July 22, 2011

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Re: Joint Proposed Rules on Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (SEC: File Number S7-16-11, RIN 3235–AK65; CFTC: RIN 3038–AD46)

The Securities Industry and Financial Markets Association ("**SIFMA**")[1], appreciates the opportunity to comment on certain key aspects of the rules and interpretations jointly proposed by the Commodity Futures Trading Commission (the "**CFTC**") and the Securities and Exchange Commission (the "**SEC**", and together with the CFTC, the "**Commissions**") in the above-referenced release[2] to further define the product definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Title VII**" of "**Dodd-Frank**").[3]

As discussed in greater detail below, SIFMA believes that:

(i) the Commissions should exclude all loan participations from the definitions of swap and security-based swap ("**SBS**");

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29,818 (proposed May 23, 2011) (amending 17 CFR Parts 41 & 240) (the "**Proposal**").

[3] Public Law 111-203, 111th Cong., 2d sess. (July 21, 2010) ("**Dodd-Frank**").

(ii) the Commissions should defer rulemaking or interpretive guidance addressing what is or is not a "foreign exchange swap" or "foreign exchange forward" until after the Secretary of the Treasury has issued a final determination under Section 721 of Dodd-Frank;

(iii) the Commissions should clarify that spot foreign exchange transactions (*i.e.*, transactions of one currency into another that settle within a customary settlement cycle) are not "foreign exchange forwards" or "swaps" under Title VII;

(iv) Title VII instruments involving futures on foreign government debt securities specified in Rule 3a12-8 under the Securities Exchange Act of 1934 (the "**Exchange Act**") should be characterized as swaps rather than SBS;

(v) terms of a total return swap ("**TRS**") that create interest rate or currency exposures incidental to the swap should not cause a transaction that otherwise would be deemed to be an SBS to be characterized as a mixed swap;

(vi) the publicly available information ("**PAI**") test should be dropped from the determination of whether an index credit default swap ("**index CDS**") is narrow-based;

(vii) if the Commissions retain the PAI test, it should be deemed satisfied for any index CDS referencing a third-party index for which either (a) specified information is provided by the third-party index provider or (b) the index serves as the basis for any index CDS offered on a regulated trading platform;

(viii) constant maturity swaps ("**CMS**") should be deemed to be swaps, rather than mixed swaps, regardless of whether the constant maturity rate leg is based on the constant maturity yield of a single, or narrow-based index of, non-exempted securities;

(ix) the definition of "control" used to determine whether two issuers are affiliated in connection with determining the number of reference entities or issuers in an index underlying a credit default swap ("**CDS**") should be set at 51% rather than 20%;

(x) the Commissions should clarify that n^{th}-to-default CDS will be deemed to be SBS and that tranched CDS will be deemed to be either swaps or SBS depending on the characteristics of the underlying reference asset pool;

(xi) the Commissions should clarify that Title VII instruments based on a security index that may, but will not necessarily, change from narrow-based to broad-based, or vice versa, under a pre-defined formula should be characterized at execution as a swap or SBS, not a mixed swap;

(xii) the procedure for requesting joint interpretations from the Commissions of the characterization of a Title VII instrument should be modified;

(xiii) the CFTC's anti-evasion proposal should be substantially narrowed to avoid unnecessarily limiting the ability of market participants to choose between legitimate structuring alternatives; and

(xiv) the Commissions should not extend the eligible contract participant ("**ECP**") "look-through" requirement to commodity pools with greater than $10 million in assets, and the "look-through" requirement should apply only to direct, as opposed to indirect, participants in the pool.

The Commissions should exclude all loan participations from the definitions of swap and SBS.

SIFMA believes that the Commissions should exclude all loan participations from the definitions of swap and SBS. Loan participations that are securities[4] and those that are identified banking products[5] are excluded from regulation as swaps or SBS. The Commissions have proposed that other loan participations will be considered swaps unless (i) the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan and (ii) the loan participations are "true participations" (*i.e.*, the participant acquires a beneficial ownership interest in the underlying loans).[6] SIFMA believes that loan participations play a key role in the global syndicated loan market as a method for transferring loans on an unleveraged basis. Loan participations differ from total return swaps in that the loan participant owns a percentage of the underlying loan and is not leveraged. Unfortunately, the Commissions' guidance in the Proposal does not exclude all such loan participations from regulation as swaps or SBS. In particular, SIFMA is concerned that, as defined, "true participation" may not incorporate certain European- and Asian-style loan participations.

As a result, SIFMA agrees with the position of the Loan Syndications and Trading Association ("**LSTA**") and the Loan Market Association ("**LMA**") that loan participations should not be considered swaps or SBS if:

1) the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan or commitment; and
2) the agreement pursuant to which the purchaser is acquiring such an interest:

[4] *See* Section 1(a)(47)(B)(iii) under the Commodity Exchange Act ("**CEA**").

[5] Legal Certainty for Bank Products Act of 2000 § 403(a) (as amended by Section 725(g)(2) of Dodd-Frank).

[6] Proposal at 29,834.

a) is a participation agreement that is, or any similar agreement of a type that has been, is presently, or in the future becomes, customarily entered into in the primary or secondary loan markets;
b) requires the grantor to represent that it is a lender under, or a participant or sub-participant in, the loan or commitment;
c) provides that the participant is entitled to receive from the grantor all of the economic benefit of the whole or part of a loan or commitment to the extent of payments received by the grantor in respect of such loan or commitment; and
d) requires that 100% of the purchase price calculated with respect to the loan or commitment is paid on the settlement date.

The Commissions should defer rulemaking or interpretive guidance addressing what is or is not a "foreign exchange swap" or "foreign exchange forward" until after the Secretary of the Treasury has issued a final determination under Section 721 of Dodd-Frank.

SIFMA believes that, until a final determination is issued by the Secretary of Treasury with respect to whether "foreign exchange forwards" and "foreign exchange swaps" should be regulated as "swaps," it would be premature to comment generally on the appropriate scope of the definition of "swap" with respect to foreign exchange derivatives products.[7] Accordingly, the Commissions should defer rulemaking to define these products until after the Secretary of the Treasury has made final its determination.

Section 721 of Dodd-Frank defines "foreign exchange swap"[8] and "foreign exchange forward"[9] and includes these instruments in the definition of "swap," but provides the Secretary of the Treasury with the authority to exempt them, under enumerated findings, which the Secretary has proposed to do. Once informed of the specifics of the Secretary's final determination, the industry will

[7] In considering this issue, SIFMA has consulted with its Global FX Division ("**GFXD**"). The GFXD was formed in cooperation with the Association for Financial Markets in Europe ("**AFME**") and the Asia Securities Industry and Financial Markets Association ("**ASIFMA**"). Its members comprise 22 global FX market participants, collectively representing more than 90% of the FX market. *See* Letter from Global FX Division of SIFMA, AFME and ASIFMA to the Department of the Treasury, November 15, 2010 (Re: Exemption of Foreign Exchange Swaps and Forwards).

[8] CEA § 1(a)(25) (as amended by Dodd-Frank § 721(a)(12) defines a "foreign exchange swap" as "a transaction that solely involves—(A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."

[9] CEA § 1(a)(24) (as amended by Dodd-Frank § 721(a)(12) defines a "foreign exchange forward" as "transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."

be better positioned to appropriately assess the need for clarification for these different products. SIFMA welcomes the opportunity to work with the Commissions at such time to establish a clear and consistent approach with respect to the applicability to such products of provisions of the CEA, as amended by the Dodd-Frank Act.

The Commissions should clarify that spot foreign exchange transactions (*i.e.*, transactions of one currency into another that settle within a customary settlement cycle) are not "foreign exchange forwards" or "swaps" under Title VII.

SIFMA believes that it is important for the Commissions to clarify that spot foreign exchange transactions are not "foreign exchange forwards" or "swaps" under Title VII. Section 721 of Dodd-Frank includes "foreign exchange forwards" in the definition of "swap."[10] "Foreign exchange forward" is defined as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."[11] This definition may unwittingly capture many typical foreign exchange spot transactions that settle within a customary settlement cycle. Spot transactions generally settle by T + 2 in the United States and T + 3 in some international jurisdictions.

Title VII instruments involving futures on foreign government debt securities specified in Rule 3a12-8 under the Exchange Act should be characterized as swaps rather than SBS.

SIFMA believes that Title VII instruments based on foreign government debt securities specified in Rule 3a12-8 under the Exchange Act should be considered swaps rather than SBS.[12] Under Rule 3a12-8,[13] debt securities of 21 foreign governments are considered "exempted securities" for the purpose of providing the CFTC with exclusive jurisdiction over futures on those securities. In determining whether to designate particular foreign government securities as "exempted securities," the SEC has considered a range of factors, including: (i)

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[10] Dodd-Frank § 721(a)(21).

[11] Dodd-Frank § 721(a)(12).

[12] Section 761 of Dodd-Frank exempts from characterization as SBS instruments based on securities exempted under section 3(a)(12) of the Exchange Act, as in effect on the date of enactment of the Futures Trading Act of 1982. Dodd-Frank § 761(a)(6). Only U.S. government securities were exempted as of the date of enactment and, as a result, all Title VII instruments based on foreign government securities themselves will be classified as SBS rather than swaps. Proposal at 29,842 n.169.

[13] SEC Rule 3a12-8, Exemption for Designated Foreign Government Securities for Purposes of Futures Trading, codified at 17 C.F.R. § 240.3a12-8.

how much information about the government is available;[14] (ii) to what extent English-language information is available;[15] (iii) whether other securities with similar disclosure requirements are already available in the U.S. market;[16] (iv) credit rating;[17] and (v) whether market evidence indicated that an active and liquid secondary trading market exists.[18] Therefore the SEC, in designating particular foreign government securities as "exempted securities," evinces a belief that there is sufficient disclosure available about the government and its securities such that further disclosure is not warranted. In addition, treating Title VII instruments on such securities as swaps will maintain consistency with the treatment of Title VII instruments on U.S. government securities.

In particular, in response to the Commissions' request for comment on the issue, SIFMA agrees with the CFTC that subjecting futures on these foreign government securities to CFTC regulation, while subjecting swaps *on those futures* to SEC regulation, is problematic. SIFMA believes that these instruments should be treated consistently with Title VII instruments that are based on futures that are not securities futures – namely, as swaps.

Terms of a TRS that create interest rate or currency exposures incidental to the swap should not cause a transaction that otherwise would be deemed to be an SBS to be characterized as a mixed swap.

SIFMA believes that terms of a TRS that create interest rate or currency exposures that are incidental to the primary purpose of the swap should not cause a transaction that otherwise would be deemed to be an SBS to be characterized as a mixed swap. SIFMA agrees with the Commissions that "the scope of mixed swaps is, and is intended to be, narrow" and that "the category of mixed swap covers only a small subset of Title VII instruments."[19] SIFMA also agrees with the Commissions that use of variable interest rates for financing purposes may be "incidental to the purpose of, and the risk that the counterparties assume in, entering into the [total return SBS]"[20] and, when that is the case, such an SBS is

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[14] Final Rule: Exemption for Certain Foreign Government Securities for Purposes of Futures Trading, 49 Fed. Reg. 8595, 8598 (Mar. 8, 1984).

[15] *Id*.

[16] *Id*.

[17] Final Rule: Exemption of the Securities of the Kingdom of Sweden under the Securities Exchange Act of 1934 for Purposes of Trading Futures Contracts on Those Securities, SEC Release 34-41453 (May 26, 1999).

[18] *Id*.

[19] Proposal at 29,860.

[20] Proposal at 29,842.

not a mixed swap. However, the Commissions state that "where such payments incorporate additional elements that create additional interest rate or currency exposures that are unrelated to the financing of the [SBS], or otherwise shift or limit risks that are related to the financing of the [SBS], those additional elements may cause the [SBS] to be a mixed swap."[21]

SIFMA believes that, as stated, this test could be seen as requiring a quantitative analysis whether a reference to interest rates or currencies in a TRS is solely for "financing purposes" or creates additional exposure that might be construed as extending beyond those purposes. For example, such a determination could require market participants to determine whether a specific interest rate or spread referenced in the TRS is sufficiently in line with market rates to constitute a financing leg of a transaction under the proposed test.

SIFMA believes that there are a number of examples where a TRS can provide for some interest rate or currency exposure that is incidental to the primary purpose of the TRS. For example, a quanto equity swap can provide a U.S. investor with currency-protected exposure to a non-U.S. equity index by translating the percentage equity return in the currency of such non-U.S. equity index into U.S. dollars. As a TRS, this transaction is equivalent to a financing of a long position in the underlying non-U.S. equity index. The currency protection is incidental to this primary purpose of the TRS. This is very different from the Commissions' examples of mixed swaps, which include a swap that references the value of an oil corporation's stock and the price of oil; one where the underlying reference is a portfolio of both securities and commodities or broad-based securities indexes; and "best of" or "out performance" swaps based on the higher of the performance of a security and a commodity.

The PAI test should be dropped from the determination of whether an index CDS is narrow-based. [22]

SIFMA believes that the PAI test should be dropped from the determination of whether an index CDS is narrow-based. The Commissions have proposed a complex set of rules concerning PAI that must be applied each time an index CDS is executed. As a result, transactions on the same or similar indexes may result in differing regulatory treatment due to changes in index components as a result of component adjustments or as the availability of information relating to a component issuer changes over time. Index rules typically are designed to ensure liquidity and transparency, and imposing the PAI test may force index

[21] Proposal at 29,842.

[22] SIFMA believes that the third prong of the definition of SBS implies that Title VII instruments on an basket of loans are SBS where the lenders would satisfy the criteria for issuers of a "narrow-based security index." SIFMA would encourage clarification of this issue.

providers to incorporate the public availability of information as a parameter in index design.

In formulating the criteria for narrow-based security indexes in the context of index CDS, the Commissions rely on the guidance and rules previously adopted regarding narrow-based security indexes in the context of security futures. They state that requiring the availability of public information about a predominant percentage of the reference entities underlying an index is necessary to "reduce the likelihood that non-narrow-based indexes referenced in index CDS or the component securities or issuers of securities in that index would be readily susceptible to manipulation, as well as to help prevent the misuse of material non-public information though the use of CDS based on such indexes."[23]

The concerns driving the allocation of regulatory authority in the context of futures contracts is very different than in the case of swaps and security-based swaps after the passage of Dodd-Frank. In their 2006 joint release on the application of the narrow-based security index definition to security futures on debt securities, the Commissions were faced with the result that futures on debt securities indexes that were not "security futures" (*i.e.*, futures on a narrow-based security index) would be publicly traded in the highly liquid futures markets and subject to the exclusive jurisdiction of the CFTC.[24] At that time, the CFTC was not directly authorized or charged with policing the potential fraud and manipulation relating to the underlying issuers.[25]

However, under Dodd-Frank, the CFTC is granted broad antifraud and anti-manipulation authority with respect to swaps. In particular, new Section 4b(e) of the CEA contains a prohibition on fraud very similar to Rule 10b-5 under the Exchange Act in connection with any order to make or the making of any swap on a group or index of securities. In addition, the CFTC has recently adopted final

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[23] Proposal at 29,848.

[24] Joint Final Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, 71 Fed. Reg. 39,534 (July 13, 2006) (the "**2006 Release**").

[25] This concern was described by the SEC in a related context in the adopting release for Rule 3a12-8 under the Exchange Act:

> "[t]he fundamental purpose of the federal securities laws is to require disclosures that will enable investors to judge for themselves the prospects and creditworthiness of the securities issuer. This aim would be frustrated if disclosure requirements could be circumvented simply by marketing the investment on a delayed delivery basis by use of a derivative instrument rather than on a cash delivery basis."

Final Rule: Exemption for Certain Foreign Government Securities for Purposes of Futures Trading, 49 Fed. Reg. 8595, 8597-98 (Mar. 8, 1984). The SEC has not expressed the separate goal of limiting trading to swaps on issuers with PAI.

rules 180.1 and 180.2 under the CEA, mirroring Section 10(b) of the Exchange Act with respect to swaps. In addition, an index CDS that would have been an SBS with the application of the PAI test will remain under the SEC's anti-fraud authority as a security-based swap agreement.[26] Thus, given the burdens of the PAI test and its reduced benefits, SIFMA believes that it should be abandoned in favor of the remaining elements of the Commissions' test for a narrow-based securities index.

If the Commissions retain the PAI test, it should be deemed satisfied for any swap referencing a third-party index for which either (a) specified information is provided by the third-party index provider or (b) the index serves as the basis for CDS offered on a regulated trading platform.

As discussed above, SIFMA believes that the PAI test should not be used to determine whether an index CDS is narrow-based. However, if the Commissions retain the PAI test, SIFMA believes that PAI should be deemed to exist where a swap either references a third-party index provided by a third-party index provider[27] or references a CDS offered on or subject to the rules of a designated contract market ("**DCM**") or swap execution facility ("**SEF**"), or by direct access in the U.S. from a foreign board of trade ("**FBOT**") that is registered with the CFTC. SIFMA does not believe that both criteria are necessary.[28]

The Commissions request comment on whether a swap referencing an index compiled by a third-party index provider should be deemed to satisfy the public information test if (i) the third-party service provider makes publicly available general information about the construction of the index, index rules, identity of components and predetermined adjustments (the "**index information requirement**") and (ii) the index is the basis for a CDS offered on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from an FBOT that is registered with the CFTC (the "**trading requirement**").[29] SIFMA believes that the index information requirement alone ensures that sufficient information is

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[26] Proposal at 29,862-29,863.

[27] The discussion in the Proposal defines "third-party index provider" as "an index provider that is not a party to an index CDS." Proposal at 29,851. A number of commonly used indexes are provided by third-party groups that receive input from market participants regarding the composition of the index. SIFMA would appreciate an explicit statement that, under such circumstances, the index provider would still be considered a "third-party index provider."

[28] In addition, the specialized test for PAI in transactions entered into solely between eligible contract participants includes a requirement that information required by Rule 144A be provided by the issuer of the component security. We note that Rule 144A only requires that the issuer make such information available upon request of a prospective investor. SIFMA believes that the Proposal should require only that such information be made available upon request as Rule 144A provides.

[29] *See* Proposal at 29,851-52 (requesting comment on this issue).

available to market participants to discourage market manipulation. SIFMA also believes that the trading requirement alone ensures that such swaps are not readily susceptible to manipulation, as DCMs, SEFs and FBOTs are restricted from offering U.S. persons contracts that are readily susceptible to manipulation.

Therefore, SIFMA believes that requiring a swap on a third-party index to meet both the index information requirement and the trading requirement to qualify as having PAI is unnecessary and problematic. For example, swaps generally reference the "on-the-run" version of an index. As a result, once a new version of the relevant index is published, liquidity in previous "off-the-run" versions vanishes, and CDS referencing these older versions of the indexes are no longer likely to trade on SEFs. It does not seem reasonable that new Title VII instruments referencing older versions of an index should therefore be SBSs rather than swaps. In addition, SIFMA believes that the SEC's concerns regarding a person that "compiles an index at the behest of another person" is better dealt with through the Commissions' anti-evasion authority.

Constant maturity swaps should be swaps, rather than mixed swaps, regardless of whether the constant maturity rate leg is based on the constant maturity yield of a single, or narrow-based index of, non-exempted securities.

SIFMA believes that constant maturity swaps ("**CMS**") should be swaps, rather than SBS or mixed swaps, regardless of whether the constant maturity leg is based on an interest rate, a single exempted security, a narrow-based index of exempted securities, a broad-based index of exempted securities or a security issued by a foreign government. In a CMS, counterparties exchange payments based on rates determined from instruments of significantly different tenors. For example, a CMS may have one leg based on overnight LIBOR and the other leg based on a five-year Treasury yield. The rates on both sides are reset at regular intervals. In this way, the CMS allows the party receiving payments based on the longer-dated instrument (generally referred to as the constant maturity leg) to obtain exposure to the shape of the yield curve. The constant maturity leg may be based on U.S. Treasury yields, Treasury auction rates, yields on debt of foreign governments, Federal Farm Credit Bank debt and debt related to indexes of mortgage-backed securities, among other things.

In general, market participants view CMS as rates trades rather than trades on securities, with the bulk of CMS rates based on exempted securities. SIFMA does not believe that regulation of a CMS should differ depending, for example, on whether the constant maturity leg references a Treasury bond, in which case it would be a swap, or a UK Treasury gilt, in which case it would be an SBS.

The definition of "control" used to determine whether two issuers are affiliated in connection with determining the number of reference entities or issuers in an index underlying a CDS should be set at 51% rather than 20%.

SIFMA believes that, for the purpose of determining whether two issuers are affiliated as part of determining the number of reference entities or issuers in an index underlying a CDS, "control" should be defined as majority ownership rather than 20% ownership. A Title VII instrument on an index of securities or issuers of securities is a security-based swap if the index is "narrow-based" and a swap if the index is not narrow-based.[30] The Commissions have proposed to define narrow-based to include any swap referencing 9 or fewer "non-affiliated issuers" or securities of "non-affiliated issuers."[31] A reference entity is defined as affiliated with another entity if it controls, is controlled by or is under common control with that entity, with "control" being defined as 20% ownership of an entity's equity or the ability to direct the voting of 20% or more of the entity's voting equity.[32]

SIFMA believes that affiliated entities should be aggregated where reference entities' credit risks are substantially similar and credit decisions are made by the same group of individuals. Therefore, a 20% ownership threshold for direct control is too low. SIFMA believes that majority control, at least, is necessary for credit risk and credit decisions to be aligned enough as to warrant collapsing two issuers into one for the narrow-based test. For example, a leveraged buyout ("**LBO**") sponsor buying less than 50% of corporate entities that are in different business sectors and engage in activities not correlated to the LBO sponsor's activities should not be deemed "affiliated" with those target businesses and therefore treated as a single reference entity for these purposes, as they are entirely separate entities for credit purposes.

SIFMA notes that the credit derivatives market has long operated on the basis of a 51% test for affiliate status. For example, the term "Affiliate," as used in the 2003 ISDA Credit Derivatives Definitions and 2002 ISDA Master Agreement, means, in relation to any person, any entity controlled, directly or indirectly, by the person, any entity that controls, directly or indirectly, the person or any entity directly or indirectly under common voting control with the

[30] Exchange Act § 3(a)(68) (as amended by Section 761 of Dodd-Frank); Proposal at 29,845.

[31] Proposal at 29,890, CEA § 1.3(zzz)(1)(i)(A); Proposal at 29,894, Exchange Act § 240.3a68-1a(a)(1)(i); Proposal at 29,890, CEA § 1.3(aaaa)(1)(i)(A); and Proposal at 29,895, Exchange Act § 240.3a68-1b(a)(1)(i).

[32] Proposal at 29,890, CEA § 1.3(zzz)(3)(ii); Proposal at 29,895. Exchange Act § 240.3a68-1a(c)(2); Proposal at 29,891, CEA § 1.3(aaaa)(3)(ii); and Proposal at 29,895, Exchange Act § 240.3a68-1b(c)(2). The Commissions adopted the 20% affiliation test in the 2006 Release. The Commissions pointed out that the definition of affiliate under the federal securities laws is generally a facts-and-circumstances determination but looked to certain rules under the Exchange Act that contain a 20% threshold for purposes of determining a relationship between two or more entities, including Exchange Act Rule 13d–1(c) and Rule 3–05 under Regulation S–X. SIFMA believes that the principles underlying those rules are not necessarily relevant to the purposes of the definition of a narrow-based security index.

person.[33] For this purpose, "control" of any entity or person means ownership of a majority of the voting power of the entity or person.

The Commissions should clarify that n^{th}-to-default CDS are SBS and that tranched CDS are swaps or SBS depending on the characteristics of the underlying reference asset pool.

SIFMA believes that the Commissions should clarify that n^{th}-to-default CDS are SBS, not swaps. The numerical test for categorization of CDS indices requires that a index based on fewer than 10 issuers be categorized as an SBS, where an issuer is only counted if "a credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the CDS based on the related notional amount allocated to such security."[34] Since payments on n^{th}-to-default CDS are triggered by a credit event with respect to a single (*i.e.*, the nth) entity, such instruments should be categorized as SBS. In addition, typically, n^{th}-to-default CDS are on baskets of less than 10 securities or issuers. SIFMA believes that all n^{th}-to-default CDS should be treated the same way, specifically as SBS.

In tranched index or basket CDS, parties agree to buy and sell credit protection on only a portion of the potential losses that could occur on an underlying portfolio of reference entities. The portion is typically denoted as a specified percentage range of aggregate losses (e.g., 2%-5%, meaning the credit protection seller would not make payments until aggregate losses exceed 2% of the notional of the transaction, and would no longer be obligated to make payments after aggregate losses reach 5%). SIFMA believes that tranched CDS should be categorized in the same manner as any index or basket CDS that is based on the characteristics of the underlying reference entity portfolio. Since the number of credit events necessary to reach and deplete the entire tranche will typically depend on the severity of loss associated with each credit event, it is not possible to know for certain at inception the number of credit events that will end up affecting actual payments. Furthermore, SIFMA believes that the categorization of a tranched CDS trade as a swap or security-based swap should not turn on the attachment and detachment points for a particular tranche. By treating index or basket CDS in the same manner as tranched index or basket CDS, the Commissions would establish rule that is easier to administer and consistent with how market participants view these products.

[33] ISDA Master Agreement section 1.18.

[34] Proposal at 29,849.

The Commissions should clarify that Title VII instruments based on a security index that may, but will not necessarily, change from narrow-based to broad-based, or vice versa, under a predefined formula should be characterized at execution as a swap or SBS, not a mixed swap.

SIFMA believes that the Commissions' intent in categorizing as a mixed swap a Title VII instrument on a security index that will change by a "predetermined self-executing formula" from narrow-based to broad-based is to capture only those Title VII instruments on indices that will change with certainty, not those that might change given specific market circumstances. SIFMA believes that the Commissions' statement that a Title VII instrument on a security index governed by a formula that "*would* cause" such a change means that the change in character must be a certainty in order for the instrument to be characterized as a mixed swap.[35] In contrast, indexes governed by a formula that may, under some market circumstances, lead to such a change should not cause Title VII instruments based on that index be treated as mixed swaps. Rather, they should be categorized based on their characteristics at the time of their execution.

The procedure for requesting joint interpretations from the Commissions of the characterization of a Title VII instrument should be modified.

SIFMA believes that the Commissions should modify the proposed process by which market participants would be able to request interpretations of the characterization of a Title VII instrument. First, SIFMA believes that, while awaiting a joint interpretation, market participants should be able to take counsel on whether a particular Title VII instrument is a swap, security-based swap or both. The swap and SBS markets are among the most dynamic financial markets and are characterized by frequent innovation and business opportunities. While SIFMA believes it is critical for market participants to be able to receive an interpretation of the characterization of these instruments, an interpretation is not helpful if the business opportunity giving rise to the request for the interpretation is no longer available at the time the interpretation is issued.[36]

As a result, SIFMA proposes that market participants unsure of the characterization of a transaction as either a swap, an SBS or a mixed swap be allowed to make a good faith characterization of the instrument and file a request for a joint interpretation while engaging in the transaction based on their initial

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[35] Proposal at 29,856 (emphasis added). This comports with the Commissions' own example provided in the proposal. "If a predetermined self-executing formula…provided that the security index underlying the Title VII instrument would decrease from 20 to 5 securities after six months…then the Title VII instrument would be a mixed swap." Proposal at 29,856 n.256.

[36] SIFMA believes that parties requesting such a joint interpretation should have the option to seek confidential treatment from the Commissions during the course of the review period in order to protect their propriety information and deal structures and seeks confirmation that such treatment will be available.

characterization. For subsequent trades, the parties to the original instrument, as well as all other market participants made aware of the Commissions' interpretation, would be bound by the interpretation. However, market participants should be assured that they will not face retroactive recharacterization of a trade executed before an interpretation was available to them. SIFMA notes that regardless of the initial characterization between swap, SBS or mixed swap by a market participant, either the CFTC or the SEC will serve as the regulator.

Second, SIFMA believes that the Commissions should be required to issue an interpretation for all requests submitted, but not withdrawn, by market participants. Currently, the Proposal allows the Commissions to choose not to provide an interpretation in any particular case and instead explain the reasons why they have not issued an interpretation. SIFMA believes that interpretations regarding characterizations of Title VII instruments are critically important for legal certainty in the swaps and SBS market and that the absence of an interpretation from the Commissions to respond to a difficult request will simply add uncertainty into the market, with different market participants taking different views on the treatment of the same instrument. To the extent the Commissions cannot agree on an interpretive issue, SIFMA believes that the Commissions should seek expedited judicial review.

The CFTC's anti-evasion proposal should be substantially narrowed to avoid unnecessarily limiting the ability of market participants to choose between legitimate structuring alternatives.

SIFMA believes that the CFTC's anti-evasion proposal is over-broad and unnecessarily limits the ability of market participants to choose between legitimate structuring alternatives. SIFMA believes that market participants should be free to weigh the nature and cost of regulation when considering legitimate structuring alternatives without fear of ex-post recharacterization of the transaction as a swap by the CFTC. If a market participant has a valid reason for pursuing one transactional form over the other, including the cost of regulation, that should be respected by the regulators, absent deceitful, deceptive, or illegitimate conduct. SIFMA is in agreement with Commissioner Sommers' dissenting statement that the CFTC is "over-reading its Congressional mandate" in "promulgating a broad [anti-evasion] regulation."[37]

SIFMA believes that the CFTC erred in stating that "deceitful, deceptive, or illegitimate conduct…is not a prerequisite for a finding of evasion."[38] SIFMA believes that an action must be either "deceitful, deceptive, or illegitimate conduct" to qualify as evasive under Title VII. Instead, the CFTC's proposal permits the CFTC to rely upon its own analysis of whether a transaction is

[37] Proposal at 29,899.

[38] Proposal at 29,867 n.326.

"structured in a manner solely motivated by a legitimate business purpose" to determine whether it is evasive.[39] Reducing costs is a legitimate business purpose absent harm to market participants or use of sham devices. As transactions are rarely, if ever, done "solely" for one purpose, this overbroad rule dramatically increases regulatory uncertainty and may have a chilling effect on legitimate non-swap transactional forms, in addition to increasing costs on both the CFTC and market participants.

In addition, the CFTC has proposed broad extraterritorial application of their anti-evasion provision.[40] Proposed Rule 1.6 under the CEA prohibits evasive activities conducted outside of the U.S., other than those structured as a security or SBS, and subjects those activities to treatment as swaps. SIFMA finds this anti-evasion authority somewhat circular because the fundamental question of which offshore transactions are subject to Title VII is not answered. To provide an important level of certainty to market participants, SIFMA believes that the CFTC should require deceitful, deceptive, or illegitimate conduct as a prerequisite to a finding of evasion.

SIFMA also believes that the Commissions should start with narrow anti-evasion rules and build those rules over time rather than beginning with a broad, potentially market-disrupting rule. Dodd-Frank gives both Commissions the authority to adopt anti-evasion rules in the future to deal with and adapt to problematic behavior.[41]

The Commissions should not extend the ECP "look-through" requirement to commodity pools with greater than $10 million in assets and the "look-through" requirement should apply only to direct, as opposed to indirect, participants in the pool.

SIFMA believes that the Commissions should not extend the ECP "look-through" requirement to commodity pools with greater than $10 million in assets. Section 721 of Dodd-Frank redefined ECP to, among other modifications, provide that a commodity pool with greater than $5 million in assets but less than $10 million in assets is not an ECP for retail foreign exchange purposes if one or more of its direct or indirect participants is not an ECP.[42] In their proposed rule further

[39] Proposal at 29,867.

[40] Proposed Rule 1.6 under the CEA, Proposal at 29,891-29,892.

[41] Dodd-Frank § Section 721(c) requires the CFTC to promulgate rules relating to anti-evasion. Dodd-Frank § Section 761(b)(3) give the SEC authority to promulgate rules relating to anti-evasion.

[42] Commodity pools with greater than $5 million but less than $10 million in total assets can only be an ECP if they are formed and operated by a commodity pool operator or a foreign person subject to comparable regulation. *See* CEA § 1(a)(18)(a)(iv). Dodd-Frank added to this provision the requirement that, for purposes of retail foreign exchange transactions, such
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defining ECP, the Commissions have proposed extending this "look-through" provision to all ECPs, regardless of assets. SIFMA believes that extending the look-through requirement to commodity pools with more than $10 million in assets is contrary to Congressional intent, as evidenced by the fact that Congress did not apply the look-through provision to all commodity pools, but instead applied it only within the prong of the ECP definition that relates to commodity pools with less than $10 million in assets.

In addition, SIFMA believes that the Commissions' look-through, regardless of the commodity pools to which it applies, should be limited to direct participants in the pool rather than extending to indirect participants. Attempting to look-through to the ultimate beneficial owner, which may be several steps removed from the direct participant, will be extremely difficult to apply and is not required by the language of Dodd-Frank.

SIFMA believes that the issues surrounding ECP eligibility for commodity pools are extremely important to the financial markets and could have significant effects if sophisticated and large commodity pools become non-ECPs and become subject to restrictions and limitations in foreign exchange transactions that are designed to protect truly retail investors. As a result, SIFMA plans to submit further commentary on this topic.

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commodity pools cannot have any direct or indirect participants that are non-ECPs. Commodity pools with greater than $10 million in assets can qualify as ECPs under CEA § 1(a)(18)(a)(v).

SIFMA appreciates the opportunity to provide the Commissions with the foregoing comments and recommendations regarding the further definition of product definitions contained in Title VII of Dodd-Frank. SIFMA would welcome the opportunity to further discuss our comments with you. Should you have any questions, please do not hesitate to call the undersigned at (202) 962-7400.

Respectfully submitted,

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cc: Honorable Gary Gensler, Chairman
Honorable Bart Chilton, Commissioner
Honorable Michael Dunn, Commissioner
Honorable Scott O'Malia, Commissioner
Honorable Jill E. Sommers, Commissioner
Commodity Futures Trading Commission
Honorable Mary L. Schapiro, Chairman
Honorable Luis A. Aguilar, Commissioner
Honorable Kathleen L. Casey, Commissioner
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Honorable Elisse B. Walter, Commissioner
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