

May 5, 2011

The Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Via Electronic Mail

Re: Phased-in Compliance Periods for Smaller Swap Dealers

Dear Chairman Gensler:

The undersigned companies respectfully submit this letter to comment on the Commodity Futures Trading Commission's ("CFTC") implementation of compliance deadlines for final rules promulgated under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). In particular, we seek an appropriately-phased implementation schedule for rules that affect smaller swap dealers.¹

We support a well-regulated and transparent derivatives market and commend the CFTC for its efforts to realize these goals. And we appreciate the CFTC's attention to phased-in implementation for the rules promulgated under Title VII of the Dodd-Frank Act and agree that a great need exists to sufficiently extend implementation deadlines for all market participants so that the aims of the Dodd-Frank Act can be achieved without undue market disruption. We also appreciate the CFTC's recognition that some market participants are better positioned to comply with the new regulatory environment on a faster timetable than others.² This, of course, means

¹ Since we are writing this letter before the CFTC has finalized regulations on the scope of institutions that will actually have to register as "swap dealers" under Title VII of the Dodd-Frank Act, our participation in this letter is not meant to take a position and has no bearing on whether we will ultimately be considered swap dealers.

² During a March 29 roundtable meeting at the CFTC, you recognized that the Commission has discretion under the Dodd-Frank Act to phase-in the implementation of rule compliance deadlines and asked for input from the public about the topic. In addition, Dan Berkovitz, the CFTC's General Counsel, recently reiterated the CFTC's commitment to establishing phased-in compliance deadlines during his April 13 testimony before the House Committee

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that the rules will have to become effective at varying intervals, according to the implementation capabilities of different market participants. We believe that smaller swap dealers, facing unique implementation burdens, need more time than larger dealers to adapt to the new regulatory environment.

Accordingly, and for the reasons discussed below, we are asking the CFTC to provide a longer phase-in compliance period for smaller swap dealers.³ These reasons fit within the following three categories:

- while larger swap dealers have the resources to develop and support their own in-house operational infrastructure and proprietary systems, smaller dealers (which lack the volume of derivatives activities to support the development of such infrastructure) are more likely to rely on outside third parties, and must compete with other smaller dealers for the services of those outside vendors;
- given the volume of their derivatives activities, smaller dealers have not established direct interfaces with derivatives clearing organizations and other entities that will play central roles under the new regulatory regime; and
- smaller dealers are often customers of larger dealers, meaning that sequencing compliance by larger dealers is the logical and necessary precursor to compliance by their smaller dealer customers.

As a result of these reasons, smaller swap dealers face added challenges and delayed ability to implement new requirements. In particular, it will be harder for smaller dealers than for larger dealers to establish connectivity with Derivatives Clearing Organizations (“DCOs”), Designated Contract Markets (“DCMs”), Swap Data Repositories (“SDRs”), and Swap Execution Facilities (“SEFs”); to test new technology; to adequately customize trading platforms to meet operational demands; to implement new compliance systems; and to develop compliant infrastructure for recordkeeping and reporting.

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on Agriculture. Mr. Berkovitz stated that the CFTC will consider setting different compliance dates based on factors such as “asset class, type of market participant, and whether the requirement would apply to market infrastructures or to specific transactions.” *Testimony of CFTC General Counsel Dan Berkovitz before the House Committee on Agriculture* (Apr. 13, 2011).

³ Based on data from the OCC, smaller dealers collectively hold less than 4% of the notional amount of the banking industry’s total derivatives contracts. See *OCC’s Quarterly Report on Bank Trading and Derivatives Activities Fourth Quarter 2010*, Table 2 available at <http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq410.pdf>.

The CFTC has been granted ample authority to create a flexible implementation timeline as it deems appropriate.⁴ As currently proposed, however, the rules promulgated under the Dodd-Frank Act that affect swap dealers do not distinguish between larger and smaller dealers, despite considerable differences in market share and operational and technological capabilities. We believe it is critical to the continued functioning of the swap markets, and the ability of smaller dealers to adapt without significant business disruption, that this authority be used, as General Counsel Berkovitz has indicated, to “tailor the timing of the implementation of the rules to the ability of entities subject to the new Dodd-Frank regulations to develop the systems, procedures, and capabilities to comply with the new requirements.”⁵

Phased implementation by dealer size would allow the CFTC to focus its resources initially on larger swap dealers, which are of critical importance to swap market functioning, while capturing the vast majority of the swap markets. Such an approach would give smaller dealers the time they need to recruit additional staff, identify infrastructure needs, work with outside vendors to build new systems, establish new relationships with execution facilities, clearinghouses, data repositories, and other entities—and be able to coordinate their compliance with larger dealers on whom they rely.

Reliance on outside third parties is, perhaps, the single greatest source of uncertainty and potential cause for delay in the ability of smaller dealers to comply with the new derivatives rules. While larger swap dealers have the resources to develop and support their own in-house operational infrastructure and proprietary systems, it is cost-prohibitive for the smaller swap dealers to develop and support similar in-house capabilities. Because of these resource limitations, smaller swap dealers depend on outside third parties for operational and technological support. Specifically, this means that, for smaller dealers, implementation speed will depend on the availability of vendor resources capable of designing, implementing, and testing new compliance and interface systems. For example, implementing a new trading platform or communication interface through an outside vendor requires significant lead time and possibly extended negotiations with the vendor about product price and functionality. This process could well be delayed or complicated by external concerns or incentives of the vendor, and the vendor may be limited in the level of product customization it can offer. Moreover, changes will occur simultaneously at other smaller dealers and vendors across the industry, limiting the availability of external resources and personnel with the required skills and knowledge base. Smaller dealers will compete with other smaller dealers to receive the necessary time and attention from vendors. In contrast, while larger swap dealers may need to re-allocate resources internally, they are shielded by their ability to develop systems in-house from the external pressures and limited resources that constrain smaller dealers.

⁴ Dodd-Frank Act Sec. 754.

⁵ Testimony of CFTC General Counsel Dan Berkovitz before the House Committee on Agriculture (Apr. 13, 2011).

We are also concerned that it will take smaller dealers more time to establish or modify arrangements with DCOs, DCMs, SDRs, and SEFs. The new regulatory environment will require interactions among many newly-formed entities, and subscription and other agreements, membership interests, trading privileges, and other relationships will have to be established. To establish required agreements while providing a seamless transition for customers—which is critical for maintaining market stability and liquidity—smaller dealers will have to evaluate existing relationships, determine systems capabilities and interfaces, identify necessary modifications, develop work plans, implement system changes, and conduct testing. Moreover, as noted above, smaller dealers are dependent on outside third-party vendors for much of their operational and technological infrastructure, as well as on connectivity with their larger dealer counterparts. Because of these operational and technological dependencies, we believe that requiring larger swap dealers to comply with the new rules first would allow smaller dealers to develop new systems after they know what the new larger swap dealers’ systems require.

The relationships between smaller and larger swap dealers underscores an additional point that counsels for later sequencing requirements for smaller dealers. Smaller dealers often serve as pass-throughs between their customers and larger dealers that take on the risk associated with a swap. In this role, smaller dealers pose little counterparty risk, and minimal risk to the system. Because regulation of smaller dealers will not appreciably reduce systemic risk, there is less urgency to sequence such regulation at an early stage. In addition, smaller swap dealers are often customers of larger dealers. Hence, sequencing larger dealer compliance first will facilitate compliance by the smaller dealers they serve.

A thoughtful and carefully measured implementation schedule is not a matter of comfort to smaller dealers; it is a matter of necessity. If smaller swap dealers cannot implement new regulations according to the required schedule, they may be forced to halt or interrupt their activities, which would cause end-users and other market participants that access the swap markets through these smaller swap dealers to suffer liquidity disruptions and diminished competition in the dealer market. We applaud the CFTC for embarking on this process and encourage the Commission to maintain an open dialog with us and to recognize the challenges faced by smaller swap dealers in phasing in the new derivatives rules.

Sincerely,

Branch Banking and Trust Company
Capital One Financial Corporation
Fifth Third Bank
PNC Bank, National Association
Regions Bank