Coalition for Derivatives End-Users
Comments to Title VII of the Lincoln/Dodd Substitute to S. 3217,
The Wall Street Transparency and Accountability Act of 2010

April 29, 2010

Introduction

The Coalition for Derivatives End-Users (the "Coalition") supports Congressional efforts to draft legislation that brings transparency to the over-the-counter (OTC) derivatives market, contains systemic risk and restores stability to the financial system. Business end-users rely on OTC derivatives to manage the risks associated with daily operations—from cost fluctuations in materials and commodities that go into making products, to the foreign currency they are exposed to when they buy or sell products overseas, to the interest rates they pay when they finance projects, investments and operations. When end-users enter into OTC derivative contracts, they do so primarily to manage risk. End-users seek to lock in prices and eliminate volatility and uncertainty due to fluctuations in interest rates, foreign currency exchange rates, and commodity prices. Removing this uncertainty allows end users to focus on growing and investing in their core businesses and creating jobs. While the Coalition supports enhanced transparency for all derivatives transactions and the reduction of systemic risk, efforts to reform the OTC derivatives markets should preserve affordable access to these critical risk management tools for the thousands of companies whose derivatives transactions did not cause the recent financial crisis.

New regulations that impose central clearing and margin requirements also should not be applied retroactively. These are contracts that were entered into often well before new regulation was contemplated, let alone passed, and the terms and economics of arms-length agreements, entered into between two parties seeking particular risk exposure and mitigation, should be respected, not altered after-the-fact.

The Coalition appreciates efforts to exempt end-users from new regulatory regimes that could stifle risk management efforts, including those that are part of the Wall Street Transparency and Accountability Act ("WSTA"). Nevertheless, the WSTA does not adequately protect end-users from regulation that should apply only to swap dealers and entities that do not use derivatives primarily to manage risk. Hence, we propose changes to WSTA to ensure that it accomplishes the goals of bringing additional transparency to the derivatives markets and mitigating risks to financial stability without discouraging end-users from entering into derivatives contracts that tend to stabilize – not introduce risk – into the economy. We suggest changes to WSTA that provide:

- Clear exemptions from central clearing, bilateral margining and exchange-trading requirements for business end-users;
- An end-user exemption that is as objective and predictable and that appropriately exempts from the regulatory scheme applicable to swap dealers those businesses that use OTC derivatives primarily to hedge business risk and, thereby, do not pose a threat to financial stability;

- Clarification that capital requirements should not be imposed on end users and that any capital requirements authorized by the Title should not be assessed to penalize the use of OTC derivatives or otherwise create an incentive to centrally clear transactions and should be based on actual risk of loss and aimed at promoting the safety and soundness of the financial system; and
- Prospective application of new requirements recognizing that market participants negotiated current trades with an understanding as to their potential obligations based on the laws and market practices in place at that time.

The comments below are not exhaustive and have been provided on an expedited timetable. Hence, the Coalition may modify or add to the comments as we examine the bill further. Moreover, the comments may not fully reflect the views of each entity that has been associated with the Coalition.

The comments in the balance of this memo are designed to suggest changes to WSTA so that it better accomplishes the goals noted above. The Coalition understands that there are multiple ways to draft a robust end-user exemption and is supportive of efforts designed to achieve this goal. The Coalition notes that one such effort, Amendment 192 filed by Senators Shelby and Crapo to the Senate Finance Committee Print, adopts a strong, objective framework for reform that provides predictable standards that recognize end-users should not face financial disincentives for attempting to manage their risk.

Specific Comments

1) Swap Principal (Page 539-541)

Purpose of proposed change: Only 10-20% of the OTC derivatives market is comprised of trades in which one of the counterparties is a business end-user. Moreover, the credit risk associated with this relatively small subset of trades is spread across thousands of businesses. The purpose of the proposed language is to ensure that business end-users that primarily use derivatives for hedging are not deemed included in all of the components of the new regulatory scheme.

Suggested change:

On page 539, delete line 14 and all that follows through line 24 on page 541 and insert the following:

(39) SWAP PRINCIPAL.—

(A) IN GENERAL.--The term "swap principal" means any person--

(i) who engages in swap transactions and is otherwise not a swap end user; or

(ii) who engages in swap transactions, is a regulated entity (as defined in section 1303(2)) of the Federal housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20), and is a government-sponsored enterprise.

(B) EXEMPTION.—The Securities Exchange Commission and the Commodity Futures Trading Commission may, by rule, regulation, or order, as necessary or appropriate in the public interest or for the protection of investors, exempt any person or category of persons from the definition of 'swap principal.'

(C) A person shall not be deemed to be a swap principal pursuant to subparagraph (A)(i) solely because that person buys or sells swaps for such person's own account or the account of any person under common control with such person, either individually or in a fiduciary capacity.

(40) SWAP END USER.—The term 'swap end user' means any person the gross aggregate notional value of whose outstanding swaps that do not qualify as bona fide hedging swap transactions—

(A) is 5 percent or less of the gross aggregate notional value of the person's outstanding swaps; or

(B) is 7 percent or less of the gross aggregate notional value of the person's outstanding swaps, provided that the percentage in excess of 5% of the aggregate notional value of the person's outstanding swaps that do not qualify as bona fide hedging transactions were executed in connection with the person's business transactions.

(41) BONA FIDE HEDGING SWAP TRANSACTION.—

(A) IN GENERAL.—The term 'bona fide hedging swap transaction' means a purchase or sale by any person of a bona fide swap that is economically appropriate to the reduction or offsetting of risks arising from the operation of a business, including, but not limited to—

(i) the potential change in the value of assets that such person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;
(ii) the potential change in the cost or value of liabilities that such person owns, has incurred, or anticipates incurring; or
(iii) the potential change in the cost or value of goods or services that such person provides, purchases, or anticipates providing or purchasing.

(B) PREVENTION OF EVASION.—A swap transaction that is undertaken solely for the purpose of avoiding registration as a swap provider shall not constitute a bona fide hedging swap transaction.

(C) For purposes of this paragraph, the term 'person' shall include any person under common control with that person.

Note: All instances of the term "major swap participant" should be stricken and replaced with the term "swap principal".

2) Swap Dealer (Page 555-557)

Purpose of proposed change: To clarify that the term "swap dealer" does not include an affiliate of a company that enters into swaps on behalf of the company or its affiliates but does not hold itself out as a dealer or make a market in swaps.

Suggested change:

On page 555, delete line 16 and all that follows through line 2 on page 557 and insert the following:

''(50) SWAP DEALER.—

''(A) IN GENERAL.—The term 'swap dealer' means any person (other than a commercial end user or financial entity end user) who—
''(i) holds itself out as a dealer in swaps;
''(ii) makes a market in swaps;
''(iii) regularly engages in the purchase of swaps and their resale to customers in the ordinary course of business; and
''(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

(B) EXCEPTION.—The term "swap dealer" does not include a person that buys or sells swaps for such person's own account, either individually or in a fiduciary capacity, or on behalf of any affiliates of such person but —

(1) not as part of a regular line of business; or
(2) does not hold itself out as a dealer in swaps and does not make a market in swaps.

''(C) DE MINIMIS EXCEPTION.—The Commission shall exempt from designation as a swap dealer an entity that engages in a deminimis quantity of swap dealing in connection with transactions with or on behalf of its customers.

3) Commercial End User (p. 578–582)

Purpose of proposed change: The definition of commercial end user is expanded to include those parties, like commercial real estate and hospital owners, that own or manage physical assets. Additionally, a Financial Entity End User definition should be added to the bill to allow entities that engage in financial activities, but who are not major swap participants or swap dealers, to receive the same protections afforded to commercial end users. Such protections, however, are not extended to Fannie Mae and Freddie Mac or to those financial entities that use derivatives for speculative purposes.

Suggested change:

Delete line 9 on page 578 through line 6 on page 582 and insert the following:

‘‘(10) END USER CLEARING EXEMPTION.—

‘‘(A) DEFINITIONS.—In this paragraph:

‘‘(i) COMMERCIAL END USER.— IN GENERAL.—In this paragraph, the term ‘commercial end user’ means any person, other than a financial entity end user, who, as its primary business activity, owns, operates, uses, produces, processes, manufactures, develops, distributes, leases, merchandises, provides or markets goods, services, physical assets, or commodities (which shall include but not be limited to coal, natural gas, electricity, ethanol, crude oil, gasoline, propane, distillates, and other hydrocarbons) either individually or in a fiduciary capacity.

‘‘(ii) FINANCIAL ENTITY END USER.— FINANCIAL ENTITY END USER.—

‘‘(I) IN GENERAL.—The term ‘financial entity end user’ means any person predominantly engaged in activities that are financial in nature.

‘(II) EXCLUSIONS.—The term financial entity end user does not include—

‘‘(aa) any person who is a swap dealer, security-based swap dealer, swap principal, major security-based swap principal;

‘‘(bb) a commercial end user

“(cc) who is a regulated entity (as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20) and a government-sponsored enterprise.

‘‘(B) END USER CLEARING EXEMPTION.—

‘‘(i) IN GENERAL.—Subject to clause (ii), in the event that a swap is subject to the mandatory clearing requirement under paragraph (2), and 1 of the counterparties to the swap is a commercial end user or a financial entity end user, that counterparty—

‘‘(I)(aa) may elect not to clear the swap, as required under paragraph (2); or

‘‘(bb) may elect to require clearing of the swap; and

‘‘(II) if the end user makes an election under subclause (I)(bb), shall have the sole right to select the derivatives clearing organization at which the swap will be cleared.

‘‘(ii) LIMITATION.—A commercial end user or a financial entity end user may only make an election under clause (i) if the end user is using the swap to hedge commercial risk, including operating or balance sheet risk.

‘(C) TREATMENT OF AFFILIATES.—

‘‘(i) IN GENERAL.—An affiliate of a commercial end user or a financial entity end user may make an election under subparagraph (B)(i) only if the affiliate uses the swap to hedge, reduce or otherwise mitigate the commercial risk, including operating and balance sheet risk, of the commercial end user or the financial entity end user parent or other affiliates of the commercial end user or financial entity end user parent.

‘‘(ii) PROHIBITION RELATING TO CERTAIN AFFILIATES.—An affiliate of a commercial end user or a financial entity end user shall not use the exemption under subparagraph (B) if the affiliate is—

‘‘(I) a swap dealer;

‘‘(II) a security-based swap dealer;

‘‘(III) a major swap participant;

‘‘(IV) a major security-based swap participant;

“(V) a commodity pool;

“(VI) a bank holding company with over $50,000,000,000 in consolidated assets

4) Amendment to Federal Assistance for Swaps Entities (p. 513-515)

Purpose of proposed change: To ensure that commercial end users have adequate potential counterparties with which to hedge risk by permitting swap dealers to remain as regulated depository institutions. Separating swap dealing entities from depository institutions presents a number of practical problems for end users, including reducing or eliminating available counterparties, increasing the cost to hedge and possibly preventing some end users from hedging certain risks. Such problems would result from a swap dealer’s limited ability to gain access to non-cash collateral pledged to a lender and a borrower’s inability to net exposures between derivatives and loans. Such a requirement could exacerbate a problem many end users already face, as fewer banks will offer derivatives, including many community and regional banks, thereby eliminating the only counterparties with which many smaller businesses hedge risk.

Suggested change:

Strike Sec. 716 of Subtitle A by deleting line 21 on page 513 through line 11 on page 515.

5) Prospective Application – No Retroactivity (p. 706)

Purpose of proposed change: The language below would ensure that regulations relating to central clearing and margin requirements are applied prospectively and not retroactively.

Suggested change:

Insert the words “or margin” in between “clearing” and “requirements” on line 19 of page 706.

6) Foreign Exchange Swaps and Forwards (p. 552-555)

Purpose of proposed change: The purpose of this change is to exempt foreign exchange swaps and foreign exchange forwards from regulation. This change recognizes that most foreign exchange forwards and swaps have short-dated maturities and that a large percentage of these trades are already settled through a global multi-currency cash settlement system. The trades would still be subject to the reporting requirement. The Secretary of the Treasury would have the ability require foreign exchange swaps and foreign exchange forwards to be regulated as swaps by making a written determination.

Suggested change:

Delete line 17 on page 552 through line 6 on page 553 and insert the following:

(i) IN GENERAL.—Notwithstanding subparagraph A, foreign exchange swaps and foreign exchange forwards shall only be considered swaps under this paragraph if the Secretary makes a written determination that either foreign exchange swaps or foreign exchange forwards or both should be regulated as swaps under this Act.

On page 554, delete line 16 and all that follows through the "(ii)" on line 3 on page 555.

7) Amendment to Capital and Margin Requirements (p. 646-649)

Purpose of proposed change: To ensure that regulators are directed to consider actual risks when determining capital requirements – not artificially increasing capital charges to create an incentive to centrally clear transactions, or otherwise penalizing OTC derivatives. This is done by removing the language instructing regulators to require "substantially higher" capital requirements for uncleared swaps and by directing regulators to consider capital and margin that are appropriate for the risk associated with swaps.

Suggested change:

On page 646, insert the following in between the word "participant" and the period on line 20:

"and that are appropriate for the risk associated with the with the swaps held as a swap dealer or major swap participant"

On page 647, insert the following in between the word "participant" and the period on line 8:

"and that are appropriate for the risk associated with the with the swaps held as a swap dealer or major swap participant"

On page 648, delete from the word "contain" on line 11 through line 2 on page 649 and insert the following:

"be established at a level appropriate for the risk associated with the cleared and non-cleared swaps held as a swap dealer or major swap participant."

On page 649, delete from the word "be" on line 8 through line 12 and insert the following:

"established at a level that is appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."

8) Amendment to Applicability of Margin Provision (p. 653)

Purpose of proposed change: To exempt commercial end users and financial entity end users from the margin requirement for uncleared trades.

Suggested change:

On page 653, delete all that follows the word "is" on line 18 through line 24 and insert the following:

> "a commercial end user or financial entity end user and the commercial end user or financial entity end user is using the swap to hedge its commercial risk."

9) Amendment to Include Exemptive Authority for International Harmonization (p. 762)

Purpose of proposed change: To provide the Treasury Secretary with the authority to exempt any swap, class of swaps, entity or class of entities from a requirement of this bill if the Secretary deems it necessary to ensure the U.S. remains globally competitive in financial markets.

Suggested change:

Insert the following after line 5 on page 762:

"Sec. 753 Exemptive Authority for International Harmonization.

In General. — The Secretary may exempt any swap, class of swaps, entity or class of entities from a requirement of this bill if the Secretary deems it necessary to ensure U.S. global competitiveness in financial markets. In order to make such an exemption, the Secretary shall –

> (A) submit a written determination to the appropriate committees of Congress, including the Committee on Agriculture, Nutrition and Forestry of the Senate, the Committee on Banking, Housing and Urban Affairs of the Senate, the Committee on Agriculture of the House of Representatives, and the Committee on Financial Services of the House of Representatives. Any such written determination shall not be effective until it is submitted to the appropriate committees in Congress.
> (B) include, in its written determination, a finding that such exemption would not create serious adverse affects on the financial stability of the United States banking system or financial markets."

Strike "Sec. 753" in line 6 of page 762 and insert "Sec. 754"

10) Amendment to Remove Audit Committee Approval Requirement (p. 583-584)

Purpose of proposed change: End users that are public companies are currently subject to significant disclosure requirements. Since January 1, 2008, FAS 161 (ASC 815) significantly increased disclosure requirements for those companies that apply generally accepted accounting principles. Additionally, most public companies implement hedging policies that clearly define roles and responsibilities for derivatives transactions, including roles deemed appropriate for senior

management, the audit committee and the board of directors. Adding an audit committee approval requirement creates an unnecessary process step that may restrict an end user's ability to mitigate its risks on a timely basis. Though companies often gain board approval for large transactions, some transactions are of an inconsequential size and thus do not warrant board or audit committee attention.

Suggested change:

Delete line 22 on page 583 through line 7 on page 584.

11) Amendment to Extend Effective Date (p. 762)

Purpose of proposed change: To move back the effective date of the legislation from 180 days following enactment to 360 days, the amount of time provided in the House bill. This legislation represents a transformation of the largest financial market in the world and market participants will need adequate time to prepare.

Suggested change:

Strike "180" in line 8 of page 762 and insert "360"