AFR meeting with Chairman Gensler 3/12/12

1. Introductions and agenda review
2. What does Chairman Gensler see as priorities for effective derivatives regulation in the coming months?
3. Issue discussion:
   - Swap dealer definition
   - Swap execution facilities and RFQs
   - Available to trade rule
   - Volcker rule
   - Speculation and manipulation in commodities markets
4. Next steps

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AMERICANS
FOR FINANCIAL REFORM
ACCOUNTABILITY • FAIRNESS • SECURITY

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March 12, 2012

The Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington DC, 20581

The Honorable Mary Schapiro
Chairman
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Dear Chairman Gensler and Schapiro:

Americans for Financial Reform (AFR) is an unprecedented coalition of over 250 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups as well as economists and other experts.

We understand that the SEC and the CFTC are close to finalizing their definitions of 'swap dealer' and that the final rules are likely to incorporate significant revisions over the original proposal. AFR commented on the original proposed swap dealer definition and was generally supportive. However, we are concerned about rumors that substantial revisions are being made in this definition in response to industry lobbying.

It is unclear from press reports alone whether the contemplated changes in the rule are so far-reaching as to undermine the statutory framework, or whether the key elements of that framework are being preserved. However, given the range of potential changes that have been rumored, we would like to raise several potential issues. Our discussion is divided into two sections, one regarding a potential hedge exemption and the other regarding potential chances in the de minimis exemption. Our argument is at a broad level of generality since we are reacting to press reports, and do not have detailed information about changes being considered.

Potential Hedge Exemption And Physical Commodity Producers

The initial proposal did not clearly include a hedge exemption to designation as a swaps dealer (although an effective exemption was discussed in the case of security-based swaps). A more clearly outlined and significant hedge exemption in the final rule could pose a number of problems.

We are concerned that the intersection of a generous hedge exemption, a large de minimis exemption, and potentially also a generous interpretation of the statutory exemption for swaps that are 'not in the ordinary course of business' could potentially shield significant swaps dealers from oversight. This is especially true for companies that combine commodity production or distribution with major trading operations. Such companies will be especially well positioned to take advantage of a generous hedge exemption.

Since the deregulation of U.S. energy markets, it has been common for energy companies to mix significant trading operations and energy production. In many cases, this grows into a major stand-alone trading operation that is an important profit center for the company.[1] This is the history of Enron and numerous other energy companies besides. Many major banks also own both physical commodities and power generation operations and could potentially take advantage of a hedge exemption.[2]

In this connection, it is important to note that the systemic protections intended by the Dodd-Frank Act extend not simply to a generalized collapse of the entire financial system such as occurred in 2008, but also to the failure of market functioning in markets for key individual commodities such as energy. For example, the California power blackouts and other market disruptions created by the activities of Enron certainly represent a systemic financial failure. It is thus important to ensure that major dealers in individual commodity markets are properly designated and are not able to shelter dealing activities as hedging.

More generally, dealing activities should not be treated differently simply because the firm performing them is also part of a corporate structure that includes entities that produce commodities. In many ways, combining a trading operation with substantial holdings of the referenced assets is particularly problematic. If a dealer can profit from price changes because of the assets it holds, that dealer has a substantial conflict of interest with its customers. The interplay between physical holdings and derivatives dealing requires the attention of regulatory authorities and highlights the importance of designating companies that combine swap dealing and commodity production as swap dealers.

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1 Parsons, John, "Do Trading and Power Operations Mix?", MIT Center for Energy and Environmental Research, Massachusetts Institute of Technology, November, 2011.

2 For example, Goldman Sachs has major ownership interests in Energy Future Holdings and Cogentrix Energy. Simon Greenshields of Morgan Stanley has stated that "We have a very strong physical presence in oil". See Osipovich, Alexander, "Risk and Energy Risk: 2012 Commodity Rankings", Energy Risk, February 9, 2012.

AFR was critical of the broad scope of the hedge exemption permitted under the Major Swaps Participants (MSP) definition. In the initial rule proposal the Commissions themselves stated that[3]:

> "The line between speculation, investing or trading, on the one hand, and hedging, on the other, can at times be difficult to discern"

In the original definitions proposal, the swap dealer definition served an important complementary function to the MSP definition in part because the dealer definition did not contain a broad hedge exemption. The inclusion of a broad hedge exemption to this definition as well could leave certain companies able to avoid either designation.

It should be remembered that the purpose of the swaps dealer and MSP designations is not to ban any swaps activity, but simply to ensure that such activity is properly capitalized and margined and is conducted according to proper business conduct standards. Thus, the issue here is not whether hedging is permitted but whether entities that are important market players conduct their swaps activities responsibly. This calls for a narrow and well policed hedging exemption. Trading operations that are significant business centers and stand ready to take advantage of dealing and trading opportunities in the market must not be able to simply pair off their trades with commodity exposures in other units of the company and claim that they are 'hedges' based on some generalized correlation.

Costs and Benefits

We are aware that energy industry representatives have raised issues relating to the costs to an energy company of being designated as a swap dealer. In particular, a law firm (Hunton & Williams) acting as counsel to the Working Group of Commercial Energy Firms (whose membership is largely undeterminable by the public) hired a consulting firm (NERA) to produce a cost analysis.[4] The Working Group is clearly an interested party, and independent analysis has determined that this study is so riddled with technical flaws that it cannot be seriously considered in the deliberations regarding the rule.[5] A flawed study, based on unavailable data, paid for by a shadowy organization cannot be considered credible. The best view of it is that the facts do not support burdensome costs.

De Minimis Exemption

The Swap Dealer Designation is Based on Function and Conduct, Not Size

Section 721 of the Dodd Frank Act clearly defines a 'swap dealer' based on market conduct – making markets in or dealing swaps, or indeed any conduct whatsoever that leads market

[3] CFR 80195, Federal Register, Vol. 75, No. 244, Tuesday, December 21, 2010.
[4] NERA Economic Consulting, "Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition Prepared for the Working Group of Commercial Energy Firms", December 20, 2011.

participants to describe an entity as a 'dealer' in swaps. While a de minimis exemption is permitted, the definition clearly pivots around market conduct and not size. It is very important that a de minimis exemption not become a test of, for example, whether the size of a single dealer is sufficient to impact the national swaps market. As implied by the very term 'de minimis', this exemption is intended only to exempt those companies who engage in very small amounts of incidental swaps activity.

The emphasis on conduct in the swap dealer definition is further confirmed by the inclusion of another entity definition based almost purely on size, the major swaps participant designation.

As A Matter of Policy, Oversight Must Not Be Limited To The Largest Entities

It is sometimes claimed that since a major goal of swaps dealer oversight is to provide prudential protections against systemic risk, such oversight should be limited to the largest entities. As discussed above, this is clearly not the intention of the statute, so this argument falls simply based on statutory interpretation. However, even for pure policy reasons, oversight of swaps dealers clearly should not be limited to the larger entities alone. First, swaps dealer designation is intended to create improvements in business practices, not only to reduce systemic risk. These improvements include both internal and external business conduct rules. These business conduct rules are intended to be especially strict when dealers are interacting with public entities and pension funds; for this reason the proposed rule lowered the de minimis exemption for transactions with these entities, and it is important that this type of distinction be maintained.

Second, prudential issues may be created by problems among large numbers of undercapitalized smaller entities. This is a major reason why prudential banking agencies regulate the full range of banks, from tiny community banks to global entities with asset bases larger than some national GDPs. Examples of systemic failures of prudential oversight that occurred among small entities include the S&L crisis of the 1980s and the banking panic that occurred during the Great Depression. The major swaps markets are currently dominated by a few large players, but we should not assume this will always be true, or that it will be true among emerging new classes of swaps.

If A Large De Minimis Exemption Is Applied To Each Individual Swaps Class Then Major Players Could Be Exempted

Even a de minimis exemption significantly larger than the originally proposed level would obviously not shield from designation the largest banks who deal across the entire range of swap classes. However, if the Commissions choose to designate dealer status based on activity in single classes of swaps, and a large de minimis exemption is applied uniformly across such classes, then major market participants in particularized swaps markets could be exempted. For example, activity that would be very small in the interest rate swaps market could be significant

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[5] See Turbeville, Wallace, "Analysis of NERA Report", February, 2012.

in the credit default swap market, particularly if the CDS market is further subdivided into classes based on reference entities.

The Original Proposed Rule Contains Data That Conflicts With A Large De Minimis Exemption

The Commissions' original proposal suggested a level of $100 million in notional value as a de minimis exemption, and made this statement:

> "We understand that in general the notional size of a small swap or security-based swap is $5 million or less, and this proposed threshold would reflect 20 instruments of that size."

If this is true, then a de minimis threshold of, for example, $3 billion in notional value would reflect 600 typical swaps transactions over the course of a year, or two to three transactions per working day. It is hard to believe that an entity that engaged in 600 swaps transactions while representing itself as a dealer in swaps should not be designated as a swaps dealer. If the Commissions have performed additional data analysis or gathered additional information that indicates that a large de minimis exemption is justified by typical market practice, then it is incumbent on them to present this data to the public.

Thank you for your time and attention and the opportunity to comment on this issue. If you have any questions, please contact Marcus Stanley, AFR's Policy Director, at (202) 466-3672 or marcus@ourfinancialsecurity.org.

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions

- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers

- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR

- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA

- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin
- UNET