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VIA E-MAIL: rule-comments@sec.gov; dfadefinitions@cftc.gov

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

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

Re: Proposed Rules Relating to Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act (File No. S7–16–10)

Dear Ms. Murphy and Mr. Stawick:

We are responding to Release No. 34-62717 (the "*Proposing Release*"), in which the Securities and Exchange Commission (the "*SEC*") and the Commodity Futures Trading Commission (the "*CFTC*" and, together with the SEC, the "*Commissions*") solicited comments on certain definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*").

We appreciate the opportunity to comment on the definitions in the Proposing Release. In light of the current economic situation, it is imperative that the Commissions draft rules and regulations, including defining the terms discussed below, in a manner to avoid market disruption and to mitigate systemic risk. In our view, the Commissions should strive to provide market participants with the consistency necessary to transition seamlessly into compliance with Dodd-Frank. In addition, the Commissions should attempt, at all costs, to avoid unintended consequences that would impair, rather than help, the recovery of the financial markets and the economy as a whole.

1. *Recommendations Regarding Swap Dealer and Security-Based Swap Dealer Definitions*

Section 721(a)(21) of Dodd-Frank amends Section 1a of the Commodities Exchange Act (the "*CEA*") to add a new paragraph (49) defining "swap dealer;" and Section 761(a)(6) of Dodd-Frank amends Section 3(a) of the Securities Exchange Act of 1934, as amended (the "*Exchange Act*"), to add a new paragraph (71) defining "security-based swap dealer." The definitions are substantially similar and our comments apply to both.

A. In General

This section of the definitions include a list of four criteria, and it appears that the satisfaction of any one of those criteria could result in a person meeting the definition of a swap dealer (or security-based swap dealer). We believe a broad reading of these criteria

by the Commissions would likely result in many more persons qualifying as a swap dealer (or security-based swap dealer) than market participants currently view as swap dealers (or security-based swap dealers).

For example, clause (iii) of the definitions of "swap dealer" and "security-based swap dealer," which reads "regularly enters into [swaps/security-based swaps] with counterparties as an ordinary course of business for its own account," potentially captures many market participants that would not be traditionally viewed as dealers. This provision should be interpreted consistently with the traditional dealer/trader dichotomy used in interpreting the definition of "dealer" in Section 3(a)(5) of the Exchange Act.

Historically, a distinction has been drawn between "dealers" and traders, with the former being subject to registration under the Exchange Act and the latter not. We believe that this dichotomy is equally applicable to clause (iii) since its language is substantially similar to the definition of dealer in Section 3(a)(5) of the Exchange Act. Factors that indicate a dealer include:

- typically accommodating customer demand and generally entering into transactions to facilitate customer interest,
- direct transactions with counterparties, as opposed to through intermediaries,
- regular turnover of positions,
- regular or continuous two-way quotes, and
- arranging or providing credit.

On the other hand, a trader would be an ordinary investor who buys and sells for his or her own account with some frequency. If interpreted broadly, clause (iii) could be read to pick up virtually all market participants (including individuals and smaller entities) who arguably trade, but do not deal, in swaps as part of a regular business. This could potentially even include entities that would satisfy the "end user" exemption from clearing found in Section 723(a)(3) of Dodd-Frank – entities that would be trading swaps as part of their regular business but also to hedge or mitigate commercial risk. It would be an odd result for persons Congress exempted from the clearing requirements to have to register as swap dealers.

In addition, a broad interpretation of clause (iii) could result in the definitions of "swap dealer" and "security-based swap dealer" being so expansive that they capture practically every "major swap participant" and "major security-based swap participant," respectively. If Congress had intended that result, there would have been no need to create the categories of "major swap participant" or "major security-based swap participant" in the first place. We believe the Commissions should incorporate some of the "dealer" factors enumerated above in interpreting the scope of clause (iii) to ensure this clause does not inappropriately capture persons as swap dealers and securities-based swap dealers.

We would also like to point out that the criteria in clause (ii) of the definitions of swap dealer and security-based swap dealer – "makes a market in swaps" – does not necessarily translate well from the securities market to the swaps markets. Depending on the liquidity

and convention for a particular swap product, "making a market" can span activities from continuously providing live, public bids and offers to being willing to provide a bid or offer quote from clients upon request. We believe the phrase "makes a market," should be interpreted in such a way to avoid capturing those entities that do not routinely make or stand ready to make two way markets for other market participants. Merely providing occasional quotes on one side of the market for a product should not trigger registration.

We would also like to note that the Commissions may need to revisit the guidance provided under clause (ii) depending on the rules that are adopted for regulated exchanges or swap execution facilities or security-based swap execution facilities (collectively, "SEFs"). Depending on what functionality is required or made available by a SEF or a regulated exchange to its participants, it could be the case that many or all participants on certain types of platforms could be viewed as dealers when trading on that particular platform.

B. Inclusion

This section of the definitions clearly state that an entity should not be treated as a "swap dealer" or "security-based swap dealer" generally, but rather have its status as a "swap dealer" or "security-based swap dealer" assessed with respect to a particular product or in a defined market.[1] This approach is both reflective of the realities of the marketplace and consistent with Congressional intent. In a letter from Senator Christopher Dodd, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, and Senator Blanche Lincoln, Chairwoman of the Senate Committee on Agriculture, Nutrition, and Forestry, to Representative Collin Peterson, Chairman of the Committee on Agriculture, and Representative Barney Frank, Chairman of the Financial Services Committee, Senators Dodd and Lincoln stressed the importance of differentiating amongst products by stating, "[i]t is also imperative that regulators do not assume that all over-the-counter transactions share the same risk profile." *Cong. Record, June 30, 2010, H5248.*

We believe it necessarily follows from this approach that capital requirements and other rules applicable to swap dealers or security-based swap dealers should apply only to those activities of a dealer falling within the swap categories for which it is required to register. Capital calculations and other requirements for swap dealers or security-based swap dealers should not encompass transactions or positions that are not subject to direct regulation. This is consistent with the legislative intent of Congress. Senators Dodd and Lincoln noted in their letter that "[i]t is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would . . . impair economic growth." *Cong. Record, June 30, 2010, H5248.* If the Commissions

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[1] Section (C) of the definition of "swap dealer" states 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", and Section (B) of the definition of "security-based swap dealer" states that "[a] person may be designated as a security-based swap dealer for a single type or single class or category of security-based swap or activities and considered not to be a security-based swap dealer for other types, classes, or categories of security-based swaps or activities."

were to apply capital requirements in a broader sense than that which we have suggested, funds and capital would be unnecessarily diverted.

2. *Recommendations Regarding Major Swap Participant and Major Security-Based Swap Participant Definitions*

Section 721(a)(16) of Dodd-Frank amends Section 1a of the CEA to add a new paragraph (33) defining "major swap participant," and Section 761(a)(6) of Dodd-Frank amends Section 3(a) of the Exchange Act to add a new paragraph (67) defining "major security-based swap participant." The definitions are substantially similar and our comments apply to both.

A. In General

First, the phrase "any person" in these definitions clarifies that the intent is for the test to be made on an entity basis and that companies managed by a single manager are not aggregated. Chairman Lincoln said as much in a colloquy with Senator Hagan during the Senate floor debate on the Dodd-Frank Conference Committee Report. In response to Senator Hagan asking, "When considering whether an entity maintains a substantial position in swaps, should the CFTC and the SEC look at the aggregate positions of funds managed by asset managers or at the individual fund level?", Chairman Lincoln responded, "As a general rule, the CFTC and the SEC should look at each entity on an individual basis when determining its status as a major swap participant." *Congr. Record, June 15, 2010, S5907.*

Second, the term "substantial position," found in clause (i) of the definitions of "major swap participant" and "major security-based swap participant," should be limited to those positions that are large enough to create a systemic risk in the market. A contrary view would be inconsistent with the legislative intent. In our view, the best measure of "substantial" from a systemic risk perspective would be based on the potential risk of the net positions such market participant holds and potential disruption to the financial markets if that market participant were to default. Measures based on notional exposures or number of trades, while easy to calculate, do not necessarily accurately capture market risk. While a risk-based measure would be best, using fair values determined in accordance with GAAP would be a better approximation than notional amount or trade count.

No matter what measure the Commissions determine to utilize, we believe that any calculation should be on a net basis and, as is currently the case, netting should be given effect across all products and transactions subject to a netting arrangement. Further, collateral should also be netted because collateral reduces possible systemic risk.[2] This view is consistent with Congressional intent, as evidenced by Chairman Lincoln's

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[2] In addition to collateral, the proposed regulations should take into account the netting or offsetting effect of other forms of certain acceptable credit risk mitigation, such as letters of credit that satisfy minimum requirements as to their terms and conditions and the credit quality of the issuer.

statement during the Senate floor debate on the Dodd-Frank Conference Committee Report:

> When determining whether a person has a "substantial position," the CFTC and the SEC should consider the person's relative position in cleared versus the uncleared swaps and may take into account the value and quality of the collateral held against counterparty exposures. The committee wanted to make it clear that the regulators should distinguish between cleared and uncleared swap positions when defining what a "substantial position" would be. Similarly where a person has uncleared swaps, the regulators should consider the value and quality of such collateral when defining "substantial position." Bilateral collateralization and proper segregation substantially reduces the potential for adverse effects on the stability of the market. Entities that are not excessively leveraged and have taken the necessary steps to segregate and fully collateralize swap positions on a bilateral basis with their counterparties should be viewed differently. *Id.*

We would also suggest that the Commissions consider committing to revisit this definition once more information becomes available about the size and liquidity of the relevant markets as the reporting aspects of Dodd-Frank are implemented.

Third, the phrase "substantial counterparty exposure," found in clause (ii) of the definitions of "major swap participant" and "major security-based swap participant," should be interpreted consistently with "substantial position" in clause (i) discussed above.

Last, the phrase "highly leveraged," found in clause (iii) of the definitions of "major swap participant" and "major security-based swap participant," must be considered in light of the industry in which the entity participates. No single leverage test is appropriate due to the vast differences in business models. For example, the leverage of an entity's peers could be used as the relevant benchmark in determining whether the level of leverage for a particular entity is "high."

B. Definition of Substantial Position

Our recommendations are discussed above under "Recommendations Regarding Major Swap Participant and Major Security-Based Swap Participant Definitions—In General."

C. Scope of Designation

As we stated above under "Recommendations Regarding Swap Dealer and Security-Based Swap Dealer Definitions—Inclusion," we recommend that the Commissions clarify that capital requirements and other rules apply only to the category of swaps or security-based swaps as to which a person is designated as a major swap participant or a major security-based swap participant. Therefore, capital calculations and other requirements should not encompass transactions or positions not subject to direct regulation.

3. *Recommendations Regarding the Forward Contract Exclusion from the Definition of a Swap*

Section 721(a)(21) of Dodd-Frank amends Section 1a of the CEA to add a new paragraph (47) defining the term "swap", including a new subparagraph (47)(B) that provides for specific exclusions from the term "swap". Among other exclusions, excluded from the term "swap" are "(ii) any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." In order to avoid legal uncertainty, the intent requirement should be read consistently with the CFTC's long-standing policy as set forth in its *Exemption for Certain Contracts Involving Energy Products*, 58 F.R. 21286 (Apr. 20, 1993) (the "*Energy Contracts Exemption*").

As recognized by the CFTC in the *Energy Contracts Exemption*, many market participants hedge price risk by entering into forward contracts that require physical delivery. Subsequently, due to changing market conditions, the parties to the contract may mutually agree to settle or "book out" their delivery obligations such that there is a cash payment but no exchange of the physical commodity takes place. The parties may do so in order to minimize delivery related expenses or to terminate any further gain or loss on the original transaction. The phrase "so long as the transaction is intended to be physically settled" may introduce uncertainty as to whether these transactions that initially required physical delivery but were subsequently settled financially for legitimate and economically beneficial reasons had been excluded from the term "swap".

This is consistent with the legislative intent of Congress. Senators Dodd and Lincoln stated in their letter that "[i]n implementing the derivatives title, Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for 'any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled' is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to 'book-out' their physical delivery obligations under a forward contract." *Cong. Record, June 30, 2010, H5248.*

Thus, to address the risk of legal uncertainty, the CFTC should affirmatively define a contract for the "sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" consistent with the factors commonly reviewed with respect to the forward contract exclusion to determine whether the requisite intent existed. For example, the definition could adopt the language in the *Energy Contract Exemption*, which includes contracts that "impose binding obligations on the parties to make and receive delivery of the underlying commodity or commodities, with no right of either party to effect cash settlement of their obligations without the consent of the other party (except pursuant to a bona fide termination right), provided, however, that the parties may enter into a subsequent bookout, book transfer, or other such contract which provides for settlement of the obligation in a manner other than by physical delivery of the commodity specified in the contract."

4. *Recommendations Regarding Mixed Swaps*

Section 721(a)(21) of Dodd-Frank amends Section 1a of the CEA to add a new paragraph (47) defining "swap," and Section 761(a)(6) of Dodd-Frank amends Section 3(a) of the Exchange Act to add a new paragraph (68) defining "security-based swap." Each of these sections adds the concept of a "mixed swap," and in both the CEA and Exchange Act, defines the term "security-based swap" to include agreements, contracts or transactions that satisfy the security-based swap definition and which also are based on the value of certain enumerated non-securities factors. Section 712(a)(8) of Dodd-Frank requires the Commissions to jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII of Dodd-Frank.

In jointly prescribing such regulations, we do not believe the Commissions should establish a new, third regulatory regime for over-the-counter derivatives in addition to the regimes required under Dodd-Frank for swaps and security-based swaps. Had such a third complete regime been intended, we believe Congress would have included more specific guidance in the statutory language itself and would likely have referred to the term mixed swap more than the four times that the term is used in Dodd-Frank. Comparing the specificity and comprehensiveness of the regimes for swaps and security-based swaps in Dodd-Frank to the handful of references to the term mixed swap, it seems clear Congress intended the Commissions to leverage the swap and security-based swap regimes when prescribing rules for mixed swaps.

Also, as discussed below, we believe that the scope of transaction types that would appropriately qualify as mixed swaps should be relatively small, further supporting the conclusion that a new, third regulatory regime would be unwarranted.

The first point we would like to make regarding the scope of mixed swaps is that a security-based swap (*e.g.*, a total rate of return swap on an equity security) which includes one or more payments calculated by reference to an interest rate (*e.g.*, LIBOR) should not be treated as a mixed swap. Such a swap would not be properly viewed as "based on" an interest rate. The LIBOR based payments reflect compensation for the financing costs associated with total rate of return swaps and are not at the core of what is being "swapped" under the contract.

The CFTC recognized as much in its adopting release for the Regulation of Hybrid Instruments (58 Federal Register 5580, Jan. 22 1993). In the adopting release, the CFTC recognized that a loan or note whose interest payments were calculated based on a floating rate, or even a formula that included a floating rate, should not be treated as a Hybrid Security, notwithstanding the fact that such rates constituted "commodities" under the CEA. If a security or loan with interest payments based on a formula which references floating rates is not a Hybrid Security, it follows that a security-based swap with a floating rate payment leg should not be viewed as a mixed swap.

Furthermore, if the more expansive reading were applied, only an extremely small category of security-based swaps would not qualify as mixed swaps. The vast majority of security-based swap products also have at least some payment or contingency that is linked to something other than the value or yield of a security. Given the detail and comprehensiveness of the security-based swap regulatory regime envisioned by Dodd-Frank, it is difficult to believe Congress intended the universe of pure security-based swaps to be a de minimus portion of the swap market.

Assuming security-based swaps with floating rate payment legs are not defined as mixed swaps, we believe the universe of mixed swaps should be relatively small. An example of a mixed swap might be a contract under which one party takes long exposure to the common stock of a US corporation while simultaneously taking short exposure to the price of gold. The question then becomes how to determine which regulatory regime – the one for swaps or the one for security-based swaps – should be applied to such a swap. Given the relatively small size of this population, and the fact that Dodd-Frank encourages the substantive regulation of swaps and security based swaps to be substantially similar, we believe the primary goals for creating a determination process should be simplicity, clarity and certainty.

We believe a preponderance type test would fail to meet those goals. Prior to the enactment of the Commodities Futures Modernization Act in 2000, the CEA's Part 34 Hybrid instrument exemption utilized such a regime and required that the commodity dependent value of the commodity dependent component of the hybrid instrument be less than the commodity independent value of the commodity independent component of the hybrid instrument. The test was unwieldy and costly to administer for hybrid instruments, which typically have a longer lead time prior to execution than do swap agreements. Imposing such a test in the context of fast paced swap markets would likely make certain mixed swaps infeasible.

As no payments may change hands at the inception of a mixed swap, any assessment of the value of a component would probably need to be based on a forward looking estimate of the likely exposure under each component. In our common stock-gold swap example, this could involve estimating potential exposure under each leg as if it were a separate swap and comparing the two. As such estimates would necessarily be based on a party's views of volatility and individual models for the particular asset class, there would be no assurances that each party would come to the same conclusion as to which component was greater. More complicated mixed swaps may prove difficult, if not impossible, to bifurcate. For example, if we changed the payout formula of our common stock-gold swap such that no payment is made referencing the common stock for a particular day unless gold prices are within a specific band, bifurcation becomes highly complex.

With some caveats mentioned below, we think a better approach would be to treat all swaps with securities based features as solely security-based swaps. In other words, the Commissions should prescribe rules that leave mixed swaps under the SEC's jurisdiction.

This is supported by Dodd-Frank, which defines mixed swaps under both the CEA and the Exchange Act as security-based swaps. In an indirect and less explicit manner, mixed swaps also fall under the swap definition (the provision excluding a security-based swap from the definition of swap expressly carves out from the exclusion those swaps falling under the provision defining mixed swaps as security-based swaps). It would seem, however, that some weight should be given to the fact that Congress took a far more straightforward path in expressly including mixed swaps in the security-based swap definition.

Such an approach would be clear, certain and simple to apply. Assuming substantive regulation is virtually the same, this approach would not result in materially different regulatory treatment than a predominance test. If the Commissions felt swaps which included references to a particular asset class (for example, agriculture) needed to be subject to direct CFTC oversight, we would not be opposed to a rule that defined all mixed swaps that referenced such an asset class as swaps (and not security-based swaps) under Dodd-Frank. Our main concern is that any rule be simple to apply and create a clear and certain result.

Finally, while under our suggestion the bulk of regulatory oversight for mixed swaps would fall under a single regulator, joint authority with respect to certain provisions of Dodd-Frank may still be appropriate. For example, notwithstanding the treatment of mixed swaps solely as security-based swaps, we would not be opposed to the CFTC having anti-fraud and anti-manipulation authority over the non-securities components of mixed swaps.

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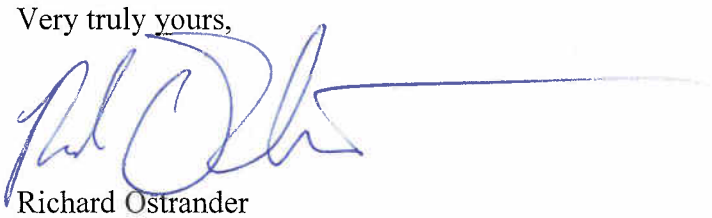
We appreciate the opportunity to comment to the Commissions on the definitions, and would be pleased to discuss any questions either Commission may have with respect to this letter. Any questions about this letter may be directed to Richard Ostrander (richard.ostrander@morganstanley.com; 212 762 5346).

Very truly yours,



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