ISDA Safe, Efficient Markets

July 22, 2011

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 S7-16-11, RIN3235-AL14, Product Definitions – Joint Proposed Rules; Proposed Interpretations: Further Definition of "Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (76 Fed. Reg. 29818)

Dear Mr. Stawick and Ms. Murphy:

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

Since 1985, ISDA has worked to make the global over-the-counter ("OTC") derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified

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financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.[1]

Below are our comments regarding the proposed rules and interpretations.

Introduction

The DFA definition of "swap"[2] is fundamentally the very broad definition used in the CFMA. As many have observed, this breadth in the CFMA was intended to provide certainty of exclusion from commodities regulation to a host of instruments that might be swap-like in some respect. Use of the same broad swap definition as the basis of regulation under the DFA automatically creates vagueness and overbreadth. The Commissions have prudently recognized the need to edit and clarify.

The Commissions wisely began this project with an Advance Notice of Proposed Rulemaking, 75 FR 51429 (the "ANPR"), which garnered numerous comment letters. The current joint proposed release and proposed interpretations, 76 FR 29818, May 23, 2011 (the "Proposal"), is responsive in many respects to comments received. It represents significant progress towards correctly focusing Title VII of the DFA. ISDA hopes that the Commissions will be equally receptive to the additional comments we offer below.

We may summarize our comments overall as an invocation of simplicity and clarity. The questions embedded in the Proposal are complex. That complexity, however, begs responses simple enough to be applied at reasonable cost in fluid business environments. We urge the question of "insurance or swap?" be answered with a basic two-question test whenever possible. We advocate that the welcome interpolation of the Brent Interpretation in the forward contract exclusion be with minimal restrictive overlay. The treatment of consumer and commercial agreements should be simplified to avoid chilling non-swap endeavors. The narrow-based index definition, the borderline between the two Commissions' jurisdictions should be simplified as a matter of the highest

[1]Information about ISDA and its activities is available on the Association's web site: www.isda.org.

[2] References in this letter to "swap" are to swap, or swap and security-based swap ("SBS"), as the context may require.

priority. Finally, the CFTC's proposed anti-evasion regulation overreaches. It would threaten reasonable business decision-making in any venture that might use swaps, and should be withdrawn.

We recognize that much thought has gone into the Proposal. We hope our comments are helpful in crystallizing that thought in a way that best serves both regulatory and business purposes.

I. Insurance Products

Commenters on the ANPR made the point that the definition of swap, taken at its face, might reach insurance products. Proposal at 29821. That some genuine parallels exist between the two different product classes complicates the defining process. As the Commissions recognize, aspects of the DFA definition of swaps seem to reach instruments traditionally viewed as insurance. The Commissions, however, wisely view "insurance" as beyond the Title VII mandate and the Proposal is a very positive step towards marking a boundary between insurance and swaps. ISDA respectfully suggests, however, that the Commissions' proposal to distinguish insurance from swaps should be further refined.

The Proposal correctly focuses on the primary, twin criteria of insurable interest and loss indemnification as traditional and continuing guides to what is insurance (the "Primary Criteria"). Proposal at 29822. In our view, these two criteria will be determinative of what is a swap as opposed to insurance in every situation. The Proposal, however, takes into account secondary factors that may distract from the clarity that fundamental reliance on the Primary Criteria will bring. Though these factors reflect genuine characteristics of some types of insurance, they are not necessarily insurance industry constants and are of secondary importance. As discussed in more detail below, these factors may be useful as ancillary guides in resolving unclear cases, but they should not become "bright line" criteria. They should remain subordinate to the Primary Criteria.

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A. Entity Qualification

The Proposal would require that an insurance product be "offered" by a U.S.-regulated insurance company[3] in order to be treated as insurance and not a swap. We think that if the product is insurance, the regulated status of the offeror is irrelevant. The Title VII mandate, after all, is to regulate swaps, not to backstop insurance regulation. The DFA has left insurance regulation to the states and it is the states that retain the right to decide which insurance products are regulated and to what extent. State sanctions are available against offerors that violate state law.

In addition, requiring an insurance company to be "supervised" or "regulated" in the United States is inconsistent with the current multi-tiered U.S. insurance regulatory regime. Under current law, U.S. insureds are not limited to purchasing insurance products from admitted (*i.e.*, state-licensed) insurance companies. They can also purchase insurance products through the nonadmitted market (on an "excess and surplus lines" or "industrial insured" basis) and can even procure insurance products independently of the U.S. regulatory regime by purchasing them in a foreign jurisdiction. The nonadmitted market—involving insurance companies that by definition are not under the supervision of U.S. insurance regulatory authorities—constitutes such an important part of the U.S. insurance market that a major part of Title V of the DFA is entirely devoted to facilitating it.

This is not to say that the regulated status of an "offeror"[4] may not be a secondary factor that may be considered in the odd case where the Primary Criteria produce an ambiguous result. We believe such cases will be rare—we believe the Primary Criteria are strong and certain in application.

[3] The Proposal would also recognize products offered under U.S. statutorily-authorized programs and products offered by certain foreign offerors of certain reinsurance products.
[4] Please note that the term "offeror" is of uncertain application in swaps markets.

B. Product Qualification

The Proposal also adopts certain ancillary product requirements in order for a product to be considered insurance, in addition to the Primary Criteria mentioned above. We respond to those ancillary requirements below:

1. Continuing Risk of Loss. We agree that risk of loss (insurable interest) is required at the outset of an insurance contract and upon its renewal. Note, however, that certain types of insurance do not require that risk of loss be maintained through the life of the policy (life insurance and annuity insurance being two examples). ISDA does not believe that swap regulation should be used to limit variability of insurance product, either by treating current insurance product as swaps or by limiting the future development of insurance product. The need to satisfy the Primary Criteria at the outset and upon any renewal of a product is a sufficient and appropriately clear means of distinguishing insurance from swaps. Continuity of risk of loss should not be adopted by the Commissions as a universal requirement for insurance products, although it may be a helpful secondary analytical factor in the rare ambiguous case, appearing in an appropriate context.

2. Proven Loss and Proportionate Payment. The Proposal would condition treatment as insurance on the ancillary requirements of proven loss and proportionate payment. Just as is true with respect to continuing risk of loss, these are not universal attributes of insurance contracts. (Life insurance and annuity contracts again being two primary examples.) To introduce as requirements conditions that are neither universal nor fundamental will only burden the markets. Again, to avoid undue complexity, we urge the Commissions to rely on the Primary Criteria, assessed at the inception of a contract and upon its renewal.

3. Trading of Insurance Products. Similarly, the Proposal would have the "trading" of an insurance contract, separate from its initial underlying insured interest, prevent the contract from being respected as insurance. Claims under

insurance policies, however, are routinely assigned and insurance trading mechanisms exist (*e.g.*, with respect to life settlements). Again, we urge the Commissions to rely on the Primary Criteria to avoid imposing unwarranted complexity and chilling both swaps and insurance markets.

4. Basis in Price, Rate or Level of Commodities. Many insurance products have some basis in the price, rate or level of a financial instrument, asset or interest in a commodity.[5] Existence of such a basis is not a useful marker for distinguishing insurance from swaps. The Primary Criteria, furthermore, can successfully distinguish the two product classes despite a commodity basis.

5. Traditional Insurance Products. Prior regulation as insurance is helpful secondarily in affirming that an existing product should not be treated as a swap. But Title VII of the DFA is not a mandate to regulate as swaps either new insurance products or existing insurance products that may have been excused from insurance regulation. Nor should the existence of prior insurance regulation stand in the way of redesigning traditional insurance products as swaps. The Primary Criteria, applied in a common-sense fashion, should be the real determinants of the swap/insurance boundary.

6. Accounting Standards. We believe that factoring accounting standards into the analysis of a product as swap or insurance will introduce unnecessary complexity in most cases. We urge reliance on the Primary Criteria. In the event applying the Primary Criteria does not produce a clear result, examination of accounting standards may be of secondary help.

7. Financial Guaranty Insurance and No Acceleration. Most, if not all, states that presently regulate financial guaranty insurance on a monoline basis forbid their insurers from covering acceleration risk upon default. Financial

[5] Examples include variable life and annuity products, crop products, "dual trigger" insurance, such as replacement power insurance, property and casualty policies purchased by some commodity producers (*e.g.*, oil refineries, copper mines), with deductibles that increase or decrease based on the price of the commodity the company produces, event cancellation insurance that uses commodity indices to determine claims, weather insurance, malpractice insurance, etc.

guaranty insurers guarantee payments in the ordinary course, but not on an accelerated basis. This is a feature of current insurance regulation; however, it may not always remain so. Title VII was not intended to freeze insurance regulation in its present form or to prevent change in the insurance industry. We believe, furthermore, that this feature was intended to protect against insurer insolvency, not to distinguish this form of insurance from non-insurance products. Absence of acceleration coverage should not be locked into insurance product design by swap regulation. The Primary Criteria can stand on their own in the financial guaranty insurance context, just as in respect of insurance product generally.

C. Insurance Wraps of Swaps

The Commissions ask if insurance wraps of swaps are themselves swaps. We believe the answer is clearly no. Insurance wraps provide protection against the risk that a swap counterparty may fail to perform its obligations. The wrap does not necessarily replicate the economics of the underlying swap, and only following default could the wrap provider end up with the same payment obligations as a wrapped defaulting swap counterparty. Applying the analysis discussed above regarding swap versus insurance characterization, an insurance wrap will clearly and appropriately qualify as insurance under the Primary Criteria.

D. Non-insurance Guarantees of Swaps

The Commissions ask if non-insurance guarantees of swaps are themselves swaps. We think not. A swap guarantee, similarly to an insurance wrap, typically provides protection against a counterparty's default. Following a default, most guarantees would result in the guarantor being responsible for monetary claims against the defaulting party. That obligation is entirely different than the arrangement provided by the underlying swap itself. The underlying swap, and the parties to it, will be regulated and reported to the extent required by Title VII. There is no plausible need for regulation of guarantees.

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This question highlights the fact that guarantees should be added to the list of commercial agreements that are not swaps, both for the reasons stated above, as well as in Section III below. Guarantees should not become swaps merely as a result of providing credit support to a swap counterparty.

E. Reinsurance

We recommend that the Commissions generally address reinsurance in the Proposal. Reinsurance of products that are insurance under the Primary Criteria also should be outside the scope of Title VII.

II. Forward Contract Exclusion

The CTFC's 1990 Brent Interpretation, 55 FR 39188, has been the basis of CFTC policy in the ensuing years with respect to the CEA section 2(a)(i) jurisdictional exclusion for certain forward contracts from futures regulation. The Commissions have helpfully applied the Brent Interpretation to the forward contract exclusion from the definition of swap.[6] The discussion in the Proposal, however, dwells heavily on the original Brent Interpretation context and language, to the extent that we fear the Brent Interpretation will enter the swaps markets unduly constrained.

We focus primarily on repeated use of the phrase "commercial merchandising transaction", *see* Proposal at 29828-29, to describe transactions within the Brent Interpretation. This phrase was used in the Brent Interpretation itself, 55 FR 39190, though it appears to have been anachronistic at the time. The discussion in the Brent Interpretation ultimately is of contracts for "merchandising or commercial purposes [and] to shift future price risks incident to commercial operations and other forward commitments." *Id*. at 39191. In fact, the Brent Interpretation itself acknowledged the CFTC's need to take account of an evolving commercial environment. *Id*. We perceive, however, that the new regulated swaps markets present a still greater evolutionary leap. We recommend that the CFTC transplant the Brent Interpretation into the swaps market

[6] We request that the Commissions consider physically-settled options on forward contracts that would be within the exclusion as themselves within the scope of the forward contract exclusion. We note that such options are frequently transacted in conjunction with transacting the forward contracts themselves.

free of the potentially misleading and narrow "commercial merchandising transaction" archetype.

The Brent Interpretation is strong enough to stand on its own. Intent to deliver (viewed in the transactional context) is reasonably clear. We urge the CFTC not to obscure Brent with characterizations that may not translate readily into the Title VII world.

On a related note, the Commissions ask if whether or not participants regularly take delivery and transaction size should be determinants of forward contract exclusion availability. We suggest that these are contextual factors that may be considered in resolving the existence of intent to deliver. They should not be viewed as independent determinants.[7]

III. Consumer and Commercial Agreements, Contracts and Transactions

The Commissions helpfully agree, *see* Proposal at 29832, with comments made on the ANPR that there is a variety of agreements that, as customary consumer and commercial agreements, are neither swaps nor SBS.[8] The Commissions offer both a list of such agreements and lists of factors that are intended to allow judgments to be made with respect to other agreements that may or may not be swaps or SBS.

A. Listed Agreements

We would add to the list of enumerated non-swap transactions guarantees (for instance, a simple guarantee of a subsidiary or affiliate's swaps), "bonds" and other functional equivalents, be they assurances of payment or performance, and regardless of whether they are entered into in connection with a swap or not. These forms of contracts both have well-established histories and are distinguishable from swaps (like credit

[7] Incidentally, the Commission notes that the DFA supersedes the Swap Policy Statement. Proposal at 29829 n.74. We suggest that the Commission maintain the Swap Policy Statement for as long as it may be a useful accompaniment to the Part 35 regulations being preserved as part of the Commission's effort to reduce uncertainty accompanying statutory effectiveness.

[8] The Commissions observe in their discussion of loan participations that certain "identified banking products are outside the scope of the swap definition." *See* Proposal at 29834 n.115. It would be helpful if the Commission would offer a similar reference in the context of this group of agreements.

default swaps) by their beneficiaries having a direct stake in the act that is guaranteed and having direct recourse to both the guarantor and the obligor whose performance is guaranteed. A guarantor, furthermore, will receive consideration from the party whose performance it guarantees and will have a reimbursement or subrogation right.

We also request that the Commissions clarify that the listed category of fixed or variable interest rate commercial loans entered into by nonbanks includes as unitary non-swap transactions commercial loans with varied rate dependent features, such as capped or floored rates.

In describing the listed consumer and commercial agreements that are not swaps, the Commissions use the term "customary." ISDA urges the Commissions to drop this adjective from their guidance. Title VII was not intended to regulate all those contracts that may be viewed, to some unknowable extent, as "non-customary" versions of consumer and commercial contracts. The swap definition, as noted in the opening of this letter, was crafted inclusively initially to serve a goal of exclusion from regulation. That inclusiveness must be affirmatively restrained or the definition will stifle innovation in kinds of agreements that Congress never intended to constrain. Reliance on the term "customary" will substantially defeat the purpose in creating lists of recognized "not swaps."

Additionally, we propose that the lists of excluded agreements include "and any other similar agreement" catchalls, also for the purpose of appropriately restraining the intrusion of an overbroad definition of swap into non-swap businesses.

B. <u>Common Factors</u>

The Commissions' lists of factors to consider in determining whether or not unlisted agreements are swaps include some factors that are so broad as to amplify the overbreadth of the swap definition itself. We suggest that the following factors be abandoned for the reasons stated below:

- Non-swaps "do not contain payment obligations that are severable" – assignment of rights and delegation of obligations are common in a wide variety of consumer and commercial transactions that should be excluded from the swap definition. In fact, the law generally favors assignability. *See*, *e.g.*, *Harris v. Key Bank Nat'l Ass'n*, 193 F. Supp. 2d 707, 715 (W.D.N.Y. 2002). Many of the kinds of agreements listed by the Commissions as excluded would fall afoul of this characteristic.

- Non-swaps are "for other than speculative, hedging or investment purposes" – particularly on the commercial side, many (if not all) of the types of transactions listed as excluded by the Commissions may be undertaken for speculative, hedging or investment purposes. Is real estate investment, for example, to become regulated as a swap business?

- Non-swaps are "not traded on an organized market or over the counter"—many of the types of contracts listed as excluded are assignable and frequently assigned or "traded." Would a factored commercial contract receivable be viewed as a swap? Many of the commercial arrangements described may be the subject of auction or request for price processes. Being the subject of an auction or request for price should not necessarily subject a contract to swap treatment. It is unclear furthermore what would constitute an organized market in this context.

IV. <u>Use of Certain Terms and Conditions in Title VII Instruments</u>

The Commissions are correct that, in some cases, the fact that a feature of a swap that is set by reference to a characteristic of a security (*e.g.*, a yield of a security that is adopted as the "fixed rate" in an interest rate swap) should not transform that swap into an SBS. *See* Proposal at 29845. The Commissions, however, narrow this principle unduly in not allowing such a swap to reflect resets or changes in the referenced characteristic where reflecting those changes is intended to effect a purpose other than transmitting the risk of changes in the characteristic itself. So, for example, a rate reset on a swap intended to return it to "market," to lessen exposure, [9] should not cause that non-SBS to become an SBS. This should be true regardless of whether the rate reset was the result of the exercise of a contractual option, based on a mandatory fixed trigger or

[9] This is a method used to diminish risk otherwise carried in the instrument. The reset is typically accompanied by a settlement.

negotiated on an *ad hoc* basis. To be clear, the question is whether the swap is intended to follow changes in the securities rate, or whether changes in the swap that may reflect changes in that rate, or that would alter that rate as used within the swap, are to effect another purpose.

V. Narrow-based Security Indices

The Commissions indicate that their prior guidance relevant to security futures will substantially apply to the determination of whether a Title VII instrument on a securities index will be a swap or an SBS. *See* Proposal at 29845-46. This prior guidance treats equity indices, volatility indices and debt security indices. The Commissions also propose new guidance and rules with respect to indices referenced by credit default swaps ("CDS") and indices of changing or fluctuating characteristics.

Preliminarily, we address the complexity of the standards the Commissions propose. We appreciate the Commissions' finely reasoned approach to managing this aspect of the awkward jurisdictional split between them. Nonetheless, we suggest a reconsideration of the resulting complex rules in the interests of greater efficiency and reasonableness in doing business. Unlike the security futures markets, which are recently-created markets that have grown to the shape dictated by their governing rules, the swap markets before Dodd-Frank regulation existed in rich diversity, with numerous index or basket products. Short of product redesign to attempt to overcome regulatory complexity, the markets must look to the regulators to create a comprehensible boundary between them that can be administered without crushing existing activity. Multi-tiered concentration tests requiring pages of guidance will be very difficult to integrate successfully into this dynamic market. Much of this regulatory complexity does not appear to be offset by significant benefits. For example, does the concentration test need to be three-part? We think not. Should the "Largest Five Component Concentration" allocation, if required to be measured at all, be not more than 60 percent? We believe 75 percent would be a more appropriate measure given the "Number" and "Single

Component" tests that precede it. The operational complexity of these tests will increase costs and compliance risks with limited countervailing positive effect.[10]

We raise these questions not because we prefer one regulatory regime to another. We do strongly prefer, however, to have one regulatory regime instead of several for the same or very similar products. Complex multi-part tests and the possibility of shifting or doubled ("mixed") regulation promises excessive compliance costs and enhanced possibility of error and dispute between transacting parties. Two principles should apply. First, criteria should be such that a transaction should be readily and transparently classifiable as a swap or a security-based swap. Second, once classified, a transaction should keep its classification to term. We offer some simplifying suggestions in the course of the following discussion, though we think that the Commissions, sensitive to the dynamic between them, may have the best perspective on how to reduce and clarify the current Proposal. We hope that the Commissions understand the great value to the markets of regulatory simplicity.

A. General

We note the following discrete points relating to the Commissions' discussion of narrow-based indices:

- The Commissions propose a 20 percent test to establish affiliation for purposes of assessing index concentration. *See* Proposal at 29849. This percentage is too low and potentially disruptive when viewed against entities that the swap markets now trade as separate entities. In the CDS market, for example, entities that share ownership ties of substantially more than 20 percent trade quite independently.[11] (This is especially true of diversified enterprises like Berkshire Hathaway, or of entities in which LBO sponsors may have invested.) These entities may have completely disparate characteristics for the purpose of an index grouping of one sort or another. It is vital that a realistic percentage test, at least 50 percent, apply for testing affiliation in this context.

[10] An active desk will be subject to enormous cost and time burdens as it will need to run these tests virtually constantly, subject to constant lawyer oversight.
[11] This is evidenced by the definition of "Affiliate" in the 2003 ISDA Credit Derivatives Definitions referencing the majority control test in the 2002 ISDA Master Agreement.

- First to default and nth to default trades challenge the Commissions' index-concentration paradigms. In our view, these transactions should be treated as SBS, to reflect their single entity triggers.

For purposes of the "public" information availability test, *see* Proposal at 29850-51,[12] concerning issuers and, in the case of indices including ABS, the ABS themselves, we believe that if there has been a Rule 144A compliant offering, the information assembled for that offering should be viewed as adequately comparable to Securities Act registration materials, if provided to the public or otherwise made available to an ECP. *See* Proposal at 29851.[13]

The Commissions take divergent views on whether the presence of a third-party index provider which bears certain disclosure responsibilities will assure adequate availability of public information in index CDS offered on SEFs, DCMs or CFTC-registered foreign boards of trade. We support the CFTC view that the presence of the third party index provider is sufficient, though we think an organized trading venue is an alternative means of achieving comfort on this point. There is no apparent reason to require that there be both a third party provider and an organized trading venue. Finally, in response to request 96, Proposal at 29854, there is no basis for a "mixed swap" outcome in this context. (The mixed swap class, of course, is intended to be narrow. *See* Proposal at 29860.)

B. Changes in Indices

In classifying indices as narrow-based or not, the Commissions would treat changes in the indices according to whether the changes are predetermined (or methodologically predetermined) or whether they reflect the discretion of the transacting parties, their agents or third-party index providers. *See* Proposal at 29855. We would be grateful if the Commissions would make clear that criteria agreed bilaterally, pre-trade by

[12] We question whether a public information availability test is needed given the expanded antifraud powers of the Commissions and the largely institutional nature of the existing OTC market.

[13] For the avoidance of doubt, we seek clarification that the sharing of 144A style information about any underlying security would not be considered an offer of the underlier potentially in violation of Section 5 of the Securities Act.

parties to a bespoke index trade are predetermined for this purpose. We agree that predetermined changes should not alter the character of an index. We disagree, however, that the power to make discretionary changes should make an otherwise broad-based index into a narrow-based index.[14]

Similarly, discretionary changes in an index that leave the index outside of the criteria for narrow-based status (putting aside discretion itself as a criterion) should not produce a change in regulatory regimes. This is consistent with the treatment of transaction amendments described on page 29856 of the Proposal.

We also disagree with the Commissions' proposal that "transactions on indices in which predetermined changes will cause an index to change character will be treated as mixed swaps from transaction inception. The Commissions allege some risk of regulatory arbitrage in this case that we have difficulty perceiving. We do not doubt that the Commissions are aware of the challenge of operating businesses in a split regulatory environment. We think the Commissions are aware of the still greater challenge involved in participating in dual-regulated mixed swaps. *See* Proposal at 29860. We urge the Commissions to "keep it simple." This may be accomplished by classifying transactions at inception and upon actual change in respect of any classification-related characteristic, be that change the product of a renegotiation or a unilateral exercise of discretion.

VI. Method of Settlement of Index CDS

The Commissions propose that a transaction on a broad index that includes a mandatory physical settlement provision will be a mixed swap. Proposal at 29859. In the name of simplicity, we think that such a transaction should be treated as a swap. The settlement mechanism for an index CDS transaction should not be determinative of its treatment as a swap or security based swap. Many transactions will contemplate physical settlement but have a cash settlement fall-back, or visa versa, making application of this approach difficult. If settlement of an index CDS transaction involves a transfer of

[14] Even the most common equity indices that would be universally viewed as broad-based have some potential for discretionary change. *See*, *e.g.*, Standard & Poor's, *S&P U.S. Indices Index Methodology* (June 2011), at 5 (available at http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l--).

a security, the SEC would retain jurisdiction over that transfer regardless of whether the OTC derivative is characterized as a swap or a security-based swap. The virtues of shared jurisdiction in this context are not apparent, particularly in light of the operational complexity such an approach would entail.

VII. Anti-Evasion Authority

The SEC forbears from attempting to create anti-evasion regulation at this time. Given the newness of swaps regulation and the considerable lack of clarity surrounding the definitions of regulated instruments and regulated persons, as well as the absence of affirmative legislative direction to regulate in this area, this seems appropriate.

The CFTC has taken a different approach, proposing anti-evasion regulations that, among other things, would cause: (1) transactions "willfully structured to evade" being swaps to be deemed swaps; (2) such deemed swaps to be part of considering whether a person is subject to a registration requirement; and (3) activity conducted outside the U.S. to willfully evade any provision of Title VII(A), to be both unlawful and treated as activity within Title VII(A).

We respectfully suggest that the CFTC oversteps with this anti-evasion proposal. A fundamental point that we hope we have helped communicate is that the statutory swap definition is not clear and that many other kinds of transactions are related to, or are close neighbors of, swaps.

As Commissioner Sommers suggests in her dissent, *see* Proposal at 29899, the real challenge for the Commission is to promulgate definitions with sufficient borders so that what is evasion and what is not will be clear. In the absence of this definitional clarity, an anti-evasion provision is automatically vague.

It is clear, given the breadth of the definition of swap, that parties will contemplate transactions that may be cast as swaps or that may be effected in some other legitimate form. Consider for example how many legitimate methods (both non-swap and swap) are available to a lender that wishes to diminish its credit risk to a borrower (*e.g.*, selling a loan participation; buying a CDS; obtaining a letter of credit; acquiring financial guaranty insurance, *etc.*). Consider as well how many factors other than regulation a party may wish to consider in making such a decision. The CFTC proposal recognizes this reality in part by giving special leave to transacting parties to choose to move a transaction to SEC jurisdiction by making the transaction a security (see proposed section 1.3(xxx)(6)). But this reality should not be limited to a choice between swap and security. Parties must be able to legitimately consider all relevant factors, including the cost and burden of regulation in making their structuring choices. It simply cannot be true that an otherwise legitimate transaction entered into as an economic alternative to a swap, and chosen because it is not a swap, becomes a swap as a result. It similarly can't be true that such transactions would be a basis for registrant status and noncompliance penalties and uncertainties.

The CFTC appears to confuse legitimate business structuring, which may include avoiding regulated activity, with illegitimate evasion of regulation. *See* Proposal at 29867 ("Business Purpose"). This is striking in view of the CFTC's reliance on tax evasion principles, including references to the distinction between legitimate avoidance and illegitimate evasion. *See id*. at 29867 n.325.

The CFTC compounds this confusion by refusing to treat deception and deceit as necessary prerequisites to an evasion finding. *Id*. at 29867 n.326. Although a non-economic transaction (offered by the CFTC as a non-deceptive means of evasion) might have some utility for tax evasion, such a transaction would serve no purpose, evasive or otherwise, from a swap perspective. Swaps are done for economic purposes. A non-economic transaction is not a substitute for a swap. A transaction, however, that fulfills the same economic purpose as a swap and offers diminished costs, and that is legitimate in its own right cannot be condemned as evasive.

Should the CFTC choose to proceed with anti-evasion regulation (and we think it should not), it is vital that the CFTC offer guidance correctly defining "willful" behavior in this context as deliberate and knowing wrongdoing *see U.S. v. Tarallo*, 380 F.3d 1174, 1187 (9th Cir. 2004), and involving deception or deceit, *see Merck & Co. v. Reynolds*, 130 S. Ct. 1784, 1796 (2010) (scienter explained).

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Just as choosing a transaction type with a view to costs and benefits (including regulatory burden) should not be encumbered with an evasion policy that makes that very thought process questionable, so choice of jurisdiction for a business activity should not be dictated by a policy that would make a decision to undertake legitimate, offshore differently regulated business violative of US law. This is especially the case when, despite urgent appeals from market participants, the CFTC has not yet addressed the substantial ambiguities accompanying extraterritorial application of Title VII. The swap markets are global and market participants are multi-jurisdictional. An anti-evasion policy that essentially penalizes these traits is unworkable.

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ISDA appreciates the opportunity to comment on the proposed product definitions. Please feel free to contact me or my staff at your convenience.

Sincerely,

Robert G. Pickel

Robert Pickel
Executive Vice Chairman
ISDA