



April 6, 2012

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant;" File No. S7-39-10

Dear Ms. Murphy:

On February 22, 2011, Better Markets, Inc.<sup>1</sup> submitted a comment letter on the rule captioned above ("Proposed Rule") regarding further definitions of swap and security-based swap ("SBS") entities. We subsequently met with Commission staff regarding certain aspects of the Proposed Rule, focusing on, among other topics, the de minimis exemption from SBS dealer designation. We appreciate the time and attention that the Commission staff has devoted to these issues.

On March 15, 2012, the Commission's Division of Risk, Strategy, and Financial Innovation ("Division") released some data and analysis ("Data") based upon a sample of certain credit default swaps ("CDS") submitted to the Depository Trust and Clearing Corporation's Trade Information Warehouse between January 1, 2011, and December 31, 2011. The press release accompanying the Data explained that the new information had "the potential to be informative for evaluating certain final rules," including rules defining SBS entities and rules implementing the statutory de minimis exception to the SBS dealer definition. The release further noted that the Data was available for review and comment as part of the comment file for the Proposed Rule.

In this letter, we are providing comment on the Data, and the implications that this newly released information has for establishing an appropriate de minimis exemption from the SBS dealer designation.

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<sup>1</sup> Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

### **SUMMARY OF COMMENTS**

- The Data reveals that the currently proposed de minimis threshold of \$100 million is actually too high. More importantly, however, it shows that under no circumstances is there any basis for the Commission to increase the threshold in the final rule. Indeed, based on the lack of any empirical support for a threshold amount above \$100 million, it would be arbitrary, capricious, and contrary to the express provisions of the law to make any increase in the currently proposed level.
- In particular, there is no basis for a \$3 billion de minimis threshold, as some have proposed. The Data makes clear that such a threshold would be grossly excessive, potentially exempting over half of the market participants currently exhibiting dealer characteristics and essentially nullifying the registration regime for SBS dealers. Moreover, a \$3 billion threshold would likely create an even larger pool of unregistered dealers by incentivizing entities close to the \$3 billion mark to scale down or reorganize their operations to qualify for the exemption. This would also decrease liquidity in the SBS market. Adopting a \$3 billion threshold for the de minimis exemption (or anything above \$100 million) would clearly be arbitrary and capricious.
- A de minimis test based upon a market participant's percentage of total SBS activity is unacceptable, because (1) it has no basis in the statutory language; (2) it would exempt potentially large amounts of SBS activity and thereby pose a significant threat of abuse to counterparties; and (3) it would prove difficult to implement, monitor, and enforce.
- The final rule must, as required by law, expressly provide that the de minimis exemption is only available with respect to "transactions with or on behalf of customers."
- The final rule must not incorporate a risk-based test for the de minimis exemption.
- The Commission should bear in mind that those who seek to engage in more than a de minimis level of SBS activity are not precluded from doing so; they simply must register and comply with the requirements imposed on dealers that Congress deemed essential for protecting the stability and integrity of the financial markets.

### **OVERVIEW OF THE DATA.**

The Data analyzes the volume of trading activity in certain CDS for the calendar year 2011 according to five criteria that serve as indicia of dealer activity. The five criteria are the extent to which an entity—

1. Transacts with multiple counterparties;

2. Transacts with non-dealer counterparties;
3. Engages in offsetting buying and selling activity measured in terms of notional amount;
4. Engages in an offsetting number of buy and sell transactions; and
5. Posts initial margin in less than 10% of their aggregate transactions.<sup>2</sup>

The Division first sorted the Data according to these five criteria and then it summarized the level of trading activity for two specific sets of market participants: those that meet at least 2 of the 5 criteria, and those that meet at least 3 of the 5 criteria. The implications of these two summaries are discussed below.

### **COMMENTS**

**The Data reveals that the currently proposed de minimis threshold of \$100 million is actually too high. More importantly, however, the Data shows that under no circumstances should the Commission increase those thresholds in the final rule. Doing so would be arbitrary and capricious.**

The summary of the Data demonstrates that the threshold in the Proposed Rule is actually too high. The Proposed Rule provides that SBS activity by an entity is “de minimis” if, among other tests, it does not exceed \$100 million in notional amount over any 12-month period.<sup>3</sup>

However, the summary of the Data reveals that applying this dollar threshold as the de minimis test would exempt from the SBS dealer definition fully 12% of the entities exhibiting at least 3 out of 5 dealer characteristics.<sup>4</sup> In addition, this threshold would exempt 17% of the entities exhibiting at least 2 out of 5 dealer characteristics.<sup>5</sup> In short, the Data indicates that **a \$100 million annual de minimis test for SBS transactions would exempt between 12% and 17% of the entities acting as dealers from the important regulatory framework that Congress mandated for this category of market participant.**

In light of this new Data, the \$100 million threshold would actually exempt more than a de minimis level of SBS activity. The meaning of the term “de minimis” is “lacking significance or importance; so minor as to merit disregard; or trifling.” If the \$100 million threshold would exempt between 12% and 17% of the firms acting as dealers, then no reasonable person could conclude that such a level of activity would be trifling. In short, if such a high percentage of firms considers the activity to be commercially necessary or at least valuable, then it cannot be deemed insignificant or de minimis.

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<sup>2</sup> Data at 3-4.

<sup>3</sup> Proposed Rule § 240.3a71-2.

<sup>4</sup> Data at 20.

<sup>5</sup> *Id.* at 21.

Indeed, based on the lack of any data supporting any amount above \$100 million, **it would be arbitrary, capricious, and contrary to the express provisions of the law to increase the threshold above the currently proposed level of \$100 million.**

**A \$3 billion level, as proposed by some, has no basis, is not supported by the Data, and would be grossly excessive. Moreover, a \$3 billion threshold would likely create an even larger pool of unregistered dealers by incentivizing entities close to the \$3 billion mark to scale down or reorganize their operations to qualify for the exemption. This would also decrease liquidity in the SBS market. A \$3 billion threshold for the de minimis exemption would clearly be arbitrary and capricious.**

If the threshold were raised above \$100 million, the Data indicates that the universe of exempted entities would grow much larger. For example, if, as some industry representatives have urged, up to **\$3 billion** in annual SBS transactions were defined as de minimis, then, based on the Data sample, **between 34% and 57%** of all entities exhibiting dealer characteristics—**one-third to more than one-half**—would be exempted from designation as a dealer.

The amount of SBS activity conducted by more than half of the entities engaged in dealing simply cannot not be regarded as de minimis, trifling, or insignificant. Implementing such a test would literally make SBS dealer registration the exception rather than the rule. In light of this fact, and the lack of any empirical support for the \$3 billion threshold, **adopting such a test would clearly be arbitrary, capricious, and subject to challenge under the Administrative Procedure Act.**

Moreover, a \$3 billion threshold would likely create an even larger pool of unregistered dealers by incentivizing entities with activity levels close to \$3 billion to scale down or reorganize their operations to qualify for the exemption. The result would be an even more astonishing exemption covering **44%** of SBS dealer-like entities under the narrow definition and **66%** under the broader definition.<sup>6</sup> Obviously, this would far exceed de minimis levels and defeat Congress's goals of protecting market participants through the registration regime.

In addition, a reduction in activity levels to benefit from the exemption would also reduce liquidity in the SBS market. For example, based upon the Data, if entities with activity levels in the SBS market of up to \$5 billion scaled back their trading to the \$3 billion level, then a 5% decrease in liquidity for smaller businesses would likely result.<sup>7</sup> A \$100 million threshold would not create such perverse incentives for the simple reason that a reduction from billions of dollars of activity to the \$100 million level would entail a fundamental change in business model rather than a modest curtailment in activity, something that market participants would be unlikely to undertake.

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<sup>6</sup> These proportions are calculated by assuming that all of the entities in the \$3-5 billion bracket scale down operations or reorganize to fit under the \$3 billion threshold.

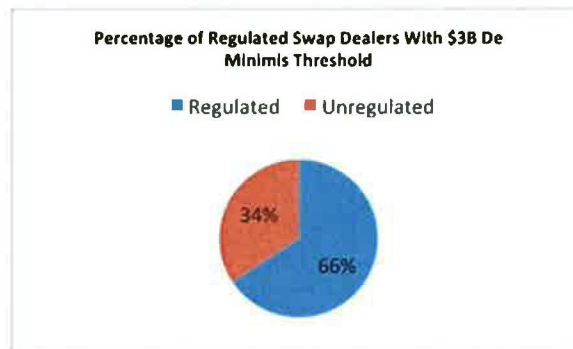
<sup>7</sup> The 5% figure is consistent across the two categories of dealer-like entities, and it is calculated by assuming an average 30% reduction in business by entities in the \$3-4 billion bracket and an average 50% reduction in business by entities in the \$4-5 billion bracket. The gross reduction is then taken as a percentage of all business done by entities outside of the top two brackets (in both cases, the largest 15 dealers), who are assumed to transact mostly with larger entities.



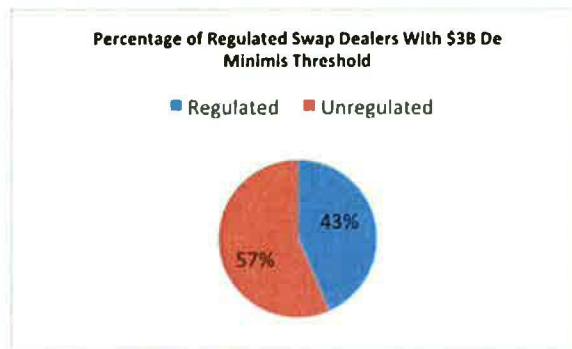
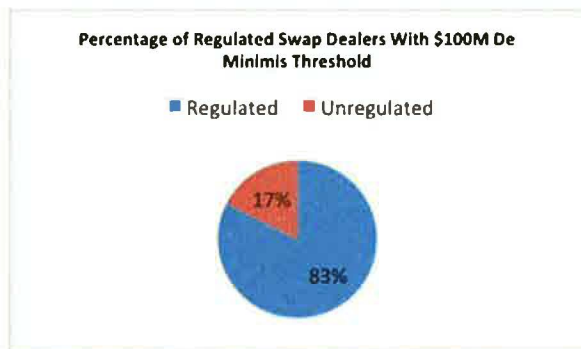
In sum, the Data shows that the \$100 million threshold as a test for de minimis activity is already too high. More significantly, it demonstrates that a \$3 billion threshold could not possibly be justified as the de minimis test for exemption from SBS dealer registration. Above all, the limit on de minimis SBS activity **must not be raised** above the currently proposed level of \$100 million.

The following graphs summarize the unacceptably high percentage of entities exhibiting dealer characteristics that would be exempt under both the \$100 million and \$3 billion thresholds:

**Under the Conservative Definition of SBS Dealer**  
**(Entities that Exhibit at Least 3 SBS Dealer-Like Behaviors)**



**Under the Broader Definition of SBS Dealer**  
**(Entities that Exhibit at Least 2 SBS Dealer-Like Behaviors)**



**A de minimis test based upon a market participant's percentage of total SBS activity is unacceptable, because (1) it has no basis in the statutory language; (2) it would exempt potentially large amounts of SBS activity and thereby pose a significant threat of abuse to counterparties; and (3) it would prove difficult to implement, monitor, and enforce.**

Some industry advocates will undoubtedly argue that the current threshold is actually too low in view of the Data, claiming that the dealers reflected in the sample who transacted SBS in the range of \$0 to \$100 million accounted for .01% or less of the total SBS activity conducted by all entities exhibiting dealer characteristics.<sup>8</sup> But this relativistic measure is inappropriate for a number of reasons:

- (1) It has no basis in the statutory language;
- (2) It violates the protective rationale underlying the Dodd-Frank Act; and
- (3) It would prove much more difficult to implement, monitor, and enforce than the bright-line test set forth in the Proposed Rule.

First, as noted in the Release, the statutory provision in the Dodd-Frank Act that authorizes the creation of a de minimis exemption does not "call for a relative test."<sup>9</sup> Since the provision authorizing the exemption includes no qualifications as to the "quantity" of activity that shall be considered de minimis, Congress clearly intended any de minimis test to be de minimis in every sense, not just de minimis in one respect but not in another. A percentage formula for the de minimis test therefore lacks support in the statutory language.

Second, a level of SBS activity that is small in relation to total market activity may nevertheless represent a significant dollar amount and a significant number of transactions.<sup>10</sup> Exempting such potentially high levels of SBS activity would clearly undermine one of the underlying purposes of the Dodd-Frank Act: preventing abuse of market participants in the complex arena of swaps and derivatives. Congress intended that SBS dealers would be subject to a broad array of regulatory requirements, not just for the purpose of limiting systemic risk but also for the purpose of limiting the amount of fraud and abuse that market participants would suffer at the hands of SBS dealers.

Accordingly, in addition to capital and margin requirements largely designed to contain systemic risk, the Dodd-Frank Act includes a range of provisions aimed at protecting counterparties, including the duty to disclose risks and conflicts of interest in connection with SBS transactions; an obligation to observe principles of fair dealing and good faith; the application of even higher standards of conduct for the protection of special

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<sup>8</sup> Data at 20-21.

<sup>9</sup> Release at 80180.

<sup>10</sup> In the Release, the Commission made a similar point in response to suggestions that de minimis levels be defined "in relation to the level of the person's other activities." Data at 80180. It correctly rejected that notion, pointing out that such a test would likely have the perverse and undesirable effect of exempting larger and more active companies in the SBS market, as opposed to smaller entities engaged in a lower amount SBS activity. *Id.*

entities; fitness standards for persons associated with SBS dealers; reporting and recordkeeping requirements; and mandatory appointment of chief compliance officers. A de minimis test framed in terms of a small market percentage but a significant dollar volume or number of dealers would defeat the purpose of these protections. Entities engaged in very significant dealing activity—and therefore posing a real threat of abuse to counterparties—would be able to avoid these important duties and restraints.

Third and finally, a percentage-based formula for the de minimis test would be more difficult to implement, monitor, and enforce than the quantitative test currently included in the Proposed Rule. Under a relativistic test, market participants would have to repeatedly calculate the ratio of their own SBS transactions to total market activity, as opposed to simply tracking the cumulative total of their SBS activity. The Commission would face a similar challenge in its surveillance of trading activity to determine if the de minimis threshold has been exceeded. Enforcement would also be complicated by disputes over the precise measure of total market activity that should be used in calculating a market participant's percentage share of all transactions.

In sum, defining the de minimis standard according to a percentage of market activity cannot be justified in light of the statutory language, the underlying purposes of the law, and the implementation difficulties it would create. The Commission must reject such an approach.

**The Commission must be guided by other basic principles as it finalizes the Proposed Rule.**

As the Commission finalizes the Proposed Rule and establishes the test for the de minimis exemption from designation as a dealer, it must be guided by a number of other important principles, some based upon the statutory mandate and others based on policies that will best serve the underlying purposes of the Dodd-Frank Act.

The final rule must expressly provide that the de minimis exemption is only available with respect to “transactions with or on behalf of customers.” This limitation appears in the Dodd-Frank Act itself and it was clearly intended to narrow the scope of the exemption. It means that no dealing activity, no matter how infrequent, is eligible for the de minimis exception unless it is conducted “in connection with transactions with or on behalf of customers” of the dealing entity.

The final rule must not incorporate a risk-based test for the de minimis exemption. The Commission has properly declined to follow the suggestion from commenters that the de minimis exception be tied to levels of risk to the financial system or to market participants or their counterparties. This approach finds no support in the statutory language or the protective purposes underlying dealer regulation. If adopted, these standards would gut the definition of SBS dealer in the same way a percentage-based formula would, as discussed above. The Commission has correctly focused instead on levels of dealing activity that are so limited that regulation as an SBS dealer with respect to capital, margin, and business conduct requirements is not warranted.

The Commission should bear in mind that those who seek to engage in more than a de minimis level of SBS activity are **not** precluded from doing so; they simply must register and comply with the requirements imposed on dealers that Congress deemed essential for protecting the stability and integrity of the financial markets. Advocates for broad exemptions and large loopholes in the SBS dealer registration requirements gloss over a simple but profound truth: Carefully limiting the amount of SBS trading that market participants may conduct without registration does not prohibit any activity, it only conditions it on compliance with registration requirements. Those requirements have been a basic feature of financial services regulation for over 75 years, and they have never interfered with enormous earnings and profits on Wall Street. The net effect of a low de minimis threshold would not be to stifle the SBS market. Instead, it would simply ensure that the market is subject to greater transparency, accountability, and oversight, all as required by the law.

## **CONCLUSION**

The Proposed Rule represents a commendable effort in an area of critical importance to the implementation of the Dodd-Frank Act. However, to prevent the de minimis exemption from essentially nullifying the registration regime for SBS dealers, the final rule must under no circumstances incorporate a higher threshold. In addition, the final rule must incorporate the other elements discussed above, which are necessary to fulfill the letter and spirit of the Dodd-Frank Act.

We hope these comments are helpful as you proceed to finalize the Proposed Rule.

Sincerely,



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