Coalition for Derivatives End-Users

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Via agency website

Re: "Clearing Exemption for Swaps Between Certain Affiliated Entities"/ RIN number 3038-AD47

I. Introduction

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comments by the Commodity Futures Trading Commission ("CFTC" or the "Commission") during the comment period for the proposed rule entitled *Clearing Exemption for Swaps Between Certain Affiliated Entities* (the "Proposal").[1] The Coalition represents companies that use derivatives predominantly to manage risks. Hundreds of companies have been active in the Coalition throughout the legislative and regulatory processes, 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. The Coalition appreciates the opportunity to submit comments regarding the proposed inter-affiliate clearing exemption.

The Coalition believes that regulation of inter-affiliate swaps should square with economic reality: inter-affiliate swaps do not increase systemic risk by creating counterparty credit risk or increasing interconnectedness between major financial institutions. Instead, such swaps are used by end-users to transfer risk within a corporate group for effective risk management. Thus, requiring entities to comply with the requirements that were designed to address systemic risk for their inter-affiliate swaps in addition to any requirements on their external swaps would create costs without any corresponding benefit and place substantial burdens on end-users and consumers. Such an additional and unnecessary regulatory burden could force companies to abandon proven and efficient methods of managing their risk through centralized risk-mitigation centers and result in corresponding costs to the economy.

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[1] 77 Fed. Reg. 50425 (August 21, 2012).

The Coalition is comprised of both financial and non-financial end-user members, all of whom use swaps to hedge or mitigate risk associated with their businesses, not to create systemic risk through speculation. Financial end-users include entities such as captive finance affiliates, mutual life insurance companies, and commercial companies with non-captive finance arms. In short, they use derivatives the same way non-financial end-users do.

The Coalition applauds the Commission for proposing to use its authority under section 4(c) of the Commodity Exchange Act ("CEA") to exempt certain inter-affiliate swaps from clearing and trading requirements, but the Coalition believes that further clarification or modification of the criteria that must be met is needed.

In abbreviated form, our main concerns with the Proposal are as follows:

- The Proposal discriminates against financial end-users by imposing more onerous regulations on them than on any other affected group.
  - While the Proposal exempts financial entities (end-users and swap dealers alike) from clearing their inter-affiliate swaps if certain conditions are met, one of those conditions—posting variation margin—is particularly onerous for financial end-users. Although the Commission provides an exception for guaranteed swaps, it is unclear what the Commission intended with the common guarantee requirement. Unlike the direct or indirect majority-ownership threshold that the Proposal provides for entities to elect the inter-affiliate clearing exemption generally, the guarantee exception departs from the majority-ownership threshold and requires 100% ownership. From the discussion in the preamble of the Proposal, it is clear that the Commission is concerned that an affiliate's default on an inter-affiliate swap could lead to such defaulting on its external swaps. Accordingly, we believe that this risk is addressed through a common guarantee of affiliates' external swaps only.
- We appreciate that non-financial end-users may be able to elect the end-user clearing exception with respect to most inter-affiliate trades. However, external facing trades entered into by treasury centers (which could be found to be financial in nature) are not explicitly exempted from clearing and trading requirements under the Proposal.
  - The ability to elect the end-user clearing exception could be put at risk if the "chain" of "hedging or mitigating commercial risk" is broken by an affiliate transacting through a treasury center.
  - In addition, the variation margin requirement could apply to swaps between multiple treasury centers of a non-financial end-user and we see no benefit to imposing such a requirement.
- The Proposal's jurisdictional requirements unfairly disadvantage end-users that operate globally and that enter into inter-affiliate swaps.
  - It is unclear when non-U.S. jurisdictions will implement comparable clearing regimes and which of a corporate group's affiliates will be subject to Commission requirements.
  - The requirement unfairly disadvantages end-users with affiliates in emerging markets (i.e., markets without comparable clearing requirements).

- The Proposal does not prescribe specific documentation and centralized risk management requirements for non-swap dealers and non-major swap participants. We ask that the Commission provide guidance that end-users have the discretion to determine the appropriate documentation and risk management to apply to inter-affiliate swaps that do not present the same counterparty credit risk, market risk and other risks as an end-user's external swaps.
- Trade by trade notification of compliance with all conditions to elect the inter-affiliate exemption to clearing could be too onerous.
- Longer reporting timeframes should be permitted for inter-affiliate swaps under Part 45 and historical swaps should not be required to be reported under Part 46.

II. An Exemption for Inter-Affiliate Swaps is Necessary

A. Congress did not intend for inter-affiliate swaps to be subject to clearing and execution requirements

Legislative history confirms that Congress did not want clearing and execution requirements to apply to inter-affiliate swaps. Senator Lincoln, Chairman of the Senate Agriculture Committee and one of the chief architects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[2] explained during debate that "[w]hile most large financial entities are not eligible to use the end-user clearing exemption for standardized swaps entered into with third parties, it would be appropriate for regulators to exempt from mandatory clearing and trading inter-affiliate swaps between wholly-owned affiliates of a financial entity."[3]

This position makes sense for good reason: Subjecting inter-affiliate swaps to clearing and execution requirements would regulate many transactions twice and destroy the efficiency of centralized hedging for end-users. Regulating both a market-facing swap and the corresponding internal swap used to transfer and centralize risk within a corporate group could require companies that are subject to mandatory clearing requirements to clear the same transaction twice: once for the market transaction and again for the internal transaction. This excessive clearing would drive up costs and deter end-users from using centralized hedging, which is possible only if end-users can use inter-affiliate swaps to manage risk in a cost-efficient manner.

B. Inter-affiliate swaps do not increase systemic risk

As discussed in Section I, inter-affiliate swaps, regardless of whether the swaps are executed by financial or non-financial end-users, do not increase the credit risk exposure that

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[2] Public Law 111–203, 124 Stat. 1376 (July 21, 2010).

[3] 156 Cong. Rec. S5921 (July 15, 2010).

external counterparties of end-users face. Unlike their swaps entered into with third parties, end-users use inter-affiliate swaps to transfer risks within their corporate group so that they can be managed efficiently. End-users typically enter into external swaps with swap dealers and other large banks that have implemented sophisticated credit risk management systems used to evaluate and review the risks of entering into swaps with end-user clients. In their review of the creditworthiness of their end-user counterparties, they typically would have the opportunity to review an end-user's activities, financial statements, the creditworthiness of any guarantor and a number of other items. These counterparties, after their credit review, request credit risk mitigants during their negotiations with end-users, including, corporate parent guarantees, collateral, credit-based legal terms, etc. Any potential effect that an end-user's inter-affiliate swaps could have on external swaps should be considered as part of an overall credit risk review – it should not be assumed that an end-user's inter-affiliate swaps create risk that should be mitigated through the exchange of variation margin.

Moreover, swaps entered into to hedge commercial risk, by their nature, help end-users to balance their risks. A swap that hedges commercial risk moves in the opposite direction of the underlying exposure. Hence, when the swap is out of the money, the underlying generates money, and vice versa.

Many end-users execute a significant portion of their swap transactions through wholly-owned central hedging units. These central hedging units generate economic savings by allowing companies to manage commercial and credit risk more effectively and secure better pricing for their derivatives—savings that companies pass on to customers or use to grow their business and create jobs. In this common hedging model, the central hedging unit may structure transactions to offset commercial risk for the parent company and its affiliates or follow specific hedging instructions from affiliated entities within the corporate group. Although variation in the structure exists, the hedging unit typically serves as the primary market-facing entity for the entire corporate group, entering into both transactions with affiliated entities and corresponding hedge positions with unaffiliated swap dealers, as necessary, to mitigate risk that exists within the corporate group on a consolidated basis.

From a risk perspective, the centralized hedging units concentrate trade and execution expertise and talent in a single entity, which improves a corporate group's ability to accurately evaluate the credit risk profile of counterparties. Centralized hedging units also allow for risk management across the entire corporate group, leading to increased efficiency and more comprehensive risk management.

Centralized hedging units have the added benefit of being able to net positions across an entire corporate group, which lowers the overall credit risk that the corporate group poses to the market generally and provides a broader base for netting of counterparty-facing transactions. Therefore, without centralized hedging units, costs would increase for all entities across the board. For example, affiliates could lose the benefit of their parent's corporate credit rating if they hedged as stand-alone entities. There would also be increased duplication of functions in execution, accounting, settlement, compliance, risk management and reporting, including mandatory filings. In addition to lowering the overall credit risk to the market, centralized hedging and netting down exposures dramatically lowers transaction costs (on bid/offer spreads)

and the savings can be in the tens of millions of dollars of shareholder money that would otherwise be wasted.

C. A clearing exemption for inter-affiliate swaps promotes financial innovation, fair competition and the public interest

Many of the benefits and opportunities for risk reduction provided by centralized hedging would disappear if the Commission imposed the same requirements on both external swaps and inter-affiliate swaps. The increased costs associated with over-regulation of inter-affiliate trades would push firms away from centralized hedging and back to a decentralized hedging approach. Further, over-regulation of inter-affiliate swaps could not only force end-users to pay increased costs to maintain a centralized hedging model, or abandon that model altogether, it could force end users to stop hedging altogether, especially if an end-user has tens of thousands of inter-affiliate swaps and hundreds of affiliates across the globe. The costs of compliance could be so high as to encourage companies to not hedge at all, which would harm shareholders and reduce jobs. Accordingly, firms that currently use a central hedging unit will be disadvantaged as compared to direct competitors that do not use the same, efficient risk management model. Over-regulation of inter-affiliate swaps would substitute a government mandate for corporate business judgment and could put economic pressure on companies to stop using the successful business model of central hedging, which has many benefits. Instead, an exemption for inter-affiliate swaps would promote responsible financial innovation, fair competition, and the public interest by allowing corporate groups to effectively manage their internal risk by using centralized, risk reducing, hedging units.

D. A regulatory clearing exemption for inter-affiliate swaps would not lead to abuse

Because inter-affiliate swaps are used to transfer risk so that it can be centrally managed within a corporate group, they do not create external counterparty credit risk. In fact, by netting down exposures and using inter-affiliate swaps, the number and notional volume of external swaps is dramatically reduced which in turn reduces external counterparty credit risk. No matter how many inter-affiliate swaps a corporate group executes among its affiliates, the corporate group's exposure to the market through external swaps would not change. Hence, there is no compelling reason to believe that inter-affiliate swaps would be used to avoid requirements imposed on external swaps, as one is not an economic substitute for the other. In any event, Section 721(c) of the Dodd-Frank Act grants regulators explicit anti-evasion authority to respond to and prevent any possible abuse as needed.

III. Concerns and Recommendations Relating to the Commission's Treatment of Inter-Affiliate Swaps

A. Variation margin

1. Variation margin should not be required as a condition to elect the inter-affiliate clearing exemption

As proposed, § 39.6(g)(2)(iv) requires affiliates to exchange variation margin for their inter-affiliate swaps, except for "100% commonly-owned and commonly-guaranteed affiliates where the common guarantor is also 100% commonly-owned."[4] The Coalition believes that neither initial margin nor variation margin should be required with respect to inter-affiliate swaps between end-user affiliates. The Commission states that variation margin is an "essential risk-management tool" that "might cause parties to more carefully consider risks involved with swaps and manage those risks more closely over time."[5] While these statements may be valid for certain market-facing swaps with third parties, such reasoning should not be applied to inter-affiliate swaps. As previously discussed in this comment, inter-affiliate swaps transfer risk within a corporate group so that it can be effectively managed, but do not create counterparty credit risk or contribute to interconnectedness among market participants. Margin requirements are aimed at mitigating systemic risk—something that does not result from inter-affiliate swaps. Further, under proposed § 39.6(g)(2)(iii), end-users would be subject to a centralized risk management program designed to monitor and manage the risks associated with inter-affiliate swaps.

As the Commission acknowledges, "a number of financial entities currently post variation margin for their inter-affiliate swaps."[6] This is certainly true with respect to banks and certain insurance companies, as other regulations require such entities to exchange variation margin with respect to their inter-affiliate transactions.[7] Applying variation margin in the context of the inter-affiliate clearing exception is thus overly broad and unnecessary, as the margin requirements under these various other regulations already address the specific regulatory concerns associated with the use of derivative transactions by banks, insurance companies, and other specific entities.

Although some market participants currently exchange variation margin with respect to their inter-affiliate swaps as required by applicable regulations, many inter-affiliate swaps in end-user corporate groups are not subject to variation margin requirements. In the ordinary course, end-users do not exchange variation margin, as such exchange would significantly reduce the liquidity available to an end-user's affiliated entities and the corporate group. The notion that the exchange of variation margin is as simple as moving collateral from one pocket to the other pocket (i.e., that the exchange of variation margin results in no net change in the commercial enterprise's balance sheet and is not an onerous requirement) is false. With respect to end-user entities that use a centralized hedging unit, affiliate entities will likely not have the liquidity to exchange variation margin. Accordingly, the affiliates would be required to borrow the money

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[4] 77 Fed. Reg. 50442.

[5] 77 Fed. Reg. 50429.

[6] 77 Fed. Reg. 50429 – 30.

[7] See, e.g., Federal Reserve Act Sections 23A, 12 U.S.C. 371c, and 23B, 12 U.S.C. 371c-1.

from the centralized hedging unit with which the affiliate is entering into the internal trade to satisfy the variation margin requirements that would be required under proposed §§ 39.6(g)(2)(iv) and 39.6(g)(3). This arrangement transfers the affiliate's loan obligation back to the centralized hedging unit, thereby effectively eliminating any perceived benefit of the exchange of variation margin in the first place.

The Proposal's variation margin condition on the election of the inter-affiliate clearing exemption is overly-broad and unnecessary, as it would capture end-user entities that enter into swaps to hedge or mitigate commercial risk. The variation margin requirement would capture both financial and non-financial end-users, and as discussed, such a costly result does not make sense, as the Commission's justifications regarding risk reduction are simply not relevant to inter-affiliate swaps between end-user affiliates.[8] Accordingly, the Coalition suggests deleting the requirement proposed in § 39.6(g)(2)(iv) and the related provision proposed in § 39.6(g)(3).

If the Commission chooses not to delete proposed § 39.6(g)(2)(iv) and § 39.6(g)(3) in the final inter-affiliate exemption rule, the Coalition recommends amending the current language of § 39.6(g)(2)(iv) to limit its application to swap dealers and major swap participants. The Coalition notes that an entity that falls outside of the swap dealer or major swap participant classifications may also be required to exchange variation margin on inter-affiliate swaps under other regulations (e.g., an insurance company end-user). The Coalition believes that any type of risk that the Commission intends to address by requiring the variation margin condition under proposed § 39.6(g)(2)(iv) would be sufficiently addressed by this alternative solution, which would not place significant burdens on end-user entities.

The Coalition stresses that the variation margin requirement should not, in any circumstance, apply to entities that are considered to be "financial entities" because such entities are predominantly engaged in activities that are financial in nature as described in CEA section 2(h)(7)(C)(i)(VIII). This alternative approach would ensure that financial end-users and non-financial end-users are not required to exchange variation margin to elect the inter-affiliate clearing exemption.

2. Guarantee requirement should be modified and clarified

If the Commission decides to require the exchange of variation margin and allow the exemption provided in § 39.6(g)(2)(iv) relating to "100% commonly-owned and commonly-guaranteed affiliates where the common guarantor is also 100% commonly-owned," the

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[8] For example, non-financial end-users will often enter into inter-affiliate trades between two treasury centers; as such transactions are good risk management since the commercial end-user would not be increasing systemic risk by entering into swaps with third parties. Under this common scenario, both treasury centers of a non-financial end-user could be considered financial entities under CEA section 2(h)(7)(C)(i)(VIII).

Coalition believes the guarantee exception should be modified.[9] The Commission provides the following scenario and analysis to explain the guarantee exception to the variation margin condition:

> [A]ssume that A and B are guaranteed, wholly-owned subsidiaries of X. B enters into a swap with non-affiliated third party T. B then enters into a back-to-back swap (mirroring the risk created in the swap with T) with A (i.e., an inter-affiliate swap). In this scenario, the risk associated with the swap with T is effectively borne by X and therefore ultimately borne by the enterprise. In such circumstances therefore the inter-affiliate swap does not create new risks for the enterprise, rather, it allocates the risk from one wholly-owned subsidiary to another. The posting of variation margin here would not substantially mitigate the risk of the inter-affiliate swap because the inter-affiliate swap itself does not create new risks for the enterprise.[10]

In the Commission's scenario above, a guarantee by X of the swap between B and T would more directly protect against the default risk that seems to concern the Commission; however, it is not clear from the Proposal that the Commission would permit only a guarantee of external swap obligations of affiliates that are party to both inter-affiliate swaps and external swaps with unaffiliated counterparties. A requirement of the guarantee of A and B by X would attempt to protect against the same risk that would be directly protected if X were to guarantee the market-facing swap between B and T.

Accordingly, the Coalition requests that if implemented, the guarantee exception be clarified to provide that for inter-affiliate swaps between "eligible affiliate counterparties,"[11] only the related market-facing swaps with third-parties are required to be guaranteed by the common owner or ultimate parent (in either case, whether directly or indirectly owned) of such affiliates. Further, for inter-affiliate swaps between a parent company and a majority-owned

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[9] 77 Fed. Reg. 50442.

[10] 77 Fed. Reg. 50430.

[11] Proposed § 39.6(g)(1) states: "Counterparties to a swap may elect not to clear a swap subject to the clearing requirement of section 2(h)(1)(A) of the [CEA] if one counterparty directly or indirectly holds a majority ownership interest in the other, or if a third party directly or indirectly holds a majority ownership interest in both counterparties, and the financial statements of both counterparties are reported on a consolidated basis (''eligible affiliate counterparties''). A counterparty or third party directly or indirectly holds a majority ownership interest if it directly or indirectly holds a majority of the equity securities of an entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership." 77 Fed. Reg. 50442. The Coalition is utilizing the term "eligible affiliate counterparties" because we recommend that the standard for the inter-affiliate clearing exemption generally also be used for the exception to the variation margin requirement.

subsidiary (whether directly or indirectly owned), only the subsidiary should be required to have its external trade guaranteed, if it is the parent entity's overall credit that external counterparties would review in their credit risk analysis, without regard to the parent entity's internal swaps. Therefore, a guarantee of the market-facing swap between the parent company and a third party would not make sense since the parent could not guarantee itself. Guarantees, if applicable, of affiliates' external swaps would sufficiently protect external counterparties from the risk of one affiliate's default as a result of its inter-affiliate swaps.

The Coalition also points out that the Commission's reference to *Copperweld v. Independence Tube* to support limiting the exception to 100% commonly-owned affiliates is not determinative for purposes of posting variation margin. As the court in that case explained, its holding was specifically and explicitly limited to the context of conspiracy under § 1 of the Sherman Act. Without further justification by the Commission, limiting the availability of the exemption to 100% commonly-owned affiliates is arbitrary, and there may be situations where entities are less than 100% commonly-owned yet the affiliates and common owner would be considered a single enterprise. There are several examples within a corporate group where ownership is less than 100% for business or legal reasons, but the economic risk is still reflected in the financial statements of the company and the corporate group has a vested interest in the efficient risk management of such affiliates. Accordingly, the Commission should not limit the guarantee exception to 100% commonly-owned affiliates. We suggest that the Commission adopt the same majority-owned threshold as proposed for the inter-affiliate clearing exemption generally.

Further, if the Commission decides to require variation margin, and adopt the guarantee exception, the Coalition requests that the Commission clarify that a parent company has the option to act as the guarantor of the transactions. Although this appears to be the intent of the provision, proposed § 39.6(g)(2)(iv) describes the common guarantor as being 100% commonly-owned, which would not be true when the ultimate parent is the common guarantor, as the parent would not be owned by another entity.[12]

If the Commission does not accept the Coalition's recommendation to eliminate the variation requirement condition in proposed § 39.6(g)(2)(iv), the Coalition recommends modifying this requirement as follows:

> (iv) With the exception of swaps between eligible affiliate counterparties, where a common majority owner of both eligible affiliate counterparties (direct or indirect) is also the guarantor of any related third party swap with an unaffiliated entity or the parent company (direct or indirect) is the party to any related third party swap with an unaffiliated entity and also is the guarantor of any related third party swap with an

[12] We also note that requiring guarantees for non-U.S. affiliates may lead to unintended consequences related to the cross-border scope of the Commission's rules and treatment of such entities by non-U.S. regulators.

unaffiliated entity of the other eligible affiliate counterparty, for a swap in which one counterparty is a swap dealer or major swap participant and the other is a financial entity, as defined in paragraph (g)(6), both parties shall pay and collect variation margin and comply with paragraph (g)(3) of this section.

3. The Commission should explicitly state that the exchange of initial margin is not required between affiliates

Although, the Proposal discusses the distinction between initial and variation margin, the Proposal does not explicitly state that initial margin is not required between affiliates. Although the implication and intent of the provision seem to indicate such interpretation, an explicit statement that initial margin is not required between affiliates would be helpful to end-users.

B. The Commission should clarify the regulatory treatment of centralized hedging units

The Coalition is concerned that a non-financial end-user's centralized hedging unit, which executes market-facing swaps in its own name to hedge or mitigate the commercial risk of non-financial affiliates, would be considered to be "a person predominantly engaged … in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956" as defined in CEA section 2(h)(7)(C)(i)(VIII). If classified in this manner, a centralized hedging unit would be treated as a financial entity and would therefore become ineligible to elect to use the end-user exception pursuant to CFTC regulation 39.6.[13] CEA section 2(h)(7)(D)(i) provides an exception for a financial affiliate of a person that qualifies for the end-user exception by providing that such affiliate may qualify for the end-user exception only if the affiliate is "acting on behalf of the person as an agent" and uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity. However, many end-users that use a centralized hedging unit model execute market facing swaps on a principal basis (i.e., the counterparty to the swap is the centralized hedging unit entity and not the affiliate for which it is executing the swap) to hedge or mitigate the commercial risk of affiliates, meaning that the 2(h)(7)(D)(i) exception would not apply to such transactions. The Commission confirmed this interpretation in its final rule for the "End-User Exception to the Clearing Requirement for Swaps" (the "End-User Exception Rule") where the Commission explained:

> [T]he Commission notes that it is important to distinguish where the treasury function operates in the corporate structure. Treasury affiliates that are separate legal entities and whose sole or primary function is to undertake activities that are financial in nature as defined under Section 4(k) of the Bank Holding Company Act are financial entities as

[13] 77 Fed. Reg. 42560 (July 19, 2012). Section 39.6(a)(1) of the Commission's regulations explains that a counterparty may not elect the end-user exception under CEA section 2(h)(7)(A) if the counterparty is a "financial entity" as defined in CEA section 2(h)(7)(C)(i). Id. at 42590.

defined in Section 2(h)(7)(C)(VIII) of the CEA because they are ''predominantly engaged'' in such activities. If, on the other hand, the treasury function through which hedging or mitigating the commercial risks of an entire corporate group is undertaken by the parent or another corporate entity, and that parent or other entity is entering into swaps in its own name, then the application of the end-user exception to those swaps would be analyzed from the perspective of the parent or other corporate entity directly.[14]

Treating centralized hedging units as financial entities under CEA section 2(h)(7)(C)(i) would effectively create a competitive disadvantage for those non-financial end-user companies that use centralized hedging units. It would require such end-users to be subject to clearing and execution requirements simply because they are using a risk mitigation structure that differs from their competitors. Such a result would discourage end-users from using central hedging units, effectively eliminate the risk mitigation, netting, and other benefits, and create more risk, cost, and duplication by requiring each affiliate to enter into swaps directly with swap dealing counterparties.

The Coalition is also concerned that the "chain" of "hedging or mitigating commercial risk" may be broken if a centralized hedging unit of a non-financial end-user is considered a financial entity, and therefore, the inter-affiliate swap may not be eligible for the end-user exception. In the Commission's End-User Exception Rule, the Commission stated, "This provision [§ 39.6(c)(1)] allows successive swaps in a chain of back-to-back swaps to qualify for the end-user exception if the first underlying swap qualifies for the exception, and each successive swap is used by a party to that successive swap that qualifies for the end-user exception to hedge or mitigate commercial risk. This result is only applicable to entities that could otherwise qualify for the end-user exception."[15] According to the Commission's interpretation, non-financial end-users that use a centralized hedging unit to execute market-facing swaps as principal may not be eligible to elect the end-user exception for their inter-affiliate transactions. Such a result seems to run contrary to the intent of CEA Section 2(h)(7), and would unfairly disadvantage non-financial end-users who hedge or mitigate commercial risk through centralized hedging units if such centralized hedging units are considered "financial entities."

The Coalition urges the Commission to address this issue by confirming that centralized hedging units shall not be considered financial entities with respect to swaps executed with third parties on behalf of non-financial entities, regardless of whether a swap is executed by the central hedging unit in its own name as a principal or in the name of its corporate parent or affiliate as an agent of the corporate parent or affiliate. We suggest that the Commission provide for a look-through to the entity or entities for which the market-facing swap is hedging or mitigating

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[14] 77 Fed. Reg. 42563.

[15] 77 Fed. Reg. 42574. Section 39.6(c)(1) of the Commission's regulations describes when a swap would be considered to be hedging or mitigating commercial risk.

commercial risk. For example, the Commission could allow a market facing swap executed by a centralized hedging unit to be eligible for the end-user exception if the centralized hedging unit is executing the market-facing swap on behalf of an affiliate that is eligible to elect the end-user exception.

C. Location and comparability conditions should not be required

The Commission's limitation in proposed § 39.6(g)(2)(v), allows election of the inter-affiliate exemption only with respect to those swaps in which both affiliates are (1) located in the U.S.; (2) located in a jurisdiction with a comparable and comprehensive clearing regime; (3) otherwise required to clear swaps with third parties in compliance with U.S. law; or (4) do not enter into swaps with non-affiliated parties. Generally, the Coalition does not believe that the requirement in proposed § 39.6(g)(2)(v) is necessary or appropriate to achieve the Commission's goal of reducing risk and preventing evasion. While the Coalition recognizes the Commission's interest in preventing evasion and reducing systemic risk, such a restriction on the use of the inter-affiliate clearing exemption will not achieve these goals since inter-affiliate swaps do not create systemic risk and, as discussed in Section II.D above, the Commission has anti-evasion authority under section 721(c) of the Dodd-Frank Act.

The Coalition has specific concerns with the condition described in proposed § 39.6(g)(2)(v). First, it is not clear when non-U.S. jurisdictions will implement comparable and comprehensive clearing regimes, but it is a safe assumption that the CFTC's mandatory clearing requirements will likely be effective prior to the existence of any comparable regime. Further, it is not clear what will constitute a "comparable and comprehensive" regulatory regime for swap clearing and how long it will take the Commission to make such a determination.[16] Accordingly, end-users that engage in inter-affiliate swaps with non-U.S. affiliates will not be able to rely on the condition presented in proposed § 39.6(g)(2)(v)(B) until clearing regimes are in place in an affiliate entity's jurisdiction and the Commission makes a determination that such clearing regime is "comprehensive and comparable." On the other hand, it is expected that the Commission's initial clearing determinations will be finalized and require compliance in the next several months, well-ahead of other G20 jurisdictions.

Further, the requirement in proposed § 39.6(g)(2)(v)(D) is problematic since U.S. end-user affiliates may enter into inter-affiliate swaps with a non-U.S. affiliate (located in a jurisdiction that does not have a comparable and comprehensive clearing regime) that

[16] The Coalition notes that while the Commission has proposed guidance relating to substituted compliance and the process for comparability determinations in its recent release entitled "Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act," such guidance has not been finalized. See 77 Fed. Reg. 41214 (July 12, 2012). See also, Comment Letter from the Coalition for Derivatives End-Users on the "Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act" (Comment No. 58510) (August 27, 2012).

occasionally enters into swaps directly with third parties. Therefore, there may be a situation where a U.S. affiliate enters into a swap with a non-U.S. affiliate that does not qualify under one of the four categories described in proposed § 39.6(g)(2)(v). The Coalition recommends that the Commission not adopt proposed § 39.6(g)(2)(v). Such provision is unnecessary, as transactions between affiliates do not increase systemic risk, regardless of the location of the affiliate.

If the Commission chooses to adopt § 39.6(g)(2)(v), the Coalition suggests that the Commission limit its applicability to swap dealers and major swap participants. Extending the condition to end-users would adversely and disproportionately impact end-users that have global operations, particularly those operating in emerging markets, by increasing costs for risk-mitigating transactions between affiliates. The Dodd-Frank Act did not contemplate regulation of end-user transactions in the same manner as swap dealer and major swap participant transactions; hence, the inter-affiliate clearing exception should be appropriately modified to account for risk-mitigating transactions between affiliates of end-users. Further, if the Commission decides to adopt a jurisdictional requirement for affiliates, the Coalition requests that the Commission permit non-U.S. affiliates that enter into 20 or fewer third party swaps per month to be eligible to qualify for the condition described under § 39.6(g)(2)(v)(D).

D. Centralized risk management

While the Coalition is supportive of the requirement for a centralized risk management program to reasonably monitor the risks associated with inter-affiliate swaps, we stress that this requirement should not be read as requiring the same level of risk management that an end-user maintains for external third-party swaps. Inter-affiliate swaps are inherently subject to few of the risks faced by external swaps (e.g., counterparty credit, market and operational risks). We note that swap dealers and major swap participants could fulfill their centralized risk management requirements by complying with §23.600 of the Commission's regulations, which requires extensive policies, procedures and monitoring of numerous risks relating to swaps, including, but not limited to, credit, market, liquidity and trade execution risks. While we appreciate that end-users would not be subject to these rigorous requirements for their inter-affiliate swaps, to create similar programs for inter-affiliate swaps would be onerous and challenging to maintain with little benefit to a corporate group or the risk being posed by such group.

We believe that the requirement in proposed § 39.6(g)(2)(iii) could be satisfied if affiliates in a corporate group are subject to the same group risk management policies relating to swaps and their risks generally. This would ensure that risks from a corporate group's external swaps are subject to the policies and procedures and are analyzed and managed centrally by a group risk function. It is often the case that corporate groups operate under group-wide risk policies that affiliates are required to follow, which creates the alignment of interest that the Commission states is critical to minimize any risk of using inter-affiliate swaps. Most end-users that utilize inter-affiliate swaps and a centralized model for managing risks currently have robust centralized risk management programs in place to monitor all external swap risks. The Coalition is supportive of the risk management requirement as long as it is interpreted reasonably and permits end-users to implement risk policies and procedures appropriate to the risks of a corporate group's inter-affiliate swaps, as we believe it is what the Commission intended in the

preamble to the Proposal which allows for sufficient flexibility for end-user companies to continue to use existing and proven centralized risk management programs.[17]

E. Trade documentation requirement is too onerous

The Coalition is concerned that the language in proposed § 39.6(g)(2)(ii)(B), which provides that an end-user claiming the inter-affiliate clearing exception must document its inter-affiliate swaps and that such documentation shall "include all terms governing the trading relationship between affiliates, including, without limitation, payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures" suggests that full ISDA Master Agreements would be required for inter-affiliate swaps.[18] Increasing these concerns is the Commission's statement in the preamble that "[t]he Commission believes [the documentation] requirement would not be onerous because affiliates should be able to use a master agreement to document most of their inter-affiliate swaps."[19]

Currently, in connection with centralized risk management programs, end-users document their swaps between affiliates in a manner that allows for risk management, tracking and proof-of-claim concerns. While many end-users document internal transactions with ISDA Master Agreements, some end-users may not have full ISDA Master Agreements for their inter-affiliate swaps, as such transactions are documented in connection with each specific company's risk management programs since they are purely internal and do not increase systemic risk. The documentation generally includes the terms of the trade that are necessary for the particular commercial end-user to effectively manage risk within the corporate enterprise, which would include the material terms of such inter-affiliate swaps. While the internal documentation contains the necessary information under the end-user's risk management program, such documentation may not be in the same format as the documentation with third parties.

The Coalition points out that swap dealer and major swap participant counterparties are subject to documentation requirements under § 23.504 of the Commission's regulations. Accordingly, as counterparties to swap dealers and major swap participants, end-users will execute the documentation necessary for their swap dealer and major swap participant counterparties to comply with § 23.504 and other Commission regulations. However, it is

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[17] The Commission notes in the preamble to the Proposal that "[t]he Commission anticipates that the program would be implemented and run by the parent company or the treasury/conduit affiliate, but the rule provides flexibility to determine how best to satisfy this requirement." 77 Fed. Reg. 50429.

[18] 77 Fed. Reg. 50442.

[19] 77 Fed. Reg. 50429.

inappropriate to apply these same requirements to end-users with respect to transactions with third parties, let alone with respect to their purely internal, inter-affiliate swaps.

A requirement for an end-user to execute full ISDA Master Agreements (or substantially similar documentation) with respect to all inter-affiliate swaps could prove to be an extremely costly or burdensome exercise for those end-users that do not currently document their swaps in such manner, with seemingly little benefit. The Coalition recognizes that certain changes to current documentation procedures may be necessary to comply with other Commission regulations; however, the Coalition requests that the Commission confirm that end-users can continue to use the documentation employed under their risk management programs, and that such documentation would not need to be the same as documentation with third parties (i.e., inter-affiliate trades need not be documented with ISDA Master Agreements or similar documentation). Further, an end-user's inter-affiliate trade documentation may not include all of the terms described in proposed § 39.6(g)(2)(ii)(B) and accordingly, the Coalition requests that such language be revised as follows:

> ; or (B) the swap is, if neither eligible affiliate counterparty is a swap dealer or major swap participant, documented in a swap trading relationship document that shall be in writing and shall include all terms necessary for compliance with its centralized risk management program, as described in § 39.6(g)(2)(iii), and Part 45 of the Commission's regulations.

F. Confirmation of the conditions in proposed § 39.6(g)(2) on a trade by trade basis is unnecessary

With respect to reporting requirements under the proposed § 39.6(g)(4), certain information must be reported to a swap data repository ("SDR"), or to the Commission if no SDR is available to receive the data, in order to elect the exemption.[20] The Proposal requires that, on a trade by trade basis, the reporting counterparty must confirm and report that both affiliate counterparties are electing not to clear the trade. Additionally, the reporting counterparty must confirm and report, on a trade by trade basis, that both affiliate counterparties are eligible affiliates as described in proposed § 39.6(g)(1) and meet the conditions required for electing the inter-affiliate exemption as described in proposed § 39.6(g)(2).

Confirming and reporting such information described in proposed § 39.6(g)(2) on a trade by trade basis could prove costly and onerous for parties that are not swap dealers or major swap participants who do not have internal systems in place to confirm such conditions with respect to compliance with proposed § 39.6(g)(2). Further, the reporting counterparty must provide how each affiliate counterparty generally meets its financial obligations associated with entering into a non-cleared trade and, if an entity is an SEC Filer, the SEC Central Index Key number and acknowledgment that an appropriate committee of the board of directors of the counterparty has

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[20] 77 Fed. Reg. 50443.

reviewed and approved the decision not to clear the trade must be provided. This information, however, may be reported on an annual basis.

Accordingly, the Coalition recommends that the reporting of the representation that affiliates are complying with § 39.6(g)(2), as required pursuant to proposed § 39.6(g)(2)(vi) and § 39.6(g)(4)(i) be permitted to be satisfied in through a board resolution or on an annual basis, rather than on a swap by swap basis, as such a requirement is unnecessary to enhance the Commission's systemic risk mitigation efforts and could prove to be extremely costly to end-users who do not currently have systems to confirm such information.

G. Regulatory reporting requirements should be modified

1. Longer reporting timeframes should be permitted for reporting inter-affiliate swaps under Part 45

Both financial and non-financial end-users will be required to report inter-affiliate swap data to an SDR in the form and manner set forth in Part 45 of the Commission's regulations. This means that an end-user that is not considered to be a reporting counterparty with respect to market-facing swaps, and therefore not responsible for reporting such data to an SDR, would nonetheless be considered a reporting counterparty with respect to its inter-affiliate swaps and would have to report inter-affiliate swap data to an SDR. The concept of reporting inter-affiliate swaps by end-users is not specifically addressed in Part 45 and is not separately considered in the cost-benefit analysis of the Part 45 rulemaking.

The simple fact is that reporting inter-affiliate swaps in the timeframes described in Part 45 (i.e., 48 business hours the first year, 36 business hours the second year and 24 business hours thereafter) will prove to be extremely costly, as almost all end-users will need to implement reporting programs only with respect to their inter-affiliate swaps, as virtually all market-facing swaps are executed with swap dealers and major swap participants. Further, end-users will be required to comply with Part 45's recordkeeping requirements with respect to their inter-affiliate swaps and the Commission has the ability to request the inter-affiliate trade data from an end-user.

Accordingly, the Coalition requests that the Commission permit reporting inter-affiliate trade data by financial and non-financial end-users on a quarterly basis.

2. End-users should not be required to report information on historical inter-affiliate swaps under Part 46

End-users will also be required to retain records and report data to an SDR relating to historical inter-affiliate swaps (i.e., inter-affiliate swaps that were "live" after July 21, 2010) pursuant to Part 46 of the Commission's regulations. Part 46 of the Commission's regulations fails to address the requirements for retention and reporting of historical inter-affiliate swaps. A requirement for end-users to report inter-affiliate swaps would be extremely costly and, like the Part 45 requirements, was not addressed in the final Part 46 rulemaking. Further, the Coalition questions the value of such data to the Commission, as such historical inter-affiliate swap data is

only used for the purposes of managing the internal risk of the company and, is visible to regulators, to the extent that an end-user is a public company, and to shareholders. Similar to Part 45, end-users will comply with the recordkeeping requirements of Part 46 with respect to their inter-affiliate swaps and the Commission has the ability to request the inter-affiliate swap data from the end-user.

Accordingly, the Coalition requests that the Commission explain that historical inter-affiliate swap data is not required to be reported pursuant to Part 46.

H. Definition of affiliate relationship

As proposed, §39.6(g)(1) states that the inter-affiliate clearing exemption would be available only for swaps between majority-owned affiliates. The Coalition supports this standard for defining "affiliate," as we believe that a majority-ownership test strikes an appropriate balance to ensure that the exemption is not applied too broadly, while providing appropriate flexibility to account for differences in corporate structures.

IV. Conclusion

We thank the Commission for the opportunity to comment on these important issues. The Coalition looks forward to working with regulators to help implement the inter-affiliate clearing exemption and other rules relating to end-users that serve to strengthen the derivatives market 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