February 22, 2011

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

Via agency website

Re: Rulemaking under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Title VII") Further Definition of "Swap Dealer" and "Eligible Contract Participant" [RIN 3235-AK65]; the Definition of Futures Commission Merchant as Amended by Title VII; Consideration of a Clearing Exception for Small Banks, Savings Associations, Farm Credit System Institutions [RIN 3038-AD10]; and the Implementation of Rules for Smaller Financial Institutions

The undersigned community and regional banks (the "Undersigned Banks") are pleased to submit comments on proposed rules released by the Commodity Futures Trading Commission (the "Commission"). We support the Commission in their efforts to promulgate and implement rules directed at reducing systemic risk and improving transparency and efficiency in the derivatives markets.

Introduction

The Undersigned Banks serve communities in 15 states, employ more than 32,800 people and collectively hold $158 billion in assets and $117 billion in deposits. We use over-the-counter ("OTC") derivatives to prudently manage risks inherent to the business of commercial banking and to offer products our customers require for their risk management needs. For example, we are able to offer a customer a long-term financing at a competitive fixed rate by pairing a variable-rate loan with an interest rate swap - thereby providing the customer with the fixed rate they desire without taking on any incremental balance sheet risk. In addition, we may offer derivatives that allow customers to manage business risk due to fluctuations in foreign currency exchange ("FX") rates. These FX products may include spot transactions, forwards and options.

Our comments and suggestions today stem from concerns that certain proposed rules could unnecessarily jeopardize our ability to manage risk, provide the services our clients demand and remain competitive against much larger financial institutions. Further, some of our smaller clients may be unable to efficiently manage business risks if we are unable to provide these risk management tools, since larger banks often are not willing to trade with smaller firms.

We would caution the Commission against finalizing rules that would place undue burdens on smaller businesses and smaller financial institutions that had nothing to do with the financial crisis and that collectively engage in a fraction of the derivatives traded by any one of the large derivatives dealers.

Statutory Exclusion from the Swap Dealer Definition for Swaps Offered by an Insured Depository Institution in Connection with Originating a Loan

Under Title VII, an insured depository institution ("IDI") is excluded from the swap dealer definition *"to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.''*[1] Proposed Rule 1.3 would apply this statutory exclusion to swaps that are directly connected to the financial terms of a loan for which the IDI is a *"source of funds to a borrower."*[2] In addition, the Commission requested specific comment on whether the statutory exclusion should be extended beyond swaps that are connected to the financial terms of the loan and if the exclusion should apply only to swaps that are executed contemporaneously with the IDI's origination of the loan.

The Undersigned Banks commend the Commission for recognizing the complexities of loan origination and for requesting comments relating to potential timing differences between swap execution and loan origination. The statutory exclusion should not be limited to swaps entered into contemporaneously with the IDI's origination of the loan; rather, the Undersigned Banks believe that the exclusion should apply to any swap entered into:

(i) in anticipation of the closing of a loan, so long as the IDI will be a source of funds for the loan, the swap is subject to termination if the loan does not close and the swap's terms are directly connected to the financial terms of the loan; and

(ii) during part or all of the remainder of the loan, so long as the swap's terms are directly connected to the financial terms of the loan.

In addition, we urge the Commission to use a more expansive interpretation of the phrase *"in connection with originating a loan"* and include additional cases where the IDI facilitates a financing for the customer. We note that in the preamble to Proposed Rule 1.3, the Commission clarifies that an IDI is a source of funds if it provides funds as part of a syndication, participation, refinancing ***"or otherwise***"[3] (emphasis added). Related to these points, we respectfully request that the Commission clarify whether or not the swaps in the following examples would fall under the statutory exclusion:

[1] 80181 Federal Register / Vol. 75, No. 244
[2] 80182 Federal Register / Vol. 75, No. 244
[3] 80182 Federal Register / Vol. 75, No. 244

- An IDI offers a customer a swap that is connected to the financial terms of a loan that the IDI originated with the customer in the past. For example, it is very common for a borrower on a variable-rate loan to decide to pay the variable rate of interest for some period of time - for example, if interest rates are at very low levels - before deciding to lock in the rate on the loan for a portion, or the entirety, of the remaining term.

- An IDI offers a customer a swap that is connected to the financial terms of a loan that has not yet closed. For example, if a bank and its borrower anticipate that they will close a loan at a predetermined date in the future, the borrower may wish to enter into a swap to hedge fluctuations in interest rates prior to closing. The borrower can fix the rate on the loan by entering into a swap that becomes effective on the closing date and matches the terms of the loan. Typically the swap would terminate if the loan does not close.

- An IDI offers a customer (the "issuer") a swap that is connected to the financial terms of a bond issuance. For example, bond deals will often involve an IDI providing a letter of credit to enhance the credit of the issuer that will receive the funds from the sale of the bonds. The letter of credit facilitates a higher rating for the bonds and a lower cost of borrowing for the issuer. In this case, the IDI is not the direct source of funds, but the IDI provides the backstop necessary to compel the bondholders to provide the funds. Moreover, if the issuer were unable to pay bondholders from operating revenue, the issuer would borrow the funds necessary to pay the bondholders by drawing down the letter of credit provided by the IDI.

- An IDI offers a customer a swap that is connected to the financial terms of a loan that the IDI purchased but did not originate (e.g., after an IDI purchases the loans of a failed IDI).

- An IDI offers a customer on a syndicated loan a swap with a notional amount that exceeds the portion of the syndicated loan that was funded by the IDI. For example, this may occur if some of the arrangers of the syndication are unable to provide a swap, or if the IDI is offering a better price for the swap than the other arrangers of the syndication.

De Minimis Exception from the Swap Dealer Definition

The Commission's proposed thresholds for the de minimis exception are very low. In order to be excluded from the swap dealer definition, a firm must meet all of the following conditions:

> *"(i) The swap positions connected with those activities into which the person enters over the course of the immediately preceding 12 months have an aggregate gross notional amount of no more than $100 million, and have an aggregate gross notional amount of no more than $25 million*

> *with regard to swaps in which the counterparty is a ''special entity'' (as that term is defined in Section 4s(h)(2)(C) of the Commodity Exchange Act)";*
>
> *"(ii) The person has not entered into swaps in connection with those activities with more than 15 counterparties, other than swap dealers, over the course of the immediately preceding 12 months"; and*
>
> *"(iii) The person has not entered into more than 20 swaps in connection with those activities over the course of the immediately preceding 12 months.[4]"*

These low thresholds - especially when coupled with a narrow interpretation of the statutory exclusion for IDIs - could have the effect of either subjecting many small banks to the substantial regulatory burden imposed on swap dealers or causing them to cease offering certain risk management services to customers. Either result would hamper the ability for many smaller banks to compete with larger financial institutions without any appreciable benefit in terms of enhanced market oversight or reduction in systemic risk.

Depending on the Commission's interpretation of the statutory exclusion with respect to the examples outlined above, community and regional banks, especially those that serve middle market customers, could easily exceed the $100 million notional test. In addition, many middle-market and small businesses buy products from foreign suppliers and/or sell products to foreign customers and are, therefore, subject to fluctuations in FX rates. As a result, many community and regional banks offer FX risk management products to commercial customers, including FX forwards and FX options[5]. It is rare that such FX trades are connected directly to the terms of a loan and, as such, these trades are not privy to the statutory exclusion from the swap dealer definition – that is, a firm offering more than a "de minimis" amount of FX trades would have to register as a swap dealer. Under the proposed tests for the de minimis exception, a firm that offers more than 20 swaps to customers in a 12-month period must register as a swap dealer. FX hedges are typically done to hedge operating cash flows, both incoming and outgoing, which means that customers often seek to enter into several small trades. In short, it would be very easy for even one customer to request more than 20 FX transactions in a 12-month period.[6]

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[4] 80212 Federal Register / Vol. 75, No. 244

[5] Dodd-Frank Act H. R. 4173—293 Title VII states FX options are included in the definition of a "swap" and FX forwards are included in the definition of a "swap" unless exempted by the Secretary of the Department of the Treasury.

[6] In the proposed rule, Commission staff stated, *"We understand that in general the notional size of a small swap or security-based swap is $5 million or less, and this proposed threshold would reflect 20 instruments of that size."* It thus appears that the number of swaps allowed in a year was chosen based on the allowed notional amount of $100 million and an estimate of the average size of a single swap. Many swaps, especially those offered by community and regional banks would be lower than $5 million. With respect to FX transactions, which are often smaller in size for the reasons stated above, the notional amount is often much lower than $1 million.

The Commission appeared to reject commenters' suggestion that the exception should be based on whether a firm's dealing activity is "de minimis" relative to its overall business; however, it does not appear that staff considered an exception based on whether a firm's dealing activity is "de minimis" relative to other firms engaged in dealing activity. The Undersigned Banks believe that it is worthwhile to compare the thresholds for the de minimis test against the size and volume of dealing done by the large financial institutions that control the vast majority of the OTC derivatives market. Even an extremely conservative analysis of the available data suggests that the Commission could increase the thresholds without running afoul of the meaning of the words "de minimis."

- The International Swaps and Derivatives Association's most recent Margin Survey shows that there are 15 dealers with more than 3,000 collateral agreements in place.[7] (Note that the number of trading relationships a dealer has would at least equal, but could exceed, the number of collateral agreements it has in place, as some relationships would not have a related collateral agreement.)
- Taking the smallest of those 15 dealers and assuming that just 10% of those collateral agreements were in place with customers that traded in the last year would give you 300 customers in one year **– 20 times the threshold above which a firm would be deemed a swap dealer under the de minimis test.**
- At No. 1 on the Office of the Comptroller of the Currency's list of banks with the largest derivatives books, J.P. Morgan has more than $77 trillion in notional in active trades in place.[8]
- The No. 10 firm on the OCC's list, SunTrust, has 0.43% of J.P. Morgan's book, at around $330 billion in notional.[9]
- Assuming that just 10%, or $33 billion, of SunTrust's total book was done with customers and that these trades were spread over 10 years would give you $3.3 billion per year – **33 times the threshold above which a firm would be deemed a swap dealer under the de minimis test**.
- There is very limited information on the number of trades done by dealers, but it is known that Lehman Brothers had more than 900,000 trades in place at the time of its bankruptcy.[10]
- Assuming just 10%, or 90,000, of Lehman's trades were done with customers and that those trades were spread out evenly over 10 years would give Lehman an

[7] See page 2 of report at: http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf
[8] See page 24 and Table I of report at : http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq310.pdf
[9] See page 24 and Table I of report at : http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq310.pdf
[10] See page 326 of report at: http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_full.pdf

average of 9,000 customer trades per year – **450 times the threshold above which a firm would be deemed a swap dealer under the de minimis test**.

Nothing in the legislative history suggests that such low thresholds are necessary to effect congressional intent. Should the Commission choose to finalize a rule adopting the low thresholds in the proposed rule, it is a matter of regulatory discretion; however, such a decision should be based on a thorough cost-benefit analysis. The Undersigned Banks do not believe the benefit of regulatory oversight over firms engaged in a relatively infinitesimal level of dealing activity outweighs the cost associated with registration and compliance for such firms.

The Undersigned Banks request that the Commission consider increasing the thresholds for the de minimis tests so that a firm must register as a swap dealer if it:

- Executes more than $2 billion notional in swaps with customers over the prior 12-month period;
- Executes more than 300 swaps with customers over the prior 12-month period; or
- Executes swaps with more than 100 different customers over the prior 12-month period.

Definition of Eligible Contract Participant ("ECP")

Section 723 of Title VII includes a Limitation of Participation provision stating that, *"It shall be unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market"*[11]. Simply put, non-ECPs will only be permitted to hedge using standardized exchange-traded derivatives that require the posting of substantial amounts of liquid collateral. The Undersigned Banks are concerned that many bank customers, including small businesses and other firms that execute hedges out of pass-through entities - such as limited liability corporations and S-corporations - may not be able to use the customized, OTC derivatives that they require for legitimate risk management purposes.

Given the vital function that hedging plays in the management of many smaller firms, and considering the essential role that small businesses play in our economy, we would urge the Commission to further define "ECP" to continue to permit these smaller firms to enter into hedges over-the-counter, providing that they meet the specific criteria previously established by the Commission in the 1989 Policy Statement Concerning Swaps Transactions (the "Policy Statement"). Specifically, the Undersigned Banks strongly urge the Commission to:

- Amend the definition of ECP to include any firm that meets the criteria set forth in the Policy Statement;

[11] Dodd-Frank Act H. R. 4173—300

- If unable to make the amendment above, amend the definition of ECP to include any firm whose parent company or controlling entity has assets equal to or greater than $10 million or net worth equal to or greater than $1 million; or

- If unable to make the amendments above, provide clarity as to the process under which a firm would seek to qualify as an ECP in light of *"financial or other qualifications"* in accordance with subparagraph (C) of the ECP definition, including the factors to be considered and the timing of such a determination.

Definition of Futures Commission Merchant

The Undersigned Banks do not believe it is appropriate for banks that offer to enter into bilateral, non-cleared swaps with customers on a **principal-to-principal basis** to be regulated as future commission merchants ("FCMs"). We believe that the FCM designation is appropriate for firms that act as **agents** and broker and/or clear futures or swaps on behalf of customers on one or more designated contract markets ("DCMs") and/or derivatives clearing organizations ("DCOs"). Moreover, if a bank's customer is required to post collateral for a non-cleared swap, that customer will be afforded certain rights and protections under the proposed rules related to segregation of collateral for non-cleared swaps. If customer's swap is cross-collateralized with the collateral securing a mortgage or through a guarantee, the rights and responsibilities of the bank and the customer are negotiated and agreed to in the mortgage and guarantee documents.

The Undersigned Banks respectfully request clarification with respect to whether a bank that offers to enter into bilateral, non-cleared swaps with customers on a principal-to-principal basis and secures the non-cleared swaps by accepting collateral or through cross-collateralization, but does not act as agent for customers as part of brokering or clearing futures or swaps on behalf of those customers on a DCM or DCO, would be required to register as an FCM.

Consideration of a Clearing Exception for Small Banks, Savings Associations, Farm Credit System Institutions and Credit Unions

The undersigned believe that it is appropriate for the Commission to exercise the authority granted under Title VII to except certain *"small banks, savings associations, farm credit system institutions, and credit unions"*[12] if such "small financial institutions" ("SFIs") meet specific terms and conditions. The Undersigned Banks offer the following comments on issues raised by the Commission in the preamble to Proposed Rule 39.6.[13]

[12] Dodd-Frank Act H. R. 4173—305
[13] 80753 Federal Register / Vol. 75, No. 246

What terms and conditions should apply to an exception for certain SFIs?

The Undersigned Banks propose that the Commission except from the "financial entity" definition any bank, savings association, farm credit system institution or credit union

(a) With assets no greater than $50 billion and
(b) With current uncollateralized exposure plus potential future exposure[14] no greater than $1 billion.

Would such an exception pose any undue risks to the swap markets or the financial system? Why or why not?

If the terms and conditions proposed above are used, the exception would not pose any undue risks to the market or the financial system. The current and potential future exposure threshold proposed above is 1/8th of the level in the Commission's proposed rule applicable for major swap participants ("MSPs"). The MSP threshold is set at a level which is meant to capture firms whose use of derivatives poses systemic risk.[15] It follows that the Commission should not view exposure of $1 billion as posing systemic risk. In addition, it is important to note that an SFI would not be exempt from clearing and trading for any speculative trades. Indeed, SFIs would have to meet the same conditions required for the end-user exception to mandatory clearing of swaps under Proposed Rule 39.6.

How should the Commission take into account the supervisory regimes to which Small Financial Institutions are currently subject, and whether those regulatory regimes adequately mitigate any risks associated with an exception?

SFIs are subject to existing regulations, many of which have been updated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Existing rules include regulations requiring these institutions to hold in reserve adequate levels of capital for all assets, including derivatives. It is likely that these capital reserve requirements will increase upon the implementation of the Basel III capital guidelines[16]. In addition, existing rules allow regulators to take certain actions, both preemptively and reactively, to prevent default, or to limit financial institution losses in the event of default. These protections together with the conditions any firm must meet in order to be exempt from mandatory clearing, adequately mitigate risks associated with an exception for SFIs,

[14] 80213 Federal Register / Vol. 75, No. 244
[15] Please see footnote 69 at 80185 Federal Register / Vol. 75, No. 244
[16] http://www.bis.org/publ/bcbs189.pdf

assuming such an exemption is predicated on the terms and conditions we have proposed above.

Should the Commission consider treating different types of swaps differently when considering whether any exception should be available for Small Financial Institutions?

If SFIs were exempted from the financial entity definition, under Title VII, only hedges of commercial risk would be exempt from the clearing and trading requirements. Speculative trades entered into by a SFI should be subject to the clearing and trading requirements of Title VII.

Would an across-the-board application of an exception to all Small Financial Institutions create any advantages or disadvantages for certain Small Financial Institutions?

Larger financial institutions are more likely to have existing systems or staff, or available resources to acquire new systems or staff, that would ease the compliance burden associated with the clearing and trading requirements. An exception for SFIs would therefore remove an advantage that larger financial institutions would have over SFIs absent the exception.

Would it be better for the Commission to simply require Small Financial Institutions to follow the same practices as other financial institutions in the future?

If the Commission is not able to except SFIs from the financial entity definition, the Commission should set forth an approach for implementation whereby SFIs are given more time to implement and comply with clearing and trading requirements than larger financial institutions.

Implementation for Smaller Banks

In recognition of the unprecedented number of new regulations that will apply to participants in the OTC derivatives market, we respectfully request that the Commission propose deadlines that provide market participants with sufficient time to prepare for compliance with the rules. The Commission should set different timelines for implementation and compliance that vary depending on the size of, and resources available to, different market participants. Specifically, the Undersigned Banks request that the Commission allow community and regional banks additional time for implementation and compliance with the rules, including rules related to the clearing, trading, reporting, confirmation and reconciliation of swaps. We understand that

one other commenter has requested that the Commission establish an advisory panel of smaller financial institutions to provide feedback and suggestions to the Commission with respect to the impact of regulations on smaller banks.[17] We support and join this request and recommend that the Commission initiate such an advisory panel by holding a roundtable discussion on issues of importance to smaller financial institutions.

We thank the Commission for the opportunity to comment. We look forward to working with the Commission to help implement rules that serve to strengthen the derivatives market without unduly burdening hundreds of community and regional banks and the customers they serve. We are available to meet with the Commission to discuss these important issues in more detail.

Respectfully submitted,

Atlantic Capital Bank
Cobiz Bank
Cole Taylor Bank
Commerce Bank, N.A.
East West Bank
First Business Bank
First National Bank of Pennsylvania
Heartland Financial USA, Inc.
Old National Bancorp
Peoples Bancorp of North Carolina, Inc.
Susquehanna Bank
The PrivateBank and Trust Co
The Savannah Bank, N.A.
The Washington Trust Company
Trustmark National Bank
UMB Financial Corporation
Valley National Bank
Webster Bank NA
WesBanco Bank

[17] See page 5 of comment letter from Independent Community Bankers of America (ICBA) dated Dec 3, 2010: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26616&SearchText=icba