February 22, 2011

Mr. David Stawick, Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC DELIVERY

Re: *Joint Notice of Proposed Rulemaking on Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", RIN 3038–AD06*

Dear Mr. Stawick:

I. Introduction

BG Americas & Global LNG ("BGA") is a business unit of BG Group plc ("BG Group"), a global natural gas company based in the United Kingdom and a major producer and supplier of natural gas to the United States. BGA is responsible for all of BG Group's operations in North and South America, the Caribbean, BG Group's global marine operations and its global liquefied natural gas ("LNG") operations. BG Group's subsidiary, BG Energy Merchants, LLC, is a major marketer of natural gas and electricity in the United States.

BGA is submitting these comments in response to the request for public comment set forth in the Joint Notice of Proposed Rulemaking, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"* ("*Proposed Definitional Rule*"), issued by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions") and published in the *Federal Register* on December 21, 2010.[1]

[1] *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"* Notice of Proposed Rulemaking, 75 Fed. Reg. 80,174 (Dec. 21, 2010).

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II. Executive summary

In this proceeding, BGA specifically addresses the proposed further definition of the terms "Swap Dealer" and "Major Swap Participant," pursuant to Sections 1a(49) and 1a(33) of the Commodity Exchange Act ("CEA"), as established by Title VII, Subtitle A, Section 712(d)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and related interpretational guidance set forth in the *Proposed Definitional Rule*.

BGA is supportive of the efforts of Congress to reform over-the-counter ("OTC") swap markets to prevent abuses that led to the financial crisis and appreciates the opportunity to comment in this proceeding. As the "gateways" through which the Commissions may exercise the new and expanded oversight authority granted under Title VII, the definition of Swap Dealer and Major Swap Participant are the most critical elements of the new framework for the regulation of OTC swap markets. The successful implementation of this regulatory framework is tied, in large part, directly to the Commissions' ability to further define and apply Swap Dealer and Major Swap Participant in a fashion that is:

1. Faithful to Congress' intent; and

2. Consistent with the requirements and structure of Title VII.

BGA is concerned that these definitions and related interpretive guidance set forth in the *Proposed Definitional Rule* are not consistent with Congressional intent underlying Title VII of the Dodd-Frank Act. As discussed herein, if adopted in their current form, the definitions of Swap Dealer and Major Swap Participant would result in the imposition of a "one-size-fits all" regulatory framework that is broader than Congress intended.

Moreover, the *Proposed Definitional Rule* fails to consider the differences between the energy commodity markets and the financial swap markets. Energy commodity markets, in which parties enter into swaps with each other to ensure physical delivery and provide financial risk management and price discovery for the physical market, are different from the swap markets. The further definition of the term Swap Dealer, in particular, by the Commission must:

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1. Recognize the unique operational characteristics of energy markets; and

2. Consider the potential downside impacts on physical and financial energy markets resulting from an overly broad and vague definition of Swap Dealer.

Finally, BGA's comments herein are influenced by the Commissions' failure to address the order of rulemakings in a logical and sequential manner. The issuance of the *Proposed Definitional Rule* in advance of the issuance of a proposed rule further defining the scope and application of the term "swap" as set forth in new CEA Section 1a(47) creates uncertainty, increases compliance risk and causes BGA and other market participants to expend resources analyzing definitional rules to which they potentially may not be subject.

III. Comments of BG Americas & Global LNG

A. General comments

The Dodd-Frank Act establishes a legislative and regulatory framework that is primarily designed to specifically prevent another financial collapse and ensuing crisis of the size and magnitude that occurred in 2008. One of the key contributing factors to this financial crisis was excessive leverage and risk taking associated with the use of complex derivatives instruments due to the lack of appropriate regulatory oversight. Title VII of the Dodd-Frank Act, among other things, was designed to bring transparency to swap markets by, in part, regulating the activities of the largest and most influential participants in swap markets as a means for reducing systemic risk to the U.S. financial and banking systems.

As noted above, BGA supports the efforts of Congress to reform the swap markets to prevent abuses that led to the financial crisis. However, the Commissions must be careful to tailor the definition of Swap Dealer and Major Swap Participant and related interpretive guidance in the *Proposed Definitional Rule* to achieve these policy goals without imposing unwarranted burdens on domestic energy markets and undue costs on the U.S. economy. BGA appreciates the opportunity to submit these comments addressing the proposed definitions of Swap Dealer and Major Swap Participant and related

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interpretive guidance, and looks forward to working with the Commissions to develop appropriately tailored definitions prior to the effective date of Title VII.

1. Issuance of the definition of Swap Dealer in advance of regulations further defining the term "Swap" creates legal and regulatory uncertainty and increases compliance risk

As noted by BGA in its *ANOPR* comments, new CEA Section 1(a)(47) defines the term "swap" and provides that a "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."[2] This exclusion, which is broadly written, has yet to be further defined in a separate rulemaking to be issued by the Commissions.

In addition, in its *ANOPR* comments, BGA urged the Commissions to address the order of rulemakings in a logical and sequential manner. Further, BGA recommends that the Commissions address their obligation to further define the definition of "swap" in new CEA Section 1a(47) near the outset of this process. As the Commissions have heard from many commenters and legislators, the order in which the proposed rulemaking proceedings are taking place implementing Title VII of Dodd-Frank has caused market participants, such as BGA, to expend resources analyzing rules to which they might not be subject.[3]

In this regard, not providing clear guidance on these points has created legal and regulatory uncertainty in both swap and physical commodity markets. BGA is concerned that such uncertainty will disrupt swap markets, increase price volatility in underlying physical commodity

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[2] New CEA Section 1a(47)(B)(ii).

[3] Given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure over-the-counter derivatives markets, BGA requests that the Commissions hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. BGA and other market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on proposed rules. The resulting comprehensive comments will allow the Commissions to better understand how their proposed rules will impact swap markets.

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markets and likely result in consumers paying increased prices for physical commodities, such as natural gas, oil and electricity. Such a result is clearly not in the public interest.

BGA intends on actively participating in any rulemaking issued by the Commissions further defining and developing regulations implementing the statutory definition of "swap." Until such a rulemaking is issued, BGA offers the following comment. The exclusion to the definition of "swap" should be interpreted consistent with the forward exclusion that is currently based upon CEA Section 1a(19) and prior CFTC interpretations including those situations where commercial parties agree to "book-out" their physical obligations under forward contracts.[4] BGA believes that any contract that contains an enforceable physical obligation should meet this exclusion and should not be considered a swap.

In light of the foregoing, if book-outs in physical markets are ultimately deemed to fall within the definition of "swap," the Commission should clarify herein that simply because a market participant engages in these transactions does not mean that it would presumptively fall within the proposed definition of Swap Dealer. Rather, in order to be deemed a Swap Dealer, a market participant must be engaged in one or more of the specific activities listed in proposed CFTC Rule 1.3(ppp)(1). Finally, until such time that any final rule further defining the term "swap" becomes effective, the Commissions should clarify that counterparties that frequently close out or financially settle certain types of physical transactions before final delivery of a particular deal are not at risk of being deemed Swap Dealers.

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[4] *See Statutory Interpretation Concerning Forward Transactions*, 55 Fed. Reg. 39,188-92 (Sept. 25, 1990), reprinted at [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,925; *see also* 58 Fed. Reg. 21,286 (Apr. 20, 1993)(order for exemptive relief establishing a limited exemption from the CEA for certain forward contracts referencing energy commodities).

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2. Further definition of Swap Dealer and Major Swap Participant should be consistent with policy objectives underlying Title VII of the Dodd-Frank Act

As the "gateways" through which the Commissions may exercise the new and expanded oversight authority granted under Title VII, the definition of Swap Dealer and Major Swap Participant are the most critical elements of the new framework for the regulation of swaps in OTC markets. The successful implementation of this regulatory framework is tied, in large part, directly to the Commissions' ability to further define and apply Swap Dealer and Major Swap Participant in a fashion that is:

1. Faithful to Congress' intent; and

2. Consistent with the requirements and structure of Title VII.

Through the definitions of Swap Dealer and Major Swap Participant, the *Proposed Definitional Rule* appears to implement an overly broad "one-size-fits all" approach to the regulation of swap markets. In doing so, the *Proposed Definitional Rule* fails to recognize:

1. The unique characteristics of OTC swap markets for energy and other physical commodities; and

2. The different types and classes of participants transacting in these markets.

These concerns are particularly relevant to the proposed definition of Swap Dealer and related interpretational guidance. Specifically, the vague definition of Swap Dealer and overly broad interpretational guidance appears to be drafted to intentionally cover a wide array of market participants that neither:

1. Create systemic risk concerns; nor

2. Engage in what traditionally is viewed as "dealer" activity in OTC swap markets or hold themselves out as "dealers."

The regulatory framework adopted in Title VII is based upon the existence of, at minimum, three distinct classes of market participants:

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1. Swap Dealers;

2. Major Swap Participants; and

3. Non-Swap Dealer/non-Major Swap Participants (otherwise referred to herein as "End-Users").[5]

BGA is concerned that these definitions and related interpretive guidance as set forth in the *Proposed Definitional Rule* are not consistent with Congressional intent underlying Title VII of the Dodd-Frank Act. It is BGA's belief that if adopted in their current form, the definitions of Swap Dealer and Major Swap Participant would result in the imposition of a regulatory framework that is broader than Congress intended and would subject certain market participants to unnecessary and burdensome operating and compliance costs. Such a result would place constraints on operating capital and cash flow for affected market participants in the energy industry. This, in turn, will limit energy companies' ability to make much needed investment in innovation, energy infrastructure, growth and jobs to cover such costs.[6]

Additionally, such an expansive interpretation of these definitions will adversely affect liquidity, efficiency and price discovery in energy markets as

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[5] This view is supported by the Chairmen of the Senate Banking and Agriculture Committees at the time when the Dodd-Frank Act was enacted, when they emphasized in a joint letter to Congressional colleagues a clear intent to create "End-Users" as a class of market participant that is separate and distinct from Swap Dealers and Major Swap Participants. *See* Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010).

[6] *See, e.g.*, Comments of the Working Group of Commercial Energy Firms submitted to the CFTC on January 24, 2011 in response to the CFTC's request for comment concerning the cost-benefit analysis conducted pursuant to CEA Section 15 as part of the proposed rulemaking addressing duties of Swap Dealers and Major Swap Participants. *See Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants*, Notice of Proposed Rulemaking, 75 Fed. Reg. 71,397 (Nov. 23, 2010). In those comments, the Working Group of Commercial Energy Firms detailed the significant costs likely to be imposed on the energy industry should energy firms be deemed Swaps Dealers or Major Swap Participants. BGA supports the positions and arguments made by the Working Group of Commercial Energy Firms therein.

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market participants either withdraw or can no longer participate to the same extent. Such an approach could harm the economy as the U.S. works to emerge from a near unprecedented financial crisis, as it will likely result in higher prices for physical energy commodities incurred by commercial, industrial and retail consumers. As such, the Commissions should focus on adopting definitions that are consistent with, and give meaning to, the intent of Congress.

Notwithstanding the fact that mitigating systemic risk is the overarching policy goal of Title VII of the Dodd-Frank Act, BGA recognizes that the prevention of excessive speculation in swap markets for physical commodities and enhanced transparency are also important policy objectives. For instance, the Dodd-Frank Act amends CEA Section 4a(a) to provide the CFTC with additional authority to establish position limits for certain energy commodities.[7] In addition, the Dodd-Frank Act injects transparency into swaps markets by requiring the issuance of various final rules and interim final rules introducing new reporting requirements applicable to all market participants.[8] Taken together, the statutory objectives new CEA 4a(a) and other provisions of the Dodd-Frank Act injecting transparency in swap markets through new reporting requirements alleviate the need for the Commissions to propose rules further defining Swap Dealer and Major Swap Participant in an overly expansive manner that captures swap market participants that Congress never intended to regulate as such.

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[7] *See* Section 737 of the Dodd-Frank Act (amending CEA § 4a(a)). Existing position limits in energy swap markets already greatly reduce the risk of any non-Swap Dealer posing significant systemic risk on the U.S. financial system. The new position limits adopted as part of amended CEA Section 4a(a) will all but eliminate this risk. As such, the Commissions should recognize that, due to position limits, any non-Swap Dealer in the energy markets is unlikely to pose significant systemic risk to the U.S. financial system.

[8] *See Real-Time Public Reporting of Swap Transaction Data,* Notice of Proposed Rulemaking, 75 Fed. Reg. 76,141 (Dec. 7, 2010); *Swap Data Recordkeeping and Reporting Requirements*, Notice of Proposed Rulemaking, 75 Fed. Reg. 76,574 (Dec. 8, 2010); *Interim Final Rule for Reporting Pre-enactment Swap Transactions*, 75 *Fed. Reg*. 63,080 (Oct. 14, 2010); *Interim Final Rule for Reporting Pre-enactment Swap Transactions*, 75 *Fed. Reg*. 63,080 (Oct. 14, 2010).

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3. The *Proposed Definitional Rule* should provide regulatory certainty for swap market participants

If adopted as proposed, the *Proposed Definitional Rule* will inject uncertainty in swap markets. For example, BGA is concerned that the definition of Swap Dealer could be interpreted in a manner that effectively leaves commercial market participants with active swap trading operations at risk of being designated as a Swap Dealer, including commercial firms that primarily transact swaps to hedge underlying physical commodity portfolios, assets or positions. In light of the foregoing, any rules or regulations implementing the definition of Swap Dealer and Major Swap Participant should include a clear methodology that will allow market participants to determine whether they, or the counterparties with whom they transact, fall within either of these definitions. This clarity and guidance is vital to ensuring the legal certainty and stability necessary to facilitate an orderly transition to new regulation under Title VII and avoid disruptions to swap markets.

B. Proposed further definition of Swap Dealer

1. The *Proposed Definitional Rule* fails to distinguish the role of dealers from traders in swap markets in a meaningful manner

Citing the unique characteristics of swap markets, the *Proposed Definitional Rule* declines to adopt interpretative guidance that distinguishes the activities of dealers from traders in *swap* markets.[9] In comments filed with the Commissions addressing the Advanced Notice of Proposed Rulemaking addressing the definition of Swap Dealer,[10] BGA requested that the Commissions establish interpretational guidance specifically tailored to swap markets that is generally analogous to the Dealer-Trader Distinction

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[9] *Proposed Definitional Rule* at 80,177-178.

[10] *Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, 75 Fed. Reg. 51,429 (Aug. 20, 2010) ("*ANOPR*").

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established by the SEC under the Securities Exchange Act of 1934 ("Exchange Act").[11]

Specifically, in its ANOPR comments, BGA noted that the definition of "Swap Dealer" is based upon the definition of a "[securities] dealer" in Section 3(a)(5) of the Exchange Act. Generally speaking, a "swap dealer" is a person:

1. Engaged "in the business" of buying and selling swaps as principal, including through a broker; but

2. Not a person who does not do so as part of a "regular business."

The exclusion for those entering into transactions "not as part of a regular business" is, in the securities laws, commonly known as the "trader exemption." The general exception to the definition of swap dealer set forth in new CEA Section 1a(49)(C) and proposed CFTC Rule 1.3(ppp)(2) are virtually identical to the trader exception set forth in Section 3(a)(5) of the Exchange Act, and yet the Commissions declined to adopt guidance analogous to the Dealer-Trader Distinction.

In lieu of adopting such guidance, the *Proposed Definitional Rule* proposes certain core criteria for identifying Swap Dealers ("Core Criteria"):

- Dealers tend to accommodate demand for swaps and security-based swaps from other parties;

- Dealers are generally available to enter into swaps or security-based swaps to facilitate other parties' interest in entering into those instruments;

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[11] *See Definition of Terms in Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Final Rule, SEC Release No. 34-47364 (Mar. 2003); *Definition of Terms in Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Proposed Rule, SEC Release No. 34-46745 (Dec. 2002) (establishing the SEC's "*Dealer-Trader Distinction*").

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- Dealers tend not to request that other parties propose terms of swaps or security-based swaps; rather, dealers tend to enter into those instruments on their own standard terms or terms they arrange in response to other parties' interest; and

- Dealers tend to be able to arrange customized terms for swaps or security-based swaps upon request, or create new types of swaps or security-based swaps at the dealer's own initiative.[12]

In order to demonstrate consistency with underlying Congressional intent and the regulatory framework embodied in Title VII, the guidance interpreting the definition of Swap Dealer must distinguish the roles of Swap Dealers and other market participants (*i.e.,* Major Swap Participants, End-Users and other "traders") in a meaningful manner. The proposed Core Criteria and Secondary Criteria for identifying Swap Dealers do not accomplish this.

For example, all participants in the swaps market enter into swaps on their own standard terms or terms they arrange in response to other parties' interest. It is commonplace for swap counterparties, including traders and End-Users, to enter International Swaps and Derivatives Association ("ISDA") master agreements under which they negotiate the applicable standard terms between counterparties. The Commission's guidance must recognize that, in certain instances, Swap Dealers and traders engage in overlapping types of

[12] To further explain these criteria, the *Proposed Definitional Rule* sets forth the following secondary set of criteria ("Secondary Criteria") to be utilized to indicate whether a market participant holds itself out as a "dealer" or is commonly known in the market as a "dealer" (i) contacting potential counterparties to solicit interest in swaps, (ii) developing new types of swaps (which may include financial products that contain swaps) and informing potential counterparties of the availability of such swaps and a willingness to enter into such swaps with the potential counterparties, (iii) membership in a swap association in a category reserved for dealers, (iv) providing marketing materials (such as a website) that describe the types of swaps that one is willing to enter into with other parties, or (v) generally expressing a willingness to offer or provide a range of financial products that would include swaps. The Secondary S/D Criteria appear to be focused on entities that historically have been viewed as "dealers" in OTC swap markets, such as major financial institutions.

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market activity.[13] This fact alone should not result in a trader being subject to comprehensive CFTC oversight as a Swap Dealer.

The Commissions should adopt interpretational guidance specifically tailored to swap markets that is based generally on the Dealer/Trader Distinction adopted by the SEC under the Exchange Act.[14] The Commissions' decision in the *Proposed Definitional Rule* to adopt Dealer/Trader Distinction-like guidance for security-based swaps, but not for swaps traded in commodity markets, is arbitrary and capricious given the fact that security-based swaps and swaps themselves are substantially similar. The *Proposed Definitional Rule* does not provide a reasoned basis for the

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[13] Furthermore, in its explanatory notes to the *Disaggregated Commitment of Traders Report*, the Commission set forth definitions for "swap dealer" and "producer/merchant/processor/user" among others. It is instructive to look at these two definitions:

> Producer/Merchant/Processor/User: An entity that predominantly engages in the production, processing, packing or handling of a physical commodity and uses the futures markets to manage or hedge risks associated with those activities.
>
> Swap Dealer: An entity that deals primarily in swaps for a commodity and uses the futures markets to manage or hedge the risk associated with those swaps transactions. The swap dealer's counterparties may be speculative traders, like hedge funds, or traditional commercial clients that are managing risk arising from their dealings in the physical commodity.

See Disaggregated Commitments of Traders Report, Explanatory Notes, available at http://www.cftc.gov/MarketReports/CommitmentsofTraders/DisaggregatedExplanatoryNotes/index.htm.

[14] The Commission should also consider how it has historically defined Swap Dealers. In a 2008 Staff Report, a Swap Dealer was described in the following way:

> The swap dealer, which is often affiliated with a bank or other large financial institution, has emerged to serve as a bridge between the OTC swap market and the futures markets. Swap dealers act as swap counterparties both to commercial firms seeking to hedge price risks and to speculators seeking to gain price exposure. In essence, swap dealers function as aggregators or market makers, offering contracts with tailored terms to their clients before utilizing the more standardized futures markets to manage the resulting risk.

Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations, Commodity Futures Trading Commission (Sept. 2008).

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Commissions' decision to adopt diametrically opposed positions for security-based swaps and swaps traded in commodity markets.

Further, interpretational guidance distinguishing the role of Swap Dealers and traders in swap markets should recognize the unique characteristics of different swap markets. BGA believes that the *Proposed Definitional Rule's* assertion that significant parts of the swaps markets do not operate without the involvement of Swap Dealers is both unsupported and flawed when applied to energy markets.[15] The adoption of interpretational guidance that meaningfully distinguishes the role of dealers and traders in swap markets will provide the regulatory certainty and stability necessary to facilitate an orderly transition to new regulation under Title VII and thus avoid disruptions to swap markets.

2. The general exception to the definition of Swap Dealer should be interpreted in a manner consistent with the "trader" exemption in the Exchange Act

Consistent with its *ANOPR* comments, BGA agrees with the Commissions' decision to tie prong three of the definition of Swap Dealer set forth in proposed CFTC Rule 1.3(ppp)(1)(iii) to the general exception to this definition in proposed CFTC Rule 1.3(ppp)(2). The language of proposed CFTC Rule 1.3(ppp)(2) is nearly identical to, and based upon, the exemption from the definition of "dealer" set forth in Section 3(a)(5) of the Exchange Act (which is commonly referred to as the "trader exemption").

Critical to the general exception is interpretation of the phrase "regular business" in proposed CFTC Rule 1.3(ppp)(2). BGA believes that market participants that do not engage in a sufficient level of customer-facing swap transactions and do not hold themselves out as "dealers" in swap markets, notably most speculative traders and End-Users should fall within the general exception. However, the use of several qualifiers in guidance interpreting the phrase "regular business," including the terms "not likely," "available," "tends to," "likely," "less likely" and "rarely," creates uncertainty regarding the scope and application of this exception to these entities.

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[15] *Proposed Definitional Rule* at 80,177, n.18.

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BGA believes that the general exception to the definition of Swap Dealer should be interpreted by the Commissions in a manner that is generally consistent with existing precedent and guidance issued under the Exchange Act.[16] Such an interpretation honors the Congressional intent underlying Title VII of the Dodd-Frank Act as it would exclude from the definition of Swap Dealer speculative traders and End-Users that:

1. Do not engage in dealing activity; or

2. Are not otherwise known as dealers in swap markets.

Moreover, because the *Proposed Definitional Rule* unequivocally places the obligation on market participants to self-select whether they must register as a Swap Dealer, such an interpretation is necessary to:

1. More clearly define the universe of market participants that fall within the definition of Swap Dealer; and

2. Provide the regulatory certainty required for market participants to rely in good faith on this exception.

3. Proposed de minimis exemption to the definition of Swap Dealer is unduly restrictive

The *Proposed Definitional Rule* adopts an unduly restrictive interpretation of the *de minimis* exemption set forth in new CEA Section 1a(49)(D). As discussed below, notwithstanding the Commissions' view that the *de minimis* exemption in proposed CFTC Rule 1.3(ppp)(4) is intended to apply only in circumstances when "an entity's dealing activity is so minimal that applying the dealer regulations to the entity would not be warranted," BGA believes that the objective thresholds set forth in this exemption will ultimately harm the efficient operation of, and liquidity in, swap markets.[17]

a. Proposed aggregate gross notional value is unduly restrictive and should be increased

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16 *See* 15 U.S.C. § 78c(a)(5).

17 *Proposed Definitional Rule* at 80,179.

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The hard-cap on aggregate gross notional value of $100 million is too low and creates a significant risk that a large number of smaller companies could withdraw from swap markets due to concerns that they could be subject to oversight as a Swap Dealer. For example, the establishment of such a low threshold for aggregate gross notional value will force small companies that engage in limited customer-facing swap transactions, which are incidental to their primary underlying physical commodity business, to decide whether the continued participation in such activity outweighs the potential cost of compliance as a Swap Dealer, including compliance with applicable prudential regulations.

This is a particular concern in the energy sector. For example, small energy companies that currently fall within the proposed *de minimis* exemption may no longer meet this exemption if the aggregate gross notional value of their existing deals exceeds the $100 million threshold. Such a situation could result merely from an increase in energy prices due to a growing economy. Currently, due to the on-going recession-like conditions in the U.S., natural gas prices remain depressed compared to periods of strong and sustained economic growth. However, if energy prices increase as the economy recovers, small energy companies that qualify for the proposed *de minimis* exemption are at risk of being required to register as a Swap Dealer because the aggregate gross notional value of their customer-facing swap transactions exceeds this unduly restrictive threshold.

BGA believes that swap markets, particularly energy markets, benefit from having small companies continuing to engage in limited customer-facing swap transactions – in terms of (i) market participant diversity, and (ii) liquidity. Accordingly, the Commissions should study this issue further and increase the aggregate gross notional value threshold to a sufficiently high level where smaller market participants will not discontinue engaging in this market enhancing activity out of concern for potential compliance costs associated with being a Swap Dealer.

b. The twenty transaction threshold should be clarified

BGA requests that the Commissions clarify the scope and application of the twenty transaction threshold embedded in the *de minimis* exemption. For example, in the energy sector, it is not clear whether the twenty

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transaction threshold would apply to all energy commodities combined or on a commodity-by-commodity basis (*i.e.,* power swaps, natural gas swaps, silver swaps, etc.).

BGA believes that, based on guidance in the *Proposed Definitional Rule* interpreting proposed CFTC Rule 1.3(ppp)(3) as covering different "types, classes, and categories of swaps," the twenty transaction threshold of the *de minimis* exemption should be applied on a commodity type-by-commodity type basis, *i.e.*, using unique product identifiers, rather than to a single, broadly-defined category of swaps. For example, the *de minimis* exception should include a twenty-transaction threshold for natural gas and a separate twenty-transaction threshold for oil. This approach is consistent with Congressional intent underlying the statutory definition of Swap Dealer and would provide energy companies with significantly more flexibility to engage in swap transactions without being required to register as a Swap Dealer.

4. Limited registration

Section 1a(49)(B) of the CEA clearly states that entities can be designated as a Swap Dealer for only one type or category of swaps. To implement this provision, the Commissions propose, in CFTC Rule 1.3(ppp)(3) using a "fact and circumstances" test.[18] However, neither the provision nor the preamble to the *Proposed Definitional Rule* provide any guidance addressing any specific factors that would be considered by the Commissions when reviewing a limited registration application. The absence of such guidance creates significant legal and regulatory uncertainty that will harm markets.

In this context, BGA respectfully requests the Commissions to avoid adopting a broad interpretation of the phrase "specified categories of swaps" in proposed CFTC Rule 1.3(ppp)(3) that effectively covers all types and classes of swaps that fall within one of the four major categories of swaps in the proposed definition of "category of swaps." Such an interpretation would render the limited registration provision meaningless for energy firms transacting in physical commodities. Further, it likely would require an energy company that trades multiple energy commodities, but only engages

[18] *Proposed Definitional Rule* at 80,182.

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in dealing activity for a single commodity or product (*i.e.,* natural gas swaps), to register as a Swap Dealer for all "other commodity swaps," as that term is defined in proposed CFTC Rule 1.3(rrr)(4).

As a consequence, an energy company's entire energy swap trading operations could be subject to Swap Dealer regulatory requirements and obligations, rather than the limited portion of its business actually engaged in dealing activity. This result is not consistent with Congressional intent underlying Title VII of the Act because it would make the limited registration provisions under proposed CFTC Rule 1.3(ppp)(3) meaningless, as well as undermine the benefits of the proposed *de minimis* exemption.

C. Proposed further definition of Major Swap Participant

1. Proposed definitional tests will capture firms that do not present systemic risk

The *Proposed Definitional Rule* sets out various definitional tests for determining whether or not a firm is a Major Swap Participant. BGA supports the Commissions' efforts to develop tests that are objective and based upon quantitative measure. However, BGA respectfully suggests that certain thresholds in the definitional tests in the *Proposed Definitional Rule* are at a level that will cause firms that do not present systemic risk to the U.S. financial system to be classified as Major Swap Participants. These levels should be set substantially higher such that the definitional tests capture only systemically important firms.

Congress clearly intended the first two prongs of the definition of Major Swap Participant to capture only those entities whose activities in swap markets make them systemically important. Even Chairman Gensler, in testimony before the Senate Committee on Agriculture, Nutrition, and Forestry on November 18, 2009, acknowledged that he thought the Major Swap Participant definition was intended to capture the "next AIG."[19]

The first prong of the definition of Major Swap Participant as set forth in CEA Section 1a(33)(A)(i) deems any entity that "maintains a substantial

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[19] *Reforming U.S. Financial Market Regulation: Hearing of U.S. Senate Agriculture Committee* (November 18, 2009, Videotape min. 41:59) (Statement of Gary Gensler, Chairman, Commodities Futures Trading Commission).

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position in Swaps," excluding, among other things, positions "held for hedging or mitigating commercial risk," a Major Swap Participant.[20] In CEA Section 1a(33)(B), Congress directed the Commissions to define the term "substantial position" at "the threshold that the Commission[s] determine 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."[21]

The second prong set forth in CEA Section 1a(33)(A)(ii) defines a "Major Swap Participant" as a party 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." BGA believes that Congress intended this standard to be a substantial threshold. This prong addresses the risk that a firm could inject huge losses into the financial network by defaulting on its swap portfolio, whether or not the default is particular to swaps.[22] In contrast to the first prong of the definition, the second prong contemplates potential losses beyond those inherent with an entity's actual swap positions.

The Commissions recommend a threshold of $1 billion in current outward unsecured exposure or $2 billion in current and future potential unsecured exposure for an entity to have a substantial position in the commodity swap category. For an entity's swap positions to constitute a substantial counterparty exposure, the Commissions propose a threshold of $5 billion of current uncollateralized exposure and $8 billion of current and potential future uncollateralized exposure. The Commissions state:

> The proposed thresholds are intended to be low enough to provide for the appropriately early regulation of an entity whose swap or security-based swap positions have a reasonable

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[20] New CEA Section 1a(33)(A)(i).

[21] As discussed below, when determining whether a position is a "substantial position" or if a position creates "substantial counterparty exposure" the following swaps should be excluded: (a) swaps that are centrally cleared; (b) swaps to the extent their market value is collateralized; and (c) swaps entered into between affiliates. These swaps do not have any significance to the stability of the financial system of the United States.

[22] *E.g.*, a Major Swap Participant becomes insolvent upon suffering massive losses on its portfolio of residential mortgage investments.

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> potential of posing significant counterparty risks and risks to the market that stress the financial system, while being high enough that it would not unduly burden entities that are materially less likely to pose these types of risks.[23]

However, the Commissions offer no evidence to support why the above thresholds were selected. The proposed thresholds do not appear to have any direct relationship to market share or systemic risk. For example, $1 billion in current outward exposure in the category of other commodity swaps is the equivalent of only 0.2 percent of the market for derivatives on "other commodities."[24]

The collapse of Enron is cited as an example of a high profile default that did not have a substantial systemic impact.[25] Prior to its collapse, Enron had approximately $18.7 billion in derivatives exposure, which constituted approximately 3 percent of the notional outstanding value in the global market for derivatives on "other commodities."[26] Enron's share of the market for derivatives on "other commodities" was over 10 times larger than the Commissions' proposed threshold. If the Commissions intend to abide by the Congressional intent underlying the definition of "Major Swap Participant," the proposed threshold should be increased substantially.

Rather than adopting the thresholds set forth in the *Proposed Definitional Rule*, BGA suggests that the Commissions jointly convene a new advisory committee, similar to its Technology Advisory Committee and other

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[23] *Proposed Definitional Rule* at 80,190, n.105.

[24] Bank of International Settlements Quarterly Review, December 2010, Table 19.

[25] *See, e.g.,* Darryl Hendricks, John Kambhu, and Patricia Mosser, *Systemic Risk and the Financial System*, Background Paper presented at Federal Reserve Bank of New York and the National Academy of Sciences Conference on New Directions in Understanding Systemic Risk, May, 2006 and James Bullard, Christopher J. Neely, and David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, 91 FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, Sep./Oct. 2009, Sec. 5, Part 1 at 403-17.

[26] Diana B. Henriques, *Enron's Collapse: The Derivatives; Market That Deals in Risks Faces a Novel One*, N.Y. Times, Nov. 29, 2001. Available at : http://www.nytimes.com/2001/11/29/business/enron-s-collapse-the-derivatives-market-that-deals-in-risks-faces-a-novel-one.html, and Bank of International Settlements Press Release: *The global OTC derivatives market at end-June 2001 Second part of the triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, December 20, 2001.

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advisory committees, for purposes of (i) developing appropriately-sized thresholds that protect against identified systemic risks to the banking and financial system, and (ii) making specific recommendations to the Commissions for purposes of implementing such thresholds as part of the definition of Major Swap Participant. The proposed advisory committee would be jointly lead by CFTC and SEC Commissioners, comprised of key CFTC and SEC staff, and a representative cross-section of individuals from the financial and non-financial sectors. It is BGA's view that the proposed advisory committee would be an asset to the Commissions in their efforts to (i) develop thresholds that are supported by empirical data, and (ii) reflect Congress' desire for the Major Swap Participant definition to capture entities whose swaps activities truly pose a systemic risk to the banking and financial system.

2. Treatment of cleared swaps and swaps subject to daily margining

The *Proposed Definitional Rule*s consider both cleared and daily margined swaps in the determination of potential outward exposure. The notional value of these swaps is discounted 80 percent when they are included in the potential future exposure calculation to account for the risk mitigation benefits of central clearing and daily margining.[27] While BGA acknowledges that the Commissions account for the risk mitigation benefits of central clearing and daily margining, the proposed 80 percent discount overstates the risk posed by daily swings in the value of such swaps.

BGA believes that cleared swaps should not be considered in the determination of whether an entity is a Major Swap Participant. If the Commissions are concerned about the risk posed by daily price swings of cleared swaps, then the proper place to address this concern is in the regulation of derivatives clearing organizations and clearing agencies.

In addition, similar to cleared swaps, swaps that are subject to daily margining should not be considered in the potential future exposure calculation. If margin requirements are set properly, the risk posed by daily fluctuations in swap valuations should not be substantial enough to necessitate including daily margined swaps in the Major Swap Participant

[27] Proposed CFTC Rule 1.3(sss)(3)(iii).

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determination calculation. Swaps that are subject to daily margining should be subject to a discount no smaller than 98 percent. This discount would properly account for the risk that a counterparty cannot meet its daily margin call, and the potential exposure associated with that risk.

3. Timing requirements

BGA supports the Commissions' timing parameters set forth in proposed CFTC Rule 1.3(qqq)(3). In particular, BGA applauds the Commissions for recognizing that exogenous market conditions could temporarily force a swap market participant over a threshold during one quarter. Allowing an entity that exceeds a threshold by 20 percent or less an additional quarter as a reevaluation period will avoid market disruptions that could result from capturing entities under the definition of Major Swap Participant that, through factors beyond their control, temporarily exceed a given threshold.[28]

However, a Major Swap Participant should not be required to wait a full year to withdraw its registration as a Major Swap Participant. Withdrawing a registration would be an affirmative business decision, which likely means that the entity is taking active steps to ensure it no longer falls under the definition of Major Swap Participant. Given the potential costs associated with the restructuring needed to fall outside the definition, it will likely not be a short-term decision. Also, the timing for withdrawal should be the same as for the initial filing. If you do not exceed the thresholds for two consecutive quarters, you should no longer be deemed a Major Swap Participant.

4. Limited purpose designations

Section 1a(33)(C) of the CEA clearly states that entities can be designated as a Major Swap Participant for only one category of swaps. BGA believes that proposed CFTC Rule 1.3(qqq)(2)'s requirement for entities to make an affirmative application to be treated as a Major Swap Participant for less than all of the major categories of swaps imposes an unnecessary and potentially substantial burden on both Major Swap Participants that are clearly a Major Swap Participant for one category of swap and the

[28] Proposed CFTC Rule 1.3(qqq)(4).

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Commissions. As discussed in Section B.4 above, this process is inconsistent with the underlying intent of Dodd-Frank.

BGA respectfully suggests that if 50 percent of a Major Swap Participant's swaps fall within one category of swaps, however such categories are ultimately defined, and that entity's swaps in other categories would not separately exceed any of the proposed thresholds, then that entity should be presumed to be a Major Swap Participant for only that one category of swap. If 50 percent of an entity's swaps fall within one category of swaps that is clearly that entity's core business then its other swaps should not be captured by the Major Swap Participant definition. Accordingly, such an entity should not have to file an application to have the scope of the application of the Major Swap Participant definition limited.

By adopting this presumption, the Commissions would avoid placing a costly and unnecessary burden on entities that are clearly only a Major Swap Participant for one class of swaps. In addition, the presumption would eliminate the need for the Commissions to process applications that are likely a mere formality.

IV. Conclusion

BGA supports the goals of this legislation and offers these comments on the *Proposed Definitional Rule* in order to assist the Commissions' development of these critical definitions. BGA looks forward to providing further comments on the Commissions' initiatives in connection with the Dodd-Frank Act.

Respectfully submitted,

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