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February 22, 2011

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant"

Dear Ms. Murphy and Mr. Stawick:

The implementation of the regulations enumerated in Dodd-Frank Wall Street Reform and Consumer Protection Act[1] ("Dodd-Frank Act") depends upon the final definitions of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant." To develop final definitions, the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC" and, together with the CFTC, the "Commissions") issued a Proposed Rule[2] in a joint proceeding. These comments are submitted in response to the Proposed Rule. I incorporate by reference my comment letter, submitted on September 20, 2010, to the Commissions in response to the Advanced Notice of Proposed Rulemaking.[3]

[1] Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80173 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. pt. 240)[hereinafter "Proposed Rules on Definition"].

[3] Comment Letter from Michael Greenberger, Law School Professor, University of Maryland School of Law, to David A. Stawick, Secretary, Commodity Futures Trading Commission, (Sep. 20, 1010)[hereinafter "Professor Greenberger's Comment Letter to Advanced Notice of Proposed Rulemaking"].

I. The Definitions of "Swap Dealers" and "Security-Based Swap Dealers" Are Appropriate.

The proposed definition of a "dealer"[4] is appropriate. Specifically it includes any person holding itself out as a swap dealer; a swaps market maker; someone regularly entering into swaps with counterparties as an ordinary course of business for its own account; or engaging in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.[5]

The Commissions provided a list of factors to be considered when applying the definitions to persons that "hold themselves out" as dealers or that are "commonly known in the trade" as dealers. These factors may include, but are not limited to, the following: soliciting counterparties to represent their interests in swaps or security-based swaps; developing and advertizing new types of swaps or security-based swaps; exhibiting a willingness to enter into newly created swaps or security-based swaps; obtaining and/or maintaining membership in a swap association in a category reserved for dealers; providing marketing materials, like a web site, on swaps or security-based swaps; or generally expressing a willingness to offer or provide a range of financial products including swaps or security-based swaps.[6]

While many market participants favor bright line rules, the overly inflexible nature of rules of this type will be too unyielding in dynamic legal and economic environments. Flexible, yet functional, definitions as those proposed for swap dealers and security-based swap dealers are tailored by the proposed "facts-and-circumstances" approach to the definitions. The use of the proposed facts and circumstances analysis will bring more focused results that will accurately reflect the dynamics of these markets.

There are exceptions to the proposed definition of a swap dealer. First, an insured depository institution cannot be a swap dealer if it enters into a swap with a customer in connection with originating a loan to that customer.[7] Second, the definition excludes persons who enter into swaps for their own account, either individually or in a fiduciary capacity, but not as part of a regular business.[8] Third, entities engaging in *de minimis* quantity of swaps are excluded from the definition.[9] Those exceptions are fully supportable.

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[4] The Commissions defined "swap dealer" and "security-based swap dealer" in an identical manner with one caveat. The treatment of insured depository institutions as a swap dealer, not a dealer as long as it is engaged in a swap with a customer it originated a loan with, is absent from the definition of a security-based swap dealer. *See* § 721(a)(21).

[5] *See* § 721(a)(21) of the Dodd-Frank Act, *supra* note 1.

[6] Proposed Rules on Definition at 80178, *supra* note 2.

[7] Proposed Rules on Definition at 80175, *supra* note 2.

[8] *Id.*

[9] *Id.*

II. *De Minimis* Exemption to "Swap Dealers" and "Security-Based Swap Dealers"

The proposed definition of a "dealer" excludes entities engaging in *de minimis* quantity of swaps or security-based swaps.[10] This exemption includes quantities that are small enough not to warrant registration for purposes of swap dealers and security-based swap dealers.

A. The Proposed Elements to Determine *De Minimis* Quantity Are Appropriate.

As my comment letter to the Advanced Notice of Proposed Rule Making,[11] the Commissions have accurately proposed to calculate aggregate effective notional amounts on a "gross basis." In this regard, the Comptroller of the Currency has made clear that this amount provides a meaningful snapshot of concentration risk because it captures market saturation.[12]

The criteria set forth presents appropriate and effective thresholds to determine whether an entity poses adequate risk to justify regulation. The consensus stems from the data published in the Comptroller of the Currency's ("OCC") third quarter report (2010) on Bank Trading and Derivatives Activities.[13] The report published a list of Top 25 Holding Companies in Derivatives. According to the report, the first and the twenty-fifth positions in aggregate derivatives contracts have notional amounts of $78.7 trillion and $41.9 billion, respectively.[14] Given the size of the derivatives market, the amount of $100 million designated by the Commissions as *De Minimis* seems appropriate.

Having said that, the dynamic nature of the financial markets, particularly the derivatives sector, should counsel caution. The *de minimis* amount should be reevaluated on an ongoing basis. If need be, the Commissions could employ "special call authority" to gather data enabling it to evaluate the efficacy of *de minimis* amounts on an ongoing basis.[15]

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[10] Proposed Rules on Definition at 80175, *supra* note 2.

[11] Professor Greenberger's Comment Letter to Advanced Notice of Proposed Rulemaking at 5, *supra* note 3.

[12] Comptroller of the Currency, OCC's QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES, FIRST QUARTER 2010, *available at* http://www.occ.treas.gov/ftp/release/2010-71a.pdf.

[13] Comptroller of the Currency, OCC's QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES, THIRD QUARTER 2010, *available at* http://www.occ.treas.gov/ftp/release/2010-71a.pdf [hereinafter "OCC report"].

[14] *Id.*

[15] Commission Regulation 18.05 provides that traders with reportable positions in any futures contract must, upon request, furnish to the Commission any pertinent information concerning the traders' positions, transactions, or activities involving the cash market as well as other derivatives markets, including their OTC business. (*See* CFTC Regulation §§18.05).

B. The Proposed Threshold for Transactions with "Special Entities" Is Too High.

The proposed threshold for the aggregate effective notional amount of $25 million for swaps with "special entities"[16] is too high. Special entities, afforded with specific protections under the Dodd-Frank Act, include federal agencies, states, state agencies and political subdivisions (including cities, counties, and municipalities), employee benefit plans, governmental plans as defined under ERISA, and endowments.[17]

Looking to the interpretation of the intent behind Dodd-Frank as expressed in the Administration's "White Paper" on financial regulatory reform[18] — "[c]urrent law seeks to protect unsophisticated parties from entering into inappropriate derivatives transactions by limiting the types of counterparties that could participate in those markets. But the limits are not sufficiently stringent" —unsophisticated parties need the added protection of restricting the aggregate effective notional amount at a level less than $25 million. The legendary abuses suffered by these protected institutions at the hands of swap dealers motivated the special protection afforded them within Dodd-Frank. I support the comment letter to the Commissions by the American Foundation of Labor and Congress of Industrial Organizations ("AFL-CIO"), which urges the Commissions to lower the threshold to $5 million "in order to ensure that pension funds and municipalities are protected when engaging in swap and security-based swap transactions."[19]

III. The Proposed Definition of Eligible Contract Participant ("ECP") is Appropriate.

The Commissions' proposal on further definition of ECP merits support. In addition, I incorporate by reference the section on ECP from my previous comment letter on Advanced Notice of Proposed Rulemaking.[20]

IV. Major Swap Participants ("MSP(s)")

The proposed legislation suggests three tests to define the term "major swap participant." The tests are designed to capture three major risks: (i) the first test deals with a concentration risk by bringing any person who maintains a "substantial position" in major swaps categories, excluding positions held for hedging or mitigating commercial risk; (ii) the second test deals with counterparty risk that could have a serious adverse effect on the financial stability of the U.S. banking system or financial markets; and (iii) the third test deals with a financial entity that is highly leveraged relative to the amount of capital that it holds and that is not subject to capital

[16] Proposed Rules on Definition at 80180, *supra* note 2.

[17] Commodity Exchange Act § 4s(h)(2)(C) and Exchange Act § 15F(h)(2)(C).

[18] Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, *available at* http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf, at 48-49 (June 17, 2009).

[19] Comment Letter from Heather Slavkin, Senior Legal and Policy Advisor, American Foundation of Labor and Congress of Industrial Organizations, to David A. Stawick, Secretary, Commodity Futures Trading Commission, (Feb. 22, 2011)[hereinafter "AFL-CIO Letter"].

[20] *See* Professor Greenberger's Comment Letter to Advanced Notice of Proposed Rulemaking at 7-8, *supra* note 3.

requirements established by an appropriate federal banking agency and maintains a substantial position in outstanding swaps in any major swap category.[21]

A. The Definition of the Exclusion of "Hedging or Mitigating Commercial Risk" from The "Substantial Position" Test Should Be Defined Narrowly.

The exemption of swaps — for hedging or mitigation of commercial risk purposes — from MSP designation should only be available if such swaps are related to the "primary business activity" of an enterprise and not for speculative purposes. The exclusion should not be defined too broadly to allow mere speculation to escape regulation. The definition of "commercial risk" in particular is relevant to the determination of whether an entity is a MSP and application of clearing requirements under the Dodd-Frank Act. A broad definition of commercial risk will result in too large an exemption from MSP designation. Substantively, an exemption from MSP designation should not relieve persons with swap positions of significant systemic importance from compliance with mandatory clearing requirements. It is, therefore, important that in order for the exception to apply, the activity contemplated by the exception must be limited to the firm's core commercial business. Darrell Duffie, a Professor at Stanford University Graduate School of Business, expressed similar concerns in his communication with the CFTC. According to Professor Duffie, the exception should not include positions that hedge financial risk or speculative positions.[22]

B. The Proposed Thresholds for the "Substantial Position" Tests Are Too High.

The first proposed test for substantial position determination is called the Current Exposure Test. It would measure a person's current uncollateralized exposure by marking the swap positions to market using industry standard practices; allowing the deduction of the value of collateral that is posed with respect to the swap positions; and calculating exposure on a net basis, according to the terms of any master netting agreement that applies.[23] The proposed thresholds for the first test would be a daily average current uncollateralized exposure of $1 billion in the applicable category of swaps, except that the threshold for the rate swap category would be $3 billion.[24]

The second proposed test for substantial position determination is called the Current Exposure Plus Potential Future Exposure. The test would allow the major participant analysis to take into account estimates of how the value of an entity's swap or security-based swap positions may move against the entity over time.[25] The proposed thresholds for the second test would be

[21] *See* § 721(a)(16) of the Dodd-Frank Act, *supra* note 1.

[22] Interview by Commodity Future Trading Commission with Darrel Duffie, Dean Witter Distinguished Professor of Finance, Stanford University Graduate School of Business (Feb. 2, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27721&SearchText [hereinafter "Interview with Professor Duffie"].

[23] Proposed Rules on Definition at 80190, *supra* note 2.

[24] *Id.*

[25] Proposed Rules on Definition at 80192, *supra* note 2.

$2 billion in daily average current uncollateralized exposure plus potential future exposure in the applicable major swap category, except that the threshold for the rate swap category would be $6 billion.[26]

The Commissions should lower the threshold of the aforementioned tests to determine a "substantial position" under the first prong of MSP designation. Large swap positions pose unexpected and devastating liquidity concerns in times of crisis. The problem becomes aggravated when multiple positions of the proposed thresholds, held by various entities across the economy, need clearing in a relatively short period. Moreover, the Commissions should also consider "interconnectedness" when finalizing thresholds. Chairman Gary Gensler has stated: "A central lesson of [Long Term Capital Management], AIG and the financial crisis of 2008 is that not only do we have institutions that have become 'too big to fail' — but also that some have become too interconnected to fail."[27] This illustrates the importance of excessive interconnectedness prevailing in our financial markets and its impact on the economy in times of crisis. Potential failure of even a handful of the highly interconnected institutions that have engaged in swaps at the proposed threshold levels would have monumental bearing on our already vulnerable economy.

In sum, the Commissions should lower the "substantial position" threshold of the eventual test adopted for MSP designation, because swap positions at the proposed levels could be large enough to pose liquidity concerns[28] and systemically and adversely impact our economy gravely due to the interconnectedness of the relevant institutions.

C. Incorporation of "Current Exposure" and "Potential Future Exposure" Components into the Determination of "Substantial Position" Designation Warrants Support.

In my comment letter to the Advanced Notice of Proposed Rulemaking, I recommended that the Commissions should consider the current as well as the potential future exposure to capture the magnitude of risk a party represents (or is exposed to) when engaged in swap transactions.[29] The President's Working Group's April 1999 report on hedge funds states that "the current credit exposure at a moment in time is the market value of the contract, and represents the replacement cost of the contract if one party to the transaction defaults at that moment.[30] The potential future exposure is "an estimate of the possible increase in the contract's replacement value from the point of view of a particular firm over a specified interval in the

[26] Proposed Rules on Definition at 80193, *supra* note 2.

[27] Gary Gensler, *Clearinghouses are the Answer,* WALL ST. J., April 21, 2010, *available at* http://online.wsj.com/article/SB10001424052748704671904575194463642611160.html.

[28] Interview with Professor Duffie, *supra* note 22.

[29] *See* Professor Greenberger's Comment Letter to Advanced Notice of Proposed Rulemaking at 6, *supra* note 3.

[30] President's Working Group on Financial Markets, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT at 9 (April 1999), *available at* http://www.ustreas.gov/press/releases/reports/hedgfund.pdf.

future, such as between the time of a potential default and the time the counterparty is able to replace the contract."[31]

Since default is an uncertain event that can occur at any time during the life of the contract, it is considered not only the contract's current exposure, but also potential changes in the exposure during the contract's life.[32] Hence, the addition of current exposure, as well as potential future exposure, to determine the substantial position designation is appropriate.

D. The Proposed Criteria to Determine Highly Leveraged Position for MSP Designation Need to Be Lowered.

The third aspect of the statutory definition of MSP addresses any financial entity, other than one subject to capital requirements established by an appropriate Federal banking agency, that is highly leveraged relative to the amount of capital it holds, and that maintains a substantial position in a major swap category.[33] The Commissions proposed two possible definitions of highly leveraged — either a ratio of total liabilities to equity, as determined in accordance with U.S. GAAP, of 8 to 1, or a ratio of 15 to 1 measured in the same way.[34] The test to determine if an entity is highly leveraged should require lower ratios than Commission's proposals.

In the proposed rules, the Commission acknowledges the limitations posed by traditional balance sheet measures of leverage to evaluate credit risk of an entity.[35] That measure presents a big picture of an entity's liabilities rather than providing a direct analysis of risks associated with swaps and may fail to take into account the off-balance sheet derivatives held, if any.[36] The Commissions' proposal reflects concerns over increased costs associated with compliance with any other measure to determine the highly leveraged status.[37]

In the light of the above-mentioned concerns over cost, the financial entities' Net Current

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[31] *Id.*

[32] Jeff Aziz & Narat Charupat, *Calculating Credit Exposure and Credit Loss: A Case Study, available at* http://www.bis.org/bcbs/ca/alrequse98.pdf.

[33] Proposed Rules on Definition at 80198, *supra* note 2.

[34] Proposed Rules on Definition at 80199, *supra* note 2.

[35] Proposed Rules on Definition at 80198-99, *supra* note 2.

[36] *See* Comment Letter by Susan Voss, President, National Association of Insurance Commissioners, Commissioner, Iowa Insurance Division, and Therese Vaughan, Ph.D., Chief Executive Officer, National Association of Insurance Commissioners, to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission, and David Stawick, Secretary, U.S. Commodity Futures Trading Commission (Feb. 18, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27749&SearchText= (stating that "Simple leverage ratios in the absence of additional analysis of the entity's accounting/reserving requirements and business risk are simply not a useful tool for evaluating whether an insurance company is 'highly leveraged.' A better approach might be to determine whether the insurer or other entity is 'highly leveraged' specifically with respect to its swaps positions, and not the balance sheet as a whole.").

[37] Proposed Rules on Definition at 80199, *supra* note 2.

Credit Exposure ("NCCE")[38] over the Tier 1 capital ("Capital")[39] should be adopted as a metric to calculate leverage. NCCE is "the primary metric used by the OCC to evaluate credit risk in bank derivatives activities"[40] and it is currently available through entities' quarterly call report, hence eliminating the cost concerns mentioned above. This metric should be developed in close consultation with the Financial Stability Oversight Council created by the Dodd-Frank Act,[41] so that the CFTC and SEC can effectively identify risks to U.S. financial stability that could arise from the failure of highly leveraged financial companies. If the CFTC and SEC determine that the NCCE over Capital is unacceptably high, in other words, the entity is undertaking too much risk, then that entity should be deemed MSP.

Sincerely,

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[38] For a portfolio of derivative contracts, NCCE is the gross positive fair value of contracts less the dollar amount of netting benefits. On any individual contract, current credit exposure is the fair value of the contract if positive, and zero when the fair value is negative or zero. NCCE is also the net amount owed to banks if all contracts were immediately liquidated. (Glossary of Terms, OCC Report).

[39] Tier 1 Capital consists of common shareholders' equity, perpetual preferred shareholders' equity with noncumulative dividends, retained earnings, and minority interests in the equity accounts of consolidated subsidiaries. (Glossary of Terms, OCC Report).

[40] Comptroller of the Currency, OCC's QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES, FIRST QUARTER 2010, *available at* http://www.occ.treas.gov/ftp/release/2010-71a.pdf.

[41] *See* § 111 of the Dodd Frank Act, *supra* note 1.