July 23, 2012

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

Re: Joint Interim Final Rule regarding Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" (CFTC RIN 3235-AK65)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned joint interim final rule ("Interim Rule") of the Commodity Futures Trading Commission ("CFTC"). The Interim Rule prohibits the consideration of swaps entered for the purpose of hedging physical positions when the CFTC determines whether a person should be classified as a swap dealer ("SD").

INTRODUCTION AND SUMMARY

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") identified two groups of swaps market participants whose importance requires heightened regulation. SDs are to be regulated because of their widespread role in effectuating swap transactions with counterparties, while "major swap participants" ("MSPs") are to be regulated because of the sheer size of their positions and the systemic risk those positions may present. The law prescribes additional risk management controls for these entities, as well as data recordkeeping and reporting requirements and business conduct standards.

In defining MSPs, the CFTC has implemented an exclusion for swaps that mitigate or hedge commercial risk from the determination of whether a market participant's positions are sufficiently large to warrant MSP classification. In the Interim Rule, the Commission has implemented a similar exclusion for the SD calculation, but it has sought comment on "all aspects" of this approach—including "whether **any** exclusion of hedging swaps from the swap dealer analysis is appropriate."[2]

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[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.

[2] Release at 30613.

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The Interim Rule should be rescinded for the following reasons:

- The Interim Rule conflicts with the plain language and structure of the Dodd-Frank Act. The statute is clear in differentiating SDs from MSPs. In the MSP definition, there is indeed a statutory exclusion for swaps that are used to hedge risks. In the SD definition, there is no such exclusion. Thus, the law clearly does not envisage a hedging exclusion for SDs and standard rules of statutory construction prohibit one being read in when Congress clearly chose to leave it out.

- Furthermore, in the provisions of the Dodd-Frank Act that define SDs, Congress thoroughly considered and adopted numerous exemptions and exclusions, but it did not incorporate any exclusion relating to swaps used for hedging purposes. The only permissible conclusion to draw from this is that Congress intentionally and knowingly decided and intended not to have such exclusion. This is additional and compelling evidence that the Interim Rule impermissibly conflicts with the statute and Congress's intent.

- The Interim Rule is also conceptually inconsistent with the statutory definition of SD. The exclusion misses the defining characteristic of the SD designation, namely that it is targeted at a group of entities who perform a certain function in the market, regardless of what their motivations may be. The statute lists a number of defining characteristics of the **behaviors** of SDs, whereas for MSPs it lists characteristics of **positions**. Thus, SDs should be evaluated on their dealer-like behaviors alone (holding themselves out as dealers, taking both sides of the market, etc.), regardless of whether some of their positions hedge risks.

- The Interim Rule is based on the false assumption that dealing and hedging are essentially exclusive activities. Swap dealers frequently trade on both sides of the market, or across various linked markets, taking on risk in one location and laying it off elsewhere. In the Interim Rule, the CFTC attempts to differentiate "hedging" of this sort from *bona fide* hedging. However, in an environment where financial institutions are increasingly trading in physical commodity markets, and where commercial entities are operating large speculative swap desks, this distinction does not make sense for the purpose of identifying swap dealers. Thus, because swap dealers often "hedge" by trading both sides of the market, and because it is often difficult for the regulators to quickly distinguish this "hedging" from *bona fide* hedging when it takes place within large financial or commercial institutions, the CFTC should not implement a hedge exclusion for SDs.

- The Interim Rule also defeats the underlying purposes of dealer registration and regulation. Dealing activity raises at least two fundamental concerns that the Dodd-Frank Act sought to address through the SD regime: the threat of fraud and abuse directed at less sophisticated counterparties, and the threat of systemic risk arising from the very nature of swap transactions on a significant scale. Both of these threats arise regardless of whether a dealer is

hedging or not. Even assuming that systemic risk is mitigated when swaps are used for hedging purposes, the threat of abusive conduct by SDs persists regardless of the purpose for which swaps are entered. By excluding hedges from the activity that would necessitate SD registration, the Interim Rule insulates significant swaps activity from the protective provisions of the Dodd-Frank Act.

- Finally, the Interim Rule will create a potential loophole that will prove extraordinarily difficult to oversee and enforce. The core elements of the SD definition already pose significant challenges in oversight and enforcement, as they are often framed in terms that are ambiguous and nuanced. The potential hedging exclusion will needlessly complicate the CFTC's task, by requiring it to evaluate whether an entity's swaps transactions are true hedges of physical positions. Market participants can be expected to invoke this exception aggressively, and some will undoubtedly do so even when their activities fall outside the *bona fide* scope of the exception. This will result in much diminished market transparency and significantly heightened levels of abuse and risk which will only burden the CFTC's resources without serving any positive regulatory objective.

DISCUSSION

Statutory Definitions

The Dodd-Frank Act defines "swap dealer" in terms of the activities engaged in by market participants, with certain specified exclusions and exceptions.

> (A) IN GENERAL.—The term 'swap dealer' means any person who—
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> (i) holds itself out as a dealer in swaps;
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> (ii) makes a market in swaps;
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> (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
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> (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps,
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> provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.
>
> (B) INCLUSION.—A person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.

(C) EXCEPTION.—The term 'swap dealer' does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

(D) DE MINIMIS EXCEPTION.—The Commission shall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers. The Commission shall promulgate regulations to establish factors with respect to the making of this determination to exempt.[3]

This clearly contrasts with the definition of 'major swap participant,' which is defined by the nature of positions and the potential systemic effects of a default:

(A) IN GENERAL.—The term 'major swap participant' means any person who is not a swap dealer, and—

(i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding—

(I) positions held for hedging or mitigating commercial risk; and

(II) positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) ("ERISA") for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

(iii) (I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and

(II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission.[4]

The absence of any hedging-related exclusion in the statutory SD definition—in direct contrast with the MSP definition—clearly shows that Congress did not intend the CFTC to adopt the exclusion set forth in the Interim Rule.

As shown above, the MSP definition carves out an exclusion for "positions held for hedging or mitigating commercial risk." No such exclusion is present in the SD definition. Had Congress intended the CFTC to implement a hedging exclusion for SDs, they would

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[3] Dodd-Frank Act, Section 721(a)(49).

[4] Dodd-Frank Act, Section 721(a)(33)(A).

have included it in the statute, as they did for MSPs. The fact that they did not do so is clear proof that they intended there to be no such exclusion.

In the Release, the CFTC argues that because there is no explicit provision concerning a hedging exclusion in the SD definition, Congress intended to leave it to the CFTC's discretion.[5] This is an erroneous line of reasoning, since Congress **did** explicitly include such an exclusion for MSPs. The fact that they did not do so for SDs demonstrates that they did not consider it a discretionary matter. The Dodd-Frank Act includes many instances where Congress expressly identified matters over which the CFTC was expected to exercise its discretion, such as the small bank clause in the *bona fide* hedger exemption from mandatory clearing.[6] The SD definition is simply not one of those cases.

Long-standing, standard rules of statutory construction prohibit reading exclusion into a statute under these circumstances. This is not a close call. The claim for discretion is simply baseless.

The numerous other carve-outs in the SD definition show that Congress carefully considered the matter.

The definition of SD in the Dodd-Frank Act is striking in that it includes multiple carve-outs and exclusions:

- one for swaps entered in connection with loan originations;
- one more allowing for limited SD designation for a single type or class of swap;
- another one for entities that enter swaps for their own account and not as part of a regular business; and
- an additional one for de minimis levels of swap activity.

The inescapable conclusion is that Congress carefully and thoroughly considered multiple contours that frame the SD definition—fully cognizant of its enormous importance under the new regime for swaps regulation.

Thus, creating a major, new regulatory exclusion based on hedging activity is utterly inconsistent with this thoughtful and comprehensive Congressional approach.

The SD definition is about external behaviors in the marketplace, not internal risk characteristics.

The Interim Rule is also conceptually inconsistent with the statutory definition of SD. The exclusion misses the defining characteristic of the SD designation: it is targeted at a group of entities who perform a certain function in the market, regardless of what their motivations may be.

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5 Release, 30611

6 Dodd-Frank Act, Sec. §723 ("The Commission shall consider whether to exempt small banks" from the financial entity definition for purposes of the mandatory clearing exemption).

Congress enumerated a list of behaviors that it deemed to be characteristic of SDs. Among them is the concept that an SD "regularly enters into swaps with counterparties as an ordinary course of business for its own account." Whether a swap is entered to hedge pre-existing risk, or to take on new risk, is irrelevant to whether it is entered "as an ordinary course of business for [the entity's] own account." Therefore, the statute – again – is clear that hedging transactions are not to be excluded.

Nor is it reasonable or factual to exclude hedging transactions on the ground that they do not comprise a "regular business."[7] There is nothing in the nature of hedging to suggest that it cannot be considered a "regular business." Whether or not it does as a matter of fact constitute a "regular business" depends purely on the regularity with which it takes place. If a market participant regularly displays swap dealer-like behaviors in a particular market, and those behaviors also happen to consistently hedge risk, commercial or otherwise, then as a matter of fact its activity constitutes swap dealing. The fact that it frequently hedges via swap-dealing transactions demonstrates that hedging is, for that entity, a "regular business" and, therefore, one that qualifies it for swap dealer designation.

Swap dealers frequently enter swaps to hedge risk; these transactions should be counted when determining whether an entity is a dealer.

Among the CFTC's list of SD-defining behaviors is "mak[ing] a market in swaps."[8] Market-making has been extensively discussed in our letters on the Volcker Rule.[9] As the letters show, market-makers vary in the degree of hedging they carry out. Nevertheless, by virtue of the fact that they trade on both sides of the market, they frequently gather risks that they then lay off. Particularly in the swaps markets, where no asset is changing hands, this leads to many situations where exposures are netted out, i.e. where existing positions are "hedged." Indeed, the very act of holding oneself out on both sides of the market and seeking to profit from the spread—the very definition of market-making—is really no more than a constant back-and-forth between taking on new exposures and then laying them off. Excluding transactions that lay off risk from the SD calculation is therefore a mistake, as one characteristic of swap dealing is a large number of "hedging" transactions.

The Release incorrectly asserts that "in general, entering into a swap for the purpose of hedging is inconsistent with swap dealing." This is inaccurate, and it rests on an artificial distinction between "entering into swaps to satisfy the business or risk management needs of the counterparty" and "entering into swaps for the purpose of hedging one's own risks generally."[10] Such a distinction suggests that swap dealers are altruistic actors, selflessly holding themselves out to enter deals designed purely to benefit their grateful customers. In reality, swap dealers enter into swap deals with customers for one reason and one reason only: because they expect to profit from them. The classic

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7 Release at 30601

8 *Id.*

9 *See* Better Markets comment letter "Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds," February 13, 2012, *available at* http://www.federalreserve.gov/SECRS/2012/March/20120309/R-1432/R-1432_021312_105537_519233431691_1.pdf; and Better Markets comment letter "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds," April 16, 2012, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=57403&SearchText=.

10 Release at 30611, footnote 214.

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market-making model involves looking for deals on one side of the market (and dictating terms)[11] that will enable the market-maker to lay off the necessary risks it has taken on by entering previous deals on the other side of the market. In other words, it involves looking for and negotiating deals that allow the market maker (as well as their counterparties) to lay off risks.

Thus, far from being inconsistent with market-making, entering into a swap to hedge pre-existing risk is, in fact, a common characteristic of market-making.

Some might argue that this market-making paradigm is irrelevant to the Interim Rule, since the sort of hedging that takes place within the context of market-making is very different from the sort of hedging that the CFTC has apparently attempted to exclude in the Interim Rule, i.e. *bona fide* hedging or hedging of pre-existing commercial risk or physical positions. [12] However, the language in the Interim Rule is so broad that it is almost certain to be stretched to include routine swap dealing activities.[13]

Furthermore, the same arguments that apply in the broader case are equally applicable to the special case of physical hedging. As has been well documented,[14], large banks and other SDs have been acquiring large physical commodity operations, and trading heavily in physical markets. While there is a possibility that the Fed will ban this practice,[15] the CFTC cannot simply assume that this will happen, or that any action by the Fed will adequately address the issue. The fact remains that as long as SDs hold large physical inventory, they can (and do) make large speculative profits by trading between futures, physical, and swaps markets. To grant an exclusion for swaps that are matched with physical inventory would therefore risk enabling large traders whose primary business is speculative, and who do in fact deal swaps, to avoid the SD designation and the duties that entails. It would also create a huge incentive for these financial firms to become more directly involved in the physical markets, further contributing to the financialization of commodity markets, the devastating effects of which have been thoroughly demonstrated.[16]

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[11] *See* Better Markets comment letter "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds," April 16, 2012, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=57403&SearchText=.

[12] Release at 30612

[13] For example, the Interim Rule broadly encompasses hedging of "[l]iabilities that the person owns or anticipates incurring." Although this wide-open formulation appears to be limited by reference to swaps that represent a substitute for transactions "in a physical marketing channel," it also includes positions "to be taken by the person **at a later time**"—a reference that lends itself to expansive interpretation. Fortunately, in one of its more important provisions, the Interim Rule also attempts to limit abuse of the exclusion by prohibiting its use if the swap activity is "structured to evade designation as a swaps dealer." However, one can expect that to be particularly difficult to prove.

[14] *See* Sheppard, D. and Leff, J. "Wall Street, Fed face off over physical commodities," March 2, 2012, *available at* http://www.reuters.com/article/2012/03/02/us-fed-banks-commodities-idUSTRE8211CC20120302; and Sheppard, D. and Alper, A., "As banks deepen commodity deals, Volcker test likely," July 3, 2012, *available at* http://www.reuters.com/article/2012/07/03/us-commodities-forwards-banks-idUSBRE86206420120703.

[15] *See* Sheppard, D. and Leff, J. "Wall Street, Fed face off over physical commodities," March 2, 2012, *available at* http://www.reuters.com/article/2012/03/02/us-fed-banks-commodities-idUSTRE8211CC20120302.

[16] *See* Better Markets, "Position Limits for Derivatives," March 28th 2011, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34010&SearchText=better%20markets.

Nor is there any reason to create a physical hedge exclusion for non-financial firms. If a commercial firm is sufficiently active in dealing swaps, then it is a swap dealer. Congress recognized that swap dealers—whether commercial or financial— play a crucial systemic role, both in terms of risk and also orderly market function. A physical hedge exclusion that allowed firms engaged in swap dealing to avoid designation would therefore be directly inconsistent with Congress's clearly expressed intent.

The Interim Rule defeats the underlying purposes of swap dealer registration and regulation.

Swap dealing activity raises at least two fundamental concerns that the Dodd-Frank Act sought to address through the SD regime: the threat of fraud and abuse directed at less sophisticated counterparties, and the threat of systemic risk arising from the very nature of swap transactions on a significant scale. Both of these threats arise regardless of whether a dealer is hedging or not.

One of the main goals of Title VII in the Dodd-Frank legislation was to mitigate the systemic risk posed by swap dealers dealing in an enormous and opaque new market. Prior to the recent financial crisis swaps and swap dealers were, and today still are, interlinked via a gargantuan web of unknown exposures, with no meta-knowledge of exposures apparent to regulators, or anyone else. The mechanism of central clearing replaces the ungainly prior web of swap dealer and customer risks with a central hub and spoke model of risks designed to provide the swaps market with real transparency and structure. However, this framework really only works to reduce systemic risk which is embedded in the swaps market if the vast majority of swaps are cleared. In fact, each time a swap that should be cleared is not, whatever the excuse may be, the broader system loses, and the public is once again a step closer to another systemic financial collapse brought about via the unknown risks embedded in the OTC swap market.

Further, even if one were to assume that systemic risk is somehow mitigated when swap dealers use swaps to hedge physical positions, the threat of abusive conduct by SDs persists, **regardless** of the purpose for which the swaps are entered. By excluding such hedges from the activity that would necessitate SD registration, the Interim Rule would insulate a significant amount of swaps activity from the protective provisions of the Dodd-Frank Act.

The Interim Rule will create a potential loophole that will prove difficult to oversee and enforce.

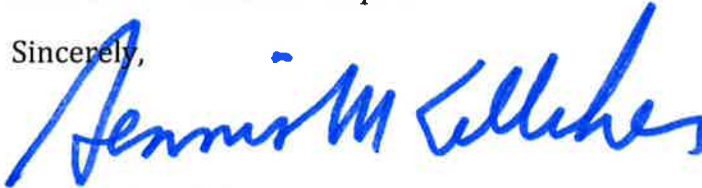
The core elements of the SD definition already pose significant challenges in oversight and enforcement because they are framed in terms that are often ambiguous and nuanced. The hedging exclusion will needlessly complicate the CFTC's duty to regulate SDs by requiring it to evaluate whether an entity's swap transactions are true hedges of physical positions.

Market participants can be expected to invoke this exception aggressively, and some will undoubtedly do so even when their activities fall outside the *bona fide* scope of the exclusion. This will result reduced swaps market transparency, heightened levels of abuse and risk, and it will burden the CFTC without serving any positive regulatory objective.

CONCLUSION

In short, there should be no hedging exclusion for swap dealer designation. We hope you find these comments helpful.

Sincerely,



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