Coalition for Derivatives End-Users

EUROPEAN ASSOCIATION
OF CORPORATE TREASURERS

11 July 2013

Mr. Mark Carney
Chair
The Financial Stability Board

Mr. Greg Medcraft
Chair
The International Organization of Securities Commissions

Mr. Brian Bussey
Co-Chair
OTC Derivatives Working Group

Ms. Jeanmarie Davis
Co-Chair
OTC Derivatives Working Group

Mr. Patrick Pearson
Co-Chair
OTC Derivatives Working Group

Delivery by e-mail

Dear Sirs:

The signatories to this letter represent thousands of end users of derivatives from countries around the world. The businesses, trade associations and professionals we represent come from diverse sectors of the economy and serve as job creators and engines of economic growth in local communities and on a global scale.

End users of derivatives are distinct from many other market participants because they use derivatives predominantly to mitigate financial and commercial risk through hedging. The use of derivatives to hedge risks benefits the global economy by allowing a range of businesses to improve their planning and forecasting and offer more stable prices to consumers and a more stable contribution to economic growth.

We support reforms to the derivatives markets and believe that enhancing transparency and reducing systemic risk will lead to stronger markets for end users.

We write to ask that in your critical roles as coordinators among national financial authorities, you ensure that the regulation of cross border derivatives incorporates key principles for the global end user community. Most of the discussion regarding cross-border rules and extraterritorial application has been focused on the regulation of large, global, and complex financial institutions and market infrastructure. We believe it is critical for you to consider the impact of cross-border rules on end users of derivatives: those companies that are bringing goods and services, such as energy, food and technology to local and global markets, and doing so more efficiently because of the risk management techniques they employ through derivatives.

We appreciate the efforts of global regulators to develop internationally coordinated derivatives market reforms, and we do not underestimate the complexity of adopting rules to suit local markets and legal frameworks, while also ensuring that the global markets are liquid, innovative and competitive. As regulators work toward finding suitable solutions, we would like to identify the following elements that we believe are critical for end users. We believe a framework that incorporates these elements will ensure that end users' hedging practices are not unnecessarily deterred or encumbered – an outcome that policymakers around the world have identified as a key objective.

1) **Final rules or guidance regarding cross-border or extraterritorial application of regimes should not be adopted in a single jurisdiction until there is agreement among international regulators. Regulators should grant appropriate and tailored relief from extraterritorial application of new requirements until such agreement is reached.**

   In 2009, and reaffirmed in 2010, G20 leaders agreed to "implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage".[1] In keeping with the spirit of this agreement, we believe it is prudent in the short term and critical to the success of global reform in the long term for regulators to agree to internationally consistent standards prior to the finalization of rules dictating the cross-border and extraterritorial reach of any individual jurisdiction's rules. We note that at their upcoming July meeting, the G20 Finance Ministers and Central Bank Governors are set to receive recommendations from international regulators on how to resolve remaining cross-border conflicts, inconsistencies, gaps and duplicative requirements by the time of the St. Petersburg G20 Summit in September. As this important work within the international community is ongoing, we would urge regulators to narrowly tailor the scope and extraterritorial applicability of rules until international agreement can be reached and subsequent cross-border guidance finalized. If rules or guidance are finalized prior to such international agreement, there is a greater likelihood of inconsistencies between regulatory regimes and regulatory arbitrage opportunities which could increase costs borne by end users that use derivatives to hedge and force them to change the way that they globally manage their risks.

2) **For cross-border end-user transactions that will result in the applicability of two or more sets of rules, regulators should permit end users to adhere to only one set of rules when the regulatory regimes are comparable and designed to achieve the same result.**

[1] http://www.g20.utoronto.ca/2009/2009communique0925.html

We agree that regulators must take precautions to prevent evasion from the robust regulatory oversight the G20 envisioned, and to avoid significant gaps that may undermine reform. The very purpose of the G20 agreement is to ensure that robust and consistent regulations are in place in each major jurisdiction to ensure that derivatives volume does not shift to dark or unregulated markets. Yet, the rules of two or more countries should not apply to the same transaction, particularly where an end user is a party, if the countries have comparable regimes in place. Otherwise, the application of comparable but not identical rules will create conflicts, disincentivize end-user hedging, and/or incentivize end users to transact only with domestic banks – an outcome that could harm liquidity and increase transaction costs, as well as introduce new risks where they otherwise would not exist. Further, swap dealer counterparties may be unwilling to transact with certain entities in order to avoid certain regulation, which would further reduce liquidity and increase transaction costs to end user companies.

End users have benefitted from the globalized nature of the derivatives markets. When transacting with a given bank today, a company is able to net exposures, simplify documentation and reduce operational complexity by booking transactions through a single entity. If cross-border rules penalize an end user by subjecting it to unfamiliar, conflicting or duplicative requirements, the end user will naturally seek to transact with domestic banks. Corporate treasurers will be forced to 1) reconsider transacting with counterparties outside of their own jurisdiction and 2) restructure the manner in which the risk mitigating benefits of derivatives are allocated among affiliates within a global corporate group. Further, banks would have regulatory incentives to set up subsidiaries in foreign jurisdictions that are subject to local rules. This would confound what would otherwise be a straightforward process of counterparty selection and would adversely affect end users, as they would cease to enjoy the benefits of netting, simplified documentation and operational simplicity enjoyed by transacting with globalized banking entities.

In addition to external counterparty relationships, many end users use inter-affiliate transactions as part of a global risk management strategy to transfer risk mitigating benefits of derivatives among affiliated entities in multiple jurisdictions. In fact, in a recent survey of more than 150 corporate treasurers in Europe and the United States, 60% indicated that they use cross-border inter-affiliate/intragroup transactions.[2] For these purely internal, risk reducing transactions, duplication or conflict between two or more sets of rules will be particularly onerous, and is unjustified given the minimal risk associated with the use of these transactions by end users and their regulation by the U.S. or comparable jurisdictions.

3) **In making comparability or recognition decisions, regulators should consider equivalency on a regime basis, and not on a requirement-by-requirement basis.**

As regulators determine how to make decisions regarding comparability and equivalency among regimes, we urge you to consider regimes comprehensively and whether they are, in principle, designed to achieve outcomes in line with the G20 objectives. By contrast, it would be extremely burdensome for end-user transactions to be subject to rule-by-rule determinations of comparability. Such burdens would derive from a need to understand, assess and comply with multiple regulatory regimes for a single transaction – a particular challenge for small and medium sized enterprises.

[2] http://www.chathamfinancial.com/chatham-financial-survey-highlights-impact-of-regulatory-uncertainty-on-derivatives-end-users/

For example, the current U.S. Commodity Futures Trading Commission cross border proposal establishes different regulatory treatment depending upon the legal and registration status of the swap dealer, the legal status of the end user, where the swap is booked, and whether non-U.S. counterparties are guaranteed by a U.S. entity. If a comparable regime results in specific rules, or elements of rules, being permitted to apply while others are not, it would create a complex and confusing web of compliance obligations for end users, requiring the adoption of piecemeal compliance plans that are disparate by counterparty and even by transaction. This principle applies both to rules themselves and exceptions thereto that a jurisdiction has granted end users. For example, the Commodity Futures Trading Commission has granted no-action relief for the reporting of inter-affiliate swap transactions for end users, provided that certain conditions are met; however, European rules do not provide relief to end users at this time. We believe that if such relief is not recognized among comparable jurisdictions, the value of such relief would be greatly reduced for end users that operate globally.

Again, the more complicated and expensive it becomes to comply with regard to cross border transactions, the more corporate treasurers will be compelled to transact within their jurisdictions, regardless of whether it results in the best and most efficient hedge. Such an outcome is at odds with the global commitment to reduce systemic risk within the financial system.

4) **The existence of a corporate guarantee for an end user's foreign affiliate transacting with other foreign entities should not trigger the application of the guarantor's home country rules.**

Generally, end users operating globally will hedge the risks associated with their commercial businesses out of both domestic and foreign affiliates. Typically, foreign affiliates will execute derivatives with other foreign entities for various commercially valid reasons. For example, a company in one country may establish an entity in another country for the purpose of forming a joint venture in the foreign country with a domestic partner that is familiar with the local market. If efficient financing terms are available in the local country, the joint venture may choose to finance its business locally in order to reduce currency risk. In such cases, companies may have interest rate risk that they hedge with local credit providers. However, in other cases, companies may finance their foreign investments with financing from their home countries. In such cases, it may be essential to enter into hedging transactions to mitigate currency risk and it may be a global or home country financial institution that is best able to facilitate the hedging need.

In many circumstances, a given foreign subsidiary may need to rely on a parent company or other affiliate to provide a guarantee of the foreign subsidiary's swap obligations. The existence of the guarantee will in some cases be integral to securing counterparties and appropriate terms and pricing for derivatives.

We have significant concerns that the existence of the guarantee may trigger the application of the guarantor's home country rules, despite neither counterparty being located in that jurisdiction. Again, where G20 reforms are in place, this layering of regulation is unnecessary for end user transactions that are hedging or mitigating commercial risk and could very well result in three layers of rules: the rules applicable in each foreign counterparty's home country, and the guarantor's home country.

> Policymakers around the world have agreed that historically end-user hedging has not posed systemic risks, and certainly was not a factor in the financial crisis. This consensus has been reflected in efforts in multiple G20 regimes to provide exceptions for end users from requirements that may otherwise be appropriate for large and complex financial institutions. Applying an additional set of rules to an end user's transaction between two foreign entities due to the existence of a guarantee does not square with this economic reality, particularly when the transaction falls within jurisdictions applying the G20 reforms.

Finally, we would like to underscore the importance of preserving the key principles of the derivatives regulatory reforms as the issues highlighted here are addressed. It is crucial that end users are able to mitigate their commercial risks in an economically viable manner. This activity is central to encouraging international trade at any time and especially at a time of low growth and economic uncertainty.

We appreciate your attention to this letter. Please feel free to contact us if you have any questions.

Sincerely,

European Association of Corporate Treasurers
U.S. Coalition for Derivatives End-Users