Coalition for Derivatives End-Users

March 10, 2014

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Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
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Via agency website

Re: Request for Comment on Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of Non-U.S. Swap Dealers Located in the United States

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comments by the Commodity Futures Trading Commission (the "Commission" or the "CFTC") regarding a staff advisory issued by staff from the Commission's Division of Swap Dealer and Intermediary Oversight on November 14, 2013 and issued as CFTC Letter No. 13-69 (the "Staff Advisory"), regarding the applicability of certain Commission regulations to the activity in the United States of registered swap dealers ("SDs") and major swap participants established outside the United States.

I. Background

The Coalition represents end-user companies that use derivatives predominantly to manage risks. Hundreds of companies have been active in the Coalition, both with respect to legislative and regulatory matters, and our message is straightforward: financial regulatory reform measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users, who did not contribute to the financial crisis, would create more economic instability, restrict job growth, decrease productive investment, and hamper U.S. competitiveness in the global economy.

Many end-user companies operate globally with numerous affiliates throughout the world. The use of such non-U.S. affiliates enables end-user companies to compete in foreign markets and appropriately manage risks on a global basis. Accordingly, many U.S.-based end-user companies have non-U.S. affiliates that engage in derivatives transactions with non-U.S. SDs as part of their hedging programs. The Coalition is concerned that the Staff Advisory would reduce liquidity in non-U.S. markets thereby decreasing the availability of derivatives products and increasing costs of hedging to end-users without any corresponding regulatory benefit or prevention of systemic risk. We are also concerned that non-U.S. end-user affiliates that frequently choose to hedge with non-U.S. SDs that use personnel or agents in the U.S. to arrange, negotiate or execute certain swaps will be subject to Transaction-Level Rules which will disadvantage such end-users compared to non-

U.S. end-users that choose to hedge with unregistered counterparties or counterparties that do not use personnel or agents located in the U.S. for the same or similar transactions.[1] Additionally, we are concerned that the substantive rules imposed by the Staff Advisory have not be been appropriately subjected to notice and comment and appropriate analysis of the costs and benefits of such a requirement.

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

II. The Commission Should Not Adopt the Staff Advisory

The Coalition strongly urges the Commission not to adopt the Staff Advisory as its implementation will negatively impact global end-user companies that have non-U.S. affiliates that enter into swaps. If implemented, the Staff Advisory will (1) increase costs to end-users that are passed on from their counterparties that were forced to modify their businesses to compete in non-U.S. markets; (2) force end-users to search for new counterparties as non-U.S. SDs exit certain markets where they had relied on the expertise of personnel or agents in the United States to arrange, negotiate or execute swaps; (3) force end-users to trade with less regulated foreign counterparties where non-U.S. SDs have exited the market; (4) require end-users to unnecessarily comply with duplicative and/or conflicting regulations; and (5) lead to competitive disadvantages for certain non-U.S. end-user affiliates that had relied on trading with non-U.S. SDs compared to other non-U.S. end-users in the same markets that currently hedge with unregistered counterparties.

Non-U.S. SDs generally will engage personnel or agents located in the United States to arrange, negotiate, or execute swaps because such personnel or agents can better serve the non-U.S. SD's clients because they have particular subject matter expertise for a particular type of transaction and because of their clients, location across time zones. For example, an entity organized under the laws of Germany may seek to hedge its risk in a particular sector by entering into a swap with a German SD; however, the German SD may use personnel in the U.S. who are experts on particular products to consult with end-user companies. Under the Staff Advisory, the transaction between two entities organized under the laws of Germany, with no risk impact to the United States whatsoever, would nonetheless be subject to the CFTC's Transaction-Level Rules, without the ability for substituted compliance, simply because the German SD arranged, negotiated or executed the swap using personnel in the United States. In this common scenario, the Commission's approach in the Staff Advisory would subject the transaction to all Dodd-Frank requirements and all of the requirements under the European Market Infrastructure Regulation without the ability for substituted compliance. This is an anomalous result that is a clear departure from the approach finalized in the CFTC's final guidance.

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[1] The Transaction-Level Rules are defined in the CFTC's final cross-border guidance. *See* Interpretive Guidance and Policy Statement, 78 Fed. Reg. 45292, 45366-68 (July 26, 2013).

To state the obvious, end-users greatly benefit from dealing with persons who have expertise in the products in which they seek to hedge or mitigate commercial risks. Further, non-U.S. affiliates of U.S.-based end-users often prefer engaging with registered SDs, as such entities are more regulated and can offer a broad scope of products to address a company's specific hedging needs. However, end-users, who are using swaps to hedge or mitigate commercial risks associated with operating their businesses, will generally seek not to trade with non-U.S. SDs when trading with such foreign entities will unnecessarily subject them to duplicative regulatory requirements, increase costs and place them at a disadvantage compared with competitors who do not trade with such non-U.S. SDs and therefore do not have to incur such costs.

The Staff Advisory will force non-U.S. SDs that use personnel or agents to "arrange, negotiate, or execute" swaps to exit certain markets or move personnel outside the U.S. in order to remain competitive in non-U.S. markets. As more non-U.S. counterparties refuse to trade with non-U.S. SDs to avoid regulation, it may become uneconomical for such non-U.S. SDs to participate in such markets. Non-U.S. SDs will either move personnel from the U.S. overseas or hire duplicative personnel in foreign markets so that they do not lose clients to unregistered counterparties or will choose to exit markets entirely. The costs that non-U.S. SDs will incur to move personnel outside the United States will undoubtedly be passed on to derivatives end-users and ultimately to customers. End-users rely on non-U.S. SDs to operate as market makers in markets that often times have very few such market makers. Further, end-users rely on non-U.S. SDs in instances in which a highly rated counterparty (e.g., AAA) is desired or required to serve as counterparty to a swap, for example, to comply with requirements imposed by lenders on derivatives used to hedge commercial loans. Counterparties that meet such requirements are extremely limited and actions that could deter them from transacting or cause them to take actions which would increase end-user costs would be particularly impactful in markets with small pools of counterparties. Therefore, the exit of non-U.S. SDs from such markets would result in a loss of liquidity that will leave non-U.S. end-user affiliates scrambling to find counterparties to hedge their risks. As a result, end-users will likely be forced to pay more for the same swaps, find new counterparties with which to transact (including the costs associated with engaging a new counterparty) or not hedge their risk altogether.

Accordingly, a swap between a non-U.S. end-user counterparty (that is not a guaranteed affiliate or conduit affiliate of a U.S. person) and a non-U.S. SD should not be subject to the Transaction-Level Rules as there is no systemic risk transferred back to the United States. Because swaps between two non-U.S. entities that merely utilize U.S. personnel in arranging, negotiating, or executing such swaps do not import any risk to the U.S. market or U.S. entities, subjecting such swaps to the Transaction-Level Rules is duplicative and unnecessary.

III. The Commission's Cross-Border Rules, Including the Staff Advisory, Should Follow Appropriate Procedural Requirements

As the Coalition explained in its August 27, 2012 comment to the proposed cross-border guidance,[2] the Commission should not adopt substantive policy, such as that in the Staff Advisory, without the appropriate notice and comment, pursuant to the Administrative Procedure Act ("APA"),[3] and conducting a full cost-benefit analysis that appropriately considers the costs and impacts on end-users.[4] The Commission's circumvention of APA requirements through adoption of the substantive criteria as a mere "advisory" or "guidance" is impermissible: "It is well-established that an agency may not escape the notice and comment requirements . . . by labeling a major substantive legal addition to a rule a mere interpretation."[5] The issuance of rules through "guidance" and "advisory" documents allows the Commission to sidestep APA rulemaking requirements and thus introduces substantial regulatory uncertainty by making it difficult for end-user companies to plan for future activities and develop appropriate hedging policies and procedures. Even though the Commission has permitted a 60-day comment period on the Staff Advisory, an "advisory" or "guidance" can be amended or withdrawn without a formal process and without opportunity for public comment in the future. In contrast, rules can be amended only by notice and comment rulemaking.

The issuance of this Staff Advisory is a clear example of the need for notice and comment rulemaking relating to the cross-border scope of Title VII of the Dodd-Frank Act. The Staff Advisory provides a departure from the Commission's "entity-based" approach in the final cross-border guidance to incorporate a broad "conduct-based" approach that is not discussed in the proposed or final cross-border guidance.[6] In fact, the only mention of such conduct-based oversight is relegated to a mere afterthought in a footnote of the final cross-border guidance and discussed in a much more narrow fact set than that provided in the Staff Advisory.[7] Market participants were modifying their businesses in an attempt to comply the Commission's final cross-border guidance when the Staff Advisory greatly changed the scope of the cross-border guidance both conceptually and substantively. The Staff Advisory, which would greatly expand the scope of non-U.S. end-user

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[2] *See* Coalition Comment Letter No. 58510 (Aug. 27, 2012); Proposed Interpretive Guidance and Policy Statement, 77 Fed. Reg. 41213 (July 12, 2012).

[3] *See* 5 U.S.C. § 553(c).

[4] *See* 7 U.S.C. § 19(a).

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

[6] *See* 77 Fed. Reg. 41213; 78 Fed. Reg. 45292.

[7] *See* 78 Fed. Reg. 45350, n. 513.

swap transactions that are subject to the Transaction-Level Rules, further underscores the need for the Commission to issue rules pursuant to the APA and Commodity Exchange Act's rulemaking processes to provide certainty, an appropriate process for considering comments, and consideration of the rules' impacts and costs on all market participants, including end-users.

IV. Substituted Compliance

To the extent that swaps between any two non-U.S. entities are subject to the Dodd-Frank Act, substituted compliance should be available. Such a position would not change regardless of whether or not either non-U.S. counterparty is a guaranteed affiliate of a U.S. person, a conduit affiliate of a U.S. person or neither. If the Commission, after notice and comment rulemaking, were to adopt a "conduct-based" concept, substituted compliance should be available for all such transactions between non-U.S. persons, regardless of whether or not a non-U.S. SD arranges, negotiates or executes such swaps using personnel or agents in the United States.

We further urge the Commission to continue to make substituted compliance determinations with respect to the Transaction-Level Rules and to provide deference to foreign regulators to regulate entities that are organized under the laws of their jurisdictions. In considering situations in which it would be appropriate to defer to foreign regulators, the Commission should focus on evaluating whether the foreign regulator's rules are designed to achieve similar outcomes as rules promulgated by the Commission. Absent such an approach, end-users will face uncertainty with respect to which requirements apply to them, and duplication when faced with similar requirements from each jurisdiction. Such a scenario would be especially burdensome when end-users conduct competitive auctions amongst their counterparties. If they include three different counterparties in a competitive auction, each subject to different substituted compliance regimes, the mix of regulatory requirements that could apply to the end-user transaction may vary considerably depending on the counterparty that wins the competitive auction. While substantial variations in requirements might be necessary in certain circumstances, the Commission should endeavor to avoid such circumstances by taking a broad outcomes-based approach to evaluating comparability. Such a reasoned approach to substituted compliance will reduce costs and duplicative regulations to market participants, including end-users.

V. Conclusion

We thank the Commission for the opportunity to comment on these important issues relating to the cross-border scope of Title VII of the Dodd-Frank Act and the CFTC's regulations. The Coalition looks forward to working with regulators to create a robust regulatory regime without unduly burdening end-users and the economy at large. We are available to meet with the Commission to discuss these issues in more detail.

Sincerely,

Coalition for Derivatives End-Users