The Clearing House
At the Center of Banking Since 1853

August 27, 2012

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581
RIN 3038-AD57

Re: Proposed Interpretive Guidance and Policy Statement on Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act

Ladies and Gentlemen:

The Clearing House Association L.L.C. (the "**Clearing House**")[1] is writing to comment on the proposed interpretive guidance and policy statement[2] (the "**Proposed Guidance**") issued by the Commodity Futures Trading Commission (the "**Commission**") on the cross-border application of certain swaps provisions of the Commodity Exchange Act (the "**CEA**"). The Clearing House welcomes the attention of the Commission to these important issues and appreciates the opportunity to provide these comments.

I. Introduction

The Proposed Guidance would affect every aspect of swaps market reform, from decisions about registration through the treatment of a counterparty at termination of a swap, making it perhaps the single most important issuance by the Commission. The consequences for swaps markets both inside the United States and globally are enormous. Because it foresaw the potential for such far-reaching impact, the industry sought clarity and guidance. We

[1] Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

[2] 77 Fed. Reg. 41213 (July 12, 2012).

appreciate the Commission's efforts to address the industry's prior recommendations in the area of cross-border application of the swaps rules. We also fully support the Commission's goals of promoting harmony among the many jurisdictions that will be implementing swaps market reform. The Proposed Guidance is a very large step toward providing clarity to market participants and recognizing the independent application by non-U.S. supervisors of their own rules.

Nevertheless, simply because any such guidance will have a sweeping effect, the impact of any ambiguities, inconsistencies and disparities in application will be amplified. Unfortunately, the Proposed Guidance contains many such uncertainties and disparities that will have severely negative consequences if implemented as proposed. Furthermore, the Proposed Guidance does not hew closely to the limitations on extraterritorial application of Title VII rules set forth in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"),[3] leading to further unexpected and unintended consequences, many of which would either create additional risks to the financial system or negatively affect the safe and sound operation of institutions.

Thus, the Proposed Guidance must be modified to provide greater clarity, to inject additional precision into those concepts that will have a material impact on markets and market participants, and to mitigate overall the negative competitive impact and disparate burdens on particular market participants or specific operational structures. We do not believe that there are overriding policy reasons to treat market participants or operational structures disparately, at least with regard to the ability of those market participants to attract, and address the needs of, the same customer pool targeted by other participants not similarly burdened. Therefore, a more careful calibration of the Proposed Guidance is necessary in order to treat market participants similarly, regardless of the structure (branch or entity) or location (U.S. or non-U.S.) they use to serve customers. To achieve these goals, the Proposed Guidance should articulate a more nuanced and risk-based approach to whether a rule or rule set is necessary to mitigate a direct and significant risk posed by offshore activities to the U.S. financial system.

In this letter, we make the following specific recommendations:

1. The U.S. person definition should be narrowed and clarified to reflect existing market practices and traditional concepts of citizenship, organization and domicile, particularly with regard to fund and other collective investment vehicle structures. (Section IV.A.2)

2. Funds with majority U.S. person ownership formed prior to the effective date of final guidance should not be considered U.S. persons by virtue of qualification under the U.S. person definition. (Section IV.A.2)

[3] Pub. L. 111-203, 124 Stat. 1376 (2010).

3. For purposes of determining U.S. person status, entities should be able to reasonably rely on counterparty representations concerning their status and on covenants to provide actual notice of changes in status, together with a grace period of at least 90 days after such notification to address compliance with a counterparty's new status. (Section IV.A.2)

4. The definitions of guaranteed entity and "conduit" entity should only include "shell entities" that are (1) non-operating companies without substantive business that are either (a) not subject to capital adequacy regulations or (b) not subject to a swap dealer, broker-dealer or bank regulatory regime, and that meet the requirements of systematically transferring all or substantially all of both market and credit risk of swaps to a U.S. person (excluding non-financial end users), or (2) entities created with the purpose of evading U.S. swaps rules as determined by the Commission. (Section IV.B.1)

5. The Commission should remove the "central booking model" concept from the guidance or, in the alternative, make certain clarifying changes as specified below. (Section IV.B.2)

6. The Commission should modify the application of registration, aggregation, and transaction-level rules to guaranteed or conduit entities and to their guarantors and back-to-back counterparties, as described in detail below. (Section IV.B.3)

7. Pre- and post-trade transparency rules, as well as the internal conflicts rules, should be treated similarly to sales practice rules and should not apply to interactions with non-U.S. counterparties. (Section IV.C.1)

8. Regulatory reporting, physical commodity trades reporting, and certain recordkeeping rules should be treated differently from other entity-level rules and should not apply to transactions with non-U.S. counterparties or, in the alternative, should benefit from a lower standard of substituted compliance. (Section IV.C.1)

9. The application of certain reporting and recordkeeping rules should be delayed to allow local supervisory clarification of the interaction with local privacy laws and, once effective, should benefit from substituted compliance (including the ability to redact data fields that may violate local laws). (Section IV.C.1)

10. Non-U.S. branches of U.S. persons should be treated as non-U.S. persons for all transactional purposes (and if this recommendation is not adopted, the Commission should clarify the application of transaction-level rules to transactions with non-U.S. branches as counterparties). (Section IV.C.2.a)

11. Transactions between two non-U.S. branches of U.S. persons should benefit from substituted compliance. (Section IV.C.2.a)

12. In addition to the rules of a "home" jurisdiction, applications for substituted compliance should be permitted for (a) the rules of a non-U.S. counterparty's jurisdiction or (b) the rules of a "host" jurisdiction. (Section IV.C.2.b)

13. U.S. registrants operating out of U.S. offices should be treated on parity with non-U.S. registrants and should not have to apply transaction-level rules when transacting with non-U.S. counterparties (or, if the Commission does not adopt this recommendation, substituted compliance should be available for such transactions). (Section IV.C.2.b)

14. Aggregation relief should be applied to all potential registrants—U.S. and non-U.S. potential registrants alike. (Section IV.D.1)

15. Firms should be permitted to submit alternative compliance schedules for aggregation. (Section IV.D.1)

16. Aggregation should not be required with the swap volume of an entity's registered affiliates. (Section IV.D.1)

17. Aggregation should only be required within a specific jurisdiction (and not with entities in other jurisdictions) if the jurisdiction has a substantive regulatory and capital regime for swap dealers. (Section IV.D.1)

18. For the purposes of aggregation, "common control" should require at least actual control (voting power of over 50%) <u>and</u> financial consolidation. (Section IV.D.1)

19. Limited designation should be available for specific branches, departments, divisions or business lines that engage in U.S.-facing swap dealing activities. (Section IV.D.2)

20. For purposes of determining the major swap participant status of a non-U.S. person, transactions with foreign branches of registered U.S. swap dealers should be excluded from the calculation (as they are from the swap dealer calculation). (Section IV.D.3)

21. Legacy portfolios should be excluded from registration calculations, and related maintenance transactions should not be treated as "dealing." (Section IV.D.4)

22. Comparability determinations for substituted compliance should be made on a holistic basis, rather than "area-by-area," with a focus on key risk-based measures rather than all Title VII requirements. (Section IV.E)

23. The determination standard for substituted compliance should be whether the non-U.S. jurisdiction's rules include elements sufficient to implement the G20

accord and not whether each element is similar to that applied by the Commission to U.S. registrants. (Section IV.E)

24. The "emerging market" exception should be modified to make it more meaningful and precise, as described in more detail below, including by raising the threshold to 15 percent. (Section IV.E)

25. Comparability determinations should be made immediately public and subsequent registrants should be permitted to file a notice of intent to utilize previous determinations in lieu of a new application. (Section IV.E)

26. Where substituted compliance is required, sufficient additional time should be provided (without the need for application) for the Commission to make appropriate comparability determinations. (Section IV.E)

27. Cross-border issues should be addressed in a formal rulemaking rather than interpretive guidance. (Section V).

II. The Proposed Guidance Exceeds the Limits Imposed by the Dodd-Frank Act

Section 2(i) of the CEA[4] explicitly states that Title VII of the Dodd-Frank Act, and any rule or regulation under Title VII, "shall not apply to activities outside the United States" (emphasis added) unless the Commission makes a finding that those activities have a "direct and significant" connection or effect on U.S. commerce or present an evasion of Title VII. Through the Proposed Guidance, the Commission has taken a provision of the CEA that is intended to limit its authority over swap activity outside the United States and instead seems to have interpreted it as an empowerment to address broadly cross-border activity, by applying substantive U.S. requirements to wholly non-U.S. activity even when the effect on or connection of that activity with the United States is solely indirect, is of questionable significance and has not evidenced evasion.

Further, the Commission has shifted the burden of proof that is clearly enunciated in the statute from itself to market participants. The Commission has not made substantiated findings in the Proposed Guidance that application of substantive U.S. requirements to overseas activities would be necessary to address direct and significant risks to the U.S. financial system. Instead of making such findings, the Commission requires registrants to substantiate the adequacy of local regulations under a vague "substituted compliance" regime that forces potential registrants to prove that the Commission's regulations should not apply. The Proposed Guidance thereby runs contrary to Congressional intent and the legislatively crafted burden of proof of Section 2(i) of the CEA by ignoring the explicit limits on the application of Title VII outside the United States, disregarding the requirements for a high level of proof or substantiation from the Commission as to why a rule should apply to activities outside the

[4] Section 722(d) of the Dodd-Frank Act, *codified at* 7 U.S.C. § 2(i).

United States and not giving proper weight and respect to time-honored principles of international comity.

In taking this approach, the Commission has merely tried to capture "any" connections with the United States and has read out of the statute the requirement that there be a Commission determination of a "direct and significant" connection. It appears that the Commission has not undertaken critical analyses of the various concepts introduced in the Proposed Guidance under the required standard. Undertaking such analyses would likely have determined that many of these concepts should not be applicable in the cross-border context. As examples:

- Non-U.S. entities guaranteed by a U.S. person would be treated differently under the Proposed Guidance from other non-U.S. entities in relation to a number of Title VII requirements. Yet a guarantee is, in fact, the very definition of an "indirect" connection. A guarantee is only triggered *contingently* if the guaranteed entity fails to address obligations subject to the guarantee. An analysis of the risks posed by the guaranteed entity to the guarantor would be more appropriate, and therefore we recommend below that the Commission recognize that robust capital and related regulatory regimes can mitigate the risks to a guarantor. Further the question of whether the guarantee is "significant" is highly dependent upon both the nature and scope of the guarantee. Coverage by the guarantee of a *de minimis* level of swaps would not be significant. In addition, the nature of the swaps may also render them insignificant – swaps could be risk-reducing or hedging swaps, for example.

- Non-U.S. entities that enter into back-to-back swaps with a U.S. entity are also treated differently under the Proposed Guidance. However, the third-party-facing, outward swap by such an entity is not directly connected to U.S. commerce or to the U.S. back-to-back counterparty. At most, the inter-affiliate swap is the only direct connection by the U.S. back-to-back counterparty. Yet, such swaps do not typically pass through the credit risk of the third-party counterparty, and such credit risks are the crux of the Dodd-Frank Act requirements behind clearing, margin and transparency. Furthermore, the inter-affiliate swap is even further removed from a guaranty because it is not even triggered by or contingent on settlement of the third-party swap. Moreover, based on the Commission's recent proposal, the Commission has shown that it can address the risks of inter-affiliate swaps separately from a broad, disparate treatment of non-U.S. entities. Similarly to the guarantee analysis above, a robust capital and regulatory regime already applicable to the non-U.S. entity will also mitigate any potential risks, and the "significance" of the back-to-back swaps also depends upon the nature and scope of the back-to-back activity.

- The longstanding legal construct of a bank branch is complex and nuanced. The Commission has recognized this in the context of the "emerging market" concept in the Proposed Guidance, although we believe (as discussed below) that more precision in calibrating such concept is warranted to make it effective. For other branches, the significance of swap dealing activities to the U.S. financial system is highly dependent upon a number of factors that the Commission has not addressed in the Proposed Guidance, including the risk-mitigating effects of both the U.S. entity-level rules applicable to these branches and the multiple regulatory constructs (U.S. and local) that are already applicable to branches.

- The Proposed Guidance would adopt an extremely broad definition of "U.S. person," a concept that plays a key role in determining the scope and applicability of numerous Title VII rules. The broad sweep of the definition would capture numerous foreign entities with little practical connection to the United States, including a foreign entity that may have a U.S.-registered commodity pool operator or a foreign entity that may have a U.S. person that is responsible for some nominal amount of the entity's liabilities. A number of the definitions specifically require look-through to "indirect" investors or responsible parties, in direct contravention of the requirement to find "direct and significant" connections. Moreover, the Proposed Guidance would impose directly on non-U.S. persons significant due diligence and information collection requirements in order to ferret out these indirect U.S. connections and to make a determination of U.S. person status of each of their counterparties, in contrast to the typical assumption of non-U.S. persons that their wholly non-U.S. transactions should instead be governed by local rules.

By not specifically focusing on the direct and significant effect on U.S. markets, the Commission concludes that a number of Title VII registration and transactional requirements should apply in non-U.S. jurisdictions. Under the Proposed Guidance, U.S. market structure reforms, such as swap execution facility rules and public reporting, could be directly imposed on foreign markets. The scope of overreach in the Proposed Guidance goes even further depending upon the outcome of determinations of the comparability of local regulations "on an individual requirement basis." The Commission could see fit to apply a multitude of U.S. regulations on foreign markets and foreign market participants based merely on a comparability analysis rather than on whether the requirement is necessary to mitigate some direct and significant risk. As a further example, U.S. transaction-level rules would fully apply to transactions between the non-U.S. branches of two U.S. banks, without the ability to undertake a substituted compliance approach, thus inevitably subjecting these wholly foreign transactions to at least two full sets of transaction rules.

Each of these examples, individually and in the aggregate, represents an unprecedented extraterritorial application of U.S. regulatory authority and fails to heed the Congressionally determined standard requiring a direct and significant effect on U.S. commerce. Comparable provisions in other regulatory regimes, many of which are applicable to the very same financial market participants—including many owner banks of The Clearing House—are much more carefully delineated and sensibly limited. For example, the Securities and Exchange Commission (the "**SEC**") has provided clear safe harbors under the securities laws for offerings outside the United States under Regulation S[5] and for foreign brokers or dealers under Rule 15a-6.[6] Even the Commission's own regulations governing commodity pool operators[7] and foreign futures and options[8] apply U.S. laws to foreign persons and markets in a far more circumscribed manner than the Proposed Guidance.

III. The Breadth of Application of the U.S. Rules is Likely to Have Significant Unintended Consequences That Will Impair Markets and Create Additional Risks

We believe that the unparalleled reach of the Proposed Guidance will result in significant negative unintended consequences for both U.S. and foreign market participants, as well as the strength of the U.S. financial system.

First and foremost, the viability of certain structural and operational models will be questioned. Non-U.S. branches of U.S. swap dealers will be severely hampered in their ability to act in local markets. U.S. swap dealers that operate through a non-U.S. branch can benefit only from potential substituted compliance when facing non-U.S. persons, whereas a non-U.S. subsidiary or affiliate would generally only apply local rules when facing non-U.S. persons. We also note the significant confusion in the Proposed Guidance as to which transaction-level standard non-U.S. registrants are to apply to transactions when facing non-U.S. branches of U.S. swap dealers.[9] If non-U.S. registrants were required to treat branches as U.S. persons, it would exacerbate the disadvantages of the branch structure and negatively affect a branch's ability to hedge and mitigate risk. U.S. swap dealers may, based solely on this Proposed Guidance, decide to restructure their operations into subsidiaries in order to be able to act similarly to local dealers, to present a favorable counterparty to foreign dealers and to eliminate potential "dual" compliance requirements. Deciding to convert to a local subsidiary is not a decision that is made easily. The process can be difficult and expensive, and it can introduce additional capital, liquidity and regulatory risks to an entity's structure, thus affecting the safe and sound operation of the institution, and transferring capital, resources and jobs to jurisdictions outside the United States. Yet it may be necessary to continue competitive participation in the local market under the terms of the Proposed Guidance.

Nevertheless, even non-U.S. subsidiaries of U.S. persons would be adversely affected in their local operations if they are guaranteed by a U.S. person or act as a conduit to a U.S. person. Non-U.S. registered swap dealers will potentially be able to use substituted compliance for transactions with such entities, but the burden of determining both the U.S. connections

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[5] 17 C.F.R. § 230.901 *et seq.*

[6] 17 C.F.R. § 240.15a-6.

[7] 17 C.F.R. § 4.7.

[8] 17 C.F.R. § 30.

[9] See Section IV.C.2.a. of this comment letter, and particularly the text associated with footnotes 44-46.

with these subsidiaries and applying for substituted compliance permission would make other potential counterparties significantly more attractive. U.S. persons, including U.S. financial institutions, may, again based solely on this Proposed Guidance, decide to remove guarantees or inter-affiliate transactions to the extent commercially feasible so as not to "taint" their local operations.

Rather than addressing direct and significant risks to the U.S. financial system, the Proposed Guidance in this regard would make an unwarranted intrusion into the appropriate corporate structures of financial institutions, and would indeed create additional and new systemic risks. If globally active U.S. firms must take capital that would otherwise be deployed for productive uses and devote this capital to the elimination of branches and the creation of new subsidiaries, the effect of the Proposed Guidance would be to constrain liquidity risk management and trap capital outside the United States. Further, given the incentive to eliminate guarantees, such an affiliate or subsidiary would need to be capitalized at a level that would allow it to transact without credit support from its parent. The result would be more than the subsidiary or affiliate merely holding the capital necessary to absorb losses from its swap activities. In many cases, this would require having the capital necessary to obtain a standalone credit rating and to compete with local or other non-U.S. firms that are based in that jurisdiction or that can operate in that jurisdiction through a branch of their non-U.S. parent entity or through a subsidiary having a guarantee from their non-U.S. parent entity.

Further, for subsidiaries or affiliates that may engage in back-to-back inter-affiliate trades, and thereby be treated as conduits, a number of harmful results will ensue. Application of these concepts will prevent effective and bona fide enterprise-wide risk management, balkanize risk, and lead to the loss of U.S. jobs. For example, because such entities will seek to avoid back-to-back transactions that could "recharacterize" their entity's status and subject their foreign-facing transactions to U.S. requirements (effectively making them severely unattractive counterparties in their local markets), either U.S.-based personnel will need to relocate abroad or new, replacement risk management personnel will need to be hired abroad so that they can manage the U.S.-related risks that are trapped in foreign affiliates. Managing such risks independently of an enterprise-wide system will inject significant costs, additional basis and counterparty risks, and unnecessary inefficiencies into risk management.

In addition to these structural impacts, additional negative consequences will result from other concepts in the Proposed Guidance. First, the broad definition of "U.S. person," including certain requirements to look through to potential participation by U.S. persons, will contribute to avoidance by non-U.S. persons of trades that may have some U.S. connection in order to shield themselves from the sweeping reach of Title VII rules under the Proposed Guidance. As a related example, the breadth of the definition will harm the ability of U.S. investors to access foreign markets because they may "taint" funds in which they invest, causing them to become a U.S. person counterparty. The logical reaction of foreign funds will be simply to shut out U.S. investors. Similarly, non-U.S.-based firms will be reluctant to conduct any U.S. swap dealing activity unless the scope of application of U.S. rules to their non-U.S.

operations—particularly the non-U.S. board, senior officers and the head office of the non-U.S. firm—is clarified.

All of these potential follow-on effects of the Proposed Guidance are already having an effect on the U.S. swaps market. We understand anecdotally from our owner banks that non-U.S. clients are starting to reduce their transactions with U.S. counterparties, and move their trading to non-U.S. affiliates or foreign-based firms. Even in its proposed form, because of the upcoming registration date, we are starting to see the swaps market move away from the United States.[10]

Ultimately, the approach taken in the Proposed Guidance goes beyond merely addressing risk to the United States, as would be consistent with Congressional intent and the scope of the statute. Instead, it would dictate the organizational structure of firms in a way that ignores international recognition of efficient bank structures, consolidated supervision of financial holding companies and enterprise-wide risk management requirements. Balkanization of risk management, harmful silo-ing of capital and liquidity, and removal of support for certain entities only serve to increase risk and are not consistent with safe and sound operational practices. In addition, the ability to compete in local markets on an equal footing, without incurring these harmful effects or engaging in significant restructuring, should be a paramount consideration for the Commission, but would be severely damaged by the approach taken in the Proposed Guidance. Although substituted compliance and certain other aspects of the Proposed Guidance do take into account the concept of equality in ability to operate, a greater leveling of the playing field is required to ensure competitiveness, consistent with the limited approach to cross-border application of Title VII under Section 2(i).

IV. An Alternative Approach Would be More Consistent with the Congressional Mandate to Apply Title VII Rules Only When There Is a Direct and Significant Risk to the U.S. Financial System

There is significant appeal to the industry in a cross-border regime that stops at the "water's edge" and allows non-U.S. entities and branches to apply only local rules (without a substituted compliance determination), at least when facing non-U.S. persons (including non-U.S. branches of U.S. persons). However, we also recognize that there is a benefit to international harmonization of rules and an interest of the Commission in fostering such harmony.

We believe that an alternative approach would satisfy the Commission's objectives of mitigating risk transfer to the United States and preventing evasion, while also balancing competitiveness and comity in a manner consistent with Congressional intent under Section 2(i) of the CEA. In particular, Section 2(i) expressly limits Title VII's application territorially, with limited exceptions for activities outside the United States that create "direct and significant"

[10] See, e.g., Rachel Armstrong, "As Dodd-Frank Looms, Asian Banks Look to Cut U.S. Trading Ties," Reuters, Aug. 20, 2012.

risk to the United States or that constitute evasion. As a result, whether a particular Title VII requirement applies to activities outside the United States should depend on whether the application of that requirement is necessary to mitigate direct and significant risk to the United States or to prevent evasion. The Commission has implicitly recognized this principle in the context of the major swap participant ("**MSP**") definition, where attribution to a guarantor is not applied if the guaranteed entity is subject to appropriate capital requirements. The Commission also recognized this risk-based principle in the Proposed Guidance's approach to the sales practice rules, which would not apply to activities outside the United States (as they are more appropriately applied by local regulators to address risks to local customers), even for transactions with guaranteed subsidiaries and foreign swap conduits. These principles should be applied in a consistent manner to all cross-border applications of Title VII under the Proposed Guidance.

Below we will discuss:

- Modifications to the breadth of the "U.S. person" definition;
- A more risk-sensitive treatment of guaranteed entities and conduit or back-to-back structures;
- The appropriate definition of transaction-level and entity-level rules, and particularly their application in the context of transactions by or with non-U.S. branches of U.S. persons;
- A more risk-sensitive approach to registration rules; and
- A holistic approach to comparability and substituted compliance analyses that is more in line with the statutory limitation to not apply U.S. rules to overseas activities unless there is a direct and significant risk to the U.S. financial system.

A. A More "Direct" Approach to the Definition of U.S. Person

1. The Scope of the U.S. Person Definition

The scope of the "U.S. person" definition under the Proposed Guidance should be narrowed so as to capture only entities with a meaningful connection to the United States and with a meaningful impact on risk to the U.S. financial system. The need for a sharpening of scope is particularly acute for funds and other collective investment vehicles, as the current definition captures entities with severely attenuated connections to the United States, including entities with a *de minimis* number of U.S. investors. A look-through analysis with regard to such funds and investment vehicles is not workable at such immaterial levels of participation by U.S. persons. As some additional examples of the breadth of this proposed definition, we note that:

- In the lead-in to the definition, the Proposed Guidance immediately adds uncertainty to the scope and utility of the definition by stating that the definition "would include, but not be limited to" the enumerated descriptions.[11] The usefulness of the definition as a tool for determining registration and transactional requirements is undermined by the lack of legal certainty in the definition.

- Although the Commission states that it proposes to interpret the term "by reference to the extent which swap activities or transactions involving one or more such person [sic] have the relevant effect on U.S. commerce,"[12] the Commission fails either to circumscribe its definition by the "extent" of the effect on U.S. commerce or to analyze the "relevant" effect as a "direct and significant" effect. As some examples:

    - Vehicles in which the "direct or indirect owners thereof are responsible for the liabilities of such entity and one or more of such owners is a U.S. person"[13] – The definition does not include appropriate levels of materiality of ownership or liability absorption by such U.S. persons, and it implies that one immaterial owner that may be responsible for certain liabilities can taint the entire vehicle. Furthermore, the definition requires a look-through to indirect owners without indicating how far removed a connection may be in order to be captured, and without adhering to the statutory requirement to find a "direct" connection. We also note that this definition is inconsistent with the repeated determination throughout the Proposed Guidance that "a foreign affiliate or subsidiary of a U.S. person would be considered a non-U.S. person, even where such an affiliate or subsidiary has certain or all of its swap-related obligations guaranteed by the U.S. person."[14]

    - Funds or other collective investment vehicles "(whether or not . . . organized or incorporated in the United States) of which a majority ownership is held, directly or indirectly, by a U.S. person(s)"[15] – Similarly to the immediately preceding bullet, this definition would require a look-through to "indirect" ownership without a determination that such

[11] Proposed Guidance, 77 Fed. Reg. at 41218.

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Id.*

ownership creates a direct and significant connection with U.S. commerce. Furthermore, this definition would require significant due diligence to identify a potentially ever-shifting group of investors. In fact, for many funds, the fund sponsor or manager may not be permitted to provide information about their investors and how much they own, individually or in the aggregate.

  - Any pooled vehicles "the operator of which would be required to register as a commodity pool operator under the CEA"[16] – This definition clearly captures any offshore pooled vehicle that happens to be operated by a registered commodity pool operator, when such registration may have been caused by wholly unrelated U.S. activities.

- The Commission itself recognizes that the definition is in flux and asks a question regarding potential expansion of the definition to, among other entities, those non-U.S. persons that are controlled by or under common control with a U.S. person. The Commission also states that it is considering whether foreign affiliates or subsidiaries guaranteed by a U.S. person should also be included in the definition. We absolutely disagree with expansion of the definition so widely, but we highlight this as evidence of the potentially overbroad application and evolving expansiveness of the proposed definition. Such concepts do not appropriately address whether there is a direct and significant connection to U.S. commerce, but merely focus on "any" connection.

Therefore, rather than widen the scope, the definition should be narrowed to appropriately capture only those entities traditionally and logically considered U.S. persons. Moreover, these definitions are so unlike other commonly used indicia of jurisdiction that market participants would have to develop and enhance systems and documentation designed to capture and implement these definitions, and develop unnecessary and extensive due diligence procedures to make determinations of the status of each of their counterparties.

2. An Alternative U.S. Person Definition

We believe that an alternative U.S. person definition based on existing market and regulatory practices for which market participants already can and do collect information on counterparties would be more appropriate. The definition should be limited to only the following:

- Any natural person who is a resident of the United States;

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[16] *Id.*

- Any corporation, partnership, limited liability company, association, joint-stock company or any form of enterprise similar to any of the foregoing (other than an Estate, Trust, Plan or Fund, each as defined below), in each case that either:
  - Is organized or incorporated under the laws of the United States, or
  - Has its principal place of business in the United States;[17]
- Any commodity pool, pooled account, collective investment vehicle or other vehicle the assets of which are invested on a collective basis regardless of form of organization (a "**Fund**"), in each case where:
  - the Fund is organized or incorporated under the laws of the United States;
  - the Fund is domiciled and principally operated in the United States, without regard to the U.S. person status of any of the vehicle's investment managers;[18] or
  - the Fund is (1) formed after the effective date of this definition,[19] (2) directly majority owned, on average as of the end of a fiscal quarter, by U.S. persons,

[17] Entities should be deemed U.S. persons based on traditional concepts of citizenship, organization and domicile, and not based on the presence of U.S. owners. In addition, we recommend below that this definition should not include the non-U.S. branches of U.S. registrants, which should be treated as "non-U.S. persons" for all transactional purposes.

[18] Operation of a Fund would be defined as establishing the vehicle, choosing the investment managers and other service vendors for the vehicle and soliciting investors for the Fund. An operator can also be the investment manager for the Fund, but need not be. For example, a non-U.S. banking entity may decide to create a Fund established in a non-U.S. country in order to provide access to a particular investment strategy to its private wealth management clients. Such operator may hire a U.S. investment manager to provide advice and asset decisions based on a formula that is proprietary to the U.S. investment manager; it may also hire, for example, a separate investment manager to provide risk hedging advice. The nucleus of operation for this vehicle is the operator and not its investment managers. We do not believe that the U.S. person status of any of a Fund's investment managers should be a basis for determining the status of the Fund itself, although the location from which the Fund is operated may have bearing on its U.S. person status. In addition, operators and fund clients will avoid hiring U.S. investment managers if it may taint their Fund. Similarly, we do not believe that a Fund should be deemed a U.S. person merely because of the U.S. registration status of its operator, such as commodity pool operator registration. There are no policy or risk mitigation benefits from tainting an otherwise offshore fund with such minimal U.S. linkages.

[19] We recommend that this portion of the definition only apply prospectively because operators and investors in existing Funds were not aware of the potential ramifications of this definition at the time the Fund was established or at the time an investment was made. For those Fund operators and investors that wish to ensure that they are creating or investing in a Fund that has a particular status under this definition, they will only be able to do so prospectively. In particular, if an ownership test is adopted, certain Funds may wish to exclude U.S. investors (a negative outcome of using ownership as a defining factor) and may have to change their documentation and operations to do so.

or, in the case of ownership by another Fund, by a Fund that is a U.S. person solely by virtue of either the first or second bullet in this definition of Fund,[20] subject to a reevaluation period of an additional fiscal quarter if the U.S. ownership level of a Fund that was a non-U.S. person as of the end of the previous quarter exceeds 50 percent but does not exceed 60 percent,[21] (3) not a publicly offered Fund that is initially offered outside the United States (in a manner compliant with Regulation S under the Securities Act of 1933) and listed principally on an exchange located outside the United States, and (4) not organized or incorporated in a jurisdiction for which the Commission has made a comparability determination with regard to transaction-level requirements;[22]

- Any plan within the meaning of Section 3(3) of the Employee Retirement Income Security Act of 1974, excluding any plan maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens (a "**Plan**");

- Any individual account (discretionary or not, and other than an Estate, Trust, Plan or Fund), maintained or managed by a dealer, investment adviser or other fiduciary where the direct beneficial owner is a U.S. person by virtue of either of the first two bullets above in this definition;

- Any estate (other than a Trust, Plan or Fund) ("**Estate**") of which any executor or administrator is a U.S. person by virtue either of the first two bullets above in this definition, except that any such Estate shall not be a U.S. person if (1) an

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[20] Although we have proposed this definition, we continue to believe that there are difficulties in using the ownership of a Fund to determine its status as a U.S. person. Such a definition would require extensive knowledge of a Fund's investor base, even if it does not stay constant over time. Further, it will likely serve to impede significantly U.S. investor access to foreign Funds. If the Commission were to determine that a U.S. person definition should include Funds having U.S. investors, the definition should not (i) look through direct investors to indirect investors (unless there is evidence of evasion), and (ii) include funds or collective investment vehicles with less than majority direct U.S. ownership.

[21] Over the life of a Fund, a number of changes may occur with respect to ownership, some of which may be beyond the direct control of the Fund's operators, such that the ownership status of the Fund may fluctuate significantly. These changes include admitting of new investors, redemption of existing investments and additional capital contributions. A reevaluation period would avoid the costly and unnecessary application of U.S. regulatory requirements (such as margin, clearing, reporting and registration) to Funds that only exceed majority U.S. ownership during a given fiscal quarter by a de minimis amount of less than 10 percent, but that are not U.S. persons in the next fiscal quarter.

[22] We see little potential for evasion by a swap dealer facing a Fund that is majority-owned directly by U.S. persons, if that swap dealer must act under rules that the Commission has already determined to be comparable.

executor or administrator of the Estate who is not a U.S. person has sole or shared investment discretion with respect to the assets of the Estate and (2) the Estate is governed by foreign law; or

- Any trust (other than an Estate, Plan or Fund) ("**Trust**") of which any trustee is a U.S. person by virtue of either of the first two bullets above in this definition, except that any such Trust shall not be a U.S. person if (1) a trustee who is not a U.S. person has sole or shared investment discretion with respect to the Trust assets, (2) the administration of the Trust is governed by foreign law, and (3) no beneficiary of the Trust (and no settlor if the Trust is revocable) is a U.S. person by virtue of the first two bullets above in this definition.

The Commission should also clarify that entities transacting with any counterparty, but especially Fund counterparties, should be able reasonably to rely on representations from the counterparty regarding its status as a U.S. person at the time of entering into the transaction, together with a covenant on behalf of the counterparty to provide actual notice of changes in status. A swap counterparty should be in the best position to determine its own status as a U.S. person and provide such representations and covenants. If, however, a person should change status (e.g., because a Fund's investor composition changes) from a non-U.S. person to a U.S. person, it would be appropriate to adopt a grace period, of at least 90 days after the registrant is notified of the change, in order for registrants to institute changes to systems, documentation and governing agreements and to come into compliance with the Proposed Guidance and Title VII rules for new swaps with that counterparty.[23]

Narrowing the U.S. person definition in this way would focus on those entities traditionally considered to have a direct and significant connection to the United States while avoiding wastefully capturing entities with little meaningful link to the U.S. financial system.[24]

B. A More Risk-Sensitive Treatment of Guarantees, Conduit Structures and Back-to-Back Bookings

1. Defining the Risks

We believe that a clearer, more precise and more appropriately risk-based analysis should apply to defining those non-U.S. persons that are either (a) guaranteed by a U.S. person

[23] This necessarily also means that existing swaps with such counterparty should not be deemed to be with a U.S. person, but only new swaps going forward.

[24] The definition we propose above is not inconsistent with the definition that we proposed as an interim (and potentially final) definition of "U.S. person" in our letter, dated August 13, 2012, on the Commission's proposed exemptive order (77 Fed. Reg. 41110 (July 12, 2012)). For the sake of completeness, we have broadened our discussion in this letter to address all of the various sub-definitions, rather than highlighting only specific aspects that present significant difficulties in implementation.

or (b) a "conduit" for swaps with a U.S. person. We believe that these concepts should generally apply only to entities that are "shell" or thinly capitalized entities, or entities that are otherwise created in furtherance of evasion of U.S. rules. Such a definition would be consistent with the risk-focused boundaries created by the Dodd-Frank Act, as a direct and significant connection to U.S. financial system risk is absent in circumstances other than when using such a shell entity.

With regard to both guaranteed entities and conduits, non-U.S. operating entities with substantive business that are subject to local capital requirements and/or local swap dealer, broker-dealer or bank registration requirements should be excluded from treatment as a guaranteed entity or conduit entity. Application of such local rules should mitigate the risk that may be transferred through a guarantee or back-to-back swap.[25] In addition, the conclusion that a "direct" connection exists in such circumstances is questionable, as the true capital and regulatory buffer required by the entity should result in any risk to the U.S. entity being indirect and contingent.

Even if a non-U.S. entity were to fail to meet these requirements for such exclusion, the Commission must still conclude that any risk incurred by the U.S. entity is "significant." A non-U.S. entity should still be excluded if it does not act in a manner that transfers significant risk of its swaps to a U.S. guarantor or back-to-back counterparty. Therefore, to be a guaranteed entity or conduit entity it must systematically transfer risks of all or substantially all of its swaps to a U.S. person <u>and</u> also transfer credit risk of counterparties to a U.S. person (rather than hedging only market risk). Without the transfer of credit risk, the underpinnings of the Dodd-Frank Act, as emphasized through clearing and margin requirements in particular, would not be present. In addition, as described further below with regard to inter-affiliate swap trading examples, many inter-affiliate trades are risk-reducing trades designed to offset risks within a consolidated group, and therefore should not be considered significant. If an entity does, however, meet these requirements, then it is acting much more like a "shell" or "conduit" of swaps to a U.S. person, rather than an operating company with its own risk management and operational infrastructure.

Narrowing the scope of those entities that are covered by guarantees or that act as conduits will assist in improving (but not fully correct) the harm that these entities will face in their local markets. Other dealers will likely avoid trades with such entities or, at a minimum, will find it extremely difficult to discern whether a potential counterparty may fall into one of these categories. Wholly non-U.S. transactions will require a significant level of U.S.-imposed

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[25] We note that even such robust entities might carry a parent or affiliate guarantee for a very simple reason. Many counterparties are required to transact, or maintain policies of only transacting, with rated counterparties. Although an entity may be well capitalized and/or subject to a financial regulatory rule set, often consolidated groups will not go through the process and expense of obtaining a rating on every entity that may engage with counterparties. Therefore, it is quite often the case that a guarantee is merely for purposes of attributing the guarantor's rating to the guaranteed entity, even if the guaranteed entity would have a quite robust financial profile in its own right.

due diligence on counterparties, and will need to include U.S.-related representations and covenants in documentation – both of which are inconsistent with the mandate in the Dodd-Frank Act that U.S. rules not apply to activities outside the United States. We believe that the more narrow definition, focusing on shell entities and those entities that are not subject to a capital or financial regulatory regime, will be more easily discerned by non-U.S. counterparties without significant due diligence.

In sum, and for purposes of the discussion below, the only entities that would be included in the definitions of guaranteed entity and conduit entity would be "shell" entities that are (1) non-operating companies without substantive business that are either (a) not subject to capital adequacy regulations or (b) not subject to a swap dealer, broker-dealer or bank regulatory regime, and that meet the requirements of systematically transferring both market and credit risk of all or substantially all of their swaps to a U.S. person, or (2) entities created with the purpose of evading U.S. swaps rules as determined by the Commission.[26]

2. Clarifying Additional Ambiguity Created by the Proposed Guidance

In addition to the discussions of guaranteed entities and conduit entities, the Proposed Guidance introduces the concept of a "central booking model" that may also have implications for registration because of the transference of risk of swaps between entities. The Proposed Guidance fails to clarify whether and how the "central booking model" concept relates to guarantees and conduit entities that are described elsewhere. We propose that the "central booking model" concept not figure into any final guidance, and that the issues perceived by the Commission in relation to this concept be addressed solely through the revised definition of guaranteed entities and conduit entities described above.

If not removed, we wish to point out the uncertainty created by introducing this concept. The Proposed Guidance states that "the U.S. person who books the swaps would be required to register as a swap dealer, regardless of whether the swaps were . . . indirectly transferred to the U.S. person (by way of a back-to-back swap or other arrangement)."[27]

- It is not clear what is meant by such "other arrangement." As we have recommended, clarity is absolutely necessary, particularly in relation to concepts that carry legal significance and trigger legal responsibilities such as registration. Further, if the Commission is driving at potential evasion situations, it has broad authority to monitor and address any evasive activity without creating an open-ended definition.

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[26] Non-financial entities that carry a guarantee from a U.S. non-financial end user parent or affiliate, or that back-to-back trades with such parent or affiliate, should also be fully excluded from the definition of guaranteed entity or conduit entity, as the parent or affiliate would not be subject to the various Title VII requirements if transacted with directly.

[27] Proposed Guidance, 77 Fed. Reg. at 41222.

- The back-to-back/central booking model concept seems to resemble the conduit structure discussed in the Proposed Guidance, but the concepts and definitions are not connected (and, indeed, are inconsistent) in the Proposed Guidance.

- We note a further inconsistency with the swap dealer registration rules related to inter-affiliate swaps. We do not believe that the discussion of the central booking model (or the concept of a conduit) are intended to abrogate the Commission's determination that inter-affiliate swaps between majority-owned affiliates are to be excluded from the swap dealer registration calculation.[28] Yet, the Commission fails to reconcile this discrepancy in the Proposed Guidance.

- The Commission fails to clarify, in its discussion of non-U.S. persons using U.S. affiliates or subsidiary intermediaries, whether the intermediary is acting as agent or principal.[29] Broadly with regard to both U.S. and non-U.S. persons that act as agent for either a U.S. or non-U.S. person, such entity should only be required to register if the agent entity "independently meets the definition of a swap dealer" (presumably through other principal trades).[30] Nevertheless, the lack of clarity in the Proposed Guidance has raised a significant number of questions, including with regard to registering entities whose sole connection to the United States as principal is either a guarantee or a back-to-back swap with a U.S. affiliate.

This lack of clarity and the resulting punitive (and inconsistent) effect on the back-to-back counterparty will detrimentally affect risk management at most institutions. It is rarely the case that back-to-back transactions are for the sole purpose of promoting a "central booking" structure. It is much more likely the case that back-to-back transactions are used to manage specific risks in those locations (and there are often multiple locations) where such risks are managed most efficiently.

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[28] See "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant,' and 'Eligible Contract Participant,'" 77 Fed Reg. 30596, 30746 (May 23, 2012) ("**Entity Definitions**"); see also Proposed Guidance, 77 Fed. Reg. at 41219 n.43 ("The Commission construes section 2(i) to apply such inter-affiliates exclusion to swaps between a non-U.S. person and its U.S. affiliates or between two affiliated non-U.S. persons.").

[29] See Proposed Guidance, 77 Fed. Reg. at 41222.

[30] We agree with the Commission's conclusion that an agent for a principal need not register as a swap dealer or MSP. See Proposed Guidance, 77 Fed. Reg. at 41231 ("[I]f the counterparty facing affiliate or subsidiary was acting merely as a disclosed agent and did not meet the definition of a swap dealer, then the Dodd-Frank Act requirements applicable to swap dealers would not be applicable to the affiliate or subsidiary, provided that the agency relationship was properly documented and the principal remained primarily responsible for the actions of the affiliate.").

For example, a swap dealer in the United Kingdom may run a full-service (not a "shell") business reaching out to customers in Europe by utilizing its EU "passport" authority to conduct derivatives with EU persons. Many clients request swaps on reference assets that can be managed locally, such as U.K. stocks or bonds. Other clients may request swaps on reference assets that are harder to risk-manage locally, such as U.S. equity indices. Inter-affiliate trades are necessary to enterprise-wide risk management by connecting the market risk of a trade to an entity that operates in the market that has the most appropriate liquidity for hedging such risk. In this case, the UK swap dealer may back-to-back a U.S. stock index swap to a U.S. affiliate that will be able to access greater market liquidity for hedging the market risk of such trade. Conversely, the U.S. affiliate may undertake a similar inter-affiliate swap to the U.K. dealer in order to facilitate hedging a U.S. client's request for a Euro-Pound swap.

Thus, the concept of a "central booking model" with satellites that simply feed the central entity is not fully accurate. Without the ability to undertake inter-affiliate trades, globally active entities would not be able to match up offsetting risks within their consolidated book, and would not be able to efficiently seek market liquidity for risk-mitigating hedging. The "central booking model" described in the Proposed Guidance de-emphasizes the significant risk management benefits that are attendant to this reciprocal inter-affiliate trading, and creates additional risks by potentially promoting the trapping of risk in entities less able to manage them, the trapping of capital and liquidity in such entities (as required to deal with the less efficiently managed risk), and the creation of additional costs and counterparty interconnections when entities replace internal back-to-back trades with external swaps required to hedge these risks.

The Proposed Guidance fails to give appropriate weight to regulatory requirements for enterprise-wide risk management and the significant benefits that inter-affiliate trades provide a consolidated group. Nevertheless, in a separate but related context, the Commission has "recognize[d] these potential benefits."[31] Therefore, these situations should be provided special treatment, and be encouraged by the regulators. Risks in these circumstances can be addressed in other ways: If the Commission is concerned about evasion of Title VII rules, it has repeatedly shown that it has broad authority to monitor and address evasion when detected. More specifically, through the recent Affiliate Swap Exemption, the Commission has shown that it can address risks of inter-affiliate swaps without imposing broad extraterritorial requirements on swaps that enhance risk management.

Again this reasoning dictates that only a more limited set of shell entities that systematically back-to-back transactions to a U.S. person should be recognized as raising the concerns the Commission seems to be seeking to address.

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[31] See "Clearing Exemption for Swaps Between Certain Affiliated Entities," 77 Fed. Reg. 50425, 50427 (Aug. 21, 2012) (the "**Affiliate Swap Exemption**").

3. Recommendations on Applying the Risk-Based Criteria

The Proposed Guidance suggests that the guarantee and conduit or back-to-back structures may have multiple effects on the registration decisions of both (1) potential registrants that face these entities and (2) these entities and their guarantors or back-to-back counterparties. In addition, the Proposed Guidance would apply transaction-level rules differently when non-U.S. registrants face a non-U.S. guaranteed entity or a conduit entity than when non-U.S. registrants face other non-U.S. persons. Based on the revised definitions described above, the following clarifications should be made in the Proposed Guidance:

- A non-U.S. entity that is excluded from the definitions of guaranteed entity or conduit entity would only count swaps with U.S. persons for determining whether it has met the *de minimis* threshold for swap dealer registration, and would not count swaps with non-U.S. counterparties that are guaranteed by or back-to-backed to a U.S. person.

- Potential MSP registrants should not require aggregation of swaps from any non-U.S. entity that is excluded from the definitions of guaranteed entity or conduit entity, even if it guarantees such entity or receives a back-to-back from such entity, as the robustness of the entities that are excluded from the definitions should mitigate risks that are transferred to such potential MSP registrant.

- For purposes of the "central booking model" discussion in the Proposed Guidance, a non-U.S. intermediary acting as principal and holding itself out as dealer to the customer will be attributed the swaps and the swaps will not be attributed to a back-to-back counterparty or to a guarantor, for purposes of registration determination, if the intermediary meets the exclusions from a guaranteed entity or conduit entity described above. Similarly, a U.S. intermediary will also not have its swaps attributed to a non-U.S. guarantor or back-to-back counterparty if it meets the exclusions from guaranteed entity or conduit entity.

- We believe that it is already clear in the Proposed Guidance that non-U.S. persons (whether or not they meet the recommended definitions in this comment letter) that are guaranteed by a U.S. person or that back-to-back swaps to a U.S. person continue to be deemed a "non-U.S. person", and therefore trades by non-U.S. potential registrants with such entities would not count toward determining swap dealer or MSP status of such non-U.S. potential registrant.

- Non-U.S. registrants that face entities excluded from the definition of guaranteed entity or conduit entity would not have to apply the substituted compliance approach to transaction-level rules when transacting with these entities.

C. Appropriate Treatment of Transaction-Level and Entity-Level Rules

1. Delineation of Rules Between the Categories

The Proposed Guidance divides various Title VII requirements into "transaction-level" or "entity-level" requirements for purposes of application to different types of U.S. and non-U.S. market participants. We believe that this distinction provides an appropriate base for determining application of the various rules to non-U.S. transactions. However, although appropriate, such distinction is not sufficiently infused with a determination of whether such rules are in fact necessary to mitigate a direct and significant risk to the U.S. financial system.

In particular, pre- and post-trade transparency rules[32] relate to local market structure regulation. Local market participants, and local regulators, will expect local transparency rules to apply just as they do with sales practice (external business conduct) rules,[33] and the Commission would not seem to have a stronger interest in their application than the local supervisors and market regulators. In addition, certain entity-level rules—notably the internal conflicts rules[34]—similarly relate to the protection of customers and should not apply to interactions with non-U.S. customers. The application of local rules related to market structure and customer protection should be particularly compelling when the underlying reference to the swap is not a U.S. interest – local regulators would have a much greater interest in transparency and customer protection in such cases. Therefore, in response to the Commission's question,[35] these rules should be treated similarly to the external business conduct rules – excluded from the transaction-level and entity-level categories, and not applied at all to transactions between a non-U.S. entity (including a non-U.S. branch of a U.S. entity) and its non-U.S. counterparty, regardless of whether that counterparty is guaranteed by, or a conduit for, a U.S. person. None of these rules would need to be subject to a comparability analysis or substituted compliance.

In addition, swap data repository reporting,[36] physical commodity trades reporting[37] and the recordkeeping rules under Rule 23.201 (other than the business records subsection) ("**Swap**

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[32] These would include real-time public reporting rules, trade execution requirements and daily trading record rules. See "Real-Time Public Reporting of Swap Transaction Data," 77 Fed. Reg. 1182 (Jan. 9, 2012); CEA § 2(h)(8); "Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants," 77 Fed. Reg. 20128, 20203 (Apr. 3, 2012) ("**Internal Business Conduct Standards**").

[33] See "Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties," 77 Fed. Reg. 9734 (Feb. 17, 2012).

[34] See Internal Business Conduct Standards, 77 Fed. Reg. at 20209-11.

[35] Proposed Guidance, 77 Fed. Reg. at 41232 (Q11b).

[36] See "Swap Data Recordkeeping and Reporting Requirements," 77 Fed. Reg. 2136 (Jan. 13, 2012) ("**SDR Reporting**").

Data Recordkeeping")[38] also more appropriately relate to the specific transactions with non-U.S. counterparties. As the Commission indicated in relation to other reporting requirements, these "have a closer nexus to the transparency goals of the Dodd-Frank Act, as opposed to addressing the risk of a firm's failure."[39] Therefore, these rules should be treated differently from other entity-level rules. The Commission states that it has an interest in application of these rules in order to fulfill "supervisory mandates concerning, among other things, increased transparency, systemic risk mitigation, market monitoring and market abuse prevention."[40] However, with regard to activities conducted in foreign jurisdictions by non-U.S. persons or non-U.S. branches of a U.S. person, compliance with the exact reporting standards in the U.S. rules should not be required. The U.S. rules were designed to be congruous with other U.S. public reporting requirements, and therefore the policy behind their applicability to entities (including non-U.S. branches of U.S. registrants) that are subject to other regulatory reporting schemes is not clear. At most, substituted compliance should be permitted, as we recognize the Commission's interest in having additional information. Nevertheless, the standard for substituted compliance should be easily reached in the context of these rules. The local supervisors that are members of the OTC Derivatives Supervisors' Group, including the Commission, have agreed that swaps should be reported to the Global Trade Repository. The Commission's access to the information in such repository should assist it in monitoring systemic risk and should suffice for substituted compliance for all non-U.S. registrants and non-U.S. branches of U.S. registrants.

Also, we note that application of these rules by non-U.S. persons or to transactions with non-U.S. counterparties will raise significant issues under non-U.S. privacy and data protection laws and negatively affect relationships with such counterparties. Registrants should not be expected to have to risk non-compliance with local privacy and data protection laws in an effort to transact with a local client base. Further, the same is true for any transactions with non-U.S. persons that benefit from a guarantee of a U.S. person or that act as a conduit for a U.S. person, as compliance with the local privacy and data protection rules and avoiding reputational risk in the local jurisdiction is not related to whether the entity is guaranteed by a U.S. person or a conduit to a U.S. person. At a minimum, the Commission should delay compliance with such rules until the local supervisor has clarified the interaction between such reporting rules and local data privacy laws, after which substituted compliance should be sufficient (under the lower standard of comparability noted in the previous paragraph). Also, all registrants should

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[37] See "Large Trader Reporting for Physical Commodity Swaps," 76 Fed. Reg. 43851 (July 22, 2011) ("**Large Trader Reporting**").

[38] See Internal Business Conduct Standards, 77 Fed. Reg. at 20202.

[39] Proposed Guidance, 77 Fed. Reg. at 41226.

[40] Proposed Guidance, 77 Fed. Reg. at 41227.

be permitted to mask or suppress data fields the disclosure of which may violate local laws, at least until further clarity from local supervisors has been received.

2. Application of the Rules in Transactional Situations

a. Non-U.S. Branches of U.S. Persons

The Commission vastly oversimplifies the very complex and unique nature of branches or agencies of a banking institution when it describes them as an "extension" of the home office or as an "agent of their U.S. person."[41] Branches and agencies enjoy a hybrid existence with an historically well-established degree of separateness from the home office of the banking institution.[42] In addition, like locally organized banks or broker-dealers, they are subject to chartering, regulation and supervision of the local regulatory body and will undoubtedly be treated as local entities for purposes of the implementation of swaps market reforms in other jurisdictions. Also, as we have discussed earlier, the artificial difference established by the Proposed Guidance between the rules applicable to a non-U.S. branch of a U.S. registrant and those applicable to transactions of non-U.S. registrants (whether non-U.S. based or a subsidiary or affiliate of a U.S. person) create a significant disparity in the ability of branches to address the needs of local customers. For these reasons, The Clearing House continues to believe that the non-U.S. branches of U.S. persons should be treated as non-U.S. persons, both for purposes of determining the application of rules to transactions with non-U.S. customers and counterparties and for non-U.S. registrants determining the application of rules to transactions with such branches. The Clearing House agrees, however, that entity-level rules (subject to making the changes to entity-level and transaction-level rules described above) should continue to apply to the whole entity and that substituted compliance for entity-level rules would not be appropriate.

Adoption of this recommendation will cure the incongruous treatment to which non-U.S. branches of U.S. swap dealers would be subject in comparison to other non-U.S. persons. Regardless of the relief provided in relation to calculation of the *de minimis* threshold for registration, non-U.S. counterparties (both dealers and clients) will continue to avoid transactions with non-U.S. branches if the transaction will be subject to other than local rules.

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[41] Proposed Guidance, 77 Fed. Reg. at 41221, 41227 n.102.

[42] See, e.g., 12 U.S.C. § 604a (authorizing regulations to permit branches "to exercise such further powers as may be usual in connection with the transaction of the business of banking in the places where such foreign branch shall transact business"); 12 C.F.R. § 211.4 (authorizing branches to engage in activities in foreign jurisdictions that are not permissible for the home office of the banking institution); Federal Financial Institutions Examination Council, Reporting Form FFIEC 030, "Foreign Branch Report of Condition" (requiring separate financial statements for each foreign branch with assets greater than $50 million); 12 U.S.C. § 1813(l)(5)(A) (deposits payable solely at a foreign branch are not afforded FDIC insurance protection); 12 C.F.R. § 204.1(c)(5) (no reserves are required to be maintained against deposits payable solely outside the United States); 12 C.F.R. § 633 (home office cannot be forced to pay deposits of a foreign branch when act of war, civil strife or action of the host country government prevents such payment at the branch, unless bank has contractually agreed to pay the deposit elsewhere).

Although we continue to hope that harmonization of transactional rules will come to fruition, we continue to be concerned that a wholly non-U.S. transaction could be the cause for the submission of, and potentially lengthy determination pursuant to, a substituted compliance application, and non-U.S. dealers and MSPs (who are more focused on comparability of entity-level rules) will avoid engaging unless absolutely necessary. This cannot be the outcome that the Commission intended, as it will seriously affect the ability of the non-U.S. branches of U.S. persons to undertake risk-reducing and hedging trades for their local operations (separate and apart from any dealing performed by the non-U.S. branch). Safety and soundness of the institution is bolstered by application of the entity-level rules to the U.S. person with the non-U.S. branch, and not through the application of new, different or additional rules to each transaction between non-U.S. branches and non-U.S. persons.

Should, however, the Commission decide not to adopt such recommendation, additional precision in the application of rules to the non-U.S. branches should be adopted in order to mitigate the negative impact on such branches. As stated by Commissioners Sommers and O'Malia in their concurring statements,[43] the Commission should strive to ensure that the Proposed Guidance does not have an adverse impact on certain classes of registrants in relation to their ability to compete for business with the same target customers as another class of registrants. To that end, we recommend the following:

When Non-U.S. Branches of U.S. Registrants Face Customers. We would accept the application of substituted compliance for transaction-level rules applicable to all non-U.S. counterparties, subject to the recommended changes to entity-level and transaction-level rules described above and to the modified, risk-based comparability analysis described below.

Application of Transaction-Level Rules by Other Registrants When Facing Non-U.S. Branches. A non-U.S. registrant trying to determine what transaction-level rules it should apply to a transaction with a non-U.S. branch would find the Proposed Guidance to be extremely unclear.

In the Proposed Guidance, the Commission describes the exclusion of transactions with non-U.S. branches of U.S. swap dealers from the determination of whether the *de minimis* registration threshold is met by a potential non-U.S. registrant. As a seeming justification for this exclusion, the Commission states that "[i]n such cases, the Dodd-Frank Act transactional requirements (or comparable requirement) would nevertheless apply to swaps with those foreign branches."[44] However, later in the Proposed Guidance, the Commission states that it would "require non-U.S. swap dealers and non-U.S. MSPs to comply with Transaction-Level Requirements for all of their swaps with U.S. persons, <u>other than foreign branches of U.S. persons</u>, as counterparties" (emphasis added).[45] Footnote 106 of the Proposed Guidance is

[43] <u>See</u> Proposed Guidance, 77 Fed. Reg. at 41239, 41241.

[44] Proposed Guidance, 77 Fed. Reg. at 41219.

[45] Proposed Guidance, 77 Fed. Reg. at 41228.

related to these statements and directs the reader to look to the sections on how entity-level and transaction-level requirements apply to branches of U.S. swap dealers.[46] However, those sections of the Proposed Guidance describe how such branches should apply the rules to their counterparties, and not how the rules should be applied by a non-U.S. registrant to the branch as a counterparty. Clarity and consistency is needed.

We believe that the intent of these statements was to be consistent with the exclusion of transactions with non-U.S. branches for purposes of determining registration status, and therefore not to require the application by non-U.S. registrants of the transaction-level rules to transactions with non-U.S. branches of U.S. persons. This would be the case even if the non-U.S. branch can only benefit from substituted compliance when applying the transaction-level rules outward to its non-U.S. counterparty. If this was, however, not the intention of the Commission embedded in the ambiguous statements cited above, then, at most, substituted compliance should suffice with regard to transaction-level rules to be applied by a non-U.S. registrant to its transactions with a non-U.S. branch of a U.S. person.

Further, to assist in avoiding the application of two full sets of transaction-level rules to certain transactions, a non-U.S. branch of a U.S. registrant should be able to also apply for substituted compliance with regard to the transaction-level rules applicable to a transaction with a non-U.S. branch of another U.S. registrant.[47] Substituted compliance should be able to address any risks that the Commission perceives in such situation, and evasion of U.S. rules can be monitored and addressed through the Commission's broad authority to counter evasion. Similarly, the "emerging market" carve-out (discussed further below) should apply to two non-U.S. branches of U.S. swap dealers conducting trades with each other in such emerging market, if the Commission continues to deem such non-U.S. branches as U.S. persons.

b. All Registrants

In the Commission's discussion of substituted compliance, the Proposed Guidance seems to contemplate that an application may be made only in relation to the "home" jurisdiction of the non-U.S. registrant (and, in other contexts, the location of a non-U.S. branch of a U.S. registrant). However, non-U.S. persons (as well as a non-U.S. branch of a U.S. person) may conduct transactions with persons in many different jurisdictions, through branches or truly cross-border. Depending upon the rules of each jurisdiction, it is possible that "home", "host" (for branch locations) or "counterparty" jurisdiction rules may be applicable. Just as the Commission would expect in relation to transactions on U.S. soil, local governments and regulators will expect their local rules to apply to transactions undertaken in their nation. We recommend that, for all potential registrants, in addition to a request for "home" (or location of branch of U.S. persons) rules to be found comparable, applications for substituted compliance

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[46] *Id.*

[47] In response to the Commission's question Q25. See Proposed Guidance, 77 Fed. Reg. at 41232.

may also be submitted for (a) the rules of a non-U.S. counterparty's jurisdiction to apply, and/or (b) the rules of a "host" jurisdiction (such as the jurisdiction in which a branch is located) to apply.

We also note that, under the Proposed Guidance, non-U.S. registrants (including their U.S. branches) may engage in transactions with non-U.S. persons without being subject to any of the transaction-level rules. In contrast, U.S. registrants acting from U.S. offices would be subject to all transaction-level rules with respect to their transactions with both U.S. and non-U.S. counterparties.[48] This approach would result in significant competitive disadvantages for U.S. registrants due to the unequal treatment of U.S. and non-U.S. entities in their dealings with non-U.S. counterparties. Competitive parity should be maintained and U.S. and non-U.S. registrants should be treated similarly when operating from U.S. offices, including not having to apply transaction-level rules to swaps with non-U.S. counterparties or, at most, being able to avail themselves of the substituted compliance approach.

Conversely, when substituted compliance is permitted in a jurisdiction, it should be permitted for any registrant, even when such registrant is facing U.S. persons in that jurisdiction. It does not follow logically that transactions in a comparable jurisdiction may still require the application of U.S. transaction-level rules (and all of the attendant systems, compliance and infrastructure) if there happens to be a U.S. person transacting in that jurisdiction.

D. A More Risk-Sensitive Approach to Swap Dealer Registration Issues

We believe an approach to swap dealer registration focused on mitigating risk and appropriately directing the limited resources of the Commission would better serve the purposes of Title VII.

1. Aggregation Concepts

Under both the Proposed Guidance and the Entity Definitions, entities would be required to aggregate the swaps of all of their affiliates, including their registered swap dealer affiliates, for purposes of the calculation of *de minimis* thresholds for swap dealer registration. The Proposed Guidance proposes that potential non-U.S. registrants would not have to aggregate their transaction volumes with the volumes of U.S.-based affiliates and also asks a question about the aggregation of a registered swap dealer's transaction volume.[49]

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[48] Under the Proposed Guidance, foreign branches of U.S. registrants would be eligible for substituted compliance with respect to the transaction-level rules for transactions with non-U.S. counterparties. As discussed in Section IV.C.2.a. above, we believe that non-U.S. branches should be treated as non-U.S. persons and therefore transaction-level requirements would not apply to their transactions with non-U.S. counterparties.

[49] See Proposed Guidance, 77 Fed. Reg. at 41222 (Q5).

We believe that the Commission has recognized, based on these questions and the calculation modifications found in the Proposed Guidance, that the aggregation principle is overly broad, and while appropriate in certain circumstances would lead to anomalous and unnecessary consequences in other circumstances. We believe that the aggregation requirement would be particularly onerous for many multinational firms operating through numerous entities, both in the United States and abroad. In order for the aggregation concept to work properly, there must be phased application of the aggregation requirements to all potential registrants.

The Proposed Guidance recognizes only a limited exemption—non-U.S. potential registrants would not have to aggregate transaction volume from their U.S. affiliates for determining compliance with the *de* minimis thresholds for registration. But, the problems associated with application of the aggregation concept apply also to decisions by U.S. persons about their registration status. For example, under the Proposed Guidance, a U.S. bank that has a foreign bank parent and non-U.S. affiliates would be required to aggregate the U.S.-facing transactions of all of its non-U.S. affiliates for purposes of the *de minimis* threshold, while its non-U.S. affiliates would not be required to aggregate the positions of the U.S. bank affiliate for purposes of their own calculations. We believe that the Commission has recognized that ambiguous results such as these may occur when applying the aggregation principles.

An alternative approach would be for the Commission to allow firms affected by the Commission's aggregation requirement to submit alternative schedules for compliance with the aggregation rule. Doing so would allow multinational firms to properly plan and prepare for registration of potentially many different entities, and would allow both potential registrants and the Commission to focus resources initially on those entities that engage in more significant swap activity. In other words, this approach would be more appropriately calibrated to capture the most significant risk first, while eventually not requiring registration of smaller entities with insignificant U.S. swap dealing. Submission of a schedule for registration would allow each affiliated group the flexibility to register the more significant dealers in an affiliate group first, and (as requested below) exclude those dealers' transaction volume from aggregation with subsequent potential registrants to determine whether those entities would be required to register.

Even if the alternative schedule approach were not adopted, at a minimum, there should be no aggregation of a registered swap dealer's volume with that of its unregistered affiliates. Without this exclusion, virtually every entity that engages in swaps with U.S. persons and is affiliated with a registered swap dealer would be automatically required to register under the aggregation rubric. To avoid unnecessary expenditure of resources on the part of both firms and the Commission, the Proposed Guidance should also exclude from the aggregation principle entities in the process of transferring their swap dealing positions to their registered swap dealer affiliates.

More broadly, the aggregation concept casts too wide a net and works on an assumption that affiliates are somehow responsible for each others' trading. A more risk-based and appropriate approach, however, would be to require aggregation only within a specific jurisdiction, provided that the jurisdiction has a substantive regulatory regime for swap dealers (including a Basel-compliant capital regime on financial institutions). We see little prospect for evasion based on this standard because the complexity of setting up a fully regulated entity would deter dealers from trying to spread dealing activity across multiple entities or multiple jurisdictions.[50]

The Commission also asks a question with regard to the concept of "common control" used in the aggregation principles.[51] In order to appropriately focus on the risk to affiliated institutions, a control threshold should not be less than actual control (voting power of over 50%) and financial consolidation into the same parent entity.

2. Limited Designation

We recognize that the Commission has determined that registration will apply on an entity basis, and not on a branch, department, division or business line basis. In addition, in the Proposed Guidance the Commission stated that all swap activities of a registrant are subject to the Dodd-Frank requirements, "not only the swap activities that trigger the registration requirement."[52] Nevertheless, the Commission asked a question about the application of the limited designation principles[53] and we believe the Commission should interpret the Dodd-Frank Act's limited designation provisions to limit the application of certain of its requirements to only the branches, departments, divisions or business lines that engage in U.S. swap dealing activities. Such a limited designation would limit the impact of certain governance rules to, and would target sales practice and related recordkeeping rules on, those businesses that engage in U.S. swap dealing. It would not apply to capital, risk management and similar rules that relate to the safety and soundness of the entity as a whole.

For non-U.S. potential registrants (whether or not affiliated with a U.S. parent), this may help in distinguishing between those locations engaged in swap dealing with U.S. persons and those locations (particularly those outside the United States) that are not. For all potential registrants, there are also certain businesses that, even though they engage in swaps, are not themselves in the business of dealing in swaps. For example, loan portfolio managers may purchase, as an end user, interest rate or credit swaps to hedge the loan book. Similarly, an institution's treasury or asset-liability management function may purchase swaps as a customer of other dealers in order to manage critical financial operations. A limited designation

[50] We do not intend the local jurisdiction's substantive regulatory regime under this aggregation standard to be subject to the comparability or substituted compliance approach in the Proposed Guidance.

[51] *Id.* (Q3c).

[52] Proposed Guidance, 77 Fed. Reg. at 41219.

[53] Proposed Guidance, 77 Fed. Reg. at 41222 (Q9).

approach would allow registrants to focus on coming into compliance in their U.S. dealing business—rather than these non-dealing or non-U.S. dealing businesses. This risk-based approach will allow the Commission to focus resources much more efficiently on those areas of an institution that have significant swap-dealing activity directly related to U.S. commerce.

In addition, it is necessary for non-U.S. potential registrants to have a greater understanding of how the U.S. rules are going to apply to their international operations. One way to accomplish greater clarity is by using the limited designation principle. By way of example, limited designation would provide relief to foreign entities (whether or not affiliated with a U.S. parent) in terms of registration of principals and the scope of required representations on Form 7-R. In particular, limited designation of this type should allow for registration of principals at the level of the relevant branch or division engaged in U.S. swap dealing activity, providing relief for multiple and variable levels of governance structures common in globally active non-U.S. banks. Further, for purposes of evaluating statutory disqualification, "associated persons" should be limited to those individuals directly involved with solicitation or acceptance of swaps with U.S. persons. This relief would enable foreign entities and the Commission to focus on the business with direct effects on the U.S. market and avoid entanglement with irrelevant foreign operations. However, if the Commission chooses not to adopt certain limited designation principles in their registration requirements, the Proposed Guidance should still include additional clarity on these issues for non-U.S. potential registrants as they are making decisions about registration and compliance.

3. Registration of MSPs

For purposes of determining MSP status of a non-U.S. person, the Commission should exclude transactions with foreign branches of registered U.S. swap dealers from the calculation of notional amounts for purposes of determining MSP status. Such transactions are excluded from the swap dealer determination under the Proposed Guidance and Title VII rules should not be extended to an entity that operates wholly outside the United States, conducts transactions principally with non-U.S. persons, and where one of its only connections to the United States consists of wholly foreign transactions with foreign branches of U.S. persons. Although we recognize the Commission's policy interest in mitigating risk through regulation of MSPs, there is certainly a competing and legitimate policy of avoiding application of U.S. rules to persons that transact principally outside the United States and that have engaged only with non-U.S. branches of U.S. institutions (in addition to other non-U.S. persons). Overall, the risk that may be created to U.S. institutions by facing potential non-U.S. MSP registrants through non-U.S. branches can be addressed through the entity-level rules applicable to, and general supervisory oversight of, the U.S. institution.[54] In addition, we believe that there will be

[54] We also note that, pursuant to Section 1a(33)(B) of the CEA, the Commission is to define a MSP by reference to "entities that are systemically important or can significantly impact the financial system of the United States." As we have discussed throughout this comment letter, the Commission has failed to heed its Congressional mandate and has attempted to impose regulations or to regulate entities that do not meet the heightened standard required for application of U.S. rules to overseas activities.

significant groups of clients that will avoid transactions with non-U.S. branches of U.S. institutions if such an exemption is not provided.

4. Legacy Portfolios

As decisions are made about appropriate structure, potential registrants may wish to curtail the dealing or similar swap activity (or U.S.-facing swap activity) of certain entities in order to register a more limited number of such entities. However, a legacy portfolio of swaps may remain at such entities, but the portfolio will run off over time. The Commission should recognize that potential registrants may make decisions to curtail activity and those entities should not be required to register. In addition, the Commission should provide an exemption from dealing and registration for "maintenance" transactions that such entities undertake that are not on the order of holding oneself out as a dealer. Permissible "maintenance" transactions that would not give rise to dealing or a registration requirement would include terminations, modifications to shorten the tenor or reduce the risk of a swap, novations or assignments out of the portfolio, continuations or extensions of maturity required by pre-existing terms of the swap, clearing and portfolio compression and hedging transactions that reduce the risk of individual or aggregate transactions in the portfolio. Excluding legacy portfolios from registration calculations in this manner would allow the Commission to more appropriately focus on entities that are actively engaged in swap dealing activity, while avoiding unnecessary expenditure of resources on legacy activities that do not pose any direct or significant risk to the United States.

E. Addressing Comparability Determinations for Substituted Compliance

In evaluating comparability of various requirements, the Commission should consider both which rules implemented by a foreign jurisdiction need to be reviewed and what the appropriate standard of review should be with regard to those rules.

In addressing the question of which rules should be reviewed, we recognize that all of the various requirements promulgated under Title VII may serve an important purpose, but an appropriate application of Section 2(i) requires that the comparability review focus on those aspects of the rules that would be necessary to be applied to overseas activities to address a direct and significant risk to the U.S. financial system. Thus, the comparability exercise is not a one-for-one matching, or "check the box" exercise, but is more limited and risk-based, and logically so, as the purpose of applying such an analysis to foreign requirements is to mitigate risk rather than export U.S. Title VII rules.

To this end, we believe it would be more appropriate to evaluate a foreign regime on a holistic basis, rather than "area-by-area" as described under the Proposed Guidance. An "area-by-area" or "individual requirement" approach represents an unwarranted extraterritorial application of the Commission's rules. First, it assumes that local regulators cannot decide for themselves how to implement the international accord reached among G20 nations. Second, it would specifically and directly apply U.S. rules to wholly non-U.S. transactions to "fill any gaps" perceived by the Commission, without regard to whether the gap being filled addresses a risk to the U.S. financial system and without appropriate deference to local regulators. Registrants risk loss of competitiveness in the local jurisdiction if even one U.S. rule has to apply to transactions in the non-U.S. jurisdiction – the application of one rule that is different from local rules, such as potentially the margin rules or requirements for trading on an exchange, can completely undermine a relationship with a counterparty. Thus, a more risk-focused approach, based on key measures and an approval of the local regime as a whole, is more appropriate, as described below.

In determining the appropriate standard of review, we note that the vague outlines of the procedure to be followed in the Proposed Guidance make no mention of materiality or a risk-based approach to comparability as is required by the statute and as has been discussed throughout this comment letter. The operative determination standard should be based on whether the key measures being reviewed appropriately incorporate the principles agreed among the G20 nations for swaps reform. For example, the Basel Committee on Banking Supervision (the "**BCBS**") and the Board of the International Organization of Securities Commissions ("**IOSCO**") recently released a consultative proposal for margin requirements for non-cleared derivatives.[55] That proposal allowed national supervisors significant flexibility to adopt variations of the guidance that was set forth in the proposal. Yet, the Commission would have to acknowledge that a jurisdiction that generally adopted the Basel/IOSCO standards was comparable. In other words, the test must be whether the regime employed in the non-U.S. jurisdiction contains sufficient elements designed to implement the principles of the G20 accord and should not be whether each element is similar to that applied by the Commission to U.S. registrants.

Using these criteria, we propose that comparability focus on certain key risk-based measures rather than each and every one of the Title VII requirements. For entity-level requirements, the standard should be whether the local rules generally include capital, risk management and overall compliance requirements that would be appropriate (not identical) to address risks that were identified in the G20 accord and that arise out of swap activity. These rules need not be new rules, as existing non-U.S. capital, supervisory and compliance requirements for financial institutions may already address many concerns. Requirements other than capital, risk management and compliance would not be given much weight in making the comparability determination.

For transaction-level requirements, key risk mitigants would include clearing requirements and margin requirements, and their comparability would be determined by whether enforcement of such requirements would appropriately (but not identically) address risks to swap dealers that were identified in the G20 accord. Requirements other than clearing and margin would not be given much weight in making the comparability determination.

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[55] See BCBS / IOSCO, "Consultative Document: Margin requirements for non-centrally-cleared derivatives," July 2012.

If there are elements that are not comparable, that should not be the death knell for the use of substituted compliance. Individual jurisdictions should be free to address risks of swap dealing in the manner that they see fit, and participation of U.S.-registered swap dealers should not be foreclosed, nor should their competitiveness be harmed, by imposing the full set of U.S. requirements on transactions with non-U.S. persons in that jurisdiction. The Commission has the power and authority to address any significant and direct risks to a U.S.-registered swap dealer, and if there is such a direct and significant risk from a non-comparable element, a solution to such individual issues should be able to be crafted (through discussion with the affected entity, with the foreign supervisor or both) without rejecting comparability or impeding operations or competitiveness in the local regime.

For those jurisdictions where the key entity-level rules (capital, risk management, and compliance infrastructure) and/or key transaction-level rules (clearing and margin) are absent, a risk-based exception is appropriate. The proposed "emerging market" exception under the Proposed Guidance is a positive step in the right direction, although modifications and additional precision are required to make the exception more appropriate:

- Given the likelihood of geographic and counterparty diversity across such jurisdictions, an appropriate "significant" risk threshold would be more meaningful at 15 percent rather than the current 5 percent.

- In calculating such 15 percent, the numerator should not include transactions with U.S. persons (as such transactions will already be covered by U.S. rules) nor transactions with non-U.S. non-financial end users (as such transactions would also not have many of the Title VII requirements apply to them even if conducted in the United States). More broadly stated, any transactions that would be exempt from (or otherwise comply with) Title VII requirements if conducted in the United States should be fully permitted even in such non-comparable jurisdictions, and all such transactions should be excluded when calculating compliance with the "emerging market" limit. If a swap dealer also voluntarily complies with U.S. swap dealer requirements when transacting in such jurisdiction, such swaps should not count toward the determination of compliance with the 15 percent threshold. The calculation also, as would be consistent with the Commission's discussion of the activity that constitutes dealing in the Proposed Guidance, should count only those transactions that are dealing transactions.

- Calculation of compliance with the 15 percent threshold should be based on the notional amount of trades performed in the subject jurisdictions as compared to the aggregate notional of all swaps of the U.S. swap dealer. We would not object, however, if smaller swap dealers were permitted a fixed maximum number that might be greater than 15 percent of their aggregate notional.

- The Proposed Guidance should remove the ambiguity and more precisely define what is meant by emerging markets. An appropriate definition would be <u>any</u> jurisdiction that fails to meet the broader, holistic comparability test (as stated in the first sentence of the paragraph leading in to these bullets).

- Dealers should be able flexibly to designate and allocate the branches that would fall into this category, based on their knowledge of the local markets, local clients and their own swaps business.

- We also believe that non-U.S. swap dealers, rather than just branches or agencies of U.S. swap dealers, should be able to rely on the exception to provide a more even playing field in those situations (such as for entity-level rules or when facing guaranteed or conduit entities) where the Proposed Guidance requires substituted compliance even for non-U.S. registrants.

- If a registrant exceeds the 15 percent threshold at some point in time, such action should not be deemed a violation and there should not be a "cliff effect" by immediately applying U.S. Title VII rules. Exceeding the 15 percent threshold should trigger a discussion with the Commission and an appropriate cure period for the excess. Based on discussions with the Commission, appropriate remedies need not be limited to bringing the amount down below the 15 percent threshold, but may include alternatives such as additional regulatory monitoring or additional capital set aside for the excess.

We mentioned above that we continue to believe that a more level playing field that allows non-U.S. branches of U.S. swap dealers to deal with non-U.S. persons under local rules without substituted compliance (as non-U.S. subsidiaries, non-U.S. affiliates, and other non-U.S. registered swap dealers are) would be preferable. However, if not adopted by the Commission, we believe that this manner of addressing entity- and transaction-level requirements and the comparability determinations (coupled with the other modifications we suggest above) should assist in preserving some level of participation and competitiveness in the local market, and would increase the focus on making internationally consistent, risk-based determinations rather than plainly "comparability" determinations.

The final guidance should also clarify a number of procedural matters. First, the Proposed Guidance implies a significant waste of registrants' and the Commission's resources in relation to the comparability analyses when it states that "prior comparability determinations [will] . . . facilitate its review of a subsequent applicant's request."[56] We would recommend that all determinations be made immediately public, and subsequent registrants should be permitted to file a mere notice to the Commission (so that the Commission has a record) that the registrant intends to utilize substituted compliance for the jurisdiction that was previously found comparable.

Second, the Proposed Guidance should be clear that, where substituted compliance is required, sufficient time will be provided, and extensions of the Commission's proposed

[56] Proposed Guidance, 77 Fed. Reg. at 41233.

exemptive order will be granted (without need for application from the industry), in order that the Commission may make appropriate determinations. Time may be required because a jurisdiction has not yet fully implemented a new rule set; time may be required because the analysis of local rules requires additional diligence. Whatever the reason, market participants cannot be disadvantaged by having to apply U.S. rules merely because "time has run out" before appropriate analyses are performed and determinations made.

V. The Proposed Guidance Impacts Structural Decision-Making, Swap Dealer and Major Swap Participant Definitions and Registration Definitions, and Therefore Should be Treated as a Rule-Making

As is absolutely clear from our discussion above, the Proposed Guidance is not inconsequential. It goes beyond a mere interpretation of the CEA and instead adopts a new substantive regulatory regime for cross-border activity that will have a very significant impact on the global derivatives business both within and outside the United States. The Proposed Guidance would also directly impact decisions about corporate structure, risk management and efficiency of operations, further evidencing its significant and substantive effect. Based on these impacts on decision-making, as well as the multitude of requirements imposed on registrants, the Proposed Guidance is not substantively different from a material rulemaking. In addition, the resolution of the ambiguities and uncertainties described above could be well served by an additional, yet appropriately circumscribed, period of time to focus on more rule-like precision.

Therefore, The Clearing House expresses its agreement with the views of Commissioners Sommers and O'Malia, as expressed in their concurring statements,[57] that cross-border issues should be addressed in a formal rulemaking rather than interpretive guidance. "Guidance" should not be an acceptable practice in relation to those concepts and structures that require legal certainty in order to determine applicable law.[58] Besides adding greater certainty for market participants, a formal rulemaking would also require a cost-benefit analysis under the Administrative Procedure Act, which we believe would reveal the significant costs and unintended negative effects associated with the cross-border approach adopted in the Proposed Guidance.

The Proposed Guidance also modifies and adds to the definitions of entities that must register as swap dealers and MSPs, adds new definitions of U.S. persons, Transaction-Level Requirements and Entity-Level Requirements (among others), and introduces significant new concepts such as the "conduit" concept and the effect of guarantees. Such fundamental concepts that drive decisions on whether or not an entity is engaged in swap dealing or is

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[57] See Proposed Guidance, 77 Fed. Reg. at 41239, 41241.

[58] We note that the SEC, in a similar context, believed it necessary to codify Rule 15a-6 in order to provide legal certainty as to the actions of non-U.S. broker-dealers that were permissible and that would or would not require broker-dealer registration. See footnote 6 and accompanying text.

required to be registered must be incorporated into the rules governing and defining swap dealer and MSP registration. Furthermore, we note that, pursuant to Section 712(d) of the Dodd-Frank Act, the Commission is required to issue joint rules with the SEC on the definitions applicable to Title VII of the Dodd-Frank Act.[59] For these additional reasons, we believe that the Commission should engage in a formal notice of proposed rulemaking.

* * *

Thank you for considering the concerns raised in this letter. If you have any questions, or need further information, please contact Alex Radetsky (e-mail: Alex.Radetsky@theclearinghouse.org, telephone number: (212) 612-9285).

Respectfully Submitted,

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Commissioner Jill E. Sommers
Commissioner Bart Chilton
Commissioner Scott D. O'Malia
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Dan M. Berkovitz, General Counsel
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[59] We also note that, even with regard to guidance, Section 712(d)(4) of the Dodd-Frank Act requires that the Commission and the SEC jointly issue interpretations and guidance, in consultation with the Board of Governors of the Federal Reserve System, on matters for which they are required to act jointly with respect to rulemaking.

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Robert W. Cook, Director of the Division of Trading and Markets
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Secretary Timothy F. Geithner
Mary John Miller, Under Secretary for Domestic Finance
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