CLEARY GOTTLIEB STEEN & HAMILTON LLP

ONE LIBERTY PLAZA
NEW YORK, NY 10006-1470
(212) 225-2000
FACSIMILE (212) 225-3999
WWW.CLEARYGOTTLIEB.COM

WASHINGTON, DC • PARIS • BRUSSELS
LONDON • MOSCOW • FRANKFURT • COLOGNE
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Writer's Direct Dial: (212) 225-2820
E-Mail: erosen@cgsh.com

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Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

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

Re: Release No. 34-62717, File No. S7-16-10; RIN 3235-AK65, 3038-AD06; Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act

We are submitting this letter in response to the August 20, 2010 Advance Notice of Proposed Rulemaking (the "ANPR") by the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC", and together with the SEC, the "Commissions"). Our comments are informed in large part by extensive consultations we have had with a number of our clients, including major U.S. and non-U.S. banks, whose U.S. operations will likely fall within the definitions of "swap dealer" and "security-based swap dealer" in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") with respect to some of their activities. We appreciate the opportunity to provide the Commissions with comments on certain (i) key definitions and (ii) substantive provisions regarding "mixed swaps" contained in Dodd-Frank.

Dodd-Frank presents a number of issues and provisions in need of clarification which, if left unaddressed, could have significant adverse and unintended consequences. Recognizing the enormous time constraints and resource burdens imposed on the Commissions under Dodd-Frank, a careful and measured implementation process is essential both to the accomplishment of Dodd-Frank's objectives and to the avoidance of unintended consequences. In particular, as discussed in greater detail below, we urge the Commissions to use their authority under Section 712 of Dodd-Frank to address ambiguities and provide clarity regarding the scope of the key definitions referred to in the ANPR.[1] We also recommend that the Commissions solicit comments regarding the proper framework for considering these definitions in the context of cross-border swap and security-based swap activities.

I. "Swap" Definition

We note preliminarily that the Gramm-Leach-Bliley Act (the "GLBA") definition used as the base text for the swap definition in Dodd-Frank was developed for the purpose of excluding the products encompassed in the definition from regulation as securities under the federal securities laws.[2] Consistent with that statute's objective of ensuring legal certainty as to what was and was not to be regulated under applicable federal securities laws, the GLBA "swap agreement" definition was intentionally drafted broadly. Over inclusiveness in scope was addressed through carefully tailored exclusions for various types of securities.[3] As a result, in the context in which the swap agreement definition was used, the breadth of the definition was not problematic in that any non-swap products that might have been captured by the swap agreement definition were not securities in any event and, as a result, their exclusion from regulation as securities was not consequential.

In contrast, to use the same intentionally broad definition in the context of Dodd-Frank would subject to federal regulation as "swaps" many products that, we believe, were never intended to be captured by Dodd-Frank. As a result, the use of the same definition in Dodd-Frank without appropriate clarifications or exclusions has the potential to produce a broad range of potentially significant unintended and undesirable consequences. We address below a number of these that we have identified to date.

A. Insurance

Dodd-Frank includes within clause (A)(ii) of the swap definition contracts that "provide[] for any purchase, sale, payment, or delivery… that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence".[4] This definition by its terms could be construed so broadly as to capture traditional insurance products, and neither the definition nor any exclusion draws any distinction between so-called "event" (or digital or binary) swaps (e.g., credit default swaps ("CDS")) that are intended to be subject to federal regulation under Dodd-Frank as swaps (or security-based swaps), on the one hand, and traditional insurance contracts that are currently (and, we presume, are intended in the future to be) subject to state

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[1] Throughout this letter, we refer to swap dealers and security-based swap dealers collectively as "Dealers" and major swap participants and major security-based swap participants collectively as "MSPs".

[2] See the definition of "swap agreement" in Section 206A of the GLBA (15 U.S.C. 78c note).

[3] See Section 206A(b) (15 U.S.C. 78c note) of the GLBA.

[4] See Section 1a(47)(A)(ii) of the Commodity Exchange Act (the "CEA") (as amended by Dodd-Frank Section 721). Unless otherwise noted, citations to the CEA or the Securities Exchange Act of 1934 (the "Exchange Act") are to those statutes as amended by Dodd-Frank.

insurance regulation, on the other. Additionally, independent of the contingent event prong of the swap definition, forms of annuities and other insurance products that have indexed or variable rate returns could be subsumed within the swap definition absent appropriate clarification.

Dodd-Frank's further inclusion of provisions preempting state insurance law regulation of swaps[5] significantly exacerbates the potential consequences of what is arguably an over-inclusive swap definition. We take as a given that neither Commission reads Dodd-Frank as a mandate for federal regulation (much less exclusive federal regulation) of traditional insurance products (e.g., life, casualty and property insurance).[6] As a result, these provisions require definitional clarifications that establish a clear and constructive functional distinction between state-regulated insurance products and federally regulated swaps.

The contours of a clear distinction between state-regulated insurance products and federally regulated swaps have been observed for many years with the knowledge and, until recently,[7] acceptance of state insurance regulators. Globally, CDS and other contingent "event" swaps are conducted on terms that expressly preclude any requirement that the protected party incur or prove a loss as a condition to the payment or performance of any obligation.[8]

This has been the basis on which state insurance regulators have demurred from asserting jurisdiction over CDS and other contingent "event" swaps.[9] In contrast, state insurance regulation is designed primarily for casualty events and generally requires that insured parties have an insurable interest in the insured property and are generally unable to obtain payment under a policy of insurance in the absence of, or in excess of, an actual loss to such property.

The distinction between these two product categories under this approach is both clear and workable and avoids any uncertainty as to whether a particular product falls within one

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[5] Section 12(h) of the CEA and Section 28(a)(4) of the Exchange Act.

[6] Given the longstanding principle of the McCarran-Ferguson Act (15 U.S.C. § 1012(b)) that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, . . . unless such Act specifically relates to the business of insurance", there is good reason to believe that Congress intended for there to be a distinction between swaps and traditional insurance contracts, and not to preempt state regulation of such contracts.

[7] In November of 2009, the National Conference of Insurance Legislators adopted a model code for the regulation of CDS. In addition, the New York State Insurance Department in its Circular Letter No. 19 (Sept. 22, 2008) also raised a question regarding the status of CDS as insurance under New York law.

[8] See, e.g., Article 9.1(b)(i) of the 2003 ISDA Credit Derivatives Definitions ("the parties will be obliged to perform … irrespective of the existence or amount of the parties' credit exposure to a Reference Entity, and Buyer need not suffer any loss nor provide evidence of any loss as a result of a Credit Event") (emphasis added).

[9] See, e.g., State of New York Insurance Department Opinion Letter (June 15, 2000) (transaction where payment was not dependent upon the buyer having suffered a loss does not meet the definition of insurance contract); State of New York Insurance Department Opinion Letter (January 21, 1982) (transaction where payment was not contingent on the protected party having a material interest which would be adversely affected by fluctuations against which it seeks protection lacks "an essential element of an insurance contract").

or the other category. Accordingly, we recommend that the Commissions further define "swap" to exclude any agreement, contract or transaction under which payment or performance is dependent on one or more specified contingencies beyond the direct control of the parties (a) which does not base the amount of any payment on the price, rate or level of a financial instrument, asset or interest or any commodity, (b) that requires the protected party to have an insurable interest (i.e., a reasonable expectation of loss upon the occurrence of the specified contingency), (c) that limits payment or performance to the actual loss arising from the occurrence of such contingency, (d) that is offered as insurance by a state-licensed provider of insurance, and (e) that the Commissions have not determined by rule or regulation to be a swap or security-based swap.

B. Futures and Commodity Options

Clause (B)(i) of the swap definition excludes "any contract of sale of a commodity for future delivery (or option on such a contract)". As the Commissions are aware, for many years uncertainty existed as to whether over-the-counter ("OTC") swaps might be regarded as futures contracts under the CEA. Congress addressed this issue initially through the Commodity Futures Modernization Act of 2000 (the "CFMA") and, more recently, through Dodd-Frank's statutory framework for the regulation of swaps. As a result of the framework established by Dodd-Frank, there are clear regulatory frameworks applicable to futures contracts required to be executed on or subject to the rules of designated contract markets and swaps that are permitted by Dodd-Frank to be executed in off-exchange transactions. The clarity established by this framework was undermined, however, by changes to the exclusion from the swap definition for futures contracts.[10]

The ambiguity created by these changes, if not clarified, seems destined to lead to serious uncertainty, and potentially consequential disputes, common before the enactment of the CFMA, about what is and what is not a swap or a futures contract. This, in turn, raises the prospect that common types of OTC transactions might be *per se* illegal (or excluded entirely from Dodd-Frank's regulatory framework) if they are conducted in accordance with the framework for swaps but are subsequently held by a court also to be futures contracts.

It is critical that the Commissions forestall this problem by clarifying the exclusion from the swap definition for futures contracts in two ways: the exclusion should (i)

[10] H.R. 4173, as engrossed in the House of Representatives, excluded "(i) any contract of sale of a commodity for future delivery (or any option on such a contract) or security futures product traded on or subject to the rules of any board of trade designated as a contract market under section 5 or 5f". See H.R. 4173 (E.H.), Section 3101. The Senate incorporated a similar exclusion in the Bill in its considerations in March 2010: "any contract of sale of a commodity for future delivery or security futures product traded on or subject to the rules of any board of trade designated as a contract market under section 5 or 5f". See Dodd Bill as amended by the Manager's Amendment of March 23, 2010. H.R. 4173, as engrossed by the Senate, however, changed this language to the exclusion clause listed in the final bill: "(i) any contract of sale of a commodity for future delivery (or option on such a contract), leverage contract authorized under section 19, security futures product, or agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i)". See H.R. 4173 (E.A.S.), Section 721 and H.R. 4173 (ENR), Section 721.

apply to exchange-listed futures contracts and options on such contracts (to eliminate uncertainty as to the swap/futures distinction) and (ii) include exchange-listed commodity options. These clarifications would establish clear, bright-line functional distinctions that will be workable for the Commissions and market participants alike.

C. Forward Contracts

Although Dodd-Frank's swap definition is largely based on the GLBA swap agreement definition, it does not include the prong of the GLBA definition that refers to contracts for the purchase or sale on a fixed or contingent basis of commodities. As a result, the term "swap" would appear to be limited to purely cash-settled instruments, with the exception of conventional and "digital" options under clauses (A)(i) and (ii) of the swap definition. Moreover, so-called "delta 1" bilateral executory swaps providing an election for physical settlement and forward contracts permitting cash settlement would be excluded from the swap definition and potentially subject to regulation or prohibition as futures contracts under the CEA (or, possibly, simply excluded from regulation as swaps or futures contracts under federal law).

Congress can hardly have intended this result. In particular, Congress excluded certain non-financial forwards from the swap definition in clause (B)(ii), which would have been unnecessary if Congress did not intend for swaps that permit contingent physical settlement to be regulated as "swaps". Accordingly, the Commissions should clarify that such contracts fall within the swap definition.

Additionally, the Commissions should clarify the scope of the exclusion in clause (B)(ii) for non-financial forwards. By its terms, that exclusion applies to a non-financial deferred delivery contract that is "intended" to be physically settled. Absent such intent, the contract would (presumptively) be regulated as a swap.

The use of an intent standard, without more, presents numerous challenges that require further clarification. As a threshold matter, intent is inherently subjective and raises many questions. What if one party intends delivery, but the other does not? What if one has the intent at initiation but not at settlement? What if – as is most often the case in commercial channels – intent is dependent on subsequently prevailing circumstances, such as how supply and demand factors change, whether production or consumption needs change, whether prices rise or fall, whether it snows or not, or whether superior commercial alternatives present themselves? Would a subsequent change in circumstance have to be unforeseen? These ambiguities give rise to considerable uncertainty and have the potential to lead to significant unproductive litigation and, as a practical matter, will interfere with legitimate commercial decision-making for no productive purpose.

To address this issue, the Commissions should clarify that the intent test incorporated in the exclusion in clause (B)(ii), consistent with contemporaneous Congressional colloquies,[11] is to be construed in the manner articulated in the CFTC's Brent Forward Interpretation. Under this interpretation, intent is effectively inferred in the case of commercial entities who regularly engage in the relevant commercial activities and who enter into agreements that create binding delivery obligations that require superseding mutual agreement to modify.[12] This clarification would resolve significant uncertainty and would be consistent with the distinction drawn consistently throughout Dodd-Frank between commercial and financial activity.

D. Credit Default Swaps

Clause (B)(vi) of the swap definition excludes contracts providing for the delivery of a security on a fixed or contingent basis.[13] This exclusion is intended to preserve SEC jurisdiction over such contracts as securities. There is an important carve-out from this exclusion for any "agreement, contract, or transaction [that] predicates the purchase or sale [of one or more securities] on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction". This sub-clause is intended to ensure that CDS would not be excluded from the swap regime.

However, by defining the contingency on which the contract is based as one expected to affect or be affected by the creditworthiness of a party "other than a party to the agreement, contract, or transaction", the sub-clause raises the question whether the exclusion in clause (B)(vi) would exclude from regulation as a swap or security-based swap CDS, including in particular, index and basket CDS, where a counterparty to the CDS is one of the reference entities. Because many major financial intermediaries, or their holding companies, are included in important market indices referenced in significant numbers of CDS transactions, the failure to address this issue would create potentially significant dislocations and inefficiencies in the CDS markets for these major indices and would, as a result, adversely affect the availability of, and liquidity for, these products.[14]

We recommend that the Commissions address this issue by clarifying that the reference to CDS in clause (B)(vi) includes any CDS that includes one or more reference entities

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[11] See 156 Cong. Rec. 5248-49 (daily ed. June 30, 2010) (colloquy between Rep. Boswell and Rep. Peterson) ("The exclusion from the definition of swap for 'any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled,' is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and CFTC's established policy on this subject.").

[12] Brent Forward Interpretation, 55 Fed. Reg. 39188 (Sept. 25, 1990).

[13] As noted above, however, the first part of the swap definition would not appear to include the securities contracts described in this exclusion because it is missing the provision in the GLBA "swap agreement" definition including contracts for purchase or sale on a fixed or contingent basis.

[14] Attempting to solve this issue by substituting other financial company reference entities for swap counterparty reference entities will likely create additional problems (e.g., the proliferation of bespoke contracts, basis risk for hedging transactions, etc.) that will be disruptive to the market without achieving any corresponding policy benefit.

in addition to any counterparty to the transaction. Such a construction would be fully consistent with the statutory definition. The inclusion of any reference entity other than or additional to a counterparty to the transaction necessarily means that the CDS satisfies the statutory requirement of a "bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction". Additionally, we recommend that the Commissions clarify that the statutory exclusion for CDS includes CDS providing for cash settlement in lieu of physical delivery.

E. Debt Instruments; Commercial Escalation and Indexation Clauses

The broad language in clauses (A)(ii) and (A)(iii) of the swap definition has raised questions as to whether a wide range of debt instruments and commercial or employment-related contracts could be subsumed in the swap definition. This uncertainty extends to many forms of indebtedness that are not securities or identified banking products (such as non-bank mortgages and commercial loans) but that have indexed or variable interest rate returns, as well as to interest rate protection products that are provided in connection with mortgages, small business and consumer loans. Additionally, a range of commercial contracts, such as leases, service contracts, employment contracts and the like, having fee or rate escalation clauses could also potentially be captured.

The potential application of the swap definition to these products and contracts is particularly problematic because, to the extent that these products and contracts are regarded as swaps, they may not be entered into with a person other than an eligible contract participant (an "ECP") unless executed on an exchange.[15] As a result, for all practical purposes they will become illegal and unavailable. The Commissions therefore should adopt rules that clarify the treatment of these types of products and contracts.

We recommend that the Commissions also clarify that notes, bonds and other evidence of indebtedness are not captured by the swap definition solely as the result of bearing a variable rate of interest,[16] whether or not, as a technical matter, they are securities or identified banking products. In this regard, the Commissions should distinguish an obligation simply to pay a variable level of interest that does not include a contra fixed (or other floating) rate payment from an obligation to exchange fixed-for-floating or floating-for-floating payments, such as those that are typical of interest rate swaps, which transfers risk through the exchange of a fixed-for-floating payment and thereby captures rate (or relative rate) changes.

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[15] See Section 2(e) of the CEA and Section 6(l) of the Exchange Act.

[16] In the case of an instrument of indebtedness whose variable return is determined through indexation to non-interest rate indices, we recommend that the Commissions adopt a substantive approach analogous to that contained in the current statutory exemptions for hybrid securities in Section 2(f) of the CEA (7 U.S.C. 2(f)) and the CFTC's Statutory Interpretation Concerning Certain Hybrid Instruments, 55 Fed. Reg. 13582 (Jan. 11, 1989) and hybrid identified banking products in Section 405 of the Legal Certainty for Bank Products Act of 2000. We recommend that the Commissions further clarify that any non-swap product that incorporates a term or feature that converts a native currency value to a foreign currency-equivalent value (or vice versa) is not, solely as a result of that feature, a swap.

This is an important distinction that relates to the meaning of the phrase "that is based on the value of . . .". This phrase is a term of art that is used to identify products as swaps based on the hallmark that the value of the swap is, as a result of its terms, "based on" a reference underlier. An interest rate swap is, for example, "based on" LIBOR, where, as a result of the exchange of floating LIBOR payments for a fixed rate of interest, changes in LIBOR determine the value of the swap. In contrast, an instrument of indebtedness that pays a variable LIBOR rate of return does not have a value that is based on LIBOR.[17] Indeed, precisely because such an instrument bears a floating rate of interest, its value is less, rather than more, likely to be affected by changing interest rates. As a result, we request that the Commissions clarify that the mere incorporation of a floating or variable rate of interest does not affect the status of the relevant instrument under Dodd-Frank.

We believe the Commissions should further clarify that an agreement that is commercial in nature or employment-related is not captured by the term "swap" solely as a result of an incidental price, compensation or rate escalation clause based on some reference index such as a relevant price, rate or cost of living index. The Commissions should also provide a similar clarification in the cases of loans or other commercial agreements that include incidental contingent repurchase or redemption clauses. Such agreements are clearly not the type of financial contract that Congress intended to be regulated as swaps.

The Commissions should additionally clarify that transactions executed in conjunction with an identified banking product between a bank and a non-ECP borrower to convert the variable rate interest cost of a mortgage or other loan to a fixed rate interest cost or vice versa, to limit the maximum interest cost of such debt, or to lock in an interest rate or foreign exchange rate for such debt, should not be captured by the swap definition.[18] This is consistent with the policy objective emanating from the provision in the "swap dealer" definition that "in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer".[19] However, a broader exclusion is necessary in the context of transactions with non-ECPs involving identified banking products, lest those contracts become subject to Dodd-Frank's exchange trading requirements and, as a result, effectively become illegal and unavailable.

F. Transactions with Foreign Central Banks, Sovereigns and Multi- or Supra-National Organizations

Clause (B)(ix) of the swap definition excludes transactions with a counterparty that is a "Federal Reserve System bank, the Federal Government or a Federal agency that is

[17] Rather, the defining characteristic of most debt instruments, including floating rate debt, is the obligor's promise to repay principal.

[18] An alternative approach might be to provide that a person entering into such a transaction shall be deemed to be an ECP for purposes of that transaction.

[19] See CEA Section 1a(49)(A).

expressly backed by the full faith and credit of the U.S. government". As a matter of comity and national treatment, the Commissions should adopt rules expanding this exclusion to include transactions with a foreign central bank, foreign sovereign or multi- or supra-national organization. Alternatively, the Commissions should specify that swaps and security-based swaps involving such counterparties are not "swaps" or "security-based swaps" within the meaning of Dodd-Frank for the purposes of specified provisions of Dodd-Frank, such as those that would subject these counterparties to the registration, mandatory clearing/trading, margin or other substantive obligations imposed under Dodd-Frank.

G. Inter-Affiliate Transactions

Wholly owned affiliated entities within a holding company group often engage in inter-affiliate swap and security-based swap transactions in order to manage risk effectively within their corporate group. For example, a parent company may issue floating rate notes and enter into an offsetting fixed-for-floating rate swap with one of its affiliates. Additionally, due to a range of commercial, tax, regulatory and market considerations, a counterparty may prefer to face one entity in a group (e.g., a U.S. subsidiary) even though, from a risk management perspective, a different entity (e.g., a foreign parent) is better positioned to incur the exposure. Similarly, one affiliate may have a risk exposure that another affiliate is better positioned to manage. Inter-affiliate transactions are often used in each of these cases.

Subjecting inter-affiliate transactions to the full range of mandatory clearing, trading and other requirements imposed under Title VII would serve no substantive policy objective and would deprive holding company groups of the efficiencies derived from these risk management transactions, or make them more expensive to utilize. In that regard, such treatment would undermine the legislation's goal of reducing systemic risk.[20] Inter-affiliate transactions also do not raise the customer protection concerns that underlie many of Title VII's provisions, such as Dodd-Frank's registration, capital, business conduct, margin, mandatory clearing, real-time public reporting and segregation requirements.

Accordingly, we recommend that the Commissions exclude swaps and security-based swaps entered into between affiliates that are under common ownership and control from the swap definition, except perhaps for select regulatory reporting, anti-fraud and anti-manipulation provisions that the Commissions identify as necessary for the protection of other market participants or to ensure that the Commissions' data sets are complete and informative.[21] This would, consistent with Congressional intent,[22] effectively exempt such transactions from

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[20] To the extent that it is necessary to ring-fence an entity from risks borne by its affiliates, regulatory regimes tailored to that objective – such as Section 23A of the Federal Reserve Act – are more appropriate vehicles than Title VII.

[21] This treatment would also be broadly consistent with the approach that the CFTC has taken in the past with respect to transactions between entities under common control for purposes of what constitutes "bona fide hedging" and what qualifies as a permissible exchange of futures for physicals transactions. See CFTC Interpretive Letter No. 94-45 (May 9, 1994).

[22] See 156 Cong. Rec. S5921 (daily ed. July 15, 2010) (Colloquy by Senator Lincoln) (hereinafter "Lincoln Colloquy")("While most large financial entities are not eligible to use the end user clearing exemption for

mandatory clearing, trading or margin requirements or registration requirements arising simply as a result of inter-affiliate transactions while preserving the Commissions' ability to discharge their statutory mandates.

II. "Mixed Swaps"

Questions have been raised as to whether the "mixed swap" provisions in CEA Section 1a(47)(D) and Exchange Act Section 3(a)(68)(D) could be read to capture even paradigmatic total rate of return swaps on a single security or loan or other security-based swaps that typically provide for the periodic payment of variable rate interest amounts. These payments are designed to compensate the short-side swap counterparty for the cost of financing and carrying the long side of the security-based swap. The purpose and result of these payments is not to provide interest rate exposure to the change in the level or value of a rate.[23]

As in the case of debt instruments that bear a floating rate of interest, the floating rate payment obligation is not the principal driver of the security-based swap and, in that sense, the security-based swap is not "based on" the level of an interest rate within the meaning of Dodd-Frank. Accordingly, a security-based swap that provides for such payments should not be considered to be "based on the value of" a rate within the meaning of CEA Section 1a(47)(D) and Exchange Act Section 3(a)(68)(D). Moreover, subjecting such security-based swaps, which comprise a broad swath of the market, to dual regulation as mixed swaps would potentially be unproductive and unnecessarily burdensome.

There are, on the other hand, a number of products that would properly be characterized as mixed swaps. For instance, a swap based on the out-performance of gold, oil or another commodity relative to a security or narrow-based security index would implicate markets subject to both CFTC and SEC jurisdiction. Similar policy concerns would also be present for a security-based swap with knock-out/knock-in events tied to the value of gold, oil or another commodity. Swaps on indices or baskets that include narrow-based security index and physical commodity components are another example. Accordingly, in order to encompass these types of products within the scope of mixed swap regulation and exclude others more properly regulated solely as "swaps" or "security-based swaps", the Commissions should clarify that mixed swaps include only those swaps whose payout/settlement payment "is based on" (i.e., is the function of) the aggregate or comparative performance of underliers that include both individual securities (or a narrow-based security index) and non-securities.

In exercising their authority with respect to mixed swaps, we recommend that the Commissions allow market participants generally to comply with either of the regimes administered by the Commissions, subject to the application of specific provisions (such as position limits, insider trading, large trader reporting and anti-fraud/anti-manipulation

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standardized swaps entered into with third parties, it would be appropriate for regulators to exempt from mandatory clearing and trading inter affiliate swap transactions which are between for [*sic*] wholly-owned affiliates of a financial entity.").

[23] See also footnote 16 above regarding instruments that include foreign currency equivalent conversion provisions.

provisions) that are necessary to accomplish Dodd-Frank's objectives in light of the characteristics of the specific mixed swap. For other provisions, each Commission should also regulate mixed swaps in a manner consistent with the other Commission.

III. "Swap Dealer" and "Security-Based Swap Dealer" Definitions

A. Dealer/Trader Distinction

For the most part, the Dealer definitions closely track concepts and terms that the SEC has previously used to distinguish "dealing" activity from "trading" activity, such as whether a person "holds himself out as a dealer", "makes a market" or "engages in any activity causing it to be commonly known in the trade as a dealer or market maker". However, some questions have been raised with respect to the scope and meaning of clause (A)(iii) of the Dealer definitions, regarding a person who "regularly enters into [swaps/security-based swaps] with counterparties as an ordinary course of business for its own account". This is a novel formulation of dealer status and we request that the Commissions clarify that this formulation (specifically, "as an ordinary course of business") is intended to preserve the "dealer" versus "trader" distinction. A broader construction of clause (A)(iii) could potentially encompass <u>non-financial</u> companies that regularly enter into swaps as part of their business activities, a result that is clearly not intended since Dodd-Frank elsewhere classifies Dealers as "<u>financial</u> entities".[24] Such a construction would also blur the distinction between Dealers, on the one hand, and MSPs, on the other, since most persons with substantial positions in swaps or security-based swaps regularly enter into swaps or security-based swaps for their own accounts.

B. Central Counterparties

Read literally, clause (A)(iii) could also encompass a derivatives clearing organization, clearing agency, designated contract market, exchange or swap or security-based swap execution facility acting in the capacity of a central counterparty. Given that those entities are subject to comprehensive regulation by the CFTC or SEC, as appropriate, that is specifically tailored to entities acting in such a capacity, it makes little sense also to subject those entities to regulation as Dealers. Accordingly, the Commissions should clarify that Dealer definitions do not encompass any person to the extent that it acts as a central counterparty in connection with swaps or security-based swaps transactions.

C. Foreign Dealers

As the Commissions are aware, the OTC derivatives markets are the most truly global of financial markets. Market participants regularly enter into transactions with counterparties in other jurisdictions or referencing currencies, commodities, securities or other underliers from other jurisdictions. Accordingly, an internationally coordinated approach to regulation of the OTC derivatives markets is essential. Moreover, so long as national and regional differences persist, coordination depends upon a clear demarcation of each country's

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[24] <u>See</u> CEA Section 2(h)(7)(C) and Exchange Act Section 3C(g)(3).

jurisdiction and a workable framework for cross-border transactions. In the case of banks, in particular, this approach also necessitates a branch-by-branch, as opposed to a legal entity-based, approach to regulation, consistent with Dodd-Frank and bank regulatory regimes globally.

Sections 2(i) of the CEA and 30(c) of the Exchange Act provide guidance to the Commissions regarding the scope of their respective statutory jurisdictions. For the CFTC, Section 2(i) provides that:

> The provisions of [the CEA] relating to swaps that were enacted by the Wall Street Transparency and Accountability Act of 2010 (including any rule prescribed or regulation promulgated under that Act), shall not apply to activities outside the United States unless those activities . . . have a direct and significant connection with activities in, or effect on, commerce of the United States [or] contravene [CFTC anti-evasion rules].

For the SEC, Section 30(c) provides that:

> No provision of [the Exchange Act] added by the Wall Street Transparency and Accountability Act of 2010, or any rule or regulation thereunder, shall apply to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of [SEC anti-evasion rules].

Both of these provisions follow closely from existing interpretations and statutory provisions setting forth each of the Commissions' jurisdictions.[25] Accordingly, we urge the Commissions to adopt a framework for cross-border transactions that is consistent with those interpretations and provisions. In particular, we recommend that, consistent with the SEC's approach to broker-dealer registration, the Commissions adopt a territorial approach to Dealer registration, that subjects a person to swap dealer registration to the extent that it uses U.S.

[25] See, e.g., Statement of Policy Regarding Exercise of [CFTC] Jurisdiction Over Reparation Claims that Involve Extraterritorial Activities by Respondents, 49 Fed. Reg. 14721 (Apr. 13, 1984) (whether a person is required to be registered under the CEA may be determined by reference to whether (i) the person is based in the United States, (ii) the person engages in the prescribed activities with customers in the United States or (iii) the prescribed activities take place or originate in the United States); In the Matter of Sumitomo Corporation, Comm. Fut. L. Rep. ¶27, 327 (May 11, 1998) (CFTC enforcement action for manipulative copper trading outside the United States that directly affected U.S. prices); Exchange Act Section 30(b) (providing that the Exchange Act "shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States"); Morrison v. National Australia Bank, 130 S.Ct. 2869 (2010) (interpreting Exchange Act Section 30(b)); Exchange Act Section 27(b) (providing U.S. courts with jurisdiction over actions by the SEC or the United States alleging antifraud violations involving "conduct within the United States that constitutes significant steps in furtherance of the violation" or "conduct occurring outside the United States that has a foreseeable substantial effect within the United States").

jurisdictional means to engage in dealing activity or engages in dealing activity directly with U.S. customers.[26]

As part of this framework, we recommend that the Commissions adopt a clarification of the terms "swap dealer" and "security-based swap dealer" that would exclude, for specified purposes, foreign Dealers who do not transact directly with U.S. customers but who transact solely through U.S. registered Dealers (including an affiliate or U.S. branch) who must comply with all relevant business conduct and margin requirements in connection with such transactions.

In the case of a foreign Dealer that elects to register, or is otherwise subject to the U.S. registration requirement, we urge the Commissions to clarify that the Commissions' clearing, execution and business conduct regulations do not apply to such a registrant in the context of home country transactions with non-U.S. customers, since non-U.S. customers would not expect, and may not desire, the non-U.S. person to be subject to U.S. regulation.[27] The non-U.S. registrant would still be responsible for complying with U.S. standards with respect to U.S. customers, although it should be permissible for such registrants to outsource the performance (but not the responsibility for compliance with) those obligations to a U.S. registered Dealer.[28]

IV. "Major Swap Participant" and "Major Security-Based Swap Participant" Definitions

A. "Substantial Position" and "Substantial Counterparty Exposure"

The key determinants for whether a person is subject to regulation as an MSP are whether (a) that person has a "substantial position" in swaps or security-based swaps above a threshold set "for the effective monitoring, management, and oversight of entities that are systemically significant or can significantly impact the financial system of the United States" or (b) that person's outstanding swaps or security-based swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets". These provide clear direction that the Commissions should act so as to regulate as MSPs only those persons whose swap or security-based swap activities cause or could cause them to be systemically significant.

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[26] See SEC Release No. 34-27017 (Jul. 11, 1989) (describing the SEC's territorial approach to broker-dealer registration).

[27] Similar considerations led the SEC staff to adopt a similar approach in the case of foreign advisers registered with the SEC under the Investment Advisers Act of 1940. See Uniao de Bancos Brasileiros S.A. (avail. July 28, 1992) (concluding that the registered foreign advisory subsidiary of a foreign bank need not comply with U.S. requirements with respect to its non-U.S. clients); see also SEC, Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (May 1992) at 229.

[28] In addition, the Commissions should also consider the extent to which they will take into account compliance with comparable home country requirements as a substitute for compliance with U.S. requirements.

Accordingly, before establishing the qualitative standards or quantitative thresholds that will govern what constitutes a "substantial position" or "substantial counterparty exposure", the Commissions should gather and examine the empirical evidence regarding existing positions and exposures necessary to evaluate comprehensively the sources and level of systemic risk in the swap and security-based swap markets. In making this evaluation, we urge the Commissions to work closely with the Board of Governors of the Federal Reserve System (the "FRB"), the Federal Reserve Bank of New York, the Treasury Department and the newly created Financial Stability Oversight Council and Office of Financial Research. In particular, given the likely overlap between those persons who will be regulated as MSPs and the nonbank financial companies designated by the Council as subject to heightened prudential standards, coordination with the FRB and the Council will be critical. To the extent that the Commissions lack the data necessary to establish standards or thresholds that apply to the market generally until after market participants have begun to report existing swaps to swap data repositories, they may wish to consider setting interim standards or thresholds so as to capture designated nonbank financial companies.

Additionally, in order to capture those positions that truly give rise to systemic risk – i.e., large, one-sided positions such as the CDS position carried by AIG Financial Products in 2008 – the Commissions should calculate positions for MSP purposes on a net basis. This would be in addition to the explicit statutory direction that the Commissions take into account a person's relative position in uncleared as opposed to cleared swaps and security-based swaps and the value and quality of collateral held against counterparty exposures.[29] Similarly, in calculating counterparty exposures for MSP purposes, the Commissions should first give effect to enforceable netting agreements and collateral, which would be consistent with applicable haircuts for capital computation purposes.

In the case of non-U.S. market participants who transact both with U.S. counterparties and non-U.S. counterparties, we believe that the MSP framework adopted by the Commissions should look to the net U.S. counterparty-facing credit exposures created by such market participants in connection with uncleared swap transactions in determining the application of U.S. MSP registration requirements. The regulatory implications of such an entity's non-U.S. facing credit exposures should be determined under the framework established by its home country regulator. At a minimum, the framework adopted by the Commissions for non-U.S. MSPs should reflect a coordinated cross-jurisdictional approach that places regulatory responsibility in the hands of the regulatory authorities best situated to conduct effective supervision.

Finally, the imposition of substantive registration and other regulatory requirements for MSPs on the basis of having a substantial position or substantial exposure, whether based on a quantitative or qualitative standard, necessitates that the Commissions

[29] See CEA Section 1a(33)(B) and Exchange Act Section 3(a)(67)(B). Excluding cleared transactions from substantial position and substantial exposure calculations except as necessary to calculate positions on a net basis is also consistent with the statutory objective to provide incentives for central clearing.

articulate a standard and process for withdrawing from MSP status after falling below the relevant triggers.

B. Commercial Risk

For non-financial entities and banking institutions, "positions held for hedging or mitigating commercial risk" are excluded from the determination of whether a person has a substantial position for MSP purposes. When defining "commercial risk", the Commissions should confirm that all risks that arise in connection with a company's business activities, including financing, foreign exchange and other risks that arise out of activities that are incidental to a company's ordinary course of business, including risks related to individual or aggregated positions, contracts or other holding of any entity, are included. Additionally, hedges undertaken on a portfolio basis or with or on behalf of an affiliate should also be regarded, or qualify, as "held for hedging or mitigating commercial risk". A more narrow interpretation – such as one defining "commercial risk" to encompass only a company's primary business activity or requiring the hedge to be undertaken on a one-to-one basis with the risk – could encourage many commercial enterprises to accumulate unhedged interest rate, foreign exchange and other exposures that they would otherwise manage.[30]

C. ERISA Exclusion

The MSP definitions also exclude "positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 2001) for the primary purposes of hedging or mitigating any risk directly associated with the operation of the plan" from the determination of whether a non-financial entity has a substantial position. The Commissions should clarify whether this exclusion applies to positions held by welfare plans or entities holding assets of such plans, such as voluntary employees' beneficiary associations, employer group trusts or bank maintained collective trust funds. The Commissions should also confirm that "risk directly associated with the operation of the plan" includes all risks associated with implementation of investment strategies by the plan or the obligations of the plan.

D. Financial Entities

The Commissions should clarify the scope of clause (A)(iii) of the MSP definitions regarding "financial entities" that are "highly leveraged". In particular, the Commissions should confirm that the term "financial entity" as used in clause (A)(iii) is to be construed more narrowly than the express definition of "financial entity" included for purposes of the end user exception from mandatory clearing requirements.[31] This reading is supported by Dodd-Frank in two ways. First, an employee benefit plan is expressly defined as a "financial

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[30] We also recommend that, to the extent feasible, the Commissions adopt a definition of "commercial risk" that is consistent with the approach to commercial end users ultimately adopted in the European Union.

[31] See footnote 22, supra.

entity" for purposes of the end user exception,[32] yet, if a plan were defined as a "financial entity" for purposes of clause (A)(iii) of the MSP definitions, it would render the exclusion from clause (A)(i) for hedging positions held by a plan largely meaningless. Second, the term "financial entity" in the end user exception includes an MSP,[33] and the use of the same definition for purposes of clause (A)(iii) of the MSP definitions would make the MSP definition circular and incomprehensible.

The Commissions should also clarify that, similar to banks, registered and well-capitalized broker-dealers and futures commission merchants should not fall within the scope of clause (A)(iii). Many broker-dealers and futures commission merchants enter into security-based swaps and swaps to hedge their securities and futures exposures, and subjecting them to registration as MSPs simply by virtue of those activities would penalize use of a sound risk management tool by entities that, as a matter of public policy, should be encouraged to utilize such tools. Additionally, as is the case with banks, broker-dealers and futures commission merchants are subject to prudential regulation that addresses the use of leverage and in many cases, face even more onerous capital charges for swap and security-based swap positions than those faced by banks.

V. Cross-Border Activity

Due to the complexity of the issues presented by cross-border activity and the need for extensive coordination with regulators and market participants in other jurisdictions, we urge the Commissions to request comment on the proper treatment for cross-border activity. We also urge the Commissions to consider whether, in order to enhance certainty and transparency in this area, they should address these issues through formal, rule-based exceptions from the swap definition and/or the Dealer and MSP definitions or exceptions from substantive registration and other requirements, or whether interpretive or no-action guidance might be more appropriate.

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[32] Id.

[33] Id.

We appreciate the opportunity to comment on the Commissions' implementation of Dodd-Frank. We would be pleased to discuss any of the comments or recommendations in this letter with the Commissions or their staff in greater detail. Please feel free to contact the undersigned at 212-225-2820 with any questions.

Sincerely,

Edward J. Rosen