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September 20, 2010

VIA ELECTRONIC MAIL
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Elizabeth Murphy
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David A. Stawick
Secretary
Commodity Futures Trading Commission
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RE: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act; Release No. 34-62717; File No. S7-16-10; 75 Federal Register 51429, August 20, 2010

Dear Ms. Murphy and Mr. Stawick:

The American Bankers Association (ABA)[1] and the ABA Securities Association (ABASA)[2] appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC) and Commodity Futures Trading Commission's (CFTC) (jointly the Commissions) Advance Notice of Proposed Rulemaking (APNR) and request for comments with respect to the Key Definitions[3] specified in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203 Stat.1376 (2010)(the Dodd-Frank Act).

Overview

Title VII of the Dodd-Frank Act is an extraordinarily complex and, in the words of Treasury Secretary Geithner, "revolutionary" revision to the way swaps, swap markets, and swap market participants are regulated. ABA and ABASA have consistently supported making credit default swaps and other financial products of systemic importance subject to appropriate supervision and oversight designed to increase transparency and better manage these risks. We recognize the legislative directive to strengthen the regulatory framework and infrastructure for the over-the-counter (OTC) swap markets. It is critical, as the Commissions establish regulations to effectuate

[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities. Learn more at www.aba.com.
[2] ABASA is a separately chartered affiliate of the ABA that represents those holding company members of the ABA that are actively engaged in capital markets, investment banking, and broker-dealer activities.
[3] Section 712(d) of the Dodd-Frank Act provides that the SEC and CFTC, in consultation with the Board of Governors of the Federal Reserve System, shall jointly further define the terms "swap", "security-based swap", "swap dealer", "security-based swap dealer", "major swap participant", "major security-based swap participant", "eligible contract participant", and "security-based swap agreement" (collectively Key Definitions).

the Dodd-Frank Act that these regulations do not harm economic growth and job creation by inhibiting banks' ability to provide long-term credit to small business customers and carry out their critical risk management functions.

The activity of our members in the swap markets varies across the size and complexity of our diverse membership. While there are, according to a recent report of the Office of the Comptroller of the Currency (OCC), five large commercial banks that have generated 97% of the notional amount of trades reported by United States banks and hold 86% of its net counterparty swap exposure,[4] many hundreds of our member banks use swaps as financial end-users.[5] The vast majority of banks that use swaps, outside of the large commercial banks that are swap dealers, enter into swaps to mitigate the risks of their ordinary banking activities. In addition, they may provide interest rate swaps to commercial banking customers to hedge their floating rate loans, many of which do not qualify as "eligible contract participants"(ECPs) under the Dodd-Frank Act, and then hedge the interest rate exposure arising from these customer-facing swaps by entering into offsetting swaps in the financial market. Whether a bank is hedging its own balance sheet risk or risks related to individual customer transactions, these swaps are hedging bank assets (either the loans or the cash flows borrowers need to repay them) or bank liabilities (the balance sheet). As a result, many of our members consider themselves to be financial end-users of swaps under the Dodd-Frank Act whose swaps activities and positions are neither of a type nor volume, or do not have the risk characteristics, to warrant registration as a "swap dealer" or "major swap participant" (MSP).

We make these preliminary observations to reflect our concern that through the rulemaking process, our members, who function as financial end-users of swaps, could be designated inappropriately as "major swap participants". This would increase the cost of risk mitigation activities unnecessarily for these banks and their customers, without contributing to the achievement of the public policy aims of the relevant provisions of the new law.

We are also concerned that creditworthy borrowers will be unable or unwilling to hedge their loans under the new regime. Exchange traded derivatives may not provide the customer with an effective hedge, and small creditworthy borrowers may not be able to afford the increased costs associated with exchange-traded derivatives. This will adversely affect small businesses that are least able to afford the increase in end-user costs and will place them at a competitive disadvantage to larger companies that as ECPs are allowed to hedge with their banks.[6] Rather than reducing risk, this result would make lending to non-ECP customers more risky, because it would prevent the customer from hedging the loan (a bank asset) and thereby protecting both the customer and the bank. Together, these outcomes would increase the costs of funds for small businesses and other commercial customers. Therefore, we offer the following comments to assist the Commissions in crafting clear definitions that will allow banks to be excluded from the definition of an MSP when they limit their swap activities to serving the commercial and hedging needs of customers in addition to hedging the institution's own financial risks. We also offer a suggestion regarding the ECP definition that will allow creditworthy small business customers to continue to hedge their loans with banks.

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[4] OCC's Quarterly Report on Bank Trading and Derivatives Activities First Quarter 2010. Available at (http://www.occ.treas.gov/ftp/release/2010-71a.pdf).

[5] According to 2nd Quarter 2010 Call Report date, 1,159 banks reported derivative holdings.

[6] See "*Evaluating Margin Lending Facilities in the OTC Derivatives Market*" by Chatham Financial. Available at http://www.chathamfinancial.com/wp-content/uploads/2010/02/510_Evaluating-Margin-Lending-Facilities-in-the-OTC-Derivatives-Market.pdf.

Major Swap Participant

1. **Commercial Risk Exclusion**

Under Title VII, market participants other than swap dealers active in the derivatives markets, may be considered "major swap participants" and subject to registration, record-keeping requirements, business conduct and prudential requirements. The "major swap participant" definition in the Dodd-Frank Act contains several terms and exclusions that have already been subject to much debate as to their proper scope. As a threshold matter, we note that the legislation contains a very robust exclusion, namely the exclusion for positions held for hedging or mitigating commercial risk, designed to ensure that the definition of an MSP does not capture companies "simply because they use swaps to hedge risk in the ordinary course of business."[7] It is very important for our members that the term "commercial risk" be interpreted broadly enough to include financial risk for depository institutions. Failing to do so will make it more difficult and costly for banks to mitigate risk effectively and possibly weaken, rather than strengthen, our nation's banking system and economy.

Many of our members use different types of swaps primarily to mitigate risks that arise in the ordinary business course of their traditional bank activities. As explained by Federal Reserve Board Chairman Bernanke, "Depository institutions use derivatives to help mitigate the risks of their normal banking activities. For example, depository institutions use derivatives to hedge the interest rate, currency, and credit risks that arise from their loan, securities, and deposit portfolios. Use of derivatives by depository institutions to mitigate risks in the banking business also provides important protection to the deposit insurance fund and taxpayers as well as to the financial system more broadly."[8] The commercial risk exclusion should be used to exclude from the MSP definition those institutions that use swaps to mitigate risks that arise in the ordinary course of business—no matter whether those risks relate to manufacturing, lending, or balance sheet risk.

2. **Identification of Risk Factors**

Moving beyond the breadth of the commercial risk exclusion contained in the statute, the identification of MSPs relies upon additional terms that have yet to be defined. Notably, the concepts of a "substantial position" in outstanding swap transactions and "substantial counterparty" exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets referenced in Section 721 of the Dodd-Frank Act are presently vague and uncertain. However, the scope of these concepts is of tremendous concern to banks. It is vitally important for the safe, sound and efficient functioning of banks and the financial markets to have certainty regarding these terms and how they will be applied.

We recommend that the goal in drafting the MSP definition should be to create clear standards based on specified risk factors to capture only those firms whose swap activities have a significant potential to create serious adverse effects on the financial stability of the United States financial system. In that regard, we believe that it would be counterproductive to create *broad categories* of the

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[7] June 30, 2010 letter from Chairman Christopher Dodd and Chairman Blanche Lincoln to Chairman Barney Frank and Chairman Colin Peterson discussing the narrowed scope of the swap dealer and major swap participant definitions. Paragraph (33) of Section 721(a)(16) of the Dodd-Frank Act provides that "The term 'major swap participant" means any person who is not a swap dealer, and—(i) Maintains a substantial position in swaps for any of the major swap [categories], excluding—(I) Positions held for hedging or mitigating commercial risk[.]

[8] May 12, 2010 Letter from Federal Reserve Board Chairman Ben Bernanke to Chairman Christopher J. Dodd.

types of companies or the size of companies that will fall within this definition. Rather, it will be necessary under the requirements of the Dodd-Frank Act for the CFTC and SEC to look at each entity on an individual basis when determining its status as an MSP. Toward that end, we believe that the Commissions should incorporate the following qualitative factors and should evaluate these factors in the aggregate for each institution of interest to determine if an institution falls within the MSP definition.

a. The Nature and Current Regulation of the Entity

As explained by Chairman Bernanke, "Banks currently conduct their derivatives activities in an environment that is subject to strong prudential Federal supervision and regulation, including capital regulations that specifically take account of a bank's exposure to derivatives transactions. The Basel Committee on Banking Supervision has recently proposed tough new capital and liquidity requirements for derivatives that will further strengthen the prudential standards that apply to bank derivative activities. Titles I, III, VI and VIII of [the Dodd-Frank Act] all add provisions further strengthening the authority of the Federal banking agencies and other supervisory agencies to address the risks of derivatives."[9]

Because banks already are subject to extensive regulation by the federal banking agencies with respect to their swap activities, the CFTC and SEC should avoid imposing the additional layer of regulation that would result if all banks that engage in swaps in a significant amount, yet within acceptable parameters, were also required to submit to the regulatory regime that accompanies the MSP designation. One of the six principles for regulatory reform implementation recently outlined by Treasury Secretary Geithner stated that policy makers, regulators and supervisors "will not simply layer new rules on top of other rules."[10] We strongly support that principle. The expanded authority and oversight of the federal banking agencies will ensure that these banking institutions are not overly levered nor able to create a "substantial counterparty" exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.

Moreover, it is important to remember that the combination of new reporting obligations for all swap transactions combined with the fulsome bank regulatory regime will provide the market regulators with extensive information about the aggregate size of positions held by banking institutions. These additional safeguards to the financial system will be in place whether or not a bank is considered an MSP.

b. The Relative Position in Cleared Versus Uncleared Swaps

It is important in this context also to recognize that most banks (as differentiated from "commercial end-users") will be required to clear all derivatives transactions accepted for clearing by a central clearinghouse.[11] The legislation explicitly requires that the Commissions, when setting the definition of "substantial position" to "consider the person's relative position in uncleared as opposed to

[9] Id.

[10] See Speech entitled "Rebuilding the American Financial System" delivered by Secretary of the Treasury Timothy F. Geithner, New York University's Stern School of Business, Aug. 2, 2010.

[11] We note that under Section 723 of the Dodd-Frank Act, in general a "financial entity" is not eligible to use the end-user clearing exemption. However, the Commissions are directed to "consider whether to exempt small banks [including depository institutions with total assets of $10,000,000,000 or less], savings associations, farm credit system institutions, and credit unions" from the financial entity definition. While not the subject of this comment letter, we would fully support the ability of these small banks to avail themselves of the end-user exemption from clearing.

cleared swaps." Consideration of this factor is vitally important as Congress determined that clearing is at the heart of reform. To the extent that transactions are primarily taking place in the context of a robust, conservative, and transparent risk management framework, there should be little or no risk that they will cause harm to the banking or the financial system. Therefore, when determining whether an institution has a substantial position in outstanding swaps, the CFTC and SEC should consider the institution's relative position in cleared versus uncleared swaps.

c. <u>The Value and Quality of the Collateral Held Against Counterparty Exposures</u>

Similarly, to the extent that an institution has uncleared swaps, the Commissions are directed by the legislation to consider the value and quality of the collateral held against counterparty exposures when defining the term "substantial position." Banks enter into customized derivatives with their customers to help raise capital for small businesses and to help businesses hedge risk. These transactions, however, are typically fully collateralized with the customer's property. Collateralization substantially reduces the potential for adverse effects on banks and the stability of the market. Entities that have taken the proper steps to fully collateralize swap positions with their counterparties should not be captured within the MSP definition absent special circumstances, such as the entity building a substantial position in speculative swaps.

d. <u>The Nature and Purpose of the Swap Activity</u>

Another factor that is important to evaluate when considering whether an institution's swaps pose "substantial counterparty" exposure is the nature and purpose of the swap activity. For example, when banks use swaps to facilitate customer loan transactions or manage interest rate risk, the institution strives to achieve a neutral position where there should be no risk of loss. These swaps can be distinguished from transactions entered into to take a position on the movement of rates, or other speculative purposes. Therefore, the determination of whether an institution's outstanding swap position creates systemic risk should include an evaluation of the purpose of the transactions. Transactions entered into with a customer to facilitate the origination of a loan with that customer, or transactions undertaken to mitigate a customer's or the institution's risk of loss should not cause an institution to be characterized as an MSP.

e. <u>The Volatility or Default Risk of the Asset Class</u>

As recognized by Chairman Dodd and Chairman Lincoln, "[i]t is important that regulators do not assume that all over-the-counter transactions share the same risk profile."[12] Banks may have relatively large positions in traditional asset classes, such as interest rate swaps, where there is not substantial volatility or default risk, particularly when they are hedged, collateralized, and diversified across many different borrowers and other customers. As between interest rate swaps and credit default swaps, for example, the threshold should be higher for determining that an institution's interest rate swaps comprise a "substantial position" or present "substantial counterparty" exposure that could have serious adverse effects on the financial stability of the United States banking system.

[12] June 30, 2010, Letter from Chairman Christopher Dodd and Chairman Blanche Lincoln to Chairman Barney Frank and Chairman Colin Peterson discussing the narrowed scope of the swap dealer and major swap participant definitions.

Eligible Contract Participant

The Dodd-Frank Act also raises the standard for certain categories of eligible contract participants, which term is relevant to the business conduct and exchange trading requirements. Furthermore, the term, "eligible contract participant" is one of the Key Definitions that must be further defined by the Commissions. We believe that the definition of an ECP should explicitly include any borrower entering into a swap with a bank or other financial institution (as defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a), provided that the swap is entered into to convert the variable rate interest cost of the borrower's debt to a fixed rate interest cost or vice versa, or to limit the maximum interest cost of such debt. The CFTC has the authority under clause (c) of the ECP definition to exempt from the ECP definition any other person that the Commission determines to be eligible in light of the financial or other qualifications of the person. We believe that constructing the ECP definition along these lines will facilitate the ability of banks to continue to provide long term credit to creditworthy customers by allowing their customers to hedge their debt.

Therefore, we propose that, for purposes of section 1a of the Commodity Exchange Act (7 U.S.C. 1a), the term "eligible contract participant" include any borrower entering into a swap with a bank or other financial institution (as defined in section 1a), provided that the swap is entered into to convert the variable rate interest cost of the borrower's debt to a fixed rate interest cost or vice versa, or to limit the maximum interest cost of such debt. For purposes of the foregoing, a "borrower" is any borrower of money or issuer of debt to which the bank or other financial institution has made or is willing to make a loan or other extension of credit, after taking into account any collateral, guaranty, or other credit support arrangement, if any.

Conclusion

ABA and ABASA appreciate this opportunity to provide meaningful comment on the Commissions' APNR on the Key Definitions in the Dodd-Frank Act. For banks, the determinations of the Commissions regarding the major swap participant and eligible contract participant definitions will likely have a profound impact on the ability of depository institutions, that are not swap dealers, to provide long-term credit to small business customers economically and to manage financial risk.

Sincerely Yours,

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American Bankers Association
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cc:
Julie Williams, Office of the Comptroller of the Currency
Scott G. Alvarez, Federal Reserve Board