Coalition for Derivatives End-Users

October 11, 2011

House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

House Agriculture Committee
1102 Longworth House Office Building
Washington, DC 20515

Re: Support for H.R. 2779, a Bill to Exempt Inter-Affiliate Swaps from the Regulatory Requirements of Title VII of the Dodd-Frank Act

To the Members of the House Financial Services and Agriculture Committees:

We are writing to express support for H.R. 2779, introduced in August by Representatives Stivers and Fudge. The bill would prevent internal swaps transactions from being subject to a significant regulatory burden, consistent with the objectives of Title VII of the Dodd-Frank Act – to mitigate systemic risk and increase transparency in the derivatives market. Without this bill, companies could be forced to alter business structures that reduce risk and lower costs, and corporate business judgment would be sidelined in favor of government micromanagement.

Each of the undersigned companies uses derivatives to help manage risks we face in the course of our business activities. Each of us also employs, or may employ in the future, a business model through which we limit the number of affiliates within our corporate group that enter into derivatives transactions with dealer counterparties. Rather than having each corporate subsidiary individually transact with dealer counterparties, a single or limited number of corporate entities face dealers. These entities then allocate transactions to those affiliates seeking to mitigate the underlying risk. This allocation is done by way of "inter-affiliate swaps" – swaps between commonly controlled entities.

This structure allows us to more effectively manage our corporate risk on an enterprise basis and to secure better pricing on our derivatives transactions. We are concerned that inter-affiliate swaps may be subject to regulations that could tie up liquidity, reduce capital investments and ultimately cost jobs. Notably, such regulations could force us to abandon a successful model for one that is less efficient.

As we understand it, regulators are considering whether to subject inter-affiliate swaps to the same set of requirements that apply to swaps with external dealer counterparties – possibly including margin, clearing, real-time reporting, and other requirements. This would be a mistake, imposing substantial costs on the economy and on consumers.

Regulation of inter-affiliate swaps should square with a simple economic reality: purely internal swaps do not increase systemic risk. Instead, inter-affiliate swaps merely allocate risk within a corporate group. The CFTC's regulatory approach should reflect this reality and the many benefits associated with the centralized model. In addition to the aforementioned benefits, this model makes good business sense for the following reasons:

- **Centralized Expertise**: The model centralizes trade expertise and execution in a single or limited number of entities. This concentration of expertise improves a corporate group's ability to efficiently and effectively manage its risks.

- **Exposure Compression**: Centralized models facilitate netting of positions across an entire corporate group, which lowers the overall credit risk a corporate group poses to the market generally.

- **Improved Transaction Pricing**: Centralized models allow affiliates to benefit from their parents' corporate credit ratings, allowing them to enjoy pricing benefits associated therewith.

Many of the benefits and opportunities for risk reduction provided by the centralized hedging model would disappear if regulators imposed the same requirements on both external and inter-affiliate swaps. This is because the increased costs associated with full regulation of inter-affiliate swaps would push firms away from centralized hedging and back to a decentralized model.

In addition to negatively impacting company risk management, regulation of inter-affiliate swaps could also subvert achievement of the Dodd-Frank Act's objectives. For example, while the Dodd-Frank Act's real-time reporting requirements aim to increase market liquidity and enhance price discovery,[1] reporting real-time transaction data for inter-affiliate swaps would accomplish neither goal. Because inter-affiliate trades are executed between commonly controlled affiliates, these transactions do not contribute to the price discovery inherent in trades executed between unaffiliated parties. It could instead misrepresent market liquidity by double-counting transactions, potentially flooding the market with irrelevant pricing data. Rather than enhancing price discovery, such information could have a distorting influence due to what could amount to the reporting of one trade twice.

The regulators have not provided definitive guidance on inter-affiliate transactions to this point. As a result, the Dodd-Frank Act could be misunderstood to require commonly-controlled affiliates to comply with a substantial set of regulatory requirements designed to mitigate risks found in certain external-facing trades. These regulations would undermine efficiencies that end-users currently realize through their centralized hedging affiliates without mitigating systemic risk.

The Stivers-Fudge bill provides a simple solution to the uncertainty that clouds the regulatory prognosis for inter-affiliate swaps. Under the bill, inter-affiliate trades would not be regulated as "swaps." While such trades would be transparent to regulators, H.R. 2779 would ensure trades

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[1] Dodd-Frank Act § 727.

between affiliates are not subject to regulations that were designed for trades between unaffiliated parties, and would honor the intent of Congress in passing the Dodd-Frank Act.

Sincerely,

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American Petroleum Institute
Bayer Corporation
BP America
Business Roundtable
Cargill, Inc.
Commodity Markets Council
Constellation Energy Group, Inc.
Deere & Company
Eaton Corporation
EOG Resources, Inc.
Financial Executives International
FMC Corporation
General Electric Company
National Association of Corporate Treasurers
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