August 13, 2018

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

RE: Notice of Proposed Rulemaking, De Minimis Exception to the Swap Dealer Rule, RIN 3038-AE68

Dear Mr. Kirkpatrick,

The Americans for Financial Reform Education Fund ("**AFR**") appreciates the opportunity to comment on the Commodity Futures Trading Commission ("**CFTC**" or "**Commission**")'s Notice of Proposed Rulemaking on the De Minimis Exception to the Swap Dealer Rule (the "**NPRM**" or **"Proposal**").[1]

The de minimis exemption is a critical element of the swap dealer rule, as it determines which swap dealers will actually be designated as regulated swap dealers and subject to formal dealer oversight. This NPRM addresses a wide range of issues surrounding this exemption. These range from the step-down from $8 billion to $3 billion in notional value that is scheduled to happen under current Commission rules, to proposals for a wide variety of expanded exemptions from the types of swaps that are counted toward the de minimis exemption. We are deeply concerned by some elements of this NPRM, especially the major expansions in exemptions from swaps that must be counted toward the de minimis threshold. Some of these expansions, especially the potential exemptions for cleared and exchange traded swaps and the exemption for swaps used for financial hedging, hold the possibility of severely undermining the swap dealer regulatory regime and therefore the statutory intent of Title VII of the Dodd-Frank Act. We expand on these issues below. Note that due to the range of complex issues raised in the NPRM, AFR is continuing to examine the issues and a lack of commentary on a particular proposal should not be taken as approval.[2] We may have further commentary in the future.

Before discussing these proposed exemptions, we will first address the issue of the step down from the current $8 billion level to the $3 billion threshold. AFR laid out our views on the de minimis notional value threshold in a previous letter responding to the Commission's

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[1] Americans for Financial Reform is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/.

[2] E.g. the fact that we do not comment on the expansion of the IDI loan exemption from the de minimis calculation should not be taken as indicating approval of the proposal.

Preliminary Staff Report on the De Minimis threshold and we will not repeat them here.[3] This latest NPRM contains updated data as compared to the Preliminary Staff Report. Based on the analysis in this Proposal, it appears that the quality of data on financial swaps has improved since the Preliminary Staff Report. Findings from the improved data do add weight to the Commission's claim that an $8 billion notional de minimis level is appropriate for some financial swaps markets.

However, the NPRM also states that the Commission continues to lack data on the notional value of non-financial commodity (NFC) swaps (FR 27449). The Proposal also finds that roughly half of all the entities with ten or more counterparties for NFC swaps are not registered as dealers.[4] This indicates that significant dealing activity in the NFC market is escaping registration due to the $3 billion threshold. The lack of notional value data in the NFC market makes it difficult if not impossible to draw definitive conclusions on the economic significance of the activity that is escaping dealer registration. We continue to believe that arguments against the $8 billion threshold are particularly strong in the case of NFC markets. The Commission should be willing to vary de minimis treatment based on market characteristics, and in particular should cut the $8 billion threshold in NFC markets where $8 billion in notional valuation represents a different level of economic significance than in some other markets.

We would also point out that none of the analysis in this NPRM analyzing the effect of particular AGNA thresholds on the swaps market takes into account the numerous expansions being proposed here regarding the amount of swaps activity that would be exempted from being counted towards the de minimis threshold. As discussed further below, these exemptions could exclude very large amounts of swaps activity from even being considered in the de minimis calculation. The effect of a higher threshold would look very different with financial hedging activity or cleared swaps activity exempted from consideration.

In relation to the $8 billion notional valuation threshold, AFR would also like to make clear our strong support for retaining the current Adjusted Gross Notional (AGNA) metric for determining the threshold. Moving away from the AGNA metric would dangerously weaken swap dealer designation. In response to Question 12 in the NPRM:

> *(12) What are the benefits and detriments to using AGNA of swap dealing activity as the relevant criterion for SD registration, as compared to other options, including, but not limited to, entity-netted notional amounts or credit exposures?*
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> We have no doubt that industry representatives will point out that gross notional amounts do not measure current market risks. However, gross notional amounts have the enormous advantage of providing a stable metric of the gross size of swaps commitments that is not reliant on either current market valuations, model forecasts based on those valuations, or institutional arrangements such as bankruptcy procedures that must be

[3] See January 2016 letter available at http://ourfinancialsecurity.org/wp-content/uploads/2016/01/AFR-comment-letter-CFTC-de-minimus-preliminary-report.pdf
[4] See Table 12 on FR 27456

> relied on to allow netting to take place even within a single pair of entities. In addition, even if gross notional amounts do not measure loss exposures due to current market risks, they remain a good measure of the total operational risks incurred by an entity in its derivatives dealing activities. The control of operational risk, not simply market risk, is a major reason for dealer designation in the first place.
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> Metrics such as credit exposures are liable to expand in unpredictable ways in situations of market stress. Consider for example the very rapid increase in net credit exposures that occurred over the six month and one year periods prior to the late 2008 financial crisis, while notional market size stayed much more stable. It is clearly crucial that dealer designation take place well in advance of periods of market stress. If entities were suddenly required to register as dealers in the midst of a market crisis due to unforeseen expansion in complex risk metrics such as credit exposure this would only add to market stress. From a practical perspective using a de minimis metric heavily dependent on current market valuations could be highly problematic.
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> Entity-netted notionals (ENNs) have the advantage of continuing to use notional amounts as a base, but still suffer from similar problems. First, by reducing derivatives exposures to constant maturity risk equivalents they ignore basis risk and are again overly reliant on modeling assumptions that may fail under market stress. In the recent CFTC study on ENNs the simply converting interest rate swap notionals to five-year risk equivalents reduced the measured market size by forty percent.[5] Even more important, the accuracy of ENNs as an exposure measure is completely dependent on the success of close-out netting arrangements in bankruptcy. These arrangements may fail in unpredictable ways in cases of market stress, as was seen in the case of Lehman Brothers.[6] Finally, any entity which carries large volumes of derivatives AGNA on its books, even if these exposures nominally net out, is vulnerable to significant losses due to operational risk, both in the ordinary course of business and in closeout situations. Like credit exposure, ENNs are a completely inappropriate metric to use in dealer designation.

But the choice to make the current $8 billion threshold permanent is only one element of this NPRM. The NPRM also proposes major expansions of existing exemptions from the de minimis calculation. These expansions are extremely consequential, since they would be likely to greatly increase the volume of swaps that would not be counted toward the de minimis threshold at all. As exemptions from the de minimis calculation become more generous, swaps market participants with much more than $8 billion in effective dealing AGNA will be able to avoid registration.

There are currently at least nine significant exclusions from swaps counting towards the de minimis threshold. These include inter-affiliate swaps, hedging swaps involving physical commodity risks, swaps entered into by an insured depository institution in connection with a

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[5]https://www.cftc.gov/sites/default/files/idc/groups/public/@economicanalysis/documents/file/oce_enns0118.pdf

[6] See Fleming, Michael and Asani Sarkar, "The Failure Resolution of Lehman Brothers", Federal Reserve Bank of New York Economic Policy Review, December, 2014. Available at https://www.newyorkfed.org/medialibrary/media/research/epr/2014/1412flem.pdf

loan, certain foreign exchange swaps, commodity options, floor trader swaps, certain cross-border swaps, and swaps resulting from portfolio compression exercises.[7]

This NPRM would expand several of the largest exclusions in this list in highly significant ways. It also suggests the possibility of adding major new exclusions, including broad exclusions for cleared swaps and swaps traded on an exchange. The increase in swaps activity that is outright excluded from being counted toward the dealer threshold could have transformative effects on the swap dealer regime and could undermine core goals of the Dodd-Frank Title VII swaps regime. This is especially true in light of the limited funding and staffing of the Commission and the resultant difficulties in policing complex exclusions from de minimis metrics.

The most problematic expansion of existing exclusions proposed in the NPRM is the expansion of the exemption for swaps hedging non-financial commercial risks to include hedges of financial risks, on an unlimited basis.

The original justification of the commercial hedging exemption was to facilitate the hedging of commercial risks by non-financial end users. The expansion to incorporate hedges of purely financial risks by financial entities is a major and potentially transformative shift. This is especially so because the requirements for financial hedging are written in the broadest possible terms, to include all possible forms of financial risk incurred due to either current or anticipated future positions.

All financial entities, including dealers, seek to manage their financial risks, and indeed dealers in particular seek to have a balanced book so as not to incur market risk. It is thus likely that most if not all dealer positions could be portrayed as hedges. This expansion in the hedging exemption opens the door to dealers of significant size escaping designation. It is already the case that hedging activities, including financial hedging, already would not subject an entity to dealer designation unless there is evidence that the entity acts as a swap dealer. This expanded exemption is thus likely to be used by entities that are already known as swap dealers but seek to reclassify some of their activity as financial hedging.

As protection against the misuse of the financial hedging exemption, the NPRM proposes to require that in order to use the exemption, the entity must not be the price maker for the swap and must not receive a bid-ask spread or other compensation for that particular swap. Enforcement of this requirement would seem to call for the Commission to determine on a swap-by-swap basis whether the entity received compensation for particular derivatives. We question whether this is practical given the limitations in Commission resources and the range of compensation structures that could be used in dealer-client relationships. We also question whether anti-evasion provisions could be used without involved and expensive litigation against potential evaders, as the Commission would have to demonstrate that the activity was actually structured to avoid designation.

[7] See FR 27447 in the NPRM for a full list.

Other expansions of exemptions in this NPRM raise significant issues as well. The NPRM proposes to codify in regulation no-action letters that exempt swaps associated with multi-lateral portfolio compression exercises from dealer designation. In doing so, it permits the exemption of any swaps defined according to the portfolio compression definition used in 23.500 of the Commission rules. This section defines portfolio compression as any "exercise in which multiple swap counterparties wholly terminate or change the notional value of some or all of [their] swaps" and "replace the terminated swaps with other swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps".

This definition appears overbroad in that it goes far beyond the termination of fully offsetting swaps to include any exercise which would result in the reduction of risk metrics for a set of swaps. For example, it appears that any set of trades which would reduce current market risks according to e.g. regulatory metrics of credit exposure could potentially qualify, even if it might actually increase credit exposure or market risk under stressed market conditions. This opens the door to a wide range of types of trades being reclassified as risk reduction exercises. The Commission should seek to limit portfolio compression exemptions to exercises that actually terminate fully offsetting swaps, or should at least strictly limit exemptions that go beyond this definition.

But perhaps the most concerning and significant new exemption floated in the NPRM, is the suggestion in Section III.B of the Proposal that all cleared and exchange-traded swaps might be exempted from being counted toward the dealer de minimis threshold.

In major markets such as interest rate swaps clearing penetration has now reached at least 75 percent of all swaps activity globally. Even in less standardized markets like credit derivatives cleared swaps are close to 40 percent of all activity.[8] A broad exemption for cleared swaps thus implies that major swap dealers could simply be exempted from dealer designation because they transact mostly in cleared swaps.

A variety of speculative justifications are given in the NPRM for exempting cleared swaps. Among these justifications are that cleared swaps do not raise systemic risk concerns on the part of the dealer because "risk management is handled centrally by the DCO" and the clearing dealer would be regulated as an FCM. We do not believe these justifications are accurate. Swaps clearing does not eliminate the systemic risk of derivatives, it moves this risk into the ecosystem of the clearinghouse. Clearing members who guarantee client swaps performance to the DCO perform significant risk and operational management roles in the cleared derivatives ecosystem. Furthermore, if Congress had believed FCM regulation provided adequate oversight for swap dealing it would have exempted FCM activity from swap dealer designation.

[8] Bank of International Settlements, "OTC Derivatives Statistics at End-June 2016", Monetary and Economic Policy Department, November, 2016 (Contains Triennial Survey). Available at https://www.bis.org/publ/otc_hy1611.pdf

Another justification is that exempting cleared swaps furthers a "central tenet of the Dodd-Frank Act" by encouraging swaps clearing. While the Dodd-Frank Act mandates clearing of appropriately liquid and standardized swaps, it is hardly a "central tenet" of Dodd-Frank that other Dodd-Frank requirements must be weakened in order to encourage clearing. Indeed, the approach taken by the Dodd-Frank Act in *mandating* clearing of swaps when appropriate implies that regulators should not rely on deregulatory measures to encourage voluntary swaps clearing.

Section III.B also suggests that swaps traded on a swaps execution facility (SEF) may receive a broad exemption from being counted toward de minimis thresholds. We do not believe this is appropriate given that current CFTC rules for swaps exchanges continue to permit a very significant price-setting role for dealers. Under current CFTC rules prices on SEFs can be set through requests for quotes (RFQs) from a limited number of dealers instead of more competitively through a central limit order book. Recent commentary from Chairman Giancarlo in his two white papers on derivatives regulation indicates that the role of dealer price-setting may become even more prominent in SEFs in the future. Even if SEFs did function more like a continuous many-to-many auction, high-volume dealers on these exchanges could still be critical to exchange functioning.

Finally, we also disagree with the breadth of delegation of authority to the director of the DSIO for determining how notional amounts are calculated for the purposes of the de minimis exemption. This delegation is subject only to the requirements that such determinations are "reasonable and analytically supported" and that they be made public. The methodology for the calculation of notional amounts directly determines which entities will be designated as swap dealers. The Commission should play the lead role in determining matters of such significance. It hardly seems reasonable to issue extensive rulemakings on the de minimis threshold but simply delegate the entire methodology for the calculation of the most critical element of the threshold.

Thank you for the opportunity to comment on this Proposed Rule. If you have questions, contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,
Americans for Financial Reform