Natural Gas Supply Association

NATIONAL CORN GROWERS ASSOCIATION

February 9, 2011

The Honorable Frank D. Lucas, Chairman
House Committee on Agriculture
1301 Longworth House Office Building
Washington, DC 20515

The Honorable Collin Peterson, Ranking Member
House Committee on Agriculture
1205 Longworth House Office Building
Washington, DC 20515

Subject: Dodd-Frank Wall Street Reform and Consumer Protection Act, Implementation of Swap Dealer Definition

Dear Chairman Lucas and Ranking Member Peterson:

The Commodity Futures Trading Commission's (CFTC) implementation of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) is critical to maintaining the economic protections provided by the Dodd-Frank Act to end-users.

The National Corn Growers Association (NCGA) and the Natural Gas Supply Association (NGSA) were active participants in the shaping of the Act during its passage and are taking an active role in the Act's successful implementation through participation in the CFTC's rulemaking process.

Financial reform must not come at the expense of America's energy and commodity producers, consumers, and ultimately, the entire U.S. economy. Absent careful CFTC implementation of the swap dealer definition, the practical effect of the Dodd-Frank Act could be mandatory clearing for many commercial end users. Imposing a clearing requirement on commercial end-users does not further the goal of ensuring financial system integrity, and instead, centralizes risk that would have otherwise been diversified, *increasing* systemic risk and unnecessarily removing productive capital from the economy.

Mandatory clearing of derivatives transactions will drain the economy of more than $650 billion* in capital. Keeping U.S. industry's capital at work in a recovering economy through the sound implementation of the end user protections in the Dodd-Frank Act will help create jobs, energy and products for U.S. consumers without compromising the integrity of the U.S. financial system.

A primary purpose of CFTC regulation of the "over-the-counter" (OTC) markets is to protect consumers from systemic risk. The CFTC's definition of Swap Dealer should balance the goals of protecting consumers from systemic risk and ensuring no unnecessary harm to the economy. Thus, the CFTC must carefully scope the definition of Swap Dealer because an unnecessarily broad definition will sweep in end-users, limiting one of the key protections for the economy incorporated into the Dodd-Frank Act.

In November 2010, NCGA and NGSA offered the following pre-proposal comments to the CFTC, outlining what we believe is a workable solution to the implementation of the swap dealer definition. NCGA and NGSA intend to provide further comments to the CFTC on this issue later this month but believe that the approach to the definition of Swap Dealer might be also be helpful in your review of the implementation of Title VII of the Dodd-Frank Act later this week.

Trading in Swaps Should Not Make a Company a Swap Dealer. The CFTC should implement the Swap Dealer definition by ensuring that both the law's general exception and the de minimis exception are properly applied. The general exception applies to entities entering into swaps for their own account (e.g. traders). The de minimis exception allows for the exclusion from a Swap Dealer designation of entities that engage in a de minimis quantity of swap transactions "with or on behalf of" their customers. These two exceptions are essential because they allow entities that use swaps to hedge or mitigate commercial risks, such as those risks that stem from the production of energy and agricultural commodities, to avoid being designated as Swap Dealers, a designation that would preclude eligibility for the end-user clearing exception. Entities designated as Swap Dealers would be required to transact their swaps on an exchange or to clear such transactions, subjecting them to costly margin and clearing expenses and draining the economy of billions of working capital dollars.

The CFTC Should Use the Concept of "Intermediation" to Define Swap Dealer. To achieve congressional goals, the CFTC should use a two-step process based on the Securities Exchange Act and the concept of intermediation (transacting to satisfy a customer order or, simply put, acting on behalf of a customer) to first implement the general exception and then implement the de minimis exception in the Swap Dealer definition. The Securities and Exchange Commission (SEC) precedent[†] on the designation of a dealer provides a

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* Estimate based on the U.S. portion of global credit exposure that is not already collateralized. Data sources include the Bank for International Settlements, Monetary and Economic Department OTC Derivatives Market Activity Report, "Cross-border derivatives exposures: how global are derivatives markets?" by Sally Davies of the Division of International Finance, Board of Governors of the Federal Reserve System, and Country Exposure Report that shows U.S. banks' exposure from derivatives. For the detailed calculation methodology, please contact the Natural Gas Supply Association at 202-326-9317.

† Vol. 15, Broker-Dealer Regulation, David A. Lipton, Section 1:6 at 1-42. 11, n.4.

comprehensive way to distinguish trading from dealing. Central to the SEC case law that distinguishes "dealing" from "trading" is the concept of intermediation. To implement the two exceptions, the CFTC should use the concept of intermediation as the basis for filtering dealers from traders, many of whom use swaps to hedge business risk. This approach will ensure that financial entities engaging in swaps with or on behalf of customers remain in the regulatory purview of the CFTC without diminishing the integrity of the end-user clearing exception.

Step one: Use the SEC model for distinguishing between "dealers" and "traders" to implement the general exception. Built into the Swap Dealer definition is a general exception excluding "persons that enter into swaps for that person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business"-- from designation as a Swap Dealer. Put another way, the general exclusion establishes that only an entity trading swaps that are not for its own account (*e.g.* done in an intermediary capacity) is a Swap Dealer. In securities markets, the SEC and the courts have identified a number of characteristics for dealing activity. While the securities market activities do not translate precisely to the commodity swaps market, the concept of "intermediation" does translate. (See inset below.) The concept of intermediation can be used to implement the general exception as the starting point for sorting dealers from traders so that the integrity of the economic protection provided by the general exclusion can be maintained.

Step two: Implement the de minimis exclusion by considering the level of "dealing" transactions relative to total swap transaction activities. An entity would not qualify for the general exception if it both trades and deals. While not universal, many commercial entities with astute trading capabilities also enter into transactions with their traditional customers that may ultimately resemble dealing. Often this "dealing" is the result of the customer's interest in transacting financial hedges with a counterparty that has physical assets and a history in bringing physical product to market. This is where the de minimis exception plays a critical role. For entities that trade swaps and engage in this limited form of dealing, the CFTC should design the de minimis exception so that the level of dealing (defined by using the concept of intermediation as reflected in the SEC regulations) is compared to their total swap transactions (e.g. trading and dealing). If the level of dealing relative to the total is small, in other words, if the entity primarily trades swaps, the de minimis exception is satisfied.

Securities Market *Intermediation* Concept Translates to Commodity Swaps Market Swap Dealer Characteristics

- performing an intermediary role in swaps markets by engaging in swap transactions with customers;
- remaining essentially neutral to price movements with respect to the swap and underlying commodity;
- quoting a two-sided market for swaps and standing ready to take the opposite side of customer orders; and
- providing financially-related, ancillary dealer activities (*e.g.* advising on investments)

The right Swap Dealer approach works for consumers and the economy. Using the concept of intermediation to implement the general and de minimis exceptions will allow the CFTC to sort true swap dealers from those entities that trade swaps to hedge commercial business risk. This approach is consistent with existing case law and the Congressional goal of avoiding unnecessary harm to the economy. Finally, the solution provides the CFTC with a practical and valid way to regulate Swap Dealers that buy and sell swaps to satisfy customer orders, without the harm to the economy that would result from avoidable and unnecessary increases in business risk management costs. Appropriate implementation of the Swap Dealer definition is essential to maintaining the integrity of the end-user protection provisions that were central to the passage of the Dodd-Frank Act.

Founded in 1957, NCGA is the largest trade organization in the United States representing 35,000 dues-paying corn farmers nationwide and the interests of more than 300,000 growers who contribute through corn checkoff programs in their states. NCGA and its 48 affiliated state associations and checkoff organizations work together to create and increase opportunities for their members and their industry. Established in 1965, NGSA represents integrated and independent companies that produce and market approximately 40 percent of the natural gas consumed in the United States.

Please do not hesitate to contact Sam Willett, Senior Director of Public Policy for NCGA at 202-628-7001 or Jenny Fordham, Vice President, Markets for NGSA at 202-326-9317, if we can provide any additional information. Thank you for your review of the implementation of title VII of the Dodd-Frank Act.

Sincerely,

National Corn Growers Association
Natural Gas Supply Association