ISDA®

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY, 10017
United States of America
Telephone: (212) 901-6000
Facsimile: (212) 901-6001
email: isda@isda.org
website: www.isda.org

June 16, 2009

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Concept Release regarding Bona Fide Hedge Exemptions: 74 Red. Reg. 12282 (March 24, 2009)

Dear Mr. Stawick:

This letter is submitted on behalf of the International Swaps and Derivatives Association, Inc. ("ISDA") in response to the concept release (the "Release") issued by the Commodity Futures Trading Commission (the "CFTC" or the "Commission") regarding whether the CFTC should eliminate bona fide hedge exemptions for over-the-counter ("OTC") derivative exposures that swap dealers have to their counterparties and replace such exemptions with limited risk management exemptions. In the short time following the publication of the Release, various policymakers—including the Secretary of the Treasury and the Commission's new Chairman—have discussed a range of proposals with respect to the regulation of derivatives and derivatives markets. Certain of these proposals, if adopted, would affect CFTC practices with respect to bona fide hedge exemptions. The questions raised in the Release with respect to OTC derivative hedges exemptions are therefore relevant in the context of the treatment of hedge exemptions as part of broader regulatory reform and any further action by the Commission should only be considered in that context.[1]

ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has over 820 member institutions from 57 countries on six continents. These members include most of the world's major institutions

1 The Release was published in the Federal Register on March 24, 2009 (74 Fed. Reg. No. 240 at 12282 *et seq.*).

that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Background

Swap Dealers' Use of Hedge Exemptions. ISDA represents the vast majority of swap dealers who execute swap transactions for a variety of end-users. To provide these services, ISDA members regularly obtain and rely on hedge exemptions to access the futures markets to hedge exposure arising from customized swap transactions. As such, ISDA believes that the experiences of its members in relation to hedge exemptions and the reliance that such institutions have placed on hedge exemptions are relevant for the Commission to consider in the context of the review that it has undertaken in connection with the Release.

Derivative transactions, such as swaps and cash-settled options, allow market participants, including commodity producers, processers, and end-users, as well as corporations, banks and governmental entities, to manage financial risks caused by fluctuating interest rates, currencies, commodity prices and securities prices. In commodities markets, swap dealers play a critical role by enabling both commercial and noncommercial market participants to transfer risks through the use of specialized transactions to address specific commodity hedging and price exposure needs. Such transactions are often not available on futures markets. For example, derivative transactions allow airlines to hedge effectively their price exposure to jet fuel, even though there are no jet fuel contracts available on the futures markets for airlines to hedge directly their price exposure. By entering into such transactions as principals the swap dealers also assume the administrative burden of managing the risks arising from the differential between the commitments undertaken in connection with derivative transactions with the transactions that are available to hedge the risks arising from such transactions.[2] These types of arrangements, for example, provide the airlines with protection from their price exposure to jet fuel. Furthermore, customized derivative transactions allow airlines and other end-users to hedge their market risks without having to access the markets directly. Requiring end-users to access the markets directly prevents them from precisely hedging their financial risks, as required to utilize FAS 133 "hedge accounting" rules. This creates additional volatility on their balance sheets, which could lower balance sheet valuations for end-users and restrict their financial growth as they must maintain capital to protect against unhedged financial risks. ISDA believes that the financial system and the economy as a whole are materially stronger and more resilient because of such swap transactions.

In order to manage the risks associated with the risk transfer transactions described above, swap dealers enter into various types of transactions as hedges. These may include OTC derivatives with other dealers or market participants and exchange traded futures and options on futures. The ability of swap dealers to access futures exchanges to hedge risks assumed in entering into OTC derivative depends in many instances on the availability of bona

---

2 Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations, at pp. 11-2.

fide hedge exemptions. Swap dealers are able to offer efficiency and competitive pricing to their clients by managing the risks associated with the various positions in their books across all markets and all participants, without regard a particular counterparty's line of business or motivation for entering into a transaction. In this manner, swap dealers aggregate and offset the various OTC derivative exposures (long and short and across all counterparties) and access exchanges (incurring the associated costs) for only the net residual risk that remains after such aggregating and offsetting.

Special Call and September 2008 Report. During the spring and summer of 2008, crude oil, gasoline and various agricultural and other commodities reached record high prices. The increased price and volatility of these commodities, especially for crude oil, prompted the CFTC to issue a Special Call to swap dealers engaged in the business of offering swaps on physical commodities to provide the CFTC with data on the activity of their end-users in both the futures and OTC markets (the "Special Call"). The Special Call required swap dealers engaged in commodity index businesses, other large swap dealers, and commodity index funds to provide data relating to the total activity of their end-users in the futures and over-the-counter markets, and to categorize the activities of their respective end-users, beginning December 31, 2007 through June 30, 2008.

In September 2008, the CFTC issued a Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations (the "September 2008 Report"). The September 2008 Report analyzed the data gathered on the end-users from December 31, 2007 through June 30, 2008 under the Special Call and issued a series of recommendations to provide greater transparency in the "manner and amount of trading that occurs through swap dealers."[3] After the publication of the September 2008 Report, the CFTC continues to gather data on the end-users from swap dealers every month.

Recommendation Five. Recommendation Five of the September 2008 Report calls on the CFTC to issue an advance notice of proposed rulemaking on whether to eliminate bona fide hedging exemptions for swap dealers and replace them with a limited risk management exemption together with a reporting requirement. The September 2008 Report suggested that the requirement be triggered when noncommercial swap clients reach a certain position level and that it also obligate swap dealers to certify that their noncommercial clients do not exceed position limits for exchange-traded futures on the underlying commodities. The Release seeks comments and information on whether to proceed with Recommendation Five to eliminate the bona fide hedge exemption for swap dealers and replace it with the conditional limited risk management exemption. The Release also asks what form the new limited risk management rules should take and how they should be implemented.

ISDA appreciates the opportunity to express its views on the Release and the ability to work with the CFTC and other policymakers to provide additional transparency into

---

3 Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations, at p. 32.

derivative transactions, and to prevent market manipulation and price disruptions. However, ISDA is concerned that implementing the recommendations in the Release as proposed would greatly limit the ability of swap dealers to facilitate the risk management of commercial and noncommercial market participants, who rely on derivative transactions to transfer risks inherent in their business/investment portfolios to specialists that have the requisite experience and infrastructure to manage such risks. Implementing the recommendations in the Release as proposed would seriously undermine this function. ISDA strongly believes that ceasing to grant to swap dealers new hedge exemptions and/or eliminating existing hedge exemptions will deprive the market of a valuable tool used by commercial and noncommercial market participants that will result in decreased liquidity and impairment of price discovery in the commodity markets. Furthermore, we recommend that the CFTC clearly define which party and under what conditions an entity would be subject to the regulations in the Release.

ISDA also believes that there are a number of more appropriate ways to promote transparency in the swap market and to prevent market manipulation and price disruption and we are pleased to share our ideas with the CFTC. In particular, ISDA agrees that carefully tailored and targeted reporting requirements can provide additional transparency into the commodity markets, allowing swap dealers to continue to serve their important risk management function for market participants. We believe, however, that even new reporting requirements need to be evaluated in light of information learned in the Special Call and in light of other regulatory and legislative initiatives.

Introduction

Analysis of Special Call Data. The Commission initiated the Special Call out of a concern that energy price volatility was exacerbated by noncommercial market participants. In point of fact, the data gathered pursuant to the Special Call supported the opposite conclusion. The Special Call data reflected more than 90% of the actual total long and short futures and options positions held by all the swap dealers as well as "essentially all of the index trading done through swap dealers" for NYMEX crude oil positions.[4] Of this universe, 20 market participants were identified to the CFTC as having aggregate positions (all on-exchange futures positions plus all OTC positions combined, on a futures equivalent basis) that exceed position accountability levels. And of those 20, 14 were commercial entities, while 6 were noncommercial entities.[5] The September 2008 Report also confirmed that none of these combined positions violated any existing laws or regulations and the amounts by which the traders exceeded the limit or level were "generally small."[6]

---

4 Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations, at p. 23.

5 Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations, at p. 23-4.

6 Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations, at p. 5.

In addition, the September 2008 Report found that, during the run up of energy prices during the first six months of 2008, the aggregate long positions of commodity index traders in NYMEX crude oil declined roughly 11%, as index traders rebalanced their portfolios in response to the rise in crude oil prices. The September 2008 report stated that, "In other words, the sharp rise in the net notional value of commodity index business in crude oil futures appears to be due to an appreciation of the value of existing positions caused by the rise in crude oil prices and not the result of more money flowing into commodity index trading."[7] The findings of the September 2008 report are consistent with other reports showing that the volatility in commodity prices were the result of supply and demand, not a result of additional activity in the markets from noncommercial participants.[8]

Additional Data. ISDA applauds the timely release of the September 2008 Report. But as the Report itself noted, the collection of data and subsequent analysis by CFTC staff was undertaken during a relatively short timeframe. Given that the CFTC has continued to collect data from swap dealers under the Special Call, ISDA believes that it would be highly useful, and perhaps essential, for the CFTC to analyze and subsequently release additional data gathered from the Special Call before taking further action on the Release or any proposed rules.

---

7 Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations, at pp. 22-3.

8 In March 2009, the Task Force on Commodity Futures Markets of the International Organization of Securities Commissions ("IOSCO"), co-chaired by the CFTC and the United Kingdom's Financial Services Authority, issued a report on the agricultural and energy commodities markets that found that economic fundamentals were the primary cause in the price volatility in the physical commodities markets during the summer 2008, not speculative activity. Task Force on Commodity Futures Markets Final Report, Technical Committee of the International Organization of Securities Commission (March 2009). The International Monetary Fund's World Economic Outlook, published in October 2008, found that "there is little discernable evidence that the buildup of related financial positions [in commodity markets] has systematically driven either prices for individual commodities or price formation more broadly." World Economic Outlook, International Monetary Fund (October 2008). A report by the European Commission concluded that the rise and fall of the price in oil in the recent past was due to supply and demand factors, with little or no evidence to suggest that speculators flooding the commodity markets caused price volatility. First Interim Report on Oil Price Developments and Measures to Mitigate the Impact of Increased Oil Prices, European Commission (1 September 2008). In addition, the preliminary assessment of the CFTC Inter-Agency Task Force on Commodity Markets is that fundamental supply and demand is the underlying causes of oil price volatility, not speculators. Interagency Task Force on Commodity Markets, Interim Report on Crude Oil, Washington D.C. Finally, a Government Accountability Office report released in January 2009, at the request of U.S. House Agriculture Committee Chairman Collin Peterson, found limited evidence that speculation was affecting commodity prices, even using empirical studies designed to detect a very weak relationship between futures speculators and commodity prices. All of the empirical studies upon which the GAO based their report showed, "...limited statistical evidence of a causal relationship between speculation in the futures markets and changes in commodity prices—regardless of whether the studies focused on index traders, specifically, or speculators, generally." Issues Involving the Use of the Futures Markets to Invest in Commodity Indexes, Government Accountability Office, at 5. GAO-09-285R Commodity Indexes (January 30, 2009).

The additional findings would establish a foundation for any proposed rules by resting the CFTC's subsequent conclusions on additional data points gathered after the rapid decline in commodity prices. This additional transparency would be beneficial to the commodity markets and helpful to policymakers as they examine the various available alternatives to the existing position limit and hedge exemption regime. We encourage the CFTC to release analysis and aggregate data gathered from June 30, 2008 to the present. We also urge the CFTC to make publicly available the additional data received from the Special Call on an aggregated basis, to provide the public with access to this valuable information.

ISDA also remains concerned that the September 2008 Report was released before the CFTC's staff could thoroughly analyze all of the data received in response to the Special Call. Given the short timeframe of the data collection upon which the September 2008 Report is based, the CFTC may not have received the full data sets needed to make a comprehensive analysis. As the CFTC has continued to gather this data after the publication of the September 2008 Report, ISDA urges the CFTC to re-examine the recommendations from the Report based on the additional data collected but not included in the September 2008 Report, before moving forward with any regulatory changes.

Discussion

ISDA appreciates the opportunity to express its views on the Release and the ability to work with the CFTC and others to craft a system that allows swap dealers to continue to facilitate the risk management of market participants, while allowing the CFTC additional transparency into swap transactions that are based on futures market prices and futures-equivalent positions. However, ISDA cautions that eliminating or limiting bona fide hedge exemptions for derivative exposures would seriously impact market participants that rely on swap transactions to transfer their commodity price risks to swap dealers that have experience, appropriate infrastructure and expertise in managing such risks. Replacing hedge exemptions with limited, risk-based exemptions would undermine the ability of dealers to manage risk consistently across counterparties and portfolios, which would likely cause dealers to be less willing to participate in the swap market, reducing the efficiency and utility of that market and, as a result, the futures markets. Reducing access to swap counterparties would expose market participants to commodity price fluctuations with only limited ability to hedge against price volatility. As a result, noncommercial market participants, and certain commercial participants, may decide not to participate in these markets, reducing the liquidity of commodity futures, thereby further impairing the ability of commercial participants to hedge their price exposure. Since hedging arrangements are often a prerequisite for loans to smaller oil and gas exploration and production companies, restrictions that reduce access to swaps could very well limit the availability of capital required to develop the resources that will be needed to promote price stability.

Of course any changes, whether creating a new reporting requirement or transitioning to a risk management exemption, will impose burdens on both swap dealers and their counterparties that the CFTC should carefully consider before moving forward. The relative benefit of any new system may be lost as the interruption of the risk management tool creates additional market instability and price volatility. ISDA encourages the CFTC to carefully evaluate the need for regulatory changes, as we strongly believe that any systemic changes to current hedge exemptions will be very difficult, for a variety of reasons outlined below.

Reporting Requirements. ISDA believes that appropriately tailored reporting requirements, as called for in Recommendation Five, can have a beneficial impact on the commodity markets and market participants. However, there are a variety of means of accomplishing the objectives identified in the Release, and we believe that a number of alternative approaches would be more effective in doing so than the proposal outlined in Recommendation Five of the September 2008 Report. For example, the CFTC could obtain aggregate position information with respect to the OTC positions of a particular end-user, through the implementation of a reporting requirement for OTC transactions analogous to the Large Trader Reporting ("LTR") system that the CFTC currently has in place with respect to participation in the futures markets. Under this approach, each swap dealer would be required to report to the CFTC once an end-user's open OTC position reached a certain level with that swap dealer, in terms of futures equivalents. This requirement would apply regardless of the commercial or non-commercial status of the counterparties. This reporting system would allow the CFTC to track the open positions of swap counterparties effectively and efficiently and to evaluate any potential effect of such positions on the futures markets. This system would also provide the CFTC with the information necessary in order to enable it to take any appropriate action. We believe that this approach is supportive of the objectives to achieve additional transparency, outlined by Commission Chairman Gensler in his recent testimony to the Senate Committee on Agriculture, Nutrition and Forestry.

Exemptions for Noncommercial End-Users; Well Defined Rule For Granting Hedge Exemptions. The elimination of the current hedge exemptions or cessation in granting hedge exemptions for transactions with noncommercial end-users could be harmful to the commodity markets, would restrict the hedging capability of commercial as well as noncommercial entities and would impair market liquidity. Specifically, such elimination or cessation of exemptions for transactions with noncommercial end-users will create market inefficiencies by preventing swap dealers from offsetting commercial positions with noncommercial positions, which allows dealers to manage risks across portfolios without regard to the line of business of a particular counterparty or the motivation of such entity for entering into derivative transactions. This approach to risk management enables the swap dealers to reduce their exposure to commodity prices and volatility, thereby promoting stability of the markets.

By way of example, a swap dealer may have matching long and short positions for a commercial and a noncommercial counterparty. If the commercial counterparty liquidates its position, the swap dealer will have no place to hedge its exposure without appropriate futures exemptions. Moreover, a swap dealer may have positions with noncommercial counterparties that allow it to hedge for commercial counterparties more efficiently. Eliminating or limiting hedge exemptions for transactions with noncommercial end-users will also limit the ability of the swap dealer to acquire a sufficient number of positions in its portfolio in advance to enable the swap dealer to provide robust and efficient pricing to a commercial counterparty.

Eliminating or limiting hedge exemptions for swap dealers hedging transactions with noncommercial end-users in swap transactions and subjecting dealers to speculative position limits in connection with such transactions will likely result in swap dealers, and their counterparties, curtailing their participation in the swap markets. This will reduce the liquidity of the futures market, harming commercial counterparties looking to hedge their price exposure. This as well could reduce liquidity on U.S. exchanges and result in a migration of trading onto foreign exchanges that continue to provide hedge exemptions for swap transactions involving noncommercial end-users. If the CFTC's objective is additional transparency into swap transactions and the reduction of price volatility in futures markets, a limited risk management exemption conditioned on the commercial status of the counterparty, in our view, will not achieve this objective.

Certification by Swap Dealers. ISDA does not believe that swap dealers are the appropriate parties to certify that a counterparty is a commercial or a non-commercial and has not exceeded position limits. If required to certify the status and aggregate position of their counterparties, swap dealers will clearly need to rely, in most instances, on the end-users' certifications, because end-users will not be willing to share proprietary information with the swap dealer for competitive or other reasons. As a result, the swap dealer will merely serve as an unnecessary, and potentially less reliable, intermediary, by passing along documentation from the end-user to the CFTC.

Coordination with Other Regulatory Reforms. ISDA believes that Recommendation Five and the proposals in the Release must be examined in light of and coordinated with other regulatory and legislative initiatives under consideration. The CFTC should coordinate this undertaking with other regulatory reforms that are in progress, in order to ensure consistency across the various approaches. The CFTC should ensure that any system for the reporting of positions by swap dealers, and for hedge exemptions, does not result in any duplication, overlap, or inconsistency with other rulemakings. For example, the Administration released its regulatory reform proposal for OTC derivatives on May 13th. CFTC Chairman Gensler recently provided testimony to Congress with respect to these initiatives. Also, many bills have been introduced in Congress that propose significant regulatory reforms including revising the hedge exemption definition, restricting position limits and imposing record keeping and reporting requirements. As the Administration and Congress develop legislative language for the regulation of OTC derivative transactions, we urge the CFTC to coordinate the proposals in the Release with these legislative efforts and other ongoing regulatory efforts.

For the reasons set forth in this letter, we believe that limited risk management exemptions should be reconsidered and therefore, we will not be addressing the specific questions.

Conclusion

ISDA understands and appreciates the need for additional transparency into the swap markets to prevent market manipulation and price manipulation and to reduce price volatility in the futures markets. However, we are concerned that the implementation of the proposals made in the Release will in fact, have the opposite effect. As briefly outlined in our letter, swap dealers perform a valuable market function by helping a wide variety of end-users manage their financial risk, through the creation of specialized swap transactions that address their specific commodity hedging and price exposure needs. By eliminating hedge exemptions for exposures incurred through derivatives with non-commercial market participants, swap dealers will no longer be able to provide this service to non-commercial end-users, which in turn will limit the services swap dealers can provide to commercial end-users. This will reduce liquidity in the futures markets, and may lead to an increase in commodity price volatility. ISDA believes that such an outcome is counter to the stated objective of the Release. ISDA cautions the CFTC that the elimination of hedge exemptions will undermine the objectives of the Release, to increase transparency into swap markets, an objective that ISDA supports. Finally, we urge the CFTC to reconsider the data it gathered under the Special Call, published in the September 2008 Report, as it made clear that non-commercial market participants did not exacerbate energy price volatility, and to consider any actions it takes in this area only in the context of broader regulatory reforms currently being considered by the CFTC and Congress.

ISDA appreciates the opportunity to provide these comments. Should you require any further information, please do not hesitate to contact the undersigned.

Sincerely,

Robert G. Pickel

Robert G. Pickel
Executive Director and Chief Executive Officer
International Swaps and Derivatives Association, Inc.