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

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

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Joint Proposed Rule: Further Definition of "Swap Dealer," "Security-Based Swap Dealer,'' "Major Swap Participant," "Major Security-Based Swap Participant'' and "Eligible Contract Participant" (CFTC RIN 3038-AD06; SEC RIN 3235-AK65; SEC File No. S7-39-10)

Dear Mr. Stawick and Ms. Murphy:

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to comment on the proposed rules (the "**Proposed Rules**"), promulgated jointly by the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**") (together, the "**Commissions**") in accordance with Section 712(d)(1) of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"), pursuant to which the Commissions are required to propose rules and interpretative guidance under the Commodity Exchange Act ("**CEA**") and the Securities Exchange Act of 1934 ("**Exchange Act**") to further define the terms "swap dealer" ("**SD**"), "security-based swap dealer" ("**SBSD**", and together with SD, "**Dealers**"), "major swap participant" ("**MSP**"), "major security-based swap participant" ("**MSBSP**", and together with MSP, "**Major Participants**") and "eligible contract participant" ("**ECP**").

ISDA was chartered in 1985 and has 800 member institutions from 54 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.

ISDA appreciates the Commissions' consideration of the issues raised by the new categories of registrants created by the Dodd-Frank Act. As we indicate below, we agree with the Commissions in many respects. We are substantially concerned, however (a) by acute problems of vagueness and overbreadth in the definition of Dealer; (b) that the Major Participants tests may be overly static, with the unintended consequence that the status of individual entities may fluctuate frequently, unnecessarily increasing uncertainty and cost and (c) that should non-U.S. entities (including non-U.S. affiliates or branches of a U.S. bank) become subject to the Dodd-Frank Act in relation to transactions with non-U.S. counterparties:

- they will be at a *competitive disadvantage* as compared to local competitors;
- there will be an issue of *conflict of entity level regulation* where they are already subject to regulation in their home jurisdiction; and
- there is the danger of *conflicts between local and Dodd-Frank Act regulation* in relation to specific transactions. Examples include circumstances where a swap is required to be cleared in two different places at once and also the requirement under the Dodd-Frank Act that counterparties face a futures commission merchant ("**FCM**").

We respectfully offer our full comments below:

A. "Swap Dealer" and "Security-Based Swap Dealer"

I. Swap Dealing Activity

The Commissions interpret the Dodd-Frank Act as prescribing a "functional and flexible" approach to categorizing market participants as Dealers, encompassing how an entity holds itself out in the market, the nature of the conduct engaged in by the person, and how the market perceives the person's activities. The release accompanying the Proposed Rules (the "**Release**") states that there is no single set of criteria that can be determinative in all swap markets, but at the same time the Commissions identify certain "distinguishing characteristics" of Dealers.

ISDA advocates the adoption of more concrete tests for the Dealer definitions.[1] These definitions are among the key building blocks of the regulatory and legislative scheme: certainty of categorization is of fundamental importance to market participants. We are particularly concerned that the "functional" tests identified in the Proposed Rules are overly broad and could capture entities that were never intended to be the subject of the Dealer definitions. For instance, the use by the Commissions of the "tend" and "generally" modifiers[2] in articulating some of the "distinguishing characteristics" of Dealers suggests an approach that may prove overly subjective and amorphous. A sophisticated investment fund, for example, that does no "dealing" *per se*, but that is nonetheless a minimally active participant in a certain type of swap or security-based swap (together, "**Covered Swaps**") market, could potentially satisfy the core tests to be a dealer, though its activities would not be sufficient to cause such an entity to be characterized as a Major Participant. As a result, it would be subject to the full slate of Dealer regulation. Such an outcome does not accomplish the Commissions' stated intent to focus on "those persons whose function it is to serve as the points of connection" in the derivatives markets, nor will it effectively achieve the goal of reducing systemic risk. The consequences of overbreadth in the Dealer definition will be felt in a variety of Dodd-Frank Act venues. Consider, for example, the effect on the Section 716(b)(2)(B) exclusion for certain banks if the number of eligible banks is diminished by virtue of their being Dealers.

The Release states that commenters to the Commissions' joint Advance Notice of Proposed Rulemaking (the "**ANPR**")[3] suggested that maintaining a "two-way" market for Covered Swaps on a regular basis is a primary indicator of dealing activity. The Release states, however, that such conduct is not applicable to swaps because while parties to Covered Swaps negotiate the terms of a contract, they are not negotiating the price at which they will transfer ownership of tangible or intangible property. ISDA disagrees that this distinction is meaningful in this context. Being a buyer or seller in the Covered Swaps markets means in general being willing to take *either side of a trade*, be it fixed or floating, floating A or floating B, *etc.* Reliance on such a distinction is also at odds with the intent of the Dodd-Frank Act to increase trading of Covered Swaps on exchanges and swap execution facilities ("**SEFs**"), facilities that are premised on the availability of buyers and sellers, and market makers to be both.[4] Clearly Congress and, in other contexts, the Commissions, have recognized that it is possible to make a two-way market in Covered Swaps. Although dealing in Covered Swaps is different from dealing in commodities or securities, ISDA believes that the Dealer definitions should be centered on the recognition that the clearest indicator of whether a person is in fact a Dealer is whether that person stands ready to take either side of a trade with U.S. customers. ISDA urges the Commissions to use this as a

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[1] We note that elsewhere in the Release, the Commissions recognize that "[o]bjective criteria should permit regulators, market participants and entities that may be subject to the regulations to readily evaluate whether swap or security-based swap positions meet the thresholds, and should promote the predictable application and enforcement of the requirements governing major participants." *See* page 80188 of the Release.

[2] *See*, for example, Page 80176 of the Release ("Dealers *tend* to accommodate demand for swaps and security-based swaps from other parties," "Dealers are *generally* available to enter into swaps or security-based swaps to facilitate other parties' interest in entering into those instruments" [emphases added]).

[3] *See* Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, Exchange Act Rel. No. 34–62717, 75 FR 51429 (Aug. 20, 2010).

[4] Of course, SEF membership need not be restricted to Dealers and accordingly SEF membership would not denote Dealer status.

"bright line" prerequisite to Dealer status.[5] Without this prerequisite, the Commissions' proposed criteria are hazardously vague. *See* "Application of the Definitions to New Types of Covered Swaps and New Activities" below.

ISDA, among other commenters, previously urged the Commissions to follow the SEC's dealer-trader distinction.[6] Typical dealing activities for purposes of that distinction include the provision of two-sided quotations, or otherwise indicating an ongoing willingness to buy and sell particular securities.[7] We reiterate the view that the Commissions should recognize this distinction between a *Dealer* and a mere Covered Swaps *trader*.

II. Entry into Swaps as Part of a "Regular Business"

To reconcile clause (A)(iii) (which describes one inclusive factor out of four) and clause (C) (which is a general exception to Dealer status resulting from *any* of the four factors) of the Dealer definitions,[8] the Release asserts that Dealers are those persons who enter into Covered Swaps for their own account as a part of, or as an ordinary course of, a "regular" business (described in the Release as those persons whose function is to accommodate demand for Covered Swaps in response to interest expressed by other parties). ISDA believes that such statutory construction substantially changes the meanings of those clauses. Clause (A)(iii) stipulates that if one "regularly" enters into Covered Swaps, that person is a Dealer. Clause (C) is an exception from the Dealer definitions generally for activity not "part of a regular business." The Commissions interpret the language of the exception to supplant the word "regularly" (*i.e.*, customarily, usually or normally) with the broader "part of a regular business." This collapses the separate clauses of the statute and broadens the Dealer definitions. ISDA requests that the Commissions separately clarify the terms "regularly" and "ordinary course" in clause (A)(iii); those terms require specific elaboration in terms of frequency and consistency. However, no matter how clause (A)(iii) is interpreted, clause (C) should always be viewed purely as an exception to all bases for Dealer status (whether such status is attained through clause (A)(iii) or through another leg of the Dealer definition).

ISDA is additionally concerned that the Commissions' interpretation of "regular business" could have unintended consequences unless linked to a clear indicator of a swap *dealing* business. For example, an entity regularly hedging commercial risk and so not a Major Participant should not

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[5] There are special situations in which specially-purposed activity might meet this requirement, but Dealer status would still be inappropriate. Some of these situations are addressed in the statutory exceptions to the Dealer definitions or in other parts of this comment letter.

[6] *See* page 8 of the ISDA comment letter to the ANPR dated September 20, 2010.

[7] In various contexts, the SEC and its staff have articulated a variety of factors that should be considered in distinguishing traders from dealers, including: "quoting a market in," "holding oneself out as willing to buy or sell securities on a continuous basis" and "running a book of repurchase and reverse repurchase agreements." *See*, e.g., Acqua Wellington North American Equities Fund, Ltd., SEC No-Action Letter (July 11, 2001); Exch Act Rel. 40,954 (Oct. 23, 1998); Davenport Management, Inc., SEC No-Action Letter (April 13, 1993); C&W Portfolio Management, Inc., SEC No-Action Letter (July 20, 1989); Fairfield Trading Corporation, SEC No-Action Letter (Jan. 10, 1988); Louis Dreyfus Corporation, SEC No-Action Letter (July 23, 1987); United Savings Association of Texas, SEC No-Action Letter (April 2, 1987); National Council of Savings Institutions, SEC No-Action Letter (July 27, 1986); Burton Securities, SEC No-Action Letter (Dec, 5, 1977).

[8] *See* Section 721(a)(21) and Section 761(a)(6) of the Dodd-Frank Act.

be made a Dealer instead. Adoption of a "two-way market" base requirement for Dealer status would help avoid this outcome and others like it.

Even in the case of an entity that has at one time been a regular dealing business, we urge the Commissions to recognize that an entity running off a portfolio (*i.e.*, engaging in hedging activity and transactions that reduce portfolio size) should not be viewed as a Dealer, though the entity may trade on both sides of the market as it winds its portfolio down. Such activity reduces systemic risk and interconnectedness. Entities no longer engaged in Dealer activities or in seeking to preserve or expand a Dealer-focused business should not be disincentivized from exiting the business.

Finally, the Commissions should clarify that guarantors of Dealers do not by virtue of extending guarantees "enter" into Covered Swaps and risk becoming Dealers themselves. We ask "for the avoidance of doubt." We see nothing in the Dodd-Frank Act or analogous regulation that would suggest such a result. Providing a guarantee alone does not constitute Dealer activity as the Commissions seek to define or as ISDA asks the Commissions to consider. The Commissions should permit non-Dealer entities to engage in back-to-back swap transactions with their affiliates pursuant to risk management and allocation strategies. Such activities should not result in an entity being classified as a Dealer and thereby subject to the resulting requirements. This approach is consistent with the Commissions' recognition that a person may not need to be considered a Dealer when its swaps activity merely represents an allocation of risk within a corporate group.

III. Holding Oneself Out as, and Being Commonly Known in the Trade as, a Dealer

The Release sets forth certain factors suggesting that a person is holding itself out as a Dealer or is commonly known in the trade as a Dealer. As a general matter, ISDA contends that "holding oneself out as a dealer" has a plain meaning that is lost in those factors. We reiterate that the most important characteristic suggesting that a person is holding itself out as a Dealer or is commonly known in the trade as a Dealer is *whether that person presents itself as standing ready to take either side of a trade*.[9] The factors offered in the Release could easily capture persons who should not be thought of as "dealers." While understanding these to be "factors" and not dispositive, ISDA is concerned that by offering these factors, the Commissions risk extending this leg of the Dealer definition beyond what was intended by Congress. Certainly the mere articulation of such broad factors will have more market participants concerned that they will be subject to Dealer registration and resulting regulation than Congress would have imagined or intended.

With respect to individual elements of this test, ISDA believes that:

- The "contacting potential counterparties" and "developing new types of swaps" elements of the test appear to be out-of-place as the derivatives markets transition to exchange and SEF trading. However, even without use of such facilities, end-users may contact potential counterparties and may develop new types of Covered Swaps.

[9] One of the factors that could be used to support such a test is whether that person presents itself as making two-way markets in Covered Swaps.

- ISDA, which is the leading trade association for participants in the Covered Swap markets, has three categories of membership,[10] none of which is limited to "dealers" (although all primary members "deal" in the vernacular sense of engaging in transactions). ISDA has a broad spectrum of members, and the use of ISDA membership in evaluating Dealer status will be of little utility in practice. ISDA is also concerned that the use of organizational membership data in this manner may chill participation in trade organizations.

- Many entities that do not otherwise engage in Dealer activities, as defined either by the Commissions or as requested by ISDA, provide marketing materials and virtually all businesses have web sites. Presumptive non-Dealers such as publicly-held end-users and investment funds may well maintain websites and distribute investor communications that identify the types of Covered Swaps that they are willing to enter into.

- "Offering a range of other financial products" has little to do with Dealer status. A variety of market participants may offer a range of financial products and may enter into Covered Swaps. A bond and municipal bond dealer, for example, may enter into swaps merely to hedge its positions. It would be inappropriate to equate such Covered Swaps activity with acting as a Dealer on the basis of the other products.

- ISDA urges the Commissions to create objective determinations. Reflecting "the perspective of persons" with "experience" and "knowledge" as suggested in the Release is facially incompatible with the making of objective determinations.

Finally, we observe that an FCM or a securities broker-dealer that undertakes no swaps activities other than clearing and holding margin for trades should be sufficiently registered as an FCM or a securities broker-dealer. Similarly, someone who acts as an introducing broker to an SD should not be viewed as "holding itself out as a dealer in swaps" and hence picked up by the definition of SD. An SD should be characterized by holding itself out as one who will enter into swaps as *principal*. This of course is supported by the Dodd-Frank Act amendment of the definition of introducing broker to reference swaps.[11]

IV. Making a Market in Covered Swaps

The Release rejects the view that the market making component of the Dealer definitions should apply only to persons that quote a two-sided market consistently.[12] We are concerned to see the

[10] Subject to certain exceptions, every investment, merchant or commercial bank or other corporation, partnership or other business organization that, directly or through an affiliate, as part of its business (whether for its own account or as agent), deals in derivatives is eligible for election as a "Primary Member" of ISDA. Providers of professional or other similar services to persons eligible to be Primary Members (including, without limitation, law firms, accounting firms and consulting firms) are eligible for election as an "Associate Member," and any person or entity (including, without limitation, end users) not eligible for membership as a Primary Member or Associate Member is eligible for election as a Subscriber.

[11] *See* Section 721(a)(15) of the Dodd-Frank Act.

[12] For the avoidance of doubt, we distinguish making a two-sided market generally from the less relevant occasional practice of offering two-sided quotes, *i.e.* simultaneously offering a "buy" price and a "sell" price.

Commissions essentially abandon the market-making factor embedded in the language of the statute. So interpreting the definitions will potentially cause persons that may engage in inconsistent trading or "one-way" trades to be treated as Dealers. As noted above, we think this is contrary to the intent of Congress.

Moreover, the term "making a market" has a clear meaning in not only the securities markets but the financial markets generally.[13] The Release states that continuous two-sided quotations and a willingness to stand ready to buy and sell a security are important indicators of market making in the equities markets, but that these indicia may not be appropriate in the context of the Covered Swap markets. The Release provides no other guidance on the meaning of this leg of the statutory definitions. ISDA maintains that the threshold indicator of whether a person is truly a Dealer is whether that person *consistently* (not "continuously") presents itself as willing to take either side of a trade. ISDA believes this indicator to be a necessary rudder to guide determinations of Dealer status.

Read as a whole, the statutory definition of Dealer uses dealing and market-making interchangeably as the "regular business" that is intended to be regulated. To lose sight of this is to lose sight of the reasonable boundaries of Dealer regulation.

The Dodd-Frank Act applies transaction reporting and antifraud responsibilities (some would say redundantly) to every person transacting swaps, whether or not a Dealer or Major Participant. In other words, basic regulation applies to all market participants. The substantial additional burdens and costs of Dealer regulation must be reserved for those whose business it is to "make the market," that is, those who consistently both buy and sell.[14] This is in accord with Dodd-Frank Act's market regulatory goals, as well as the legislation's obvious intent to preserve healthy growth and innovation in the U.S. swap markets.

V. Application of the Definitions to New Types of Covered Swaps and New Activities

The Release posits that a flexible, "facts-and-circumstances" approach would allow the Dealer definitions to cover appropriate persons as the Covered Swap markets evolve. As noted above, ISDA believes that a "facts and circumstances" approach must include sufficient guidance, including concrete criteria, to allow potentially regulated parties to understand their regulatory position and guide their own conduct. "Vagueness arises when a statute is so unclear as to what conduct is applicable that persons of common intelligence must necessarily guess as to its meaning and differ as to its application." *Mason v. Florida Bar*, 208 F.3d 952, 958-59 (11th Cir. 2000). "The root of the vagueness doctrine is a rough idea of fairness" and "serves two central purposes: (1) to provide fair notice of prohibitions, so that individuals may steer clear of unlawful conduct; and (2) to prevent arbitrary and discriminatory enforcement of laws." *Id.* Or

[13] The CFTC Glossary defines "market maker" as "a professional securities dealer or person with trading privileges on an exchange who has an obligation to buy when there is an excess of sell orders and to sell when there is an excess of buy orders…." *See* http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_m.html.

[14] The Commissions offer a "point of connection" euphemism, Release at 80177, as a substitute for well-accepted concepts of who is a Dealer. We cannot agree that this phrase has any meaning whatsoever that would enable a person to guide its conduct or to understand its potential responsibilities. See section V. below.

as the Supreme Court said recently in striking down a jurisdictional test, "[t]here is no more damning indictment of the [lower court's test] than the [lower court's] own declaration that 'the presence or absence of any single factor which was considered significant in other cases… is not necessarily dispositive in future cases.'" Consistently, ISDA encourages the Commissions, to the extent possible, to adopt objective criteria to promote predictable application and enforcement, now and in the future.

VI. Designation of a Person as an SD

In determining whether a person meets the applicable definitions, the Release provides that the Commissions may use information from other regulators, swap data repositories, registered clearing agencies, derivatives clearing organizations and other sources. We urge that any such "other sources" that are used in making such determinations be required to be both reliable and positioned to have, and have, relevant and verifiable information. Any sources used by the Commissions (and any information provided by such sources) in making a determination of Dealer status should be revealed in full to the entity being evaluated.

VII. *De Minimis* Exemption to the Definition

The Release maintains that the *de minimis* exemption should apply only when an entity's dealing activity is so minimal that applying Dealer regulations to the entity would not be warranted. ISDA believes that the notional amount of Covered Swaps entered into by an entity may not be the optimal indicator of the extent of its dealing activities. In certain markets (*e.g.*, foreign exchange) it would be relatively easy for the activities of a small trader that enters into few Covered Swaps to exceed a $100m notional amount (or $25m for Covered Swaps with special entities). Similarly, footnote 42 of the Release indicates that the *de minimis* exemption has been too narrowly framed. It would serve no regulatory purpose, and would not help achieve the Dodd-Frank Act's orderly market goals, to classify and regulate as a Dealer (as footnote 42 states) a person who in the previous 12 months has entered into only one Covered Swap, with a single counterparty, regardless of the transaction size of that Covered Swap.[15] Even if such a transaction were large enough to present systemic risk, it would conceivably be captured by the applicable Major Participant definitions, a more appropriate categorization for an entity with such limited swaps activity on one side of the market.

The Commissions have requested comment as to the significance of the fact that the statutory *de minimis* exemption specifically references transactions with or on behalf of a customer. ISDA sees the reference to a "customer" for purposes of establishing a *de minimis* test as an indication that Congress believed that Covered Swap dealing activity as a whole involves entering trades as an accommodation to customers (*i.e.*, unaffiliated, non-Dealer, non-Major Participant persons or entities entering into trades with a Dealer in the course of such Dealer's Covered Swap dealing activity). Any extension of the Dealer definitions risks overreaching the statutory definition. Covered Swap dealing should be limited to dealing activity as an accommodation to an entity's U.S. customers. Consistently, a party's hedge trades should not "count" against the *de minimis*

[15] We think that the Commissions should set *realistic* notional limitations, varied by transaction type, as part of a *de minimis* test. Alternatively, the Commissions might have the *de minimis* exemption depend on frequency of transacting (e.g. 25 trades in 12 months) instead of notional value.

allowance and should not be viewed as dealing activity, nor should there be double counting when swaps are entered into with or on behalf of customers and then hedged with offsetting swaps with other market participants. In short, the following should not be seen as dealing activity for purposes of the *de minimis* exemption:

- Trades between affiliates.[16]
- Trades with Dealers or Major Participants.[17]
- Trades with customers *other than* U.S. customers.[18]
- A party's hedge trades.

Reference is also made in the Release and the Proposed Rules to the "effective" notional amount of a Covered Swap, without clearly articulating the meaning of this term in this context. The "notional amount" of a Covered Swap is typically clear on the face of any swap agreement, but the "effective notional amount" is not: without further clarification, the "effective notional amount" concept may introduce an element of ambiguity and uncertainty into a test which should be objective and clearly delineated.

The Commissions have also requested comment as to whether, in lieu of the self-executing approach proposed by the Commissions, entities should be required to submit exemptive requests to the relevant agency. In the interests of reducing costs, both for the industry and the Commissions, we support the self-executing approach.

VIII. Statutory Exclusion for Swaps in Connection with Originating a Loan

The SD definition excludes an insured depository institution ("**IDI**") "to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." The Release proposes circumstances in which the statutory exclusion would not apply, including where the purpose of the swap is not linked to the financial terms of the loan. ISDA believes that the exclusion of transactions not linked to the "financial terms" of the loan should be reconsidered. Such exclusion is inconsistent with the treatment of commercial risk elsewhere in the Proposed Rule[19] and in the Dodd-Frank Act as a whole. Swaps of various sorts may well be required by covenants in loan agreements as a matter of prudent lending. Certainly swaps required in loan documentation that fall within the scope of what a reasonable and prudent lender

[16] Under pre-existing regulation, an entity that acts only for its affiliates need not register as a futures commission merchant. *See* CFTC Regulations 1.3(y) and 3.10). None of the goals of the Dodd-Frank Act would seem to be served by including affiliate trades. Affiliate trades of course are especially important to coordinated risk management in cross-border businesses.

[17] The SEC does not include trades with security-based swap dealers in the 15-counterparty/12-month period element of the test. In the interests of regulatory conformity we urge both Commissions to similarly exclude transactions with swap dealers from all elements of the test. Such trades among "professionals" do not implicate legislative goals in any tangible way.

[18] *See* our comment letter dated January 24, 2011 to the CFTC's proposed regulations with respect to the registration of SDs and MSPs (the "**ISDA Registration Letter**").

[19] *See* the Major Participant definitions.

may require should be within the loan origination exclusion.[20] In order to offer a swap to a customer in connection with originating a loan with that customer, the IDI must also be able to acquire an offsetting swap in the market to hedge itself without this hedging activity resulting in the IDI being classified as an SD. To view these offsetting trades otherwise would render the exclusion meaningless, and therefore the rule should clarify that the exclusion extends to this hedging activity. In addition, ISDA believes that to the extent an IDI enters into a loan, and then uses a swap to hedge its own credit exposure to the borrower, that hedge should be viewed as being in connection with the origination of the loan for purposes of the statutory exclusion. To view this as dealing activity could discourage effective credit risk management.

IX. Designation as a Dealer for Certain Types, Classes or Categories of Covered Swaps/Activities

The Release states that a person may apply to the Commissions to be designated as a Dealer for only specified categories of Covered Swaps or activities (upon an appropriate showing) without being classified as a Dealer for all categories. We note that clause (B) of the SD definition in the Dodd-Frank Act provides that "[a] person *may* be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities." (emphasis added).[21] We believe that the statutory language should be interpreted to mean that a dealer may be designated as a Dealer for its U.S. dealing lines of business only – subject to the maintenance of such separate books and records as may be reasonable.[22] (Dealer status and concomitant regulation will be destructive of U.S. competitiveness unless appropriately focused on protection of U.S. counterparties. U.S. counterparties will also face increased costs and decreased liquidity if U.S. regulation forces non-U.S. SDs to create fragmented booking structures to avoid duplicative and conflicting regulatory regimes.) We also believe that with respect to any judgment as to whether a person could make an "appropriate showing" to the Commissions in connection with a potential limited Dealer designation, it would be highly useful from an efficiency perspective if the Commissions could set forth criteria that they might consider in evaluating such a showing. Finally, we urge the Commissions to make clear that categories of swaps activities that may be established for purposes of determining MSP status are *necessarily not* determinative of categories available to an entity seeking relevant relief.

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[20] For example, the terms of a commercial loan facility will commonly require the borrower to comply with various conditions before it is able to draw on the facility, including, for example, the entry into hedging agreements related to the borrower's underlying business operations. Those hedges may not be linked to the financial terms of the loan, but as conditions to the loan existing in the first place, the statutory exclusion should apply to those hedges. It may be vital to the business interests of the borrower that the lender is not constrained in providing the needed swap.

[21] Clause (B) of the SBSD definition contains equivalent language.

[22] While it is likely that the bulk of the activity within a Dealer will be the Dealer's market-making and customer-driven activities, certain financial institutions may house activities within the same legal entity that are "end-user" in nature (such as a financial institution's treasury department that may hedge that financial institution's own balance sheet using derivatives). We believe that these activities should be exempt from the requirements that attach to an entity that must register as a Dealer (including margin, capital and business conduct requirements). Similarly, trades between affiliates should not attract these requirements.

X. Territorial Scope

In order to mitigate the concerns outlined above in relation to applying too wide a territorial scope in connection with the Dealer provisions, the requirements should be interpreted to mean that only business with U.S. counterparties (excluding non-U.S. affiliates and branches of U.S. banks) should be determinative as to whether the entity is a Dealer or not.[23] We believe that:

- A branch, division or office of an entity should be able to be designated as a Dealer without subjecting the whole entity to regulation; and
- Designation as a Dealer should only be triggered where there is ongoing business with U.S. counterparties. Non-U.S. entities (including non-U.S. affiliates and branches of U.S. banks) should not be required to register as Dealers where they are conducting business with non-U.S. counterparties. In particular, the following aspects should not, of themselves, trigger the designation of a non-U.S. entity as a Dealer:
  - (a) the fact they are affiliates/branches of a U.S. bank;
  - (b) the fact there may be a guarantee of a U.S. entity; or
  - (c) the fact that there may be outstanding legacy positions with U.S. counterparties.

In addition, if a Dealer is a non-U.S. entity (including a non-U.S. affiliate or branch of a U.S. bank):

- no Dodd-Frank Act requirements should relate to business with non-U.S. counterparties;
- compliance with local home regulator requirements should generally be sufficient to satisfy entity level requirements applicable to Dealers pursuant to the Dodd-Frank Act (*e.g.*, capital, risk management policies, *etc.*); and
- the domicile of a platform on which a transaction is executed or cleared should not be the sole determinant of registration as a Dealer if both parties to the transaction are domiciled outside the U.S.

And, of course, inter-affiliate transactions should not trigger Dealer designation requirements for the non-U.S. affiliate.

B. <u>"Major Swap Participant" and "Major Security-Based Swap Participant"</u>

I. "Major" Categories of Covered Swaps

The first and third tests of the Major Participant definitions encompass entities that have a substantial position in a "major" category of Covered Swaps. The CFTC proposes to designate

[23] *See Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010).

four "major" categories of swaps, which are together intended to cover all swaps. The SEC proposes to designate two "major" categories of security-based swaps, which are together intended to cover all security-based swaps.[24]

Determining the appropriate "major" categories is a difficult task, with a complex of associated issues. We think the Commissions have done as well as they might in scaling and dividing the categories they propose.

II. "Substantial Position"

The Commissions propose that "substantial position" would be measured by a two-part test that encompasses measurements of "current uncollateralized exposure" and "potential future exposure." ISDA believes that a Basel-inspired substantial position test has much to offer. We are concerned, however, by particular aspects of the test described below, as well as the sheer complexity of the required calculations.

Risk Mitigants

ISDA supports the recognition by the Commissions that the substantial position tests should incorporate objective numerical criteria, thereby permitting regulators, market participants and potential registrants to readily determine whether or not their Covered Swap positions meet the applicable thresholds. Similarly, ISDA applauds the recognition by the Commissions that exposure calculations should be adjusted on account of the risk mitigating effects of clearing and the posting of collateral and margin. The proposed 80 percent reduction, however, as against the risk-reducing effect of these very tangible mitigants is insufficient. We recommend a minimum of a 98 percent reduction as appropriate recognition of the integrity of these mitigants.

ISDA also appreciates the acknowledgment by the Commissions of the risk mitigating effects of netting agreements. However, the Proposed Rules provide that an entity would be permitted to offset only swaps, security-based swaps and "securities financing transactions". We request that the Commissions also permit parties to offset against all "nettable" contracts for purposes of the Bankruptcy Code, including securities contracts and forward contracts.[25] Given their equivalent treatment under the Bankruptcy Code and other statutes, there is no reason why these contracts should be distinguished from swaps, security-based swaps and securities financing transactions.

The Commissions express the preliminary belief in the Release that an entity that has net uncollateralized exposure to a counterparty should, for purposes of the substantial position test, allocate that net uncollateralized exposure pro rata in a manner that reflects the exposure associated with each of its out-of-the-money swap positions, security-based swap positions and non-swap positions. Of course, collateral requirements between parties are typically established

[24] Although the Commissions have designated major categories for swaps and security-based swaps, we request clarification from the Commissions as to which category, if any, mixed swaps would fall into. In addition, in connection with the security-based swap categories, we would be grateful if the SEC could clarify the appropriate characterization of swaps based in whole, or in part, on debt securities convertible into equity. In other contexts (e.g., Regulation SHO), the SEC treats convertible securities as equities. We believe that similar treatment is warranted in this context.

[25] Laws of other jurisdictions, of course, may also be germane. *See* the ISDA Registration Letter.

on a net portfolio basis that would ignore the categories of positions referenced by the Commissions. Putting this point aside, we believe the allocation proposed to be pragmatic and simple enough to be used.

The Exposure Tests

ISDA has significant concerns about the use of the Basel II Current Exposure Method ("**CEM**") to calculate exposure for purposes of the thresholds. The CEM approach applies a set of specified "conversion factors" to the notional principal amount of a trade on a position-by-position basis, subject to certain adjustments and netting. However, the CEM approach fails to fully recognize the effects of hedged positions, which greatly inflates the exposure calculation, particularly for larger market participants (which MSPs are presumed to be). These problems are exacerbated by CEM's "60/40 gross/net" approach to netting recognition for potential exposure, which only partially reduces gross exposures, and by the fact that the CEM conversion factors were originally calibrated more than 15 years ago and were not designed for products (such as credit products) that were developed later.

ISDA believes that use of the CEM approach is inconsistent with a focus on systemic risk. Instead, we believe that the "standardized method" formula under the international Basel II framework should be used to measure exposure. The "standardized method" provides greater recognition of hedges and netting; this would be particularly significant for the larger participants. Although this approach is not offered under Basel II implementation in the United States, it has attained international recognition – it is permitted in the European Union and under the Basel II international framework.

The Commissions have requested comment as to whether the substantial position thresholds should also account for entities that have large in-the-money positions that may indicate their potential significance to the market. ISDA does not believe it necessary for the exposure calculations to specifically take in-the-money positions into account because, by definition, the applicable entity would offer no potential exposure with respect to those positions, and to the extent that those in-the-money positions are reversed, the exposure tests require daily calculations, and so those reversals would quickly manifest themselves in the exposure calculations.

The Commissions also request comment as to whether and how it would be appropriate to adjust the threshold amounts over time. ISDA believes that it would be appropriate to periodically reassess the threshold amounts as the size and fundamental characteristics of the Covered Swap markets evolve over time, as well as to account for changes to valuation methodologies over time and varying economic conditions. However, given the complexities entailed by the substantial position calculations, we recommend that such reassessments take place several years apart.

Thresholds and Look-Backs

The effect of becoming a Major Participant is profound, introducing an entity to full-bore regulation and attendant responsibilities. Tests chosen to determine Major Participant status should not be so readily subject to fluctuation as to create a real risk that entities may move in and out of regulated status on other than a deliberate basis.

To that end, we propose that the look-back period to determine if an entity has become an MSP be set at a full year of meeting the quarterly daily average test in consecutive, successive immediately preceding quarters.

Other Comments

As a general matter, it is possible that entities that may fall within the Major Participant definition may not currently undertake the regulatory accounting necessary as a first step to determining whether those entities maintain "substantial positions." In this context we do note that the Commissions have expressed the belief that few entities will actually have to perform the required calculations. Nonetheless, we would suggest that a reasonable grace period of three full calendar quarters be allowed following the effectiveness of the Proposed Rules in order to permit potential Major Participants to determine whether they are in fact Major Participants. We would also be grateful for confirmation that (i) nothing in the Proposed Rules is intended to require Dealers or Major Participants to compute, assist with, or otherwise verify classification computations for counterparties who are, or may be, Major Participants and that (ii) market participants will be allowed to enlist the assistance of third-party services to assist them in performing the calculations.

The Commissions have requested comment as to how inconsistencies among market participants may be resolved with respect to (i) the value of an entity's exposure in connection with a Covered Swap position, and (ii) the value of the collateral posted in connection with relevant positions. We believe that the starting point for any such valuation should be the use of an entity's internal valuation methodology – so long as that methodology is consistent with the valuation methodology used by such entity in connection with its own audited financial statements (be they U.S. GAAP or International Accounting Standards). We recognize that such valuation methodologies may be proprietary, and this may lead to inconsistencies across the market, but we do not believe there to be a feasible alternative at present.

III. "Hedging or Mitigating Commercial Risk"

For purposes of the definition of MSP, the CFTC maintains that whether a position hedges or mitigates commercial risk should be determined by the facts and circumstances at the time the swap is entered into, and should take into account the person's overall hedging and risk mitigation strategies. In the context of the MSBSP definition, the SEC would require that a security-based swap position be "economically appropriate" to the reduction of risks in the conduct and management of a commercial enterprise, where those risks arise from the potential change in the value of assets, liabilities and services connected with the ordinary course of business of the enterprise.

ISDA applauds the broad concept of commercial risk that is suggested by the Commissions in the Release. We also agree that it would be appropriate to take into account a person's overall hedging and risk mitigation strategies. We do however note that the Commissions dispute[26] the suggestion that use of the word "mitigating" within the Major Participant definitions was

[26] See footnote 127 of the Release.

intended to mean something significantly more than hedging.[27] We believe that "risk mitigation" can include activities that are different from hedging. As such, we suggest a broadening of the test so that a particular position that has been taken as part of a *bona fide* risk mitigation strategy would be deemed to be a position taken to hedge or mitigate commercial risk.

The proposed rules provide that positions held for the purpose of hedging underlying speculative positions would not be deemed to be held for the purpose of hedging or mitigating commercial risk. ISDA believes that such a distinction should not matter so long as the "hedge" is an intended mitigant. The Commissions' proposed treatment of hedges of speculative positions would inevitably result in there being more unhedged speculative risk in the market. Indeed, this distinction begs the question as to how a market participant who has a mixed hedging/speculative motive for holding a particular position should treat that position (*e.g.* that position is needed for hedging purposes, but the market participant has also taken a view of the market which means that the market participant anticipates making a return on the hedge). This distinction also leads to the somewhat perverse, narrow result that hedged speculation would cause a person to be more likely to be a Major Participant than if that person was a naked speculator.

The Commissions also request comment as to whether the hedging or mitigating commercial risk exemption should be available to financial entities. For the reasons that are set-out by the Commissions in footnote 125 of the Release, we believe that this exemption should be available to financial entities.

IV. "Highly Leveraged"

The Commissions propose two possible definitions in this context (*i.e.*, an entity would be "highly leveraged" if the ratio of its total liabilities to equity is (i) in excess of 8 to 1 or (ii) in excess of 15 to 1).[28] Given the sheer number of financial institutions that employ leverage in some way to enhance their returns, ISDA maintains that only those institutions with the very highest leverage ratios should be deemed to be "highly leveraged." The 15 to 1 ratio should be viewed as a *floor* for the Commissions' consideration. The "grave threat" standard of Title I of the Dodd-Frank Act cuts against ordinary course use of this ratio as an upper limit.

V. Managed Accounts

The Release states that the Major Participant definitions should not be construed to aggregate the accounts managed by asset managers or investment advisers to determine if the asset manager or investment adviser itself is a Major Participant. ISDA supports the Commissions' proposed approach for treating Covered Swap positions in managed accounts as positions of the underlying clients of asset managers. We encourage the Commissions to clarify and generalize

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[27] Hedging can be viewed as a means of reducing earnings volatility. Thus if a person has an exposure of +100 and sells -80 futures, that person's net position is +20, and that person can be said to have placed a hedge. Mitigation, by contrast, is broader. If instead of selling the futures a person buys a far out of the money put option, that put option might have a small delta today (perhaps only -10, giving a net of 90) and may not be an "economically appropriate" hedge for ordinary market movements. However if the underlying drops 50 percent, the put could be said to have mitigated the person's far downside.

[28] ISDA would be grateful for clarification from the Commissions as to whether off-balance sheet positions should be considered in determining the leverage ratio for a person.

this view by stating that all Covered Swap positions should be attributed to the *legal* owner(s) of such positions rather than to any agent or party exercising discretion or advising with respect those positions. We emphasize the importance of specifying legal ownership, because concepts of beneficial ownership may be broad and unclear.

VI. Designation as a Major Participant for Certain Types, Classes or Categories of Covered Swaps/Activities

As with the Dealer definition, Major Participants who engage in significant activity with respect to only certain types, classes or categories of Covered Swaps may apply for relief with respect to other types of Covered Swaps from certain of the requirements that are applicable to Major Participants. A Major Participant could seek a limited designation at the same time as, or at a later time subsequent to, the person's initial registration as a Major Participant. We note that clause (C) of the MSP definition in the Dodd-Frank Act provides that "a person *may* be designated as a major swap participant for 1 or more categories of swaps without being classified as a major swap participant for all classes of swaps." (emphasis added).[29] We believe that the statutory language should be interpreted to mean that a Major Participant may be designated as a Major Participant for its Covered Swaps for which it is a Major Participant only – subject to the maintenance of such separate books and records as may be reasonable. We also believe that with respect to any judgment as to whether a person could make an "appropriate showing" to the Commissions in connection with a potential limited Major Participant designation, it would be highly useful from an efficiency perspective if the Commissions could set forth criteria that they might consider in evaluating such a showing.

VII. Legacy Portfolios; SPVs

The Commissions request comment on whether the rules further defining Major Participants should exclude entities from the Major Participant definitions if their Covered Swap positions are limited to legacy positions. ISDA supports the view that persons maintaining legacy portfolios who are substantially inactive and in run-off should not be viewed as Major Participants (or as Dealers). In fact, looking at the example of derivative product companies now in runoff, requiring Major Participant compliance, including posting of collateral, could cause market instability. Similarly, special purpose vehicles ("SPVs") dedicated to structured finance or securitization transactions should not be viewed as Major Participants in the unlikely event that they would meet the quantitative tests. These SPVs have limited functionality and resources. They are simply unable to comply with the burden of Major Participant regulation.

VIII. Legal Entity Identifiers

ISDA believes that current lists of market participants classified as MSPs or Dealers should be made available electronically and in real time to the public by the Commissions (or the applicable self-regulatory organization), and that these lists should use legal entity identifiers. The availability of counterparty classifications with legal entity identifiers is critical to ensuring that Dealers and Major Participants can comply with their duties (including real-time reporting

[29] Clause (C) of the MSBSP definition contains equivalent language.

and "know your client" requirements") and to generally minimizing confusion throughout the lifecycle of a transaction.

IX. Aggregation

The Commissions request comment on when affiliate positions should be aggregated in order to determine Major Participant status. In general, we think that the Commissions should respect lawfully maintained corporate separateness and integrity. Instances to the contrary must be the rare cases where there is a joint malfeasance executed through the separate entities that would justify such extraordinary action. Of course, multi-jurisdictional and extra-territorial concerns would also need to be recognized as limitations on any proposed tendency towards aggregation. It follows from the foregoing that the mere provision of a guarantee would be an insufficient basis for aggregation. As stated in the earlier discussion regarding Dealers, entities should be allowed to engage in back-to-back swap transactions with their affiliates pursuant to risk management and allocation strategies without triggering Major Participant status.

C. Extraterritorial Concerns

We have within the foregoing discussion touched on a number of points where restraint by the Commissions will be required if Dodd-Frank Act implementation is not to distort what are now global markets functioning within a relatively level international playing field. We think that the concerns outlined above as to competition and conflicts of regulator and regulation in respect of individual entities and individual transactions are important and merit careful consideration of the bounds of the Dealer and Major Participant definitions. For example, as stated earlier, it is vital that Dealer status and Dealer regulation be measured on the basis of U.S. counterparty business only. We are aware that in addition to our own prior statements,[30] others have shared their views on this matter with the Commissions. We urge the Commissions to study these views and to "do no harm" to the international character of the derivatives markets. It is imperative that U.S. and non-U.S. regulators must coordinate requirements to avoid unintended impediments to, and fragmentation of, the derivatives markets.

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ISDA appreciates the opportunity to provide its comments on the Release and the Proposed Rules and looks forward to working with the Commissions as the rulemaking process continues. Please feel free to contact me or ISDA's staff at your convenience.

Sincerely,

Robert Pickel
Executive Vice Chairman

[30] *See* ISDA Registration Letter.