Coalition for Derivatives End-Users

July 22, 2011

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Commodity Futures Trading Commission
Three Lafayette Centre
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Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
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<u>*Via agency website*</u>

Re: "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement;' Mixed Swaps; Security-Based Swap Agreement Recordkeeping," */ File No. S7–16–11*

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comments by the Commodity Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC") regarding the proposed rule and proposed interpretive guidance promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") entitled "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement;' Mixed Swaps; Security-Based Swap Agreement Recordkeeping."[1] We are pleased to work with the CFTC and the SEC (collectively, the "Commissions") to ensure that customary commercial arrangements are not treated as swaps. Treating these arrangements as swaps could limit the availability of affordable, efficient loan products for end-users.

The Coalition represents companies that employ derivatives predominantly to manage risks. Hundreds of companies and associations have been active in the Coalition throughout the legislative and regulatory process, and our message is straightforward: The Coalition seeks to ensure that financial regulatory reform measures 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.

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[1] 76 Fed. Reg. 29818 (May 23, 2011).

Request for Comment on Interpretive Guidance Regarding Consumer and Commercial Agreements that Are Not Swaps

The Commissions' proposed rule contains proposed interpretive guidance to assist consumers and businesses in understanding whether certain agreements commonly used by consumers and commercial businesses will be regulated as swaps. The proposed guidance enumerates specific consumer and commercial agreements that will not be regulated as swaps. The guidance notes, however, that this list is not exclusive and provides additional criteria by which to evaluate other agreements not explicitly included in the list.[2] The Commissions request comment about whether the proposed guidance is "useful, appropriate, and sufficient" for evaluating whether an agreement is a swap.[3]

The Coalition appreciates the Commissions' effort to reduce uncertainty by proposing guidance that we believe could be useful for evaluating whether an agreement may be regulated as a swap. As proposed, however, the guidance is not sufficient to provide market participants with certainty that standard commercial loan arrangements and agreements closely related thereto will not be regulated as swaps. The Coalition thus requests that the Commissions confirm that standard features of commercial loans or the loans themselves are not swaps. Such confirmation would reduce market-inhibiting and inadvertent uncertainty and ensure that existing commercial borrowing practices and customary features of commercial contracts, and the development of new features, will not be disrupted as a result of new regulation.

Commercial Borrowing

End-users depend on commercial lending as a primary source of financing for their operations. To meet their varied and specific financing needs effectively, end-users require access to an array of loan products with customizable terms and features, which the current commercial loan market provides. For example, some of the longstanding features of commercial loans that end-users bargain for have included fixed or floating rates, interest rate locks, interest rate caps and floors, flexible termination and early repayment terms, and other customizable terms.[4]

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[2] 76 Fed. Reg. 29833.

[3] 76 Fed. Reg. 29833-29834.

[4] To be clear, while in certain circumstances end-users may enter into separate derivatives transaction if the loan does not include these features, in the case of the arrangements relevant to this comment, these features are provided by the lender as part of the loan agreement and do not result from a swap with the end-user. While lenders may enter into derivatives in order to offer these loan features to end-users, those derivatives are typically between the lender and a third

[Footnote continued on next page]

Having these options available allows end-users to choose a commercial loan that best meets their specialized business needs. For example, a floating rate loan could provide end-users with less expensive financing in the near-term and greater prepayment flexibility than might otherwise be available through fixed-rate products. Fixed-rate loans give end-users a way to reduce uncertainty about future financing expenses, which allows for more accurate long-term planning. The various features of today's commercial loans have thus arisen over time from the needs of the commercial lending market and are inextricably tied to the loans themselves. Additionally, the evolution of these features in variable rate loans has enabled conventional lenders, who are limited in their ability to offer fixed rate loans, to provide products that better suit borrowers' needs.

The Coalition is concerned that interpretive guidance in the proposed rule provides insufficient certainty that commercial loan agreements with certain features and agreements closely related thereto may not be regulated as swaps. Creating uncertainty as to the possible regulation of certain commercial loans as swaps would needlessly increase end-user borrowing costs, resulting in a smaller range of effective and efficient borrowing choices available to end-users for meeting business needs. Faced with restricted access to credit options, end-users may have difficulty financing their operations and business growth.

Moreover, the Coalition is aware of nothing in the text or legislative history behind the Dodd-Frank Act that would suggest certain types of commercial loans or features therein should be regulated as swaps. Absent a clear intent to impose significant costs on the existing borrowing practices of end-user companies, and a strong rationale grounded in the reduction of systemic risk, we believe that such loans should be exempt from the definition of swap. We therefore urge the Commissions to clarify that standard existing commercial borrowing practices are not swaps and will not regulated as such.

Treatment of Commercial Borrowing Arrangements

The proposed rule states that "[f]ixed or variable interest rate commercial loans entered into by nonbanks"[5] are not included in the swap definition and explicitly clarifies that *consumer* rate locks and *consumer* loans with embedded derivative-like features are not swaps. But the proposed rule does not specifically address whether common types of commercial loans, such as *commercial* rate lock agreements and *commercial* loan caps and floors, are within the scope of the swap definition. These features and agreements are used for similar purposes as their consumer-product equivalents. Regulatory clarification that existing commercial lending products will not be treated as swaps will help ensure that the proposed rule does not disrupt important existing market practices.

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party, and as such would already be subjected to the new regulatory regime for derivatives being established by the Commissions.

[5] 76 Fed. Reg. 29833.

1. Criteria for Determining Whether Commercial Borrowing Arrangements Are Swaps

The proposed rule provides criteria for considering commercial transactions that will not be included in the definition of a swap. The criteria include the following:

- do not contain payment obligations, whether or not contingent, that are severable from the agreement, contract, or transaction;
- are not traded on an organized market or over-the-counter;
- are entered into by commercial or non-profit entities as principals (or by their agents) to serve an independent commercial, business, or non-profit purpose; and
- are used for other than speculative, hedging, or investment purposes.[6]

These criteria create ambiguity with respect to the treatment of commercial loans and their more typical features. Accordingly, the Coalition urges the Commissions to instead focus their commercial loan inquiry on whether the transaction is one that is commonly viewed as a commercial loan in the market or whether the agreement (in the case of a commercial rate lock) is clearly and closely related to a commerical loan. This approproach would avoid a classification of customary commercial lending arrangements as swaps and would provide clarity to borrowers. Moreover, if a transaction is structured in order to evade Title VII, the Commissions have strong anti-evasion tools at their disposal.

2. Treatment of Commercial Loans by Banks and Nonbanks

Commercial loans are made by banks and nonbanks, and borrowers rely on both for financing. The proposed rule helpfully contains proposed interpretive guidance that would exclude fixed or variable interest rate commercial loans made by nonbanks from the definition of swap. This appears to be generally consistent with the treatment of bank commercial loans, which are excluded from CFTC jurisdiction as "identified banking products."[7] Nevertheless, there remains a possibility that bank and nonbank lenders, and therefore borrowers, will be subject to different interpretations with respect to regulation of their loans by the CFTC. For example, the CFTC could determine that a feature of a nonbank commercial loan constitutes a swap, while the relevant bank regulator takes a contrary view as to the very same feature. This would create uncertainty for borrowers that is clearly not intended, and any such uncertainty should be dispelled by the CFTC.

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[6] 76 Fed. Reg. 29833.

[7] *See* Section 403(a) of the Legal Certainty for Bank Products Act of 2000, 7 U.S.C. 27a(a), as amended by Section 725(g)(2) of the Dodd-Frank Act.

Treatment of Certain Commercial Contract Arrangements

End-users often take into account the variability of interest rates and currency rates in certain commercial contracts. For example, multi-national companies may contract with foreign suppliers or customers to purchase or deliver manufactured goods at a pre-determined time in the future. Actual delivery occurs, and the contracts may allow for adjustments to the purchase price or other features based on changes in foreign exchange rates. Similarly, contracts for the sale of goods that have a value that is highly correlated to interest rates could include features that adjust, for example, the purchase price of an asset based on changes in interest rates. Commercial lease arrangements often include adjustments based on changes in underlying inflation rates. All of these features are an integral aspect of the contract or loan and are not severable. These features are important aspects of commercial lease agreements because they diminish risks inherent in commercial leases. Absent such features, the value of fixed lease payments (and the value of the underlying assets to which they relate) could be diminished through inflation. Also, the contracts and loans described are not separately traded on organized markets.

The Coalition requests confirmation that the CFTC's 1985 interpretation[8] on embedded options related to price in physical commodity forwards still applies and would extend to all commercial contracts involving physical commodities, such as the commerical arrangements described above. This interpretation holds that, among other things, the CFTC would consider whether the embedded option targets the delivery term or the price. As the above features pertain to price rather than delivery term, we believe that the CFTC did not intend to classify the described commercial arrangements as swaps.

Non-Deliverable Forward Contracts

The Coalition believes that the Commissions should not include non-deliverable forward contracts ("NDFs") in the definition of "swap" or "security-based swap." NDFs generally are used when practical problems exist with foreign exchange ("FX") forwards, such as currency controls in a foreign country. NDFs are cash-settled, short-term forward contracts in a foreign currency, in which the profit or loss is calculated as the difference between the contractually agreed upon FX rate and the FX rate on the date of settlement. Similar to FX forwards, NDFs are used to hedge exposure to the FX markets and have a fixed rate that is agreed upon on the inception of the contract. When used to hedge a commercial risk in lieu of FX forwards, either because FX forwards are inaccessible or impractical, NDFs have an equivalent result as if FX forwards were used. Additionally, FX forwards, like NDFs, are often cash-settled because of the difficulty predicting the timing of currency delivery can be difficult. Given that NDFs are used for the same purposes and have the same effects on the market as FX forwards, which the

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[8] *See* Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. 39656 (Sept. 30, 1985).

Treasury Department has proposed to exempt from swap regulation,[9] we encourage the Commissions to use their authority to not include NDFs in the swaps definitions.

Conclusion

We thank the Commissions for the opportunity to comment on these important issues. The Coalition looks forward to working with the Commissions 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 Commissions to discuss these issues in more detail.

Sincerely,

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

[9] 76 Fed. Reg. 25774 (May 5, 2011).