COMMITTEE ON CAPITAL MARKETS REGULATION

February 22, 2011

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

Elizabeth M. Murphy
Secretary of the Commission
Securities and Exchange Commission
100 F Street, NE
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Re: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,174 (CFTC RIN 3038–AD06, SEC File No. S7-39-10, SEC RIN 3235-AK65)

Dear Mr. Stawick and Ms. Murphy:

The Committee on Capital Markets Regulation (Committee) appreciates the opportunity to comment on the joint Proposed Rules[1] of the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) (together, the Commissions) regarding definitions related to swap markets under §§ 721 and 761 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[2]

Since 2005, the Committee has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains fifty-seven recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.[3] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

The Committee has concerns with the definitions of "swap dealer" and "major swap participant"[4] under the Proposed Rules. Overall, these definitions should be tailored with an eye toward minimizing systemic risk arising out of interconnectedness, where the failure of one counterparty could lead to the failure of another.[5] The definitions should

[1] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80174 (Dec. 21, 2010) (hereinafter Proposed Rules).
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 721, 761 (hereinafter Dodd-Frank Act).
[3] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (May 2009), http://www.capmktsreg.org/research.html.
[4] Our concerns apply equally to the definitions of "security-based swap dealer" and "Major Security-Based Swap Participant."
[5] *See* Dodd-Frank Act §§ 721(a)(16), 761(a)(6).

also take into account their regulatory consequences, namely being required to register, being subject to enhanced capital and margin requirements, having to follow specific business conduct standards, and being ineligible for the end user exception to mandatory clearing.[6]

**Definition of Swap Dealer**

As proposed, the definition of "swap dealer" may capture some active, non-dealer market participants who should be considered commercial end-users of swap transactions. The Dodd-Frank Act defines "swap dealer" to include any person who "regularly enters into swaps with counterparties as an ordinary course of business for its own account."[7] The Proposed Rules specify that "certain distinguishing characteristics of swap dealers" include that "[d]ealers tend not to request that other parties propose the terms of swaps or security-based swaps; rather, dealers tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest."[8] Additionally, "[d]ealers tend to … create new types of swaps or security-based swaps at the dealer's own initiative."[9] These clarifications may present problems going forward because it is not uncommon for a range of buy-side participants, including commercial end users, either to set terms for proposed swap transactions or to create new types of swaps, without ever engaging in dealing activity.

We strongly recommend that the Commissions maintain the proven and well-understood definition of "dealer" under the current securities laws. Doing so will maintain needed certainty in the markets, and we understand there to be no basis for departing from this definition in regard to the derivatives markets. Moreover, maintaining the current "dealer" definition will put to rest any concern by commercial-end users who are engaging in hedging activity that they will be caught as dealers.

**Definition of Major Swap Participant**

Section 721 of the Dodd-Frank Act defines "major swap participant" as "any person who is not a swap dealer, and (i) maintains a *substantial position* in swaps" or "(ii) whose outstanding swaps create *substantial counterparty exposure*" or "(iii)(I) is a *financial entity* that is *highly leveraged*…; and (II) maintains a *substantial position* in outstanding swaps."[10] The Committee has five concerns with this definition.

Many of these concerns relate to the proposed definition of "substantial position"[11] as it relates to "major swap participant." The proposed definitions set out threshold levels for "substantial position" that include measures of uncollateralized

[6] Dodd-Frank Act §§ 731, 764 (registration); 725(c), 764(e) (capital and margin); 731, 764(h) (business conduct standards); 723(a)(3), 763(a) (end user exception).
[7] Dodd-Frank Act § 721(a)(49)(iii); *accord* Dodd-Frank Act § 761(a)(6).
[8] Proposed Rules at 80,176.
[9] *Id.*
[10] Dodd-Frank Act § 721(a)(33) (emphasis added); *accord* Dodd-Frank Act § 761(a)(6).
[11] Proposed Rules, CFTC §1.3(sss)(1), SEC § 240.3a67–3(a), 75 Fed. Reg. at 80,213, 80,216.

current exposure and potential future exposure of a party's swaps.[12] The uncollateralized current exposure is the value of the person's swap positions with negative value, less the value of the collateral that person has posted.[13] The potential future exposure is generally the total notional principal amount of a person's positions, adjusted by several multipliers including factors based on maturity and swap category, netting agreements, and daily mark-to-market margining agreements or central clearing.[14] For each category of swaps, each Commission has proposed thresholds for current exposure, potential future exposure, or both, above which a person is deemed to have a substantial position and will therefore be considered a major swap participant.[15] The Commissions use the same principles for defining "substantial counterparty exposure," but without dividing the positions by category.[16]

First, in the definitions for "potential future exposure," the notional value for a swap position that is centrally cleared should be excluded from the calculation or further discounted. Under the Proposed Rules, a centrally cleared swap is adjusted to 20% of the original value, less any other adjustments for types of swaps.[17] This discount reflects the view, shared by the Basel Committee on Banking Supervision, that central counterparty clearing significantly reduces counterparty exposure.[18] In the event of a default, the clearinghouse may need to seek support from its participants, but the present discount overstates that risk.[19]

Second, the thresholds used for the "substantial position" and "substantial counterparty exposure" levels should first apply to the largest exposure that any swap participant has to any other swap participant. For example, a $1 billion net exposure dispersed among 15 dealer counterparties represents an average $67 million loss to each. This would not be systemic, whereas a $1 billion net exposure to one dealer could potentially represent a material reduction of its net capital. If a separate test is set for an individual participant's aggregate counterparty exposure, assuming the primary individual counterparty exposure test has not been met, this amount should be set high enough that the overall losses could actually alter liquidity in the markets affected, so closer to $10 billion.

For the reasons above, the actual thresholds for "substantial position," which for all but interest rate swaps are $1 or $2 billion per category, and "substantial counterparty exposure," which are between $2 and $8 billion, may be too low for generalized,

[12] *Id.*
[13] *Id.* CFTC § 1.3(sss)(2), SEC § 240.3a67–3(b), 75 Fed. Reg. at 80,213, 80,216.
[14] *Id.* CFTC § 1.3(sss)(3), SEC § 240.3a67–3(c), 75 Fed. Reg. at 80,213–14, 80,216–17.
[15] *See* Proposed Rules, CFTC §1.3(sss), SEC § 240.3a67–3, 75 Fed. Reg. at 80,213, 80,216.
[16] *See id.* at 80,215, 80,217.
[17] Proposed Rules, CFTC § 1.3(sss)(3)(iii)(A), SEC § 240.3a67–3(c)(3), 75 Fed. Reg. at 80,214, 80,217.
[18] Basel Committee on Banking Supervision, *Capitalisation of Bank Exposures to Central Counterparties* 1 (Dec. 2010) ("Generally speaking, the Committee proposes that trade exposures to a qualifying CCP will receive a 2% risk weight.").
[19] *See id.* at 4 ("The small but positive capital charge is intended to ensure that banks track and monitor their exposures to CCPs as part of good risk management and to reflect that even trade exposures to compliant CCPs are not risk free.").

dispersed, counterparty exposure. In addition, any thresholds set by the Commissions should, at the very least, be adjusted for inflation. The Commissions presently have insufficient data to determine appropriate size thresholds. The simplest way to set the thresholds in a way that minimizes disruption to the market is to phase them in over time. The thresholds should be set very high at the beginning, capturing only a few entities until the Commissions are able to collect and analyze data that supports lowering the thresholds.

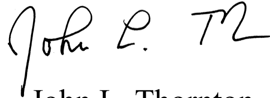
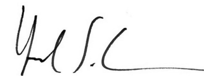
Third, for the third trigger for becoming a major swap participant, whether a financial company is "highly leveraged," the Proposed Rules use a simple calculation of the company's liability to equity ratio based on generally accepted accounting principles.[20] For some types of entities engaged in swaps, this determination should take into account some sensitivity to risk, as bank capital standards do.

Fourth, the definition does not clarify how the Proposed Rules apply for funds with a "master fund" and "feeder fund." This arrangement is particularly helpful for hedge funds with foreign investors.[21] Although we take no position on how the rules should apply to the arrangement, the Commissions should clarify the issue before promulgating final rules.

Finally, the proposed current exposure test considers the "negative value" of a party's position—the extent to which it is "out of the money"—in determining whether that party should be a major swap participant.[22] This is a market risk focus. The idea is that if the out-of-the-money party does not settle its position, its counterparties could be exposed, and potentially fail, as a result. Thus, out-of the-money parties with large enough exposures will be deemed to be major swap participants and thereby forced to comply with whatever collateral rules the Commissions will promulgate. Although those collateral requirements are not the subject of this rulemaking, it is important to require a major swap participant to post collateral regardless of whether its counterparty requests it. Requiring collateral, even if the counterparty does not request it, will help to alleviate the credit risk to an in-the-money counterparty from an uncollateralized exposure to the out-of-the-money counterparty.[*]

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

Respectfully submitted,

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[20] *See* Proposed Rules, CFTC § 1.3(vvv)(2), SEC § 240.3a67–6(b), 75 Fed. Reg. at 80,215, 80,218.
[21] *See* René M. Stulz, *Hedge Funds: Past, Present, and Future*, 21 J. ECON. PERSPECTIVES 175, 177 (2007).
[22] Proposed Rules, CFTC § 1.3(sss)(2), SEC § 240.3a67–3(b), 75 Fed. Reg. at 80,213, 80,216.
[*] Not all Members of the Committee agree with this paragraph.