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Sent: Monday, September 20, 2010 3:49 PM
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Cc: Greenberger, Michael <mgreenberger@law.umaryland.edu>
Subject: Comment Letter on Definitions
Attach: Michael_Greenberger_on_Definitions_Final.pdf

Attached please find a comment letter of Professor Michael Greenberger in response to Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act (File Numbers S7-16-10). If you have any questions, please feel free to contact Professor Michael Greenberger at 410-706-3846 or mgreenberger@law.umaryland.edu or the undersigned at the number below.

Thank you.

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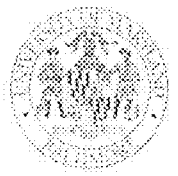

UNIVERSITY OF MARYLAND
SCHOOL OF LAW

September 20, 2010

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

Re: Definitions Contained in Title VII of Dodd-Frank Act, File No. S7-16-1.

Dear Mr. Stawick:

These comments are submitted in response to the notice of the Advanced Notice of Proposed Rulemaking[1] issued by the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") in this joint proceeding.

I. Definition of "Swap"

The definition of "swap" in the Dodd-Frank Act is very broad, and includes any agreement, contract, or transaction that provides for the exchange of payments based on the value of one or more underlying financial or economic interests or property of any kind; or dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.[2] This broad definition of swap[3] is more expansive than the traditional definition of swap, which is limited to "an agreement between two parties to *exchange a series of cash flows* measured by different interest rates, exchanges rates, or prices with payments calculated by reference to a

[1] Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51429 (Aug. 13, 2010).

[2] *See* §721(a)(21)(47).

[3] The legislation also includes foreign exchange swaps in the definition of "swap," but leaves discretion to the Treasury Department to determine whether these contracts should be regulated as swaps. If the Treasury Department notifies Congress that foreign exchange swaps should be exempt from regulation, the Dodd-Frank Act would still impose certain business conduct standards and reporting requirements on OTC foreign exchange market participants that are "swap dealers" or "major swap participants". *See* §721(a)(21)(47).

principal base (notional amount)."[4] For example, commodity index swaps, which do not exchange a series of cash flow, but require a fixed price for underlying basket of commodities, fall under the definition of swap.[5]

Under the Dodd-Frank Act, the term "swap" does not include "any sale of a nonfinancial commodity or security for deferred shipment or delivery, *so long as the transaction is intended to be physically settled*."[6] This exclusion is intended to be consistent with the "forward contracts" exclusion in the Commodity Exchange Act[7] and the CFTC's policy on forward contracts.[8] The Dodd-Frank Act is unambiguous that *only* physical commodities forward contracts will be excluded from the definition of a swap, provided that the physical commodities are intended to be physically settled. Therefore financial instruments that call for physical settlement will be deemed swaps and are regulated by the statute.

As to determining the intent of the parties, the CFTC should take the Dodd-Frank Act at its plain meaning, and thus require parties' actual intent to deliver as a prerequisite to be a forward contract. In doing so, the Commission should look to the law that distinguishes a futures contract from a forwards contract. In *CFTC* v. *Zelener*, the Seventh Circuit held that the relevant inquiry is whether the transaction involves "a sale of the commodity" or "a sale of the contract."[9] A contract would be regarded as a futures contract, which would fall under the definition of swaps, if the contract is fungible or absent that, if the seller promises to allow the buyer to enter into an offsetting contract on demand.[10] This test will assist the Commission in determining whether the parties intended the contact to be physically settled.

II. Definition of "Swap Dealer"

In the Dodd-Frank Act, the term swap dealer is defined as any person who is a dealer or market maker in swaps or who regularly enters into swaps with counterparties in the ordinary course of business for its own account.[11] The term 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."[12]

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[4] 54 Fed. Reg. at 30,695.

[5] The term 'swap' means any agreement, contract, or transaction that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on […] commodities, […], indices; or transaction commonly known as a commodity swap. *See* §721(a)(21)(47).

[6] *See* §721(a)(21)(47).

[7] 7 U.S.C. §1 *et seq*.

[8] "The intent of the exemption for forward contracts in Section 2(a)(1)(A) is to exclude marketing transactions in the normal stream of commerce for a commodity or its byproducts where delivery is intended, but delivery is delayed for commercial convenience or necessity." (*Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options*, 50 Fed. Reg. 39656-02, 39660 (Sept. 30, 1985)).

[9] 373 F.3d at 865 (2004).

[10] *Id.*

[11] *See* §721(a)(21).

[12] *See* §721(a)(21).

Chairman Gensler's understanding of this definition in his remarks before the International Swaps and Derivatives Association Regional Conference held in New York on September 16, 2010 is correct. He stated "initial estimates are that there could be in excess of 200 entities that will seek to register as swap dealers [under the Dodd-Frank Act]."[13] This includes, *inter alia*, "[209] global and regional banks currently known to offer swaps" as "Primary Members" of ISDA.[14] Under ISDA's bylaws, Primary Members are defined as:

> Every investment, merchant or commercial bank or other corporation, partnership or other business organization that, directly or through an affiliate, as part of its business (whether for its own account or as agent), deals in DERIVATIVES shall be eligible for election to membership in the Association as a Primary Member, provided that no person or entity shall be eligible for membership as a Primary Member if such person or entity participates in DERIVATIVES transactions solely for the purpose of risk hedging or asset or liability management.[15]

Although some of these members may be beyond the extraterritorial reach of the CFTC or SEC, Chairman Gensler stated, "it is likely that most, if not all, of [ISDA]'s global and international members would [seek to register in the U.S.]"[16] The CFTC and SEC should adopt the ISDA's definition of Primary Members as its own by regulation for purposes of deciding which institutions should be regulated as a swaps dealer.

The CFTC and SEC should clarify the meaning of "the purpose of risk hedging or asset or liability management" because an entity may claim to engage in derivatives transactions for the purpose of risk hedging or asset or liability management and yet, may still generate significant revenue from such transactions that could materially affect that entity's financial condition. In determining what constitutes "regular business," as that term appears in "Exception" to the definition of a swap dealer,[17] the Commission should consider a financial institution's annualized average trading revenue from all swaps activities as a percentage of total gross trading revenue. This percentage should be considered as an absolute number in order to capture the magnitude of impact, both positive and negative, of swaps activities on the institution's gross trading revenue. Using this absolute percentage provides insight as to the nature of institution's "regular business." The absolute percentage threshold should be two percent of gross trading revenue because it is reflects "material[ity]" in the absence of authoritative materiality guideline.[18]

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[13] Opening Statement of Chairman Gary Gensler, ISDA Regional Conference, Sept. 16, 2010, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-50.html.

[14] *Id.*

[15] *See* Official Website of International Swaps and Derivatives Association, Inc., "Primary Membership," *available at* http://www.isda.org/.

[16] Opening Statement of Chairman Gary Gensler, ISDA Regional Conference, Sept. 16, 2010, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-50.html.

[17] "(C) EXCEPTION. - The term 'swap dealer' does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of *a regular business*." (*See* §721(a)(21)).

[18] Ahmad H Juma'h, *The Implications of Materiality Concept On Accounting Practices and Decision Making*, 5 INTER METRO BUS. J. 1, 22 (Spring 2009), *available at* http://ceajournal.metro.inter.edu/spring09/jumah0501.pdf.

At present, however, a financial institution's trading revenue from swaps activities is unavailable to the public or to the regulators. This is evidenced by the fact that Goldman Sachs was urged to disclose its derivatives trading revenue to the Financial Crisis Inquiry Commission. Goldman Sachs indeed reported that 25% to 35% of its revenue comes from derivatives-based businesses on August 7, 2010.[19] To meet this lack of transparency at present, the CFTC and SEC should issue a "special call"[20] requiring all entities that have annual trading revenue over one billion dollars to provide the Commission with audited financial statement that shows gross and net trading revenue from all swaps activities over the last two years from the date of the special call. Those numbers gathered by the special call should be used to determine what the percentage should be and it should be used as a threshold in going forward.

The legislation does provide an exception to entities that engage in a "*de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers."[21] The CFTC and SEC should consider the "*de minimis* exception" under the Gramm Leach Bliley Act[22] in determining the "*de minimis* quantity" of swaps transactions. Under Section 201 of the Gramm Leach Bliley Act, a bank is not considered a "broker" if the bank does not effect more than 500 securities transactions in any one calendar year.[23] The CFTC and SEC should set the bar at 500 swaps transactions per one calendar year. As aforementioned, however, the Commission should refrain from granting the *de minimis* exception without also considering the dollar amount of each transaction.

III. Definition of "Major Swap Participant"

One of the most important provisions of the Dodd-Frank Act is Section 721(a)(16), which introduces the new term "Major Swap Participant."[24] Particularly, this provision is important because an end user who is deemed a major swap participant will be subject to rules and regulations that apply to swap dealers.

The legislation provides that the term "major swap participant" means any person who is not a swap dealer and meets one of the three alternative tests.[25] The three alternative 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 serious adverse effect on the financial stability of the U.S. banking system or

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[19] Liz Rappaport, *At Goldman, Derivatives Were 25% to 35% of '09 Revenue*, WALL ST. J., August 9, 2010, *available at* http://online.wsj.com/article/SB10001424052748703988304575413782484193438.html.

[20] 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).

[21] *See* §721(a)(21).

[22] Gramm-Leach-Bliley Financial Services Modernization Act, 15 U.S.C. §§6801-09 (Nov. 12, 1999). [hereinafter "GLB Act"]

[23] See §201 of GLB Act.

[24] *See* §721(a)(16).

[25] *See* §721(a)(16).

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 requirements established by an appropriate federal banking agency and maintains a substantial position in outstanding swaps in any major swap category.[26]

i. First Test

In order to apply the first test, the Commission must first define what constitutes "substantial position" in swaps in any "major swaps category." The Act requires that the term "substantial position" be defined at the "threshold that the swaps regulator determines to be prudent for the effective monitoring, management or oversight of entities that are systemically important or can significantly impact the financial system of the United States."[27]

In determining a "major swaps category", the Commission should first categorize commodities into generic categories, such as agriculture, credit, energy, foreign exchange, interest rate, metals, and any other general category as the Commission sees fit. The Commission, then, should look into each overarching categories to determine appropriate subgroups. For example, an "energy category" should be broken down to subgroups of crude oil, ethanol, refined products, natural gas, electricity, and coal. The Commission should then further break down the types of commodity into specific commodity products, i.e., Light Sweet Crude Oil (WTI), Brent Crude Oil, and MB Gulf Coast Sour Crude Oil. At this precise level, the Commission would be able to capture market participants who have a substantial position in just one of the specific commodity products. Therefore, any person who has a substantial position in one of those sub categories should fall under the definition of a major swaps participant for that category.[28] For every kind of swaps, the same analysis should be done so as to avoid situations where a trader is heavily involved in one subgroup from escaping regulation because that subgroup does not factor large in the generic category.

The Commission should define "substantial position" by looking into the *gross notional value* of an entity's swaps positions within a subgroup of a major swaps category. As the Comptroller of the currency has made clear, notional amount provides a meaningful snapshot of concentration risk because it captures market saturation.[29] If an entity has swaps positions that are 10% or more in a gross notional value in a subgroup of a major swaps category, the entity should be deemed to have a substantial position because its position is substantial enough to be relevant to the economy or the financial system as a whole.

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[26] *See* §721(a)(16).

[27] *See* §721(a)(16).

[28] "(C) SCOPE OF DESIGNATION. – For purposes of subparagraph (A), a person may be designated as a major swap participant for 1 or more categories of swaps without being classified as a major swap participant for all classes of swaps." (*See* §721(a)(16)).

[29] 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 [hereinafter OCC report].

ii. Second Test

The second test covers an "entity whose swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets."[30] In determining the term "substantial counterparty exposure," the Commission should consider the following two factors together: (i) "current exposure;" and (ii) "potential exposure."[31] The President 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."[32] 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 future, such as between the time of a potential default and the time the counterparty is able to replace the contract."[33]

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.[34] Therefore considering both current and potential exposure, the Commission should look into an entity's number of counterparties. If the Commission determines that the entity is too interconnected through many counterparties, this entity should be deemed to have a high degree of counterparty risk. Even if each contract is of a small amount, the failure of this entity could potentially cause a widespread panic in the market. In addition to considering the number of counterparties, the Commission must consider the financial stability of a counterparty in order to capture an end user who enters into a large contract with one counterparty that could create substantial counterparty exposure.

iii. Third Test

The third test covers a financial entity that is "highly leveraged relative to the amount of capital that it holds," that is not an entity subject to U.S. bank capital requirements, and that maintains a "substantial position" in swaps in any "major swaps category."[35]

Leverage can be defined in terms of risk, in which case it is a measure of economic risk relative to capital.[36] Therefore the Commission should consider financial entities' Net Current

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[30] *See* §721

[31] 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.

[32] *Id.*

[33] *Id.*

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

[35] *See* §721

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

Credit Exposure ("NCCE")[37] over the Tier 1 capital ("Capital")[38] as a metric to calculate leverage. Net current credit exposure is "the primary metric used by the OCC to evaluate credit risk in bank derivatives activities"[39] and it is currently available through entities' quarterly call report. This metric should be developed in close consultation with the Financial Stability Oversight Council created by the Dodd-Frank Act,[40] which, *inter alia*, includes all major bank regulators[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 that the entity cannot absorb its potential loss, then that entity should be deemed a under the alternative test a "major swap participant."

IV. Definition of "Eligible Contract Participant"

The Dodd-Frank Act makes it unlawful for any person other than an eligible contract participant ("ECP") to enter into a swap that is not on, or subject to, the rules of a board of trade or designated contract market.[42] Since trades between ECPs do not fall within the strict and highly protective regulations of a designated contract market, an ECP should be narrowly defined, in another words, the threshold for escaping strict designated contract market trading should be high, in order to ensure that participants in the less regulated swap market have indicia of being able to tolerate the risk of lesser regulation.

Although the Dodd-Frank Act does not statutorily increase the existing threshold for determining whether a party is an ECP (other than municipal counterparties, which increased from $25 million to $50 million in investments,[43] the Commission *has the discretion to increase the threshold* because the statutory language uses the terms, "*in excess of*."[44] In another words, rather than setting an absolute threshold, Congress intended that the CFTC and SEC consider

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[37] 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).

[38] 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).

[39] *See* 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.

[40] *See* §111

[41] The Financial Stability Oversight Council will have ten voting members, consisting of the Treasury Secretary, who also acts as Chairman of the Council, the Chairman of the Federal Reserve, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection (a new agency created by the Act), the Chairmen of the FDIC, SEC and CFTC, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board and an independent member having insurance expertise appointed by the President and confirmed by the Senate, and five nonvoting members. (*See* §111).

[42] *See* §723(a)(2).

[43] *See* §723.

[44] *See* §741.

whether the minimum threshold should be raised in light of the riskiness of the lesser regulated swaps market. The Commission must use that discretion to ensure that only biggest players who have adequate capital can engage in what has proven to be high risk products.

Under existing law generally speaking, a counterparty to be an ECP has to have in excess of $10 million in total assets with some limited exceptions allowing lesser amounts in the case of an individual using the swap for risk management purposes.[45] These thresholds are far too low. It allows too many counterparties without sufficient sophistication to invest in these less regulated products. Therefore the CFTC and SEC should exercise the statutory discretion to increase the ECP threshold across the board to $ 50 million as Congress has done for municipal counterparties. This is a metric with which Congress was obviously comfortable and it would weed out of this less regulated market those who are not able protect their financial interests in the absence of the full protection of trading on designated contract markets.

Sincerely,

Michael Greenberger, J.D.
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University of Maryland School of Law

[45] Philip Mc Bride Johnson and Thomas Lee Hazen, DERIVATIVES REGULATIONS, § 1.18[5] at 328-29 (Aspen, 2004).