July 22, 2011

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Commodity Futures Trading Commission
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Ms. Elizabeth M. Murphy
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Re: PRODUCT DEFINITIONS- Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping
(CFTC RIN 3038-AD46 and SEC File Number S7-16-11, RIN 3235-AL14)

Ladies and Gentlemen:

Better Markets, Inc.[1] appreciates the opportunity to comment on matters identified in the above-captioned joint proposed rules and proposed interpretations ("Release") of the Commodity Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC") (the CFTC and the SEC being hereinafter collectively referred to as the "Commissions"). The Release clarifies the definitions of swaps ("Swaps"), security-based swaps ("SBS"), security-based swap agreements ("SBS Agreement"), and mixed swaps ("Mixed Swaps"), pursuant to and in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

Title VII of the Dodd-Frank Act establishes a new, comprehensive, and profoundly important regulatory regime governing Swaps, SBS, and Mixed Swaps. Abusive and opaque markets for these instruments, involving massive concentrations of hidden risk, were a primary cause of the financial crisis of 2008, which continues to plague the American and international economies. A significant feature of this marketplace was the ability of insurance companies such as AIG and the monolines to enter what were in substance

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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derivatives transactions but in the form of insurance contracts. This painful history highlights the need to clearly and broadly delineate the categories of derivatives that will be subject to regulation under Title VII. In short, to implement fully the Congressional mandates of the Dodd-Frank Act, the Commissions must refine the statutory definitions so that they encompass all transactions that, *in substance*, constitute Swaps and SBS.

The Commissions explicitly recognize the importance of this task, even though the Dodd-Frank Act already includes detailed and comprehensive definitions of Swap, SBS, and Mixed Swaps.[2] A primary purpose of the Release is described by the Commissions as follows:

> The Commissions thus believe that it is important to clarify the treatment under the definitions of certain types of agreements, contracts, and transactions, such as insurance products and certain consumer and commercial contracts.[3]

The Release addresses four broad areas:

- Identifying instruments that fall entirely outside the purview of Title VII;
- Clarifying the distinctions between Swaps and SBS;
- Establishing a procedure through which parties can seek a joint interpretation from the Commissions regarding the proper characterization of instruments; and
- Establishing anti-evasion principles that will help thwart attempts to circumvent regulation through product design.

The Release provides useful guidance on all of these topics, cataloguing a wide range of products and providing increased clarity to market participants as to the scope of the product definitions. In particular, the requirement that insurance products outside the scope of Title VII be regulated by governmental authorities and that obligations insured by financial guaranty insurance policies not be subject to acceleration are firmly based on substantive business realities.

However, the Release falls short of fulfilling the requirements of the Dodd-Frank Act in certain critical respects. A recurrent problem in the Release is the failure to ensure that the substance of a transaction rather than its form determines how it is categorized under the definitions. The sudden revelations in 2008 about the enormous exposures of AIG (and the monoline bond insurers) are a strong reminder of the dangers of non-transparency resulting from overly formal—and ultimately misleading—complexities in financial

[2] Release at 29821.
[3] *Id.*

product design. Accordingly, the Release must be amended to address the following matters:

- Instruments such as financial guaranty insurance that provide payment based on the price, rate, or level of an underlying asset or commodity should be regulated as Swaps or SBS, regardless of whether they are labeled as insurance.

- The Release's emphasis on the intent to deliver physical commodities in relation to the forward contract exclusion from the Swap definition is appropriate. However, to ensure that the forward contract exclusion does not become a loophole for unregulated Swaps transaction, the Release must impose additional tests to ensure that the delivery requirement is bona fide.

- In addition, more guidance is necessary relating to certain energy-related contracts, with respect to which physical delivery is not a substantive element of the transaction, despite common characterizations.

- The exclusion for securities purchases and sales with delayed delivery also requires further interpretation. The Release does not adequately establish parameters to prevent cash settlements from being used to evade the regulation of SBS.

- Market participants must not be permitted to employ Mixed Swaps to obscure the underlying substance of transactions. Since the economic consequences are the same, these market participants must be required to disaggregate Mixed Swaps and enter into separate simultaneous transactions.

- The process for requesting interpretive guidance on the proper characterization of Swaps and other instruments must apply to SBS Agreements and must be more transparent.

- The anti-evasion rules will be a useful weapon against fraud, and the SEC must adopt such rules without waiting to collect more commentary or to gather more experience in the implementation of the Dodd-Frank Act.

COMMENTS

Instruments that Provide Payment Based on the Price, Rate, or Level of an Underlying Asset or Commodity Should Be Regulated as Swaps or SBS, Regardless of Whether They Are Labeled as Insurance.

Given the inherent similarities between insurance contracts and derivatives, and the history of abuses involving insurance products, it is essential that the Release establish clear criteria for differentiating the two types of instruments. The Release sets forth a number of useful tests for identifying bona fide insurance contracts that will not be

regulated as Swaps or SBS. Those tests focus on the terms of the contract and the issuing entities.[4]

In addition, the Release recognizes a particular threat with respect to financial guaranty policies or bond insurance, and it therefore establishes another safeguard: to qualify as insurance, those policies must not permit the beneficiary of the policy to accelerate the payment of any principal due on the covered debt securities.[5] This acceleration feature is a common attribute of a derivative, not a true insurance policy.

However, more needs to be done to ensure that the Swap and SBS definitions are sufficiently broad. The acceleration provision in the Release is not a silver bullet. If financial guarantee insurance is called upon in a default, the debt service obligation is transferred to the insurance company. Measured properly, the cost to the insurance company is the net present value, at the insurance company's cost of capital, of the stream of debt service payments, less any amounts recovered from the insured obligor.

The reason financial guaranty insurers require control over default is to manage the cost of a claim: if their cost of capital is higher than the nominal interest rate of the insured debt, they elect to pay out over time; otherwise, they direct acceleration and finance the payout at their cost of capital. As a result, while requiring no mandatory acceleration interposes a step that distinguishes financial guaranty insurance from a derivative, it does not definitively distinguish the two based on substantive differences.

The Commissions must establish another important test: if an insurance instrument provides for payment on an agreement, contract, or transaction that is based on the price, rate, or level of a financial instrument, asset, or interest in any commodity, then it is, in substance, a Swap or an SBS, regardless of its label, and it should be regulated as such. An insurance policy that guarantees the price, rate, or level of a security, asset, or commodity is substantially the same as a transaction denoted as a Swap, which similarly guarantees such price, rate, or level. While the form is different, the outcome is the same for the insured party and the risks are the same for the insurer.

A functional analysis with respect to bond insurance further illustrates the need to establish this additional test for insurance products. Bond insurance that wraps a Swap or an SBS transfers the risk of counterparty non-performance to the insurer. The insurance is an embedded and essential feature of the Swap or SBS, which is valued based on the financial guaranty insurance policy. The ongoing value of the Swap or SBS is in large measure determined by the likelihood that the insurance proceeds will be available if the counterparty does not meet its obligations. It is very similar to the hedge of counterparty default risk using credit default swaps ("CDS").

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[4] Release at 29822.
[5] Release at 29823.

If the Release does not adopt this approach, then form will prevail over substance and the safeguards provided under Title VII will be lost to the very products that played such a prominent role in the financial crisis. The lack of transparency and risk mitigation that proved so dangerous in 2008 will persist unless the final release treats the financial guaranty insurance policy as a Swap or SBS.

The Exclusion for Forward Contracts Must Be Strengthened To Ensure That It Is Not Used to Evade the Regulatory Requirements Governing Swaps and SBS.

The definitions of Swaps and SBS exclude forward contracts. However, forward contracts have presented major interpretive difficulties in the past,[6] and therefore the exclusion must be clearly defined under Title VII to prevent evasion. The core feature that distinguishes forward contracts from both futures and Swaps is the intent to settle the contract through physical delivery of the underlying commodity. The challenge is in setting standards that ensure the presence of a genuine intent to deliver.

The Release recognizes that intent to deliver is an essential element of a forward contract, and it correctly notes that such intent may be inferred primarily from two factors. First, the contract must contain a binding delivery obligation, and second, the parties to the contract must regularly make or take delivery of the referenced commodity.[7] The Release must go further and provide additional guidance to ensure that Swaps and SBS masquerading as forward contracts do not escape regulation. As discussed below, this is particularly important in the context of energy contracts. The forward contract exclusion must also be narrowed as applied to SBS.

First, the Release should provide additional guidance for determining when parties "regularly" make or take delivery of the referenced commodity. While a bright-line test establishing a minimum delivery frequency may not be appropriate, some quantitative metric is necessary. "Predominance" or "more often than not" standards at a minimum should apply.

Second, the guidance should supply some test for confirming the presence of bona fide intent to deliver. For example, the intent to make or take delivery of the underlying commodity must be present at the initiation of the transaction, it must relate to a demonstrable commercial need to make or take delivery of the commodity, and any decision to settle through an alternative mechanism must be justified in terms of a change in commercial circumstances.

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[6] These interpretive difficulties center on whether the requirement of delivery is bona fide, and they are illustrated in the case of *CFTC v. Zelener*, 373 F. 3d 861 (7th Cir. 2004). The Seventh Circuit held that spot contracts for the sale of foreign currency were contracts for actual delivery and not futures contracts, even though investors could and invariably did settle their transactions *without* taking delivery of any foreign currency. The holding ran counter to precedent and illustrated the difficulties that arise in applying the delivery concept to various types of commodities contracts. The *Zelener* decision ultimately required a legislative remedy to restore at least the CFTC's fraud jurisdiction over such foreign currency transactions.

[7] Release at 29829.

In light of these factors, and in light of the new market structures established by the Dodd-Frank Act, the scope and application of the Brent Interpretation to Swaps on nonfinancial commodities should be reevaluated. Under the Brent Interpretation issued by the CFTC in 1990, forward contracts do not lose their status as such even though the parties can extinguish their delivery obligations through the practice of entering separate cancellation or "book-out" agreements. The rationale for this view was that the contracts *themselves* contained a binding obligation to make or take delivery (of crude oil), and that the parties had to negotiate and enter *separate* transactions if they wanted to avoid their delivery obligations.[8]

This is a potentially dangerous loophole that market participants may exploit. By entering so-called forward contracts and routinely extinguishing delivery obligations through book-out agreements, parties would be able to trade Swaps without being subject to the new regulatory regime imposed by the Dodd-Frank Act. Although the practices described in the Brent Interpretation can be a workable accommodation to commercial enterprises engaged in genuine merchandizing transactions, the context has changed dramatically with the advent of the Dodd-Frank Act. The incentives to evade the new regulatory requirements are much stronger now, and unless abolished or modified, the Brent Interpretation may provide the mechanism to accomplish this evasion. Incorporating the additional factors discussed above, relating to delivery frequency and proof of intent to deliver, will help prevent abuses of the Brent Interpretation.

Contracts for physical power pose unique challenges related to the forward contract exclusion from the Swaps definition. The CFTC's criteria for the exclusion are described in the Release and focus on the following test for evaluation of a specific contract:

> [energy contracts] that impose binding obligations on the parties to make and receive delivery of the underlying commodity, with no right of either party to effect a cash settlement of their obligations without the consent of the other party (except pursuant to a bona fide termination right such as default).[9]

In addition, the Release poses the following question:

> How would the proposed interpretive guidance set forth in this section affect full requirements contracts, capacity contracts, reserve sharing agreements, tolling agreements, energy management agreements, and ancillary services?[10]

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[8] Release at 29828.
[9] Release at 29829 n. 72.
[10] Release at 29832.

The traded power markets involve these and many other types of contracts that are actually exchanges of cash flows based on referenced values and have no relevant characteristics of physical delivery. For example—

- Contracts related to transmission rights (ancillary services) are in substance Swaps based on the cost of congestion between two points on the transmission grid, measured by the difference between actual prices assigned at those points by the grid operator.

- Capacity contracts are often documented using physical forms, but in reality constitute Swaps that are used to hedge the price risk associated with periodic auctions of the contracts to provide reliable capacity to the grid operator.

While the fact that these and other contracts must be within the scope of the Swap definition may be inconvenient to participants in power market derivatives trading, the contracts simply do not meet the rational tests developed by the CFTC. This must be made explicit in the interpretation.

Moreover, basic power contracts often do not meet the intent to deliver test. Power is not a tangible commodity that can be delivered in the conventional sense. The seller schedules an amount of generation with the grid operator and the buyer schedules simultaneous consumption of energy, each at an assigned location. The basic contractual relationship is defined by the difference between an agreed price and the actual price paid by the buyer to the grid operator. It is obvious that a Swap can be transacted in the form of a physical delivery contract even though the counterparties are uninterested in the actual, physical actions of each other. They simply do not schedule capacity and load as a pair and they settle the contract in cash based on the readily available price differentials.

Accordingly, the CFTC must be vigilant that contracts which are physical in form are not used to circumvent regulation of Swaps. The Release interpretations must be expanded to require that such contracts, at a minimum, allocate secondary costs associated with delivery (such as congestion charges and penalties to which those who actually schedule capacity and load on the grid are subject), in order to demonstrate intent to deliver.

The Release provides for a broad exclusion in respect of contacts for the purchase and sale of securities for subsequent delivery.[11] This approach also must be made more restrictive.

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[11] Release at 29830-31.

The securities subject to such a delivery obligation are often easily convertible into cash, which facilitates cash settlement without actual delivery. The SEC must focus attention on the fact that formal characterization of a delivery contract for securities can be used to disguise a transaction that is substantively an SBS. Additional requirements are needed to establish intent to deliver. Cash settlement options should be forbidden in contracts for subsequent delivery. In addition, a party that frequently unwinds "physical" positions with cash settlements using side agreements must be considered as not having the requisite intent to deliver.

All of the changes discussed above are necessary to prevent the forward contract exclusion from creating easy opportunities for abuse and evasion of the requirements that must apply to all instruments that are in fact Swaps or SBS.

The Release Must Require the Disaggregation of Mixed Swaps.

The Commissions grapple with the issue of Mixed Swaps in the Release. The example provided is a transaction that constitutes a Swap on the value of the shares of an energy company combined with a Swap on the price of oil.[12] This example is very instructive. Economically, the two counterparties could have entered into two separate Swaps, one on the share value and one on the commodity value, with the same results.

The approach in the Release must be fundamentally changed. The regulatory complexity of dealing with a Mixed Swap far outweighs the legitimate benefits to the counterparties from documenting the transactions as a Mixed Swap. In fact, it must be questioned whether Mixed Swaps provide any legitimate benefits, since the only rational way to characterize the transaction in terms of risk management and profit and loss is to disaggregate it.[13]

Requiring the Swaps to be disaggregated into a Swap and an SBS has many benefits:

- Price reporting will be more useful.
- Transparency will be increased.
- Regulatory reporting and monitoring will align with the transaction databases of the counterparties.
- Illegitimate motivations, such as obfuscation of prices and fees, will be thwarted.

In today's marketplace, complex transactions are common. However, the Dodd-Frank Act implementation process (in particular, the enormously enlightening roundtables) has made it abundantly clear that derivatives based on esoteric risks

[12] Release at 289860.

[13] CFTC Roundtable, *Swap Data Recordkeeping and Reporting*, Comments of Adam Litke, commencing on transcript page 187 (Jan. 28, 2011).

constitute only a tiny fraction of the market.[14] Most transactions that pose issues in terms of categorization and trade data reporting are simply composites of more common and measurable derivatives risk. These transactions are then routinely disaggregated into component risks by the counterparties to allow risk management systems to record and monitor risks. A major motivation for documenting transactions in their complex form is to obscure the true costs and risks they entail.

Congress intended that a transparent marketplace should emerge from the wreckage of the financial crisis, and this intent will be thwarted if the Commissions enable market participants to obscure the true nature of Swap transactions through reliance on a broad concept of Mixed Swaps, one that exalts form over substance. Market participants should facilitate the regulatory effort by disaggregation rather than the regulators accommodating the participants by overuse of the Mixed Swap concept.

The Process for Requesting Interpretive Guidance Must Apply to SBS Agreements and Must Be More Transparent.

The Release establishes a process, modeled on § 718 of the Dodd-Frank Act, that would enable market participants to request joint, interpretive guidance from the Commissions regarding the definitions of Swap, SBS, and Mixed Swap. This is a positive mechanism that will help prevent financial instruments from falling into any regulatory gaps under Title VII. The process should be strengthened in two ways.

First, the process should encompass requests for interpretive guidance regarding the definition of SBS Agreements, as well as Swaps, SBS, and Mixed Swaps. Although SBS Agreements have not generated confusion since they were first included in the Commodity Futures Modernization Act of 2000, their precise scope may become more significant in the context of the comprehensive framework under the Dodd-Frank Act. Moreover, SBS Agreements are subject to different levels of regulatory authority allocated between the CFTC and SEC.[15] Market participants may therefore require guidance in the future, and there is no reason to exclude these instruments from the process set forth in the Release.

Second, the process for seeking interpretive guidance must be made more transparent. Obviously, any requests for guidance, as well as any guidance actually provided by the Commissions, should be made public. In addition, the Release should require the Commissions to make public any decision not to provide interpretive guidance, along with an explanation of the grounds for any such decision. These requirements are necessary not only to ensure that regulatory requirements are easily accessible to market participants and members of the public, but also to ensure that the Commissions are fulfilling their respective duties to implement the Dodd-Frank Act faithfully and in accordance with the public interest.

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[14] *Id.* at transcript pages 193-4.
[15] Release at 29862.

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The Anti-Evasion Rules Proposed Are Appropriate, and the SEC Must Adopt Similar Rules Without Waiting for Additional Commentary or Gathering Experience in Implementing the Dodd-Frank Act.

The Release includes a proposed rule implementing the CFTC's anti-evasion rule-making authority. Recognizing that the methods and techniques of evasion are "limited only by the ingenuity of man," the CFTC has adopted an appropriately principles-based approach.[16] Accordingly, the CFTC's anti-evasion rule would generally define Swaps to include "those transactions that are willfully structured to evade the provisions of Title VII governing the regulation of Swaps."[17]

To supplement this broad principle, the Release would provide additional guidance by identifying factors that the CFTC would consider when determining whether a given Swap represented an attempt to evade the law. First, and highly appropriate, is the axiom that "in determining whether a transaction has been willfully structured to evade, neither the form, label, nor written documentation of the transaction shall be dispositive."[18] Second, the CFTC will consider the extent to which a person has a legitimate business purpose for structuring the instrument in a particular manner.[19] Finally, the CFTC will consider the extent to which the conduct involves deceit, deception, or other unlawful or illegitimate activity.[20]

This approach is sound and it will help to ferret out attempts by market participants to evade the legal and regulatory requirements under the Dodd-Frank Act.

The SEC must also exercise its anti-evasion rule-making authority. The Release explains that the SEC *may* consider whether to propose specific rules regarding anti-evasion in light of comments received or in light of experience with the new regime established under Title VII. Rather than adopting this wait and see approach, the SEC must promulgate anti-evasion rules without delay. It is inconceivable that any collection of comment letters, no matter how numerous or ardent, could justify a decision to refrain from exercising this profoundly important authority. It is similarly impossible to imagine that experience in implementing the Dodd-Frank Act would teach that no safeguards against evasion by market participants are necessary.

On the contrary, experience has taught—and will forever demonstrate—that regulators must deploy every means at their disposal to prohibit, detect, and remedy violations of the laws and regulations designed to protect the public from avarice and deceit in our financial markets. Promulgating anti-evasion rules will provide additional and necessary tools to the SEC, and it will send a much-needed signal to the marketplace that the SEC has a firm resolve to police the derivatives markets aggressively.

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[16] Release at 29866.
[17] *Id.*
[18] *Id.*
[19] Release at 29867.
[20] *Id.*

CONCLUSION

The definitions of Swaps and SBS are essential elements of the regulatory framework mandated by the Dodd-Frank Act. The Commissions have done an admirable job in refining these concepts. With the changes advocated above, the definitions will have the breadth necessary to reach all of the activity that Congress intended to regulate under the Dodd-Frank Act.

We hope these comments are helpful.

Sincerely,

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