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January 19, 2016

The Honorable Timothy Massad
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

RE: Comments on Swap Dealer *De Minimis* Exception Preliminary Report

Dear Chairman Massad,

Americans for Financial Reform ("**AFR**")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission ("**CFTC**" or "**Commission**")'s preliminary report on the *de minimus* exception to the swap dealer definition in Regulation 1.3(ggg)(4) ("**Preliminary Report**").

We commend the Commission and the Division of Swap Dealer and Intermediary Oversight staff for their work in compiling this Preliminary Report. We believe that the Commission should continue on the path laid out in the final rule and reduce the *de minimis* threshold to $3 billion after the $8 billion phase-in threshold terminates on December 31, 2017. We do not see sufficient evidence in the report to justify either maintaining the current level, or increasing it.

This is true in part because of the serious limitations in the data presented in the report. Where these data limitations leave open questions, the Commission should ensure that the marketplace gains the benefits that come from registration by erring on the side of inclusiveness. When an entity holds itself out to the market as a dealer – which is a requirement for designation – we believe that the Commission should seek to ensure proper risk management and adherence to business conduct standards.

In addition, we are concerned that the Commission has not satisfied the intent of Congress by registering all financial dealers and all major swap participants. Absent a comprehensive effort by the Commission to determine if full market coverage has been achieved, we strongly oppose increases in currently planned swap dealer thresholds to exempt additional entities that would not

[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/.

be exempted under current rules. Such an effort would have to be based on much better data than this study, and would also have to explicitly include study and discussion of Major Swap Participant ("**MSP**") registration, which so far appears ineffective and has captured almost no entities.

We have provided a general discussion below outlining our overall comments on the Preliminary Report. We have provided in **Appendix A** additional answers to specific questions posed in the Preliminary Report. Finally, we have included in **Appendix B** a list of suggested questions that we urge the Commission to answer in subsequent publications, or in its final report on the *de minimis* exception, to provide the marketplace and the general public with a more complete window into the United States swaps market.

I. Introduction

Reckless swaps and derivatives trading played a critical role in the financial crisis. Sharp and unforeseen increases in derivatives margin demands, the complexity and opacity of derivatives exposures, and poor provisioning for potential derivatives losses greatly increased stress on the financial system. Trading in commodity, specifically energy, derivatives also appears to have played a major role in the sharp run-up and then collapse in oil prices in 2008, a contributor to economic instability during the period.[2]

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") put in place key statutory changes intended to place better controls on derivatives markets and prevent the recurrence of a systemic crisis like the one experienced in 2008. The regulation of swap dealers, and the protections it affords the marketplace and the public, is a key element of the derivatives reforms of Dodd-Frank.

The Commodity Exchange Act ("CEA") Section 1a(49) directs the CFTC to exempt from designation as a swap dealer entities that engage in a *de minimis* amount of swap dealing. In a 2011 letter, AFR wrote that we believed the proposed $100 million *de minimis* threshold was appropriate.[3] AFR wrote two subsequent letters underscoring the dangers of raising the threshold from its initial $100 threshold, including the complications of companies combining this larger threshold with the hedging exemption.[4] We highlighted that the statute defines the swap dealer role in terms of its function in the market, not its size and not the nature of its non-trading business.

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[2] Singleton, Kenneth J, *The 2008 Boom/Bust In Oil Prices,* GRADUATE SCHOOL OF BUSINESS, STANFORD UNIVERSITY, (May 17, 2010), available at http://www.cftc.gov/idc/groups/public/@swaps/documents/dfsubmission/dfsubmission_091410_31_0.pdf

[3] Letter from Americans for Financial Reform to the SEC and CFTC, Tighten Definitions To Prevent Loopholes For Big Banks ,(Feb. 22, 2011), available at http://ourfinancialsecurity.org/2011/02/afrs-comment-letter-on-seccftc-definitions/.

[4] Letter from Americans for Financial Reform to CFTC Chairman Gary Gensler and SEC Chair Mary Schapiro (Apr. 17, 2012) http://ourfinancialsecurity.org/wp-content/uploads/2012/04/AFR-SEC-CFTC-Swap-Dealers-Letter-4-17-12.pdf and Letter from Americans for Financial Reform to CFTC Chairman Gary Gensler and SEC Chair Mary Schapiro (Mar. 12, 2012) http://ourfinancialsecurity.org/wp-content/uploads/2012/03/AFR-CFTC-SEC-Letter-Swaps-Dealers-3-12-12.pdf.

In May 2012, the CFTC and the Securities and Exchange Commission ("**SEC**") jointly issued final rules that established a $3 billion cap on an entity's dealing activity involving swaps over the prior 12 months, but with a phase-in threshold of $8 billion that is due to expire in December 2017. The Commissions noted in their joint final rule that "a de minimis exception, by its nature, will eliminate key counterparty protections provided by Title VII for particular users of swaps and security-based swaps. The broader the exception, the greater the loss of protection."[5] AFR agrees with the Commissions that a failure to move ahead on the reduction to 3 billion, or any further broadening of the *de minimis* exception creates great potential for loss of protections to the counterparties of dealers, to the swaps market overall, and to the public more broadly.

As we noted in our April 2012 letter, broadening the *de minimis* threshold also creates implications for other rules. For example, certain requirements in the business conduct rules apply to swaps dealers but not to major swaps participants. As the 2008 financial crisis clearly demonstrated, allowing regulated and non-regulated entities to engage in the same conduct under different rules enables dangerous and abusive practices to migrate to the less regulated entities.

II. Extensive Data Issues Exist in the Preliminary Report

The Commission acknowledges many issues in the data compiled in the Preliminary Report:

- Commission staff had to rely on assumptions to guess whether or not transactions constituted swap dealing;[6]
- The Commission excluded approximately 260,000 interest rate swap ("**IRS**") and credit default swap ("**CDS**") transactions because they lacked a valid Legal Entity Identifier ("**LEI**"), and thus the counterparties could not be identified. As the Commission notes, the aggregate notional amount of these transactions was "approximately $30 trillion, comprising approximately 23% of the total notional amount of IRS and CDS";[7] and
- Commission staff were unable to definitively identify all entities engaged in swap dealing activity, and thus filtered out certain entities' transactions entirely, including those who did not have a certain number of counterparties they traded with.
- These categorical exclusions included all insurance companies, all hedge funds, and all swaps between non-U.S. persons. All of these exclusions are problematic and exclude substantial activity, but we are particularly concerned that given the Commission's definition of "U.S. person" swaps between non-U.S. persons may include swaps involving major subsidiaries of the largest U.S. banks.[8]
- Commission staff were unable to determine financial valuations for commodity swaps, and quantity data on these swaps were frequently inconsistent and unreliable. Valuation data was also unreliable for equity derivatives and FX swaps.

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[5] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30628 (May. 23, 2012) (to be codified at 17 CFR 1 and 17 CFR 240).

[6] Commodity Futures Trading Commission, Swap Dealer *De Minimis* Preliminary Report, (Nov. 18, 2015) at 12.
[7] *Id.*at 13.
[8] See Americans for Financial Reform, "Letter to CFTC and SEC Regarding De-Guaranteeing", (Nov. 25, 2014), available at http://ourfinancialsecurity.org/wp-content/uploads/2014/11/De-Guaranteeing-Letter1.pdf

Given that nearly a quarter of the total notional amount of IRS and CDS were excluded from the Preliminary Report, combined with the fact that numerous additional transactions were excluded based on non-determinative staff assumptions and valuation data was unreliable for entire classes of significant swaps, AFR believes that this report is not an appropriate basis for conclusions regarding dealing activity in the market. The lack of data puts the burden on the Commission to justify any change to the automatic lowering of the *de minimis* threshold scheduled to go into effect in December 2017.

The CFTC must ensure that the data is uniform and accurate, and they have the appropriate compliance in place, before the Commission contemplates any changes to the threshold. It may make sense to revisit the discussion of raising the *de minimis* threshold once the data is complete, but until then, the Commission has provided no reason to alter the course of its prior rulemaking. Instead, the Commission should focus on improving the quality of data reporting.

III. Concerns Regarding Commodity Markets In Particular

In the current list of CFTC-registered derivatives dealers, there only appear to be three major non-financial commodity derivatives dealers (British Petroleum, Cargill, and Shell Oil). It is questionable whether these three entities exhaust the number of non-bank dealers in the commodity derivatives markets. For example, significant players in the oil and natural gas derivatives markets such as Trafigura, Vitol, Statoil, BP, and Koch Supply and Trading are not registered. According to the latest data from the Bank of International Settlements, over the counter derivatives on non-precious metal commodities have a notional value of $1.36 trillion and a gross market value of over $200 billion.[9]

Based on Tables 15 and 16 in the Preliminary Report, there appear to be at least seven non-financial entities with over 75 counterparties and over 5000 transactions in non-financial commodities who are not currently registered as dealers. There are many more unregistered non-financial entities with over two dozen counterparties and over 1000 transactions.[10] We find it difficult to believe that all of these entities are simply hedging commercial risk, and that none make markets or are major swap participants in any class of commodity derivatives.

Our concerns in this area are heightened because staff acknowledges that commodity derivatives data are inadequate, meaning that important information on activities in this market might not be reflected in the report.

Senator Diane Feinstein has twice written to the Commission requesting a series of metrics, including data on the percentage of the energy swaps trading transactions being executed by registered swaps dealers, information on how many energy swap dealers have registered with the Commission, how many energy swap dealers are claiming an exception from registration due to the *de minimis* threshold, and how these metrics would change should the *de minimis* threshold

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[9] Bank of International Settlements, *Global OTC Derivatives Markets, Commodity Contracts, H1 2015*, available at http://www.bis.org/statistics/d5_2.pdf

[10] Since no non-financial entities are registered as Major Swap Participants, we know that none of these entities are captured in the MSP designation either.

be returned to its original $100 million threshold.[11] The information requested by Senator Feinstein is important to considering the current level of the *de minimis* threshold in commodity markets and whether important dealer entities in these markets are currently escaping designation. The Commission should make it a priority to gather the data to respond to Senator Feinstein's question and to examine more closely whether dealer and MSP registration in the commodity markets are currently adequate.

IV. Generous Exclusions Already Exist from the *De Minimis* Calculation

As highlighted in Appendix A of the Preliminary Report, there are extensive exclusions already made to the *de minimis* calculation:

- Swaps related to loans made by insured depository institutions;
- Swaps between affiliates, swaps by cooperatives with members;
- Swaps that hedge physical positions;
- Swaps by floor traders;
- Certain types of cross-border swaps;
- FX swaps and forwards;
- Commodity trade options; and
- Swaps resulting from portfolio compression.

As also noted in the Preliminary Report, there is yet another exclusion from the term "swap dealer" for "certain inter-governmental or quasi-governmental financial institutions."

Despite clarifying that there are at least eight different categories of swaps that do not count toward the *de minimis* calculation, the Preliminary Report provides no insight into the aggregate notional amount of exempted swaps. Nor does it provide a sense of what percentage (or range of percentages) of existing swap dealers' swaps are excluded from the *de minimis* calculation. Given the very generous exemptions the CFTC has already built into the dealer registration, and the very serious gaps in the data provided in the Preliminary Report, it would be inappropriate for the Commission to propose changes to the existing phase-in termination. We request additional information from the Commission on the extent of these exclusions in Appendix B.

V. Congressional Intent Does Not Support Broadening Exemptions to the Swap Dealer Rules

In drafting the swap dealer definition and the *de minimis* exception, the intent of Congress was to ensure that commercial end users, and those entities akin to end users, were excluded. Their intent was *not* to exclude dealers, no matter their size. Senators Chris Dodd and Blanche Lincoln articulated this in a 2010 letter they wrote to Chairman Barney Frank of the House Financial Services Committee and to Chairman Colin Peterson of the House Agriculture Committee:

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[11] Letter from Senator Diane Feinstein to CFTC Chairman Gary Gensler, (May 20, 2013), http://www.feinstein.senate.gov/public/index.cfm/press-releases?ID=A89F9D6F-45EF-42E6-904D-372B7D100497 and Letter from Senator Diane Feinstein to CFTC Chairman Timothy Massad, (Jul. 23, 2015), http://www.feinstein.senate.gov/public/index.cfm/press-releases?ID=704CFF4B-A213-4D1A-BB93-AD94CCCD816C.

> Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in their ordinary course of business. Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business. For example, the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business. Congress incorporated a de minimis exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.[12]

As the letter from Senators Dodd and Lincoln makes clear, Congress was explicit in exempting commercial end users from the derivatives rules, and the *de minimis* exception from the Swap Dealer definition was explicitly intended to ensure that small end user entities managing commercial risk were not captured. However, the Commission has expanded this *de minimis* exemption to cover a wide range of financial entities, including those who could meet the activity-based definition of "swap dealer." When taking into account Congressional intent, the final rule's $3 billion threshold, combined with its extensive exclusions, is too generous. Thus, the Commission's presumption ought to be that those that hold themselves out as swap dealers should be covered by a regulatory regime, and the *de minimis* exemption should be modest. Indeed, the goal was not to exempt entities who were bona fide dealers, the goal was to exempt end users.

As AFR noted in our April 2012 letter, the ability to designate swap dealers for heightened prudential oversight is a key element of the derivatives reforms in Title VII of Dodd-Frank. This is a point underscored by House Agriculture Committee Chairman Peterson in 2010. When speaking on the conference report on H.R. 4173, the Wall Street Reform and Consumer Protection Act, Chairman Peterson stressed the importance of the prudential oversight of swap dealers:

> One of the sources of financial instability in 2008 was that derivative traders like AIG did not have the resources to back up their transactions. If we don't require these major swap participants and swap dealers to put more backing behind their swap deals, we will only perpetuate this instability. That is not good for these

[12] 156 Cong. Rec. S6192 (daily ed. July 22, 2010) (letter from Senators Dodd and Lincoln to Representatives Frank and Peterson), available at: https://www.gpo.gov/fdsys/pkg/CREC-2010-06-30/html/CREC-2010-06-30-pt1-PgH5233.htm.

> markets, and it is certainly not good for end users. I am confident that after passing this conference report we can go home to our constituents and say that we have cracked down on Wall Street and the too-big-to-fail firms that caused the financial crisis.[13]

As stressed by Chairman Peterson, the regulation of swap dealers affords important protections to the marketplace and the public; the Commission must preserve those benefits, and allows the $8 billion phase-in *de minimis* threshold to expire as scheduled.

VI. Size-Based Exemptions to Swap Dealer Registration Are Especially Concerning Given the Failure of Major Swap Participants to Register

Changes in the dealer registration threshold also raise particular concerns given the failure of the Commission to register any significant number of MSPs. The Dodd-Frank Act contemplated full coverage of major participants in the derivatives markets through the use of two different classes of registered entities. Swap Dealer registration was an activity-based classification designed to capture entities which made markets in derivatives, while MSP registration was designed to capture large-scale participants in derivatives markets that did not hold themselves out as dealers or market-makers. While a significant number of swap dealers have been registered, to our knowledge the Commission has registered only two MSPs.[14] We are concerned that this level of registration does not accurately reflect the true number of large-scale participants in derivatives markets who may create risks to counterparties or to markets through inadequate risk management, incomplete reporting, or poor business conduct.

Given the clear intent of the Dodd-Frank Act to register all significant entities in the swaps market, we do not believe that the discussion of swap dealer de minimis should proceed in a manner that is isolated from discussion of MSP registration. While separating the discussion of Swap Dealer and MSP registration might be sensible if the Swap Dealer classification was completely activity based, a discussion of the de minimis requirement introduces the question of size or scale of activity. The current state of MSP requirements and registrations indicates that if swap entities of significant size are not captured through the dealer classification, they will not be captured through the MSP classification either. Absent a comprehensive effort by the Commission to determine whether all significant parties in the derivatives markets are captured as intended by the Dodd-Frank Act, we do not believe the Commission should contemplate changing the currently planned dealer threshold. Given that this study explicitly excludes from consideration a wide range of entities that might qualify as MSPs, and focuses throughout on dealer-specific considerations like counterparty counts, it certainly does not qualify as such a comprehensive effort.

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[13] 156 Cong. Rec. H5233-H5261 (Jun. 30, 2010) (Conference Report On H.R. 4173, Dodd-Frank Wall Street Reform And Consumer Protection Act, statement from Representative Colin Peterson), available at: https://www.gpo.gov/fdsys/pkg/CREC-2010-06-30/html/CREC-2010-06-30-pt1-PgH5233.htm.

[14] See Commodity Futures Trading Commission, *Provisionally Registered Major Swap Participants as of March 1, 2013*, available at http://www.cftc.gov/LawRegulation/DoddFrankAct/registermajorswappart

We would also note that improving the coverage of major swap participant registration would also help to address the data shortcomings in this Preliminary Report, as registered MSPs would be required to report directly to the Commission.

In conclusion, the overriding Congressional intent in Dodd-Frank was to improve the stability of the financial system, and new regulation of derivatives, including the protections and market oversight afforded by the swap dealer registration rules, was critical to this effort. Given all the Preliminary Report's data limitations, it does not make sense to expand the exemptions available to market participants when we do not know the risks associated with it, and when the public has an incomplete window into the impact of raising the *de minimis* threshold.

Your consideration of these comments is appreciated. For questions, please contact Alexis Goldstein, Senior Policy Analyst at Americans for Financial Reform, at alexis@ourfinancialsecurity.org; or Marcus Stanley, the Policy Director of Americans for Financial Reform, at marcus@ourfinancialsecurity.org or (202) 466-3672.

Sincerely,

Americans for Financial Reform

Appendix A: Answers to Specific Questions:

4(1): How would the exclusion of SEF or DCM-traded and/or cleared swaps from an entity's de minimis calculation impact the policy considerations underlying swap dealer regulation and the de minimis exception?

Dodd-Frank did not specify that an entity should not be considered a swap dealer on the basis of how the transaction was executed. If an entity is holding itself out as a swap dealer, it should be registered as such, regardless of whether that dealer's trades went through a SEF or a DCM. We oppose the Commission departing from the letter of the law in this manner.

In addition, it is worth nothing that trades executed on SEFs via request for quotes (RFQs) are indisputably dealer transactions, and it would thus be totally inappropriate to exclude them from any *de minimis* calculation. In addition, the separation of the clearing and exchange trading requirements by the Commission mean that some SEF-traded swaps are not cleared.

4(2): Should anonymity be a factor in determining whether exchange-traded and/or cleared swaps are treated differently under the de minimis exception?

Dodd-Frank's transaction level rules were meant to incent exchange-like trading that facilitated not only dealer-to-dealer trades, but dealer-to-client and even client-to-client. If the full potential of Dodd-Frank is realized going forward, it means a more diverse market with a larger number of dealers engaged in smaller notional amounts of transactions.[15] This will likewise be encouraged if the Commission adopts rules requiring anonymity. In any event, proceeding with the final rule as originally contemplated - dropping from an $8 billion to a $3 billion threshold - is appropriate.

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[15] *See* 77 Fed. Reg. 30628 (May. 23, 2012) ("Moreover, in determining the scope of the exception, it is important to consider not only the current state of the swap and security-based swap markets, but also to account for how those markets may evolve in the future. This is particularly important because the full implementation of Title VII--including enhancements to pricing transparency and the increased access to central clearing--reasonably may be expected to facilitate new entrants into the swap and security-based swap markets. To the extent that such entrants engage in dealing activity below the de minimis threshold--either for the long term or until their activity surpasses the threshold--the relative amount of unregistered activity within the market may be expected to increase. Accordingly, a higher de minimis threshold may not only result in a certain percentage of unregistered activity being transacted initially, consistent with the current market, but also may result in an even greater proportion of unregistered activity being transacted in the future.").

Appendix B: Request for Additional Information in the Commission's Final D*e Minimis* Report

1. The Commission should provide estimates of Potential Swap Dealing Entities by Gross Notional Amounts of equity swaps, FX transactions included for the *de minimis* threshold, and non-financial commodity swaps.
2. The Commission should document how extensive the current exemptions are to the *de minimis* threshold.
    - The report's appendix lists eight different categories of swaps that do not count toward the de minimis calculation, but the Preliminary Report provides no insight into the outstanding notional amount of exempted swaps.
    - The Commission should release an analysis of how extensive the amount of exempted swaps are at registered swap dealers, including if possible a range of percentage values across the registered swap dealers. For example, how many registered dealers had 10% or less of their swap transactions excluded from the *de minimis* calculation? How many dealers had 20%, 30%, or 40% of their swap transactions excluded from the *de minimis* calculation? How many dealers had 50%, 60%, 70%, 80% or 90% of their swap transactions exempted from the *de minimis* calculation?