From: Klem, Christopher A. <Christopher.Klem@ropesgray.com>
Sent: Thursday, September 2, 2010 11:51 AM
To: SegBankruptcy <SegBankruptcy@CFTC.gov>
Subject: Comment on Requirement to Register as FCM upon Acceptance of Collateral
Attach: Comments to CFTC on Definition of Major Swap Particpant.pdf

---

We have separately submitted the following comments to the Commission at OTCDefinitions@CFTC.gov. However, as part of the discussion involves the requirement to register found in Section 724(a) of the Dodd-Frank Act, we are resubmitting the comments to the above email address as well. For ease of use, the comments are submitted as both email text and a PDF document.

We appreciate this opportunity to submit advance comments that may help inform the Commission's rulemaking. The following comments reflect the interests of clients who act as traditional institutional investors and participate as investors for their own accounts in a broad range of investments, including swaps, in the effort to achieve appropriate long-term, risk-adjusted returns on their investment portfolios.

First , we urge that the definition of "Major Swap Participant" to be established under the authority of Section 721 (a)(33) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") be kept suitably narrow so as to as to maintain the distinction between centrally located market participants posing potential systemic risk and institutional investors. Second, we urge that, a fortiori, the definition of "Swap Dealer" under the authority of Section 721(a)(49) of Dodd-Frank be focused on intermediary activities, and not investment activities. Finally, we urge that Section 724(a) of Dodd-Frank, adding a new subsection (f)(1) to Section 4d of the Commodity Exchange Act, be implemented so as to allow institutional investors to negotiate for and receive collateral from Swap Dealers (and Major Swap Participants), without having to register as a future commissions merchant under that act.

There is significant anticipation concerning the test that the Commission will employ to define "Major Swap Participant" status. Our understanding from early in the process of financial reform is that such status is intended to be a relatively narrow category that will complement the category of "Swap Dealers." In this regard, the "Major Swap Participant" category is designed to pick up a limited number of highly active market participants which, while they may arguably defy categorization as a traditional intermediary, nevertheless pose systemic risk by reason of their placement in the markets. This early and limited concept of "Major Swap Participant" has been reinforced by the progress of the legislation into final law. Under Dodd-Frank, "Swap Dealers" and "Major Swap Participants" are regulated for the most part in an identical fashion. The applicable scheme of regulation is plenary and includes: price reporting obligations (Section 727), registration, statutory disqualifications for associated persons, capital and margin requirements, recordkeeping requirements, business conduct standards, trading and documentation requirements, risk management requirements, internal procedure and disclosure requirements, and a requirement for a chief compliance officer (Section 731). This fulsome scheme of regulation is typical of and appropriate for financial intermediaries positioned centrally in the market and is not appropriate for institutional investors who are positioned on the periphery of the market and who look to the dealers for their trades.

We believe that there are strong policy reasons for restricting the definition of "Major Swap Participant" to intermediary-like entities. First, the regulatory costs associated with "Major Swap Participant" status may discourage institutional investors from participating in the swap markets in order to avoid such status, thereby shrinking capacity and liquidity to the detriment of all market participants. Second, capital being fluid, institutional investors may well be driven by cost considerations to transact overseas, at some incremental peril to themselves and to the domestic markets as a result of market fragmentation. Third, while Dodd-Frank strives to make the derivatives markets safer for all participants, the regulation of some significant number of major institutional investors as "Major Swap Participants" could inadvertently erect a high barrier of entry against other sophisticated institutional investors participating in the markets on an unregulated basis. At the margin, regulation has the unfortunate side effect of dictating trading terms in favor of the regulated entities (which by definition are viewed as being more systemically important). The inclusion of some significant number of institutional investors as "Major Swap Participants" would only increase the tilt of the playing field to the discouragement of others. Our markets are better served by promoting a healthy negotiation between dealers and investors. It is important that

our regulation retain the distinction between these two categories.

We point out that Dodd-Frank includes provisions which promote market stability by requiring trading information from institutional investors. Included here are the recordkeeping requirements of Section 729 and the large trader reporting requirements of Section 730. Thus, regulation of institutional investors as "Major Swap Participants" is not required in order to have these investors contribute to market transparency and the information otherwise available to the Commission.

We turn now to the actual statutory definition of "Major Swap Participant" in Section 721(a)(33) of Dodd-Frank. Subsections (A)(ii) and (iii) appear to describe financial intermediaries that are centrally located in the market. Subsection (A)(i) is arguably broader in that it allows the Commission to define the status based on position size alone -- i.e., a "substantial position in swaps for any of the major swap categories as determined by the Commission." However, the definition of "Substantial Position" for this purpose, found in subsection (B), unambiguously focuses this test on systemic risk to the financial system. Given this focus, we would urge the Commission to carefully pick the metrics for measuring a substantial position, and to set the bar very high and in such a way as to minimize short-term uncertainty over status.

We believe that this can best be accomplished by using multiple, cumulative metrics. Obvious metrics include nominal exposure and/or value, both of which are more meaningfully measured on a "net" basis. In addition, we would urge the Commission to use the authority, provided by the definition of "Substantial Position," to take into account the value and quality of collateral. Among other matters, this would provide institutional investors a healthy incentive to negotiate for high quality collateral in their counterparty arrangements. Beyond traditional metrics, we believe there should be metrics taking into account both (i) frequency of trading and (ii) frequency of trading with persons who are not "Swap Dealers" (an activity characteristic of dealers and quasi-dealers but not of institutional investors on the periphery of the market). By using cumulative metrics in this way, the Commission can avoid potential regulatory "overkill," which would not be conducive to deep and sound markets.

For a similar reason, we urge the Commission to take a narrow approach to fleshing out the category of "Swap Dealer" identified in subsection (A)(iii) of Section 721(a)(49), which covers "any person. . . who regularly enters into swaps with counterparties as an ordinary course of business for its own account." The particular words could conceivably cover a broad range of activity, including traditional institutional investment. However, the overall context of Section 721(a)(49) makes clear that the Congress was focused on the activities of intermediaries – market making, routine trade solicitation, bid publication, short-term profit-making based on immediately laying off risk on both sides of a trade. Obviously, the policy arguments in favor of narrowly construing this part of the definition of "Swap Dealer" are even stronger than in the case of the definition of "Major Swap Participant."

Finally, Section 724(a) of Dodd-Frank requires registration under the Exchange Act whenever a person accepts money, securities or property by way of margin from a "swaps customer." The key to interpreting this provision is the word "customer." Under the standards discussed above, the institutional investor at the periphery of the market is the "customer" and is not itself subject to the registration requirement upon acceptance of margin. Otherwise, traditional, prudential up-front and mark-to-market collateral requirements (bilateral or otherwise) that institutional investors might negotiate with their dealers would have the effect of subjecting such investors to regulation as futures commission merchants. Without explicit clarification of this point as part of the Commission's rulemaking, dealers may resist posting collateral with the protest that their doing so would first require registration by the customer. Clearly, these were not results intended by Congress.

We are today providing similar comments to the Securities and Exchange Commission in connection with its rulemaking relating to the Section 761 definitions of "Major Security-Based Swap Participant" and "Security-Based Swap Dealer." We understand that the definitions of "Major Swap Participant" and "Major Security-Based Swap Participant," and of "Swap Dealer" and "Security-Based Swap Participant" are to be coordinated. We believe that the same principles should inform that parallel rulemaking.

We thank you again for taking the approach of soliciting advance comments on this complex and critical rulemaking.

Christopher A. Klem
ROPES & GRAY LLP
T +1 617 951 7410 | M +1 781 724 7651 | F +1 617 235 0061
One International Place
Boston, MA 02110-2624

christopher.klem@ropesgray.com
http://www.ropesgray.com/

Circular 230 Disclosure (R&G): To ensure compliance with Treasury Department regulations, we inform you that any U.S. tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. tax-related penalties or promoting, marketing or recommending to another party any tax-related matters addressed herein.

This message (including attachments) is privileged and confidential. If you are not the intended recipient, please delete it without further distribution and reply to the sender that you have received the message in error.

____

We appreciate this opportunity to submit advance comments that may help inform the Commission's rulemaking. The following comments reflect the interests of clients who act as traditional institutional investors and participate as investors for their own accounts in a broad range of investments, including swaps, in the effort to achieve appropriate long-term, risk-adjusted returns on their investment portfolios.

First , we urge that the definition of "Major Swap Participant" to be established under the authority of Section 721(a)(33) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") be kept suitably narrow so as to as to maintain the distinction between centrally located market participants posing potential systemic risk and institutional investors. Second, we urge that, a fortiori, the definition of "Swap Dealer" under the authority of Section 721(a)(49) of Dodd-Frank be focused on intermediary activities, and not investment activities. Finally, we urge that Section 724(a) of Dodd-Frank, adding a new subsection (f)(1) to Section 4d of the Commodity Exchange Act, be implemented so as to allow institutional investors to negotiate for and receive collateral from Swap Dealers (and Major Swap Participants), without having to register as a future commissions merchant under that act.

There is significant anticipation concerning the test that the Commission will employ to define "Major Swap Participant" status. Our understanding from early in the process of financial reform is that such status is intended to be a relatively narrow category that will complement the category of "Swap Dealers." In this regard, the "Major Swap Participant" category is designed to pick up a limited number of highly active market participants which, while they may arguably defy categorization as a traditional intermediary, nevertheless pose systemic risk by reason of their placement in the markets. This early and limited concept of "Major Swap Participant" has been reinforced by the progress of the legislation into final law. Under Dodd-Frank, "Swap Dealers" and "Major Swap Participants" are regulated for the most part in an identical fashion. The applicable scheme of regulation is plenary and includes: price reporting obligations (Section 727), registration, statutory disqualifications for associated persons, capital and margin requirements, recordkeeping requirements, business conduct standards, trading and documentation requirements, risk management requirements, internal procedure and disclosure requirements, and a requirement for a chief compliance officer (Section 731). This fulsome scheme of regulation is typical of and appropriate for financial intermediaries positioned centrally in the market and is not appropriate for institutional investors who are positioned on the periphery of the market and who look to the dealers for their trades.

We believe that there are strong policy reasons for restricting the definition of "Major Swap Participant" to intermediary-like entities. First, the regulatory costs associated with "Major Swap Participant" status may discourage institutional investors from participating in the swap markets in order to avoid such status, thereby shrinking capacity and liquidity to the detriment of all market participants. Second, capital being fluid, institutional investors may well be driven by cost considerations to transact overseas, at some incremental peril to themselves and to the domestic markets as a result of market fragmentation. Third, while Dodd-Frank strives to make the derivatives markets safer for all participants, the regulation of some significant number of major institutional investors as "Major Swap Participants" could inadvertently erect a high barrier of entry against other sophisticated institutional investors participating in the markets on an unregulated basis. At the margin, regulation has the unfortunate side effect of dictating trading terms in favor of the regulated entities (which by definition are viewed as being more systemically important). The inclusion of some significant number of institutional investors as "Major Swap Participants" would only increase the tilt of the playing field to the discouragement of others. Our markets are better served by promoting a healthy negotiation between dealers and investors. It is important that our regulation retain the distinction between these two categories.

We point out that Dodd-Frank includes provisions which promote market stability by requiring trading information from institutional investors. Included here are the recordkeeping requirements of Section 729 and the large trader reporting requirements of Section 730. Thus, regulation of institutional investors as "Major Swap Participants" is not required in order to have these investors contribute to market transparency and the information otherwise available to the Commission.

We turn now to the actual statutory definition of "Major Swap Participant" in Section 721(a)(33) of Dodd-Frank. Subsections (A)(ii) and (iii) appear to describe financial intermediaries that are centrally located in

the market. Subsection (A)(i) is arguably broader in that it allows the Commission to define the status based on position size alone -- i.e., a "substantial position in swaps for any of the major swap categories as determined by the Commission." However, the definition of "Substantial Position" for this purpose, found in subsection (B), unambiguously focuses this test on systemic risk to the financial system. Given this focus, we would urge the Commission to carefully pick the metrics for measuring a substantial position, and to set the bar very high and in such a way as to minimize short-term uncertainty over status.

We believe that this can best be accomplished by using multiple, cumulative metrics. Obvious metrics include nominal exposure and/or value, both of which are more meaningfully measured on a "net" basis. In addition, we would urge the Commission to use the authority, provided by the definition of "Substantial Position," to take into account the value and quality of collateral. Among other matters, this would provide institutional investors a healthy incentive to negotiate for high quality collateral in their counterparty arrangements. Beyond traditional metrics, we believe there should be metrics taking into account both (i)frequency of trading and (ii) frequency of trading with persons who are not "Swap Dealers" (an activity characteristic of dealers and quasi-dealers but not of institutional investors on the periphery of the market). By using cumulative metrics in this way, the Commission can avoid potential regulatory "overkill," which would not be conducive to deep and sound markets.

For a similar reason, we urge the Commission to take a narrow approach to fleshing out the category of "Swap Dealer" identified in subsection (A)(iii) of Section 721(a)(49), which covers "any person. . . who regularly enters into swaps with counterparties as an ordinary course of business for its own account." The particular words could conceivably cover a broad range of activity, including traditional institutional investment. However, the overall context of Section 721(a)(49) makes clear that the Congress was focused on the activities of intermediaries – market making, routine trade solicitation, bid publication, short-term profit-making based on immediately laying off risk on both sides of a trade. Obviously, the policy arguments in favor of narrowly construing this part of the definition of "Swap Dealer" are even stronger than in the case of the definition of "Major Swap Participant."

Finally, Section 724(a) of Dodd-Frank requires registration under the Exchange Act whenever a person accepts money, securities or property by way of margin from a "swaps customer." The key to interpreting this provision is the word "customer." Under the standards discussed above, the institutional investor at the periphery of the market is the "customer" and is not itself subject to the registration requirement upon acceptance of margin. Otherwise, traditional, prudential up-front and mark-to-market collateral requirements (bilateral or otherwise) that institutional investors might negotiate with their dealers would have the effect of subjecting such investors to regulation as futures commission merchants. Without explicit clarification of this point as part of the Commission's rulemaking, dealers may resist posting collateral with the protest that their doing so would first require registration by the customer. Clearly, these were not results intended by Congress.

We are today providing similar comments to the Securities and Exchange Commission in connection with its rulemaking relating to the Section 761 definitions of "Major Security-Based Swap Participant" and "Security-Based Swap Dealer." We understand that the definitions of "Major Swap Participant" and "Major Security-Based Swap Participant," and of "Swap Dealer" and "Security-Based Swap Participant" are to be coordinated. We believe that the same principles should inform that parallel rulemaking.

We thank you again for taking the approach of soliciting advance comments on this complex and critical rulemaking.

Christopher A. Klem
Ropes & Gray
Boston, Massachusetts
(617) 951-7410
christopher.klem@ropesgray.com