

February 22, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant" (File No. S7-39-10 and RIN 3038-AD06)

Dear Ms. Murphy and Mr. Stawick:

The Investment Company Institute¹ and the Asset Management Group ("AMG") of the Securities Industry and Financial Markets Association,² (collectively, "the trade associations" or "we") welcome the opportunity to comment on the definitions of key terms in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") related to the regulation of swaps.³ Our

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.68 trillion and serve more than 90 million shareholders.

² The AMG's members represent U.S. asset management firms whose combined assets under management exceed \$20 trillion. The clients of AMG member firms include, among others, registered investment companies, state and local government pension funds, universities, ERISA funds, 401(k) and similar types of retirement funds, and private funds such as hedge funds and private equity funds.

³ See SEC Release No. 63452, 75 FR 80174 (December 21, 2010) ("Release"), available at <http://www.sec.gov/rules/proposed/2010/34-63452fr.pdf>. Throughout this letter, we will use the term "swaps" to refer to

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members are participants in the swaps markets and support efforts to improve the fair and orderly operation of these markets and minimize systemic risk. ICI and AMG are each submitting separate letters today that address all of our respective comments and concerns on the proposed rules set forth in the Release, but we would like to jointly comment on an area that is a very important concern for the members of both of our organizations, the potential regulation of registered investment companies⁴ as “major swap participants” (“MSPs”). We recommend that the Securities and Exchange Commission and the Commodity Futures Trading Commission exclude funds from the definition of MSP as regulating funds as MSPs would not further the important goals of the Dodd-Frank Act.⁵

Funds are subject to a comprehensive regulatory framework under the federal securities laws that sets them apart from other types of financial entities and ensures that their swap activities do not threaten the U.S. financial system.⁶ Current regulation of funds addresses their margin, capital, leverage, risk disclosure, recordkeeping, registration, and business conduct. The risk associated with funds’ swap activity is mitigated by their use of collateral and asset segregation, and regulatory limits on their ability to use leverage. Application of the requirements in the Dodd-Frank Act designed to create regulatory oversight of leverage, volatility, and collateral related to swap trading to funds would therefore unnecessarily subject them to duplicative or potentially inconsistent regulatory requirements at significant additional costs to fund investors with no corresponding systemic benefits.

Current regulation of funds provides the necessary and prudent level of oversight of these swap market participants. Existing requirements protect both the fund and the fund’s counterparty from risks associated with swap transactions.⁷ Compliance with these requirements makes funds that enter into swap transactions arguably the most regulated end users in the U.S. over-the-counter market today. Therefore, applying the MSP provisions of the Act to funds would not serve the purposes of the Dodd-Frank Act.

both swaps and security-based swaps. Likewise, we will use the term “major swap participant” or “MSP” to refer to both major swap participants and major security-based swap participants.

⁴ For purposes of this letter, we refer to U.S. registered investment companies as “funds.”

⁵ We also strongly agree with the view expressed by the Commissions in the Release that advisers to funds should never be deemed to be MSPs as a result of the swap positions maintained by the funds that they advise. Among other reasons, looking to advisers with respect to positions maintained by funds that they manage would be inconsistent with the proposed rules’ goal of capturing entities whose swap positions create systemic risk.

⁶ For a detailed discussion of the federal securities laws applicable to funds, *see* (i) Letters from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and David A. Stawick, Secretary, Commodity Futures Trading Commission, dated September 20, 2010 and February 22, 2011; and (ii) Letters from Timothy W. Cameron, Esq., Managing Director, Asset Management Group, Securities Industry and Financial Markets Association, to David A. Stawick, Secretary, Commodity Futures Trading Commission, and Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated September 20, 2010 and February 22, 2011.

⁷ *See, e.g.*, Section 18 (asset coverage requirements and restrictions on leverage and senior securities) and Section 17 (custody requirements for collateral) of the Investment Company Act of 1940 and the rules promulgated thereunder.

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The undersigned trade associations would be pleased to further assist the Commissions in any way possible as the discussions on the definition of MSP go forward.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel
Investment Company Institute

/s/ Timothy W. Cameron

Timothy W. Cameron, Esq.
Managing Director
Asset Management Group,
Securities Industry and Financial Markets Association

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O' Malia, Commissioner
Commodity Futures Trading Commission



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Dear Ms. Murphy and Mr. Stawick:

The Investment Company Institute¹ welcomes the opportunity to comment on the definitions of key terms in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") related to the regulation of swaps.² As participants in the derivatives markets, our members have supported reform efforts, including Title VII of the Dodd-Frank Act, that would improve the fair and orderly operation of these markets. As stated in our comment letter on September 20, 2010, we continue to support a balanced approach to the interpretation of the defined terms contained in that

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.68 trillion and serve more than 90 million shareholders.

² See SEC Release No. 63452, 75 FR 80174 (December 21, 2010) ("Release"), available at <http://www.sec.gov/rules/proposed/2010/34-63452fr.pdf>. Throughout this letter, we will use the term "swaps" to refer to both swaps and security-based swaps. Likewise, we will use the term "major swap participant" or "MSP" to refer to both major swap participants and major security-based swap participants.

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legislation in order to provide important protections for the markets without imposing costs well in excess of the benefits sought to be achieved.³

To avoid unnecessary and burdensome regulatory overlap, we continue to strongly recommend that the Securities and Exchange Commission and the Commodity Futures Trading Commission exclude registered investment companies (and their registered investment advisers with respect to a managed fund's investments)⁴ from the definition of the term "major swap participant" ("MSP").⁵ The Commissions have specifically requested comment on whether certain types of entities should be excluded, conditionally or unconditionally, from the definition of MSP "on the grounds that such entities do not present the risks that underpin the major participant definitions and/or to avoid duplication of existing regulation." Both of these grounds are present in the context of funds and warrant a categorical exclusion.

Specifically, the Dodd-Frank Act authorizes the Commissions to regulate MSPs by subjecting them to capital and margin requirements, requiring them to conform to business conduct standards, and requiring them to meet recordkeeping and reporting requirements.⁶ As discussed further below, funds are already subject to stringent regulatory requirements similar to those that are required by the Dodd-Frank Act.⁷ Much of the risk associated with their swap activity is mitigated by funds' use of collateral and asset segregation, and regulatory limits on their ability to use leverage. Moreover, funds remain the most regulated financial institutions under the federal securities laws.

Current regulation of funds therefore provides the necessary and prudent level of oversight of these swap market participants. Existing requirements protect both the fund and the fund's

³ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and David A. Stawick, Secretary, Commodity Futures Trading Commission, dated September 20, 2010 ("2010 ICI Letter").

⁴ For purposes of this letter, we refer to U.S. registered investment companies as "funds."

⁵ We presented this recommendation in our prior letter to the Commissions and identified some of the most important regulations and rules limiting a fund's ability to take on risk and affect financial stability in the derivatives markets; we believe it is important to do so again.

⁶ See Section 731 of the Dodd-Frank Act.

⁷ See 2010 ICI Letter, *supra* note 3. In formulating regulation and further defining the term MSP, among others, the Commissions were advised to focus on those risk factors that contributed to the recent financial crisis such as excessive leverage and under-collateralization of swap positions and to consider the nature and current regulation of swap market participants. See Congressional Record, S5907, July 15, 2010 (remarks by Senator Lincoln in a colloquy related to the passage of the Dodd-Frank Act) ("Lincoln Colloquy").

counterparties from risks associated with swap transactions. Applying the MSP provisions of the Dodd-Frank Act to funds would not address the intent or spirit of the legislation.⁸

I. Comprehensive Regulatory Framework

Funds are the only financial institutions that are subject to all of the four major federal securities laws. The Securities Act of 1933 (“the 1933 Act”) and the Securities Exchange Act of 1934 (“the 1934 Act”) regulate the public offering of shares and ongoing reporting requirements of funds, respectively. The Investment Company Act of 1940 (“the 1940 Act”) regulates a fund’s structure and operations, and addresses fund capital structures, custody of assets, investment activities (particularly with respect to transactions with affiliates and other transactions involving potential conflicts of interests), and the composition and duties of fund boards. All investment advisers to funds are required to be registered under, and are regulated by, the Investment Advisers Act of 1940 (“Advisers Act”), which, among other things, imposes recordkeeping requirements on advisers and regulates their custodial arrangements. As an additional layer of regulation, the federal securities laws provide the SEC inspection authority over funds and their investment advisers, principal underwriters, distributing broker-dealers, and transfer agents.

II. 1940 Act Regulation of Funds

Similar to the concerns targeted in the Dodd-Frank Act, the 1940 Act helps ensure the integrity of the U.S. financial system, focusing in particular on the transparency and stability of funds as market participants and investment vehicles. It imposes stringent regulation on funds, which level of regulation is not imposed on other financial institutions or products under the federal securities laws.

A. Capital and Margin

The Dodd-Frank Act imposes capital and margin requirements on MSPs for certain uncleared swaps to address leverage, collateralization, and exposure concerns. Likewise, the 1940 Act contains multiple provisions designed to address funds’ stability with respect to investment activities.

- Limitations on capital structure. Under Section 14(a) of the 1940 Act, funds are subject to minimum capital requirements.⁹ Under Section 18 of the 1940 Act, funds are subject to

⁸ If the Commissions do not exempt funds from the definition of MSP, we recommend that they clarify the proposed calculations in the definition of MSP for the terms “substantial position,” “substantial counterparty exposure,” and “highly leveraged” as discussed in Appendix A.

⁹ Under Section 14(a), no registered fund and no principal underwriter of a fund may publicly offer a fund’s shares unless the fund meets the applicable minimum capital requirements. Further, this capital must be provided with a bona fide investment purpose, without any present intention to dispose of the investment, and must not be loaned or advanced to the fund by its promoters.

limitations on their structural complexity that ensure that all fund shareholders share pro rata in the returns on a fund's investments.¹⁰

- Limitations on leverage. Under Section 18 of the 1940 Act and later SEC and staff guidance, a fund is prohibited from taking on a future obligation to pay unless it “covers” the obligation by setting aside, or earmarking, assets sufficient to satisfy the potential exposure from the derivative transaction.¹¹ The assets used for “covering” such obligations must be liquid, marked-to-market daily, and held in custody.¹² According to the SEC, these coverage requirements: (1) function as a practical limit on both the amount of leverage undertaken by a fund and the potential increase in the speculative character of the fund's outstanding shares; and (2) assure the availability of adequate funds to meet the obligations arising from such activities.¹³ These limitations therefore ensure that a fund cannot cause or contribute to systemic risk through its use of derivatives.
- Requirements for custody of investment securities. Under Section 17(f) of the 1940 Act, funds must “place and maintain” their assets in the custody of a bank, or subject to certain SEC rules, a member of a national securities exchange or the fund itself.¹⁴ In particular, Rule 17f-6 under the 1940 Act explains how assets should be maintained in connection with commodity futures or commodity option contracts.
- Limitations on exposure to certain counterparties. Under Section 12(d)(3), funds' exposure to securities of securities-related businesses are subject to certain percentage limitations. These limitations prevent funds from exposing their assets to the entrepreneurial risks of securities-related businesses, further a fund's ability to maintain the liquidity of its portfolio, and eliminate the possibility of certain reciprocal practices between funds and securities-related businesses.¹⁵

B. Registration, Reporting and Recordkeeping

The Dodd-Frank Act imposes registration, reporting and recordkeeping requirements on MSPs. The books and records requirements in the Dodd-Frank Act provide for inspection and examination by the Commissions as well as daily trading records of swaps. Funds are already subject to

¹⁰ See generally, Section 18 under the 1940 Act.

¹¹ Under certain circumstances, a fund may also enter into transactions that offset the fund's obligations. See Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) 48,525 (June 22, 1987).

¹² See Merrill Lynch Asset Management, L.P., SEC No-Action Letter, 1996 WL 429027 (July 2, 1996) and Investment Company Act Release No. 10666 (April 18, 1979), 44 FR 25128 (April 27, 1979) (“Release 10666”).

¹³ See Release 10666, *supra* note 12.

¹⁴ As a practical matter, this option is rarely used; most fund assets are maintained with a bank custodian.

¹⁵ See Regulation of Investment Companies, Lemke, Lins and Smith, Lexis, Volume 1, September 2009.

similar registration, reporting and recordkeeping requirements under Sections 8, 30 and 31 of the 1940 Act. Section 8 establishes the registration requirements for funds. Section 30 provides for periodic and interim reporting to ensure reasonably current information is available regarding funds. Section 31 sets forth the general recordkeeping requirements for funds, providing that such records are subject to examination by the SEC.¹⁶ In addition, registered investment advisers to funds are subject to their own registration, recordkeeping and reporting requirements under Sections 203 and 204 of the Advisers Act, and are also subject to inspection and examination. Consequently, we believe that additional regulation of funds would be unnecessary and would not further the aim of the Dodd-Frank Act.

C. Business Conduct Standards and Risk Disclosure

Both the Dodd-Frank Act and the 1940 Act contain business conduct standards so that MSPs and funds, respectively, avoid fraud and manipulation and exercise diligent supervision of their businesses. Under the Dodd-Frank Act, MSPs must disclose, in certain circumstances, to counterparties in swap transactions information about the risks and characteristics of the particular swap and any material incentives or conflicts of interest the MSP may have in connection with the swap. The manner in which MSPs must communicate information about swaps must be fair and balanced following the principles of fair dealing and good faith. In addition, each MSP must designate a chief compliance officer.

The 1940 Act contains numerous parallel requirements for funds.¹⁷ Form N-1A (the registration form used by funds to register under the 1940 Act), for example, requires funds to disclose their investment strategies and risks, including temporary defensive investment positions the fund might take, as well as portfolio turnover, and portfolio holding information. A fund's derivative transactions must be consistent with its investment objectives and policies set forth in the fund's registration statement.¹⁸ A fund's investment adviser also must file and update periodically its Form ADV with the SEC to disclose material information regarding its investment practices, policies, and potential conflicts, among other things.

Rule 38a-1 under the 1940 Act requires each fund to adopt policies and procedures reasonably designed to prevent violations of the federal securities laws (*e.g.*, fraud and manipulation) and to provide for oversight of the fund. A fund also is required to have a chief compliance officer who is approved by the fund's board of directors and who must annually provide the board a written report on

¹⁶ Section 31 of the 1940 Act also specifically requires records of a fund's daily purchases and sales of securities, among other records, be maintained, in some cases, permanently.

¹⁷ See 2010 ICI Letter, *supra* note 3.

¹⁸ The SEC provided additional guidance to funds to ensure that their derivatives-related disclosure is sufficient and provides investors with the information necessary to evaluate a fund's derivatives activities. See Letter to Karrie McMillan, General Counsel, Investment Company Institute, from Barry D. Miller, Associate Director, Division of Investment Management, Securities and Exchange Commission, July 30, 2010.

the adequacy of the compliance policies and procedures of the fund and its investment adviser, among others, as well as on the effectiveness of the implementation of these policies and procedures and any material compliance matters. Pursuant to Section 17(j) of the 1940 Act, funds and their registered investment advisers must have written codes of ethics to prohibit fraudulent or manipulative conduct. Finally, Section 36 of the 1940 Act sets forth the regulatory framework for addressing a breach of fiduciary duty with respect to a fund. Funds' investment advisers are also subject to the foregoing requirements.¹⁹

III. Exemption From Definition of MSP Warranted

Regulating funds as MSPs is unnecessary to achieve the stated goals of the Dodd-Frank Act. The comprehensive regulatory framework imposed on funds ensures that their swap activities do not threaten the U.S. financial system. As discussed above, funds are already subject to an extensive array of rules and regulations under the federal securities laws – and subject to substantially higher levels of transparency in their operations – that set them apart from other types of financial entities. Notably, these laws and regulations address funds' margin, capital, leverage, risk disclosure, recordkeeping, registration, and business conduct. Application of the Dodd-Frank Act's requirements, which were designed to create regulatory oversight of leverage, volatility, and collateral related to swap trading, to funds would therefore unnecessarily subject them to duplicative or potentially inconsistent regulatory requirements at significant additional costs to fund investors with no corresponding systemic benefits.²⁰

* * * * *

¹⁹ Under Section 206 of the Advisers Act, it is unlawful for investment advisers to engage in fraudulent, deceptive, or manipulative conduct. Specifically, as fiduciaries, investment advisers have an affirmative duty of care, loyalty, honesty, and good faith to act in the best interest of their clients. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

²⁰ The ABA task force report on funds' use of derivatives commented on the value of the existing regulatory framework, identifying some areas in which the framework could be further strengthened. The report concluded that the framework has worked well and will continue to provide an appropriate structure for funds' investment in derivatives, particularly with some additional clarifications and guidance as recommended by the task force. *See Report of the Task Force on Investment Company Use of Derivatives and Leverage*, Committee on Federal Regulation of Securities, ABA Section of Business Law, July 6, 2010.

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If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, Heather Traeger at (202) 326-5920, or Ari Burstein at (202) 371-5408.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Robert W. Cook, Director
James Brigagliano, Deputy Director
Division of Trading and Markets
Securities and Exchange Commission

Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O' Malia, Commissioner

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Julian Hammar, Assistant General Counsel
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Appendix A

Clarification of Terms Used Under Definition of MSP

If the Commissions do not provide a categorical exclusion for funds from the definition of MSP, it is critical that they provide additional clarification regarding the thresholds and calculations underlying the terms “substantial position,” “substantial counterparty exposure,” and “highly leveraged” as used in that definition.¹ The calculations required by the various tests for these terms include and exclude certain swaps positions either inconsistently or without explanation. ICI believes the appropriate analysis of these terms and interpretation of the definition of MSP would exclude funds because much of the risk associated with funds’ swap activity is mitigated by their use of collateral and asset segregation, and regulatory limits on their ability to use leverage.² The calculations should therefore be clarified, as recommended below, to fully recognize these safeguards. In addition, we recommend that the proposed thresholds for these terms be applied on an individual fund level in recognition of the fact that the marketplace and the SEC generally apply the provisions of the federal securities acts to funds at this level, treating individual funds and series funds as if the separate portfolios were separate investment companies.³

I. Substantial Position

The proposal would provide that an entity qualifies as an MSP because it holds a “substantial position” if, in the applicable major swap category, it has a daily average of more than \$1 billion, or \$3 billion for rate swaps, in uncollateralized exposure (“current exposure test”) or it has a daily average of \$2 billion, or \$6 billion for rate swaps, in current uncollateralized exposure plus aggregate potential outward exposure (“current exposure plus potential future exposure test”).⁴

A. Current Exposure Test

The proposed “current exposure” test would be the sum of the aggregate uncollateralized outward exposure (*i.e.*, uncollateralized and out-of-the-money swap positions) to all counterparties within a major swap category. Uncollateralized exposure would be obtained by marking-to-market an entity’s positions with negative value using industry standard practices. Certain positions would be excluded from consideration, such as positions for the purpose of hedging or mitigating commercial

¹ See SEC Release No. 63452, 75 FR 80174 (December 21, 2010) (“Release”), available at <http://www.sec.gov/rules/proposed/2010/34-63452fr.pdf>.

² In support of this position, we recommend that the Commissions provide that entities may forego altogether the MSP tests, related to the terms “substantial position,” “substantial counterparty exposure,” and “highly leveraged,” if their aggregate notional value is less than the proposed thresholds as determined on a regular basis (*e.g.*, once a calendar quarter).

³ See Legal Considerations in Forming a Mutual Fund, Philip H. Newman, ALI-ABA Course Materials, June 2010.

⁴ The proposal would divide swaps into four categories: rate swaps, credit swaps, equity swaps and other commodity swaps. It would divide security-based swaps into two categories: security-based credit derivatives and other security-based swaps.

risk. An entity would be permitted to calculate its exposure on a net basis, by applying the terms of master netting agreements entered into between the entity and a single counterparty.

First and foremost, ICI recommends that swap positions or exposure (both current and future exposure) should be calculated net of all collateralized swap transactions, as the collateral serves the same protective purpose as the Dodd-Frank Act.⁵ Collateralization provides the receiver with recourse to a pledged asset in the event of a default on a swap transaction. Moreover, in tri-party arrangements, the tri-party agent maintains custody of the collateral thereby providing certainty regarding the safe-keeping of collateral in the case of a default or other event necessitating access to the collateral. These measures should be fully recognized for their strong ability to reduce the potential for adverse effects on the stability of the market.

Second, we support the proposed use of the mark-to-market value, using industry standard practices, of the uncollateralized exposure because notional value is not necessarily indicative of the risks associated with a swap position. Industry practices for the marking-to-market of exposure for purposes of transactions governed by ISDAs/CSAs⁶ typically provide for the daily assessment of the replacement cost of each such transaction and the collateral level is, subject to certain thresholds, equal to the net replacement cost of such transactions between the fund and the counterparty under the ISDA. We believe this is an appropriate definition for mark-to-market value.

Third, we support the use of master netting agreements and agree with the Commissions' statement that failing to "account for this netting of exposure could lead the entities to engage in needless offsetting exchanges of collateral." We believe, however, that the proposal fails to clarify several important issues related to netting. The Commissions should specify that net in-the-money positions and fully collateralized net out-of-the-money positions are excluded from the substantial position calculations because they pose little to no risk on the stability of the market. For the same reason, net out-of-the-money positions with excess collateral should be excluded.

Fourth, we recommend that swaps on government securities be excluded from the evaluation of whether an entity holds a substantial position in swaps. The government security market is unique when compared with other markets. Not only does it dwarf markets such as the commodity and equities markets in size, but also supply and demand is controlled by the Federal Reserve instead of market participants. Consequently, the proposed thresholds for MSPs, which are designed to monitor and safeguard against adverse market impact due to the use of swaps in the market, are ill-suited for such a vast market as government securities.

⁵ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and David A. Stawick, Secretary, Commodity Futures Trading Commission, dated September 20, 2010 ("2010 ICI Letter").

⁶ The ISDA is the standard industry agreement for entering into swap transactions. ISDAs can be accompanied by CSAs, which establish collateral obligations for ISDA transactions.

Fifth, we recommend that the Commissions clarify that cleared trades are excluded from the current exposure calculation.⁷ We are unaware of any distinguishing risk factors that would support the exclusion of netted exposures but not cleared exposures. Further, cleared exposures are excluded, in part, from the calculations for the potential future exposure test. Finally, excluding cleared trades from the calculations would encourage clearing, as supported by the Dodd-Frank Act, and recognize that clearing houses assess potential exposure on a granular basis.⁸

B. Current Exposure Plus Potential Future Exposure Test

The “current exposure plus potential future exposure” test would measure whether an entity holds a substantial position in swaps by calculating the sum of an entity’s aggregate uncollateralized outward exposure and the aggregate potential outward exposure. The proposed calculations for the future exposure portion of the test would be based on the total notional principal amount of an entity’s positions,⁹ adjusted by certain risk factors that reflect the type of swap at issue and the duration of the position. Specifically, the proposed test would include an 80 percent risk adjustment for swaps that are cleared or subject to mark-to-market margining.

We believe that the proposed calculations for this test, including the proposed risk adjustments, should be clarified to reflect the recommendations we have suggested for the current exposure test. In other words, we recommend that the Commissions fully exclude cleared trades, trades on government securities, fully collateralized trades, and overcollateralized trades from the calculation of potential outward exposure.¹⁰ Trades subject to master netting agreements with daily mark-to-market margining should also be fully excluded from the calculations instead of arbitrarily subject to only an 80 percent discount. All of these measures together are necessary to ensure a reasonable assessment of potential future exposure. In addition, as discussed above, these trades do not pose significant risks to swap participants or, therefore, the stability of the financial markets.

C. Hedging or Mitigating Commercial Risk

The proposal includes an exemption from the substantial position analysis for positions held for “hedging or mitigating commercial risk.” The Release explains that such positions must be economically appropriate to the reduction of risks in the conduct and management of a commercial

⁷ In the Release, the Commissions state that the effect of the current exposure test would “effectively result[ing] in cleared positions being excluded from the analysis.” This comment suggests that cleared positions are not outright excluded from the test.

⁸ We also recommend that the Commissions clarify that the following exposures are excluded from the calculations: (1) exposures accrued during standard collateral transfer periods and (2) minimum transfer amounts of less than USD1 mm per master netting agreement (as in the potential future exposure test). The Release is somewhat ambiguous as to the exclusion of these exposures.

⁹ The Commissions should provide guidance on how to apply the nine proposed categories for notional principle amounts to the six major swap categories for purposes of performing the required calculations.

¹⁰ We further recommend that if a dealer is calculating potential exposure and holding Independent Amounts (as defined in the ISDA/CSA), such trades should be fully excluded from the threshold calculations.

enterprise and cannot be held for a purpose that is in the nature of speculation or trading. In determining whether a position is held for hedging purposes, we recommend that the Commissions look to CFTC Rule 1.3(z)(1), which has long been interpreted by the CFTC to include portfolio risk-reduction transactions.

Following this rule, the common understanding of “hedging” encompasses a broad range of transactions that offset other specific risks, regardless of whether the hedger is a physical market participant or whether the risk hedged is commercial or financial. This common understanding also is reflected in the CFTC’s instructions regarding disclosure of hedge positions on Form 40.¹¹ Form 40 instructs that “activities hedged by the use of futures or options markets...would include...asset/liability risk management, security portfolio risk management, etc.” Traders that may use this form to indicate hedged positions include mutual funds, pension funds, endowments, and managed accounts, as well as producers and manufacturers. We believe this instruction is an appropriate articulation of activities that constitute “hedging” for purposes of the exemption.

II. Substantial Counterparty Exposure

The proposal would provide that an entity qualifies as an MSP if its swaps create “substantial counterparty exposure” as determined by the sum of its positions across all swap categories. In contrast to the “substantial position” test, when calculating its exposure for the “substantial counterparty” test, an entity could not exclude positions held for hedging or mitigating commercial risk. We recommend that the Commissions clarify the same items enumerated above in our discussion of the substantial position test and the current exposure and potential exposure calculations. We believe that the proposed thresholds for evaluating substantial counterparty exposure could be set at an appropriate level if these clarifications were made and the related exposures were excluded from the requisite calculations.

III. Highly Leveraged

The ratios proposed to determine whether an entity qualifies as a MSP because it is “highly leveraged” would not apply to funds in the manner envisioned by the Commissions because, unlike other market participants, funds are significantly limited in their ability to use leverage. We believe this strongly supports our recommendation that funds be excluded from the definition of MSP because their swap activity does not contribute to the systemic risk targeted by the Dodd-Frank Act.

IV. Applying the Proposed Definitions

A. Individual Funds and Series

The Commissions should specify that the calculations of a fund’s swap exposure, including netting of swap positions, should be conducted at the individual fund, or series, level when determining whether an entity is an MSP. On the one hand, aggregating positions by fund families or asset managers

¹¹ See CFTC Form 40, Statement of Reporting Trader, Part B, Item 3 and Schedule 1.

would not accurately account for the potential systemic risk posed by funds entering into swap transactions, would overstate the risks to regulators, and would impose disproportionate regulatory burdens and costs on funds whose investment activity does not significantly threaten market stability. On the other hand, looking through a fund to the beneficial owner, or fund shareholder, is impractical and would not capture the entity-level exposure targeted by the Dodd-Frank Act because of its potential effect on systemic risk.

As explained in detail in our prior letter, a sponsor creating a fund may establish each fund as a new, separately organized entity under state law or as a new “series company,” that has the ability to create multiple sub-portfolios (*i.e.*, individual mutual funds), or series.¹² Significantly, liquidation of one fund series is isolated to that series and shareholders must look solely to the assets of their own portfolio for redemption, earnings, liquidation, capital appreciation, and investment results.¹³ The safeguards provided by segregation of assets and collateral as well as the separate treatment of funds and fund series, distinct from each other and their asset managers, severely limit the ability of a fund or related funds to significantly impact the U.S. financial system.

B. Limits on MSP Designation

The Dodd-Frank Act specifically provides that an entity “may be designated as a major swap participant for 1 or more categories of swaps without being classified as a major swap participant for all classes of swaps.”¹⁴ The Commissions, however, have proposed that an entity that qualifies as an MSP in any category of swaps would be designated an MSP for each category of swap that it enters into, without regard to the category of such swap. The proposal also includes a provision that would permit an entity to apply to the appropriate Commission to limit its designation to one or more specified categories or types of swaps. We recommend that, consistent with Congressional intent, the Commissions modify the proposal to provide that, for purposes of determining whether an entity has a substantial position in swaps, an entity would be an MSP only for the category of swap in which it crosses the proposed thresholds.¹⁵ If an entity qualifies as an MSP under the substantial counterparty exposure test or the highly leveraged test, however, it would be designated an MSP for all swap categories. Subject to the current proposal, the entity would then have the ability to apply to the appropriate Commission to limit that designation to certain categories of swaps.

¹² Series funds are effectively independent in economic, accounting, and tax terms but share the same governing documents and governing body. *See supra* note 3 and 2010 ICI Letter *supra* note 5.

¹³ *See Regulation of Series Investment Companies under the Investment Company Act of 1940*, Joseph R. Fleming, Business Lawyer, August 1989.

¹⁴ *See* Section 1a(33)(C) of the Commodity Exchange Act, as amended by the Dodd-Frank Act.

¹⁵ To address the practical implications of being designated an MSP for a particular category of swaps, we recommend that the Commissions tie any MSP-related requirements, such as margin or capital requirements, to an individual swap category.

C. Notice Registration

The proposal would provide that an entity must register as an MSP and a security-based MSP if its swap positions meet the criteria for each corresponding major participant test. To avoid duplicative, burdensome, and unnecessary registration and regulation, we recommend that a fund qualifying as an MSP and a security-based MSP be required (1) to register fully with the CFTC for its swap activity but (2) to file only a notice registration with the SEC with respect to its security-based swap business, instead of becoming subject to the panoply of security-based swap rules. The fund already would be rigorously regulated by the SEC pursuant to the 1940 Act and the SEC would have full access to the funds books and records as well as examination authority to pursue any questionable conduct. The fund, however, would be relieved of compliance with a third regulatory regime governing its swaps activity, which would be not only duplicative but also potentially in conflict with its 1940 Act requirements.