MEMO# 24987

February 23, 2011

ICI Letters on Definition of Major Swap Participant

[24987]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 25-11
DERIVATIVES MARKETS ADVISORY COMMITTEE
ETF ADVISORY COMMITTEE No. 19-11
EQUITY MARKETS ADVISORY COMMITTEE No. 17-11
FIXED-INCOME ADVISORY COMMITTEE No. 25-11
SEC RULES MEMBERS No. 37-11
SMALL FUNDS MEMBERS No. 25-11 RE: ICI LETTERS ON DEFINITION OF MAJOR SWAP PARTICIPANT

As we previously informed you, the Securities and Exchange Commission and the Commodity Futures Trading Commission jointly sought comment on the definitions of certain key terms in the Dodd-Frank Act related to the regulation of swaps. [1] ICI submitted two comment letters focusing on the proposed definition of "major swap participant" ("MSP") and recommending that funds be excluded from that definition. The letters are attached and briefly summarized below.

I. ICI Letter on the Definition of MSP

A. Exemption for Funds from Definition of MSP

ICI's letter recommends that the Commissions exclude funds from the definition of the term MSP because funds are already subject to stringent regulatory requirements similar to those that would be required by the Dodd-Frank Act and therefore do not contribute to systemic risk as contemplated by the Act. It notes that existing regulatory requirements protect both the fund and the fund's counterparties from risks associated with swap transactions. The letter explains in detail that funds are subject to all of the four major federal securities acts and highlights the capital, leverage, recordkeeping, reporting, registration, risk disclosure, and compliance requirements of the Investment Company Act of 1940. It concludes that current regulation of funds provides the necessary and prudent level of oversight of these swap market participants.

B. Clarification of Terms used in MSP Definition

In the appendix, ICI recommends that, if the Commissions do not provide an exclusion for funds from the definition of MSP, the Commissions should provide additional clarification regarding the thresholds for the tests underlying the terms “substantial position,” “substantial counterparty exposure,” and “highly leveraged” as used in that definition. The appendix explains that the calculations required by the various tests include and exclude certain swaps positions either inconsistently or without explanation. It recommends that the calculations be clarified to fully recognize that 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 appendix also states that the Commissions should clarify that “hedging” for purposes of the “substantial position” calculations includes portfolio risk-reduction transactions.

In addition, the appendix recommends that the proposed thresholds for the tests underlying the definition of MSP be applied on an individual fund level, treating individual funds and series funds as if the separate portfolios were separate investment companies because they each represent a separate group of shareholders with independent investment objectives. Further, it recommends that the Commissions modify the proposal to provide that an entity would be an MSP only for the category of swap in which it crosses the proposed thresholds, not for all swap categories. The appendix concludes with a recommendation to permit notice registration in the case of entities that must register as an MSP with both Commissions due to their swap and security-based swap activity.

II. Joint ICI and Asset Management Group Letter on the Definition of MSP

ICI’s joint letter with the Asset Management Group of the Securities Industry and Financial Markets Association seeks to exclude funds from the definition of MSP, noting that compliance with existing regulatory requirements makes funds that enter into swap transactions arguably the most regulated end users in the U.S. over-the-counter market today. It concludes therefore that applying the MSP provisions of the Dodd-Frank Act to funds would not serve the purposes of the Act.

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Attachment

endnotes

[1] See ICI Memorandum 24788, dated December 14, 2010. See also, SEC Release No. 63452, 75 FR 80174 (December 21, 2010), available at http://www.sec.gov/rules/proposed/2010/34-63452fr.pdf.

[2] For example, the letter suggests that the Commissions specify that net in-the-money positions and fully collateralized net out-of-the money positions are excluded from the “substantial position” calculations.