United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510–6250

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Submitted by E-mail

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RE: **Further Definitions of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant"**

Dear Secretary Stawick and Secretary Murphy:

The purpose of this letter is to respond to your request for comments on further definitions of "swap dealer," "security-based swap dealer," "major swap participant," and "eligible contract participant" under the Commodities Exchange Act (CEA) and the Securities Exchange Act of 1934 (Exchange Act).[1] Firms meeting those definitions would be subject to registration, as well as requirements related to capital, margin, and business conduct.[2]

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[1]Section 712(d) of the Dodd-Frank Act, Public Law 111-203, 124 Stat. 1376 (2010), provides that the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) (collectively, the "Commissions "), in consultation with the Board of Governors of the Federal Reserve System, shall jointly propose rules and interpretive guidance under the CEA and the Exchange Act to further define the terms cited above. The Commissions presented a joint proposal containing proposed definitions of "swap dealer," "security-based swap dealer," "major swap participant," and "eligible contract participant" and invited comment on each such definition and its subparts. Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant''; Proposed Rule, 75 Fed. Reg. 80174 (Dec. 21, 2010).

[2] *See, e.g.*, Dodd-Frank Act §§ 731 and 764.

Hedging Exemption. While the Commissions invited comments on each of the definitions, this comment pertains to the proposed definitions of "major swap participant" and "major security-based swap participant," and focuses specifically on the exclusion of swap positions and security-based swap positions taken for purposes of "hedging or mitigating commercial risk."[3]

As the CFTC acknowledges in its discussion of the "hedging or mitigating commercial risk" exclusion, it is often difficult to distinguish between swap positions taken for purposes of "hedging or mitigating commercial risk," which qualify for exclusion, and similar positions taken for purposes of speculation, investment, or trading, which do not qualify for exclusion.[4] As the CFTC stated in the joint proposed rulemaking release: "Although the line between speculation, investing or trading on the one hand, and hedging, on the other can at times be difficult to discern, the statute nonetheless requires such determinations."[5]

With respect to the definition of a "major swap participant," the CFTC proposes that whether a position is taken for hedging or mitigating commercial risk 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."[6]

With respect to a "major security-based swap participant," the SEC proposes analyzing a security-based swap position taken for purposes of "hedging or mitigating commercial risk" in terms of whether the position is "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where they arise from the potential change in the value of assets, liabilities and services in connection with the ordinary course of business of the enterprise."[7]

While these broad interpretations of "hedging and mitigating commercial risk" attempt to encompass many situations in which a commercial entity legitimately has taken a position to hedge or mitigate its commercial risk, the very breadth of the language may invite abuse and lead to the evasion of capital, margin, or business conduct requirements applicable to "major swap participants" and "major security-based swap participants" under the Dodd-Frank Act.

The "hedging or mitigating commercial risk" exclusion is of particular concern, because it may be invoked by financial firms which are barred from the "end user" exception to the law's mandatory clearing requirements, as discussed below. Many financial firms are in the business of speculation, investing, and trading, and the commercial risks they face are ultimately related to the positions taken for those purposes. Positions taken for speculative, investment, or trading purposes are not eligible for exclusion from the law's capital, margin, and business conduct requirements. Allowing financial firms to invoke a hedging exclusion without strict standards and controls may invite evasion of Dodd-Frank's regulatory requirements by enabling firms to mask speculative positions under the guise of hedges.

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[3] *See, e.g.*, Dodd-Frank Act §712.
[4] 75 Fed. Reg. 80195.
[5] Id.
[6] Id.
[7] Id.

In addition to concerns about potential abuse of the "hedging and mitigating commercial risk" exclusion and the evasion of otherwise applicable regulations, it also appears that exclusion may need additional procedural safeguards, such as specific identification of the risk hedged against, an audit trail, and provisions governing the appropriate termination or unwinding of hedges when the underlying risk hedged against has been sold or otherwise resolved.

Subcommittee Investigations. The Permanent Subcommittee on Investigations, which I chair, has found that a financial firm's description of the purpose of a transaction may not always accurately reflect the economic reality or motivation for the transaction, and also that transactions can be shaped to mask their true underlying purposes.

Over the past two years, the Subcommittee has conducted an extensive investigation delving into key causes of the financial crisis. As a part of that investigation, the Subcommittee has analyzed hundreds of financial derivative products, including credit default swaps (CDS), residential mortgage-backed securities (RMBS), and collateralized debt obligations (CDOs). It gathered and reviewed extensive documentation related to those derivatives and interviewed dozens of financial institution employees, government officials, and academic experts. It also held four hearings and released thousands of hearing exhibits.

The Subcommittee's last case study, examining the role of investment banks in the financial crisis, demonstrated that a financial firm's characterization of the purpose of a transaction may not reflect the firm's true economic motivation. The Subcommittee's case study considered how Goldman Sachs made extraordinary profits by shorting, or betting against, the U.S. subprime mortgage market. Goldman also underwrote and sold to its clients' complex structured financial products, including collateralized debt obligations or "CDOs," without disclosing that it was betting against those same products. In defending its conduct, Goldman Sachs and its executives repeatedly asserted that the firm served only as a market-maker with respect to the CDO products it sold to customers, when in many cases it was actually serving as the issuer, underwriter, or placement agent, and therefore had heightened disclosure obligations. Indeed, the primary purpose of Goldman Sachs's large net short positions in the subprime mortgage market was for proprietary trading profits, not the accommodation of customer demand in its market making business.

Goldman Sachs sometimes claimed that its large short positions in the U.S. mortgage market were merely "hedges" against other, unspecified long positions. However, internal documents showed that the long positions held by Goldman Sachs's mortgage department were already hedged when the firm put on most of its profitable short positions. A key architect of the firm's big short position against the housing market insisted at the time, and recently re-affirmed, that the profitable short positions were not a hedge. Further, while Goldman's Mortgage Department had taken a $9 billion short position that it appropriately used as a hedge against other long positions for some time, it did not unwind that hedge as it sold off or wrote down the underlying long positions. After the long positions were sold or written off, Goldman retained the $9 billion short position, which increased in value as the subprime mortgage market collapsed. Though Goldman Sachs itself would likely qualify as a "swaps dealer" and "security-based swaps dealer" under the Dodd-Frank Act and therefore ineligible for the "hedging and

mitigating commercial risk" exclusion, Goldman Sachs's characterization of its activities as "market-making," its description of its net short positions as hedges, and its transformation of a massive $9 billion hedge into a $9 billion net short trading position, are illustrative of the complexities and possibilities for misuse of the "hedging or mitigating commercial risk" exclusion.

Dodd-Frank Act. The Dodd-Frank Act was enacted, in part, to bring transparency and order to the previously unregulated derivative markets, and to eliminate the need for future taxpayer bailouts. Under the Dodd-Frank Act, a person qualifies as a "major swap participant" or "major security-based swap participant" if it meets any one of three criteria set forth in the statute. Like derivatives dealers, major participants in the swaps markets are subject to a number of regulations, including requirements related to capital, margin, and business conduct.

The first criteria in the definition of a "major swap participant" or "major security-based swap participant" is that the person "maintains a substantial position in any of the major [security-based] swap categories ..., excluding— (I) positions held for hedging or mitigating commercial risk; and (II) positions maintained by any employee benefit plan ... for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan."[8]

In discussing their proposed interpretation of "hedging or mitigating commercial risk," the Commissions noted that Congress used very similar language in the Dodd-Frank Act to provide an exception from mandatory clearing requirements for so-called "end-users."[9] End users are described in the statute as non-financial entities that use swaps or security-based swaps to "hedge or mitigate commercial risk."[10] The Commissions propose to interpret the phrase "hedging or mitigating commercial risk" in the definitions of major swap and security-based swap participants in the same manner as the phrase "hedge or mitigate commercial risk" in the mandatory clearing exception.[11] This approach should help ensure that the two terms are analyzed in similar ways and will lead to similar corporate mechanisms to track and report such mechanisms.

The Commissions propose allowing "positions established to hedge or mitigate commercial risk" to qualify for the exclusion, regardless of whether the person holding the position is a financial or non-financial entity,[12] even though the Commissions acknowledge that this approach is different from that taken regarding the purportedly analogous "end user" exemption, which does not apply to financial firms.

The Commissions further propose using differing tests for determining whether a particular position hedges or mitigates commercial risk.[13] For major swap participants, the CFTC proposes examining "the facts and circumstances at the time the swap is entered into"

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[8] Dodd-Frank Act, §§ 721 and 761.
[9] 75 Fed. Reg. 80194.
[10] See CEA section 2(h)(7)(A) and Exchange Act section 3C(g)(1)(B).
[11] 75 Fed. Reg. 80194.
[12] Id.
[13] 75 Fed. Reg. 80195.

taking into account "the person's overall hedging and risk mitigation strategies."[14] For major security-based swap participants, the SEC proposes examining whether the position is "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise" and whether the risks arise "from the potential change in the value of assets, liabilities and services in connection with the ordinary course of business of the enterprise."[15]

The Comissions' proposed approaches seek to exclude security-based swaps that pose relatively little risk to the financial system, because they are undertaken to offset risks from an entity's commercial operations. Fact-based tests are also a reasonable response to the great variety of financial instruments and transactions covered by the law. The major drawback of the Commissions' approach, however, is that each Commission fashions its own fact-intensive test. The establishment of two different tests may lead to confusion and regulatory arbitrage between the two agencies and the markets they oversee.

The Commissions' proposed interpretations also make clear that the swaps and security-based swaps that may be eligible for the exclusion are not limited to those that would be recognized as hedges for accounting purposes, but are meant to encompass a broader range of transactions referred to as "economic hedges," regardless of their accounting treatment.[16] This approach means that the Commissions would not be able to rely solely on how a company accounts for a position on its books to determine whether it is really a hedge.[17]

Both the CFTC's proposed "facts and circumstances" test and the SEC's "reduction of risks" test provide broad standards that lend themselves to abuse and evasion of the regulatory requirements intended to govern major swap participants and major security-based swap participants. The tests may encourage firms to misidentify the purpose of the underlying transactions, or to construct underlying risks and hedges that mask the true speculative or trading purpose of the transactions.

Enhancements. The Commissions should provide additional safeguards against possible evasion and abuse of the "hedging or mitigation commercial risk" exemption.

First, the Commissions should require that firms seeking to rely on the exemption adopt policies and procedures to facilitate compliance with the related statute and regulations, and to facilitate oversight of the firms' actions. Those policies and procedures should include documenting that a position taken for "hedging or mitigating commercial risk" is not taken for the impermissible purposes of speculation and trading. The Commissions should consider requiring those policies and procedures to include:

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[14] Id.
[15] Id.
[16] Financial Accounting Standards Board Statement No. 133 (FAS 133) establishes accounting and reporting standards for derivative instruments and hedging activities.
[17] 75 Fed. Reg. 80195.

- self-identification of all hedging transactions at the time the transaction is entered into, including the nature and amount of the risk being hedged, and the nature and amount of the hedge itself;
- routine testing and examinations of the efficacy of the hedging strategies utilized by the firm to ensure compliance; and
- annual certification of financial firms' hedging policies, procedures, and practices by the firms' senior executives.

Second, the Commissions should consider using the accounting hedge treatment or the bona fide hedging exemption as guideposts for whether a hedge would qualify for an exemption under the new rules. By abandoning the accounting rule, the proposal arguably provides firms with greater flexibility, but also allows for greater ambiguities and opportunities for evasion that could severely weaken the rule.

Third, the Commissions should also consider implementing absolute size or size of market thresholds above which the "hedging or mitigating commercial risk" exclusion would no longer apply. If a firm is very large and the size of its underlying risks alone creates substantial systemic risk, the fact that it is merely hedging or mitigating its risks should not allow it to escape meaningful regulation under the Dodd-Frank Act.[18]

Fourth, it is unclear what benefit is gained by allowing a financial firm to invoke the exemption and avoid otherwise applicable capital, margin, and business conduct requirements. Thus, to the extent a firm's ordinary business entails substantial speculation and trading positions, the Commissions should consider whether the exemption should be allowed at all, or, if so, whether reliance on the exemption should be subject to heightened scrutiny.

Finally, the exemption should require an audit trail and should also be accompanied by a strong anti-evasion provision to stop the engineering of purported hedges that would appear to fall within the exclusion but actually are impermissible trading or speculation.

Thank you for the opportunity to comment on this matter.

Sincerely,

Carl Levin
Chairman
Permanent Subcommittee on Investigations

[18] *See, e.g.*, 156 Cong. Rec. S5907 (daily ed. July 15, 2010) (colloquy between Senators Hagen and Lincoln outlining the intent of the definitions for "major swap participant").