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COMMENT

KOCH INDUSTRIES INC

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OFFICE OF THE SECRETARIAT

October 9, 1998

COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD

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Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Over-the-Counter Derivatives Concept Release

Dear Ms. Webb:

In response to the Commission's Concept Release on OTC derivatives published on May 12, 1998, in the Federal Register, Koch Industries, Inc. is submitting this two-part response, consisting of general comments on the issues raised in the Concept Release, as well as responses to the questions posed by the Commission. Koch Industries, Inc.[1] is a large, highly diversified energy company involved in virtually all phases of the oil and gas industry, as well as agriculture, chemicals, chemical technology products, energy services, metals and minerals services, real estate, and financial services. Based in Wichita, Kansas, Koch is the nation's second-largest privately held company based on revenues. It operates in 39 states and 22 countries, and it employs more than 16,000 people worldwide.

A key component of Koch's energy business is the operation of three refineries in Texas and Minnesota that together process about 540,000 barrels of crude oil per day into gasoline, diesel fuel, jet fuel and other products. Koch also owns and operates one of the largest pipeline systems in the U.S., a 37,000 mile system for transporting crude oil, petroleum products, natural gas, and natural gas liquids. Koch's agriculture businesses include beef production, grain storage and processing, animal feed production, fertilizer sales, and other retail farm services.

Koch is a major participant in the OTC derivatives market. It uses swaps and other instruments for its own account and in conjunction with providing risk management tools for its customers, often as part of the marketing of energy products. Koch also conducts trading activities, relating to a wide variety of commodities, on exchanges in the U.S. and foreign countries.

[1] Koch Industries, Inc. is the parent company of numerous subsidiaries. Hereafter, the term "Koch" will be used to refer to the Koch affiliates that are engaged in commodity trading activities, both collectively and individually, as appropriate.

P.O. Box 2256 • Wichita, Kansas 67201 • 316/828-5500

1. The Market's Dramatic Growth Has Resulted from Lack of Regulation.

In response to the Commission's overarching question of whether regulatory oversight in the OTC market is warranted, Koch believes that there is no need for a regulatory scheme in the OTC derivatives market. In the Concept Release, the Commission states that the "[u]se of OTC derivatives has grown at very substantial rates over the past few years," citing a 46% growth in the first six months of 1997 and a 154.2% growth since year-end 1994. As both an end-user and a dealer in the OTC derivatives market, Koch is particularly well positioned to comment on the cause of this tremendous growth. We believe that it has resulted primarily from the enormous value the parties have received from the OTC products.

Based on our experience with these instruments, we know that the market participants value their ability to engineer documents with terms tailored to address issues that are significant and possibly unique to each contracting party. It is the recognized value of this flexibility that has driven the growth in the use of the OTC products. The statistics that the Commission uses to describe the growth in this market are a testimonial to the fact that the parties value the products, the freedom to tailor the contractual terms to address their specific needs, and the efficiency with which the contract terms are performed. Koch believes that it is the absence of regulatory constraints that allows the participants to maximize the value of these instruments.

2. Abusive Conduct is Minimized by Existing Remedies and Does Not Justify Regulatory Intervention.

Further evidence that the market is operating efficiently is found in the lack of systemic abuses reported by the participants in the market. In the report of the U.S. General Accounting Office ("GAO") on the OTC derivatives market published in October, 1997, end user satisfaction with sales practices in the market is described as high. In support of this determination, the GAO states that records reflecting complaints to regulators, regulatory enforcement actions, and public records of litigation demonstrate that sales practice problems are not widespread. As a matter of fact, when sales abuses occurred, the abuses were attributable to a small number of dealers. In gathering data for the report, the GAO identified 18 incidents of end-user losses with OTC derivatives that involved sales practice concerns. Of these 18 incidents, 9 involved one dealer. This limited number of "bad-actors" in the market fails to justify the cost of regulatory oversight.

Currently, in order to be a counterparty to a swap, each party to the contract must be an eligible swap participant, and as such, must possess some level of financial capacity. These parties are fully capable of protecting themselves against sales practice abuses. Moreover, Mr. Alan Greenspan, Chairman of the Federal Reserve, has repeatedly stated that end-users who have been victims of deceptive practices have demonstrated an ability to obtain restitution either by taking legal action or by threatening to do so. (See, for example, his testimony on July 30, 1998, before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry.) When losses do occur due to fraud and abuse, there are existing legal remedies available to the aggrieved party.

Although some parties have incurred large losses that are attributable to sales practices, the well publicized cases involved Procter & Gamble, Gibson Greetings, and Orange County, California. Regardless of the level of any reasonable financial threshold used to determine financial sophistication, these parties would have exceeded that threshold at the time they entered the OTC market. These parties certainly had the capability to access knowledgeable counsel before entering into instruments that contained risks they did not understand. Financial thresholds, therefore, do little to avoid losses arising out of abuses or misunderstandings. Consequently, the fact that these sophisticated parties incurred losses provides no justification for disrupting a well-functioning market with regulatory intervention.

Even if parties to swaps were not required to be financially sophisticated, wide spread abuses in the OTC derivative market would be prevented by a well-established characteristic of a free market. According to Mr. Greenspan, as noted in the GAO report, dealers are motivated by the need to stay competitive, which requires that they maintain a good reputation. It would be counter-intuitive for a dealer to engage in abusive sales practices, knowing that such abuses would result in the dealer becoming competitively disadvantaged.

Koch often enters into swaps that are designed to hedge risks that would otherwise be borne by Koch's customers. Koch is well aware of the fact that if the customer believes that Koch engages in abusive practices, Koch will likely lose all of the customer's business. The incentives of Koch and its customer are aligned in the sense that both parties' long-term objectives are achieved if large losses are avoided. The desire to achieve long term financial stability is a much greater and more efficient motivator for avoiding fraud and abuse than regulatory requirements.

3. Regulations Would Have An Adverse Impact On The Market.

A. The Instruments' Greatest Value Would Be Lost.

The greatest value these products offer the market participants, compared to standardized risk management tools, is the value derived from the uniquely tailored terms of each contract. Often, neither Koch nor its customer can find an existing product that is designed to offset the specific element of risk that a tailored swap agreement addresses. If, due to the imposition of a regulatory scheme, Koch and its customers lose the ability to customize the contract, the greatest value of the contract is lost.

Similarly, forcing the trading of these products onto an exchange would have an equally disastrous impact. The ability to customize terms is essential to a party who is attempting to mitigate a unique, or uncommon, element of risk. It is economically infeasible to attempt to trade contracts with varying terms on an exchange. The customized instrument would, therefore, disappear from the market. If the end user is not able to find a tool through which it can offset risk, the end user absorbs the risk. Consequently, the end user may sustain large losses due to the absence of adequate risk shifting instruments in the market.

B. Regulations Would Increase Costs And Reduce Efficiencies.

In addition to exposing end users to risks they would otherwise shift away, any new regulation of this market will result in added costs to the market participants. These costs may result from many events, including the dedication of resources to studying and understanding any new requirements set forth in the regulations. Once the regulations are understood, there will be the added cost of implementing procedures to ensure compliance. Any time compliance is required, it adds costs to products. The costs are often passed on to the ultimate consumer of goods and services, or, in some cases, the product simply disappears from the market.

Although Koch's customers generally are not the ultimate consumers of goods and services, to maintain profitability, our customers would have to pass increased costs and losses on to the buyers of their products. Consider, as an example, a major manufacturing entity that is a large buyer of natural gas. Suppose this manufacturer has identified a basis risk that is inherent in its anticipated requirements for gas. Further suppose that required standardization of contracts eliminates the customer's ability to hedge this basis risk. If the manufacturer absorbs recurring losses that could have otherwise been offset with tailored swaps, the manufacturer would attempt to pass these losses on to purchasers of its products. Similarly, if the manufacturer or Koch experiences greater costs arising out of procedures designed to comply with regulation, the consumer most likely will ultimately experience higher costs for goods and services. Eventually, in most cases, the consumer pays the ultimate cost of an expense burdened market that cannot offer valuable products at the lowest possible cost.

C. New Regulation Would Create Legal Uncertainty.

There has been no authoritative finding that a swap agreement is a futures contract. Furthermore, the Commission has a long and consistent history of proclaiming an intent to not standardize or force the trading of these instruments onto an exchange. Any attempt to deviate from this path will assuredly cause legal uncertainty among market participants. Legal uncertainty translates to legal risk. In the face of legal risk, market participants will choose to either vacate the market, reduce their creativity in crafting instruments that address unique elements of risk, or increase the costs of the instruments to justify absorbing increased risk. Again, the costs associated with these reactive behaviors will most likely be absorbed by the ultimate consumer of goods and services.

4. Benefits Derived From Regulations Are Insufficient To Justify Costs.

Considering the costs and losses that would derive from regulatory intervention in an otherwise efficiently functioning market, there are insufficient benefits that would justify the increased costs. The data set forth in the GAO report fails to demonstrate a systemic problem that is specific to these instruments. Regulatory intervention cannot cure a problem that does not exist. Furthermore, these OTC instruments are often used to offset price, volume and basis risks that exist in, and are sometimes unique to, the core businesses of the market participants. Regulatory oversight will not operate to reduce these risks. Instead, regulatory oversight will likely result in the elimination of instruments that mitigate these risks. Koch, like other market participants, has experienced losses with these instruments. A contributor to the losses has been the credit risk of the counterparty. Absorbing credit risk is not unique to trading swaps; rather, it is an element of conducting every business. A party to a swap agreement can mitigate the credit risk to which it is exposed through the careful evaluation of its counterparty's credit capacity.

Koch is particularly well qualified to assess the attributes of the OTC market. From our vantage point as both an end-user and a dealer, Koch believes that the free market is operating efficiently and effectively without regulatory burdens. The imposition of a regulatory scheme will undoubtedly diminish the efficiency and effectiveness of these products and the market. Koch, therefore, believes that there is no need for regulatory intervention in the OTC market.

Again, we appreciate the Commission's consideration of our comments. To further assist the Commission's analysis of the status of the current market, we attach hereto our responses to the questions posed by the Commission in the Concept Release. If the Commission has any questions regarding our responses, please contact me at 316-828-5590.

Respectfully,

C. J. Nelson

C. J. Nelson
Vice President

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RESPONSE OF KOCH INDUSTRIES, INC.
TO QUESTIONS IN THE OTC DERIVATIVES CONCEPT RELEASE

The Commission's questions, although often specific in nature, generally focused on the issue of whether there is a need for the Commission to intervene in the operations of this market through the imposition of regulation. Rather than respond to each specific question, Koch has chosen to address the general theme embedded in specific subject categories. Although the Concept Release addresses both swap and hybrid instruments, Koch's experience with these instruments is concentrated in swaps. Our response is, therefore, limited to swap agreements.

1. **Eligible Transactions and Eligible Participants:**

A. The Commission Should Minimize Its Interference In This Market.

The Commission has asked for comments on changes that may be needed to the current swaps exemption to assure that Part 35 provides legal certainty to the current market and fulfills the statutory goals set forth in Section 4(c) of the CEA. Koch recommends that the Commission exhibit conduct consistent with that which it has exhibited in the past. Specifically, the Commission should continue to minimize its interference in the over-the-counter markets in swap instruments. The Commission can accomplish this result in two ways: 1) avoid issuing new regulations, and 2) relax the constraints that prevent potential participants from entering into swaps.

Part 35, published in the Federal Register in 1993, was consistent with previous policy statements demonstrating the Commission's intent to minimally regulate the trading of swap instruments. As indicated by the GAO Report published in October, 1997, since the adoption of Part 35, the swap market has grown dramatically. This growth is evidence that the consistent approach the Commission has exhibited regarding the treatment of over-the-counter swap instruments has created a perception of legal stability in the marketplace. If the Commission continues to display a consistent pattern of conduct by not placing an additional layer of regulation on this financial market, the beneficial perception of legal stability will be augmented.

If, however, the Commission places an additional layer of regulation on the swap market, the market will be adversely impacted. The Commission's placement of a new layer of regulation in this market would be a deviation from the Commission's demonstrated conduct and will certainly adversely impact the perception of legal stability in the marketplace. This adverse impact will manifest itself in retarded growth or a constriction in the use of these valuable financial instruments.

B. The Commission Should Relax The Eligible Swap Participant Rules.

Koch believes that the market is unnecessarily constrained by the regulated financial thresholds in the definitions of "eligible swap participants". Relaxation of the eligible swap participant constraints will further enhance the ability of the swap market to grow, develop, and serve individuals and entities who need risk management tools. Furthermore, abatement of the "eligible swap participant" rules would demonstrate that the Commission is behaving in a manner consistent with earlier conduct. Again, this consistent conduct will benefit the marketplace through increased use of these valuable and efficient financial tools.

C. There Is No Need For Clarification Of Terms.

The Commission has asked whether some of the terms currently used in Part 35 need clarification. There is no need for a clarification of these terms. The growth in the marketplace is evidence that the market participants are comfortable with their understanding of the terms used in Part 35. Attempting to define terms that are currently understood will diminish the comfort of legal certainty that currently exists in the market place. New definitions of existing terms will undoubtedly cause the participants in the swap market to examine past conduct to determine whether existing or expired contracts conform with the new, expanded, and perhaps restricted, definitions. Uncertainty will prevail in the marketplace until the participants regain comfort that their conduct, is, and has been, within the scope of the new definitions of understood terms.

Legal uncertainty translates to a perception of legal risk. Heightened risk of any kind, including legal risk, results in elevated costs to market participants. In this case, the added cost of heightened legal risk will come in the form of additional legal fees as market participants turn to lawyers seeking advice as to whether the new rules require that the participants modify their conduct. For some, the prospect of legal fees will cause the participants to exit the market, thus resulting in a constricted and less diversified environment. This market, like any other market, benefits from a larger number of participants in the market. If the Commission's conduct results in participants exiting the market, this conduct will have an adverse, rather than beneficial, impact on this market.

Additionally, if new words and phrases are used to describe established, understood terms, the new language may be used to attack and invalidate existing contracts. Occasionally, with the benefit of hindsight, a contract participant determines that if it had entered into a different type of risk management tool, or the same tool on different terms, the ultimate result would have been of greater benefit. The new words and phrases expounding the definitions of terms in Part 35 may be used in an attempt to attack and invalidate existing contracts, or justify a breach of an expired contract. Again, such uncertainty will cause a constricted and less diversified financial environment as participants leave the marketplace.

D. Relaxation of Constraints is Consistent With The Objectives of Sections 4(c)(1) and (c)(2) of the CEA.

Relieving the constraints on the definition of an eligible swap participant, and otherwise allowing the market to continue to operate under the current swap exemption, without an additional layer of regulation or further defined terms, is consistent with Sections 4(c)(1) and (c)(2) of the CEA. Pursuant to Sections 4(c)(1) and (c)(2), the Commission may, if it determines that the agreement will be entered into solely between appropriate persons, exempt any agreement from the CEA, provided the Commission determines that the exemption would be consistent with the public interest. To date, there has been no determination that the swap agreements are futures contracts. Thus, there is no consensus that swap agreements fall within the scope of the CEA. Until such determination is made, a relaxation of oversight cannot be deemed violative of Sections 4(c)(1) and (c)(2).

In the alternative, even if authorities determine that swap contracts fall within the definition of a futures contract, and are, therefore, subject to the Commission's jurisdiction, relaxation of these rules is appropriate. The Commission's obligations are to determine that, if a contract falls within the scope of the CEA: 1) any exemption granted is in the public's interest, and, 2) that the contract will be entered into solely between appropriate persons. The definition of "appropriate person" includes persons that the Commission determines to be appropriate in light of their financial or *other qualifications*. Any entity or person who could benefit from the risk shifting benefit of a swap contract would be an appropriate person, regardless of the size of gross asset or net worth positions.

The GAO report demonstrates that the size of the company or its net worth is irrelevant in determining counterparty or contractual risk. The large publicized losses under swap agreements occurred between large and financially sophisticated entities. Losses absorbed by these entities are evidence that the financial thresholds in the definition of "eligible swap participant" do not protect those who enter contracts without understanding their terms. These arbitrarily assigned thresholds only prohibit participation by those who would otherwise seek the advice they need to understand terms of a contract that could be very beneficial to their financial objectives.

The growth of the swap market strongly demonstrates that the market works efficiently. The volume and widespread use of these contracts is the market's proclamation that these contracts are in the public's best interest. The beneficial attributes of these contracts should be accessible to all who may need to use them.

E. Fungibility Should Be Facilitated Only If Standardized Terms Are Not Also Mandated.

The Commission has also asked whether the swaps exemption should be extended to fungible instruments. Koch believes that the most beneficial attributes of swaps are the customized contract terms that address the specific needs of the counterparties. The customization of each swap agreement inhibits fungibility. Requiring that the terms of all swap agreements be standardized in order to facilitate fungibility will significantly reduce the most valuable characteristic of the contracts. Koch is, therefore, opposed to mandating standardized contract terms to facilitate fungibility.

Koch acknowledges that a fungible contract could offer a participant more flexibility in managing its risks than a nonfungible instrument, and, in some circumstances, value would be perceived in this flexibility. If a fungible swap contract were available, and the counterparties to the contract deemed that contract to be the most advantageous tool for satisfying their specific needs, there should be no reason to restrict the parties' ability to enter into the contract. Koch supports allowing fungible contracts in the swap market, but only so long as fungibility is not accompanied with mandatory, costly, and constraining standardized terms.

2. Clearing and Transaction Execution Facilities:

A. Exchange Traded Swaps Should Be An Alternative And Not A Requirement.

The Commission generally asks whether swap agreements should be cleared through an organized exchange. Koch is opposed to any mandate requiring that swap contracts be traded on an exchange. As described earlier, the most valued characteristic of a swap agreement is its customized terms that are designed to address risks that are specific to the counterparties. To facilitate exchange trading, the swap agreements would have to be standardized. Mandatory standardization of the terms of every swap would extinguish the most valuable component of the instruments.

Koch would support the exchange trading of swaps if exchange trading were at the option of the participant, and not a mandate from the Commission. Exchanges have the attribute of offering liquidity in some circumstances. Correspondingly, some swap agreements are so similar that they could be standardized without losing much value. The ideal set of circumstances, therefore, would be that *at the participant's sole and complete discretion,* the participant could chose a standardized swap agreement, thereby allowing the participant to utilize an exchange if it so chose, or, the participant and its counterparty could enter into a customized over-the-counter agreement. If exchange trading of swap contracts is allowed, the participant's ability to exercise its discretion to enter into a standardized or customized agreement must be permitted in order for the swap agreement to continue to serve the market in as efficient a manner as it currently serves.

3. Registration, Capital, and Internal Controls:

A. Prudent Business Practices Meet The Commission's Objective.

The Commission has asked for commentors' opinions as to whether the Commission should intercede in this market by mandating registration of participants, capital requirements and internal controls. Koch strongly opposes any interference by the Commission in the swap market through mandated registration of participants, capital requirements or internal controls. The Commission's objective in requiring compliance with any regulation requiring maintenance and disclosure of business practices and profiles would be to provide counterparties access to information. Koch agrees that acquiring information about counterparty credit worthiness is essential to a successful swap transaction. Acquiring this information, however, should be left to the discretion of the parties

B. Developing A Business Relationship Provides Access To Essential Information.

The Commission's goals are met through free market practices of prudent business procedures. Where successful achievement of the objectives of the agreement are dependent upon counterparty performance, prudent business practice mandates that counterparties exercise due diligence to become familiar with their counterparties prior to entering into agreements. Although registration may provide a market participant some financial information on the counterparty, this financial information, as well as more current results of financial performance, may be acquired by simply requiring delivery of the information prior to entering into the agreement. Furthermore, the delivery of the financial information will not reveal the most important element of credit quality, that of the counterparty character. Information acquired through the registration process will do little to answer questions regarding credit risk and character. Character can only be assessed through knowing one's counterparty.

Koch has learned, through its participation in this market, that the most valuable information is acquired through the development of business relationships. It is only through the development of the relationship that Koch learns about the business stability and integrity of its counterparty. This independently acquired knowledge is of much greater value than the information any registration document could possibly reveal. There would be little incremental benefit derived from the Commission's mandated disclosures.

C. Regulating These Areas Would Be Costly Without A Countervailing Benefit.

Compliance with any regulation in any of these areas will be costly and burdensome without a countervailing benefit. The information required by regulation is often stale and therefore of little value. The burdensome cost of regulatory compliance will not be outweighed by allowing a counterparty access to incomplete and stale information that will be insufficient to make a prudent business decision.

The determination of the counterparty's credit capacity, as well as the participant's willingness to accept that risk, should be based on the participant's analysis of the counterparty and the participant's risk tolerance profile. Neither registration nor notice filings will protect market participants from the other risks that may result in financial losses in the swap market. In addition to credit risk, financial losses with swaps result from inherent volatility of price, volume and basis. Registration will not be an effective tool for the assessment of these risks.

4. **Sales Practices:**

A. There Is No Evidence Of Systemic Fraud And Abuse In The Swaps Market.

The Commission asks whether disclosure of financial risks inherent in swap agreements would serve to avoid sale practice abuses. Koch strongly believes that there is no evidence of systemic fraud and abuse that would give rise to a requirement for risk disclosure statements. The GAO report clearly indicates a lack of widespread abuse in sales practices in this market. Additionally, where fraud and abuse has occurred, the participants have successfully sought legal remedies. The conclusion, therefore, is that free market objectives and the current legal system operate to constrain and remedy the minimal amount of fraud and abuse in this market.

Furthermore, the value of the risk disclosure would be limited if mandated disclosure terms are generic in nature. Each swap agreement is unique in the sense that it is designed to address specific risks. A generic risk disclosure statement cannot be designed to reveal unique risks imbedded in each swap agreement. Again, Koch believes that risk assessment should remain with the market participants. Prudent business practices would mandate that each party to a swap agreement would understand its terms and assess its risk. Only after such assessment is made, can a party to a swap agreement determine whether the swap is an appropriate instrument in the participant's portfolio.

B. Dealers Should Not Be Participant's Fiduciaries.

Koch is especially concerned with the possibility that, by mandating the delivery of information, dealers of these instruments may become a fiduciary of the market participants. Currently, dealers have no fiduciary duty to market participants. They do not act as agents or advisors, nor should they. To impose a fiduciary responsibility on the dealers would reduce the dealer's effectiveness in acting as an intermediary and result in a costly and constrained environment. If preliminary disclosures are required, the information will be of little value in assessing risks of subsequent transactions. If detailed disclosures of each transaction are required, the dealer would be exposed to tremendous legal risk arising out of inaccurate or incomplete information. The cost of creating and delivering accurate and complete information would be prohibitive. Due to the unique nature of the swap agreements, each party to the agreement should be responsible for assessing the risk of the instrument's terms, not the dealer.

The market provides an effective and efficient mechanism to assure a high level of sale practice integrity. Participants in the swaps market rely on repeat business to establish sustainable profits in this market. If a participant misleads a counterparty in any transaction, the participant will likely lose the confidence and, therefore, any repeat or collateral business with its counterparty. Participants in this market are sufficiently skilled to understand that maintaining a business profile that includes high integrity is essential to achieving long term profitability.

5. Summary:

In summary, the recurring theme in our response to the Commission's request for comment is that the market has demonstrated that it operates effectively and efficiently. The market has grown at an impressive rate, due to the ability of parties to tailor terms of each swap without regulatory interference. Furthermore, there is no evidence of any systemic weakness in the market's operation. A layer of regulation will only result in costly, ineffective and inefficient compliance efforts, thereby reducing the value of the instruments. There is no need for the Commission to increase its regulatory oversight of this market. There is, however, an opportunity to reduce the constraints on the characteristics of the eligible swap participants. Koch urges the Commission to reduce the financial constraints in the definitions of eligible swap participants and allow all persons who would benefit from this risk management tool access to these valuable instruments.