

Joint Report on Retail Swaps

As Required by
Section 105(c) of the
Commodity Futures Modernization Act of 2000

Board of Governors
of the
Federal Reserve
System



Department of
the Treasury



Commodity Futures
Trading Commission



Securities and
Exchange
Commission



December 2001

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**Board of Governors of the Federal Reserve System
Department of the Treasury
Commodity Futures Trading Commission
Securities and Exchange Commission**

December 26, 2001

The Honorable J. Dennis Hastert
Speaker of the House
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

We are pleased to transmit our report on retail swaps as required by the Commodity Futures Modernization Act of 2000 (“CFMA”).

The CFMA directed the Board of Governors of the Federal Reserve System, the Secretary of the Treasury, the Commodity Futures Trading Commission, and the Securities and Exchange Commission (the “agencies”) to study issues regarding the offering of swap agreements to retail customers, principally small businesses and individuals.

Specifically, the study was to address the potential uses of swap agreements by retail customers; whether financial institutions are willing to offer such swap agreements; the appropriate regulatory structure, if any, to address customer protection issues with respect to the offering of such swap agreements; and other matters the agencies deemed necessary or appropriate to address. The agencies interviewed several potential market participants whose views are described in the report.

The CFMA also directed the agencies to submit a report to Congress on the findings and conclusions of the study, along with any recommendations for legislative action.

As indicated in the report, the agencies do not recommend legislative action at this time for swap agreements offered to retail customers.

Staff of the Federal Deposit Insurance Corporation, the Federal Reserve Bank of New York, and the Office of the Comptroller of the Currency worked with the agencies during the study and participated in the preparation of the enclosed report.

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We appreciate the opportunity to convey this report to you.

Sincerely,

Alan Greenspan
Chairman
Board of Governors of the Federal Reserve

Paul H. O'Neill
Secretary
Department of the Treasury

James E. Newsome
Chairman
Commodity Futures Trading Commission

Harvey L. Pitt
Chairman
Securities and Exchange Commission

**Board of Governors of the Federal Reserve System
Department of the Treasury
Commodity Futures Trading Commission
Securities and Exchange Commission**

December 26, 2001

The Honorable Richard B. Cheney
President of the Senate
United States Senate
Washington, D.C. 20510

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JOINT REPORT ON RETAIL SWAPS

As Required by Section 105(c) of the Commodity Futures Modernization Act of 2000

I. INTRODUCTION

The Commodity Futures Modernization Act of 2000 (“CFMA”) requires the Board of Governors of the Federal Reserve System (“Board”), the Secretary of the Treasury (“Treasury”), the Commodity Futures Trading Commission (“CFTC”), and the Securities and Exchange Commission (“SEC”) to conduct a study of issues involving the offering of swap agreements to persons other than eligible contract participants.¹ This Report responds to the CFMA’s requirement that the agencies submit to Congress by December 21, 2001, the findings and conclusions of the study and their recommendations on whether any legislative action is necessary and appropriate.

A primary purpose of the CFMA was to create a clear legal foundation and regulatory framework for many types of over-the-counter (“OTC”) derivatives transactions entered on a principal-to-principal basis between “eligible contract participants” (“ECPs”) as defined in Section 1a(12) of the Commodity Exchange Act (“CEA”).² Parties that do not qualify as ECPs include individuals who do not have total assets in excess of \$10 million (or \$5 million if they enter swap agreements for risk management) and non-financial entities that do not have total assets in excess of \$10 million (or net worth in excess of \$1 million if they enter swap agreements in the ordinary conduct of business or for risk management). For purposes of this study, non-ECPs are “retail customers,” and swaps offered to them are “retail swaps.”

Since its enactment, the CFMA has excluded OTC swap agreements and other specified derivatives transactions between domestic and foreign financial institutions, broker/dealers, insurance companies, commodities firms, and other ECPs from most of the CEA. The CFMA’s limitation of this exclusion to ECPs was consistent with the recommendation of the President’s Working Group on Financial Markets that OTC swap agreements between institutional counterparties generally should not be subject to the CEA.³

The CFMA did not address the legal or regulatory status of swap agreements with retail customers, with the exception of clarifications to a provision of the CEA known as the Treasury

¹ Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 – Appendix E, §105(c), 114 Stat. 2763A-365 (2000).

² 7 U.S.C. §1a(12).

³ President’s Working Group on Financial Markets, *Report on Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (November 1999).

Amendment, which excluded certain transactions in foreign currency, government securities, and other specified financial instruments from the CEA.⁴ Specifically, the CFMA explicitly excluded OTC foreign currency futures and options transactions offered to retail customers by certain federally and state-regulated entities from most provisions of the CEA.⁵

This Report does not cover retail swap agreements in foreign currency because Congress has addressed these transactions in the CFMA's revisions to the Treasury Amendment. However, in the CFMA, Congress did not address CEA issues involving retail swap agreements on underlying assets or instruments not covered in the clarifications to the Treasury Amendment.⁶ Instead, Section 105(c) of the CFMA posed the following topics for the agencies to investigate in the study:

1. The potential uses of swap agreements by persons other than eligible contract participants.
2. The extent to which financial institutions are willing to offer swap agreements to persons other than eligible contract participants.
3. The appropriate regulatory structure to address customer protection issues that may arise in connection with the offer of swap agreements to persons other than eligible contract participants.
4. Such other relevant matters deemed necessary or appropriate to address.

⁴ 7 U.S.C. §2(c). Prior to the CFMA, there was disagreement concerning the scope of a provision of the CEA known as the "Treasury Amendment," which provided an exclusion from the CEA for foreign currency transactions. The CFMA provided clarity to this issue. With respect to government security transactions, futures on government securities which trade on an organized exchange are subject to the jurisdiction of the CFTC. 7 U.S.C. §2(c)(2)(A). Other transactions in government securities, regardless of the nature of the counterparties, are excluded from most provisions of the CEA. 7 U.S.C. §2(c)(1).

⁵ OTC futures and options transactions in foreign currency offered to or entered into with retail customers are excluded from most provisions of the CEA if the counterparty is a regulated bank, a registered broker-dealer or futures commission merchant ("FCM") or affiliate thereof, or one of a number of other federally or state-regulated entities. 7 U.S.C. §2(c)(2)(B). However, such transactions remain subject to certain provisions of the CEA, including antifraud, if entered into by an FCM or affiliate of an FCM that is not also one of the other enumerated entities. 7 U.S.C. §2(c)(2)(C).

OTC foreign currency futures and options transactions offered to or entered into with retail customers by all other entities are subject to the CEA and the CFTC's jurisdiction, as provided in the amended CEA, as are foreign currency futures and options transactions executed or traded on an organized exchange (other than foreign currency options executed or traded on a national securities exchange, which are subject to SEC jurisdiction).

⁶ Analysis of whether any particular types of retail swaps are subject to the CEA or any other federal laws falls outside the scope of the study required by Congress and this Report.

To investigate these topics, the agencies interviewed representatives of derivatives dealers (including commercial and investment banks and a non-financial firm), a derivatives trading system, and a trade association on August 1 and 2, 2001, in New York. Institutions were selected based on the nature and scope of their derivatives activities and their interest in expressing views on the questions posed. Appendices 1 and 2 of this Report contain a list of interviewed institutions and a copy of interview questions.

Part II of this Report consists of a summary of what the agencies learned from these interviews. Part III sets forth the agencies' conclusions and recommendations. Appendix 3 has been prepared by Treasury Department staff in order to address tax issues associated with retail swap agreements. Staff of the Federal Deposit Insurance Corporation, the Federal Reserve Bank of New York, and the Office of the Comptroller of the Currency worked with the agencies during the study and participated in the preparation of this Report.

II. SUMMARY OF INTERVIEWS

In general, the interviewees stated that they are satisfied with Congress's clarification of the applicability of the CEA to derivatives activity in the CFMA. Therefore, most interviewees are not currently advocating legislative action or a regulatory framework with respect to retail swaps, since they have no current interest in entering into this business. They indicated that there does not appear to be either any demand for retail swaps at present or any financial incentive for firms to offer retail swaps, in light of the array of alternative products currently available.

Two of the interviewees expressed an interest in retail swaps. One firm expressed an interest in providing energy derivatives as a hedging vehicle for small businesses and individuals that do not meet the requirements to be ECPs and indicated a belief that there is demand for such a product. Another firm indicated a philosophical belief that current law is too restrictive and that swaps should be available to non-ECPs.

A. Potential Uses of Retail Swaps

Among the potential uses for swap agreements by non-ECPs that the interviewees identified in the course of the study are the following.

1. Equities

The interviewees generally observed that equity derivatives may be used for two purposes: to hedge an existing position in an individual equity security or to create synthetic exposure to one or more individual securities or security indices.

Hedging. OTC equity derivatives are frequently used to hedge exposure to adverse price movements in a security, typically when the counterparty has a concentrated position in the security that

it does not wish to liquidate, perhaps due to tax consequences, or when the counterparty is unable to liquidate a position in a security due to transfer restrictions under federal securities laws. Although such counterparties typically meet the statutory criteria for ECPs, one interviewee suggested that the growing number of “dot-com” millionaires in the late 1990s could potentially have generated interest in the development of equity derivatives products for holders of restricted securities that own net assets of between \$1 million and \$5 million.

Several of the interviewees noted, however, that firms generally do not recommend the use of swap agreements to hedge positions in individual equity securities because of tax considerations.⁷ Under the Internal Revenue Code, they said, entering into a swap agreement to hedge an appreciated financial position, such as equity that has risen in value since being acquired, may be deemed a constructive sale. If substantially all the economic risk of the underlying financial position is eliminated, the holder is required to recognize any gains for tax purposes. Consequently, the commercial and investment banks interviewed indicated that they typically advise persons seeking to hedge partially or reduce exposure to an equity position to enter into OTC options contracts, based on their view that the use of such contracts may not always trigger a taxable event. They also indicated that this strategy does not raise CEA issues, since options on securities are considered “securities” under the federal securities laws and are not subject to the CEA.

Synthetic Exposure. The interviewees also noted that OTC equity derivatives could be used to gain exposure to a security in lieu of purchasing or selling the security directly. It might be advantageous to use an equity derivative for this purpose, in their view, if greater leverage could be obtained (as compared to a traditional margin account), or if the cost of executing, clearing or settling trades in the underlying security or securities were comparatively expensive, as in the case of the component stocks of a security index or securities in certain non-U.S. markets.

Several interviewees questioned, however, whether retail investors would be able to use retail swaps for these purposes. Some interviewees expressed the view that swap dealers were unlikely to permit retail investors to obtain significantly greater leverage using a swap agreement than by purchasing or selling the underlying security or a standardized derivative instrument in a traditional margin account, largely because of credit concerns. For example, some of the commercial and investment banks interviewed indicated that they typically require their customers to collateralize the derivative contract with the securities they are seeking to hedge.

Some interviewees opined that, in light of the relative cost of negotiating and entering into swap agreements,⁸ individually-tailored swap agreements might not be cost effective for all but the highest net

⁷ The discussion of tax issues in this section of the Report reflects the comments of interviewees, and no inference should be drawn concerning whether the Treasury Department agrees or disagrees with the opinions or analyses of tax issues expressed by the interviewees. A discussion written by Treasury Department staff of tax issues of relevance to retail swaps can be found in Appendix 3.

⁸ See discussion in Part II.B below.

worth individuals and institutional investors as a means of establishing a synthetic exposure. The commercial and investment banks interviewed also generally noted that retail investors currently have access to a wide variety of securities and derivatives products to gain exposure to equity securities, including equity-linked notes, warrants, exchange-traded funds, mutual funds, exchange-traded options and, likely in 2002, exchange-traded security futures.

2. Interest Rate Products

Several interviewees noted that there was very little demand for interest-rate swap agreements at present except among institutions and high net worth individuals that already qualify as ECPs. For example, one firm remarked that, to the best of its representatives' recollections, it had never entered into fixed income swaps with an entity that owned or had under management less than \$100 million in assets.

Some interviewees said that non-ECPs could potentially use interest-rate swap agreements to obtain the benefit of more favorable interest rates on household or small business expenses, such as mortgage or consumer debt, separately from the underlying loan. These interviewees added, however, that at the present time, it is convenient for non-ECPs to refinance a mortgage or transfer consumer debt, and the ability to enter into an "unbundled" swap agreement would not appear to offer retail customers a cost-effective or convenient alternative.

3. Energy

Several interviewees stated that non-ECPs may have an interest in swap agreements on energy products, such as electricity, natural gas, and heating oil, as a tool to assist small businesses and households in controlling energy costs. One firm further indicated an interest in offering such contracts as a third party – *i.e.*, to provide risk management transactions for such commodities without also supplying the underlying commodity.

This firm noted that, as a result of the deregulation of the energy markets in certain states, households and businesses have entered into forward contracts for full or partial energy requirements with competing energy providers at fixed or capped prices. It was further noted that, in localities where physical delivery of energy products may be restricted because of regulatory or operational constraints, cash-settled swap agreements have in some cases been available for ECPs in order to provide them a means to hedge their exposure to price fluctuations. Accordingly, small businesses and, to some extent, households that are not ECPs may similarly desire to enter into swap agreements in order to control their energy costs when forward delivery contracts are not available; in this firm's view, current uncertainty about the status of such contracts under the CEA has hindered their development.

Some interviewees, however, opined that the current tax treatment of gains and losses on swap agreements entered into by individuals (and outside the context of conducting a trade or business) to hedge energy costs may make such agreements less attractive. They indicated that while gains on energy swap agreements would be fully taxable, losses on these swaps either would not be deductible

or would qualify as a miscellaneous deduction, which are only deductible to the extent total miscellaneous deductions exceed two percent of adjusted gross income.⁹

In summary, all but two of the interviewees reported that there does not appear to be significant demand for retail swaps at present, with one firm specifically stating that there was retail interest in swap agreements with respect to energy products. The interviewees generally noted that retail customers currently have access to a wide range of derivative instruments and other alternatives to swap agreements to meet their financial needs, for example, for purposes of hedging or gaining exposure to particular securities or interest rates. To the extent that non-ECPs might seek to use swap agreements to protect against adverse price movements with respect to household or business expenses (*e.g.*, interest rates, energy prices), several interviewees suggested that in most circumstances it would be cheaper and more convenient for non-ECPs to purchase such protection together with the underlying loan or commodity, rather than in a separate transaction.

B. Extent to Which Institutions Are Willing to Offer Swap Agreements to Persons Other than ECPs

According to most of the interviewees, derivatives market participants are not generally planning to offer swap agreements to retail customers at present, apart from the interest there may be in offering retail swaps with respect to energy products. In general, the interviewees noted that firms currently have no commercial interest in offering swaps to retail customers because there is no demonstrable demand for them. Lack of demand is apparently sufficient to preclude any desire on the part of these institutions to explore issuance of these instruments, thus obviating the need to analyze legal issues.

In responding to any customer demand for such products that might arise in the future, some interviewees identified specific considerations derivatives firms would need to address generally in developing and marketing swap products to non-ECPs. In particular, to the extent that non-ECPs were to prefer retail swaps over existing alternatives because of specific perceived advantages – such as greater flexibility – firms would have to consider the costs associated with providing those features in a retail context. These include, for example, administrative issues associated with negotiating retail swaps, the potential credit risks of offering retail swaps to non-ECPs, and the need to implement sales practices for the offering of swap agreements to non-ECPs.

Administrative Issues. Four interviewees specifically indicated that administrative and technological issues related to the entering into and preparing the documentation of retail swaps would have to be considered in developing a profitable business model for such products. For example, to make offering of retail swaps feasible from an administrative and technological perspective, swap dealers may need to standardize retail swaps significantly. Standardization could facilitate the swap

⁹ This issue is discussed in Appendix 3.

dealer's management of exposure and enable it to take advantage of economies of scale in marketing and distribution. On the other hand, one firm suggested that the principal advantage of swap agreements over existing standardized or exchange-traded instruments is their flexibility, in that they could be structured to meet specific customer objectives. Accordingly, it appears that one challenge for firms in determining the feasibility of offering retail swaps is the potential tension between the desire to mitigate infrastructure costs by standardizing terms of retail swaps and the need to offer products that would meet the financial objectives of specific retail customers.

Creditworthiness. Three interviewees specifically noted that swap dealers would have to consider the ability to monitor the creditworthiness of non-ECPs in developing a viable retail swap product for retail customers, particularly in light of the expected size and profitability of retail transactions. Several of the commercial and investment banks interviewed indicated that, in the context of their existing swap business with ECPs, they employ extensive risk management practices to control their credit exposure to counterparties. These practices usually include, among other things, extensive analysis and monitoring of the counterparty's financial status by a credit committee or similar body, in light of particular transactions being contemplated.

Sales Practices and Appropriateness. Two of the firms interviewed specifically noted that derivatives firms would need to develop adequate sales practice procedures to assess the appropriateness of swaps for retail customers to protect themselves against the risk of private litigation or, where applicable, regulatory enforcement proceedings. Many of the commercial and investment banks interviewed indicated that they currently have highly detailed procedures for ensuring the appropriateness of equity options offered to certain ECP clients, such as private banking clients. In evaluating the appropriateness of individual transactions for their existing ECP clients, the commercial and investment banks interviewed indicated that they often produce multiple drafts of term sheets, engage in frequent discussions with the client, and consult with various departments within the firm to ensure thorough analysis.

One firm expressed the view that it would be very difficult, in light of the extensive procedures it currently employs in transactions with ECPs to justify recommending a swap transaction to a retail customer.

Legal Uncertainty. Two interviewees remarked that legal uncertainty was an impediment for the development of retail swaps with respect to energy products. Given the lack of interest in offering other types of retail swaps, however, it does not appear that most institutions have felt the need to analyze comprehensively CEA issues as they might apply to retail swaps.

In this connection, most interviewees strongly advised against taking legislative action regarding the application of the CEA to retail swaps. As discussed in greater detail in Part II.C below, these interviewees believe that legislative action with respect to retail swap transactions, in the absence of evidence of demonstrable retail demand or institutional interest in offering most of these instruments, does not appear justified.

C. Appropriate Regulatory Structure to Address Customer Protection Issues that May Arise in Connection with the Offering of Swap Agreements to Persons Other than ECPs

The interviewees generally believed that it is premature to consider the appropriate regulatory structure to address customer protection issues that may arise in connection with the offering of retail swaps in the absence of demonstrable demand for a retail swaps product. There was a general reluctance among most of the interviewees to address CEA issues legislatively so soon after the enactment of the CFMA, which served to resolve many of the legal issues about which swap market participants had been concerned.

One interviewee noted that creating a regulatory regime for a product that does not as yet exist could have the effect of channeling business into artificial regulatory structures that are unnecessary and do not address the needs of the market place. Another interviewee cautioned that unnecessary legislative or regulatory activity to create such a product might stimulate artificial interest in a product that could, in turn, give rise to abusive marketing or sales practices by unregulated entities.

As noted above, one interviewee indicated that there is interest in offering retail swaps with respect to energy products, for example, to small businesses that do not meet the ECP criteria of the CFMA. With respect to the appropriate manner to address CEA issues for such products, the interviewee did not advocate a legislative solution, nor did it propose the development of a new regulatory regime for these products. Two other interviewees observed that firms interested in offering retail swaps would generally prefer to seek regulatory relief for such products on an case-by-case basis instead of reopening the CFMA for debate in light of the considerations discussed above.

Some firms suggested that there was no need for a specialized regulatory structure to address public policy issues. Likewise, several interviewees expressed concern that a specialized regulatory framework for retail swaps might affect traditional products -- such as contracts that offer price or interest-rate protection in connection with an agreement to provide the underlying commodity or loan -- that are offered subject to existing federal and state regulation. One firm identified the following issues for consideration by policymakers in determining the need for regulation and the appropriate regulatory structure for retail swap products:

- whether there exists, or is any need for, a special federal or state regulatory framework for the underlying instrument, and the extent to which unregulated swaps activity might affect regulated markets for the underlying instrument (*e.g.*, price discovery mechanisms in securities markets);
- whether federal law would preempt the application of state laws to retail swap products;
- whether the party offering a retail swap product is a regulated entity subject to adequate regulation; and

- how regulatory action might result in offshore migration of derivatives activity, and how offshore activity might affect a domestic retail swaps market.

III. CONCLUSIONS AND RECOMMENDATIONS FOR LEGISLATIVE ACTION

The agencies do not believe it is necessary at this time to recommend legislative action for swap agreements offered to persons other than ECPs.

According to the interviewees, persons who are not ECPs seem at this time to have sufficient instruments at their disposal to meet their risk management and investment needs, and there is currently a lack of interest among most major market participants in offering swaps to retail customers. As noted in this report, energy swaps are a possible exception to both findings.

With respect to retail energy swaps, it is possible, upon request by a market participant, that the CFTC could exercise administrative authority as appropriate, on a case-by-case basis, within the limitations of its current statutory jurisdiction under the CEA regarding such requests. In this connection, the CFTC would need to consider, among other issues, the extent of its authority to grant relief, whether the granting of such relief would be in the public interest, and any implication such relief might have on potential state regulation of such products.

If at some future date interest in retail energy swaps increases beyond the scope of the CFTC's authority to address regulatory issues related to these products in a satisfactory manner, Congress may wish at that time to consider the desirability of further legislative action with respect to the legal status of and federal regulation, if any, of retail energy swaps, as they did in the CFMA with respect to OTC transactions in foreign currency with retail customers. If further legislation is considered in the future, in addition to the specific regulatory issues identified by the interviewees, consideration should be given at that time to the economic functions served by retail energy swaps, the public interests to be protected, and the impact of any new regulatory regime on the development of retail products.

Appendix 1
List of Interviewees

Commercial Banks:

Bank of America

JP Morgan Chase & Co.

Investment Banks:

Goldman Sachs Inc.

Lehman Brothers Inc.

Morgan Stanley Dean Witter

Others:

Blackbird Holdings, Inc.

Enron Energy Services, Inc.

International Swaps and Derivatives Association

Appendix 2
List of Interview Questions

1. What do you see as the potential uses of retail swaps?
2. Are you willing to offer retail swaps (or currently doing so)? If not, why not?
 - What types of underlying assets?
 - What type of contracts?
 - In what notional amounts?
 - What types of retail customers? Individuals? Small businesses? Other?
 - What are the risks involved in offering these products? How would you (do you) manage those risks?
3. What is the appropriate regulatory structure to address customer protection issues that may arise in connection with the offering of retail swaps?
 - Is there a need for regulation to protect customers?
 - Should the regulatory structure differ depending on whether the entity offering/booking the swaps is otherwise regulated?
 - Should the regulatory structure differ depending on whether the market for the underlying asset is subject to regulation?
4. What other matters (for example, tax and other regulatory issues) are necessary or appropriate for a study of retail swaps to address?

Appendix 3

The Taxation of Over-the-Counter Derivatives in the Hands of Retail Customers¹

The following discussion considers the tax issues that may arise if over-the-counter derivatives are made available to persons other than eligible contract participants. Throughout the discussion, the distinction between hedging activities undertaken by retail customers pursuing a trade or business and those undertaken in other contexts is a critical determinant of the applicable tax treatment.

Investment Versus Hedging Activities

Retail customers may enter over-the-counter (“OTC”) derivatives contracts for purposes of either investment or hedging.² Where the motivation is the opportunity for gain, the transaction may be characterized as investment, and there are essentially no tax issues peculiar to OTC derivatives. Current law addresses the taxation of investment contracts of all kinds in the hands of natural persons, corporations, and pass-through entities such as partnerships. Although a realization-based system favors certain investment products over others, there is no reason to believe that the current system poses any differential obstacles to retail customers entering OTC derivatives contracts for purposes of investment.³

Tax Hedges

Current law recognizes the economic importance of business hedges by offering a regime under which taxpayers may reasonably match the timing of gain or loss from an existing exposure with the timing of loss or gain from the hedge. This ability to match timing for tax purposes is critical as, in the absence of special hedging rules, there will often be a mismatch between the timing of the tax consequences of the hedge and the timing of the tax consequences from the existing exposure. For

¹ This appendix was prepared by Treasury Department staff and does not reflect the views of the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, or the Securities and Exchange Commission.

² As used in this appendix, the term “retail customers” refers to individuals and business that are not eligible contract participants as defined in the Commodity Exchange Act, “investment” includes speculation, and “hedging” is used in its colloquial sense, regardless of whether there is a hedging transaction for tax purposes.

³ A realization-based system imposes tax on the gains from most investment contracts at the time of a “realization” event, typically a sale. For example, tax is assessed on the gains from a stock investment only after the shares have been sold. In contrast, a mark-to-market system imposes tax at regular intervals even if no realization event has occurred. Such systems involve measuring the fair market value of a position at the close of the tax period and calculating tax based on any gain or loss during that period. Only certain instruments and specific classes of taxpayers must mark to market under current law. In addition, if a taxpayer eliminates substantially all of the opportunity for gain and risk of loss from an appreciated financial position, tax on the appreciation may be triggered as if the position had been sold.

example, an airline hedging the cost of jet fuel may do so with a mix of instruments that produces tax consequences for the airline that are taken into account at times that are different from the times when the airline takes its fuel expenses into account for tax purposes. Under the special hedging provisions, a taxpayer may reasonably match the timing of the tax results of the hedge to the timing of the deduction for the fuel expenses.

By also matching the tax character of gains or losses from business hedges with the tax character of the existing exposure, the tax system ensures that both are taxed not only at the same time but also at the same rate. Indeed, in the absence of a provision preventing hedges from producing capital gains and losses, some hedging losses would become temporarily or even permanently nondeductible.

To qualify for this treatment, however, a number of conditions must be satisfied: First, the existing exposure that is hedged must be in the context of a trade or business. Hedges reducing exposure related to personal consumption, including those for household energy usage, are therefore not accorded this treatment.

In addition, only certain types of exposures fall under these provisions. For the hedge to receive the special tax treatment, the existing exposure must be an ordinary item. For example, it may depend on the price of ordinary property, that is, property that does not produce capital gain or loss for tax purposes. Business inventory is perhaps the most obvious example of ordinary property. Capital assets, including stocks and other personal property, fall outside of this category. A tax hedge may also be used to protect against adverse movements in the cost of borrowing or the price underlying other ordinary business expenses. Excluded, however, from the category of permitted exposures are cash flows, whether dividends or business profits.

There is no reason, in principle, why retail customers could not rely on the tax hedge provisions to facilitate business hedging activities that employ OTC derivatives. The requirement that a tax hedge must be in the context of a trade or business, however, excludes significant classes of potential retail customers. For these customers, even if the hedged exposure results in taxable income or deduction, the inapplicability of the tax hedge regime makes possible a mismatch between the timing of the tax consequences of the hedge and the timing of the tax consequences of the hedged exposure.

Non-Deductibility of Payments Pursuant to OTC Derivatives

Hedging outside the context of a trade or business raises another fundamental difficulty. Under current law, non-business retail customers would find that gains with respect to the hedging instrument are generally taxable at the rates applicable to ordinary income,⁴ but losses are, at best, only partly deductible. For example, the hedging losses may be subject to the limitations on the deductibility of capital losses or to the total ban on deductions for expenditures for personal consumption. This

⁴ Many hedges would produce short-term capital gains and losses.

asymmetric treatment might discourage retail customers from using OTC derivatives to manage risk outside the context of a trade or business.

Under Federal tax law, most OTC derivatives contracts entered by retail customers are “notional principal contracts” (“NPCs”), which are defined as a “financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.”⁵ This definition includes many common OTC derivatives designed to hedge exposure to energy prices. Under these derivatives, payments are calculated based on an index derived from energy prices.

Among the cash flows pursuant to NPCs are periodic payments. These payments could, under a typical NPC, flow either from the retail customer to the dealer or from the dealer to the retail customer. Again considering the example of a contract to hedge exposure to energy prices, payments might flow to the retail customer after any month in which actual prices rose above a threshold level specified in the contract. Should prices instead fall below a threshold level, the retail customer would have to make the monthly payment. For those entering such OTC derivatives contracts in the course of a trade or business, payments received would be included in income, and subject to tax at the ordinary rate. Payments made pursuant to the contract would be deductible as a normal business expense.

For those wishing to hedge outside of the context of a trade or business, however, the symmetry would break down.⁶ Payments received from the dealer would be included in income and taxed at ordinary rates. On the other hand, payments made to the dealer might not be deductible.⁷ The prospect of taxation of payments from the dealer, with no potential offset in the form of deductible payments to the dealer, would reduce the attractiveness of retail OTC derivatives products.

Also of concern from a tax policy perspective is the fact that the asymmetry, which effectively “whipsaws” taxpayers, is effectively eliminated if the hedge is imbedded into an energy sales contract. Once again considering the case of the household energy contract, the asymmetry disappears if an energy supplier contracts with a customer to provide electricity at a fixed rate during a specific period of time. Economically, this arrangement is not different from spot purchases combined with a hedge because the gains and losses on the imbedded hedge are reflected in the fixed price paid for the electricity. When the spot price is low and the fixed price exceeds the spot price, there is in effect a loss

⁵ Treas. Reg. § 1.446-3(c)(1)(i).

⁶ In addition, hedging outside a trade or business context does not constitute a tax hedge; thus the retail customer is unable to reasonably match for tax purposes the timing of gain and loss from the existing exposure with gain and loss from the hedging instrument.

⁷ Even if such payments were deductible, individual income taxpayers are subject to a 2 percent floor on miscellaneous deductions. Unless the amount of such payments, coupled with other miscellaneous deductions such as unreimbursed employee expenses, exceeds 2 percent of adjusted gross income, no deduction is permitted.

on this imbedded hedge. When the spot price is high, the situation is reversed and the imbedded hedge economically produces a gain. In this case, neither the gain nor the loss on the imbedded hedge is a tax event; so the treatment (or non-treatment) is entirely symmetric. One of the basic principles of good tax policy is neutrality, in the sense that tax concerns should not provide incentives to make a particular choice among economically equivalent transactions. In this case, however, there is a clear tax incentive to purchase both electricity and imbedded risk management from a single supplier, rather than purchasing electricity from one source and risk management from another.