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Sent:	Tuesday, September 21, 2010 6:18 PM
To:	OTCDefinitions <OTCDefinitions@CFTC.gov>; secretary <secretary@CFTC.gov>
Cc:	Mamak, Matthew <Matthew.Mamak@alston.com>
Subject:	CFTC Rulemakings Under Dodd-Frank Wall Street Reform and Consumer Protection Act - Definitions
Attach:	FDR - Comment Letter to CFTC Dated 9-20-10_1.PDF

To Whom It May Concern:

Attached please find a comment letter on behalf of the Committee on Futures and Derivatives Regulation of the Bar of the City of New York with respect to CFTC Rulemakings Under Dodd-Frank Wall Street Reform and Consumer Protection Act – Definitions. The items addressed in this letter are not the only issues the Committee has identified in the statute. However, due to timing constraints the Committee has decided to address other issues at a later time

Best,

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September 20, 2010

The Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
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Washington, D.C. 20581

Filed via email: OTCDefinitions@CFTC.gov

Re: CFTC Rulemakings Under Dodd-Frank Wall Street Reform and Consumer Protection Act – Definitions

We write on behalf of the Committee on Futures and Derivatives Regulation (the "Committee") of the New York City Bar Association (the "Association") to provide advance comments that may assist the Commission's forthcoming proposed rulemaking under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") prior to the publication of proposed rules and the commencement of the attendant official comment periods.

The Association is an organization of over 23,000 members. Most of its members practice in the New York City area. However, the Association also has members in nearly every state and over 50 countries. The Committee consists of attorneys knowledgeable about the trading and regulation of futures contracts and over-the-counter derivative products, and it has a practice of publishing comments on legal and regulatory developments that have a significant impact on futures and derivatives markets.

Set forth below are the Committee's comments on the definitions of "major swap participant," "swap dealer," "swap," and "special entity," which are being provided in response to your Advance Notice of Proposed Rulemaking published in 75 Fed. Reg. 51429. These advance comments are principally of a conceptual nature and remain subject to any additional comments that the Committee may provide as official comments following the Commission's issuance of proposed rules implementing these definitions.

SUMMARY OF ADVANCE COMMENTS:

(1) ***Definition of "Major Swap Participant."*** With respect to the definition of "major swap participant," the Committee proposes:

(i) that the Commission clarify and/or confirm:

(A) whether a position would be deemed to be "substantial" for the purposes of subparagraphs (i) and (iii) of the "major swap participant" definition if it does not give rise to "substantial counterparty exposure" similar to that referred to in subparagraph (ii) thereof,

(B) that the calculation of a party's "substantial position" as used in such definition should take into account applicable master agreement netting and be based upon an entity's net, as opposed to gross, counterparty exposure,

(C) whether the determination of a "substantial position" should take into account only those swaps that are not subject to clearing,

(D) that the determination of a "substantial position" should take into account collateral that has been provided to minimize exposures,

(E) how uncleared swaps that hedge cleared swaps should be considered for purposes of the term "substantial position," and

(F) how the term "financial entity" should be defined for purposes of subparagraph (iii) of the "major swap participant" definition; and

(ii) that the Commission consider, in order to achieve a greater degree of legal certainty regarding the definition of "major swap participant," whether to specify a minimum dollar threshold of counterparty net exposure below which an entity's outstanding swap exposure would not be considered to be "substantial" for purposes of such definition.

(2) ***Definition of "Swap Dealer."*** The Committee seeks clarity whether, for purposes of subparagraph (iii) of the definition of "swap dealer" (*i.e.* "[any person who...] regularly enters into swaps with counterparties as an ordinary course of business for its own account"), the term "swap dealer" should be deemed to exclude principal investors and "traders," similarly to how the SEC interprets the term "dealer" for purposes of the Securities Exchange Act.

(3) ***Changes of Status; Categories, Types, Classes and Groups of Swaps.*** The Committee proposes that the Commission provide legal certainty through a process that would allow an entity reasonable time to register after it first comes within the "major swap participant" or "swap dealer" definitions and to deregister once it no longer fits within these definitions. The Committee also asks the Commission to clarify the significance of, and process for determining, the various "categories," "types" and "classes" of swaps for purposes of the definitions of "swap dealer" and "major swap participant."

(4) ***Definition of "Swap."*** With respect to the definition of "swap," the Committee seeks clarification: (A) whether this definition includes financial guaranty insurance products, (B) that (i) only transactions under master agreements (and not master agreements themselves) are subject to the Act and (ii) contractual master agreement netting should be taken into account in any determination of swap exposure under the Act, and (D) whether, due to section 1a(47)(B)(ix) of the CEA, as amended, Federal agencies expressly backed by the full faith and credit of the United States are excluded from the definition of "special entity" for purposes of swap dealers' enhanced duties under section 731 of the Act.

(5) ***No-Action Letter or Advisory Process.*** Finally, with respect to all definitions, including those not specifically commented on in this letter, the Committee proposes that the Commission establish a no-action letter or other advisory process to allow parties to obtain prompt guidance concerning the application of the rules to novel or unusual facts.

DETAILS OF ADVANCE COMMENTS:

(1) Major Swap Participant

Section 721(a)(16) of the Act amends the Commodity Exchange Act (the "CEA") to define "major swap participant" in section 1a(33) of the CEA.[1] We believe that some of the terms used in the definition, *i.e.* "substantial position," "major swap categories," "hedging,"

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[1] "(33) MAJOR SWAP PARTICIPANT.—

(A) IN GENERAL.—The term 'major swap participant' means any person who is not a swap dealer, and—

(i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding—

(I) positions held for hedging or mitigating commercial risk; and

(II) positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

(iii)(I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and

(II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission.

(B) DEFINITION OF SUBSTANTIAL POSITION.—For purposes of subparagraph (A), the Commission shall define by rule or regulation the term 'substantial position' at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States. In setting the definition under this subparagraph, the Commission shall consider the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.

(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.

(D) EXCLUSIONS.—The definition under this paragraph shall not include an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company."

"commercial risk," "substantial counterparty exposure," "highly leveraged" and "financial entity," are ambiguous and require clarification.

"Substantial Position" vs. "Substantial Counterparty Exposure"

Section 1a(33)(B) of the CEA, as amended, directs that the term "substantial position" be defined by the Commission "at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States." In light of this statutory direction, it appears that the concept of "substantial position" in subparagraphs (i) and (iii) of the "major swap participant" definition is similar to the concept of "substantial counterparty exposure" in subparagraph (ii) ("[any person...] whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets"). If the regulatory burdens of a major swap participant contemplated by the Act are intended to be imposed only on entities with swap positions that create systemic exposure, then reconciling the concepts of "substantial counterparty exposure" and "substantial position" is appropriate.[2]

As noted below under *Recognition of Netting Under Master Agreements*, clarification is needed to confirm that, when transactions are entered into under a master agreement that provides for termination netting, the definitions of "substantial position" and "substantial counterparty exposure" will be calculated based on net, as opposed to gross, exposures. In this respect, section 1a(33)(B) of the CEA, as amended, directs the Commission in defining "substantial position" to consider "the person's relative position in uncleared as opposed to cleared swaps." The Commission may also take into consideration "the value and quality of collateral held against counterparty exposures." Given these statutory directions, it would appear that only swap positions that create counterparty exposure on a net basis should be factored into the determination of whether a swap portfolio constitutes a "substantial position." Virtually all market participants calculate net exposures with reference to amounts due upon an early termination of the swaps or the amount that would be due in consideration of entering into replacement swaps that would have the effect of preserving the economic equivalent of any payment or delivery in respect of all terminated swaps under a master agreement. As a result, the definition should be based upon counterparty net exposures rather than gross exposures or notional amounts.

With respect to cleared swaps, the language in section 1a(33)(B) of the CEA, as amended, is ambiguous as to how cleared trades should be treated or whether cleared trades should be ignored for purposes of meeting the definition of "substantial exposure." Cleared

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[2] In determining whether a swap position is a "substantial position," subparagraph (i) allows for exclusions of certain types of hedging positions mentioned in clauses (I) and (II) thereof. In contrast, subparagraph (iii) effectively provides that such exclusions do not apply to a "financial entity" that is "highly leveraged." If all three prongs are to be given independent meaning, it would seem that not all "substantial positions" in outstanding swaps create "substantial counterparty exposure." Otherwise, subparagraph (ii) would always govern and the additional criteria in subparagraph (i) (*i.e.* the exclusions of hedging positions) and subparagraph (iii) (*i.e.* the entity being a highly-leveraged financial entity) would not add any substance to the definition. Consequently, it could be argued that a "substantial position" is one that, together with either of these additional criteria, creates "substantial counterparty exposure."

swaps do not create the same type of exposures that uncleared trades may create. With respect to uncleared swaps, it is also possible to manage counterparty risk on a bilateral basis if such swaps are appropriately collateralized. In this respect, clarification is needed as to how the "value and quality of the collateral" would factor into the definition. Also, it is unclear whether and how uncleared swaps that hedge cleared swaps are to be considered for purposes of the term "substantial position." The Commission's clarification of these points would be helpful.

Given the foregoing ambiguities inherent in the concepts of "substantial position" and "substantial counterparty exposure" as defined and applied in the Act, we would recommend that the Commission introduce a minimum dollar threshold of counterparty net exposure below which an entity's outstanding swaps would not satisfy such definitions for the purpose of determining whether such entity is a major swap participant. This objective criterion should provide legal certainty and promote regulatory efficiency.

Subparagraph (iii) of section 1a(33)(A) of the CEA, as amended, uses the term "financial entity." There is no general definition of such term. However, the same term is used in section 2(h) of the CEA, as amended, and is defined in that section for the purposes of the commercial end-user exception to the clearing requirement. It is unclear whether the term "financial entity" in section 1a(33) is intended to have the same meaning as in section 2(h).

(2) Swap Dealer

Section 721(a)(21) of the Act amends the CEA to define "swap dealer" in section 1a(49) of the CEA, as amended.[3] The arguably broadest of the prongs in the definition of "swap dealer" is paragraph (A)(iii): "[any person who...] regularly enters into swaps with counterparties as an ordinary course of business for its own account." This language closely resembles the definition of "dealer" in section 3(a)(5) of the Securities Exchange Act ("any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise"). The definition of "dealer" has been interpreted by the SEC to exclude principal investors and "traders," to the effect that a hedge fund engaged in buying and selling securities for its own account, absent other facts, typically would not be required to register as a broker-dealer with the SEC. It should be clarified whether a similar 'trader exception' applies to the

[3] "(49) SWAP DEALER.—
(A) IN GENERAL.—The term 'swap dealer' means any person who—
(i) holds itself out as a dealer in swaps;
(ii) makes a market in swaps;
(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps,
provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.
(B) INCLUSION.—A person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.
(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.
(D) DE MINIMIS EXCEPTION.—The Commission shall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers. The Commission shall promulgate regulations to establish factors with respect to the making of this determination to exempt."

definition of "swap dealer," which exception would be distinct from and in addition to the exceptions in section 1a(49)(C) and (D) of the CEA, as amended, which refer to occasional and de minimis swap dealing activities, respectively.

(3) Changes in Status; Categories, Types, Classes and Groups of Swaps

In order to address the fact that the status of an entity may change over time, the rules implementing the Act's registration requirements for swap dealers and major swap participants should provide a reasonable time for a party to register after it first comes within the "swap dealer" and/or "major swap participant" categories and a de-registration process for entities that no longer fit within such categories. This is particularly pertinent with respect to major swap participants since the criteria for classification as such depend on the size and composition of the entity's swap positions, and those positions may fluctuate.

Subparagraphs (i) and (iii) of section 1a(33)(A) of the CEA, as amended, refer to the existence of a "substantial position" in "any of the major swap categories" and "any major swap category," respectively. Section 1a(33)(C) of the CEA, as amended, provides that "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." It is unclear what is meant by "major swap category" and "classes of swaps" and what the difference is between a "class" and a "category" of swaps. Further, the definition of swap dealer in section 1a(49) of the CEA, as amended, uses the term "type of swap" in addition to "class" or "category" of swap: "[a] person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities." Section 2(h)(2)(A)(i) of the CEA, as amended, provides that "[t]he Commission on an ongoing basis shall review each swap, or any group, category, type, or class of swaps to make a determination as to whether the swap or group, category, type, or class of swap should be required to be cleared." Given the above-quoted language, the Committee believes it is important that the proposed rules clarify the practical consequences of a party having different definitional categorizations with respect to different "types, classes or categories" of swaps.

(4) Definition of Swap

Financial Guarantee Insurance Products

Section 721(a)(21) of the Act amends the CEA to define "swap" in section 1a(47) of the CEA, as amended. The definition includes in paragraph (A)(ii) of subsection (47), "any agreement, contract, or transaction ... that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is 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." Further clarity would be helpful as to whether this definition includes financial guaranty insurance products and, if so, how any attendant jurisdictional and/or State law preemption issues are intended to be resolved.

Recognition of Netting Under Master Agreements

Section 1a(47)(C) of the CEA, as amended, includes a rule of construction for "master agreements." That provision, however, does not provide all the guidance that is needed to ensure

that the rules take into account the practical reality that virtually all swap market participants use master agreements with netting provisions to document their swaps and to reduce their counterparty risk. It is essential for practical purposes to expand that provision to provide a definition of "master agreement" and to create a presumption that any calculation of exposure of a party for the purposes of applying any definition or any capital or margin requirement applicable to that party with respect to swaps and security-based swaps that (a) are not required to be cleared by a registered derivatives clearing organization and (b) are documented under a master agreement, should be based upon the net exposure of the party with respect to all transactions documented under the master agreement.

Federal Agencies as "Special Entities"

Section 1a(47)(B)(ix) of the CEA, as amended, excludes from the definition of "swap," "any agreement, contract, or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States." However, section 4s(h)(2)(C) of the CEA, as amended, defines "special entity" to include, among others, Federal agencies for purposes of swap dealers' enhanced duties in connection with acting as advisers to, or entering into swaps as counterparties to, special entities. Since a "swap" as defined in section 1a(47) cannot be entered into by a Federal agency backed by the full faith and credit of the United States, it would appear that the only type of Federal agency covered by the special entity rules are those not backed by the full faith and credit of the United States. The Committee believes that further clarity in this respect would be appropriate.

(5) No-Action Letter or Advisory Process

Because the rules will not be able to anticipate all the issues that will arise from the required changes in the swaps markets, the Committee believes that the Commission should establish a no-action letter or other advisory process to allow parties to obtain prompt guidance concerning the application of the rules to novel or unusual facts. Such process should apply to all definitions used in the Act, including those not specifically commented on in this letter.

* * *

We appreciate the opportunity to present our views to you on this matter of importance to us as practitioners of derivatives law and regulation.

Respectfully yours,

Timothy P. Selby, Chair
The Committee on Futures and Derivatives Regulation,
New York City Bar Association

New York City Bar Association
Committee on Futures and Derivatives Regulation
Timothy P. Selby, Chair

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* These members of the Committee did not participate in this comment letter.
§ These members comprise the Ad Hoc Working Group.