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VIA FEDERAL eRULEMAKING PORTAL

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Title VII of the Dodd-Frank Act: Further Definition of Certain Terms; SEC File Number S7-39-10

Ladies and Gentlemen:

The American Insurance Association ("AIA") appreciates the opportunity to submit supplemental comments on the proposed rules and interpretive guidance of the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (together, the "Commissions"), to further define the terms "swap dealer," "security-based swap dealer," "major swap participant" and "major security-based swap participant," in accordance with section 712(d)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or "Act").[1]

AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to U.S. consumers and businesses, writing more than

[1] 75 *Fed. Reg.* 80173 (December 21, 2010).

$117 billion annually in premiums. Our members have a significant interest in the Commissions' proposed rule and interpretations.

SUMMARY

Property-casualty insurers enter into swaps and security-based swaps to hedge or mitigate their risk or use swaps or security-based swaps for *bona fide* hedging purposes. Because swap and security-based swap activities engaged in by property-casualty insurers are conducted in a prudent manner, under extensive supervision by state insurance authorities, AIA believes that property-casualty insurers that engage in typical insurance activities do not undertake the type of activities that would warrant their designation as swap dealers or security-based swap dealers.

With regard to the first "substantial position" test, because with virtually all swaps and security-based swap activities entered into by property-casualty insurers would be for hedging or mitigating commercial risk, it is unlikely that any property-casualty insurer would have a substantial position in one of the major categories of swaps or security-based swaps.

The second test for "substantial position" applies to a person whose outstanding swaps or security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. AIA believes that no property-casualty insurer would maintain a swap or securities-based swap position that would result in such a level of risk to the nation's financial system. Nonetheless, AIA believes that it is important for the Commissions to establish an exception for positions that are entered into for purposes of hedging or mitigating commercial risk in recognition of the fact that such activities present no threat of destabilization.

AIA strongly opposes the 15 to 1 or 8 to 1 leverage ratios proposed by the Commissions for use in the third test of "substantial position." Applying such a ratio to property-casualty insurers ignores the unique nature of their business and business model. Moreover, the use of same leverage ratio for all industries is inconsistent with the approach adopted by the Financial Stability Oversight Council for evaluating nonbank financial companies for heightened prudential supervision, which is based on evaluating companies according to the industries in which they are market participants. AIA recommends that the Commissions consult with industry and state insurance authorities to determine the appropriate leverage measure for property-casualty insurers.

BACKGROUND

Title VII of the Dodd-Frank Act establishes a comprehensive regulatory framework for swaps and security-based swaps in order to help reduce risk, increase transparency and promote market integrity within the financial system. The Act (1) provides for the

registration and comprehensive regulation of swap dealers, security-based swap dealers, major swap participants and major security-based swap participants; (2) imposes clearing and trade execution requirements on swaps and security-based swaps; (3) creates recordkeeping and real-time reporting requirements; and (4) enhances the rulemaking and enforcement authorities of the Commissions over all registered entities and intermediaries subject to the Commissions' oversight. The Dodd-Frank Act provides that the CFTC is to regulate "swaps," and the SEC is to regulate "security-based swaps." The Act also adds to the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 ("Exchange Act") definitions of the terms '"swap dealer," "security-based swap dealer," "major swap participant" and "major security-based swap participant," and instructs the Commissions, in consultation with the Federal Reserve Board, to jointly further define these and other terms.

The Commissions now propose to further define "swap dealer," "security-based swap dealer," "major swap participant" and "major security-based swap participant," as well as to discuss certain factors that will be relevant when a market participant determines its status with respect to these terms.

SWAP DEALER AND SECURITY-BASED SWAP DEALER

The Dodd-Frank Act defines the terms "swap dealer" and "security-based swap dealer" in terms of whether a person engages in certain types of activities involving swaps or security-based swaps. Entities that meet either of these definitions are subject to statutory requirements related to registration, margin, capital and business conduct. These activities are:

1. Holding oneself out as a dealer in swaps or security-based swaps;
2. Making a market in swaps or security-based swaps;
3. Regularly entering into swaps or security-based swaps with counterparties as an ordinary course of business for one's own account; or
4. Engaging in activity causing the person to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps.

A person that engages in any of these activities is a swap dealer or security-based swap dealer.

As the Commissions indicate in their Federal Register notice, the Dodd-Frank Act defines the terms "swap dealer" and "security-based swap dealer'" in a functional manner, based primarily on how a person holds itself out in the market, the nature of the conduct engaged in by the person, and how the market perceives the person's activities. The Commissions concluded that "[t]his suggests that the definitions should not be interpreted in a constrained or overly technical manner."[2] The Commissions noted that

[2] 75 *Fed. Reg.* at 80176.

characteristics that distinguish swap dealers and security-based swap dealers include the following:

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

Accordingly, the Commissions state that persons who enter into swaps as a part of a regular business are persons whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties. Conversely, persons who do not fulfill this function should not be deemed to enter into swaps as part of a regular business and are not likely to be swap dealers. The SEC indicates that it will consider the same factors as also generally applicable to the analysis of whether a person is a security-based swap dealer. The Commissions concluded that entities that use security-based swaps to hedge their business risks, absent other activity, likely would not be regarded as dealers.[3]

As the Commissions are no doubt aware, the activities of property-casualty insurers are subject to extensive regulation by state insurance authorities in order to ensure that the activities do not present undue risk to policyholders. Property-casualty insurers enter into swaps or security-based swaps to hedge or mitigate their risk or use swaps or security-based swaps for *bona fide* hedging purposes. Because swap and security-based swaps are engaged in by property-casualty insurers in a prudent manner, under the watchful eye of state insurance authorities, we believe that property-casualty insurers that engage in typical insurance activities do not undertake the type of "activities" that would trigger regulation by the Commissions under the proposed rule and do not otherwise meet the characteristics identified by the Commissions. Therefore, we believe that property-casualty insurers that enter into swaps or security-based swaps would be excluded from the definitions of swap dealer and security-based swap dealer.

MAJOR SWAP PARTICIPANT AND MAJOR SECURITY-BASED SWAP PARTICIPANT

The Commissions' proposed definitions of "major swap participant" and "major security-based swap participant" ("major participants") focus on the market impacts

[3] 75 *Fed. Reg.* at 80178.

and risks associated with an entity's swap and security-based swap positions. Entities that are determined to be major participants must generally follow the same statutory requirements that apply to swap dealers and security-based swap dealers because of the concern that they could pose a high degree of risk to the U.S. financial system. The Dodd-Frank Act establishes three alternative tests for determining whether a person will be deemed to be a major participant.

The first test includes a person that maintains a "substantial position" in any of the major categories of swaps or security-based swaps, as those categories are determined by the CFTC or SEC. This test does not include positions held for hedging or mitigating commercial risk, and positions maintained by or contracts held by certain employee benefit plans under ERISA for the primary purpose of hedging or mitigating risks directly associated with the operation of the plan.

The second test covers a person whose outstanding swaps or security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.

The third test includes any financial entity that is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency, and maintains a substantial position in swaps or security-based swaps for any of the major categories of swaps or security-based swaps.

Substantial Position Test

The Dodd-Frank Act directs the CFTC and the SEC to define "substantial position" at the threshold that they 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." When defining substantial position, the CFTC and the SEC are to consider the person's relative position in uncleared (as opposed to cleared) swaps or security-based swaps. The Commissions also may take into consideration the value and quality of collateral held against counterparty exposures. The Commissions state that while they are not proposing any exclusions from the major participant definitions, they request public comment on whether certain types of entities should be excluded from the definitions' application.[4] AIA believes that, based upon the nature of their activities and comprehensive supervision by state insurance authorities, property-casualty insurers are the type of entities that should be excluded from the definitions' application.

The Commissions propose to designate four categories of swaps as "major." These are rate swaps, credit swaps, equity swaps and other commodity swaps. This definition will

[4] 75 *Fed. Reg.* at 80186.

cover virtually all swaps. The Commissions also propose to designate two categories of security-based swaps as "major security-based swaps." The first category would include any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness (including loans), or a credit event relating to one or more issuers or securities, including a credit default swap, total return swap on one or more debt instruments, debt swap, debt index swap, or credit spread. The second category would include any other security-based swaps not covered by the first category. This would include equity swaps. AIA agrees with the Commissions' belief that that these definitions would cover substantially all significant swaps and security-based swaps.

The Dodd-Frank Act requires the Commissions to define the term "substantial position" as a threshold that is "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." The Commissions propose two tests that would account for these exposures. The first test would focus on an entity's current uncollateralized exposure; the other supplements a current uncollateralized exposure measure with an additional measure that estimates potential future exposure. A position that satisfies either test would be a "substantial position."

The first proposed substantial position test, which would focus solely on current uncollateralized exposure, would set the substantial position threshold by reference to the sum of the uncollateralized current exposure, obtained by marking-to-market, arising from each of the person's positions with negative value in each of the applicable major category of swaps or security-based swaps (other than positions excluded from consideration, for example, positions for the purpose of hedging or mitigating commercial risk). This test, therefore, would measure the portion of the exposure that is not offset by the posting of collateral. For purposes of the definition of major swap participant, the Commissions are proposing to set the current uncollateralized exposure threshold at a daily average of $1 billion in the applicable major category of swaps. However, the threshold for the rate swap category would be a daily average of $3 billion. For purposes of the definition of major security-based swap participant, this threshold would be based on a daily average of $1 billion in the applicable major category of security-based swaps. The Commissions indicate the view that these levels are appropriate for identifying entities that present a significant potential to pose the systemic importance or risks to the U.S. financial system through their swap and security-based swap activities.

AIA believes that, in light of the nature of property-casualty insurers' use of swaps and security-based swaps, virtually all swaps and security-based swap activities would be entered into for hedging or mitigating commercial risk, and therefore would be excluded from the above calculation. As a result, after applying the first substantial position test, it is unlikely that any property-casualty insurer would have a substantial position in any of the major categories of swaps or security-based swaps.

Substantial Counterparty Exposure

The second test relates to a person whose outstanding swaps or security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. The Commissions propose that the calculations of substantial counterparty exposure would be performed in largely the same way as the calculation of substantial position in the first major participant definition tests, except that the amounts would be calculated by reference to all of the person's swap or security-based swap positions, rather than by reference to a specific major category of such positions. The CFTC proposes that the second major participant definition test be satisfied by a current uncollateralized exposure of $5 billion, or a combined current uncollateralized exposure and potential future exposure of $8 billion, across the entirety of an entity's swap positions. For purposes of the definition of major security-based swap participant, the SEC proposes that the second test be satisfied by a current uncollateralized exposure of $2 billion, or a combined current uncollateralized exposure and potential future exposure of $4 billion, across the entity's security-based swap positions.

The Commissions recognize that this test does not contain an exception for positions established for the purpose of hedging or mitigating commercial risk. AIA believes that it is important for the Commissions to establish an exception for positions that are entered into for purposes of hedging or mitigating commercial risk. Otherwise, the definition runs the risk of being over-inclusive because it may sweep in entities such as property-casualty insurers that are highly regulated and present virtually no systemic risk to the U.S. financial system. AIA believes that it is good public policy for the Commissions to carve out from the second test swap and security-based swap transactions that are entered into for hedging purposes or to mitigate commercial risk. Such transactions are not the types of transactions Congress was concerned with, because they present no threat to destabilize the financial system.

Definition of "Highly Leveraged"

The third test of the major participant definitions includes a financial entity other than one subject to capital requirements established by an appropriate Federal banking agency that is "highly leveraged relative to the amount of capital" the entity holds, and that maintains a substantial position in a "major" category of swaps or security-based swaps. The third test of the major participant definitions does not define "highly leveraged" and does not provide an exception for positions held for purposes of hedging or mitigating commercial risk.

Commenters previously stated that the term "highly leveraged" should be interpreted by looking at the leverage associated with other firms in an entity's line of business, rather than by applying an across-the-board measure of leverage. They further indicated the view that it is inappropriate to apply leverage ratios to which banks are subject to

other enterprises. Notwithstanding these comments, the Commissions have preliminarily concluded that they do not believe that it is necessary for the leverage standard to account for the degree of leverage associated with different types of financial entities.

The Commissions noted that Title I of the Dodd-Frank Act provides that the Federal Reserve Board must require a bank holding company with total consolidated assets of $50 billion or more, or a nonbank financial company supervised by the Federal Reserve, to maintain a debt to equity ratio of no more than 15 to 1 if the company is determined to pose a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the U.S. As a result, the Commissions are proposing a similar leverage ratio of no more than 15 to 1 as a measure of a highly leveraged entity for purposes of the proposed rules.

AIA believes that the Commissions should not adopt such an inflexible standard for property-casualty insurers. AIA believes that it is inappropriate for the Commissions to apply a bank-centric leverage measurement to property-casualty insurers because insurers have very different balance sheets than do banks, and operate on a different business model. Moreover, the 15 to 1 leverage ratio set forth in Title I applies to companies that have been determined to pose a "grave threat to the financial stability of the U.S."[5] There is little reason to apply this severe standard to companies that have not been determined to present such a risk to the nation's financial system.

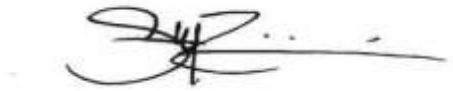
As an alternative, the Commissions propose to apply an 8 to 1 liabilities to equity leverage ratio as the test for a highly leveraged entity on the basis that such a ratio is consistent with the exemption in the third test of the major participant definitions for financial institutions that are subject to capital requirements set by the Federal banking agencies. AIA strongly objects to the application to property-casualty insurers of a ratio that was designed exclusively to address characteristics of the banking industry. One size does not fit all situations. It is important for the Commissions to understand the unique nature and business model of the insurance industry, which is based on an inverted cycle of production. Applying a leverage ratio tailored for banks to property-casualty insurers could result in significant harm to insurers. A measurement that may be suitable for banks is not at all appropriate for property-casualty insurers. Further, the Commissions' preliminary decision not to adopt an industry-specific approach to measure leverage conflicts with the Financial Stability Oversight Council's proposed framework for evaluating nonbank financial companies for heightened prudential supervision, which is based on evaluating companies according to the industries in

[5] Dodd-Frank Act § 165(j)(1).

which they are market participants.[6] Accordingly, AIA requests that the Commissions confer with representatives of the property-casualty insurance industry, as well as the National Association of Insurance Commissioners to establish a leverage measurement that is suitable for the industry.

AIA appreciates the opportunity to comment on the Commissions' request for public comment. We look forward to working with you to address the issues raised in our comments.

Sincerely,



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[6] "Notice of Proposed Rulemaking Regarding Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies" (12 CFR Part 1310; Docket ID: FSOC-2010-001), 76 Fed. Reg. 4555, 4561 (Jan. 26, 2011).