BETTER
MARKETS

August 13, 2018

Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444 (June 12, 2018); RIN 3038-AE68.

Dear Mr. Kirkpatrick,

Better Markets, Inc.[1] appreciates the opportunity to submit comments concerning the Commodity Futures Trading Commissionôs (ñCFTCò) proposed regulations amending the de minimis exception[2] initially adopted in the CFTC and Securities and Exchange Commissionôs (ñSECò) joint ñswap dealerò definition rulemaking in 2012 (the ñNew De Minimis Proposalò).[3]

INTRODUCTION

The New De Minimis Proposal introduces new regulations that exceed the scope of the CFTCôs stated mandate to address the de minimis threshold, violates the Administrative Procedures Act[4] and

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with alliesð including many in financeð to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americansô jobs, savings, retirements, and more.

2 See De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444 (June 12, 2018), available at https://www.cftc.gov/sites/default/files/2018-06/2018-12362a.pdf.

3 See Further Definition of ñSwap Dealer,ò ñSecurity-Based Swap Dealer,ò ñMajor Swap Participant,ò ñMajor Security-Based Swap Participantò and ñEligible Contract Participant;ò 77 Final Rules, Fed. Reg. 30596, 30611 (May 23, 2012), available at https://www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf.

4 5 U.S.C. § 553(b) et seq. The Administrative Procedures Act directs federal agencies to give interested persons an opportunity to participate in rulemakings through the submission of written data, views, or arguments to be considered in the agencyôs deliberative process. 5 U.S.C. § 553(c). Rulemakings must provide sufficient factual detail on the legal basis, rationale, and supporting evidence for regulatory provisions such that interested parties are ñfairly apprisedò of content, the reasoning of the agency implementing them, and the manner in which such regulations foreseeably may affect their interests. See, e.g., Mid Continent Nail Corporation v. United States, 846 F.3d 1364, 1373-1374 (Jan. 27, 2017); U.S. Telecom Assôn v. F.C.C., 825 F.3d 674, 700 (June 14, 2016), citing Honeywell Intôl, Inc. v. E.P.A., 372 F.3d 441, 445 (June 29, 2004); Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin., 407 F.3d 1250, 1259-1260 (May 24, 2005); Am. Medical Assôn v. Reno, 57 F.3d 1129, 1132-1133 (June 27, 1995); Florida Power & Light Co. v. U.S., 846 F.2d 765, 771 (May 13, 1988).

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statutory requirements for joint rulemaking, impermissibly expands swap dealing exclusions beyond the plain meaning and legislative intent of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (ñDodd-Frank Actò),[5] cites to incomplete and misleading data analyses, and relies on unsubstantiated representations made by market participants benefitting from the proposal.

Better Markets urges the CFTC to remedy these issues through a three-step process. First, the CFTC must amend its swap data and chief compliance officer reporting regulations to ensure it has sufficient data to provide an informed basis for administrative action. Second, and in the meantime, the CFTC should provide the regulatory certainty desired by market participants by permitting the $3 billion de minimis threshold to become effective upon the expiration of the CFTCôs current phase-in extension order,[6] more than six years after the CFTC finalized regulations defining the term ñswap dealerò as mandated in the Dodd-Frank Act in 2010.[7] Third, and only if warranted, the CFTC should re-propose an appropriately data-driven version of the New De Minimis Proposal.

COMMENTS

I. In violation of the Administrative Procedures Act and the joint rulemaking requirements under the Dodd-Frank Act, the New De Minimis Proposal seeks amendments to the "swap dealer" definition that, in effect, exceed the CFTC's stated objective of addressing the de minimis threshold for swap dealer registration.

The New De Minimis Proposal far exceeds the CFTCôs stated objective of addressing the ñquantityò of swap dealing permissible within the de minimis exemption.[8] Moreover, the CFTC, rather than proposing regulations and guidance with the benefit of meaningful public comment, chooses to effect these extensive changes through sleight of handð a series of exclusions from the de minimis threshold for swap-related activities that it acknowledges constitute ñdealingò under its own regulations but nevertheless would be excluded from dealing thresholds under the proposal. Such actions, among other things, fail to give the public sufficient notice of the content, scope, and import of the New De Minimis Proposal, depriving the public of a meaningful opportunity to provide input on a foundational element of the CFTCôs

5 See Public Law 111ï 203, 124 Stat. 1376 (2010), available at https://www.cftc.gov/idc/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf.

6 The CFTC established the final $3 billion de minimis threshold based on the aggregate gross notional swap dealing activities of unregistered persons in May 2012, subject to a five-year phase-in period with a higher $8 billion threshold. The CFTC subsequently issued two consecutive orders extending that phase-in period, and the higher $8 billion threshold, through December 31, 2018. See Order Establishing De Minimis Threshold Phase-In Termination Date, 81 Fed. Reg. 71605 (Oct. 18, 2016), available at https://www.gpo.gov/fdsys/pkg/FR-2016-10-18/pdf/2016-25143.pdf; Order Establishing a New De Minimis Threshold Phase-In Termination Date, 82 Fed. Reg. 50309 (Oct. 31, 2017), available at https://www.gpo.gov/fdsys/pkg/FR-2017-10-31/pdf/2017-23660.pdf.

7 The CFTC and SECôs joint final ñswap dealerò definition regulation was published on May 23, 2012. See Further Definition of ñSwap Dealer,ò ñSecurity-Based Swap Dealer,ò ñMajor Swap Participant,ò ñMajor Security-Based Swap Participantò and ñEligible Contract Participant;ò 77 Final Rules, Fed. Reg. 30596, 30611 (May 23, 2012). Furthermore, Congress made clear in section 712(a)(3) of the Dodd-Frank Act that the CFTC must issue regulations regarding swap dealers ñin final form not later than 360 days from the date of enactment,ò which elapsed in July 2011, or more than seven years ago. See Title VIIð Wall Street Transparency and Accountability, Subtitle Að Regulation of Over-the-Counter Swaps Markets, Part Ið Regulatory Authority, Sec. 712(a)(3), Public Law 111ï 203, 124 Stat. 1376 (2010). If the current $3 billion de minimis threshold is permitted to take effect, the first swap dealer would not be required to register with the CFTC until January 1, 2020, or more than seven and half years after the industry was provided notice of the de minimis threshold and almost a decade after the passage of the Dodd-Frank Act.

8 See 7 U.S.C. 1a(49)(D) (stating that the CFTC ñshall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing in connection with transaction with or on behalf of its customersò).

regulatory framework. Final regulations based on the New De Minimis Proposal would be fatally flawed as a result.

The proposed exclusions are a solution in search of a problem. Indeed, they introduce many conceptual and procedural problems by rewritingð again, without sufficient noticeð the ñswap dealerò definitions through the de minimis threshold. Each also changes substantive aspects of the CFTCôs and SECôs ñswap dealerò definitions rulemaking, upsetting what is now well-settled guidance on the scope of swap dealing exclusions under the Dodd-Frank Act.

A. The CFTC's unilateral commencement of a rulemaking to implement hedging and other de minimis exclusions violates procedural requirements for joint rulemakings and interpretations under the Dodd-Frank Act.

The CFTC must commence even incremental rulemakings touching upon cornerstone definitional issues in accordance with procedural requirements, including those mandated by the Dodd-Frank Act. Section 712(d) of the Dodd-Frank Act instructs the CFTC and the SEC to issue joint rulemakings, in consultation with the Board of Governors of the Federal Reserve System (ñFederal Reserveò), to define terms critical to regulation of the derivatives markets, including the term ñswap dealer.ò[9] To prevent subsequent actions that could undermine the joint rulemaking process, Congress further provided that CFTC and SEC ñinterpretationsò or ñguidanceò relating to definitions subject to the joint rulemaking requirement shall be effective only if issued jointly as well,[10] and after consultation with the Federal Reserve.[11]

The CFTC claims, however, that ñ[a] joint rulemaking is not required with respect to changes to the de minimis exception-related factors,ò[12] because section 1a(49) of the Commodity Exchange Act (ñCEAò) instructs the CFTC alone to exempt entities engaged in a de minimis quantity of swap dealing from designation as a swap dealer (ñSDò).[13] That claim is invalid, and it would impermissibly enable the CFTC to conduct an end-run around the statutory joint rulemaking requirement. The de minimis dealing threshold is just thatð a dealing threshold. Even if statutory language could be construed to permit unilateral action on the de minimis dealing threshold itself (i.e., a specific ñquantity of swap dealingò[14] permitted without registration), that language logically and legally cannot be extended to permit unilateral regulatory actions affecting core definitional issues that must be accomplished through joint rulemaking. In short, the CFTC may not stretch its authority with respect to the de minimis threshold beyond reasonable

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9 See the Dodd-Frank Act, Public Law 111-203, Section 712(d), 124 Stat. 1376, 1644 (2010).

10 Congress provided that the agencies, in consultation with the Federal Reserve, shall further define the term ñswap dealerò in CEA section 1a(47)(A)(v) and unequivocally stated that ñ[a]ny interpretation of, or guidance by either Commission regarding, a provision of [Title VII], shall be effective only if issued jointly by the [CFTC] and the [SEC], after consultation with the Board of Governors . . . .ò

11 See Section 712(d)(4) of the Dodd-Frank Act.

12 See De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444, 27458, fn. 120 (June 12, 2018). See also Commodity Exchange Act Section 1a(49)(D).

13 7 U.S.C. 1a(49)(D). In addition, CEA section 1a(49)(D) instructs the CFTC alone to establish factors with respect to the making of the determination to exempt such entities from designation. See also Further Definition of ñSwap Dealer,ò ñSecurity-Based Swap Dealer,ò ñMajor Swap Participant,ò ñMajor Security-Based Swap Participantò and ñEligible Contract Participant;ò 77 Fed. Reg. 30634, fn. 464 (May 23, 2012).

14 See 7 U.S.C. 1a(49)(D) (stating that the CFTC ñshall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealingò).

bounds, especially to amend critical terms, such as ñswap dealer,ò without regard for statutorily required processes.

Moreover, although the CFTC states that it ñcontinues to coordinate with the SEC on SD and security-based swap regulations,ò it apparently did not do so specifically with respect to the provisions of the proposal. Indeed, unlike the CFTCôs final release adopting the de minimis threshold,[15] the New De Minimis Proposal does not describe the consultation process at all. Instead, it appears the CFTC commenced the New De Minimis Proposal in a regulatory vacuum, ignoring the Congressional requirement that it pursue regulatory harmonization to the extent appropriate through consultation with other financial regulators.[16]

The most revealing demonstration of the CFTCôs intent to revise the SD definition itself is its revision of the facts-and-circumstances analysis for distinguishing hedging from dealing.[17] The CFTC contends that the New De Minimis Proposal is not subject to procedural requirements applicable to revisions of the SD definitions rulemaking, because, it claims, the ñthe Hedging De Minimis Provision does not revise the scope of activity that constitutes swap dealing.ò[18] That is untrue. The proposed exclusion from the de minimis threshold, and financial hedging in that context specifically, is relevant only to SD registration. It is also contrary to the dealer-trader distinction framework intended to provide guidance on swap-related activities that constitute dealing.[19] However, as is well known and recognized, hedging activities relating to risks arising from dealing properly constitute dealing activities themselves and therefore cannot be excluded from SD registration thresholds. To technically confirm that conclusion, while effecting a reversal of its regulatory implications, as the CFTC does, is conceptually misguided, inconsistent with common understanding and practice, and untenable as an unauthorized, de facto revision of the SD definitions rulemaking.

In other words, the New De Minimis Proposal has a clear definitional objectiveð to expand dealing exclusions for hedging and other types of swaps. It is those definitional ends and effects that are dispositive of the procedural requirements for rulemaking, not the means for achieving them. The CFTCôs conclusory

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15 The CFTC and SEC noted in the very first sentence in the final release jointly defining and interpreting the term ñswap dealerò that the commissions were adopting rules and interpretive guidance ñin consultation with the Board of Governors of the Federal Reserve System.ò Further Definition of ñSwap Dealer,ò ñSecurity-Based Swap Dealer,ò ñMajor Swap Participant,ò ñMajor Security-Based Swap Participantò and ñEligible Contract Participant;ò 77 Fed. Reg. 30596 (May 23, 2012). In contrast, the CFTC did not describe any effort to jointly adopt or coordinate the New De Minimis Proposal with the SEC or Federal Reserve.

16 Congress provided that regulations adopted jointly must be ñcomparable to the maximum extent possible, taking into consideration differences in instruments and in the applicable statutory requirements.ò Section 712(d)(2)(D) of the Dodd-Frank Act. Moreover, ñ[b]efore commencing any rulemakingò regarding swap dealers more generally, the CFTC must ñconsult and coordinate to the extent possibleò with the SEC and the prudential regulators ñfor the purposes of assuring regulatory consistency and comparability.ò Section 712(a) of the Dodd-Frank Act.

17 Further Definition of ñSwap Dealer,ò ñSecurity-Based Swap Dealer,ò ñMajor Swap Participant,ò ñMajor Security-Based Swap Participantò and ñEligible Contract Participant;ò 77 Fed. Reg. 30596, 30608 (May 23, 2012) (stating ñunder the interpretive approach to the definition of both the terms ñswap dealerò and ñsecurity-based swap dealer,ò whether a person is acting as a dealer will turn upon the relevant facts and circumstances, as informed by the interpretive guidance set forth in this Adopting Releaseò).

18 Id. at 27462.

19 See the extensive discussion of this conclusion below, based on interpretive language in the preamble to the CFTC and SECôs joint SD definition rulemaking. Further Definition of ñSwap Dealer,ò ñSecurity-Based Swap Dealer,ò ñMajor Swap Participant,ò ñMajor Security-Based Swap Participantò and ñEligible Contract Participant;ò 77 Fed. Reg. 30596 (May 23, 2012).

assertions about its unilateral <u>de</u> <u>minimis</u> authority, recited in two footnotes,[20] cannot nullify the more specific statutory directives for joint rulemaking provided in section 712 and other provisions of the Dodd-Frank Act. In short, the CFTCôs unilateral <u>de</u> <u>minimis</u> authority has specific statutory limits, and the CFTC cannot invoke or rely upon that authority to effect a <u>de</u> <u>facto</u> amendment to the SD definition, which requires joint rulemaking.

B. The New <u>De</u> <u>Minimis</u> Proposal impermissibly expands swap dealing exclusions beyond the plain meaning and legislative intent of the Dodd-Frank.

The New <u>De</u> <u>Minimis</u> Proposal is contrary to the purposes of the Dodd-Frank Act and inconsistent with existing regulations and interpretations. In addition, swaps executed to hedge risk exposures from dealing swaps are inextricably tied to market-making activities and revenues, as evidenced in securities disclosures, and therefore must constitute **dealing** swaps.

1. The New <u>De</u> <u>Minimis</u> Proposal's hedging exclusion is unnecessary, permits hedging-related swap dealing to be excluded from SD registration thresholds, and is inconsistent with existing regulations and interpretations.

The New <u>De</u> <u>Minimis</u> Proposal excludes from the <u>de</u> <u>minimis</u> threshold swaps used to hedge financial and physical risks, which, the CFTC argues in part, may better ensure end-users have access to liquidity from unregistered swap dealers.[21] Promoting unregulated swap dealing, however, is not a valid statutory objective. Congress named Title VII of the Dodd-Frank Act, the ñWall Street Transparency and Accountability Act,ò[22] and more generally, provided that the purpose of the Dodd-Frank Act was to ñimprov[e] accountability in the financial systemò and ñprotect consumers from abusive financial services practices.ò[23] The swap dealer registration framework is a critical means for achieving those objectives. It is hard to understand how the CFTCôs use of discretion to exempt swap dealing entities from its oversight can be reasonably viewed as consistent with the goals of promoting transparency, accountability, and consumer protection, in particular as business conduct regulations are applicable solely to registered swap dealers.[24]

Moreover, the CFTCôs rationale for a more explicit regulatory exclusion for the benefit of end-users is baseless and contradictory. The final SD definition resulted in provisional registration of SDs more

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[20] <u>See</u> <u>Id.</u> at 27448 (stating ña joint rulemaking is not required with respect to the de minimis exception factors,ò a conclusion irrelevant to whether finalized changes to the SD definition can be effected through the de minimis exception). <u>See</u> <u>also</u> <u>Id.</u> at 27445, fn. 13 (stating that ña joint rulemaking with the SEC is not required to amend the de minimis, pursuant to paragraph (4)(v) of the SD Definitionò).

[21] <u>See</u> De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444, 27476 (June 12, 2018) (stating, for example, ñ[w]ith respect to the Hedging De Minimis Provision, market liquidity may improve as entities would be able to execute hedging swaps knowing that the swaps would not necessarily constitute swap dealing that counts towards the de minimis thresholdò).

[22] <u>See</u> Public Law 111ï203, 124 Stat. 1376 (2010).

[23] <u>Id.</u>

[24] The New <u>De</u> <u>Minimis</u> Proposal also is inconsistent with the CEAôs other purposes, which include the following: (1) to deter and prevent disruptions to market integrity; (2) to ensure the financial integrity of swap-related activities and the avoidance of systemic risk; (3) to protect against fraudulent or abusive sales practices and misuses of customer assets; and (4) to promote responsible innovation and fair competition among market participants. Because the CFTC emphasizes that the proposal may encourage competition between registered and unregistered swap dealers, we note, here, that competition between regulated swap dealing entities and unregulated swap dealing entities, each engaging in activities that are functionally identical, actually encourages unfair competition, in addition to impeding the other CEA objectives. <u>See</u> 7 U.S.C. 5(b).

than six years ago; any disincentive to continued participation in the markets on account of SD registration ambiguities or concerns would have required an end to ancillary dealing as part of the 12-month rolling de minimis calculation beginning in October 2012.[25] In addition, existing regulations and interpretations already provide a detailed and well-settled framework for distinguishing swap dealing from other types of hedging activities. A facts-and-circumstances analysis within the dealer-trader distinction framework excludes from swap dealing, for example, those swaps executed solely to manage price risks on a commodity essential to a companiesô commercial operations, currency risks relating to a companiesô overseas sales, and interest rate risks on a companiesô own debt instruments.[26] The CFTC nevertheless tries to have it both ways, suggesting at times that it intends merely to codify the types of activities that are already eligible for exclusion from swap dealing[27] and suggesting at other times that it intends the new exclusions to encourage competition.[28]

Furthermore, revealing the CFTCôs actual intent in the New De Minimis Proposal, the de minimis hedging exclusion goes far beyond an incidental dealing exclusion and invites reliance even by entities regularly engaged in hedging inextricably tied to swap dealing. Although the CFTC introduces conditions to constrain reliance on the de minimis hedging exclusion, the conditions themselves introduce the type of interpretive uncertainty that the CFTC claims the proposal is intended to resolve. Thus, although Better Markets would applaud any clarifications that would have the effect of ensuring market-making and similar dealing activities are included in de minimis thresholds, we note that the proposed conditions have not been appropriately drafted to ensure that this will be the realized effect.

Indeed, the New De Minimis Proposal is almost certain to have the opposite effect. The conditions proposed on use of the de minimis hedging exclusion will be interpreted by an army of highly compensated industry lawyers to permit the exclusion from SD registration analyses even those swaps intended to hedge specific risks arising from swap dealing activities. Consider the ambiguous and malleable language purportedly restricting reliance on the de minimis hedging exclusion:

> . . . (1) The person is entering into the swap for the primary purpose of reducing or otherwise mitigating one or more specific risks for the person, which includes, without limitation, market risk, price risk, rate risk, basis risk, credit risk, volatility risk, foreign exchange risk, liquidity risk, or similar risks arising in connection with existing or anticipated identifiable assets, liabilities, positions, contracts, or other holdings of the person or any affiliate of the person; (2) For that swap, the person is not the price maker and does not receive or earn a bid/ask spread, fee, commission, or other compensation for entering into the swap; (3) The swap is economically appropriate to the reduction of risks that may arise in the conduct and management of an enterprise engaged in the type of business in which the person is engaged; (4) The swap is entered into in accordance with sound business

[25] See Frequently Asked Questions (FAQ) ï Division of Swap Dealer and Intermediary Oversight (ñòDSIOò) Responds to FAQs About Swap Entities, available at https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf (noting that ñ[w]ith the swap definition final rulemakingôs October 12, 2012 effective date, all swaps entered into by a person after October 12th in connection with the personôs swap dealing activities are relevant in determining whether the person is within the swap dealer definitionò).

[26] The key characteristic for distinguishing such excluded hedging activities from swap dealing under current law is that they are not in any way related to accommodating the demand of others and do not involve profits derived from intermediation.

[27] See, e.g., De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444, 27463 (June 12, 2018) (incorrectly asserting that ñ[t]he proposed Hedging De Minimis Provision is consistent with the CFTCôs position in the SD Definition Adopting Releaseò).

[28] Id. (stating, for example, ñmarket liquidity may improve as entities would be able to execute hedging swaps knowing that the swaps would not necessarily constitute swap dealing . . .ò).

> practices; and (5) The person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.[29]

This language yields the inescapable conclusion that hedging swaps intended to address risks arising from swap dealing activities would qualify for exclusion from the de minimis threshold. Most concerning, even CFTC-registered SDs, including subsidiaries of U.S. bank holding companies, would be permitted to conduct additional swap dealing activities through unregistered affiliates.

The conditional language, at first glance, appears to resemble the CFTCȭs swap dealing exclusion for hedging physical positions, drawing on principles long applied to bona fide hedging exemptions in the position limits context.[30] However, a closer examination reveals that the CFTC carefully replaced language used to confine the effect of these other hedging provisions. For example, in condition (3) above, the hedging swap must be economically appropriate to the reduction of risks that may arise in the Ȱconductandmanagementofanenterpriseengagedinthetypeofbusinessinwhichthepersonisengaged.ȱ[31] This tautological condition generally mirrors language from the CFTCȭs physical hedge exclusion from de minimis calculations, which provides that, among other things, an excluded swap must be economically appropriate to the reduction of the personȭs risks in the Ȱconduct and management of a commercial enterprise.ȱ[32] The effect of that seemingly minor substitution should be unmistakably clear: Financial and other institutions would be able to rely upon the new de minimis hedging exclusion even for transactions hedging risks arising from swap dealing businesses. That, of course, would be contrary to the plain language of the activities-based Ȱswap dealerȱ definition[33] and the CFTCȭs purported intent in proposing the de minimis hedging exclusion.

Better Markets also notes the CFTCȭs determination to permit hedging of Ȱexisting or anticipatedȱ liabilities incurred by affiliates and to limit the price maker and compensation criteria to the hedging swap alone (i.e., Ȱthat swapȱ).[34] In a one-to-one world, where hedging activities occur immediately upon the completion of a directional position, the effectiveness of such a hedge can be more readily identified and monitored. In modern banking and commercial energy operations, however, institutions have adopted portfolio hedging strategies that attempt to mitigate risks arising from pools of related positions. The New De Minimis Proposal, by failing to impose meaningful conditions on the hedging exclusion, would likely

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[29] See proposed (4)(i)(D), 83 Fed. Reg. 27479 (June 12, 2018) (emphasis added). See also Id. at 27463.

[30] Id. at 30612 (stating that Ȱthe CFTC believes it is appropriate to adopt an interim final rule that draws upon the principles of bona fide hedging that the CFTC has long applied to identify when a financial instrument is used for hedging purposes, and excludes from the swap dealer analysis swaps entered into for the purpose of hedging physical positions that meet the requirements of the ruleȱ).

[31] Id, at 2749.

[32] See Regulation 1.3(ggg)(6)(iii).

[33] The CEA defines the term "swap dealerȱ to include any person involved in the following swap-related activities: (1) holding oneself out as a dealer; (2) making a market; (3) regularly entering into counterparty transactions as an ordinary course of business for its own account; or (4) engaging in any activity causing the person to be commonly known in the trade as a dealer or market maker. 7 U.S.C. 1a(49).

[34] Building an exclusion on the fiction of the one-to-one hedge in which the SD is the price maker on a client-facing trade, as dealer, and separately hedges that risk, permits the SD to contend it is not a price maker on the interdealer trade, potentially excluding much of the interdealer market from de minimis calculations. In addition, we note a drafting error. The de minimis hedging exclusion permits swaps entered into for the purpose of hedging to be excluded from the SD registration analysis, Ȱsubject to conditions in paragraphs (4)(i)(D)(1) through (4)(i)(D)(6) of [the proposed] definition.ȱ See proposed (4)(i)(D), 83 Fed. Reg. 27479 (June 12, 2018). There is no proposed (4)(i)(D)(6) in the published version of the New De Minimis Proposal.

permit institutions to build substantial derivatives positionsð ostensibly to manage risks relating to existing assets or dealing portfoliosð and to label, and perhaps mischaracterize, those transactions as ñhedgesò after the fact. This is precisely what J.P. Morgan Chase & Co. did in connection with multi-billion dollar losses on its synthetic credit portfolio.[35]

Moreover, by including ñanticipated liabilitiesò in condition (1) above, the CFTC may invite institutions to ñpre-hedgeò anticipated dealing risks by putting on hedging positions before there is anything to hedge.[36] That leaves too much to institutional judgment. From a practical perspective, the CFTCôs supervision of the de minimis hedging exclusion will continue to prove difficult and inevitably lead to undetected industry misconduct, in particular as unregistered swap dealing entities are not required to submit to U.S. regulators analyses, metrics, policies, or procedures relating to de minimis calculations and hedging practices.[37] Pre-hedging activities also carry significant risks of front-running, especially in the absence of an SD examinations program to scrutinize order entry and position information controls. Thus, the CFTCôs facilitation of unregulated pre-hedging in connection with swap dealing activities, apparently based on the incorrect and unsupported assertion that it is a ñnecessaryò and separable element of risk-management, is inadvisable.

Finally, the New De Minimis Proposal fails to restrict reliance on the de minimis hedging exclusion even by financial institutions openly engaged in swap dealing activities, where the spread, compensation, and price making in connection with a hedging swap, or series of hedging swaps, frequently arises from a combination of interdealer and other market transactions. If history is any guide, it would not be long before an ISDA protocol[38] facilitates the exchange of representations that each counterparty in the interdealer market is neither the ñprice makerò nor the recipient of ñcompensationò within the meaning of the CFTCôs proposed regulations, at least for hedging swaps between the adhering counterparties. The

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35 See JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses, Majority and Minority Staff Report, Permanent Subcommittee on Investigations, United States Senate, available at https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20JPMorgan%20Chase%20Whale%20Trades%20(4-12-13).pdf (finding, among other things, that J.P. Morgan Chase & Co. mischaracterized high risk trading as hedging, claimed at times that its synthetic credit portfolio (ñSCPò) functioned as a hedge against bank credit risks, and ñfailed to identify the assets or portfolios being hedged, test the size and effectiveness of the alleged hedging activity, or show how SCP lowered rather than increased bank riskò).

36 This apparently continues to be permitted despite at least one U.S. court finding the practice tantamount to front-running. See Former Global Head of HSBCôs Foreign Exchange Cash Trading Found Guilty of Orchestrating Multimillion-Dollar Front-Running Scheme, U.S. Department of Justice (Oct. 23, 2017), available at https://www.justice.gov/opa/pr/former-global-head-hsbcs-foreign-exchange-cash-trading-found-guilty-orchestrating. See also, e.g., HSBC, Information about HSBCôs Foreign Exchange and Metals Terms of Dealing, available at https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=8&ved=2ahUKEwjakc3W9-XcAhWvslkKHV_3D9UQFjAHegQIAxAC&url=https%3A%2F%2Fwww.business.hsbc.com.kw%2F-%2Fmedia%2Flibrary%2Fcommon%2Fmena%2Fpdf%2Ffx-terms-of-dealing.pdf%3Fla%3Den-GB&usg=AOvVaw3rUoHwuqNwVHEehr7NDbai (stating that ñ[w]here a client indicates interest in a potential transaction, provides a request for quote or leaves an order, HSBC may use that information to engage in Pre-Hedging activities by dealing as principal with a view to facilitate a potential transactionò and disclosing that ñ[a]ny such Pre-Hedging transactions could be at different prices from the price at which HSBC transacts with a client, may affect the market price or liquidity, and may result in a profit or loss to HSBCò).

37 Although a somewhat narrower point, Better Markets recommends that SD CCO annual reports be required to include de minimis reporting of the aggregate calculation across each SDôs unregistered affiliates, thereby ensuring that provisionally registered SDs, at least, are required to monitor compliance with the threshold and certify reported calculations as to their ñaccuracyò and ñcompleteness.ò See CEA section 3.3(f)(3) (stating that ñ[t]he report shall include a certification by the chief compliance officer or chief executive officer of the registrant that, to the best of his or her knowledge and reasonable belief, and under penalty of law, the information contained in the annual report is accurate and completeò).

38 For more information on the Dodd-Frank Act protocols instituted by the International Swaps and Derivatives Association, Inc. (ñISDAò), see https://www.isda.org/protocols/.

CFTC therefore is incorrect in stating that the hedging swap limitations will ñnot improperly exclude swap dealing activityò from the de minimis threshold.[39] Indeed, based on CFTCôs proposed language, we find it doubtful that the de minimis hedging exclusion would restrict swap-dealing-related hedging activities at all:

> When the person is not the price maker of the hedging swap, or otherwise receiving compensation, the person is not accommodating the needs of a counterparty, such swap is generally not swap dealing activity, and therefore should not be counted for purposes of the de minimis exception.[40]

The CFTCôs above assertion is incorrect in several respects. First, the hedging element of an SDôs portfolio is inextricably tied to its accommodation of the needs of its counterpartiesand therefore constitutes an extension of client-facing swap dealing activities. The profit and loss generated on client-facing activities, moreover, frequently is judged relative to interdealer hedging costs, including costs of hedging specific risk sensitivities in a portfolio of client transactionsð separate and apart from individual client-facing trades. The hedging element of client-facing dealing trades, in reality, cannot be conceptually or practically separated from the risk-taking element of dealing. In other words, hedging is a fundamental element of dealing.

Perhaps most concerning, however, the CFTC appears to have mischaracterized or misunderstood its own interpretations with respect to the regulatory treatment of hedging swaps in connection with swap dealing activities. The New De Minimis Proposal notes the following, for example, which is inconsistent with the CFTCôs final ñswap dealerò definition release and the SECôs cognate interpretations of hedging transactions relating to security-based swap dealing transactions:

> The SD Definition Adopting Release also states that, generally, swaps that hedge positions that were entered into as part of swap dealing activity would also not need to be counted towards a personôs de minimis threshold calculation if they meet the requirements of the proposed exception. The proposed Hedging De Minimis Provision is consistent with the CFTCôs position in the SD Definition Adopting Release.[41]

Those statements are incorrect. The CFTC did not state that hedging positions that were entered into as ñpart of swap dealing activityò would not be counted towards the de minimis threshold, and the CFTC cites to no such language supporting that categorical conclusion. In addition, the New De Minimis Proposal is not consistent with what the CFTC did, in fact, state with respect to hedging activities relating to dealing. This mischaracterization understates, if not obscures, the importance of policy changes sought in the New De Minimis Proposal.

Indeed, the SEC and CFTC previously and sensibly indicated the exact opposite, that hedging constitutes an inextricable element of dealing activities and therefore must be counted for de minimis purposes. Consider the agenciesô own characterization of the hedging issue in the final SD definition release:

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39 De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444, 27463 (June 12, 2018).

40 Id. at 27463.

41 Id.

> ñ. . . the exclusion from the swap dealer analysis of swaps hedging physical positions . . . is similar to the [other] exclusions . . . However, to the extent a person engages in dealing activities involving swaps, <u>the presence of offsetting positions that hedge those dealing activities would not excuse the requirement that the person register as a swap dealer</u>.[42]

In contrasting the hedging of swap dealing from other types of hedging activities that would be excluded more definitively from swap dealing calculations, the CFTCôs clear intent was to clarify that offsetting positions, depending on facts and circumstances, may constitute swap dealing activities within the dealer-trader distinction framework. In addition, the CFTC intended to clarify offsetting positions do not in any way affect the characterization of the dealing swaps that they are intended to hedge.

Moreover, the agencies stated the following as word of caution in light of the practical challenges of distinguishing hedging from dealing:

> While we recognize that a rule delineating the swap activities that do not constitute swap dealing would simplify and make more certain, at least in some contexts, the application of the swap dealer definition, <u>there are also reasons for caution in incorporating a categorical exclusion for hedging</u>.[43]

In other words, directly contrary to what the CFTC states in the New <u>De</u> <u>Minimis</u> Proposal, the CFTC and SEC make no such categorical statement that ñswaps that hedge positions that were entered into as part of swap dealing activity would also not need to be counted towards a personôs de minimis threshold calculation.ò To the contrary, a number of statements by the agencies make abundantly clear that such swaps are <u>not</u> categorically excluded.

The CFTC and SEC also address this principle in addressing the scope of dealing in the context of the substantially similar statutory definition of security-based swap dealer:[44]

> . . . To the extent that a person engages in security-based swap activity to hedge commercial risk, or otherwise to hedge risks <u>unrelated to activities that constitute dealing</u> under the dealer-trader distinction (particularly <u>activities that have the business purpose of seeking to profit by providing liquidity</u> . . . the Commissions would not expect those hedging transactions to lead a person to be a security-based swap dealer. Of course, to the extent a person engages in dealing activities involving security-based swaps, <u>the presence of offsetting positions that hedge those dealing activities would not excuse the requirement that the person register</u> . . . [Moreover,] if a person were to use other instruments to hedge the risks associated with its security-based swap dealing activity, that hedging would not undermine the obligation of the person to register as a security-based swap dealer,

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42 Further Definition of ñSwap Dealer,ò ñSecurity-Based Swap Dealer,ò ñMajor Swap Participant,ò ñMajor Security-Based Swap Participantò and ñEligible Contract Participant;ò 77 Fed. Reg. 30634, 30612, fn. 220 (May 23, 2012).

43 <u>Id.</u> at 30613, fn. 223 (May 23, 2012). <u>See</u> <u>also</u> <u>id.</u> at 30613, fn. 232 (ñ. . . in practice, the difficulty of distinguishing, in applying the swap dealer definition, swaps entered into for the purpose of hedging from other types of swaps will be resolvable when the facts and circumstances of a personôs swap activities are taken into consideration in light of our interpretive guidanceò).

44 <u>See</u> <u>id.</u> at 30606 (providing that ñ[b]ecause the definitions of the terms ñswap dealerò in the CEA and ñsecurity-based swap dealerò in the Exchange Act are substantially similar, the rules further defining those terms and the accompanying interpretations in this Adopting Release reflect common underlying principlesò).

> notwithstanding the fact that it could be asserted that the dealing positions happen to hedge those other positions.[45]

Thus, again, it is clear that the New De Minimis Proposal misrepresents the views of the commissions with respect to the hedging of dealing swaps under existing law.

Finally, the CFTCôs Division of Swap Dealer and Intermediary Oversight (ñDSIOò) issued clarifications squarely addressing the hedging of dealing swaps in a Frequently Asked Questions (ñFAQò) document published shortly after adoption of the final SD definition regulation.[46] In the FAQ, as in the preamble to the final SD definition regulation, DSIO states that hedging activities arising from swap dealing activities must be considered as part of the facts-and-circumstances analysis under the dealer-trader distinction framework.[47] Consider the following statement that most directly contradicts the CFTCôs statements on the consistency of its New De Minimis Proposal with the final SD definition release:

> Is hedging activity included in calculating the de minimis amount for swap dealers?
>
> Depending on the circumstances, hedging activity may be included in the de minimis amount calculations. As stated in the Adopting Release, the relevant question in determining whether swaps count as dealing activity against the de minimis thresholds is whether the swaps fall within the swap dealer definition under the statute and the final rules, as further interpreted by the Adopting Release. In other words, a person must consider the swap in light of all other relevant facts and circumstances to determine whether such hedging activity is swap dealing activity (e.g., accommodating demand for swaps, making a market for swaps, etc.).[48]

Departing from this prudent reluctance to exclude dealing-related hedging from the SD registration analysis, the CFTC now proposes to permit only a portion of the dealing equation to count and misconstrues the nature of the swap dealing business. The CFTC and SEC already permit $8 billion of swap dealing activities under the de minimis threshold, and already exclude confined hedging activities from the SD de minimis calculation, despite the absence of hedging exclusions in CEA section 1a(49) and their notable inclusion in the substantial position analysis relating to major swap participant.[49] To further permit interdealer trading to be excluded from that threshold allows the de minimis exception to swallow the rule.

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45 Id. at 30619, fn. 280 (May 23, 2012).

46 See Frequently Asked Questions (FAQ) ï Division of Swap Dealer and Intermediary Oversight (ñòDSIOò) Responds to FAQs About Swap Entities, available at https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf (also providing, for example, that ñ[d]epending on the circumstances, a back-to-back swap entered into for hedging purposes may be included in the de minimis calculationò).

47 Id.

48 Id. at 1-2.

49 7 U.S.C. 1a(33) (stating that major swap participants may exclude from their substantial position analysis ñpositions held for hedging or mitigating commercial riskò).

2. Swaps executed to hedge risk exposures from dealing swaps are inextricably tied to market-making activities and constitute dealing swaps, as acknowledged in other contexts by SDs themselves.

The CFTCôs expansion of the de minimis exclusions to include dealing swaps is based on a fiction that swaps executed to hedge risk exposures arising from dealing swaps can be readily distinguished from swaps arising from client-facing activities. That is incorrect, but it is not necessary to take our word for it. Consider the J.P. Morgan Chase & Co.ôs (ñJPMorganò) Form 10-K, containing the following description of derivatives market-making activities:

> Market-making derivatives
>
> The majority of the Firmôs derivatives are entered into for market-making purposes. Clients use derivatives to mitigate or modify interest rate, credit, foreign exchange, equity and commodity risks. The Firm actively manages the risks from its exposure to these derivatives by entering into other derivative transactions or by purchasing or selling other financial instruments that partially or fully offset the exposure from client derivatives.[50]

JPMorganôs own description of market-making, in a highly scrutinized securities filing with substantial financial consequences for material misstatements of fact, includes as part of its description of market-making those hedging transactions that, in its words, ñpartially or fully offset the exposure from client derivatives.ò[51]

Moreover, for accounting purposes, JPMorgan differentiates between ñgains and losses on derivatives used for specific [internal] risk management purposesò and those arising from risk-mitigating activities in connection with market-making, which are treated as profit-and-loss in the market-making businesses. In this regard, JPMorgan notes the following in connection with its gains and losses from derivatives relating to market-making activities:

> Gains and losses on derivatives related to market-making activities and other derivatives
>
> The Firm makes markets in derivatives in order to meet the needs of customers and uses derivatives to manage certain risks associated with net open risk positions from its market-making activities, including the counterparty credit risk arising from derivative receivables. All derivatives not included in the hedge accounting or specified risk management categories above are included in this [market-making] category. Gains and losses on these derivatives are primarily recorded in principal transactions revenue.[52]

In addition, the notes to the *Gains and Losses on derivatives used for specific risk management purposes* tellingly states the following:

[50] JPMorgan Chase & Co., Form 10-K, Fiscal Year ended December 31, 2017, Note 5 ï Derivative instruments, 179, available at http://files.shareholder.com/downloads/ONE/5970536725x0xS19617-18-57/19617/filing.pdf.

[51] Id.

[52] Id. at 189, Notes to consolidated financial statements (emphasis added).

> These derivatives do not include credit derivatives used to mitigate counterparty credit risk arising from derivative receivables, which is included in gains and losses on derivatives related to market-making activities and other derivatives.[53]

This language is typical among all major swap dealers, leading to only one conclusion: SDs are well aware that market-making activities include derivatives activities used to hedge swaps executed to accommodate counterparty demand.

The Goldman Sachs Group, Inc.ôs (ñGoldmanò) Form 10-K confirms challenges of differentiating between client-facing and hedging swaps as part of market making. Consider Goldmanôs statement in its *Market Making Activities* section from its Form 10-K as follows:

> Our [market-making] results are influenced by a combination of interconnected drivers, including (i) client activity levels and transactional bid/offer spreads (collectively, client activity), and (ii) changes in the fair value of our inventory and interest income and interest expense related to the holding, hedging and funding of our inventory (collectively, marketmaking inventory changes). Due to the integrated nature of our market-making activities, disaggregation of net revenues into client activity and market-making inventory changes is judgmental and has inherent complexities and limitations.[54]

We note that Goldman emphasizes that ñinterconnected [market-making revenue] drivers,ò including spreads on ñclient activityò and changes in the value of hedging-related positions, are ñintegratedò and not easily ñdisaggregatedò for purposes of differentiating between components of its market-making businesses.[55] Consider, too, Goldmanôs descriptions of the revenue attribution and accounting for the hedging of market-making positions:

> Risk Management. The firm also enters into derivatives to actively manage risk exposures that arise from its marketmaking and investing and lending activities in derivative and cash instruments. The firmôs holdings and exposures are hedged, in many cases, on either a portfolio or risk specific basis, as opposed to an instrument-by-instrument basis. The offsetting impact of this economic hedging is reflected in the same business segment as the related revenues.[56]

Note that Goldman states that the ñoffsetting impact of this economic hedging is reflected in the same business segment as the related revenues,ò meaning that revenue attribution for market-making activities is intended to be net of, and inextricable linked to, the costs of hedging the dealing transactions themselves. This is yet another description of swap dealing from a sophisticated market participant explaining, in a highly scrutinized securities disclosure, that the distinctions between dealing swaps and the hedging of dealing swaps are mostly artificial.

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53 Id. (emphasis added).

54 The Goldman Sachs Group, Inc., Form 10-K, Fiscal Year ended December 31, 2017, Management Discussion and Analysis, Market-Making Activities, 58, https://www.goldmansachs.com/investor-relations/financials/current/10k/2017-10-k.pdf.

55 Id.

56 Id. at 126, Notes to Consolidated Financial Statements.

In short, far from being distinct from market-making, swaps executed to hedge pre-existing or anticipated swap dealing risks are, in fact, a fundamental attribute of market-making, as the CFTC itself has long recognized.

II. The CFTC should have established an informal adjudicatory process that accounts for the public interest and reasonably relies upon representations concerning each legal entity's swap-related activities.

The New De Minimis Proposal, in several respects, is based on a fundamental misunderstanding of the CEAôs activities-based registration requirement.[57] The CEA defines the term "swap dealerò to include any person involved in the following swap-related activities: (1) holding oneself out as a dealer; (2) making a market; (3) regularly entering into counterparty transactions as an ordinary course of business for its own account; or (4) engaging in any activity causing the person to be commonly known in the trade as a dealer or market maker.[58] However, CEA section 1a(49)(D) also instructs the CFTC to (1) exempt from designation as an SD any legal entity that engages in a de minimis quantity of swap dealing in connection with customer transactions; and (2) issue final regulations to establish factors for making a ñdetermination to exemptò such legal entities from SD registration.[59]

The structure of CEA 1a(49)(D) is noteworthy in setting forth separate directives to exempt swap dealing entities involved in de minimis dealing activities and to establish, by regulation, factors for determining whether to exempt specific entities from registration. Consider the Dodd-Frank Actôs specific language relating to the de minimis exemption:

> DE MINIMIS EXCEPTION. ð The Commission shall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers. The Commission shall promulgate regulations to establish factors with respect to the making of this determination to exempt.[60]

The CFTC historically reads these provisions to require a rulemaking that exempts any entities involved in less than a threshold amount of swap dealing. In our view, a correct reading of these two separate ñshallò statements is that they authorize the CFTC to issue exemptive orders for individual or similarly situated legal entities based upon generally applicable factors for determining whether such entities may be involved in de minimis swap dealing activities. It is unreasonable to conclude, as the CFTC apparently has, that Congress intended the CFTC to exempt a speculative number of persons involved in swap dealing activities through a blunt, wholesale exemption from registration that is divorced from the particular circumstances of any one petitioner. If Congress had intended that outcome, it would have and could easily have done so directly and clearly, rather than by the especially tortured means the CFTC seems to think it did. That is to say, the CFTC would not need a rulemaking to establish ñfactorsò with respect to its ñdeterminations to exemptò entities from SD designation (as expressly required by the statute) if the determination to exempt would be made by rulemaking in the first instance.

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57 7 U.S.C. 1a(49).

58 7 U.S.C. 1a(49)(A)(i)-(iv).

59 7 U.S.C. 1a(49)(D).

60 Id.

From a policy perspective, there are a number of benefits to the CFTC proceeding with an informal adjudicatory process. First, the CFTCôs exemptive authority requires a public interest finding that would, by necessity, include consideration of improvements to counterparty protections, financial stability, and market integrity, among other public interest objectives, as the basis for any exercise of the CFTCôs discretionary authority. In addition, as an informal adjudicatory process, the CFTCôs use of orders for individual or similarly situated entities would require the agency to exempt de minimis swap dealing based on petitioner representations on specific, rather than abstract or theoretical, swap dealing activities. Deviations from those representations, and violations of any other condition(s), would invalidate the petitionerôs reliance on the exemption.

The exemptive process also would avoid many of the methodological challenges in the New De Minimis Proposal, because it better ensures that the CFTC has a sufficiently informed basis to act incrementally on specific, narrow issues presented in petitions. Given the CFTCôs acknowledgement that swap data reporting makes calibration of the de minimis threshold an imprecise exercise, we view informal adjudication as superior to the flawed, incomplete, and frequently irrelevant aggregate data sets that serve as a poor proxy for information that the CFTC should be most interested in considering for SD registration purposes.[61]

III. The SD registration requirement requires consideration of swap dealing activities, not risk measures, in determining whether a swap dealing entity is required to register as a swap dealer.

Nevertheless, the New De Minimis Proposal proceeds on the basis that CEA section 1a(49) requires the CFTC to provide a blanket exemption for entities engaged in a de minimis quantity of swap dealing activities. Although the statutory structure does not support that interpretation, the de minimis exemption under any faithful reading of CEA section 1a(49) at least must require consideration of the quantity of swap dealing, not net exposures or other irrelevant risk-based measures. In addition, the language in the supposed exemptive mandateð de minimisð must be construed in a manner that is faithful to Congressô intent that the quantity of exempted swap dealing activities be minimal. That concept has intuitive boundaries that can be drawn far short of billions of dollars and thousands of transactions by unregulated entities.

The CFTC requests comment on the use of entity netted notional amounts as a replacement or supplement for gross notional activities in the SD registration analysis and as a risk-based measure for other regulatory purposes (e.g., thresholds relevant to clearing, margining, trading, reporting, and capital). It is not surprising, therefore, that industry commenters have seized the opportunity to support reconsideration of the use of notional amounts across the Dodd-Frank regulatory framework. That effort preceded the New De Minimis Proposal. The International Swaps and Derivatives Association, Inc. (ñISDAò), for example, published a research note in May 2018 regarding the ñUses of Notional Amount in Derivatives Regulation.ò[62] In its paper, ISDA noted the following with respect to the use of notional amounts in financial reforms adopted in the aftermath of the 2008 banking crisis:

> In implementing the G-20 reforms, regulators have relied heavily on notional amount outstanding as a measure to curtail derivatives risk. For example, under CFTC rules, entities have to register as

[61] For more discussion in this regard, please see section IV.

[62] See ISDA Research Note, Uses of Notional Amount in Derivatives Regulation (May 2018), available at https://www.isda.org/a/1trEE/Notional-Based-Regs.pdf.

> swap dealers and so comply with a variety of requirements if their aggregate gross notional amount of swaps over the prior 12 months is above $8 billion.
>
> While notional amount is helpful in understanding the extent of trading activity, it is not a measure of risk . . . There is now growing recognition of the value of a risk-based regulatory framework, in which regulatory and prudential supervisory requirements and mandates hinge on risk exposures and not on arbitrary and/or non-risk-based metrics and thresholds.

The de minimis threshold appears to be the test case for a much broader industry initiative to emphasize net exposures, and not activities, for regulatory purposes, interestingly while ISDA acknowledges that notional amounts are ñhelpfulò in understanding ñthe extent of trading activity.ò[63]

The CFTC evinces an interest in reconsidering the Dodd-Frank Actôs required activities-based analysis for swap dealer registration as well. It explicitly notes that it is aware of ñpotential viable alternative metricsò to gross notional measures for SD registration, for example, and ñremains open to the possibility of relying on a different approach in the future, such as a threshold based on entity-netted notional amounts or other risk metrics, including . . . initial margin, open positions, material swaps exposure, net current credit exposure, gross negative or positive fair value, potential future exposure, value-at-risk, or expected shortfall.ò[64] Although Better Markets appreciates the candor of the agency in this regard, it again emphasizes that such ñalternativeò measures are irrelevant to the activities-based SD registration analysis required by the Dodd-Frank Act.

Moreover, although Better Markets agrees with the CFTCôs decision not to propose alternative measures for SD registration in the New De Minimis Proposal, it notes, in any event, that the proposal fails to provide enough specificity with respect to these ñpotential viable alternative metricsò to provide an opportunity for meaningful comment on matters foreseeably within the contemplation of the agency. For this reason, no such alternative in which aggregate gross notional amount is only a single ñcomponentò of a more complex or conjunctive registration calculation could be the logical outgrowth of the New De Minimis Proposal.

IV. The CFTC's regulatory coverage statistics are incomplete, misleading, and irrelevant to the Dodd-Frank Act's activities-based standard for SD registration.

The CFTCôs proposed de minimis exclusions knowingly contemplate billions of dollars in notional amounts and thousands of transactions in unregulated swap dealing activities, with hundreds of counterparties, being conducted through financial institutions and others that otherwise would be regulated under current law. In absolute, not relative terms, the CFTCôs proposal is likely to mean that entities

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63 Id.

64 See De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444, 27448 (June 12, 2018), available at https://www.cftc.gov/sites/default/files/2018-06/2018-12362a.pdf. The CFTC also cites to an unpublished, 13-page paper on entity-netted notional amounts for a single asset class that is not, strictly speaking, relevant to the de minimis question and by its own terms, contains ñvery preliminary resultsò with the goal of capturing ñmarket risk transfer,ò not swap dealing activities. See Introducing ENNs: A Measure of the Size of Interest Rate Swap Markets (Jan. 2018), available at https://www.cftc.gov/sites/default/files/idc/groups/public/@economicanalysis/documents/file/oce_enns0118.pdf. Nevertheless, one section of that paper states ñthe great empirical difference between notional amount and [entity netted notional amounts] in the [interest rate swaps] market argues strongly for moving away from notional amount as a metric of market size and risk transfer.ò Id. As we noted above, the market size and risk transfer questions are not relevant to the SD registration analysis and indeed, the paper neglects to mention that even entity netted notional amounts do not address a number of risks that would benefit from the discipline of SD risk management program requirements, including counterparty credit, settlement, and liquidity risks.

involved in the global swap markets remain unregulated in significant respects. The CFTC should not cede jurisdiction over these swap dealing entities merely because the statutory discretion provided by imprecise terms, like ñde minimis,ò permit statistical acrobatics that make even billions of dollars in swap dealing activities sound minimal. Even a significant number and notional amount of swaps can constitute an insignificant percentage of the massive $221 trillion swap markets.[65]

Repeatedly citing relative percentages in the regulatory coverage statistics is misleading and irrelevant. The CFTC states, for example, that the ñapproximately 96 percent of all reported swap transactions involved at least one registered SDò[66]ð or ñalmost allò swaps as measured by aggregate gross notional amounts and transaction counts. It concludes therefore that unregulated swap dealing is ñlimited.ò[67] However, as we note above, the CFTC is focused on the wrong measures. Both percentages should be expected as SDs transact, and possibly report, in tremendously high volumes relative to other market participants. That says nothing about the absolute level of swap dealing activities relevant to SD registration under CEA section 1a(49)(A).

The regulatory coverage statistics from a counterparty perspective are equally flawed, as the CFTCôs own estimates provide that 680 counterparties would benefit from the full panoply of external business conduct disclosures and other regulatory protections under the $3 billion de minimis threshold that do not receive them today. In swap market terms, that is a significant number. Yet, the CFTC notes that ñthese small [relative] increases in . . . Estimated Counterparty Coverage indicate that the systemic risk mitigation, counterparty protection, and market efficiency benefits of SD regulation would be enhanced in only a very limited manner.ò[68] Expanding Dodd-Frank counterparty protections potentially to hundreds of market participants would have more than a ñlimitedò effect on counterparty protection once relative statistics are abandoned. Better Markets notes, too, that more than 6,000 counterparties transacted with other counterparties and not SDs within the market, and therefore were not direct beneficiaries of certain Dodd-Frank counterparty protections, despite having conducted more than 77,000 transactions at $68 billion in notional amount.[69]

A. The CFTC's acknowledged data limitations argue for better field-level and affiliate reporting of swaps, which would give the CFTC an informed basis to consider changes to the $3 billion de minimis threshold.

The CFTC acknowledges that the de minimis threshold must be informed by a data-driven analysis of the swaps markets. Better Markets recommends, consistent with that view, that the CFTC address data-quality issues discussed in the New De Minimis Proposal prior to amending the swap dealer de minimis exception threshold or expanding any exclusions from the de minimis calculations. We agree with the Financial Services Roundtable (ñFSRò) and other commenters that have recommended that the CFTC not rely upon incomplete swap data repository (ñSDRò) information in pursuing changes to the de minimis threshold. FSR recently argued, for example, that ñfor purposes of the considering any modifications to the de minimis exception at this time . . . that SDR data is still not currently sufficient and should not be

65 The 102 CFTC-registered SDs executed 97.6% of more than 4.4 million swaps across the asset classes, with certain exclusions, in 2017 alone. Those transactions dilute the apparent, but not actual, significance of unregulated activities. Indeed, by the CFTCôs logic, an SD engaging in $250 billion of countable dealing activitiesð in addition to dealing activities that are not countedð would be less than one percent of global swap market activities.

66 See De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444, 27446 (June 12, 2018).

67 Id. at 27450.

68 Id. at 27453.

69 Id. at 27451.

relied upon for purposes of determining or modifying the de minimis threshold amount.ò[70] The lack of reliable data does not argue against maintaining the CFTCôs blunt, activities-based gross notional activities thresholdð it argues for it.

Indeed, in the New De Minimis Proposal, the CFTC itself notes that swap data ñconstraints limited the usefulness of the SDR data to identify which swaps should be counted towards a personôs de minimis threshold, and the ability to precisely assess the current de minimis threshold or the impact of potential changes to the current exclusions.ò[71] In light of that admission, the CFTCôs determination to implement changes to current regulations is not only speculative but cuts against the CFTCôs very argument for relying on swap data in the first instance. Moreover, it gives a scientific air to what amounts to a series of arbitrary policy judgements. It also confirms that the effect of changing the de minimis threshold is too speculative to provide a reasoned basis for administrative action.

The New De Minimis Proposal compounds the complexities incident to an imprecise regulatory framework. That framework should be revised to focus on strict, observable measures like total notional or transactional activities that would be preferable to a subset of such activities that potential registrants are empowered to interpret for themselves and are not presently required to monitor, report, or internally track by regulation across the firm. This sort of overengineering does not keep it simpleð it keeps it complex and obfuscates important facts about the swap markets. Moreover, if the CFTCôs data is flawed, the solution is fix the data regulations implemented over the last eight years and finally get the regulatory reporting rightð not to feel around in the dark and compound problems by basing decision-making on imprecise and irrelevant measures.

B. The CFTCs data filtering methodology for purposes of the New De Minimis Proposal is flawed and inadequately explained.

The CFTC relies upon a 10 unique counterparty filter to limit proposalôs confidential data set to swap-related activities that, it believes, are indicative of dealing. In the New De Minimis Proposal, the CFTC observed that ñafter excluding inter-affiliate and non-U.S. swap transactions, 83 percent of registered SDs had 10 or more reported counterparties, while approximately 97 percent of unregistered entities had fewer than 10 counterparties.ò[72] It reasoned therefore that the counterparty filtering threshold appeared ñreasonable . . . to better identify entities likely engaged in swap dealingò and ñreduced the likelihood of false positives,ò including ñentities likely engaged in hedging or other non-dealing activity.ò[73]

This logic is fatally flawed and undermines the totality of the analysis that follows from an incorrect assumption. First, the fact that the CFTC-registered swap dealers, including every major Wall Street bank, tend to have more than 10 counterparties is irrelevant, as that should be expected of the dominant swap dealers in the market. That metric alone does not suggest that one can be a swap dealer only if its operations and target counterparty population are similarly scaled. The fact that unregistered entities tend to have fewer than 10 counterparties is similarly irrelevant. If a commodities affiliate of a large firm, for example, holds itself out as a swap dealer or stands ready to accommodate the demand of nine CPs, that affiliate is a swap dealer on account of its swap dealing activities under the Dodd-Frank Act, unless those activities do not exceed the de minimis threshold or otherwise are excluded from the SD registration analysis.

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[70] https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=60606&SearchText=

[71] See Id.

[72] Id.

[73] Id.

Rather than rely upon such assumptions, the CFTC should have provided the public an opportunity to comment on alternative assumptions, including, for example, the usefulness of filters that are tailored to particular asset classes (e.g., commodity swaps could have been presented with a different counterparty filter). Moreover, there is some ambiguity on terms used in the CFTCôs analysis. Needless to say, without precise definitions of filtering criteria used to remove data from the proposalôs data set, it is not possible for the public to meaningfully comment either on the appropriateness of the filters or the results of the analysis.

Even once we accept the methodology in the New De Minimis Proposal, however, the CFTCôs easy casesð those firms facing at least 10 counterparties and executing at least $3 billion notional in swaps activitiesð would capture 13 legal entities.[74] We find that significant. These 13 legal entities, not currently registered with the CFTC but engaged in billions of dollars of potential swap dealing activities, are not likely to constitute a massive change in regulatory coverage by any relative measure. However, in absolute terms, their swap dealing activities appear to exceed the de minimis thresholds recommended by all but one industry commenter that used notional amounts in original public comments on the de minimis exception adopted in 2012. The industry itself, it seems, would have viewed these 13 legal entities to be likely swap dealers.

CONCLUSION

It is ironic but telling that the CFTCôs repeatedly stated rationale for the New De Minimis Proposalð simplifying the SD registration frameworkð would be achieved through dozens of pages of new regulations introducing complexities to a framework that has been in place since 2012. Almost a decade since the failure of Lehman Brothers and other events of the financial crisis, it is worth remembering the key role that unregulated, complex, and opaque derivatives markets played in undermining the stability of the U.S. financial system. We encourage the CFTC to be mindful of those lessons and ensure that it errs on the side of properly regulating firms involved in swap dealing. We also encourage the CFTC to be mindful of procedural requirements for definitional rulemakings under the Administrative Procedures Act and the Dodd-Frank Act.

The purpose of the New De Minimis Proposal ostensibly is to reduce ñuncertaintyò in the marketplace about the scope of dealing activities and to reduce the ñinefficient application of the SD Definition.ò[75] In reality, ñcertaintyò is not only an illusory goal but one hardly achievable through principles-based standards that upset now long-settled issues and interpretations. The clearest path forward, if certainty were the goal, would have been to permit the current de minimis threshold to remain in effect. The New De Minimis Proposal instead introduces the very kind of interpretive uncertainty that the proposal claims to address.

The New De Minimis Proposal also seeks an approach that apparently permits market participants to ñcherry pickò dealing activities to arrive at desired regulatory outcomes, with minimal enforcement or informational mechanisms to monitor such unregulated activities, short of the CFTCôs subpoena power.[76]

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[74] Id. at 27452.

[75] See De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444, 27462 (June 12, 2018) (stating, for example, that ñthe absence of an explicit exclusion in the regulations for swaps entered into for purposes of hedging financial positions has caused uncertainty in the marketplace regarding whether swaps that hedge, for example, interest rate risk, credit risk, or foreign exchange risk, would also need to be counted towards a personôs de minimis threshold . . . .ò).

[76] Requiring the involvement of the CFTCôs Division of Enforcement to appropriately monitor the new interpretation of swap dealing is unlikely to encourage open and candid dialogue on compliance and other issues, and it would unnecessarily burden the CFTCôs limited enforcement resources with supervisory responsibilities ordinarily met through examinations programs and intermediary oversight.

This permits financial institutions and others to decide for themselves whether a significant portion of their swap dealing activities constitutes ñswap dealingò for SD registration purposes. In that circumstance, there can be no reasonable doubt that the New De Minimis Proposal will be interpreted, applied, and argued by the industry to expand the exception beyond all recognition, resulting in violations of the statute and congressional intent.

Finally, in adopting the dealer-trader distinction framework in its joint definitions rulemaking, the CFTC and SEC noted that ñthe practical difficultyò often ñlies in determining when a person has entered into a swap for the purpose of hedging, as opposed to other purposes for entering into swaps, such as accommodating demand for swaps or as part of making market in swaps, and in distinguishing a swap with a hedging purpose from a swap with a hedging consequence.ò[77] The New De Minimis Proposal does nothing to solve that practical difficulty; indeed, it greatly exacerbates it. But more problematically, it removes the necessary regulatory constraints that, however imperfect, at least served as a partial disincentive to prohibited risk-enhancing behaviors.

We hope these comments are helpful.

Sincerely,

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[77] Further Definition of ñSwap Dealer,ò ñSecurity-Based Swap Dealer,ò ñMajor Swap Participant,ò ñMajor Security-Based Swap Participantò and ñEligible Contract Participant;ò 77 Final Rules, Fed. Reg. 30596, 30611 (May 23, 2012).