March 8, 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: Core Principles and Other Requirements for Swap Execution Facilities; 17 CFR Part 37 / RIN Number 3038–AD18

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 Notice of Proposed Rulemaking entitled "Core Principles and Other Requirements for Swap Execution Facilities." We are glad to work with the CFTC to ensure that the final rules appropriately foster the legislative intent of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[1] and also prevent unnecessary burdens or consequences for end-users.

Introduction

The Coalition appreciates Congress's and the Commission's objectives of increasing transparency in the over-the-counter ("OTC") derivatives market. We believe the proposed rule on swap execution facilities ("SEFs") attempts to ensure that end-users have access to information that helps them secure better pricing. We expect that aspects of the proposed rule will serve this end. For example, end-users will likely benefit from access to low-cost pricing information made available through SEFs, even if they are not directly subject to the trading requirement. We are concerned, however, that in some cases, the proposed rule could work at cross-purposes with the Commission's objectives, possibly increasing costs for end-users and restricting end-users' discretion to execute transactions in the way they deem most efficient and effective to hedge their commercial risk.

Although many end-users will be exempt from the Dodd-Frank Act's mandatory clearing and trading requirements, other end-users may be subject to these requirements. At this time, uncertainty remains about how these requirements will apply to end-users. The Coalition had hoped that the rulemaking process would provide a sufficient degree of certainty so that SEF rules, which do not directly impact entities that are exempt from clearing requirements, would

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

not be of concern to end-users. Unfortunately, the clearing rule's reach is likely to extend to hundreds or thousands of end-users and remains uncertain in several respects.

Several factors add to this uncertainty, which include: (1) the small number of final rules that have been issued; (2) the unusually quick timeframe by which rules are being made; and (3) the overlap of key rulemakings that are highly dependent on each other. The Coalition is concerned that some rules may be disjointed and that key terms could be interpreted too narrowly. In particular, three interrelated rulemaking areas influence the impact of SEFs on end-users:

- Entity Definitions[2]
- Process for Review of Swaps for Mandatory Clearing[3]
- Real-Time Reporting and Definition of Block Trades[4]

Rulemaking Area #1: Entity Definitions

The Coalition has long supported an approach that focuses regulatory requirements on market participants that have the potential to pose risk to the financial system. We have urged policymakers to develop an end-user exemption that relies on the reasons underlying the use of swaps and to avoid a rigid approach that relies solely on entity type or organization. Below are illustrative examples that demonstrate the problems of a rigid approach, which may cause end-users to be directly and negatively impacted by the SEF rules:

- **Corporate pension plans**: Employee pension plans would fall under the definition of financial entities under the Dodd-Frank Act. Many employee pension plans that belong to non-financial end-users could be subject to mandatory clearing and trading requirements in spite of their parent entities' exemption.

- **Captive finance units of manufacturers**: Although Congress specifically exempted captive finance affiliates from the definition of financial entities and major swap participants ("MSPs") under certain conditions,[5] it is not clear how many captive finance

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[2] Joint Proposed Rule, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", RIN 3235-AK65, 75 Fed. Reg. 80174 (Dec. 21, 2010).

[3] Notice of Proposed Rulemaking, Process for Review of Swaps for Mandatory Clearing, RIN 3038-AD00, 75 Fed. Reg. 67277 (Nov. 2, 2010).

[4] Notice of Proposed Rulemaking, Real-Time Public Reporting of Swap Transaction Data, RIN 3038-AD08, 75 Fed. Reg. 76140 (Dec. 7, 2010).

[5] *See* Dodd-Frank Act §721(a)(16) (excluding from the definition of "major swap participant" an entity whose "primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90

[Footnote continued on next page]

affiliates would ultimately be able to avail themselves of this exemption.[6] Captive finance affiliates of manufacturers frequently finance the implements that are sold with their products, but that they do not directly manufacture. For example, a tractor manufacturer may sell and finance a rake or backhoe that attaches to the tractor it manufactures. Depending on regulatory interpretation, such issues may preclude a captive finance affiliate from using the captive finance exemption. If such an entity were precluded from using the exemption, the entity would be subject to clearing and trading requirements, and would have to execute transactions on a SEF.

- **End-users that may become major swap participants**: The Coalition supports the Commission's focus on the risks posed by major participants to the financial market. There are many areas in the proposed definitions, however, that would benefit from clarification or modification. Because it is not possible to determine how many end-users may ultimately be classified as MSPs, the proposed SEF rule is highly relevant to end-users.

The above are just some of the examples of how the mandatory trading requirement could be applicable to end-users hedging commercial risks. Thus, the seemingly unrelated rulemaking area of SEF regulations could have substantial implications for end-users that employ derivatives to manage risks.

Rulemaking Area #2: Process for Review of Swaps for Mandatory Clearing

The Dodd-Frank Act stipulates that transactions required to be cleared must also be executed on a SEF or designated contract market ("DCM").[7] Because of the interplay between the clearing and trading requirements, the process for review of swaps for mandatory clearing could be characterized as the gateway or main determinant of the trading requirement for different types of transactions. With this effect in mind, the Coalition offered a number of suggestions in our comment letter regarding clearing.[8] The Coalition's comment letter included the following key points:

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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").

[6] The Coalition's Comment Letter on "Entity Definitions" provides further details. *See* "Entity Definitions Comment," *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27971&SearchText=.

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

[8] *See* "Mandatory Clearing Comment," *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26916&SearchText=.

- Liquidity is an important factor not only in determining mandatory clearing requirements, but also for determining the need for trade execution; and
- Some less liquid trades could be suitable for clearing but not for trade execution, yet the proposed rule does not recognize such a distinction.

Because of the statutory linkage between trading and clearing, end-users may be required to execute certain clearable transactions on SEFs or DCMs, even if these transactions would not be suitable for execution. This is a particularly acute problem for end-users because they tend to employ customized transactions to hedge their idiosyncratic commercials risks, and these transactions by their nature could well be clearable, but would not be especially suitable for execution on SEFs. With this in mind, the Coalition is concerned about the process for reviewing which transactions are "made available for trading" under the SEF rules.

Rulemaking Area #3: Real-Time Reporting and the Definition of Block Trades

The Coalition has submitted a comment letter on real-time reporting[9] and has met with the CFTC on this topic. The linkage between real-time reporting and SEF trading is key to how the SEF rules may impact end-users. Specifically, the proposed rules determining block trade sizes would influence what transactions are required to trade on or off SEFs. The Coalition has pointed out how the proposed block trade rules and the underlying regulatory framework could inappropriately exclude many relatively illiquid swaps from the block trade size qualification.

The Coalition is also concerned about whether the proposed "distribution" and "multiple" tests are appropriate for different categories of swaps given the current lack of granular swap data repository ("SDR") data on end-user transactions. The end-user community is therefore concerned that many large size end-user transactions could be ineligible for the block trade size qualification, and thus would be have to trade on a SEF.

Dual Regulatory Objectives and the Protection of End-Users

The Coalition understands that the Dodd-Frank Act's legislative objectives are "to promote the trading of swaps on swap execution facilities and to promote pre-trade price transparency in the swaps market."[10] The Coalition believes, however, that these dual objectives could lead to the fulfillment of one at the expense of the other. We envision circumstances—especially those that affect certain end-users executing customized transactions—where the proposed rules may ultimately serve to unnecessarily disadvantage end-users by limiting their ability to choose the appropriate number of counterparties and mode of execution. This would frustrate rather than fulfill the goals of promoting SEF usage and could work against the goals of price transparency and price efficiency.

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[9] *See* "Real-Time Reporting Comment," *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27640&SearchText=.

[10] 7 U.S.C. § 7b-2(e) (Dodd-Frank Act Sec. 733).

Treatment of intercompany swaps

Entities are concerned that intercompany swaps (transactions between affiliated entities under the same corporate umbrella) potentially could be subject to the trade execution requirement. Many entities have centralized treasury groups where hedging and hedge accounting expertise resides. These centralized treasury groups may execute dealer counterparty-facing transactions and enter into other, offsetting transactions with affiliates. These matching or back-to-back transactions allow affiliated entities to hedge their commercial risks, while taking advantage of the efficiency and expertise of a centralized dealer counterparty-facing treasury group. The Coalition believes that the substantive benefit of pre-trade transparency is not advanced by requiring intercompany swaps to be traded on a SEF. Such trading would distort the price discovery process. It could also actually mislead market participants as the pricing information would be duplicative and would double count the reality of what is taking place in the market.

Request for quote protocol

The proposed rules require Request for Quote ("RFQ") systems to "transmit a request for a quote to buy or sell a specific instrument to *no less than five market participants* in the trading system or platform."[11] End-users do often involve multiple market participants in a competitive auction even before the creation of SEFs. Certain end-users, however, also encounter situations in which they may choose not to broadcast their transaction details to multiple participants. Overly prescriptive SEF rules would restrict this discretion and may unnecessarily prevent end-users' from having access to efficient and cost effective hedging.

Our concerns with the proposed SEF rule, then, are closely related to concerns the Coalition raised in its real-time reporting comment letter.[12] We believe "that enhancing price discovery is a means to an end," the end being fairer pricing for market participants and that "there are certain circumstances in which a heightened level of real-time price disclosure can work cross-purpose to this end."[13] As noted in a recent report by the International Organization of Security Commissions ("IOSCO"), "excessive or improperly calibrated trade transparency requirements could result in fewer opportunities to trade as a result of a withdrawal of liquidity by some participants, notably those who would be likely to incur additional costs in the execution of large

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[11] 76 Fed. Reg. 1241 (Jan. 7, 2011) (emphasis added).

[12] *See* "Real-Time Reporting Comment," *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27640&SearchText=.

[13] *See* "Real-Time Reporting Comment," *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27640&SearchText=.

transactions necessary to facilitate financing and hedging activities."[14] Below are several situations where a requirement to effectively broadcast transaction details to five or more market participants may serve to harm, not help, many end-users.

- **Large non-block swaps**: As highlighted earlier, many large transactions may not meet the stringent requirements of the block trade test. Communicating the details of these large transactions to more than one or two other parties could adversely affect end-users' ability to execute trades efficiently. This counter-intuitive impact results from dealer counterparties pricing transactions at unusually high prices to offset the increased difficulty in laying off their risks after execution. By requiring an end-user to broadcast transaction details to several counterparties, market participants with less competitive bids will be able to benefit by taking up contrary positions in the market, which will make it difficult for a successful bidder to hedge its risk. Additionally, the proposed rule creates an incentive for market participants to submit purposely weak bids simply to benefit from the knowledge gained by the five market participants requirement. For example, many Coalition members raise debt in the capital markets to fund their businesses. They often seek to hedge the interest rate risk associated with these debt issuances by entering into one or more interest rate swaps with dealer counterparties. If forced to communicate trade details to more than one or two market participants on a larger debt issuance, end-users may be unable to successfully hedge their risk, either because of prohibitive costs or because of few willing dealer participants in the marketplace.

- **Customized swaps that are less liquid but do not qualify as illiquid or bespoke**: We understand that "illiquid or bespoke swaps"[15] will qualify as Permitted Transactions that can be executed outside of SEFs. Situations may arise, however, when a swap does not qualify as illiquid or bespoke but would still benefit from the protection afforded by such designation. In these circumstances, broadcasting the transaction details to five or more participants would have a deleterious effect on pricing efficiency and, again, work against promoting trading of swaps on SEFs.

- **Confidential transactions**: End-users may manage risk on a sensitive deal in which the terms of a hedge could reveal confidential information. For example, an entity seeking to acquire another entity may want to hedge interest rate or foreign exchange risk associated with the acquisition. In doing so, the terms of the swap(s) could reveal the entity's involvement or otherwise compromise its competitive position. Similarly, an entity seeking to hedge the interest rate risk associated with an impending debt issuance may

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[14] Technical Committee of the International Organization of Security Commissions, *Report on Trading of OTC Derivatives*, at 34, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf.

[15] 76 Fed. Reg. 1241 (Jan. 7, 2011).

also be disadvantaged. An end-user may elect to hedge a debt issuance before the issuance is made by entering into forward-starting swaps. In this situation, it is important that the transaction details associated with the issuance not be made public. Under the proposed rules, an end-user would have to disclose confidential information prematurely to more market participants than absolutely necessary to meet its hedging objectives. This would increase the chance that transaction details about the issuance would be made public.

We strongly support Representative Barney Frank's call for "harmonizing" swaps regulation to the "maximum extent possible" in order to "maintain liquidity and stability in these new markets and reduce costs."[16] We also urge the Commission to avoid an overly prescriptive approach that removes end-user choice. Such an approach to execution may be appropriate for the futures markets but would not be appropriate for swaps that are "very different products than those currently traded in the highly-evolved equities and futures markets" and that "serve a variety of different purposes."[17] Moreover, many end-users are more sophisticated than many equity market participants and thus do not require as prescriptive an approach.

Although we appreciate the Commission's attempt to provide for competition through the RFQ proposal, end-users have several tools at their disposal to assess pricing and obtain competitive quotes in the derivatives market. End-users tend to enter into straightforward, albeit often customized, swaps and have treasury departments that are experienced and understand the swap markets and how their swaps are priced. End-users should be able to determine how many swap dealers should be included in any given request for quote. For example, end-users may request quotes from one or two swap dealers on a highly-customized or large swap order, but for standardized, highly-liquid swaps, end-users may request quotes from several swap dealers.

Process for reviewing which swaps are "made available for trading"

The Coalition also seeks to ensure that the proposed rules regarding a swap being "made available for trading" on a SEF are conducive to healthy competitive markets that are free of conflicts of interest. We generally support a market-driven approach where SEFs have a degree of discretion in making swaps available for trading. This discretion, however, must have checks and balances involving quantitative and qualitative inputs from market participants, including end-users. This would help ensure that swaps that are made available for trading are indeed appropriate for execution on a SEF. The Securities and Exchange Commission ("SEC") has

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[16] Letter from U.S. Rep. Barney Frank to Mary L. Schapiro, SEC Chairman, and Gary Gensler, CFTC Chairman (Feb. 18, 2011).

[17] Letter from U.S. Rep. Barney Frank to Mary L. Schapiro, SEC Chairman, and Gary Gensler, CFTC Chairman (Feb. 18, 2011).

analyzed the issue of conflicts of interest in the context of which swaps are "made available for trading" in its proposed rule regarding security-based SEFs.[18]

The proposed rule states that if one SEF designates a swap as available for trading, then all other SEFs shall be required to treat economically equivalent swaps as being made available. This would create unnecessary incentives for SEFs to aggressively list many types of swaps even if such swaps are not appropriate for execution on a SEF. Also, end-users could be disadvantaged if they do not meet the requirements to trade on a SEF that lists a swap that is then deemed subject to a mandatory trading requirement. An alternative approach, which the SEC references in its proposed rule regarding security-based SEFs,[19] would allow SEFs to "list" rather than "make available" swaps for trading without triggering a mandatory trading requirement. This would allow for market participants to compare on and off facility trading over a period of time, and the Commission could use this data to determine whether the swaps should be "made available" for trading.

The Coalition believes that these suggestions comport with the legislative history of the Dodd-Frank Act. As Senator Lincoln, then-chairman of the Senate Agriculture Committee, noted:

> In interpreting the phrase "makes the swap available to trade," it is intended that the Commission should take a practical rather than a formal or legalistic approach. Thus, in determining whether a swap execution facility "makes the swap available to trade," the Commission should evaluate not just whether the swap execution facility permits the swap to be traded on the facility, or identifies the swap as a candidate for trading on the facility, but also whether, as a practical matter, it is in fact possible to trade the swap on the facility. The Commission could consider, for example, whether there is a *minimum amount of liquidity such that the swap can actually be traded on the facility*. The mere "listing" of the swap by a swap execution facility, in and of itself, without a minimum amount of liquidity to make trading possible, should not be sufficient to trigger the Trade Execution Requirement."[20]

Illiquid or bespoke transactions

The Coalition recommends that the Commission carefully define illiquid or bespoke transactions to include typical end-user trades. Under the proposed rule, in general, swaps that are required to be cleared are also required to be executed on a SEF or DCM. All trades that are suitable for clearing, however, are not necessarily suitable for execution on a SEF. This is especially the case for trades that are illiquid or bespoke.

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[18] 76 Fed. Reg. 10968–70 (Feb. 28, 2011).

[19] 76 Fed. Reg. 10970 (Feb. 28, 2011).

[20] 156 CONG. REC. S 5923 (daily ed. July 15, 2010) (statement of Senator Blanche Lincoln) (emphasis added).

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