The Business Council for Sustainable Energy®

CFTC Swap Dealer Definition is Key to Renewable Energy Development and Achieving Environmental Goals

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 comprehensive way to distinguish trading from dealing. Central to the SEC case law characteristics that distinguish dealing from trading is 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. 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 although it engages in some dealing, the de minimis exception is satisfied.

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 assists the advancement of U.S. environmental energy objectives. 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.

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