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February 22, 2011

Mr. David A. Stawick Secretary Commodity Futures Trading Commission Three Lafayette Centre 1155 21st Street, N.W. Washington DC 20581	Ms. Elizabeth M. Murphy Secretary Securities and Exchange Commission 100 F Street, N.E. 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 Number S7-39-10, RIN 3235-AK65).

Dear Ms. Murphy and Mr. Stawick:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**") is writing in response to the joint Notice of Proposed Rulemaking (the "**Release**"), published on December 21, 2010 by the Securities and Exchange Commission (the "**SEC**") and the Commodity Futures Trading Commission (the "**CFTC**" and, together with the SEC, the "**Commissions**"), regarding the Commissions' proposed rule (the "**Rule**") further defining terms including "major swap participant" and "major security-based swap participant" (collectively, "**MSP**").[1] The AMG appreciates having had the opportunity to provide the Commissions with pre-comment letters on this topic dated September 20, 2010 and November 24, 2010.[2]

The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered investment companies, state and local government pension funds, endowments, ERISA funds, 401(k) and similar types of retirement funds, and private funds such as hedge funds and private equity funds. In their role as asset managers, AMG member firms, on behalf of their clients, engage in transactions, including transactions for hedging and risk management purposes, that are classified as "swaps" or "security-based swaps" (collectively, "**Swaps**") under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**").

[1] Further Definition of "Swap Dealer," Security-Based Swap Dealer," "Major Swap Participant," Major-Security-Based Swap Participant" and "Eligible Contract Participant", 75 Fed. Reg. 80,174 (proposed December 21, 2010) (amending 17 CFR Pts. 1 & 240).

[2] *See* http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission21_112410-sifma.pdf, which includes both letters.

As described below, the AMG believes that: (a) registered investment companies, ERISA and governmental benefit plans and foreign entities subject to comparable foreign regulation should not be regulated as MSPs; (b) the MSP designation should be made at the level where recourse and counterparty risk reside; (c) market participants with relatively small Swap positions should benefit from a safe harbor exclusion from the MSP test calculations and reduced frequency of required testing; (d) the quantitative tests for "substantial position" should be simplified, clarified and more closely aligned with their purposes; (e) a uniform definition of the phrase "hedging or mitigating commercial risk" should be adopted; and (f) the "hedging or mitigating commercial risk" and ERISA position exemptions should be extended to the test for "substantial counterparty exposure."

Registered investment companies, ERISA and governmental benefit plans and entities subject to comparable foreign regulation should not be regulated as MSPs.

In the Release, the Commissions ask whether they "should exclude, conditionally or unconditionally, certain types of entities [including registered investment companies and ERISA plans] from the major participant definitions, on the grounds that such entities do not present the risks that underpin the major participant definitions and/or to avoid duplication of existing regulation."[3] As stated in our September 20, 2010 and November 24, 2010 letters, the AMG strongly supports excluding registered investment companies, ERISA plans and governmental benefit plans from MSP regulation.[4] These entities are subject to significant regulatory requirements and restrictions relating to their investments, capital structure and governance, which minimize risk and obviate the need for their regulation as MSPs. Similarly, the AMG believes that entities subject to comparable foreign regulation, such as UCITS funds, should be exempted from MSP regulation.

The MSP designation should be made at the level where recourse and counterparty risk reside.

A. The MSP designation should be made at the level of the individual funds or sub-funds in whose names the swap positions are held and to whom counterparties' recourse is limited.

The AMG commends the Commissions for recognizing that it is inappropriate for the MSP designation to be applied at the level of the asset manager.[5] As stated in our letters to the Commissions dated September 20, 2010 and November 24, 2010, asset managers do not contribute to systemic risk, the funds and accounts that asset managers advise are separate legal entities without any shared assets or liabilities, creditors typically have no recourse to the asset manager for the positions they manage, and, as an MSP, regulation would be duplicative since asset managers are already subject to

[3] *See* Release at 80,203.

[4] *See* September 20, 2010 AMG Letter at 7-12 *and* November 24, 2010 AMG Letter at 2.

[5] *See* Release at 80,201.

regulation and have fiduciary duties to each account or fund they manage under the Investment Advisers Act of 1940.[6]

In the Release, the Commissions state that "since the major participant definitions focus on the entity that enters into [Swaps], all of the managed positions of which a person is the beneficial owner are to be aggregated (along with such beneficial owner's other positions) for purposes of determining whether such beneficial owner is a major participant."[7] The Commissions include a helpful footnote that clarifies that this position applies only to managed accounts.[8] Nevertheless, the AMG requests formal clarification that aggregation based on beneficial ownership will not apply to investment funds. The AMG strongly believes that it would be inappropriate to look through an investment fund to its beneficial owners and attribute the positions of the fund to those beneficial owners for purposes of determining MSP status.[9] Not only would it be impractical to allocate positions of funds to their investors, particularly in the case of retail mutual funds, but shareholders of funds are not themselves the legal counterparties to Swap positions; and the risk, capital and collateral is held with the fund itself, or a sub-fund where applicable, and not by its shareholders. Accordingly, the AMG requests that the Commissions' final rule make clear that, with respect to investment funds, MSP status is to be determined solely at the fund or sub-fund level where the swap positions are held and to whom counterparties' recourse is limited.

B. Where Swap documentation recognizes the separate recourse of a separately managed account, the MSP designation should be made based on the positions of the particular managed account rather than aggregating all managed positions of that accountholder.

In its discussion of managed accounts, the Release states that individual accounts of a particular accountholder should be aggregated for purposes of determining whether that accountholder is an MSP.[10] However, many asset managers enter into Swaps on behalf of managed accounts under an ISDA Master Agreement executed by the asset manager on behalf of the managed accountholder. Such ISDA Master Agreements frequently provide that the counterparty to the transaction does not have recourse to the accountholder's other assets held in other accounts (including collateral accounts)

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[6] *See* November 24, 2010 AMG Letter at 2.

[7] *See* Release at 80,201.

[8] *See* Release at 80,201 n.164.

[9] In addition, if the Commissions were to adopt the "beneficial owner" standards of Section 13 of the Securities Exchange Act of 1934 with respect to investment managers of investment funds for the determination of MSP status, the Swaps positions of multiple funds managed by the same investment adviser (or affiliated advisers) could be required to be aggregated. Such a result would be inconsistent with the Commissions' position set forth in the Release, as well as the legislative history of the Dodd-Frank Act, which indicates that lawmakers intended major participant status is to be considered on a fund-by-fund basis, without aggregation.

[10] *See* Release at 80,201 ("[A]ll of the managed positions of which a person is the beneficial owner are to be aggregated (along with such beneficial owner's other positions) for purposes of determining whether such beneficial owner is a major participant.").

managed by the same or other asset managers. Where this is the case, the Commissions should respect the separate nature of these accounts and not aggregate the accountholder's Swap positions with positions in other accounts owned by the same accountholder.

Where the risk related to any one account is effectively "ring-fenced" from other accounts owned by the same accountholder, accountholders should be able to hire investment managers to monitor compliance with applicable regulatory requirements on an account-by-account basis and diversify their assets among multiple investment managers without the burden of tracking compliance across their entire portfolio. At the same time, while asset managers may be in the best position to determine whether a single managed account qualifies as an MSP, asset managers do not have access to the information about positions of the accountholder at other asset managers and, as a result, cannot make the determination on behalf of the accountholder on an aggregate basis. Aside from the practical difficulties of sharing such information, requiring asset managers to aggregate the positions of the holders of their managed accounts by sharing information with each other could breach fiduciary obligations and require asset managers to share sensitive investment and strategy information with their competitors. Such an approach may require coordination between the various asset managers to monitor compliance with the MSP thresholds.

As a result, the AMG believes that in cases where Swap counterparties recognize recourse solely to the assets of a separate account, the MSP designation should be made only with respect to that individual managed account. The AMG understands that the Commissions might be concerned that certain accountholders would spread their assets among many asset managers or through separate trading agreements with limited recourse solely to avoid designation as an MSP. The AMG believes this is unlikely to occur as it would be prohibitively expensive and operationally burdensome. In addition, any such evasive activity is best addressed through use of the Commissions' anti-evasion powers.[11] The AMG also believes that limiting the MSP designation to individual managed accounts should not affect the ability of accountholders to rely on the "hedging or mitigating commercial risk" and ERISA hedging exemptions.

The Commissions should provide a safe-harbor exclusion from the MSP calculations and, for those market participants for which the safe harbor is not available, a reduction in required frequency of, the MSP test calculations where entities engaging in Swap trading are substantially below the applicable thresholds.

The AMG commends the Commissions for proposing an objective quantitative test of "substantial position." AMG members have performed the proposed test on both real and mock portfolios in order to assess the workability of the test and to determine their clients' likelihood of being designated as an MSP under it. AMG members have found the Rule overly complex and burdensome and, in some cases, lacking the clarity needed for precise calculations. While the AMG believes that the proposed *thresholds*

[11] As the Commissions note in the Release, "The Commissions have the authority to adopt anti-evasion rules to address the possibility that persons who enter into [Swaps] may attempt to allocate the [Swaps] among different accounts (thereby attempting to treat such other accounts as the entity that has entered into the swaps or security-based swaps) for the purpose of evading the regulations applicable to major participants." See Release at 80,201.

generally achieve the Commissions' intended result of "provid[ing] for the appropriately early regulation of an entity whose [Swap] positions have a reasonable potential of posing significant counterparty risks and risks to the market that stress the financial system, while being high enough that it would not unduly burden entities that are materially less likely to pose these types of risks,"[12] the AMG believes that the required method of calculation of the thresholds is unnecessarily complex and burdensome and may result in inconsistent application. Given this complexity and burden, and the fact that the Commissions have indicated that they expect very few entities to have to regularly perform these calculations,[13] the AMG requests that the Commissions modify the requirements for conducting the test in the following ways.

The AMG believes that a safe harbor from MSP testing is appropriate where the undiscounted notional amount of Swaps is below all individual thresholds for the sum of Current Uncollateralized Exposure ("**CUE**")[14] and Potential Future Exposure ("**PFE**")[15] in the MSP tests both within each major category of Swaps – $6 billion for rate swaps and $2 billion for other individual major categories of Swaps – and looking across the major categories of Swaps – $8 billion for all major categories of swaps combined and $4 billion for all major categories of security-based swaps combined. The AMG believes that it is unlikely that a market participant would qualify as an MSP with undiscounted notional values below these levels. As a result, it is unnecessary to subject such entities to the administrative burdens of performing the complex calculations otherwise required by the test. This is consistent with the SEC's comment that "an estimate of an entity's mark-to-market exposure associated with its security-based swap positions can be derived from the level of an entity's notional positions."[16]

For those entities that are not able to avail themselves of the safe harbor, the AMG believes that market participants that are otherwise required to perform the calculations should be able to do so on a less frequent basis if the entity is below every applicable threshold by at least 50%. The AMG would suggest that the Commissions require such market participants to perform the calculations once a month using month-end, rather than daily, data. If such market participant's Swap positions exceed 50% of any applicable threshold based on such a month-end test, it thereafter would be required

[12] *See* Release at 80,190 n.105.

[13] *See, e.g.,* Release at 80,204-05 ("[t]he CFTC believes that because the proposed quantitative thresholds are very high, only very few market participants would have to conduct a detailed analysis to determine whether they are encompassed by the proposed definition"); Release at 80,207 ("[b]ased on the current over-the-counter derivatives market, [the SEC] estimate[s] that no more than 10 entities that are not otherwise security-based swap dealers would have either uncollateralized mark-to-market positions or combined uncollateralized current exposure and potential future exposure of a magnitude that may rise close enough to the level of our proposed thresholds to necessitate monitoring to determine whether they meet those thresholds").

[14] By "current uncollateralized exposure test," we mean the Commissions' tests for "daily average aggregate uncollateralized outward exposure."

[15] By "potential future exposure test," we mean the Commissions' tests for "daily average aggregate potential outward exposure."

[16] *See* Release at 80,207 n.181.

to run the calculations using daily data until it again fell below the 50% mark for all thresholds.

The definition of "substantial position" should be simplified and, at the very least, requires certain clarifications and modifications.

The AMG suggests that the Commissions incorporate certain simplifications, clarifications and modifications to the "substantial position" tests – the CUE and PFE tests. The following suggested changes would reduce the burdens and costs to Swap market participants, and more closely align the tests with the objectives they are meant to achieve.

A. The CUE Test

As described in the Release, the CUE test is meant to capture the "potential risk that an entity would pose to its counterparties if the entity currently were to default."[17] The test generally requires that an entity aggregate the mark-to-market values of its out-of-the-money positions in a specific "major category" and subtract from that amount the value of the collateral it has posted with respect to those positions with that counterparty in that "major category." Netting arrangements are given effect across an entity's portfolio with a specific counterparty. The AMG believes that such a test, generally, is an appropriate measure of uncollateralized exposure; however, the AMG suggests the following clarifications and modifications:

- **Cleared Trades.** The AMG believes that the Commissions should explicitly exclude cleared trades from the CUE calculations. Footnote 92 of the Release states that the CUE test "would account for the risk-mitigating effects of central clearing in that centrally cleared [Swaps] are subject to mark-to-market margining that would largely eliminate the uncollateralized exposure associated with a position, effectively resulting in cleared positions being excluded from the analysis."[18] The AMG agrees that the daily mark-to-market margining associated with cleared positions eliminates uncollateralized exposure. Therefore, the AMG requests that the Commissions explicitly state in the Rule that cleared positions do not need to be considered for the CUE test. Doing so will greatly simplify the test and ease computational burdens.

- **Net In-The-Money Portfolios.** The Commissions should clarify in the Rule that net in-the-money portfolios with respect to a particular counterparty need not be considered in calculating an entity's CUE with respect to any major category. This is entirely consistent with the Commissions' provisions for netting arrangements in the CUE test. However, the AMG requests that the Commissions explicitly state this in the Rule itself. This would avoid the necessity of complex calculations where a portfolio with a specific counterparty is known to be net in-the-money.

[17] *See* Release at 80,188.

[18] *See* Release at 80,189 n.92.

- **Net Out-Of-The-Money But Fully Collateralized Portfolios.** The AMG believes that the Commissions should clarify that portfolios with a particular counterparty that are fully collateralized do not need to be considered for purposes of calculating an entity's CUE with respect to any major category. Similar to the request above, this appears to be the Commissions' intent but would be clearer and would ease computational burdens if stated explicitly in the Rule.

- **Thresholds and Minimum Transfer Amounts.** The AMG believes that thresholds and minimum transfer amounts ("**MTAs**") should only be counted as part of the CUE calculation to the extent they represent true uncollateralized exposure. As a result, the AMG requests that the Commissions clarify the treatment of thresholds and MTAs in several ways.

  First, it is confusing that thresholds and MTAs appear to apply to the calculation of CUE, rather than PFE, but are located in the portion of the Rule that discusses PFE discounts for Swaps that are marked-to-market or cleared. As a result, the AMG requests that the Commissions first clarify whether thresholds and MTAs are relevant to the calculation of CUE or to PFE. If they are relevant to CUE (as we believe they are) the Commissions should move the provisions into the section of the Rule relating to the CUE test. Since it is not clear to the AMG how thresholds and MTAs could factor into the PFE analysis (which does not take into account posted collateral), we assume that they are relevant only to the calculation of CUE.

  Second, the AMG believes that the Commissions should not count threshold amounts or MTAs in excess of $1 million in the CUE calculation to the extent that the portfolio remains collateralized after the threshold or MTA is accounted for.[19] Similarly, the Commissions should clarify that thresholds and MTAs in excess of $1 million will not be added to CUE where a portfolio with a particular counterparty is net in-the-money and would remain so after applying a threshold or MTA. Simply put, since the purpose of the CUE test is to measure uncollateralized exposure, threshold amounts and MTAs are not relevant in these cases. To the extent a portfolio with a particular counterparty is net out-of-the-money and undercollateralized, the actual amount of undercollateralization, rather than the entire threshold or MTA, should be added to CUE if the undercollateralization is less than the threshold or MTA. Similarly, the AMG believes that thresholds and MTAs should not be counted in CUE to the extent that no trades have been entered into by the parties under the relevant agreement providing for the threshold or MTA as it would be nonsensical to deem such an agreement as creating current exposure.

[19] For example, consider Person X who is $2 million net out-of-the-money on its interest rate swaps with Dealer Y and has a threshold of $1 million with Dealer Y. If Person X has a $5 million independent amount posted with Dealer Y, Person X will be required to post to Dealer Y $6 million ($2 million net out-of-the-money exposure + $5 million independent amount – $1 million threshold). Person X's exposure to Dealer Y is fully collateralized, notwithstanding the applicability of the threshold.

In addition, the AMG requests that the Commissions confirm the AMG's understanding that MTAs of $1 million or less will not be counted as part of CUE[20] and that the $1 million MTA discussed in the Rule does not apply on an aggregate basis across all dealers.

- **Operational Delays; Overnight Risk.** The AMG requests that the Commissions codify in the Rule their comment in footnote 92 of the Release that they generally do not expect "operational delays associated with the daily exchange of collateral . . . to lead to uncollateralized exposure" for purposes of the CUE test.[21] The AMG agrees that exposure accruing during standard market collateral transfer periods should not be counted as uncollateralized exposure, but believes that the inclusion of the statement in the Rule itself is necessary to ensure clarity and certainty.

- **Mark-To-Market Margining**. The AMG believes that the Commissions should clarify in the Rule when a Swap is "subject to daily mark-to-market margining."[22] Footnote 113 of the Release explains that this is the case "for as long as, the counterparties follow the daily practice of exchanging collateral to reflect changes in exposure (after taking into account any other positions addressed by a netting agreement between the parties)."[23] The AMG believes that this definition correctly defines mark-to-market margining and should be stated explicitly in the Rule.

- **Pro-Rata Allocation of Collateral.** The AMG requests that the Commissions explicitly incorporate into the Rule the methodology for pro-rata allocation of collateral in the presence of netting agreements as described in footnote 102 of the Release. Currently, the Rule is silent on how collateral should be allocated across an undercollateralized portfolio subject to a netting agreement and guidance is only given in the Release. The AMG requests that the Commissions clarify that this procedure would also apply to the allocation of collateral among individual netting agreements under an umbrella netting agreement.

- **Mixed Swaps.** The AMG requests that the Commissions provide guidance as to how exposure and collateral will be measured and allocated for mixed swaps.[24]

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[20] The Rule specifically states that MTAs exceeding $1 million will be counted as part of CUE, but does not explicitly state that MTAs of $1 million or less will not.

[21] *See* Release at 80,189 n.92.

[22] This applies not only to the CUE test but also to the PFE test.

[23] *See* Release at 80,192 n.113.

[24] The AMG believes, as stated in its September 20, 2010 letter, "that the Commissions should promulgate rules that would impose a predominance test on mixed swaps such that a security-based swap that has only incidental or *de minimis* characteristics of a swap would be treated as a security-based swap, and that a swap that has only incidental or *de minimis* characteristics of a security-based swap would be treated as a swap." *See* September 20, 2010 letter at 12.

B. The PFE Test

As described in the Release, the PFE test is meant to capture "an estimate of how much the value of a [Swap] might change against an entity over the remaining life of the contract."[25] The test generally requires that an entity multiply the total notional amount of its Swaps by a factor representing the risk of that Swap based on asset class and residual maturity. The value is then reduced based on netting arrangements and if the position is cleared or marked-to-market daily. While we understand that the Commissions believe that such an outward looking test is necessary,[26] the AMG respectfully disagrees that it is appropriate to measure such risk as the amount that "the value of a [Swap] might change against an entity over the ***remaining life of the contract***."[27] Ideally, this risk would be measured as the potential volatility in exposure for the shortest period within which a non-defaulting party can close out trades, liquidate collateral and apply proceeds to exposures or replace the trade. After the non-defaulting party closes out the trade, liquidates collateral and applies the proceeds to meet outstanding liabilities, no additional risk remains with respect to that counterparty. The AMG, however, recognizes the need for a rule that is relatively simple to apply, so all interested parties can calculate PFE without excessive burden. Accordingly, the AMG suggests the following clarifications and modifications:

- **Collateral and Cleared Positions.** The AMG believes the PFE test should measure potential exposure only to the extent that exposure is not collateralized through initial margin, such as Independent Amounts posted under an ISDA-based or similar Credit Support Annex or initial margin posted to a clearinghouse. The level of collateral required by each dealer or clearinghouse is tailored to the specific potential future risk presented by each individual transaction, which should be superior to the generic approach used in the PFE calculation proposed in the Release. The sophisticated parties that enter into these relationships carefully calculate the amount of collateral that would be required to close out trades, liquidate the collateral on hand and apply the proceeds to the exposures or replace the trade. Such collateralization effectively acts as an agreed measure of "potential future exposure," and when it exists, there should be no need for parties to make a separate determination of potential future exposure under the Rule.[28]

[25] *See* Release at 80,188.

[26] The AMG understands the Commissions' concern that a CUE test, on its own, "could be overly narrow by failing to identify risky entities until some time after they begin to pose the level of risk that should subject them to regulation as major participants" and that "[b]ecause exposure can change significantly over short periods of time, and a [Swap] position that may pose large potential exposures nonetheless would often have a mark-to-market exposure of zero at inception, an entity's positions may already pose significant risk to counterparties and to the market even before its uncollateralized mark-to-market exposure increases up to the applicable threshold." *See* Release at 80,188.

[27] *Id*. (emphasis added).

[28] The AMG believes that while the current PFE test is too generic, it is difficult to apply and any more customized approach may be too burdensome to be operable.

If trades are not so margined to address potential future exposure, calculations of such exposure should be made using the generic PFE test proposed in the Release. However, positions should receive a full discount with respect to the extent of margin held by a dealer (or third party) in excess of current exposure. In this vein, the AMG requests clarification that overcollateralization and net in-the-money positions will receive proper credit in the PFE calculations and that the Rule will allow for negative CUE to offset against PFE.

The AMG also believes that cleared positions should be fully excluded from the calculation of PFE rather than discounted only by 80%. Commission rules will require that clearinghouses use appropriate margining methodologies to determine initial margin amounts to account for potential future risks. Removing cleared positions from the PFE calculation would encourage clearing of Swaps, as desired by Congress. Lastly, clearinghouses are likely to accept only high quality collateral. Accordingly, giving full credit for cleared trades will also have the effect of rewarding the use of such high quality collateral.

- **Risk Factor Categories.** The AMG believes that, for those trades for which the generic PFE calculations will apply, the Commissions should map the risk factor categories used in the PFE calculation to the "major categories" of swaps and security-based swaps for clarity. While there are 4 major swap categories and 2 major security-based swap categories, there are 6 risk factor categories for swaps and 3 risk factor categories for security-based swaps.

- **Master Netting Agreement Reduction**. The Commissions should simplify the proposed master netting agreement calculation and clarify how it is to be applied. AMG members are uncertain how to correctly apply the proposed calculations and do not understand the rationale behind the proposed formula. For example, it is unclear whether "gross current exposure" should be calculated as the sum of the absolute values of exposures for each Swap within a specific major category by counterparty or whether a different calculation is envisioned by the Commissions.

- **Effective Notional Modifications.** The AMG suggests the Commissions provide additional guidance on how to convert stated notional amounts to effective notional amounts "[i]f the stated notional amount on a position is leveraged or enhanced by the structure of the position."[29] The AMG understands the Commissions' concerns that economically equivalent transactions could potentially be achieved with different notional amounts by scaling interest or other payment rates. As a result, the AMG understands the potential need for modifications to determine the effective notional amount. However, for computational clarity, the AMG requests that the Rule provide a quantitative formula by which stated notional amounts are to be modified.

[29] *See* CFTC Rule 1.3(sss)(3)(ii)(A)(2); SEC Rule 3a67–3(c)(2)(i)(B).

The Commissions should adopt a uniform definition of the phrase "hedging or mitigating commercial risk."

The AMG believes that the Commissions should adopt a uniform definition of the phrase "hedging or mitigating commercial risk," for purposes of the hedging exemption to the "substantial position" test for MSP designation (the "**hedging exemption**"). Differing definitions will lead to confusion and interpretive disparities based on whether industry participants seek to use the hedging exemption for CFTC-regulated swaps or SEC-regulated security-based swaps. Since the Commissions have indicated they will use the same definitions in other rulemakings, [30] the AMG believes that it is important that any disparities be eliminated.

The AMG believes that the CFTC's definition of "hedging and mitigating commercial risk" is clearer and potentially easier to apply than the SEC's. Although the Release states that both the swaps and security-based swaps that are included within the exclusion to the Rule would not be limited to those qualifying for hedge accounting, we are concerned that, unlike the CFTC definition, the requirements relating to security-based swaps in Rule 3a67–4(c) would effectively impose a second regime similar to that imposed by accounting standards.[31] The SEC has also indicated its desire to very narrowly interpret the term "economically appropriate."[32] In particular, it would likely prove to be very difficult in practice to analyze whether certain hedge transactions would "introduce any new material quantum of risks . . . more than reasonably necessary to manage the identified risk" or "reflect over-hedging."[33] The AMG believes that legitimate hedges may not be captured in the hedging exclusion if this language is viewed too narrowly. For example, industry participants seeking to hedge commercial risk often

[30] For example, the Commissions note in the Release that they intend to interpret "hedging or mitigating commercial risk" for purposes of the non-financial end-user exception from clearing in the same way as they do for the MSP Test. *See* Release at 80,194. *See also* End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80,747 (proposed December 23, 2010) (amending 17 CFR Part 39); End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. 79,992 (proposed December 21, 2010) (amending 17 CFR Part 240).

[31] *See* SEC Rule 3a67-4(c) which conditions the exclusion on the following requirements:

> (1) The person identifies and documents the risks that are being reduced by the security-based swap position;
> (2) The person establishes and documents a method of assessing the effectiveness of the security-based swap as a hedge; and
> (3) The person regularly assesses the effectiveness of the security-based swap as a hedge.

[32] "The SEC preliminarily plans to interpret the concept of 'economically appropriate' based on whether a reasonably prudent person would consider the security-based swap to be appropriate for managing the identified commercial risk. The SEC also preliminarily believes that for a security-based swap to be deemed 'economically appropriate' in this context, it should not introduce any new material quantum of risks (i.e., it cannot reflect over-hedging that could reasonably have a speculative effect) and it should not introduce any basis risk or other new types of risk (other than the counterparty risk that is attendant to all security-based swaps) more than reasonably necessary to manage the identified risk." *See* Release at 80,195 n.129.

[33] *Id*.

enter into proxy hedges that are more cost-effective than hedges customized to fit the exact risk being hedged. If a hedge position has an 80% correlation with the commercial risk being hedged, the AMG is concerned that the remaining 20% exposure might be viewed as introducing a "new material quantum of risk" and disqualify the hedge from the exclusion. Whether a Swap position creates a "new material quantum of risk" requires a judgment call that could result in the improper exclusion of legitimate hedging or risk mitigating transactions from the Rule's exemption.

As mentioned above, the SEC definition requires each entity that seeks to rely on the exemption to "identif[y] and document[] the risks that are being reduced by the security-based swap position; . . . establish[] and document[] a method of assessing the effectiveness of the security-based swap as a hedge; and . . . regularly assess[] the effectiveness of the security-based swap as a hedge."[34] The AMG believes that these requirements, which reach beyond the statutory requirement, will be unnecessarily burdensome on market participants.

Finally, the AMG suggests that the Commissions delete the requirement that, beyond qualifying as an appropriate hedge as discussed above, a swap can "[n]ot [be] held for a purpose that is in the nature of speculation, investing or trading" and a security-based swap "[n]ot [be] held for a purpose that is in the nature of speculation or trading" in order to qualify for the hedging exemption.[35] The AMG believes that such a requirement might disqualify legitimate hedges and that proxy hedges in particular, as discussed above, could potentially be viewed as "speculative" and disqualified from the hedging exemption. That result would not comport with Congress's clear intent in excluding hedges in the statute.

The commercial risk and ERISA position exemptions should be extended to the "substantial counterparty exposure" test.

The AMG believes that the exception from "substantial position" in the first statutory prong of the MSP test for positions used to hedge or mitigate commercial risk and positions used to hedge risks related to operation of ERISA plans should be made available for such positions when calculating "substantial counterparty exposure" for purposes of the second prong of the statutory MSP definition.[36] The Commissions have decided to use the same quantitative methods for "substantial position" and "substantial counterparty exposure." In addition, as the Commissions suggest, such hedging positions

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[34] *See* SEC Rule 3a67-4(c).

[35] *See* CFTC Rule 1.3(ttt)(2)(i); SEC Rule 3a67–4(b)(1).

[36] *Compare* CFTC Rule 1.3(qqq)(1)(ii)(A) (defining "major swap participant" under the "substantial position" test as a person "[t]hat maintains a substantial position in swaps for any of the major swap categories, excluding both positions held for hedging or mitigating commercial risk, and positions maintained by any employee benefit plan . . . for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan") *with* CFTC Rule 1.3(qqq)(1)(ii)(B) (defining "major swap participant" under the "substantial counterparty exposure" test as a person "[w]hose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets"). The language with respect to the SEC portion of the Rule is parallel.

"may not raise the same degree of risk to counterparties as other [Swap] positions."[37] Therefore, should the Commissions choose not to exclude ERISA plans from regulation as MSPs altogether, the AMG believes that the Commissions, at a minimum, should extend the hedging or mitigating commercial risk and ERISA hedging exceptions to the "substantial counterparty exposure" test.

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The AMG thanks the Commissions for the opportunity to comment on the joint proposed rulemaking concerning the definition of "major swap participant" and "major security-based swap participant" under Title VII. The AMG would welcome the opportunity to further discuss our comments with you. Should you have any questions, please do not hesitate to call the undersigned at 212-313-1389.

Respectfully submitted,

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cc: Chairman Mary L. Schapiro, SEC
Commissioner Luis A. Aguilar, SEC
Commissioner Kathleen L. Casey, SEC
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Commissioner Elisse B. Walter, SEC
Chairman Gary Gensler, CFTC
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Commissioner Michael Dunn, CFTC
Commissioner Scott D. O'Malia, CFTC
Commissioner Jill E. Sommers, CFTC

[37] *See* Release at 80,198.