ISDA | Safe, Efficient Markets

February 6, 2013

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

Re: Further Proposed Guidance Regarding Compliance with Certain Swap Regulations (RIN 3038-AD85)

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**Commission**") with comments and recommendations regarding the Further Proposed Guidance Regarding Compliance with Certain Swap Regulations (the "**Further Proposed Guidance**")[1].

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

The Further Proposed Guidance follows earlier proposed cross-border guidance (the "**Proposed Guidance**")[2], but applies to only a small number of the topics addressed in the Proposed Guidance. ISDA welcomes the Commission's decision to postpone further action on the remainder of its Proposed Guidance and allow time for further consultation with international and domestic regulators. A harmonized approach to cross-border regulation is of paramount importance to the derivatives markets. Only a harmonized approach can minimize the burdens of duplicative regulation, prevent inconsistent regulatory mandates from foreclosing transactional activity, allow an efficient utilization of regulatory resources, and preserve open access to

[1] 78 Fed. Reg. 909 (January 7, 2013)
[2] 77 Fed. Reg. 41214 (July 12, 2012)

national markets and a level playing field for entities engaged in cross-border swaps business. The swaps market has grown organically as a global market. Regulation failing to protect this characteristic will forfeit great economic value.

Our comments in this letter are limited to the specific issues raised by the Commission in the Further Proposed Guidance. We refer the Commission to our comment letter dated August 10, 2012 as the Commission continues to consider other issues addressed in the Proposed Guidance. We underscore in particular the discussion in that letter concerning the appropriateness of addressing the cross-border application of Commission swaps regulation through the rulemaking process. Even within the narrower context of the Proposed Further Guidance, the challenges of crafting administrable and unambiguous provisions and the significant cost implications of extra-territorial jurisdiction, as described below, demonstrate the benefits to be gained from the in-depth consideration afforded by rulemaking process.

1. Proposed Alternative Approaches to the De Minimis Exemption

Under the Commission's Final Exemptive Order regarding Compliance with Certain Swap Regulations (the "**Exemptive Order**"),[3] when determining whether its swap dealing activities exceed the de minimis threshold, a non-U.S. person may exclude all swaps with non-U.S. persons, irrespective of whether its obligations under the swaps are guaranteed by a U.S. person. ISDA supports the Exemptive Order's approach and agrees that the presence or absence of a guarantee by a U.S. person should have no effect on the de minimis calculation. In contrast, under the Proposed Guidance, when making its de minimis calculation, a non-U.S. person would be required to include swaps with non-U.S. persons if its obligations under the swaps are guaranteed by a U.S. person.[4] ISDA urges the Commission not to revert to the approach taken in the Proposed Guidance.

The Proposed Guidance would essentially regard U.S.-guaranteed non-U.S. persons as U.S. persons for purposes of determining their swap dealer status. However, as the Commission recognizes in its discussion of proposed prong (ii)(B) of the U.S. person definition,[5] a guarantee of an entity's swap obligations by a U.S. person is not a sufficient nexus to recast the guaranteed non-U.S. person as a U.S. person. Comity also dictates that the approach suggested in the Proposed Guidance not be adopted. The quantum of dealing with non-U.S. persons by a non-U.S. person is primarily a decisional factor for non-U.S. jurisdictions to consider in their regulation of swaps. The Commission's focus on U.S.-guaranteed non-U.S. persons does not adequately recognize the role of foreign regulation, which may very well suffice to offset the Commission's concerns about U.S.-guaranteed non-U.S. persons dealing with other non-U.S. persons. Creating a policy recognizing that the non-U.S. person's regulated status should be a function of the laws of the jurisdictions in which it is active would be consistent with comity and regulatory reciprocity.

The Commission's rationale for the approach taken in the Proposed Guidance is based on the possibility that adverse effects on U.S. persons and the U.S. financial system could arise because

[3] 78 Fed. Reg. 858 (January 7, 2013).
[4] 77 Fed Reg. 41221.
[5] 78 Fed. Reg. 912.

the risk of default by the non-U.S. person ultimately rests with the U.S. guarantor.[6] ISDA submits again, however, that introducing a bias toward swap dealer ("**SD**") registration of guaranteed non-U.S. affiliates is not an appropriate regulatory tool to address the postulated adverse effects.

These postulated effects do not stem from the manner in which the non-U.S. person conducts its swap dealing activities with other non-U.S. persons. Rather, the Commission appears to be concerned that the risk transfer arrangements between the U.S. guarantor and the non-U.S. person could cause the guarantor to become a source of instability to the U.S. financial system. Much of the SD compliance apparatus that the Proposed Guidance would impose on the guaranteed non-U.S. person is not relevant to this concern. External and internal business conduct rules, for example, cannot assure the ultimate solvency of an SD. Nor is it clear that encouraging further capitalization of overseas affiliates of a U.S. guarantor, causing financial resources to be contributed overseas, necessarily advances the stability of the U.S. financial system. Other more targeted regulatory mechanisms were provided by the Dodd-Frank Act to protect the U.S. economy from harm as a result of risk exposures accumulated in unregulated entities – major swap participant and supervised non-bank financial company status being two examples.

Because the presence of a U.S. guarantor is not relevant under the Exemptive Order, there would be no need for the Commission to consider and promulgate new formulations of the definition of the term "guarantee" (as suggested by the Commission's questions at 78 Fed. Reg. 912), a result that would compound the open questions and complexity stemming from the Commission's interpretation deeming guarantees of swaps to be swaps.

2. Aggregation

Under the Exemptive Order, a non-U.S. person that was engaged in swap dealing activities with U.S. persons as of December 21, 2012 is not required to aggregate the swap transactions of its U.S. affiliates and, if the non-U.S. person has a registered SD in its affiliated group, it is also not required to aggregate the swaps of any non-U.S. affiliate that either was engaged in swap dealing activities with U.S. persons as of December 21, 2012 or is registered as a SD. ISDA urges the Commission to make this treatment of grandfathered affiliates permanent in order to avoid disrupting established transactional relationships. In the event that the Commission declines to do so, it should at a minimum provide an adequate compliance period (of not less than 180 days) after publication of its final approach toward aggregation in order to allow time for appropriate transitional arrangements within affected affiliated groups.

In the Further Proposed Guidance, the Commission has proposed an alternative aggregation rule that would require non-U.S. persons to aggregate the transactions of their U.S., non-SD affiliates.[7] ISDA urges the Commission not to adopt the alternative. As the Commission

[6] 77 Fed Reg. 41220-221.

[7] 78 Fed. Reg. at 911. The Commission states, at 78 Fed. Reg. at 911, that the non-U.S. person "would not be required to include … swap dealing transactions of any non-U.S. affiliate under common control that is registered as an SD." The statement could be read to imply that the non-U.S. affiliate must include transactions by U.S. affiliates that are SDs. We assume, and seek the Commission's confirmation, that such a reading is not intended as it would result in the anomaly noted by the Commission in the immediately following discussion, namely that any affiliate of

recognizes in its discussion of the proposed alternative,[8] application of the aggregation rule to non-U.S. affiliates may impose significant burdens on such non-U.S. affiliates without advancing significant regulatory interests. Expanding the scope of aggregation to include swaps of U.S. affiliates would exacerbate this disproportionality.

Moreover, it is unlikely that non-SD U.S. affiliates will have arrangements in place to monitor the U.S. person status of their swap counterparties. Consequently, the Commission's proposed alternative approach would either (a) require imposing on U.S. affiliates the costly and otherwise unnecessary burden of tracking the U.S. person status (under the Commission's evolving definitions) of all of their swap counterparties or else (b) result in the inappropriate counting by non-U.S. persons of transactions of their U.S. affiliates with non-U.S. counterparties, an anomalous outcome because these same non-U.S. counterparties would not enter into the de minimis calculation if they transacted directly with the non-U.S. affiliate.

As the Commission continues to consider the role of aggregation among affiliates for purposes of the de minimis exception, ISDA offers the following as principles against over-inclusiveness that any approach should observe:

1) Both non-U.S. persons and U.S. persons should be able to exclude from their de minimis calculations swap transactions of any affiliate (whether U.S. or non-U.S.) that is registered with the Commission as a SD. Because transactions by a registered SD (whether U.S. or non-U.S.) are subject to Dodd-Frank Title VII protections, no purpose would be served by attributing them (potentially many times over) to affiliated entities in order to impose SD registration on those affiliates.

2) U.S. persons should in no event be required to include swap transactions of non-U.S. affiliates with non-U.S. persons, as such transactions have insufficient nexus to the United States.

3. U.S. Person Definition

The Commission proposes an alternative to the version of prong (ii)(B) of the definition of U.S. person that was included in the Proposed Guidance. The Proposed Guidance included the following as prong (ii)(B):

> (ii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund, or any form of enterprise similar to any of the foregoing, in each case that is [sic]… (B) in which the direct or indirect owners thereof are responsible for the liabilities of such entity and one or more of such owners is a U.S. person.[9]

The Further Proposed Guidance offers the following alternative:

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a registered SD could not avail itself of the de minimis exemption if the registered SD's swap dealing activities exceed the de minimis threshold.

[8] Id. (describing the Commission's understanding based on comments received).

[9] 77 Fed. Reg. at 41218.

> (ii) A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing, in each case that is … (B) directly or indirectly majority-owned by one or more persons described in prong (i) or (ii)(A) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity (other than a limited liability company or limited liability partnership where partners have limited liability).[10]

Like the definition in the Proposed Guidance, the proposed alternative prong (ii)(B) would consider certain entities in which the direct or indirect owners have responsibility for the obligations and liabilities of the entity as U.S. persons. Although the proposed alternative offers helpful clarification and limitation of the previously proposed version, ISDA urges the Commission not to incorporate prong (ii)(b) in either its original or alternative versions into the definition of U.S. person.

The proposed alternative prong (ii)(B) is narrowed to focus on entities with unlimited liability. As stated above, while this narrowing is welcome, it does not adequately address the problems inherent in prong (ii)(B). The Commission has not explained why an organizational structure that does not confer limited liability on owners is inherently more susceptible to "persons … creating such indirect ownership structures for the purpose of evading the Dodd-Frank regulatory regime."[11] Presumably, the choice to do business through an unlimited liability entity reflects commercial, jurisdictional and tax factors, including the trade off between minimizing initial capital contributions versus achieving greater certainty regarding the ultimate amount of loss that could be incurred. As the Commission recognizes in its discussion of commodity pools and investment vehicles, a distinction exists between "separate, active operating businesses" and entities that allow owners to gain exposure to the financial positions of the entity. The Commission has not demonstrated that unlimited liability entities are less likely to be operating businesses than any other type of organizational form. Nor has the Commission explained why ultimate liability of U.S. direct or indirect owners automatically "satisfies the requisite jurisdictional nexus",[12] particularly when such owners may not be in privity with, or even known to, the entity's swap counterparties.

Moreover, the proposed definition contains ambiguities that will make it unworkable for market participants. First, the reference to indirect owners will make a person's status under the definition unknowable in many instances, as there may be no way for a SD, MSP or the entity itself to know the nature of its indirect owners at all relevant times. Second, the proposed definitional text and the surrounding discussion are ambiguous as to whether the U.S. owners with unlimited responsibility must constitute a majority of the entity's ownership interests or whether, once U.S. majority ownership is established, it suffices that a single U.S. owner has unlimited responsibility. Thus, it is unclear how the proposal would apply to the case of a limited partnership with a U.S. general partner, as the only partner with unlimited liability, holding a small portion of the economic interest in the entity. Remedying this defect would require a definition of majority ownership that takes into account the various classes of interests

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[10] 78 Fed. Reg. at 912.
[11] Id.
[12] Id.

that an unlimited liability entity may issue. Third, the concept of "unlimited responsibility" remains amorphous, despite the Commission's helpful clarification, because it could turn on fact-sensitive and uncertain legal judgments under doctrines such as "veil-piercing" or "alter ego" entities.

In the event the Commission decides to adopt a version of prong (ii)(B) notwithstanding the foregoing considerations, ISDA believes that the definitional text should at a minimum address the following difficulties raised by currently proposed text. First, the limited and selective listing in the final parenthetical of limited liability companies and limited liability partnerships as excluded entities creates questions regarding why other entity types mentioned at the beginning of prong (ii), such as corporations, are not excluded. Accordingly, it would be more appropriate to provide a non-exhaustive listing of excluded entities in final guidance. Second, the exclusion from consideration under prong (ii)(B) of guarantees of swap obligations by U.S. persons, which appears in the explanation of the proposed definitional text, should be made explicit in the definition, and the definition should refer to "unlimited responsibility for all of the obligations and liabilities …". More generally, the definition should make clear that unlimited responsibility does not include responsibility arising out of separate contractual arrangements or extraordinary circumstances, such as conduct by owners that results in veil piercing or limited partner participation in management of a partnership.

4. Investment Vehicles

The Commission proposes an alternative prong (iv) of its U.S. person definition to encompass commodity pools, pooled accounts, investment funds or other collective investment vehicles not described in prong (ii) of the U.S. person definition and that are majority-owned by one or more persons described in prongs (i) or (ii) of the definition. As a preliminary matter, ISDA suggests that, in light of the unique characteristics of investment vehicles, all of the definitional considerations relevant to this type of entity be consolidated into a single prong of the U.S. person definition, where their application can be tailored to investment vehicles. In particular, prong (ii)'s "principal place of business test" is inapposite and unclear with respect to investment vehicles and should not be applied to them.[13] To implement this consolidation, the word "fund" should be struck from, and the phrase "other than an entity described in prong (iv)," should be added (after "foregoing,") to, prong (ii) of the U.S. person definition.

The lack of a definition of majority ownership in prong (iv) will lead to arbitrary or indeterminate results for many types of investment vehicles due to the varied capital structures of entities within this prong. For example, the nominal equity of an entity may represent only an insignificant economic interest. Thus, if majority-ownership is defined based on voting equity, U.S. person status may be unrelated to the degree of U.S. economic participation in the entity. Although it is not difficult to formulate alternative definitions, such as ones based on ownership

[13] Even with respect to non-investment entities, the "principal place of business" test, as described in footnote 42 of the Exemptive Order, is not straightforward, particularly in the case of multi-jurisdictional corporate groups. A SD or other person attempting to determine the U.S. person status of its counterparty will not have direct knowledge of governance and control arrangements within its counterparty's corporate group. ISDA therefore requests that the Commission provide guidance to the effect that reliance on representations as to an entity's non-U.S. person status will not be deemed to be unreasonable solely because of the presence of affiliates of the entity organized under U.S. law or personnel located in the United States.

of the most subordinated tranche that represents more than a nominal economic interest, or on ownership of entire capital structure, the practical consequences of any of these alternatives can be considered only following a more concrete Commission proposal offered for public comment. Such proposal should give special consideration to structured finance vehicles, which merit further analysis due not only to their complex capital structures but also to practical difficulties in monitoring ownership of their securities.

The alternative prong (iv) contains an exclusion for certain publicly-traded entities. ISDA welcomes the Commission's acknowledgment of the difficulties faced by publicly-traded funds with respect to verification of ownership.[14] However, the proposed language's limitation to publicly traded vehicles that are "not offered, directly or indirectly, to U.S. persons" greatly diminishes the usefulness of the exclusion. It is unclear what would constitute "indirect" offers to U.S. persons. Further, basing the exclusion on the Commission's U.S. person definition would require issuers worldwide to modify customary offering procedures. Accordingly, ISDA suggests that the Commission should provide a safe harbor for investment vehicles whereby securities offered in accordance with local law and customary documentation practices in the local market, as well as offerings conducted in accordance with the Regulation S safe harbor (which is familiar to many foreign issuers) under the U.S. Securities Act of 1933, would be deemed to be owned by non-U.S. persons. Furthermore, in order not to bias issuers against the inclusion of Rule 144A or other U.S. tranches in offerings, ISDA suggests that issuers should be able to rely on the relative amounts of the relevant class of securities sold in the Regulation S and Rule 144A (or other U.S.) tranches to determine U.S. ownership. Because the term "publicly-traded" may raise interpretative questions in certain contexts, ISDA suggests that the Commission make clear that the above treatment based on the offering of securities is available with respect to any securities that are held in book-entry form through a clearing system or central securities depositary.

Similar difficulties are raised by the reference in prong (iv) to indirect ownership. For the reasons explained above with respect to prong (ii)(B), a majority-ownership test can be administrable and cost-justified only if it is based on information readily available to the issuer. Although the approach described in the preceding paragraph would address these difficulties in the case of publicly-traded or book-entry securities, there may be other cases where beneficial ownership is knowable only at great cost and effort, if at all. Consequently, ISDA suggests that any ownership test be based on the reasonable belief of the issuer.

As the complexities regarding U.S. person status make clear, ISDA believes that it is crucial to the smooth functioning of the swap markets that SDs and major swap participants be able to rely on counterparty representations and that definitional tests be sufficiently clear and workable so that counterparties are able to ascertain their status and make the requisite representations.

[14] 78 Fed. Reg. at 913.

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ISDA appreciates the ability to provide its comments on Further Proposed Guidance and looks forward to working with the Commission as it continues to consider this important issue. Please feel free to contact me or ISDA's staff at your convenience.

Sincerely,

Robert G. Pickel

Robert Pickel
Chief Executive Officer