financial regulatory reform measures should 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.

Many end-user companies operate globally with numerous affiliates throughout the world. Accordingly, end-users frequently engage in cross-border derivatives transactions as part of their hedging programs. The Coalition is concerned that the Proposal would impose burdens and costs on end-users and end-user transactions without any corresponding regulatory benefit or prevention of systemic risk. We are also concerned that the term "conduit," as used in the Proposal could lead some end-users to move away from using a central hedging center for executing their trades. Because central hedging increases efficiency and reduces a company's risk, the Coalition urges the Commission to revise the portions of the Proposal that would discourage the use of central hedging.

Also, as a general matter, the Coalition represents all end-users and believes there is not a compelling reason to impose disparate cross-border requirements on financial and non-financial

[1] Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

end-users. Financial end-users include pension plans, captive finance affiliates, mutual life insurance companies, and commercial companies with non-captive finance arms. Like non-financial end-users, these entities do not pose systemic risk to the financial system and use derivatives predominantly to hedge risks associated with their business.

The Coalition is pleased to offer comments focused on ensuring that the cross-border scope of the Dodd-Frank Act reflects legislative intent, does not impose undue burdens on the business community, and permits end-users to manage risks efficiently and effectively.

II. The Proposal Would Increase Costs While Diminishing Access to Pricing Sources and Market Participants for Derivatives End-Users

The Coalition is concerned that applying the Dodd-Frank Act with a broad extraterritorial scope to non-U.S. affiliates of U.S. swap dealers could force U.S. swap dealers to create and fully capitalize separate entities to avoid the competitive disadvantage that non-U.S. affiliates of U.S. entities would face. If the Proposal is implemented as written, non-U.S. affiliates of U.S. entities would have a higher regulatory burden than foreign market participants that lack any connection to the U.S. As a result, swap dealing entities that engage in global dealing activities may be forced to separately capitalize their global swap dealing activities. The separate capitalization of swap dealing entities will harm end-user counterparties through increased end-user costs that will be passed along from the banks' increased capital investments and the need to enter into new swap relationship documentation with the separately capitalized entities.

If U.S. swap dealers are disadvantaged as compared to non-U.S. swap dealers, it is likely that end-users, including non-U.S. affiliates of U.S. end-users, would have fewer counterparty options as U.S. swap dealers exit certain non-U.S. markets. Fewer counterparties would mean less competition and liquidity, higher prices, and concentrated counterparty exposure, all of which would increase risk.

For example, U.S. swap dealer counterparties may spin-off their non-U.S. operations into separately capitalized legal entities or exit the operations altogether. Global end-user companies often use the same swap dealer to trade a particular type of swap product to reduce documentation requirements, reduce costs, and take advantage of portfolio netting. Under the Proposal, end-users would have fewer global swap dealers with whom to transact as spin-offs could make it more challenging and expensive to mitigate risks on a global basis. End-users would face decreased liquidity, as fewer counterparties would offer particular products. Further, end-users would be required to negotiate new swap relationship documentation if they choose to transact with new legal entities—a costly and time-consuming process. Additionally, end-users would not enjoy the same level of netting benefits achieved by trading with the same global bank as they do today. Netting allows end-users to more efficiently and effectively manage their swap dealing activities.

As a result, the cost to end-users of executing cross-border swaps likely would increase. At the same time, end-users would face greater counterparty risk due to an increased number of counterparties with which they trade. The Commission should take appropriate steps in its final cross-border guidance to prevent competitively disadvantaging U.S. swap dealers. Any such disadvantages would increase costs and reduce efficiencies for derivatives end-users.

III. "U.S. Person" Definition

The Coalition firmly believes that a guarantee by a U.S. person of a non-U.S. affiliate or subsidiary should not cause the guaranteed non-U.S. person to be considered a "U.S. person" as described in the Proposal. The Commission specifically asks in Question 1a whether the term "U.S. Person" should be interpreted to include a foreign affiliate or subsidiary guaranteed by a U.S. person.[2] The Commission's question suggests that a U.S. person guaranteeing the non-U.S. affiliate could pull such guaranteed non-U.S. affiliate into the Commission's definition of "U.S. person" and therefore subject such non-U.S. affiliate to Dodd-Frank Act Transaction-Level Requirements or substituted compliance. The Coalition is concerned that non-U.S. affiliates of U.S. end-user companies may be disadvantaged when transacting with non-U.S. counterparties, as non-U.S. counterparties may decline to enter into swap transactions with a non-U.S. affiliate unless the U.S. end-user is guaranteeing such affiliate – which in turn could cause the affiliate to be regulated under Title VII. The solution, we believe, is to *not include* a foreign affiliate or subsidiary of a U.S. end-user, guaranteed by that end-user, in the definition.

IV. Conduits

Although Congress specifically identified and defined the types of entities that should be subject to swaps regulation and although the concept of a "conduit" entity exists nowhere in the Dodd-Frank Act or in any rule promulgated under the Dodd-Frank Act issued by any regulator (including the Commission's own entity definitions rule), the Commission nonetheless creates a new type of regulated entity—the "conduit" entity—in the Proposal.[3] To address the Commission's concerns about the flow of risk from certain non-U.S. entities that have relationships with U.S. entities, the Proposal provides that Transaction-Level Requirements would apply to "conduit" entities, which are defined in the Proposal as non-U.S. entities (i) that are majority owned directly or indirectly, by a U.S. person; (ii) that regularly enter into swaps with one or more other U.S. affiliates or subsidiaries of the U.S. person; and (iii) whose financial statements are included in the consolidated financial statements of the U.S. person.[4]

A. The definition of "conduit" should be revised to exclude all end-users.

Including any end-users in the "conduit" definition would not help achieve the Commission's stated goal of addressing the possible flow of risk to the United States, and we urge

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[2] See 77 Fed. Reg. 41218.

[3] As a threshold matter, the Coalition believes it is inappropriate for the Commission to create a new type of regulated entity through mere interpretive guidance without issuing a formal, proposed rule.

[4] See 77 Fed. Reg. 41229.

the Commission to revise the "conduit" definition to exclude explicitly all transactions in which any party is an end-user. In the Proposal, the Commission sets forth two specific concerns that the "conduit" concept is meant to address: preventing the exposure of U.S. persons to "risks from and incurred by the conduit,"[5] and preventing a U.S. swap dealer or major swap participant ("MSP") from avoiding regulation under the Dodd-Frank Act by executing its swaps through foreign affiliates.[6] Including end-users within the "conduit" definition or applying the concept to end-user transactions, however, would not advance either of the Commission's stated goals. Because end-users do not increase systemic risk, a non-U.S. end-user entity cannot increase the systemic risk exposure of its U.S. affiliates. Also, because end-users are already exempt from many Dodd-Frank Act requirements for their U.S. swap transactions, there is little incentive for end-users to execute swaps abroad for the purpose of evading Dodd-Frank Act requirements.

The "conduit" definition, as currently written, is over-broad and would unnecessarily classify many non-U.S. end-user affiliates as "conduits." The Coalition is concerned that the "conduit" definition in the Proposal could potentially include both non-U.S. end-user affiliates that enter into both street facing and inter-affiliate swaps and non-U.S. central hedging centers. Such a result would create a significant yet unnecessary competitive disadvantage for U.S. end-user companies that manage their risks through both U.S. and non-U.S. affiliates.

For example, a U.S. end-user may have majority ownership in a non-U.S. end-user entity where the non-U.S end-user entity executes swaps with non-U.S. entities for commercial business or tax reasons. The non-U.S. end-user entity then enters into internal swap transactions with its affiliate U.S. end-user. For end-users, inter-affiliate trades serve as an internal allocation of risk—not as speculative trades that create risk. In effect, inter-affiliate trades are largely equivalent to inter-company loans, which merely shift capital and risk among entities in the same corporate group. Yet, under the "conduit" definition as proposed, such swap transactions entered into by that non-U.S. end-user would be found subject to increased regulatory requirements as compared to other non-U.S. entities operating in the same swaps market. These increased regulatory burdens would be placed on the non-U.S. end-user's swap transactions even though, because it is an end-user that is hedging or mitigating commercial risk, the non-U.S. end-user could not be increasing the systemic risk exposure of its U.S. affiliate. The non-U.S. end-user would thus face higher transaction costs when executing trades with non-U.S. persons, and some swap dealers may refuse to enter into swaps with the non-U.S. end-user that is classified as a "conduit." As a result, the U.S.

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[5] The Commission expresses concern that "given the relationship between the conduit and the U.S. person, the U.S. person is directly exposed to risks from and incurred by the conduit." 77 Fed. Reg. 41229.

[6] The Commission states it is concerned that "rather than execute a swap opposite a U.S. counterparty, which would be subject to the Dodd-Frank transactional requirements, a U.S. swap dealer or MSP could execute a swap with its foreign affiliate or subsidiary, which could then execute a swap with a non-U.S. third-party in a jurisdiction that is unregulated or lack [sic] comparable transactional requirements." 77 Fed. Reg. 41229.

end-user and the non-U.S. end-user affiliates would face higher hedging costs and reduced hedging choice without any corresponding prevention of systemic risk to the U.S. financial system.

Many end-users execute a significant portion of their swap transactions through wholly-owned central hedging centers.[7] In this common organizational model, the hedging center typically structures transactions to offset commercial risk for the parent company and its affiliates or follows specific hedging instructions from affiliated entities within a corporate group. From a risk perspective, the central hedging combines trade expertise and execution in a single entity. Although variation in the structure of trades exists, a hedging center typically serves as the primary market-facing entity for an end-user's entire corporate group, entering into hedge positions with unaffiliated swap dealers to lay off commercial risk and entering into inter-affiliate trades internally with affiliated entities. Central hedging allows for the central hedging affiliate to manage risk across the entire corporate group, leading to increased efficiency and more comprehensive risk management and has the added benefit of being able to net positions across an entire corporate group, which lowers the overall credit risk a corporate group poses to the market generally. The Coalition is further concerned that all non-U.S. central hedging centers would be categorized as "conduits" and therefore could be disadvantaged when dealing with non-U.S. counterparties, as described above.

The Coalition believes that the regulation of inter-affiliate trades should square with a simple economic reality: these internal trades do not increase systemic risk. Thus, imposing requirements that are designed to address systemic risk on inter-affiliate trades would create costs without any corresponding benefit. We urge the Commission to revise the "conduit" definition to ensure that the Proposal does not discourage the use of non-U.S. central hedging centers, disadvantage non-U.S. end-user entities, or lead to the needless regulation of cross-border inter-affiliate trades in which either counterparty is an end-user.

B. The Coalition agrees with the Commission that the "conduit" concept should not be applied to swaps in which neither party is a swap dealer or an MSP

As described in the preceding section above, the Coalition believes that the "conduit" definition should not apply to any end-user transactions, regardless of the counterparty. We thus applaud the Commission for recognizing that transactions between non-U.S. entities in which neither party is a swap dealer or MSP do not pose systemic risk to the U.S. financial system and for stating in the Proposal that the Commission does not intend to apply the "conduit" concept to

[7] Some end-users have central hedging centers execute market-facing swaps as an agent on behalf of the end-user (i.e., the swap is executed in the end-user's name). Other end-users have central hedging centers execute market-facing swaps as the principal (i.e., the swap is executed in the name of the central hedging center). In both structures, the central hedging center enters into internal, inter-affiliate trades in connection with the market-facing swap.

transactions in which no swap dealer or MSP is a party.[8] We urge the Commission to go further, however, and revise the rule to exclude all transactions that involve end-users from the "conduit" concept. As described above, simply put, end-users do not create exposure to the risks that the Commission is intending to address by creating the "conduit" entity.

V. Cost-Benefit Analysis and Notice and Comment

A. The Proposal Should Be Re-Issued as a Proposed Rule with Full Notice and Comment Subject to the Administrative Procedures Act

The Proposal would have a substantive effect on the way end-users operate, make business decisions, and structure their operations and should therefore be re-issued as a proposed rule subject to the Administrative Procedures Act ("APA").[9] Issuing the Proposal as guidance, instead of as a proposed rule, defeats the primary reason that the Commission issued the guidance: to provide greater regulatory certainty to market participants. Even though the Commission has permitted a 45-day comment period now, guidance can be amended or withdrawn without a formal process and without opportunity for public comment in the future. In contrast, rules can be amended only by notice and comment rulemaking. Issuing the Proposal as guidance would allow the Commission to sidestep APA rulemaking requirements and thus introduces substantial regulatory uncertainty by making it difficult for companies to rely on the Proposal as they plan for future activities.

Although the Proposal repeatedly claims to merely interpret CEA section 2(i), the Proposal contains many requirements, duties, exceptions and other provisions that go well beyond interpretation and that create substantive rights.[10] The Proposal also creates a new type of regulated entity—a "conduit" entity— which is not in the text of CEA section 2(i) or any other section of the Dodd-Frank Act. Further, the Proposal creates a substituted compliance regime that lays out how the Commission will determine whether a foreign jurisdiction is eligible for substituted compliance even though nothing in CEA section 2(i) mentions substituted compliance.

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[8] The Commission states, "[A]t this time, the Commission makes clear that such non-U.S. affiliate or subsidiary would not be subject to the Dodd-Frank swap provisions, except pursuant to specific Dodd-Frank Act provisions (or Commission regulation adopted thereunder) or Commission orders." 77 Fed. Reg. 41234.

[9] As Commissioner O'Malia noted in his concurrence: "[T]he Commission is issuing today's Proposed Guidance in a manner that is outside of the requirements set forth in the Administrative Procedures Act." 77 Fed. Reg. 41241.

[10] The Proposal imposes specific duties and obligations on non-U.S. entities in the form of Entity-Level Requirements and Transaction-Level Requirements. For example, non-U.S. swap dealers are required to comply with capital, risk management, chief compliance officer and swap data recordkeeping and reporting rules but are not required to comply with external business conduct standards for swaps with non-U.S. counterparties. See 77 Fed. Reg. 41227-29.

Moreover, the Proposal establishes the cross-border scope of the CFTC's entire regulatory regime under Title VII of the Dodd-Frank Act. The Proposal creates a detailed framework for determining: (1) which swap dealers and MSPs would have to register with the CFTC; (2) which Entity-Level Requirements would apply to swap dealers and MSPs; (3) which Transaction-Level Requirements would apply to swaps between swap dealers and MSPs and other entities; (4) the criteria for substituted compliance determinations; and (5) which Transaction-Level Requirements would apply to swaps without either a swap dealer or MSP as a counterparty.

During a July 17, 2012 hearing before the Senate Committee on Agriculture, Nutrition and Forestry, Robert Cook, Director of the Security and Exchange Commission's ("SEC") Division of Trading and Markets explained that the SEC will follow notice-and-comment procedures when issuing its rule regarding the cross-border scope of Title VII "to give investors, market participants, foreign regulators and other interested parties an opportunity to consider, as an integrated whole, our approach to the registration and regulation of foreign entities engaged in cross-border transactions involving U.S. persons."[11]

The Commission should follow the SEC's lead and do the same. Issuing the cross-border criteria as guidance insulates any future changes to the Proposal from the cleansing scrutiny that the APA provides. Instead, by failing to issue the Proposal as a proposed rule, the Commission has created a regime where dramatic changes in its cross-border regulatory approach could be made operative without the benefit of comments considered through the APA process. This circumvention of APA requirements through adoption of the substantive criteria as mere guidance in the Proposal is impermissible: "It is well-established that an agency may not escape the notice and comment requirements . . . by labeling a major substantive legal addition to a rule a mere interpretation."[12] Issuing as guidance what is effectively a substantive component of a rule promotes neither the transparency nor the rigor to which a rule subject to the APA's notice and comment requirements is exposed. We would suggest, therefore, a formal proposed rule that remedies this flaw. The Commission also should commit to providing a reasoned explanation for any future procedural or substantive changes to its cross-border regulatory approach and provide a full and robust opportunity for public comments before any changes are made final.

B. CFTC Should Conduct a Cost-Benefit Analysis Before Finalizing the Proposal

As discussed above, the Proposal would create costs for market participants by creating competitive disadvantages. As previously discussed, these costs will indirectly affect end-user

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[11] Senate Committee on Agriculture, Nutrition and Forestry. "Holds Hearing on the Impact of the 2010 Financial Regulatory Overhaul Law, Panel 1." (Date: 7/17/12). Text from: CQ Congressional Transcripts. Available from CQ Transcriptswire. Accessed: 7/19/12.

[12] *Appalachian Power Company v. Environmental Protection Agency*, 208 F.3d 1015, 1024 (D.C. Cir 2000).

counterparties. These costs resulting from the Proposal were not reflected in the cost-benefit analysis sections of other CFTC rules. In fact, other CFTC rules avoided considering the costs of the cross-border scope altogether by explaining that the CFTC will address the cross-border scope for a particular rule in a future Commission release.[13]

The resulting effects of the Proposal will impact virtually all market participants either directly or indirectly, including end-users. Further, SEC Director Cook testified that the SEC will conduct a "full economic analysis and the cost-benefit analysis" before it issues its regulation about the cross-border reach of Title VII.

Given the new costs, both direct and indirect, that the Proposal is creating on the swaps market and the Proposal's function as a substantive rule, the Coalition urges the Commission to conduct a full cost benefit analysis prior to finalizing the Proposal.

VI. Conclusion

We thank the Commission for the opportunity to comment on these important issues. The Coalition looks forward to working with regulators to create a robust regulatory regime without unduly burdening end-users and the economy at large. We are available to meet with the Commission to discuss these issues in more detail.

Sincerely,

Agricultural Retailers Association
Business Roundtable
Commodity Markets Council
Financial Executives International
National Association of Corporate Treasurers
National Association of Manufacturers
U.S. Chamber of Commerce

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[13] See, e.g., 77 Fed. Reg. 2613 ("[I]n the [proposed rule], the Commission requested comment on the extraterritorial application of the SD and MSP registration requirements. … Issues relating to which entities are SDs or MSPs and the substantive requirements applicable to them, including the extraterritorial application of such substantive requirements, are beyond the scope of this rulemaking.") Id. at 2619-20.