

August 24, 2012

SUBMITTED ELECTRONICALLY

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

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

RE: Petition for Rulemaking on the Definition of Eligible Contract Participant in Commodity Exchange Act Section 1a(18), Interpretive Letter, Exemptive Relief, or Other Guidance

Dear Mr. Stawick and Ms. Murphy,

The American Bankers Association (ABA)¹ is requesting rulemaking, an interpretive letter, exemptive relief, or other guidance from the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC) (together, the Commissions) on the eligible contract participant (ECP) definition in Commodity Exchange Act Section 1a(18), which is incorporated by reference in Securities Exchange Act Section 3(a)(65). This definition is a key component of the new regulatory framework for the swaps markets. As a result of the Dodd-Frank act, only ECPs will be able to enter into over-the-counter (OTC) swaps.

While the definition of final swap dealer and security-based swap dealer (together, swap dealer) definition rule provided some clarity on the ECP definition, it left some significant issues unaddressed. The Commissions listed some of the issues related to the ECP definition that they may consider in the future.² We urge the Commissions to act expeditiously to ensure the transition to the new regulatory regime does not unduly disrupt the lending markets.³

¹ The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$14 trillion banking industry and its 2 million employees. Learn more at www.aba.com.

² See footnote 596 of the Entity Definitions Rule at 77 Fed. Reg. at 30647. These issues include: (i) the ECP status of jointly and severally liable borrowers and counterparties, non-ECPs guaranteed by ECPs, and non-ECP swap collateral providers; (ii) whether bond proceeds count toward the "owns and invests on a discretionary basis \$50,000,000 or more in investments" element of the governmental ECP prong; (iii) the relationship between the ECP and eligible commercial entity definitions for purposes of CEA section 1a(18)(A)(vii); (iv) the scope of the "proprietorship" element of the entity prong of the ECP definition in CEA section 1a(18)(A)(v); (v) the meaning of the new "amounts invested on a discretionary basis" element of the individual prong of the ECP definition; (vi) whether persons can be ECPs in anticipation of receiving, but before they have, the necessary assets; and (vii) that

Given the unprecedented depth and breadth of rulemaking required to establish an entirely new framework for regulating the swaps markets, the need for additional rulemaking, exemptive relief, or interpretive guidance is not surprising. However, absent clarity on some threshold issues, banks will be unnecessarily discouraged from offering swaps to customers if it is unclear whether those customers will qualify as ECPs. In many cases, this will limit the availability of credit to borrowers looking to finance their business operations.

It often takes months to negotiate and close a loan, so loan officers are already lacking key guidance on the ECP definition that they need to ensure potential customers can continue using swaps to hedge and mitigate loan risk. In the absence of guidance, the uncertainty is already causing some banks to reconsider whether borrowers with limited cash flows will have the ability, without swaps, to service debt should interest rates rise in the future. The result will be decreased lending – especially to individuals and small and medium-sized businesses – at a time when our country needs access to credit to ensure sustained economic recovery, as well as decreased economic efficiency.

I. Background

Section 2(e) of the Commodity Exchange Act (CEA) and Section 6(l) of the Securities Exchange Act of 1934 will make it illegal to enter into a swap with anyone other than an ECP unless it is done on or subject to the rules of a designated contract market. As a result, it will be illegal to enter into over-the-counter (OTC) swap transactions with a non-ECP after the swap definition implementation date on October 12, 2012.

This deadline is rapidly approaching. Many swaps will still be OTC transactions after that date because they are exempt from clearing or they are customized, so banks and their customers all need guidance about which individuals or entities will be ECPs. Furthermore, the uncertainty is already having an impact on loan negotiations, since many of the loans currently being negotiated will not close until after the implementation date.

If banks and their customers do not have sufficient guidance about which parties are ECPs, then loan officers remain uncertain whether many of their borrowers will be able to use swaps to hedge commercial risks and protect cash flows needed to repay their loans. As a result, they will not have information about the most central components of loan underwriting, the ability to repay. This will not just affect the banks' ability to offer swaps to those customers. It will also affect the banks' ability to lend to those customers because of the impact on the customers' ability to repay the loan and the banks' ability to manage associated risks.

The CFTC did provide assurance that it would not bring enforcement action so long as a party entering into a swap follows “reasonably designed policies and procedures to verify the ECP status

swap dealers are not among the entities listed in CEA section 2(c)(2)(B)(i)(II) as acceptable counterparties to non-ECPs engaging in retail forex transactions.

³ See Final Order, 76 Fed. Reg. 42508, 42509 (July 19, 2011).

of a swap counterparty.”⁴ However, the CFTC did not provide any additional clarity about the ECP definition or what might be appropriate verification procedures, especially in the context of lending to borrowers where there are multiple obligors. The SEC has not provided any similar assurances about potential enforcement action or any other relief. In the meantime, banks and their customers are left wondering whether they can engage in certain swap transactions or, if they do, whether the swaps will be subject to rescission and possibly a private right of action in the event that the Commissions later define ECP in a way that does not include certain counterparties. This is having a chilling effect on banks, especially those who lend to medium and small businesses that are so critical to restoring the economic health of our economy.

Accordingly, we urge the Commissions to act expeditiously to issue an interim final rule,⁵ provide an interpretive letter,⁶ or publish additional guidance on the issues raised in this letter. Alternatively, the CFTC could reconsider the decision not to extend the effective date for Section 2(e) and the SEC could grant exemptive relief until the Commissions have had sufficient time to give these issues further consideration.⁷ If none of these is possible or there are other options that will proceed more quickly, then we ask the Commissions to grant alternative relief.

We ask the Commissions to provide guidance throughout this letter because we assume it will be the swiftest course of action. Pursuant to Dodd-Frank Act Sections 712(d)(1), (2), and (4), it appears that the Commissions need to act jointly, after consultation with the Board of Governors, to issue any rule, interpretation, or guidance regarding the ECP definition. While we understand that joint action presents additional challenges, it is imperative that these issues be resolved expeditiously. Accordingly, ABA urges the Commissions to pursue any appropriate alternatives that provide clarity and legal certainty as soon as possible to ensure that the normal course of lending is not disrupted.

II. Discussion

A. Amounts Invested on a Discretionary Basis

Absent certainty as to which assets will qualify as amounts invested on a discretionary basis in order to qualify as an ECP, banks and their customers who are individuals will be unable to determine whether their swaps are legally enforceable. As a result, banks and their individual customers will be less likely to use swaps to hedge and mitigate risk. Banks may also be reluctant to lend or will do so on less advantageous terms that may leave borrowers with few or no options for the long-term, fixed rate, or flexible loans they need to run their businesses.

⁴ Second Amendment to July 14, 2011 Order for Swap Regulation, 77 Fed. Reg. 41260, 41263 (July 13, 2012) (hereinafter Second Amendment).

⁵ The Commissions have rulemaking authority pursuant to Section 13.2 of the Public Rulemaking Procedures of the Commodity Exchange Act and Section 192(a) of the Securities and Exchange Commission Rules of Practice.

⁶ See Commodity Exchange Act Regulation 140.99 and Securities Act Release No. 6269.

⁷ See ABA Comment Letter on Effective Date Amendments: Second Amendment to July 14, 2011, Order for Swap Regulation, dated May 30, 2012 and Second Amendment at 41263.

1. Individuals

Individuals will be required to have “amounts invested on a discretionary basis” in excess of \$5 million, but do not have guidance about what qualifies as an investment or what “discretionary basis” means. The CFTC has stated that it will not be treating personal property as “assets invested on a discretionary basis.”⁸ However, the CFTC has not yet clarified what would be considered personal property.

Many individuals have a wide range of assets used to invest for retirement, run a business, or otherwise provide an income or appreciate in value for an investment return. For example, they may own commercial or residential rental real estate or own shares in privately-held businesses. They may have bank deposits, brokerage accounts, money market or mutual fund accounts, or collective investment funds that pool trust account assets. Individuals may also have investments in a wide range of retirement accounts, such as individual retirement accounts (IRAs), Keogh plans for self-employed individuals or unincorporated businesses, or 401(k) plan accounts. They may also have money invested in life insurance policies.

We encourage the Commissions to clarify the definition of investments and what constitutes personal property. The definition of investments at a minimum should include securities and the following if they are held for investment purposes: real estate, commodity interests, physical commodities, financial contracts that are not securities, and cash and cash equivalents (including foreign currencies). Cash and cash equivalents should include bank deposits, certificates of deposit, bankers acceptances and similar bank instruments, and the net cash surrender value of an insurance policy. In addition, the following should be deemed to be held for investment purposes if they are held in connection with the following businesses: (i) real estate if it is owned by an individual who is in the business of investing, trading, or developing real estate; and (ii) commodity interests or physical commodities owned or financial contracts entered into by an individual engaged in the business of investing, reinvesting, or trading them.

2. Joint Investments

Banks also need guidance on how to treat spouses with a joint investment account. For example, if spouses are co-borrowers and are executing the swap to hedge their bank loan, is it sufficient if their joint investment account has more than \$5 million? Or does there have to be \$10 million in the account because there are two borrowers? The situation would be complicated further if there were a prenuptial agreement providing that the couple’s property or investments would go disproportionately to one spouse or the other in the event of divorce. Or the couple might be domiciled in a community property state and one spouse might want to enter into the swap by himself or herself in reliance on a joint account with over \$5 million but less than \$10 million in investments.

These are real life scenarios and ABA urges the Commissions to provide investors and financial institutions with legal certainty about how to address them so that individuals can continue to enter

⁸ Second Amendment at 41263.

into swaps. We encourage the CFTC and SEC to adopt a simple and easily administrable rule that allows spouses to include the following in determining ECP status:

- If an individual is entering into a swap, he or she can include investments in his or her own name and those in which the individual has a joint, community property, or other similar ownership interest; and
- If both spouses are jointly entering into a swap, they can each include investments in their own name, those in their spouse's name, and those in which they have a joint, community property, or other similar ownership interest.

B. Sole Proprietorships

The ECP definition applies asset and net worth tests to proprietorships rather than the “amounts invested on a discretionary basis” test applicable to individuals. The plain reading of the statutory provision would include sole proprietorships. However, ABA is seeking confirmation that it encompasses sole proprietorships, because they typically are not separate legal entities.

Many sole proprietorships have illiquid assets like land, buildings, livestock, or crops and should qualify as ECPs under the asset or net worth test applicable to proprietorships. This issue is particularly important for agricultural borrowers. Since many Midwestern states prohibit corporations, limited liability companies and other corporate enterprises from owning farms, they would suffer disproportionate adverse impact if they have to meet the investments test.

In order to clarify that individual proprietorships may qualify as ECPs using the asset or net worth test, ABA urges the Commissions to allow banks to rely on representations of individual proprietorships that they are doing business as a proprietorship in a state in which individuals may operate a business as a proprietorship, regardless of whether organizational documents are required in that state. Otherwise, sole proprietorships operating in states that do not require separate legal existence will be at a significant disadvantage.

C. Purchase Money Loans, Construction Loans, and Other Asset Financing

ABA also requests that the Commissions provide guidance on the ECP status of borrowers entering into purchase money loans, construction loans, and other asset financing. In the absence of such guidance, the banks and borrowers in these types of loans may not be able to enter into swaps to hedge risk and would be exposed to rising interest rates. Since banks may be unwilling to lend unless borrowers can hedge their interest rate risk, the viability of many commercial real estate acquisitions and construction projects might be at risk.

For example, banks regularly make loans to acquire commercial real estate properties, but the borrowers in these purchase money loans may be unable to qualify as ECPs until after the loan closes and title to the property has passed. Since income from the property to service the debt will be limited, a bank may require the borrower to hedge the loan's interest expense to avoid a default on its debt service if interest rates rise.

Banks also make construction loans that are funded incrementally as construction progresses and payments are made to cover construction costs. Borrowers may need to hedge against rising interest rates as part of the terms of the loan commitment but may not be able to qualify as ECPs until well after the loan closes. In other words, while the completed project may be an asset that exceeds \$10 million, these borrowers may be unable to qualify as ECPs under the asset test until the project is completed. These borrowers likely will not be able to hedge using a swap during at least part of the construction phase unless they can qualify using the net worth test, and they are often unable to do so since they are typically single asset entities.

Not only is this an issue for commercial real estate lending – it also affects financing projects subsidized by the Federal government through tax credits for affordable housing and community development.⁹

ABA requests that the CFTC and SEC provide guidance to ensure that borrowers and banks are not exposed to the risks of interest rate increases between the date a commitment is issued for a purchase money loan, construction loan, or other financing of assets and the date the borrower qualifies as an ECP. This is especially important since increases could threaten the viability of the project and a bank's willingness to commit to these facilities. Any borrower should qualify as an ECP by virtue of a financing commitment issued by a financial institution or any of its affiliates if the proceeds of the financing are to be used to acquire or construct assets that can reasonably be expected to have a fair market value in excess of \$10 million and the swap is for hedging or mitigating the commercial risk of that financing.

D. Multiple Obligors

The ECP definition contemplates a simple counterparty relationship between two parties. Frequently the lending or credit relationship is more complex between banks and their customers seeking to use swaps to hedge their interest rate, currency, commodity, or other exposures to commercial risk. Banks assess risk and underwrite loans and swaps based on an overall credit relationship with a customer or customers, and the swap exposure is almost always much smaller than the loan exposure.

ABA urges the Commissions to provide clarity about how the new law will apply in the context of these relationships, including loans or extensions of credit that are made by related parties that are jointly and severally liable or are secured by collateral owned jointly by the parties.

⁹ For example, the Low Income Housing Tax Credit (LIHTC) program provides tax credits to increase the supply of affordable housing in communities across America and accounts for the majority of all affordable housing development in the United States today. Due to the limited initial equity investment, low asset value during construction, and high loan-to-value financing needed, one party has estimated that 10-15% of LIHTC projects undertaken in 2010 would not have been able to use swaps to hedge during the initial construction phase except for the fact that the swaps qualified under the CFTC's "line of business" test that has been replaced by the ECP definition. Similarly, the New Market Tax Credit (NMTC) program provides tax credit incentives to investors in certified Community Development Entities that invest in low income communities. By one estimate, approximately fifty percent of NMTC deals would not have qualified as ECPs in 2010 absent further CFTC guidance on construction loans.

1. Related Obligors

Borrowers seek to manage loan risk by entering into swaps based on the strength of the same obligors and assets that support the underlying loan or credit. For example, borrowers may include a parent company, its subsidiaries or other affiliates, or associated persons in the case of a partnership. If non-ECP obligors must be excluded, or if their obligations for swaps as co-counterparty, co-owner of collateral or guarantor are potentially unenforceable, this could discourage banks from financing these businesses or offering them swaps to manage their loan exposure. We don't believe Congress meant to interfere with these types of financing, particularly in view of the favorable treatment of swaps entered into in connection with the origination of loans.

In order to ensure that related obligors can continue to hedge their loan risk, they should be able to aggregate their investments, net worth, and assets for purposes of determining their ECP status. There is precedent for this type of treatment – Rule 2a51-1(g)(3) under the Investment Company Act of 1940 permits a parent company and majority-owned subsidiaries to aggregate investments for purposes of determining whether they meet the definition of a qualified purchaser. Aggregate attribution should apply not only to investments, but also to net worth and assets.

Alternatively, if one of the related obligors in a transaction is an ECP, the remaining related obligors should be treated as ECPs for purposes of the transaction and related security arrangements.

2. Multiple Guarantors

Another common credit arrangement involving multiple obligors is a loan and swap with an ECP limited liability company (LLC) that is guaranteed by the LLC owners, who may not all be ECPs. In fact, it is standard bank underwriting practice to require LLC, "S" corporation, and limited liability partnership owners to guarantee the loan and the related swap. This ensures that the owners' interests are aligned and that the owners are responsible for all or their pro rata portion of the debt in the event of default.

In these types of transactions, having a single ECP as an obligor should be sufficient to satisfy the ECP definition. If the LLC is an ECP, then it should be immaterial whether all of the owners may or may not be guarantors or ECPs. In addition, it would be particularly problematic if the owners have to qualify as ECPs under the individual prong of the ECP definition. Congress did not intend to interfere with these ordinary course lending arrangements.

Since the price and other economic terms of a swap take into account all aspects of the credit arrangement, any additional guarantees from ECPs or non-ECPs would benefit the borrower and increase the willingness of banks to lend. Accordingly, if one of the obligors in the transaction is an ECP, whether acting as counterparty or guarantor, then the remaining obligors should be treated as ECPs for purposes of the transaction and related security arrangements.

III. Procedures for Verifying ECP Status

Banks and their customers also need guidance on these threshold issues in order to verify their counterparty's ECP status. The CFTC has stated that it will not bring enforcement action against

swap counterparties that make “good faith efforts” to comply by implementing and following reasonable policies and procedures to verify a counterparty’s ECP status.¹⁰ ABA asks the Commissions to confirm that receipt of a written representation from the individual or entity that it meets the requisite asset, net worth, or investment test of the ECP definition would be sufficient to establish a reasonable basis of compliance.

The new business conduct rules for swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants would allow them to rely on a customer representation that specifies the provision under which the customer is qualifying as an ECP. If those entities comply with the ECP verification requirements in the new business conduct rules, they should be afforded legal certainty with respect to each transaction. In addition, any other bank that adopts and implements similar policies and procedures appropriate for the size and composition of its swaps portfolio should be able to rely on a comparable customer representation.

Furthermore, the determination as to whether or not an individual or entity meets the ECP definition should be made at the time the party enters into a swap. Market participants have long entered into transactions with persons they believe in good faith to be ECPs, or “eligible swap participants (ESPs) under Part 35 of the CFTC’s rules, based on information available to them or on representations provided to them by their counterparties. Thus, when the CFTC adopted Part 35 in 1993, it stated that “it is sufficient that the parties have a reasonable basis to believe that the other party is an eligible swap participant at such time [of entering into the transaction]. . . . An eligible swap participant that has a reasonable basis to believe that its counterparty is also an eligible swap participant when it enters into a master agreement may rely on such representation continuing, absent information to the contrary.”¹¹

So this approach is consistent with how the swap transaction eligibility has been applied and interpreted previously. An individual or couple that qualifies as an ECP at the time of the swap transaction would not have to requalify or terminate the swap in the event of a change in circumstances such as divorce. Nor would a corporation with \$10 million in assets that later loses \$1 million in value face uncertainty about its continued ability to hedge its business risks. Absent actual notice of facts that would reasonably put a bank on notice that a counterparty no longer meets the ECP definition, a bank should also be entitled to rely on a representation in a master agreement that is deemed repeated at the time of each related transaction. Any alternative for determining eligibility is untenable, since not only would it require constant monitoring but it would also expose swap counterparties to unnecessary uncertainty in swaps transactions.

Conclusion

ABA appreciates the Commissions’ consideration of our request for rulemaking, interpretive relief, an exemptive letter, or additional guidance on the ECP definition. For the reasons cited above, we strongly urge the Commission to provide relief expeditiously so that loan officers will have the information that they need to continue underwriting loans and there is no undue disruption in lending. Banks cannot move forward to implement the new swaps regulations in October absent

¹⁰ Second Amendment at 41263.

¹¹ Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587, 5589 (Jan. 22, 1993).

this guidance, and the consequences are severe since it will be illegal to engage in OTC swaps with non-ECPs. The uncertainty is already beginning to have an impact as loan officers consider commitments that may close on or after the October effective date.

If you have any questions or need additional information, please feel free to contact the undersigned at 202-662-5253.

Sincerely,



Diana L. Preston
Vice President and Senior Counsel
Center for Securities, Trust & Investments
American Bankers Association

cc:

Commodity Futures Trading Commission

The Honorable Gary Gensler
The Honorable Jill E. Sommers
The Honorable Bart Chilton
The Honorable Scott O'Malia
The Honorable Mark P. Wetjen
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Board of Governors of the Federal Reserve System

Ms. Jennifer J. Johnson, Secretary