ISDA®

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
United States of America
Telephone: 1 (212) 901-6000
Facsimile: 1 (212) 901-6001
email: isda@isda.org
website: www.isda.org

September 20, 2010

Mr. David 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, NE Washington, DC 20549-1090

Re: File Number S7-16-10 - Advance Notice of Proposed Rulemaking; Request for Comments: Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (75 Fed. Reg. 51429)

Dear Mr. Stawick and Ms. Murphy:

The International Swaps and Derivatives Association, Inc. ("ISDA") is writing in response to the advance notice of proposed rulemaking issued by the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") regarding definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act").

ISDA was chartered in 1985 and has over 830 member institutions from 57 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

Below are our preliminary comments regarding the definitions referenced in Sections 721 and 761of the Dodd-Frank Act.

I. Transaction with Affiliates

A number of definitions treated in our comments below reflect a concern with containment of risk and, in some cases, transaction volume as an indicator of risk. It seems inappropriate in each of these definitions to view affiliate transactions as "risky" or to count affiliate transactions in assessing overall risk, "substantialness" of a position or otherwise. Under pre-existing regulation, of course, an entity that acts only for its affiliates need not register as a futures commission merchant. CFTC Regulations 1.3(y) and 3.10(c). As Senator Lincoln recently said, "It would be appropriate for regulators to exempt from mandatory clearing and trading inter-affiliate swap transactions which are between wholly-owned affiliates of a financial entity." Similarly, such affiliate trades should not figure in determinations of swap dealer or major swap participant ("MSP") status or their securities-based equivalents. This concept is vital in permitting affiliate groups to centralize their portfolio management. We urge that the principle recognized by Senator Lincoln be implemented to the fullest.

II. Definitions

"Swap" and "Security-Based Swap"

The definition of swap (and, hence, security-based swap) in the Dodd-Frank Act is based on a definition of "swap agreement" in Title III of the Commodity Futures Modernization Act of 2000 (the "CFMA") that was fashioned to be broad to fulfill the exclusionary and exemptive purposes of the CFMA. This broad definition may now be used to impose regulation on transactions that are already subject to regulation under other statutes or that are outside of the reasonably contemplated scope of regulation of the Dodd-Frank Act. A non-exclusive list of examples includes:

- Catastrophe bonds.
- Loan participations.[1]
- Commercial arrangements having "derivative-like" elements embedded (such as a home mortgage with a rate-lock feature) that should be excluded on the basis of a "hybrid" like test.
- Variable rate notes.

Elements of the definitions of "swap" and "security-based swap" fail to capture the existing commercial realities of relevant markets. For example, participants in the physically-settled commodity markets often use cash settled variants as an intrinsic and continuing aspect of their trading businesses. Clause (B)(ii) of the definition of "swap" is partially parallel to the language of Section 1a(19) of the Commodity Exchange Act of 1936 (the "CEA"). A body of law has been developed around Section 1a(19) of the CEA in the futures trading context in prior years. It is unclear whether the express reference in the Dodd-Frank Act to "intended to be physically settled"

---

[1] Many loan participations are within the identified banking products exception of Section 403 of the Legal Certainty for Bank Products Act of 2000 (7 U.S.C. 27a).

means more or less than the aggregate body of law that has been developed around Section 1a(19).[2] Although we believe that body of law favors an expansive reading of Section 1a(19), any ambiguity that might lead to a narrow reading of clause (B)(ii) should not interfere with established market practice. Transactions that have become a functionally-integrated part of physical trading businesses should remain outside the scope of the definition of swap.

Paragraph (C) of the definition of "swap," the rule of construction regarding master agreements, needs to be clarified to be certain that master agreements (as opposed to transactions under master agreements) do not need to be cleared, traded, or otherwise be subject to the requirements of the Dodd-Frank Act.

"Mixed Swaps"

The category of "mixed swaps" created by the Dodd-Frank Act receives little clear treatment under the Act. This is a substantial matter as the mixed swap category will likely include most swaps that have any securities underlying. Mixed swaps are swaps with one leg that is "securities-based" and another leg or legs based on an underlying that would not be considered securities-based. The absolute nature of a securities-based "marker" may overwhelm transactions dominated by other underlyings. Conversely, typical transactions with a leg based on a securities underlying and a leg based on an interest rate underlying would appear to properly be categorized as security-based swaps. For example, a typical equity swap synthetically providing exposure to an equity security will have one party paying on the basis of a variable interest rate. These rate-based payments are incidental to what is essentially a security-based transaction, and should not yield mixed swap status.

Under section 712 of the Dodd-Frank Act, the CFTC and the SEC, in consultation with the Board of Governors, are to jointly prescribe regulations for mixed swaps, though the Act seems to emphasize the SEC's jurisdiction over mixed swaps as security-based swaps.[3] These provisions and other related provisions offer no indication how the agencies are to resolve attendant issues -- ranging from sorting out the definitional confusions bound to attach from the compounding of the "swap" and "security-based swap" definitions, to establishing some sort of "preponderance" or other bounding tests. Some of these attendant issues are beyond the scope of a comment on definitions; however, certainly establishing some definitional clarity would be a substantial first step.

---

[2] Clause (B)(ii) of the definition of 'swap' in the Dodd-Frank Act provides that "The term 'swap' does not include…any sale of a nonfinancial commodity or security for deferred shipment or delivery, *so long as the transaction is intended to be physically settled*." (emphasis added). Section 1a(19) of the CEA (as renumbered by the Dodd-Frank Act) provides that "The term "future delivery" does not include any sale of any cash commodity for deferred shipment or delivery."

[3] <u>See</u> sections 721 and 761 (new Commodity Exchange Action section 1a (47) and new Securities Exchange Act section 3(a)(68)(D), respectively. Despite these affirmative declarations, mixed swaps, unlike other securities-based swaps, remain residually "swaps" and are in the CFTC's jurisdiction, as well. Although the drafting is baroque, the end result is consistent with section 712.

"Major Swap Participant," "Major Security-Based Swap Participant" and Related Terms

Definition

There are three general categories of MSP within the meaning of Title VII of the Dodd-Frank Act. The term includes any person who is not a "swap dealer" and:

(1) maintains a *substantial position* in swaps for any of the major swap categories as determined by the Applicable Regulator, excluding positions held for hedging or mitigating *commercial risk* or risk associated with the operation of an ERISA plan ("MSP Category 1");

(2) whose 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 ("MSP Category 2"); or

(3) is a financial entity that is *highly leveraged* relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency and which maintains a *substantial position* in outstanding swaps in any major swap category ("MSP Category 3"). [4]

As a threshold matter, it is vital that a clear, stable and objective test is formulated for MSP determinations. It is not in the interests of regulators or market participants to have a definition that lacks clarity and that might subject market participants to short periods of MSP qualification. Portfolio positions and market values are subject to substantial fluctuations. The regulatory criteria for MSP status must avoid capturing accidental or transient MSPs.

The Applicable Regulators have statutory authority to further elaborate by rule new definitions with respect to Title VII (see Sections 721(b) and (c) and Section 761(b)). In the MSP context, this letter focuses on the definitions of "substantial position" and "commercial risk" and the meaning of the phrase "highly leveraged."

MSP Category 1

To fall under MSP Category 1, an entity will have to maintain a "substantial position" in swaps, excluding positions held for hedging or mitigating "commercial risk." The Applicable Regulators are required to define the terms "substantial position" and "commercial risk." Both of these concepts are discussed below.

Substantial Position

The Applicable Regulator is required to define the term "substantial position" at the threshold that the Applicable Regulator determines to be prudent for the effective

[4] For purposes of the analysis set forth herein, the term "major swap participant" shall be deemed to also include the term "major security-based swap participant," the term "swap dealer" shall be deemed to also include the term "security-based swap dealer," the term "swap" shall be deemed to also include the term "security-based swap" and the term "Applicable Regulator" shall mean the CFTC or the SEC, as the case may be.

monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States. In setting the definition, the Applicable Regulator is required to consider the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.

The scope of the Applicable Regulator's rulemaking requirement means that a "substantial position" must be large enough individually to implicate "systemic risk." Anything less than this would undercut the legislative intent expressed both in the statutory guidance on "substantial position" and in the scope of prong (ii) of the definition of MSP (i.e., that the MSP's 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). In order to encourage the continued use of derivative products in a responsible manner by entities that cannot possibly pose systemic risks to United States financial stability, without fear of being designated as a MSP, "substantial position" should be defined by reference to only those non-swap dealers that maintain the derivative positions that actually present systemic risk. The types of swap that are held by a party and the nature of that party's trading activities should also be considered. Some forms of swap, for example, are naturally less risky than others, even if for large notional amounts that may suggest a "substantial position"; such swaps are in fact stable, not volatile and easily unwound and should not be viewed as creating a "substantial position."

In general, it is important that qualitative as well as quantitative factors are taken into consideration when defining "substantial position." Given that the stated intent of the legislation reflects the notion that clearing of swaps is an important safeguard against risk to the United States financial system, and given the protections built into the clearing system by the legislation, only uncleared swaps should be taken into account in making a "substantial position" determination. Similarly, effect should be given to all applicable netting provisions that the entity in question is subject to. The legislation, furthermore, encourages the regulators to take into consideration the value and quality of collateral held against counterparty exposures and this also corresponds with the notion that a qualitative measure should be used in defining the term "substantial position." Prudent clearing, netting and collateralization are all recognized risk-reducers, with collateralization being perhaps the most elemental of the three.[5]

MSP was intended to capture enterprises that are not swap dealers, but that are systemically important to the United States financial system. AIG Financial Products is an historical example of such an entity. The definition of MSP makes it clear that the term "substantial position" should be determined at a threshold determined to be prudent for the effective monitoring, management and oversight of entities that are systemically important or can significantly impact the financial system of the United States.

[5] The posting of initial and variation margin will provide tangible assets of value to which a counterparty should have recourse in the event of the other counterparty's default or bankruptcy/insolvency. Initial margin covers a degree of volatility, while mark-to-market margin responds to actual market movements. An institution should only lose funds under a fully collateralized arrangement (subject to certain legal risks) if the counterparty defaults and during the default period (prior to liquidation of the collateral) there is a significant increase in mark-to-market exposure or decrease in collateral value held (for example, because of a fall in market prices for the relevant collateral securities or default by the issuer of the collateral securities) after taking into account initial margin and haircuts on the value of the collateral securities.

Commercial Risk

In their June 30 letter to House Financial Services Committee Chairman Frank and House Agriculture Committee Chairman Peterson, Senate Banking Committee Chairman Dodd and Senate Agriculture Committee Chairman Lincoln emphasized that derivatives are an important tool that businesses use to manage risks and volatility. The letter cites the use of derivatives to hedge the interest rate exposure of a global manufacturing company as an example of this, thereby recognizing that the use of derivatives for commercial risk mitigation would encompass a broader range of activities than, for example, hedging against movements in raw material prices. In other words, "financial" risks are "commercial risks."

The dictionary definition of the word "commercial" is "of, pertaining to, or characteristic of commerce."[6] The term "commercial risk" should be defined against this background. Any number of commercial enterprises (including agricultural companies, airlines, retailers, manufacturers and financial services firms) use swaps as a means of managing any number of risks, from risks such as shifts in interest rates, foreign exchange rates and commodity prices, to more exotic (but depending on the particular industry, equally pressing) risks such as the weather. They may also use credit default swaps to guard against the default of customers and counterparties. All of these risks, including financial risks, in the business contexts of these diverse enterprises, are commercial, whether risk-managed on a transaction by transaction or portfolio basis. Given that Congress sought to encourage the management of commercial risk through derivatives and not penalize those entities whose hedging activities otherwise might give those entities "systemic" stature, it is important that the definition of "commercial risk" captures the broadest possible forms of commercial risk.

<u>MSP Category 2</u>

As discussed above, MSP was intended to be responsive to phenomena like AIG Financial Products or other entities of systemic relevance. As such, very few, if any, investment funds should qualify as MSPs under any of the MSP categories that are discussed in this letter.[7] This "systemic risk" theme is explicitly echoed in MSP Category 2, and should be a driving consideration in establishing the boundaries of the MSP definition as a whole. The meaning of the term "substantial counterparty exposure," while not expressly delegated to any federal rulemaking authority, will ultimately be left to the determination of the Applicable Regulator. However, the words used in MSP Category 2 make quite clear the systemic scale of what should come to be defined as "substantial counterparty exposure."

---

[6] Dictionary.com Unabridged; based on the Random House Dictionary.

[7] Certainly, many investment funds, if not outside the scope of the definition of MSP as a result of a lack of systemic import, should be outside the scope of the definition of MSP for some of the reasons specified elsewhere in this letter (including because they are not "highly leveraged" in relative terms and because they do not maintain "substantial positions in swaps" given that many of their swaps will be subject to clearing and because they will be required to post collateral by their counterparties). Further, the language and configuration of the definition of MSP make clear that only principals, and not mere asset managers or agents, are potentially MSPs.

MSP Category 3

The construction of MSP Category 1 and MSP Category 3 is virtually identical.[8] The discussion of "substantial position" above applies equally to MSP Category 3. MSP Category 3 is primarily differentiated from MSP Category 1 in that a person falling thereunder must:

(1) be a financial entity;

(2) that is *highly leveraged*; and

(3) that is not otherwise subject to minimum capital requirements by a federal banking regulator.

Although the Applicable Regulators are not required to further define the term "highly leveraged," the meaning of that term is worthy of consideration. Given that one of the primary objectives of the legislation in general, and the definition of MSP in particular, is to provide oversight of systemically important entities in the derivatives market, the term "highly leveraged" should be tied-into the term "substantial position" to objectively capture only those entities whose substantial derivatives positions and high leverage ratios make them systemically important to the United States financial system. The use of leverage is vital in an entrepreneurial society and the responsible use of leverage is fundamental to the recovery of the United States economy. Certainly, leverage ratio limits to which banks and other regulated entities are subject would be unsuitably low for other enterprises. Given the sheer volume of financial institutions that employ leverage in some way to enhance their returns, only those institutions with the very highest leverage ratios should be deemed to be "highly leveraged." In addition, similar qualitative factors to those proposed above in the discussion of the meaning of "substantial position" should also be used in making any such determinations. In particular, for the avoidance of doubt, when considering an institution's leverage, any posted collateral should be considered and effect should be given to all applicable netting provisions.

"Swap Dealer" and "Security-Based Swap Dealer"

Definition

The Dodd-Frank Act currently defines "swap dealer" to be any person who (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, 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. The term "swap dealer" also does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as part of a regular business. The regulators shall exempt from designation as a swap dealer any entity that engages in

[8] There are some small differences that are difficult to correlate but which we note. MSP Category 1 refers to a substantial position "for" any of the major swap categories, while MSP Category 3 refers to a substantial position "in" any major swap category. MSP Category 3 is also limited to "outstanding" swaps while MSP Category 1 is not. Perhaps some meaning may be drawn from these differences as the MSP definition is applied over time.

a de minimis quantity of swap dealing in connection with transactions with or on behalf of customers.

Ordinary Course/Owner Account

The broad four-pronged nature of the definition of “swap dealer” means that this definition could be interpreted to include entities that pose no systemic risk to the economy. In particular, item (iii) of the definition may be read as including as swap dealers entities that do not hold themselves out as swap dealers and that do not engage in activities causing such entity to be known in the trade as a swap dealer, but who hold relatively small proprietary trading books. Such entities perhaps may not escape designation as swap dealers by virtue of the de minimis exception, since such exception only applies to those who engage in swap dealing with or on behalf of their customers. Given the demands of the registration process and attendant requirements in the Dodd-Frank Act that apply to swap dealers, it will be important that the regulators clarify that entities who hold relatively small proprietary trading books are not to be deemed swap dealers. Support for such an exemption can be found in the exemption from registration as a futures commission merchant for entities that carry only proprietary accounts. CFTC Regulations 1.3(y) and 3.10(c). Further support for such an exemption can be found in the nature of the duties that persons designated as “swap dealers” will have to satisfy. Such duties would better fit the types of activities engaged in by swap dealers who engage in swap dealing with or on behalf of customers; it is less clear how these duties would be relevant to persons engaged only in proprietary trading.

Market Making

Item (ii) of the definition of “swap dealer” (makes a market in swaps) should only capture the handful of entities that consistently offer two-way prices in swaps and are consistently open to doing business on both sides of the market. It should not apply to typical market participants, whether commercial or financial, who are not in the business of making a two-way market.

Own Account/Not Regular Business

The exemption from the definition of “swap dealer” for a person that enters into swaps for such person’s own account, either individually or in a fiduciary capacity, but not as part of a regular business, tracks the exception from the definition of “dealer” under Section 3(a)(5)(B) of the Securities Exchange Act of 1934. This is often referred to as the dealer/trader distinction. A body of guidance, primarily in the form of no-action letters, has been built by the SEC with respect to the dealer/trader distinction. As a result, the dealer definition has been interpreted to exclude “traders.” The dealer/trader distinction recognizes that dealers normally have regular clientele, hold themselves out as buying and selling securities at a regular place of business, have a regular turnover of inventory (or participate in the sale or distribution of new issues, such as by acting as an underwriter), and generally provide liquidity services in transactions with investors (or, in the case of dealers who are market makers, for other professionals). It would seem logical, consistent and entirely appropriate for the definition of “swap dealer” to exclude “swap traders” for the same reasons that “traders” are currently excluded from the definition of “dealer.” This would diminish, but not entirely satisfy, the need for the “small proprietary trader” exemption proposed above.

De Minimis

The regulators are required to promulgate regulations to establish factors with respect to the making of de minimis exemption determinations. This exception should be large enough to be meaningful. The origins of the legislation and Congressional intent should be considered when such factors are promulgated. The legislation was intended to capture and regulate systemically important entities. To the extent that an entity that could otherwise be considered a "swap dealer" is not as such systemically important and offers no material risk individually to the United States financial system, it should be excluded from the definition of "swap dealer." Additional factors that should be used to make de minimis exemption determinations (which are used in the "substantial position" determination for major swap participants in Sections 721 and 761 of the Dodd-Frank Act) are that person's relative position in cleared and uncleared swaps, as well as the value and quantity of collateral held against counterparty exposures.

Recognition of Foreign Regulation

If an entity is already subject to some appropriate form of regulation it should also be exempted (including foreign financial entities that are subject to comparable regulation in their home jurisdictions, which are currently exempted from registration as futures commission merchants). Likewise, a rule like Securities Exchange Act Rule 15a-6, would be suitable. Recognition of foreign-regulated entities is basic to maintaining the necessary connections between the U.S. and foreign markets.

Effect of Taking Margin

The mere receipt of margin should not automatically require a party to register as a security-based swap dealer pursuant to Section 763 of the Dodd-Frank Act. Presumably this requirement applies only to security-based swap dealers (and not to major security-based swap participants and other market participants), since presumably only they would have security-based swaps customers. Nonetheless, without any clarification that this is the case, it is possible that market participants who would not otherwise be security-based swap dealers and who currently receive margin might consider not requiring such margin in the future so that they will not risk having to register as a security-based swap dealer. This result would undoubtedly create more systemic risk, a result at odds with the intent of the legislation.

III. Swap Dealers as Futures Commission Merchants

Separate from the definitions of "swap dealer" and "major swap participant," clarification is required with respect to whether swap dealers and major swap participants should be required to also register as futures commission merchants in certain circumstances. Section 724 of the Dodd-Frank Act provides that a person should register as a futures commission merchant in order to accept margin from a "swaps customer" to secure a swap cleared by a derivatives clearing organization. Again, only a swap dealer would have a swaps customer. Section 724 of the Dodd-Frank Act thus begs the question of when a margin-accepting swap dealer must register as a futures commission merchant. The definition of "futures commission merchant" in Section 1a(28) of the CEA (as renumbered by the Dodd-Frank Act) provides clarification. A futures commission merchant solicits or accepts orders from customers (that is, acts as an agent) and accepts collateral in connection therewith. Accordingly, a swap dealer acting solely as principal cannot be a futures commission merchant merely by accepting collateral. Given the registration requirements and standards of conduct for swap dealers, they should not be required to register as futures commission merchants in circumstances other than those expressly provided for in the Dodd-Frank Act, including circumstances in which they only trade with their affiliates, other swap dealers and major swap participants, if they clear their own swaps or if they take collateral from other entities on non-cleared swaps.

IV. Eligible Contract Participant

The eligible contract participant test has been modified to include an assessment of "amounts invested on a discretionary basis." Clarification of that phrase is required, as is the method of determining the desired facts.

* * *

ISDA appreciates the ability to provide its comments on the advance notice of proposed rulemaking and looks forward to working with the CFTC and SEC as you continue the rulemaking process. Please feel free to contact me or ISDA's staff at your convenience.

Sincerely,

Robert Pickel
Executive Vice Chairman