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Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: *De Minimis* Exception to the Swap Dealer Definition, RIN 3038-AE68

Dear Secretary Kirkpatrick:

The Institute of International Bankers (the "**Institute**") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "**Commission**") in response to the above-captioned proposal (the "**Proposal**")[1] regarding the *de minimis* exception to the "swap dealer" definition in the Commission's regulations (the "***De Minimis* Exception**"). The *De Minimis* Exception is one of the key building blocks of the Commission's regulatory regime under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"), and its calibration requires a careful balance of competing regulatory objectives, which is based on detailed analysis of market data.

We support the Commission's proposal to provide the market with legal certainty by fixing the *De Minimis* Exception's aggregate gross notional amount ("**AGNA**") threshold at its current $8 billion level. We also support the Commission's efforts to promote loan origination and hedging activity through the Proposal's exclusions. As described below, however, we think that additional steps are necessary to succeed in these efforts.

[1] 83 Fed. Reg. 27,444 (June 12, 2018).

In particular, the Commission should take the steps we outline below to expand the ability of foreign banks to participate in the U.S. swap markets by (i) providing hedges to their lending customers, (ii) hedging their own risk, and (iii) providing liquidity to U.S. dealers, who may otherwise need to redirect swap transactions through their foreign branches. Taking these steps is particularly important given the role foreign banks play in the U.S. corporate and industrial lending markets and the U.S. securities markets. In the aggregate, the Institute members' U.S. operations have approximately $5 trillion in assets, fund approximately 25% of all commercial and industrial bank loans made in this country and contribute significantly to the depth and liquidity of U.S. financial markets. In addition, many foreign banks participating in the U.S. markets have a market profile similar to domestic regional and community banks. These smaller foreign banks should benefit from the same regulatory treatment that the Commission affords those domestic banks.

I. The *De Minimis* Threshold

A. AGNA Threshold

Consistent with our prior submission to the Commission on this topic,[2] we believe that calibrating the *De Minimis* Exception based on market data is the only way to ensure that the exception effectively promotes swap market competition and liquidity without materially reducing the scope of activity covered by swap dealing regulation. We therefore appreciate the Proposal's examination of swap data repository ("**SDR**") data.

We agree that the data make clear that a reduction in the *De Minimis* Exception's AGNA threshold to $3 billion would not materially increase the amount of swap activity subject to swap dealer regulation, but would likely decrease market competition and liquidity.[3] We accordingly support the Commission's proposal to fix the AGNA threshold at $8 billion instead of letting it decline to $3 billion.

After fixing the AGNA threshold at $8 billion to resolve the uncertainty currently posed by a potential decrease in the threshold to $3 billion, the Commission should continue to evaluate SDR data to determine if an increase in the threshold would be appropriate. For example, we note that the SDR data compiled by the Commission's staff show that an increase of the AGNA threshold to $20 billion would result in only a minimal reduction of regulatory coverage of the swap markets, across all the Commission's metrics.[4] Even such a modest

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2 *See* Letter from IIB dated January 19, 2016, attached as Appendix A.

3 Proposal at 27,453.

4 According to that data, increasing the AGNA threshold from $8 billion to $20 billion would only result in a 0.05% decrease in the number of interest rate swap, credit default swap ("**CDS**"), foreign exchange-related swap and equity swap transactions subject to swap dealer regulation, a 0.01% decrease in the AGNA of such transactions

increase would, however, provide a meaningful benefit to banks and their customers by allowing for limited ancillary dealing activity without materially reducing the extent of swap activity subject to swap dealer regulation.

B. Counterparty Count Threshold

1. Addition of a Counterparty Count Threshold

Although tenors and notional amounts vary dramatically across asset classes, the *De Minimis* Exception relies on a standalone AGNA threshold to determine whether a person's swap dealing activity is sufficiently extensive to merit swap dealer registration. This singular focus has arbitrarily limited the availability of the *De Minimis* Exception to entities that enter into foreign exchange-related swap transactions, because those transactions tend to have relatively shorter tenors and are often amended or terminated and replaced with new positions prior to maturity. It also arbitrarily limits the exception's availability to entities that enter into interest rate swap transactions, which tend to have higher notional amounts relative to their risks.[5] As a result, the AGNA of such transactions can effectively be multiples of the AGNA of other types of transactions that present greater underlying risk and involve similar counterparty interactions.

As a result, a small foreign bank that enters into a small number of rate swaps or foreign exchange-related swaps with a relatively small number of customers (as is common for swaps offered to banking customers) will often exceed the $8 billion threshold. These types of swaps are often ancillary to banking activities, such as customers' hedging swaps connected to their commercial lending, export credit or business combination transactions (*e.g.*, a foreign exchange hedge between the signing and closing of an acquisition).

An additional threshold relating to a person's number of counterparties would help to avoid these arbitrary outcomes by taking into account more characteristics of a person's swap activities. In particular, adding a counterparty count threshold would help to ensure that a

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covered by swap dealer regulations, and a 2.8% decrease in the total percentage of counterparties to such transactions covered by swap dealer regulation. Proposal at 27,454-56.

5 For example, a recent weekly swaps report from the Commission notes that the total gross notional outstanding in interest rate swaps is more than 71 times larger than the outstanding notional in credit swaps. *See* Weekly Swaps Report released August 1, 2018, *available at*: https://www.cftc.gov/sites/default/files/idc/groups/public/%40swapsreport/documents/file/CFTC_Swaps_Report_08_01_2018.xlsx (noting the current outstanding notional for the CDS market is $ 3,835 trillion versus $273,633 trillion in the interest rate market). Further, the minimum block size for super-major currencies of tenors less than or equal to 46 days is $6.4 billion, which represents a level that would result in roughly 50% of the total notional amount of such swaps qualifying as block trades. *See* Appendix F to Part 43 of Commission Regulations. By contrast, the largest minimum block size for a credit swap is $320 million.

person does not become subject to swap dealer registration solely because the person's gross notional amount of swap dealing activities with a small number of counterparties was artificially inflated by a handful of large transactions or by amendments or terminations of a small subset of transactions.

Importantly, an additional counterparty count threshold would be relatively efficient for firms to implement. Because the thresholds would apply conjunctively (*i.e.*, a person would need to exceed both the AGNA threshold and the counterparty count threshold to lose eligibility for the *De Minimis* Exception), firms could, at their election, choose to continue solely to track their AGNA, choose to track their number of counterparties or choose to track both thresholds.

Similar to the AGNA threshold, the calibration of the dealing counterparty count threshold should be based on market data and a comprehensive analysis as to what calibrations will allow greater competition and ancillary dealing activity without materially reducing the extent of swap activity subject to swap dealer regulation.[6]

2. Exclusion of Transactions with Swap Dealers from Counterparty Threshold

The counterparty count threshold should exclude swaps opposite registered swap dealers. Excluding registered swap dealers from the threshold would not materially decrease Commission oversight of the swap market or otherwise conflict with the aims of swap dealer regulation. All swaps involving a U.S. swap dealer counterparty will still be subject to Dodd-Frank's clearing, trade execution, margin, segregation, documentation, confirmation, portfolio reconciliation and compression and recordkeeping requirements. In the case of foreign banks that would rely on the *De Minimis* Exception, comparable home country capital requirements will also typically apply. In addition, inter-dealer swaps do not pose the same sales practice and counterparty protection concerns as dealer-customer swaps, as evidenced by the many exceptions from external business conduct standards that apply to inter-dealer swaps.

This exclusion would have important benefits for the financial stability of U.S. swap dealers. Foreign banks are often the key sources of liquidity for rates and foreign exchange derivatives denominated in or related to less commonly traded foreign currencies, particularly for U.S. swap dealers in need of hedging opportunities. Excluding transactions with swap dealers from the dealing counterparty count threshold would encourage these foreign banks to either return to the U.S. market or step up their U.S. activities. This would facilitate the ability

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6 For example, based on the SDR data compiled by the Commission's staff, 83% of registered swap dealers had 10 or more reported counterparties, while approximately 97% of unregistered entities had fewer than 10 counterparties. Proposal at 27,449.

of U.S. swap dealers to engage in hedging and other trading activities in non-U.S. markets and to provide liquidity in non-U.S. underliers to their U.S. customers.[7]

Excluding registered swap dealers from the counterparty count threshold would also be consistent with the Commission's recognition that non-dealers tend to enter into swaps with swap dealers more often than with other non-dealers.[8] Additionally, the exclusion would help to implement the statutory text of the *De Minimis* Exception, which specifically requires the Commission to "exempt from designation as a swap dealer an entity that engages in a *de minimis* quantity of swap dealing in connection with transactions <u>with or on behalf of its customers</u>."[9] In particular, if a person's number of non-dealer counterparties falls below a *de minimis* threshold, then the gross notional amount of the person's swap dealing transactions is less likely to be composed of transactions with or on behalf of customers. In contrast, if a person has more than a *de minimis* number of non-dealer counterparties, then even its swap dealing transactions with registered swap dealers are likely to be connected with its transactions with or on behalf of customers.

3. No AGNA Backstop

Limiting the availability of the counterparty count threshold to entities whose swap activity falls below an AGNA threshold is unnecessary to serve the goals of swap dealer regulation and would re-inject the arbitrariness that a dual-factor threshold is meant to solve. Such a backstop could limit the ability of foreign banks to offer interest rate and foreign exchange hedges, but impose no such limitation to a similarly situated bank whose customers are looking to enter into credit or equity swaps. As discussed above, these kinds of distinctions would not only be arbitrary, but also prevent small foreign banks from providing hedging transactions to U.S. swap dealers in respect of illiquid currencies.

4. Affiliated Entities as a Single Counterparty

A counterparty count threshold should treat non-swap dealer counterparties that are subject to common control as a single counterparty.[10] This approach is consistent with many

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[7] Similar considerations have long supported a similar exemption in the securities broker-dealer context. *See* Securities Exchange Act Rule 15a-6(a)(4)(i) (exempting a foreign broker-dealer's securities transactions with an registered broker-dealer).

[8] *See* 77 Fed. Reg. 30,596, 30,598 (May 23, 2012) ("**Entity Definitions Adopting Release**"); Proposal at 27,449 (noting that 97% of unregistered entities had fewer than 10 counterparties).

[9] Section 1a(49)(D) of the Commodity Exchange Act ("**CEA**") (emphasis added).

[10] Swap dealer counterparties should also be subject to this treatment if they are not otherwise excluded from the counterparty count threshold. For non-U.S. *de minimis* dealers, U.S. counterparties subject to common control would be treated as single counterparty.

of the Commission's Title VII rules that require consolidation of affiliates, including in the *De Minimis* Exception itself and the Commission's uncleared swaps margin rules.[11] In the uncleared swaps margin rules, the Commission requires consolidation of not only the covered swap entity's margin affiliates, but also those of the covered swap entity's counterparty. As that approach implicitly recognizes, counterparties may enter into swaps through a particular entity for funding, tax or other reasons. For instance, a manufacturer with different subsidiaries in Japan and France may enter into Yen-Dollar swaps through its Japanese entity and Euro-Dollar swaps through its French entity so as to avoid complications resulting from transferring funds across affiliates. Nonetheless, in many instances, the relationship between the swap parties is on a group level. As a result, treating each legal entity as a separate counterparty would inject into the dealing counterparty count threshold the kinds of arbitrary results that the threshold would be intended to eliminate.

D. Delegation of Authority to DSIO to Determine Notional Amounts

The Commission proposes to delegate authority to the Director of the Division of Swap Dealer and Intermediary Oversight ("**DSIO**") to determine the methodology used to calculate the notional amount for any group, category, type, or class of swaps for purposes of the AGNA threshold calculation.[12] We agree that this delegation is appropriate to provide the flexibility such determinations would require. Codifying all permitted methodologies or requiring other Commission action to approve each new methodology would not be sufficiently responsive to market changes.

However, we recommend that the Commission require DSIO to provide the public with prior notice of any such proposed determinations and an opportunity to provide feedback. This would help ensure that the methodologies are "economically reasonable and analytically supported" as the Commission requires[13] and meet the Commission's stated purpose of being responsive to changing market conditions.

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11 *See* 17 C.F.R. § 1.3, definition of "swap dealer," paragraph (4)(i)(A); *see also* 17 C.F.R. § 23.161 (setting the compliance dates for the Commission's uncleared swaps margin rules based on the AGNA of uncleared swaps of a covered swap entity and its margin affiliates and the covered swap entity's counterparty and the counterparty's margin affiliates); 17 C.F.R. § 23.151, definition of "initial margin threshold amount" (defining the initial margin threshold amount under the Commission's uncleared swaps margin rules as the size of the exposure resulting from all uncleared swaps between a covered swap entity and its margin affiliates on the one hand, and a covered counterparty its margin affiliates on the other).

12 Proposal at 27,464-65.

13 *Id.*

II. Transactional Exclusions

A. Loan Origination Exclusion

We support the exclusion from the *de minimis* threshold for swaps entered into in connection with loan origination (the "**Proposed Loan Origination Exclusion**"),[14] but we recommend that the Commission expand the exclusion to cover U.S. branches and agencies of foreign banks in addition to U.S. insured depository institutions ("**IDIs**").[15] Preventing U.S. branches and agencies of foreign banks from relying on the Proposed Loan Origination Exclusion would unnecessarily discourage foreign banks' participation in the U.S. swap and loan markets, reducing credit available to U.S. companies.

There also is no clear regulatory justification for applying worse treatment to foreign banks than U.S. IDIs under the Proposed Loan Origination Exclusion. Foreign banks' U.S. branches and agencies are subject to prudential regulation that is similar to the regulation of U.S. IDIs, and they are treated like U.S. IDIs for many purposes under U.S. law.[16] In addition, by statute, both uninsured and insured U.S. branches and agencies of foreign banks may receive discount window advances on the same terms and conditions that apply to domestic insured state member banks.[17]

The Commission has full legal authority to put U.S. branches and agencies of foreign banks on the same level playing field as U.S. IDIs for purposes of the Proposed Loan Origination Exclusion. When it adopted the existing swap dealer definition exception for swaps related to loan origination, the Commission and Securities and Exchange Commission (the "**SEC**") asserted that the text of CEA Section 1a(49)(A) constrained their ability to make the

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14 We also note that the Commission previously clarified that a swap may continue to qualify for the existing swap dealer definition exception for loan origination even if an IDI later transfers or terminates the loan in connection with which the swap was entered into, so long as the swap otherwise qualifies for the exception and the loan was originated in good faith and not a sham. Entity Definitions Adopting Release at 30,623. A question has arisen as to whether the exception would continue to apply if, following such a transfer, the IDI amends, novates or partially terminates the related swap to conform to changes in the terms of the loan. We ask that the Commission confirm that the swap resulting from any such amendment, novation or termination may also qualify for the existing exception and the Proposed Loan Origination Exclusion.

15 Proposal at 27,458-62.

16 *See* Cleary Gottlieb Steen & Hamilton LLP, David Polk & Wardwell LLP and Sullivan & Cromwell LLP, *White Paper on the Separate Entity Doctrine as Applied to the U.S. Branches of Foreign Headquartered (Non-U.S.) Banks* (April 18, 2012), *available at* https://www.clearygottlieb.com/-/media/organize-archive/cgsh/files/publication-pdfs/white-paper-on-the-separate-entity-doctrine.pdf.

17 Section 13(14) of the Federal Reserve Act; 12 U.S.C. § 347d.

exception available to entities other than U.S. IDIs.[18] No such constraint exists with respect to the Proposed Loan Origination Exclusion, as the Commission is acting pursuant to its authority under CEA Section 1a(49)(D), rather than Section 1a(49)(A). Indeed, the Commission and SEC specifically noted that the *De Minimis* Exception was the mechanism through which the Commission could address undue competitive disparities: "Regarding some commenters' statements about the competitive effect of this interpretation of the term 'insured depository institution,' we believe that the scope of application of the "swap dealer" definition to various entities should be treated in the *de minimis* exception, which is available to all persons."[19]

Additionally, we disagree that allowing U.S. agencies and branches of foreign banks to avail themselves of the Proposed Loan Origination Exclusion would even conflict with CEA Section 1a(49)(A), if that provision was relevant. We note in this regard that the CEA does not define the term "insured depository institution," and Sections 712(d) and 721(b) of Dodd-Frank granted the Commission further definitional authority in this context. We further note that treating U.S. agencies and branches of foreign banks as "insured depository institutions" for purposes of Section 1a(49)(A) would be consistent with the decision by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), in the context of Section 716 of Dodd-Frank (the so-called "**Swaps Push-Out Rule**"), to clarify that the definition of IDI in that parallel part of Title VII of Dodd-Frank includes any uninsured U.S. branch or agency of a foreign bank.[20] After the Federal Reserve took that step, Congress codified the clarification.[21] As a result, we believe expanding the availability of the Proposed Loan Origination Exclusion to U.S. branches and agencies for foreign banks would be consistent with congressional intent.

B. <u>Hedging Exclusion</u>

We support the Commission's proposed exclusion from the *de minimis* threshold for swaps entered into to hedge financial or physical positions (the "**Proposed Hedging Exclusion**").[22] As the Commission notes, although swaps entered into for such purposes are generally not indicative of dealing, the facts-and-circumstances test for applying the "swap dealer" definition creates regulatory uncertainty that discourages some firms from using swaps to hedge. The current exception from the "swap dealer" definition for swaps entered into to hedge

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[18] *See* Entity Definitions Adopting Release at 30,623.

[19] *Id.*

[20] *See* 12 C.F.R. § 237.21.

[21] H.R. 83 (113th): Consolidated and Further Continuing Appropriations Act, January 3, 2015; 15 U.S.C. § 8305(b)(3).

[22] Proposal at 27,462-63.

physical exposures helps to address this issue for firms that use swaps to hedge physical positions, but it does not help firms that use swaps to hedge financial risks, such as interest rate or foreign exchange risk associated with their liabilities. As a result, the current physical position hedging exception is not typically relied on by banking institutions, including foreign banks. Nor does it help commercial end users who use swaps for liability management purposes. A bright-line test along the lines of the Proposed Hedging Exclusion could provide the certainty foreign banks and others need to enter into hedging transactions.

Below we propose a number of clarifications designed to ensure that the Proposed Hedging Exclusion provides the certainty it is intended to achieve.

1. Price Maker Prohibition

Greater clarity is needed regarding the requirement that a person seeking to rely on the Proposed Hedging Exclusion not be "the price maker [or] receive or earn a bid/ask spread, fee, commission, or other compensation" (the "**Price Maker Prohibition**").

First, several clarifications are needed in the context of exchange-traded and cleared swaps:

- In the context of such swaps, market participants often engage in hedging strategies that involve submitting limit orders. Although these orders necessarily form part of the price-making process of a central limit order book, they are not submitted to profit from providing liquidity. Rather, limit orders present a less costly method of entering into hedging transactions because they allow firms to hedge passively without paying a bid/ask spread. To address this issue, the Commission should clarify that the Price Maker Prohibition does not prohibit price-making on trading platforms other than through responses to request for quotes.

- Firms can receive volume rebates or other fees from a trading platform or clearing organization or clearing member that are calculated based on all of the firm's swaps, regardless of whether the swaps are connected with dealing activity. To address this issue, the Commission should clarify that the Price Maker Prohibition only prohibits the relevant types of compensation from a person's counterparty, not third parties.

To ensure appropriate limits on parties using the Proposed Hedging Exclusion for trading on platforms, we would recommend that the Commission clarify that the exclusion is not available to participants in a trading platform's market-marker program, similar to the condition applicable to the Commission's floor trader exception to the "swap dealer" definition.

Second, the Commission should clarify the meaning of "other compensation." As proposed, the language is quite vague, particularly considering the profitability of a swap varies over its term and is not appropriately viewed in isolation from related activity that it hedges. The language could therefore create the same kind of uncertain facts-and-circumstances test that the Proposed Hedging Exclusion is designed to avoid. To prevent this, the Commission should make clear that "other compensation" is limited to compensation similar to bid/ask spreads and commissions.

2. Anti-Evasion Requirement

The Commission should confirm that the anti-evasion prong of the Proposed Hedging Exclusion will be applied similarly to the Commission's other anti-evasion rules. Specifically, the Commission should make clear that a transaction would not run afoul of this restriction if it is designed to achieve a legitimate business purpose and that the Commission's intention is not to create a new evasion standard with this language.[23]

C. Exclusion for Portfolio Compression Exercises

We support the proposed codification of the no-action relief issued by the Division of Swap Dealer and Intermediary Oversight regarding the application of the *De Minimis* Exception to swaps entered into in connection with multilateral portfolio compression exercises (the "**DSIO No-Action Relief**").[24] As the Commission notes, portfolio compression exercises do not involve dealing activity, but are simply mechanisms to allow market participants to reduce their risk. Excluding swaps resulting from such exercises from the *de minimis* threshold therefore reduces systemic risk without implicating any of the other considerations related to swap dealer regulation.

However, the DSIO No-Action Relief and, by extension, the Proposal contain an unduly narrow definition of portfolio compression exercises. Both reference Commission Regulation 23.500(h), which defines "multilateral portfolio compression exercise" as "an exercise in which multiple swap counterparties wholly terminate or change the notional value of some or all of the swaps submitted by the counterparties for inclusion in the portfolio compression exercise and, depending on the methodology employed, replace the terminated swaps with other swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps in the compression exercise."

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23 *Cf.* Entity Definitions Adopting Release at 30,651.

24 *See* CFTC Letter No. 12-62 (December 12, 2012); Proposal at 27,463-64.

This definition includes two unnecessary limitations. First, in addition to terminating and amending swaps, portfolio compression exercises may reduce a portfolio's risk by causing the participants to enter into a wholly new swap that, in combination with existing swaps, reduces the parties' portfolio sensitivity to one or more market factors. As with other swaps resulting from portfolio compression exercises, these new swaps are not the result of dealing activity, but simply a mechanism to reduce risk. The Commission should therefore extend the same treatment to them as other swaps resulting from portfolio compression exercises.

Second, firms may also reduce risk by engaging in bilateral portfolio compression exercises. Like multilateral portfolio compression exercises, bilateral portfolio compression exercises allow for the reduction of risk through the termination of existing swaps, the replacement of such swaps with new swaps with lower notional amounts and/or the entrance into risk-reducing new swaps. The swaps resulting from bilateral portfolio compression exercises do not involve dealing and should be included within the scope of the proposed exclusion. To avoid evasion, however, swap activity arising from bilateral compression exercises should only be covered if the party does not earn a bid/ask spread, commission, or similar compensation.

D. <u>Exclusion for Platform-Traded and Cleared Swaps</u>

We support an exclusion from the *de minimis* threshold for swaps that are executed on an exchange or other multilateral trading platform, such as a swap execution facility ("**SEF**") or designated contract market ("**DCM**"), and cleared by a derivatives clearing organizations ("**DCO**"). As the Commission identifies in the Proposal, additional swap dealer regulation of such platform-traded and cleared swaps is not necessary to reduce systemic risk or to increase counterparty protection or market transparency and oversight because such swaps are already subject to comprehensive regulation.[25] It is instructive that not only are many swap dealer regulations inapplicable to these transactions, but also there is no concept in the Commission's regulations of a "futures dealer." This absence represents a recognition that the intermediaries meriting regulation in the context of exchange-traded and cleared derivatives are the SEFs, DCMs, DCOs, futures commission merchants ("**FCMs**") and introducing brokers ("**IBs**"), not dealers. By imposing comprehensive regulatory regimes on SEFs, DCMs, DCOs, FCMs and IBs, the Commission is able to achieve the systemic risk mitigation, counterparty protection and market integrity goals that, for OTC swaps, are obtained through swap dealer regulation. It follows that, to the extent swaps are exchange-traded and cleared, it is unnecessary and redundant to regulate the parties to such swaps as swap dealers.

Further, as the Commission notes, excluding platform-traded and cleared transactions from the *de minimis* threshold would incentivize market participants to enter into such transactions, rather than OTC or uncleared trades. This would further Congress's and the Commissions' goals of encouraging more platform-trading and clearing of swap transactions.

[25] Proposal at 27,468.

Below we make additional recommendations regarding such an exclusion.

1. No AGNA Backstop or AGNA Haircut

We do not think it appropriate to limit the availability of an exclusion for platform-traded and cleared swaps through an AGNA backstop or to use a haircut to notional amounts instead of a clear-cut exclusion from the *de minimis* calculation. Such limitations would conflict with the main premise for the exclusion, which is that the comprehensive regulatory regime applicable to platform-traded and cleared swaps makes it unnecessary to subject such swaps to swap dealer regulation. This rationale applies regardless of the size of a particular market participant's portfolio because such a market participant would still be subject to regulatory requirements, such as margin requirements and either intermediation by an FCM subject to net capital regulation (if a customer) or DCO participation standards subject to Commission oversight (if a clearing member). These requirements are just imposed via DCOs and FCMs, rather than on the particular transacting parties.

2. Exclusion Should Apply to All Swaps Submitted for Clearing and Executed on a Multilateral Trading Platform

We recommend that the CFTC clarify that the exclusion for platform-traded and cleared swaps applies to swaps that are intended to be cleared at the time of execution, as well as the resulting novated swaps with the DCO. A swap that is submitted for clearing is extinguished upon novation and replaced with two new novated swaps. If the resulting novated swaps are excluded from the *de minimis* threshold but the initial swap submitted for clearing is not, the exclusion would not have effect. The Commission has previously stated that it would not consider novation to a DCO to be swap dealing activity.[26]

Additionally, consistent with the broader range of execution functionality offered by SEFs and the concomitant scope of SEF oversight and Commission relief from external business conduct standards and swap documentation rules,[27] it should not matter whether a swap executed on a platform and submitted for clearing is executed anonymously or with a known counterparty. The Commission should clarify that this exclusion applies to swaps regardless of whether or not they were transacted on anonymous basis.

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26 78. Fed. Reg. 45,292, 45,325 (July 26, 2013) ("Where a swap is created by virtue of novation, such swap does not implicate swap dealing, and therefore it would not be appropriate to include such swaps in determining whether a non-U.S. person should register as a swap dealer.").

27 *See* CFTC Letter No. 13-70 (November 15, 2013).

3. Exclusion Should Apply to Swaps executed on Non-U.S. Trading Platforms or Cleared at Non-U.S. DCOs

Any exclusion from the *de minimis* calculation for platform-traded and cleared swaps should also encompass swaps executed on non-U.S. trading platform or cleared at non-U.S. DCOs. Foreign trading platforms and DCOs that provide services for persons located in the U.S. must register with the Commission unless they benefit from an exemption or similar relief based on the Commission's conclusion that they are subject to comparable home country regulation.[28] Therefore, any U.S-related swap transactions executed on non-U.S. trading platforms or cleared at non-U.S. DCOs would either be subject to direct Commission regulation and oversight or a regulatory regime that the Commission has found comparable to such regulation and oversight.

F. Exclusion for Non-Deliverable Forwards

We support an exclusion from the *de minimis* calculation for non-deliverable foreign exchange forward transactions ("**NDFs**").[29] As the Commission recognizes, NDFs are economically and functionally analogous to deliverable foreign exchange forwards, which the Department of Treasury has exempted from the CEA's definition of a "swap" and therefore excluded from the *de minimis* calculation.[30] They can be used interchangeably in the markets to hedge currency-related risks, but an NDF may be required where the underlying currency is non-deliverable or because parties wish to reduce bilateral settlement risk.[31]

G. Exclusion for Cross Border, Post-Allocation Swaps

The Commission's published guidance regarding the cross-border application of Title VII ("**July 2013 Cross-Border Guidance**,")[32] recognized that, in certain instances where a non-U.S. person enters into a swap in circumstances where it does not know the identity of its counterparty, it is appropriate not to subject the non-U.S. person to regulation under Title VII. The specific instance addressed by the July 2013 Cross-Border Guidance involved swaps executed anonymously by a non-U.S. person on a DCM, SEF or foreign board of trade

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[28] CFTC, "Division of Market Oversight Guidance on Application of Certain Commission Regulations to Swap Execution Facilities" (November 15, 2013).

[29] Proposal at 27,470.

[30] 77 Fed. Reg. 69,694 (November 20, 2012).

[31] Proposal at 27,470.

[32] 78 Fed. Reg. 45,292 (July 26, 2013).

("**FBOT**") and cleared.[33] In this instance, the Commission recognized that the Commission's interest in regulating the swap was outweighed by the non-U.S. person's practical difficulties in determining whether the swap would be subject to Commission regulation, given that the non-U.S. person would have no information regarding its swap counterparty prior to execution of the swap.

As discussed in our previous advocacy in connection with Project K.I.S.S.,[34] a similar issue arises in connection with swaps subject to post-trade allocation. When a non-U.S. person enters a swap with a non-U.S. asset manager that is subject to post-trade allocation, the non-U.S. person does not know whether its counterparty(ies) is(are) a U.S. person, a non-U.S. person or some combination thereof, until after execution occurs. For cleared swaps or swaps executed under a prime brokerage arrangement, the non-U.S. person might never find out the ultimate beneficial owners of the swap because the non-U.S. person will, by the time allocation occurs, already face a clearing organization or prime broker as its counterparty.

For these post-allocation swaps, the non-U.S. person is not in a position to ascertain whether the Commission's rules apply. At the same time, it would not be reasonable for a U.S. beneficial owner to expect the protection of U.S. swap dealer registration or external business conduct rules when it appoints a non-U.S. asset manager to trade with non-U.S. swap counterparties. It also should be the responsibility of any such U.S. beneficial owner to ensure that its non-U.S. asset manager satisfies Commission mandatory clearing, trading or real-time reporting requirements for its swaps.

To address this issue, the Commission should clarify that when a non-U.S. person enters into a swap with a non-U.S. asset manager that is subject to post-trade allocation, and the swap is submitted for clearing or given up to a non-U.S. prime broker before the asset manager allocates it, the non-U.S. person does not need to count the swap toward its swap dealer *de minimis* threshold calculations (or be responsible for compliance with the Commission's transaction-level rules) unless the non-U.S. asset manager expressly indicates before or at the time it enters into the swap that the swap will be allocated to one or more U.S. persons.[35]

We also note that additional issues related to cross-border, post-allocation swaps may arise in connection with business restructurings resulting from the withdrawal of the United Kingdom from the European Union. We or our members may look to address these issues with the Commission at a later date.

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33 *See*, *e.g.*, July 2013 Cross-Border Guidance at 45,325.

34 *See* Letter from IIB dated September 29, 2017.

35 Notably, the SEC has adopted a similar clarification for purposes of its Title VII reporting rules. *See* 81 Fed. Reg. 53,546, 53,582 (August 12, 2016).

IV. Legacy Portfolios

Following any modification of the *De Minimis* Exception, firms may reorganize their swap dealing activities to conform to the new exception (*e.g.*, by consolidating dealing activity subject to registration in a smaller number of legal entities), resulting in one or more affiliates ("**Legacy Swap Affiliates**") that will have discontinued new swap dealing activity but will be left with legacy swap portfolios for some indeterminate period of time until they are able novate or exit all such swaps. Legacy Swap Affiliates will not be able to terminate their entire portfolios unilaterally, and novation typically requires consent of the counterparty and in some cases compliance with non-U.S. regulatory requirements. In addition, the novation process often requires supplemental or new relationship documentation between the legacy customer and the successor swap dealer.

In the meantime, it is unlikely that such swap portfolios will remain entirely dormant, and many swaps will experience lifecycle events. To promote regulatory certainty in such cases, we recommend that the Commission clarify to what extent routine maintenance activities associated with legacy swap transactions (such as partial or full terminations, partial or full novations (out), and amendments that shorten the duration of outstanding swaps) include responding to counterparty requests (or, in the case of a non-U.S. Legacy Swap Affiliate, a U.S. counterparty request) in connection with existing swap positions.

Any transaction undertaken primarily for the purpose of achieving a Legacy Swap Affiliate's own trading objectives (*i.e.*, risk/portfolio reduction) and not solely for the purpose of accommodating its counterparties'(or, for a non-U.S. Legacy Swap Affiliate, U.S. counterparties') trading objectives or supplying liquidity to the market should not be considered swap dealing activity. Specifically, a Legacy Swap Affiliate should not need to count its swap activity in its *de minimis* calculation if it (i) only entertains a counterparty-initiated request in relation to the legacy swap transactions where the proposed transaction meets the Legacy Swap Affiliate's own criteria for reducing the legacy swap portfolio's duration or size; (ii) limits new swap transactions to those that are required under terms of the relevant swap or that are entered into for purposes of hedging, clearing or portfolio compression; and (iii) refrains from engaging in market-making, supplying liquidity, quoting two-sided markets or seeking to profit from bid-offer spreads or other activities generally indicative of swap dealing in relation to the legacy swap transactions.

Absent clarification, Legacy Swap Affiliates may have to decline counterparty requests regarding the termination or other disposition of their outstanding swaps. Such a result is not in the interests of the end-user community and could result in unnecessary risks and costs to these counterparties. Correspondingly, the absence of relief would have the practical effect of increasing risk to the Legacy Swap Affiliate over time (*vis-à-vis* the risk they would face were they permitted to enter into risk and portfolio reducing transactions).

In light of the foregoing, the Commission should clarify that a person need not include Legacy Portfolio Maintenance Swaps in the calculation of its *de minimis* threshold. For this purpose, a "**Legacy Portfolio Maintenance Swap**" would include only the following types of transactions by a Legacy Swap Affiliate with respect to a legacy swap transaction: partial or full terminations; modifications that shorten the duration of an outstanding swap; partial or full novations (out) of legacy swap transactions; or submission of swaps for clearing.[36]

* * *

The Institute appreciates the consideration of these matters by the Commission staff. Please do not hesitate to contact the undersigned at (212) 421-1611 with any questions regarding this letter.

Respectfully submitted,

Briget Polichene
Chief Executive Officer
Institute of International Bankers

[36] Legacy Swap Affiliates may also engage in other types of swap activities, such as swaps entered into for the purpose of hedging or mitigating risk or pursuant to pre-existing contractual commitments (*e.g.*, in connection with swaptions or forward-start swaps), that benefit from an exclusion from the *de minimis* threshold or for which the "swap dealer" analysis is more straightforward.

Appendix A

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January 19, 2016

Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Comments on Swap Dealer *De Minimis* Exception Preliminary Report

Dear Secretary Kirkpatrick:

The Institute of International Bankers (the "**Institute**") appreciates the opportunity to provide comments to the staff of the Commodity Futures Trading Commission (the "**Commission**") on their Swap Dealer *De Minimis* Exception Preliminary Report (the "**Report**")[1] pursuant to Commission Regulations §1.3(ggg)(4) (the "***De Minimis* Exception**"). The *De Minimis* Exception is one of the key building blocks of the Commission's regulatory regime under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"), and its calibration requires a careful balance of competing regulatory objectives that is based on detailed analysis of market data. We appreciate the staff's effort to engage in such analysis and its solicitation of comments from the public.

We are concerned about the imprecise relationship between the *De Minimis* Exception's existing $8 billion gross notional threshold, on the one hand, and the types of swap dealing activities that bear materially on the Commission's systemic risk mitigation, counterparty protection and market oversight/transparency objectives, on the other hand. This imprecise relationship has, in many cases, led to the arbitrary classification of certain entities as swap dealers. This issue has been of particular significance for smaller foreign banks, many of which have curtailed their participation in, or withdrawn from, the U.S. swap markets because of their

[1] Swap Dealer *De Minimis* Exception Preliminary Report, Commission Staff Report (Nov. 18, 2015).

inability to rely on the *De Minimis* Exception. Prior to the October 12, 2012 date when swap dealing activity began to count toward the *de minimis* threshold, smaller foreign banks commonly had entered into swaps with U.S. counterparties ancillary to those banks' traditional banking activities or as part of trading in the inter-dealer market.

Smaller foreign banks also face disadvantages relative to many of their competitors due to the limited scope of the exclusions that exist from counting certain types of swaps toward the *de minimis* threshold. In particular, the exclusion for swaps entered into by insured depository institutions ("**IDIs**") in connection with originating loans (the "**Loan Origination Exclusion**")[2] and the exclusion for swaps entered into for purposes of hedging physical positions (the "**Hedging Exclusion**")[3] are typically not available to foreign banks, even when they engage in the same or similar swap activities as other firms. To foster a level playing field, these exclusions should be clarified or expanded, and the Commission should take care to ensure that any additional exclusions it might adopt do not result in undue competitive disparities.

At the same time, we recognize the desirability of structuring the *De Minimis* Exception (and associated exclusions) in a straightforward, objective manner that minimizes the costs for market participants and the Commission to identify whether an entity is eligible to rely on the *De Minimis* Exception. Likewise, the benefits of any potential changes to the *De Minimis* Exception must be balanced against associated transitional costs.

In light of these considerations, and as described in greater detail below, the Commission should modify the *De Minimis* Exception and provide for an orderly transition as follows: (i) adopting a multi-factor threshold whereby a person would not be required to register as a swap dealer unless it exceeds both a gross notional threshold and a non-dealer counterparty count threshold; (ii) expanding the Loan Origination Exclusion and the Hedging Exclusion to cover relevant swap activities engaged in by foreign banks; (iii) to the extent the Commission adopts additional exclusions for non-financial commodity swap dealing or for swaps that are executed on a swap execution facility ("**SEF**") or designated contract market ("**DCM**") and/or cleared, ensuring that any such exclusions do not introduce undue competitive disparities; and (iv) promoting an orderly transition to the modified *De Minimis* Exception through clarification of the treatment of swap activities connected to the wind-down of a legacy swap portfolio.

We believe that the foregoing modifications and clarification would encourage smaller foreign banks to re-enter the U.S. swap market, which would allow them to expand their U.S. corporate and industrial lending activities and promote market competition and liquidity. The movement of trading activity onshore would also increase the percentage of activity subject

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2 Commission Regulations §1.3(ggg)(5).

3 Commission Regulations §1.3(gg)(6)(iii).

to Commission oversight, even as the more tailored *De Minimis* Exception reduces the burden on finite Commission resources. Finally, the foregoing modifications could be structured so as to ensure that they do not undermine achievement of systemic risk mitigation, counterparty protection, and market oversight/transparency objectives.

If the Commission does not adopt our proposed modifications and clarification, but instead maintains the existing gross notional threshold, then the Commission should not permit that threshold to decrease from its current $8 billion level. Any decrease in the gross notional threshold would exacerbate the issues described in this letter.

I. Background

The Institute's membership comprises a diverse group of internationally headquartered financial institutions from over 35 countries around the world doing business in the United States. All of our members, regardless of their registration status in the United States, are subject to comprehensive prudential regulation and supervision in their home jurisdictions. In the aggregate, Institute members' U.S. operations have approximately $5 trillion in assets, fund 25% of all commercial and industrial bank loans made in this country and contribute significantly to the depth and liquidity of U.S. financial markets. These statistics cover not only the largest foreign banks, many of which have provisionally registered as swap dealers with the Commission, but also a large number of smaller foreign banks, which are typically less active in the U.S. swap market but whose U.S. swap activities nonetheless perform important functions.

In particular, foreign banks have historically engaged in U.S. swap dealing activity that is ancillary to the lending, payment and cash management services and other traditional banking services that they offer to U.S. customers. In addition, for rates and foreign exchange derivatives denominated in or related to less commonly traded foreign currencies, foreign banks based in the relevant foreign jurisdiction are often key providers of liquidity, particularly for U.S. swap dealers in need of hedging opportunities. U.S. swap dealers, in turn, are key sources of liquidity for foreign banks looking to hedge exposures incurred in the course of providing financial services (including swaps) to their foreign customers.

The application of the current $8 billion gross notional threshold to the foregoing activity can often lead to arbitrary results. For example, foreign exchange derivatives tend to have relatively shorter tenors but are often amended or terminated and replaced with new positions prior to maturity, effectively multiplying the notional amount of such transactions disproportionate to their underlying risk. In addition, due to the larger notional size of rate swaps relative to other asset classes,[4] entering into a relatively small number of rate swaps with a

[4] For example, the most recent weekly swaps report from the Commission notes that the total gross notional outstanding in interest rate swaps is more than 50 times larger than the outstanding notional in credit swaps. *See* Weekly Swaps Report of January 13, 2015, *available at*: http://www.cftc.gov/MarketReports/SwapsReports/NotionalOutstanding/index.htm (noting the current outstanding notional for the credit default swap market is $4,691

relatively small number of customers (as is common for interest rate swaps connected to lending activities) can still disqualify a foreign bank from reliance on the *De Minimis* Exception. Other types of swaps that are ancillary to banking activities, such as customers' hedging swaps connected to their business combination transactions (*e.g.*, a foreign exchange hedge between the signing and closing of an acquisition), also tend to have large notional sizes that can subject a foreign bank to swap dealer registration even when offered infrequently to a relatively small number of customers. The limited availability of the Loan Origination Exclusion and the Hedging Exclusion exacerbate these issues.

Due to the disproportionate impact of the $8 billion gross notional threshold on the activities described above, even relatively limited participation in the U.S. swap market can subject a foreign bank to swap dealer registration. For many foreign banks, the burdens associated with swap dealer registration—such as the development of detailed and prescriptive policies, procedures, systems and controls designed to comply with Commission business conduct, documentation and recordkeeping requirements—far outweigh the commercial benefits associated with the limited number of swap transactions and trading relationships that triggers registration.

As a result of these issues, many foreign banks have been forced to curtail their U.S. swap market activity significantly or to withdraw completely. Doing so has limited the ability of those foreign banks to provide banking services to U.S. customers. It also has required U.S. swap dealers hedging exposures through swaps with foreign banks to do so through the U.S. swap dealers' foreign branches or affiliates, increasing costs and further pushing swap market activity offshore, sometimes outside the regulatory purview of the Commission.

As described below, we believe that the most effective ways for the Commission to address these issues would be to (i) reduce the potential for arbitrary results by modifying the existing gross notional *de minimis* threshold so that it becomes part of a multi-factor threshold; (ii) expand the Loan Origination Exclusion and the Hedging Exclusion to cover relevant swap activities engaged in by foreign banks; and (iii) to the extent the Commission adopts additional exclusions for non-financial commodity swap dealing or for swaps that are executed on a SEF or DCM and/or cleared, ensure that any such exclusions do not introduce undue competitive disparities. We also believe that clarifying the treatment of legacy portfolio swap activities would help mitigate some of the transitional costs associated with modifying the *De Minimis* Exception.

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trillion versus $247,395 trillion in the interest rate market). Further, the minimum block size for super-major currencies of tenors less than or equal to 46 days is $6.4 billion, which represents a level that would result in roughly 50% of the total notional amount of such swaps qualifying as block trades. *See* Appendix F to Part 43 of Commission Regulations. By contrast, the largest minimum block size for a credit swap is $320 million. *See id.*

II. Multi-Factor *De Minimis* Threshold

For the reasons described below, we believe that the Commission should modify the *De Minimis* Exception so that a person is not required to register as a swap dealer unless it exceeds both (i) a gross notional threshold and (ii) a non-dealer counterparty count threshold. These thresholds should be set at levels designed, based on an empirical analysis, to ensure that an appropriate percentage of U.S. swap market activity is composed of transactions involving one or more registered swap dealer counterparties.

A. Rationale for Adding a Counterparty Count Threshold

Expanding the existing, notional-based threshold for the *De Minimis* Exception to encompass an additional threshold relating to a person's number of counterparties would help to avoid arbitrary outcomes by taking into account more characteristics of a person's swap activities. In particular, adding a counterparty count threshold would ensure that a person would not become subject to swap dealer registration solely because the person's gross notional amount of swap dealing activities with a small number of counterparties was artificially inflated by a handful of large transactions or by a handful of short-dated transactions that are subsequently amended or terminated and replaced with new positions prior to maturity.

Adding a counterparty count threshold also would be consistent with the Commission's goal of adopting a "swap dealer" definition that identifies "those persons whose function is to serve as the points of connection in the swap markets."[5] Even if a person engages in a large notional volume of swap dealing transactions, if those transactions are with a small number of counterparties, then the person would not satisfy this criteria. The Commission staff's data analysis also indicates that a person's number of counterparties is correlated to swap dealing activity.[6]

Importantly, a multi-factor *de minimis* threshold would be relatively efficient for firms to implement. Firms could, at their election, choose to continue solely to track their gross notional volume of swap dealing activity. Alternatively, they could track their number of counterparties, or track both factors. This flexibility would also increase regulatory certainty.

These latter characteristics of a multi-factor *de minimis* threshold compare favorably to adopting different *de minimis* thresholds for different asset classes. In contrast with a multi-factor *de minimis* threshold, complying with asset class-specific *de minimis* thresholds would require firms to modify their existing policies, procedures, systems and controls relating

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[5] *See* 77 Fed. Reg. 30596, 30598 (May 23, 2012) (the "**Entity Definitions Adopting Release**").

[6] Report at pp.55-56 (noting that swaps with a limited number of counterparties, even in high notional amounts, may not be indicative of swap dealing activity).

to the gross notional threshold to categorize their swaps into the relevant asset categories and track those categories separately. We also note that designing and administering asset class-specific *de minimis* thresholds would require the Commission to increase its reliance on data in the equity, foreign exchange, and non-financial commodity asset classes. Increasing reliance on this data could be problematic until its quality improves. For these reasons, we favor a multi-factor threshold over asset class-specific thresholds, even though most of the issues faced by foreign banks under the *De Minimis* Exception are concentrated in the rates and foreign exchange asset classes.

B. Exclusion of Registered Swap Dealer Counterparties

It would encourage new swap market entrants if the new counterparty count threshold excluded counterparties that are registered as swap dealers. In particular, the non-U.S. firms that have shifted their trading activity outside the United States might be enticed to re-enter the U.S. swap market. Encouraging these firms to participate in the U.S. swap market would facilitate the ability of U.S. swap dealers to engage in hedging and other trading activities in non-U.S. markets and to provide liquidity in non-U.S. underliers to their U.S. customers.[7]

At the same time, excluding registered swap dealers from the counterparty count threshold would not materially decrease Commission oversight of the swap market. All swaps involving a U.S. swap dealer counterparty will still be subject to Dodd-Frank's clearing, trade execution, margin, segregation, documentation, confirmation, portfolio reconciliation and compression, and recordkeeping requirements. In the case of foreign banks that would rely on the *De Minimis* Exception, comparable home country capital requirements will also typically apply. In addition, inter-dealer swaps do not pose the same sales practice and counterparty protection concerns as dealer-customer swaps, as evidenced by the many exceptions from external business conduct standards that apply to inter-dealer swaps.

Excluding registered swap dealers from the counterparty count threshold also would be consistent with the Commission's recognition that non-dealers tend to enter into swaps with swap dealers more often than with other non-dealers.[8] Additionally, the exclusion would help to implement the statutory text of the *De Minimis* Exception, which specifically requires the Commission to "exempt from designation as a swap dealer an entity that engages in a *de minimis* quantity of swap dealing in connection with transactions <u>with or on behalf of its customers</u>."[9] In

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[7] Similar considerations have long supported a similar exemption in the securities broker-dealer context. *See* Securities Exchange Act Rule 15a-6(a)(4)(i) (exempting a foreign broker-dealer's securities transactions with an registered broker-dealer).

[8] Entity Definitions Adopting Release, 77 Fed. Reg. at 30598.

[9] Section 1a(49)(D) of the Commodity Exchange Act ("**CEA**") (emphasis added).

particular, if a person's number of non-dealer counterparties falls below a *de minimis* threshold, then the gross notional amount of the person's swap dealing transactions is less likely to be composed of transactions with or on behalf of its customers. In contrast, if a person has more than a *de minimis* number of non-dealer counterparties, then even its swap dealing transactions with registered swap dealers are likely to be connected with its transactions with or on behalf of its customers. Consistent with these characteristics of swap dealing activity, under the proposed exclusion, a person's swap dealing transactions with registered swap dealers would still be relevant for purposes of the *De Minimis* Exception, and so could not be unlimited in amount, if the person enters into swaps with more than a *de minimis* number of non-dealer counterparties.[10] In this respect, the proposed exclusion is distinguishable from earlier proposals that would make swaps with registered swap dealers completely irrelevant to the *De Minimis* Exception.[11]

C. <u>Establishment of Numerical *De Minimis* Thresholds</u>

The numerical thresholds for the gross notional threshold and non-dealer counterparty count threshold should be based on an empirical analysis of which thresholds would, applied conjunctively, ensure that a minimum percentage of the notional volume of U.S. swap market activity involve a registered swap dealer as at least one of the counterparties to the

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10 For example, assume that the gross notional threshold remains at $8 billion, and the Commission adopts a non-dealer counterparty count threshold of 50. If a person entered into $4 billion in notional amount of swap dealing transactions with 51 non-dealer counterparties and more than $4 billion in notional amount of swap transactions with registered swap dealers that was connected to its swap dealing, then both groups of transactions would count toward the gross notional threshold and the person could not rely on the *De Minimis* Exception.

11 We acknowledge that, when the Commission initially implemented the *De Minimis* Exception in 2012, it declined to permit an unregistered dealer to engage in unlimited dealing activity so long as its counterparties are not customers. In so doing, the Commission explained that "[s]uch an unlimited exception would appear to be contrary to the express language of the statutory exception" and "would lead to the perverse result of discouraging entities from entering into swaps . . . to facilitate risk management activities of customers." Entity Definitions Adopting Release, 77 Fed. Reg. at 30631. On these grounds, however, the proposed exclusion of registered swap dealers from the counterparty count threshold is distinguishable from a proposal to exclude swaps with registered swap dealers from the gross notional threshold. First, the instant proposal would still impose a *de minimis* limit on swap dealing transactions with or on behalf of customers, but it would use a non-dealer counterparty count threshold as a proxy for whether a person's swap dealing transactions are "with or on behalf of its customers"; if that proxy indicated more than a *de minimis* amount of customer business, then, as described above, all of the person's swap dealing transactions (including those with registered swap dealers) would count toward the person's gross notional threshold. Second, by permitting a person to enter into swap dealing transactions with a *de minimis* number of non-dealer counterparties, the proposed exclusion would ensure that any disincentive against customer facilitation would be justified by the need to ensure appropriate regulation of persons engaged in significant customer-facing swap dealing activities.

transaction.[12] The Commission should seek public comment on the appropriate level for this percentage and the methodology for calculating it.

By expressly tying the level of the thresholds to the outcome that they produce, this approach would avoid arbitrary results, make explicit the trade-offs that are inevitably implicit in any numerical thresholds adopted by the Commission, and thereby help to appropriately balance the competing objectives advanced by regulating swap dealers, on the one hand, and the *De Minimis* Exception, on the other hand. This approach would be consistent with the approach employed by the Commission in implementing Dodd-Frank's block trade public dissemination delays, where the Commission likewise needed to balance competing regulatory objectives.[13]

In reviewing this metric, we observe that, based on the analysis contained in the Report, sizeable increases in the level of the gross notional threshold, even to a level as high as $100 billion, would have a minimal impact on the percentage of trades that occur with registered swap dealers.[14] Similarly, a relatively high counterparty count threshold, even one as high as 50, would appear to result in only a very limited reduction in the percentage of swaps that occur with swap dealers.[15] This data also suggests that conjunctive application of a gross notional threshold and a counterparty count threshold would not materially decrease the volume of swap activity conducted by registered swap dealers, so long as the levels of the thresholds are calibrated appropriately.

[12] In order to ensure an appropriate level of regulation of the inter-dealer market, the Commission could also seek to ensure that the percentage of swap transactions that occur between registered swap dealers does not materially decrease from its current level.

[13] When the Commission established minimum block trade sizes, it did so based on the amounts that would result in a target notional volume of the market for each swap category becoming subject to real-time public dissemination. *See* Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 78 Fed. Reg. 32866 (Jul. 30, 2013).

[14] The Report explains that a $100 billion gross notional threshold would reduce the notional amount of interest rate and credit default swaps entered into by swap dealers by less than 2 percent overall. Report at p.48 (noting that at the current $8 billion threshold, $132,140 billion in dealing activity is covered, and that at a $100 billion threshold, $130,223 billion would be covered).

[15] The Report indicates that the percentage of potential swap dealing entities with more than 50 counterparties and who were registered as swap dealers was in the range of 74% (for non-financial commodity swaps) to 100% (for credit default swaps and equity swaps). Report at p.52.

III. Transactional Exclusions

A. Loan Origination Exclusion

Currently, the Loan Origination Exclusion is only available to U.S. IDIs.[16] However, foreign banks' U.S. branches and agencies are subject to prudential regulation that is similar to the regulation of U.S. IDIs and are treated like U.S. IDIs for many purposes under U.S. law.[17] In addition, by statute, both uninsured and insured U.S. branches and agencies of foreign banks may receive discount window advances on the same terms and conditions that apply to domestic insured state member banks.[18]

The Loan Origination Exclusion's disparate treatment of otherwise similarly situated market participants unnecessarily creates competitive disparities that discourage foreign banks' participation in the U.S. swap market and makes it more difficult for foreign banks to extend credit to U.S. companies. To address these issues, the Loan Origination Exclusion should be made available to U.S. branches and agencies of foreign banks.

We note that this clarification would be consistent with the decision by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), in the context of Section 716 of Dodd-Frank (the so-called "Swaps Push-Out Rule"), to clarify that the definition of IDI in that parallel part of Title VII of Dodd-Frank includes any uninsured U.S. branch or agency of a foreign bank.[19] After the Federal Reserve took that step, Congress codified the clarification.[20] As a result, we do not believe that it would be inconsistent with congressional intent for the Commission to adopt a similar clarification here. We also note that the CEA does not define the

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16 Section 2 of Dodd-Frank provides that "except as the context otherwise requires . . .," the definition of "insured depository institution" has the same meaning as in the Federal Deposit Insurance Act (18 U.S.C. §1813). "Insured depository institution'' is defined by section 3(c)(2) of the Federal Deposit Insurance Act to mean a bank or savings association the deposits of which are insured by the Federal Deposit Insurance Corporation, and, for some purposes under section 3(c)(3), an uninsured U.S. branch or agency. *See* 12 U.S.C. §§1813(c)(2) and (c)(3).

17 *See* Cleary Gottlieb Steen & Hamilton LLP, David Polk & Wardwell LLP and Sullivan & Cromwell LLP, *White Paper on the Separate Entity Doctrine as Applied to the U.S. Branches of Foreign Headquartered (Non-U.S.) Banks* (Apr. 18, 2012), *available at http://www.cgsh.com/files/News/54ed2f8a-78d0-41e3-8a4e-9399b184a035/Presentation/NewsAttachment/c45a20d1-e994-4b09-b120-95ce13d1649f/3-Firm%20White%20Paper%20on%20U.S.%20Branches%20of%20Foreign%20Banks.pdf.*

18 Section 13(14) of the Federal Reserve Act; 12 U.S.C. §347d.

19 *See* 12 C.F.R. §237.21.

20 H.R. 83 (113th): Consolidated and Further Continuing Appropriations Act, January 3, 2015; 15 U.S.C. §8305(b)(3).

term "insured depository institution," and Sections 712(d) and 721(b) of Dodd-Frank granted the Commission further definitional authority in this context.

B. Hedging Exclusion

Although swaps entered into for the purpose of hedging are generally not indicative of dealing,[21] the facts-and-circumstances test for applying the "swap dealer" definition creates regulatory uncertainty that discourages some firms from using swaps to hedge. Although the existing Hedging Exclusion helps to address this issue for firms that use swaps to hedge physical positions, it does not help firms that use swaps to hedge financial risks, such as interest rate or foreign exchange risk associated with their liabilities. As a result, the existing Hedging Exclusion is not typically relied on by banking institutions, including foreign banks. Nor does it help commercial end users who use swaps for liability management purposes.

The Commission structured the bright-line test for the Hedging Exclusion based on its existing *bona fide* hedging exception from position limits.[22] We believe that a more appropriate basis for the exclusion would be Commission Regulations §1.3(kkk) ("**Rule 1.3(kkk)**"), which provides a bright-line test for determining when a firm is using swaps for the purpose of hedging or mitigating commercial risk, including financial risk. Using Rule 1.3(kkk), instead of the *bona fide* hedging exception, would help to eliminate the undue disparity between physical and financial hedging, thus promoting beneficial hedging activity by firms who use swaps to hedge their liabilities or otherwise hedge using financial swaps that are not substitutes for transactions in physical marketing channels. Importantly, although it allows hedging of financial risks, Rule 1.3(kkk) does not cover positions held to hedge or mitigate the risk of another swap position unless that other position itself is held for the purpose of hedging or mitigating commercial risk.[23] Thus, expanding the Hedging Exclusion to cover swaps that fall within Rule 1.3(kkk) would not allow the exclusion to cover swaps that hedge swap dealing activity. Another advantage of the hedging test under Rule 1.3(kkk) is that, like the *bona fide* hedging exception, it is already well known and used by market participants for purposes of several Commission rules.[24] Expanding the Hedging Exclusion to cover swaps that fall within

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21 *See* Entity Definitions Adopting Release , 77 Fed. Reg. at 30608.

22 Entity Definitions Adopting Release, 77 Fed. Reg. at 30612.

23 Commission Regulations §1.3(kkk)(2).

24 Initially, Rule 1.3(kkk) applied in connection with the major swap participant and eligible contract participant definitions. Commission Regulations §§1.3(m)(7)(iii) and (kkk). Subsequently, the applicability of the test was expanded to the end-user exception from mandatory clearing. Commission Regulations §50.50(c).

Rule 1.3(kkk) would thus involve minimal additional compliance costs while also promoting regulatory consistency.[25]

C. Exclusion for Non-Financial Dealers in Commodity Swaps

Various non-financial firms engage in swap dealing activity connected to their physical commodity businesses, and some of them have argued that they should benefit from a *per se* exclusion from the "swap dealer" definition for this activity.[26] Some financial firms also engage in physical commodity businesses, often through separately organized affiliates. If the Commission decides to adopt an exclusion for commodity swap dealing in connection with a physical commodity business, such an exclusion should not foster undue competitive disparities between those commodity firms that are affiliated with financial entities, and those that are not. Rather, such an exclusion should be available to any non-financial entity engaged in a physical commodity business, regardless of its affiliation status. Accordingly, the determination of whether an entity qualifies as "non-financial" for purposes of such an exclusion should be made without reference to whether such entity is under the control of, or common control with, one or more financial entities.[27]

D. Exclusion for Cleared and/or SEF/DCM-Executed Swaps

The Report discusses the potential for a broad exclusion from swap dealer registration for swaps that are executed on a SEF or DCM and/or cleared. This exclusion would appear to be similar to the current floor trader exception from the "swap dealer" definition.[28]

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[25] Expanding the Hedging Exclusion in this way would also promote consistency with the Federal Reserve's rules pursuant to Section 165 of Dodd-Frank. Specifically, pursuant to that provision, the Federal Reserve has adopted rules that will require foreign banking organizations that have U.S. non-branch assets of $50 billion or more to establish an intermediate holding company for those U.S. operations. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations; Final Rule, 79 Fed. Reg. 17240 (Mar. 27, 2014). These rules will create incentives for foreign banks, including those that have registered their foreign parents as swap dealers, to manage the risks of their U.S. operations on a standalone basis, including through swaps. Without a clear safe harbor from swap dealer registration, however, it will be costly for affected firms to engage in such hedging activities.

[26] *See* Report at p.39.

[27] Financial holding companies that engage in physical commodity businesses are subject to consolidated prudential oversight and associated regulation of their physical commodity and commodity swap activities. Accordingly, we believe that entities operating in an unregistered capacity as part of a larger consolidated financial holding company group pose less risk to the market than independent non-financial firms, which are generally not subject to any prudential regulatory oversight.

[28] *See* Commission Regulations §1.3(ggg)(6)(iv).

The current floor trader exception is not available to floor traders affiliated with a registered swap dealer.[29] We do not believe that this limitation is warranted. If the Commission goes beyond the existing exception to adopt a general exclusion from the *de minimis* threshold for all swaps that are executed on a SEF/DCM and/or cleared, such an exclusion should be available to all qualifying market participants, regardless of whether they are affiliated with a registered swap dealer. The considerations in favor of adopting such an exclusion—*i.e.*, that swaps executed on a SEF/DCM and cleared benefit from execution on transparent and competitive platforms and reduce systemic risk and exposure to counterparties through central clearing[30]—apply regardless of whether or not an entity entering into such swaps is affiliated with a registered swap dealer.[31] Furthermore, adopting preferential treatment for entities not affiliated with swap dealers would give those entities an undue competitive advantage in connection with providing liquidity on SEFs and DCMs, which could undermine the goals of Dodd-Frank by discouraging swap dealers from devoting resources to competing as market makers on those facilities.

IV. Legacy Portfolios

Any modification of the *De Minimis* Exception is likely to lead firms to engage in efforts to reorganize their swap dealing activities to conform to the new exception. Other regulatory changes, such as changes to capital requirements, are also likely to cause firms to reorganize their swap dealing activities.[32] Following these reorganizations, many firms will have one or more affiliates ("**Legacy Swap Affiliates**") that will have discontinued new swap dealing activity.

For a variety of reasons, however, it will not be possible or practical for Legacy Swap Affiliates to novate their entire swap portfolios to the entity that will succeed the relevant swap dealing activity, or to unilaterally terminate such swaps. Nor is it likely that such portfolios will remain entirely dormant until expiration. In particular, novation typically requires consent of the counterparty and in some cases compliance with non-U.S. regulatory requirements. In addition, the novation process often requires supplemental or new relationship documentation between the legacy customer and the successor swap dealer. Many swaps experience lifecycle

[29] *See* Commission Regulations §1.3(ggg)(6)(iv)(C).

[30] *See* Report at pp.61-62.

[31] We also note that the relief granted by the Commission and its staff with respect to such swaps reduces the extent to which making an exclusion for them available to an entity affiliated with a registered swap dealer could create opportunities for evasion. *See, e.g.,* No-Action Letter No. 13-70 (Nov. 15, 2013) (no-action relief from external business conduct and documentation requirements).

[32] In this regard, we note that the Commission has not yet adopted final capital rules for registered swap dealers.

events. As a result, the Legacy Swap Affiliates will undoubtedly be left with legacy swap portfolios for some indeterminate period of time following cessation of new dealing activity.

Under the Commission's interpretation of the "swap dealer" definition, simply maintaining a static portfolio of legacy swap transactions would not be indicative that a person is acting as a swap dealer. However, a technical question arises to the extent that routine maintenance activities associated with legacy swap transactions (such as partial or full terminations, partial or full novations (out), and amendments that shorten the duration of outstanding swaps) include responding to counterparty requests in connection with existing swap positions.

We believe this technical issue is addressed in circumstances where an entity that has not registered as a swap dealer only enters into such transactions with counterparties pursuant to such requests that satisfy its own portfolio management objectives. Specifically, a Legacy Swap Affiliate should not be considered to engage in swap dealing activity if it (i) only entertains a counterparty-initiated request (or, in the case of a non-U.S. Legacy Swap Affiliate, a U.S. counterparty-initiated request) in relation to the legacy swap transactions where the proposed transaction meets its own criteria for reducing the legacy swap transaction portfolio's duration or size; (ii) limits new swap transactions (or, in the case of a non-U.S. Legacy Swap Affiliate, new swap transactions with U.S. persons) to those that are required under terms of the relevant swap or that are entered into for purposes of hedging, clearing or portfolio compression; and (iii) refrains from engaging in market-making, supplying liquidity, quoting two-sided markets or seeking to profit from bid-offer spreads or other activities generally indicative of swap dealing in relation to the legacy swap transactions (or, in the case of a non-U.S. Legacy Swap Affiliate, legacy swap transactions with U.S. persons).

Under these conditions, any resulting transaction would be fairly described as having been undertaken primarily for the purpose of achieving a Legacy Swap Affiliate's own trading objectives (*i.e.*, risk/portfolio reduction) and not solely for the purpose of accommodating its counterparties' (or, for a non-U.S. Legacy Swap Affiliate, U.S. counterparties') trading objectives or supplying liquidity to the market. We also believe that clarifying the status of these transactions would be fully consistent with Dodd-Frank and related public interest considerations. Absent clarification, Legacy Swap Affiliates may have to decline counterparty requests regarding the termination or other disposition of their outstanding swaps. Such a result is not in the interests of the end-user community and could result in unnecessary risks and costs to these counterparties. Correspondingly, the absence of relief would have the practical effect of increasing risk to the Legacy Swap Affiliate over time (*vis-à-vis* the risk they would face were they permitted to enter into risk and portfolio reducing transactions). Neither result is consistent with the objectives of Dodd-Frank or applicable public interest considerations.

In light of the foregoing, the Commission should clarify that a person need not include Legacy Portfolio Maintenance Swaps in the calculation of its *de minimis* threshold. For this purpose, a "**Legacy Portfolio Maintenance Swap**" would include only the following types of transactions by a Legacy Swap Affiliate with respect to a legacy swap transaction: partial or full terminations; modifications that shorten the duration of an outstanding swap; partial or full novations (out) of legacy swap transactions; or submission of swaps for clearing.[33]

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The Institute appreciates the consideration of these matters by the Commission staff. Please do not hesitate to contact the undersigned at (212) 421-1611 with any questions regarding this letter.

Respectfully submitted,

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[33] Legacy Swap Affiliates may also engage in other types of swap activities, such as swaps entered into for the purpose of hedging or mitigating risk or pursuant to pre-existing contractual commitments (*e.g.*, in connection with swaptions or forward-start swaps), that benefit from an exclusion from the *de minimis* threshold or for which the “swap dealer” analysis is more straightforward.