October 12th, 2012

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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," "Product Definitions Rule") of the Commodity Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC") (the CFTC and the SEC collectively referred to as the "Commissions"). The Release clarifies the definitions of swap, security-based swap ("SBS"), security-based swap agreement, and mixed swap pursuant to and in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

To protect against another crippling financial crisis, Congress mandated strong and direct regulation of the previously unregulated over-the-counter ("OTC") derivatives market. The Product Definitions Rule is the linchpin of this new regime, with the potential to implement the law comprehensively and rigorously, or to create huge and dangerous loopholes, depending on the quality of its definitions and exceptions.

[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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Recognizing this fact, the Commissions have solicited additional comment on the narrow issue of a revamped approach to embedded optionality in forward purchase agreements.[2] We believe the Commissions' revised approach is fundamentally sound, and we offer some specific comments.

SUMMARY OF COMMENTS

The Commissions have proposed a three-part test for embedded price optionality and a seven-part test for volumetric optionality to distinguish genuine forwards from swaps. These tests must be effective or else they will create a large loophole. In addition, the exclusion for forward contracts must not be allowed to be used to evade the regulatory requirements governing swaps and SBS.

In a previous letter to the Commissions,[3] Better Markets argued that:

- A test to distinguish forwards from swaps must capture the economic realities of the instruments, rather than allowing certain formalistic traits to supersede the actual use to which the contracts are put.

- The Commissions 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.

- The Commissions 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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[2] Release 48241.

[3] Better Markets Comment Letter, "Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping," 5-8, July 22, 2011, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47905&SearchText=better%20markets.

We believe the three-part test for embedded optionality and the seven-part test for embedded volumetric optionality set forth in the Release adequately address these concerns.

COMMENTS

The definitions of swaps and SBS exclude forward contracts. However, forward contracts have presented major interpretive difficulties in the past,[4] 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**.

Allowing swaps to masquerade as exempted forwards would create a large and dangerous loophole within the commodity derivatives markets. This risk is not a mere possibility. It is a virtual certainty given the industry's demonstrated ability, indeed zeal, to tailor the form of financial instruments for the sole purpose of avoiding regulation. If not prevented now, this evasion-enabling loophole will become so large that it will de facto nullify the rule.

With this in mind, the Commissions have proposed two tests to distinguish genuine forwards from swaps, one relating to price optionality embedded in forward contracts, and one relating to volumetric optionality in forward contracts. Each of these tests supplies essential safeguards that are necessary to close potential loopholes in the forward exemption, as identified by Better Markets in its previous comment letter.[5]

- The delivery requirements in part 2 of the price optionality test and parts 2, 4, and 5 of the volumetric optionality test require that the intent to deliver is present at inception and that delivery is the predominant feature of the contract. The guidance notes that price optionality will eliminate the eligibility of a contract for exempt status if it targets the delivery clause of the contract. Similarly, in the volumetric case, delivery must remain the predominant feature of the contract.

- This will also help prevent abuses of the Brent Interpretation, since repeated booking out of forwards will undermine any claims of intent to deliver, violating the requirements listed above, and thereby opening the violators to retroactive

[4] 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.

[5] *See* discussion *supra* and note 3.

punishment. For this reason, the delivery and intent to deliver conditions should also be explicitly extended to all forwards, not just those containing embedded optionality.

- The fact that the option cannot be detached and separately marketed from the rest of the contract ensures that the forward exemption cannot be used as a loophole for entering into commodity options without falling under the general clearing and reporting requirements for those instruments.

- The exercise or non-exercise clause in part 7 of the volumetric optionality test stipulates that the embedded optionality must be triggered by commercial, rather than financial factors.

Thus, the proposed tests should adequately capture the factors necessary to ensure that the narrow forward exemption provided for in the Dodd-Frank Act is faithfully implemented, and a loophole is avoided. However, the Commissions must collect and examine data over the next 6 to 12 months (and periodically thereafter) on claimed exemptions to ensure that the tests are working as designed and are having the intended result of eliminating evasion.

ECONOMIC ANALYSIS

The approach in the Release

The Release makes clear that the CFTC and the SEC have each satisfied their respective duties with respect to considering the economic impact of the Product Definitions Rule. Moreover, both Commissions have examined those economic impacts not only with respect to each component of the Rule, but also, as is appropriate, from a broader and more holistic perspective.

For example, on a detailed level, the Release reviews how each definition in the Rule will reduce "assessment costs" by increasing legal certainty about whether a number of specific instruments will be subject to regulation under Title VII. The Release further examines how the definitions will help prevent evasion of the regulatory scheme by encompassing **all** instruments that should be subject to regulation under Title VII.

In addition—and of critical importance—the Release reveals that each Commission has appropriately considered the broader "programmatic" benefits that arise from the definitions. First, the Release describes the all-important context in which the implementation of Title VII is occurring. It reviews the crippling financial crisis that starkly demonstrated the urgent need for much stronger and more comprehensive regulation of financial firms and the derivatives markets in particular:

> In the fall of 2008, an economic crisis threatened to freeze the U.S. and global credit markets. The Federal government intervened to buttress the stability of the U.S. financial system. The crisis revealed the vulnerability of the U.S. financial system and economy to wide-spread systemic risk resulting from, among other things, poor risk management practices of certain financial firms and the lack of supervisory oversight for financial institutions as a whole. More specifically, the crisis demonstrated the need for regulation of the over-the-counter derivatives markets.[6]

Second, the Release goes on to describe the comprehensive new regulatory framework for swaps and SBS established in the Dodd-Frank Act, aimed at reducing risk, increasing transparency, and promoting market integrity.[7]

Third, with respect to the Product Definitions Rule specifically, the Release explains that the definitions will trigger many of the "programmatic benefits" of the entire array of protections afforded under Title VII. The Release summarizes those fundamental benefits and it correctly includes the ultimate benefit of avoiding another financial crisis:

> By fulfilling the statutory mandate [to establish definitions], many of the programmatic benefits of Title VII and the CFTC's implementing regulations are triggered, including risk reduction, increasing transparency, and promoting market integrity and, by extension, **the increased possibility of preventing or reducing the severity of another global financial crisis such as occurred in 2008.**[8]

Finally, the Release observes that these programmatic benefits are difficult to quantify and measure, but "can be expected to manifest themselves over the long run and be distributed over the market as a whole."[9]

As explained more fully below, the historical context in which all of the Dodd-Frank Rules are being promulgated, and a more holistic view of the economic impact of those rules across the entire market and over time, are extremely important and must be considered in any economic analysis under the Commodity Exchange Act or the securities laws. Both Commissions are to be commended for incorporating this perspective.

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6 Release at 48307; *see also* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf. Both this Report and the Report referenced *infra* note 16 are incorporated by reference as if fully set forth herein.

7 Release at 48307-08.

8 *Id.* at 48309 (emphasis added).

9 *Id.* at 48310.

The persistent and unfounded criticisms from industry regarding economic analysis

Even when the Commissions have clearly fulfilled their respective duties to consider the economic impact of their rules, as set forth in their respective statutes, representatives from industry have nevertheless challenged proposed rules claiming – without merit – that the Commissions failed to appropriately conduct what the industry refers to as "cost-benefit analysis."[10] (It must be noted, however, that what the industry is really arguing for is an "industry cost-only analysis.")

These attacks rest on a series of fundamentally flawed claims. For example, in challenging rules promulgated by the CFTC, the industry has:

(1) greatly exaggerated the actual duty imposed on the CFTC by its governing statute, Section 15(a) of the CEA;

(2) entirely disregarded the paramount statutorily required role of the public interest in the rulemaking process; and

(3) indefensibly ignored the enormous cost of the financial crisis and the benefit of the rules designed to help prevent a recurrence of that crisis or something far worse.[11]

Core principles that must apply to economic analysis

To analyze these attempts to undermine financial reform on what industry claims to be cost-benefit grounds, it is vitally important to bear in mind several core principles that accurately define the true nature and scope of the obligation that each Commission has when considering the economic impact of its rules.

1. *Under the CEA and the securities laws, neither the CFTC nor the SEC has any statutory duty to conduct cost-benefit analysis; in fact, their far more narrow obligation is simply to consider certain factors related to the public interest.*

Section 15(a) of the CEA imposes a limited obligation on the CFTC simply to "consider" the costs and benefits of its rules in light of five specified public interest factors. [12] Similarly, the securities laws only require the SEC to "consider, in addition

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[10] As detailed in Appendix B to BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf, the Business Roundtable case is an excellent example of both a meritless industry challenge and a court that misread and misapplied the statute.

[11] *See* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf.

[12] Better Markets has set forth a comprehensive analysis regarding the scope of Section 15(a) in the *amicus curiae* brief it filed in support of the Commission in *ISDA v. CFTC*, Civil Action No. 11-cv-2146 (RLW), *available at*

to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[13]

Congress's careful choice of words in these statutes, and the case law construing similar provisions, make clear that each agency has broad discretion in discharging their respective duties. In fact, the Supreme Court has long recognized that when statutorily mandated considerations are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty.[14]

In fact, neither the CFTC nor the SEC has any statutory or other obligation to quantify costs or benefits, weigh them against each other, or find that a rule will confer a net benefit before promulgating it. The rationale for this flexible obligation in the law is clear: requiring the these financial regulators to conduct a resource intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives.

2. *The Commissions must be guided by the public interest as they consider the economic impact of their rules, not by concerns over the costs of regulation imposed on industry.*

The five factors that the CFTC must consider as specified in Section 15(a) reflect Congress's primary concern with the need for regulations that serve the public interest and accomplish the agency's mission, not with a need to spare industry the costs of regulation. Without exception, each factor relates to a public benefit that

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http://bettermarkets.com/sites/default/files/Corrected%20Brief%20of%20Better%20Markets%20as%20Amicus%20Curiae%20in%20Support%20of%20Defendant%20CFTC%20Apr.%2030,%202012.pdf ("*Amicus* Brief"). In that case, representatives of industry challanged, *inter alia*, the Commission's consideration of costs and benefits in connection with the position limits rule. *See also* Better Markets *Amicus* Brief filed in another case challenging a different rule, *available at* http://bettermarkets.com/sites/default/files/ICI%20v.%20CFTC%20-%20Amicus%20Brief%20of%20Better%20Markets%20June%2025,%202012.pdf. In addition, Better Markets has written to the Office of Management and Budget ("OMB") opposing CFTC Commissioner Scott O'Malia's request that OMB review the cost-benefit analysis performed by the Commission in connection with several recently finalized rules. Letter from Better Markets to Jeffrey Zients, Acting Director of OMB (Feb. 29, 2012) ("Letter to OMB"), *available at* http://bettermarkets.com/sites/default/files/O'Malia%20CBA%20letter%20to%20OMB.pdf. In the Letter to OMB, Better Markets makes clear that various executive orders and OMB guidelines requiring cost-benefit analysis are inapplicable to the Commission's rulemaking. Both *Amicus* Briefs and the OMB Letter are incorporated by reference as if fully set forth herein.

[13] 15 U.S.C. § 77b(b) (amending the Securities Act of 1933); 15 U.S.C. § 78c(f) (amending the Securities Exchange Act of 1934); 15 U.S.C. § 80a-2(c) (amending the Investment Company Act of 1940); 15 U.S.C. 80b-2(c) (amending the Investment Advisers Act of 1940) (emphasis added); *see also* 15 U.S.C. § 78w(a)(2) (requiring consideration of the impact of a rule on competition).

[14] *Sec'y of Agric. v. Cent. Roig Ref. Co.*, 338 U.S. 604, 611 (1950).

arises from a robustly regulated marketplace, including preventing abuse, promoting competition, enhancing transparency, and limiting systemic risk.[15]

Tellingly, none of the factors listed in the statute mentions any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements. Removing any doubt, the fifth and final factor in Section 15(a) requires the CFTC to consider generally "any **other public interest** considerations."[16]

It is equally clear under the securities laws that the SEC's primary mission is to protect investors and the public interest **notwithstanding** the costs of regulation to the financial industry. This follows not only from the language, structure, and purposes of the securities laws (as reflected in the statutory language and innumerable Supreme Court decisions), but also from legislative history expressly declaring that the SEC's preeminent mission to protect investors is not to be subordinated to considerations regarding the economic impact of its rules. This is all detailed in a recent report "Setting the Record Straight on Cost Benefit Analysis and Financial Reform at the SEC."[17]

3. *For any rule promulgated in accordance with the Dodd-Frank Act, the ultimate "public interest consideration" is implementing the reforms that Congress passed to prevent another financial crisis.*

As the CFTC and the SEC consider the ecomomic impact of their rules implementing the Dodd-Frank Act, they must give proper weight to Congress's overriding objective: to institute a comprehensive set of reforms, including a regime for regulating swaps, to prevent another financial collapse and economic crisis, including trillions of dollars in financial losses and incalculable human suffering. The dollar cost alone of the financial collapse and still-unfolding economic crisis comes to at least $12.8 trillion.[18] Therefore, as the CFTC assesses the costs and benefits of proposed rules under Section 15(a), and as the SEC considers whether its rules will promote efficiency, competition, and captital formation, they must each continue to consider, above all, the benefits of the entire collection of reforms embodied in Title VII and the Dodd-Frank Act, of which any specific rule is but a single, integral part.

Congress's resolve to prevent another massively costly financial crisis clearly overrides industry's claimed cost concerns under the Dodd-Frank Act. Congress passed the Dodd-Frank Act knowing full well that it would impose significant costs on industry, yet it determined those costs were not only justified but necessary to stabilize our financial system and avoid another financial crisis. Those costs include the elimination of extremely profitable lines of business as well as

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15 7 U.S.C. § 19(a)(2).

16 7 U.S.C. § 19(a)(2)(E) (emphasis added).

17 Better Markets, Setting The Record Straight On Cost-Benefit Analysis And Financial Reform At The SEC (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf.

18 *See* Report, *supra* note 11.

significant and ongoing compliance costs. A leading example is the establishment of the new, comprehensive regulatory regime for swaps. It will require the financial industry to incur significant costs arising from new personnel and technology, ongoing compliance, margin and collateral, and reduced revenues and profits.

Importantly, the financial reform law and the rules implementing it do not, in fact, add any incremental costs (or, if they do, those costs are de minimis). The real question is who pays the costs: industry in a regulated environment that prevents financial failure and bailouts or the public and society paying to stop the failure and respond to the economic crisis it creates.[19]

Congress fully understood this. It knew that re-regulation would impose costs on the industry, in some cases totaling billions of dollars. The Dodd-Frank Act reflects Congress's unflinching determination to shift the costs of de-regulation and non-regulation of the financial industry back to the industry from a society that has paid and continues to pay the bill for industry's unregulated excesses. In substance, Congress conducted its own cost-benefit analysis and concluded that the enormous collective benefits of the law far exceeded the costs and lost profits that industry would have to absorb.[20]

Indeed, against the backdrop of the worst financial and economic crises since the Great Depression, it is inconceivable that Congress would enact sweeping reforms and then allow the implementation of those reforms to hinge on the outcome of a biased cost-benefit analysis that ignored the overriding purpose of the new regulatory framework—and that gave controlling weight to cost concerns from the very industry that precipitated the crisis and inflicted trillions of dollars in financial damage and human suffering across the country.

In short, the following analytical framework must guide any consideration of the economic impact of rules implementing the Dodd-Frank Act.

- Congress's ultimate objective in the Dodd-Frank Act was to prevent another crisis and the massive costs it would inflict;
- The Product Definition Rule is an integral component of the reforms that Congress decided were necessary to achieve this objective; and
- The costs of compliance and reduced profits that industry may have to absorb by virtue of the reforms in Title VII, as well as the entire Dodd-Frank Act, pale in comparison with the benefits of preventing another crisis—a benefit that can be valued at over $12.8 trillion.

[19] *See supra* note 17 at 39-44
[20] *Id.* at 43.

Analyzed this way, as required by the statutes, the Commissions have satisfied the statutory obligations to conduct the appropriate economic analysis.

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. Having implemented the previously suggested improvements, the definitions will now have the breadth necessary to reach all of the activity that Congress intended to regulate under the Dodd-Frank Act. Preventing loopholes as discussed above will finish the job (which will have to be monitored and checked to ensure that the tests work as intended).

We hope these comments are helpful.

Sincerely,

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