

## **PAPERWORK REDUCTION ACT SUBMISSION**

### **SUPPORTING STATEMENT**

#### **for the Paperwork Reduction Act New Information Collection Submission for Proposed Rule 3a67-4 (Definition of ‘Hedging or Mitigating Commercial Risk’)**

##### **A. Justification**

##### **1. Necessity of Information Collection**

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) adds to the Commodity Exchange Act (“CEA”) and the Securities Exchange Act of 1934 (“Exchange Act”) definitions of the terms “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” and “eligible contract participant.” These terms are defined in Sections 721 and 761 of the Dodd-Frank Act.

Section 712(d)(1) of the Dodd-Frank Act provides that the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) (together with the CFTC, the “Commissions”), in consultation with the Board of Governors of the Federal Reserve System, shall jointly further define the terms “swap,” “security-based swap,” “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” “eligible contract participant,” and “security-based swap agreement.” Further, Section 721(c) of the Dodd-Frank Act requires the CFTC to adopt a rule to further define the terms “swap,” “swap dealer,” “major swap participant,” and “eligible contract participant,” and Section 761(b) of the Dodd-Frank Act permits the SEC to adopt a rule to further define the terms “security-based swap,” “security-based swap dealer,” “major security-based swap participant,” and “eligible contract participant,” with regard to security-based swaps, for the purpose of including transactions and entities that have been structured to evade Title VII of the Dodd-Frank Act.

The definitions of major swap participant and major security-based swap participant in section 721(a) and section 761(a) encompass persons that satisfy any of three alternative tests. The first test encompasses persons that maintain a “substantial position” in any of the “major” categories of swaps or security-based swaps, as those categories are determined by the CFTC or SEC as applicable. This test excludes both “positions held for hedging or mitigating commercial risk,” and positions maintained by or contracts held by any employee benefit plan (as defined in paragraphs (3) and (32) of section 3 of ERISA (29 U.S.C. 1002)) for the primary purpose of hedging or mitigating risks directly associated with the operation of the plan.<sup>1</sup>

In light of the requirements in the Dodd-Frank Act noted above, the CFTC and the SEC issued a joint Advance Notice of Proposed Rulemaking (“ANPRM”) on August 13, 2010, requesting public comment regarding the definitions of “swap,” “security-

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<sup>1</sup> See CEA section 1a(33)(A)(i); Exchange Act section 3(a)(67)(A)(ii)(I).

based swap,” “security-based swap agreement,” “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” and “eligible contract participant” in Title VII of the Dodd-Frank Act.<sup>2</sup> The Commissions reviewed more than 80 comments in response to the ANPRM. The Commissions also informally solicited comments on the definitions on their respective websites. In addition, the staffs of the CFTC and the SEC have met with many market participants and other interested parties to discuss the definitions.

On December 7, 2010, the Commissions jointly proposed rules and interpretative guidance to further define the terms “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” and “eligible contract participant” (“the December 7, 2010 proposing release”). Proposed rule 3a67-4 defines when, for purposes of section 3(a)(67) of the Exchange Act and proposed rule 3a67-1, a security-based swap position shall be deemed to be held for the purpose of hedging or mitigating commercial risk. For a security-based swap position to be held for the purpose of hedging or mitigating commercial risk under proposed rule 3a67-4, the person holding the position must satisfy several conditions, including the following: (1) the person must identify and document the risks that are being reduced by the security-based swap position; (2) the person must establish and document a method of assessing the effectiveness of the security-based swap as a hedge; and (3) the person must regularly assess the effectiveness of the security-based swap as a hedge.

## 2. Purpose and Use of the Information Collection

The collections of information in proposed rule 3a67-4 are designed to help prevent abuse of the exclusion and to help ensure that the exclusion is only available to those entities that are engaged in legitimate hedging or risk mitigating activities.

## 3. Consideration Given to Information Technology

We believe that only highly sophisticated market participants would potentially meet the proposed thresholds for the major security-based swap participant designation and thus have a need to take advantage of the exclusion for positions held for hedging or mitigating commercial risk (and be required to meet the attendant collection requirements). We understand from our staff’s discussions with industry participants that the entities that have security-based swap positions and exposures of a magnitude that they could potentially be deemed to be major security-based swap participants may currently create and maintain the documentation proposed to be required in rule 3a67-4, as part of their ordinary course business and risk management practices. We understand that information technology is commonly used to assist in the creation and maintenance of the documentation requirements in proposed rule 3a67-4, however, the proposed rule does not mandate how an entity must meet its documentation requirements.

## 4. Duplication

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<sup>2</sup> See Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, Exchange Act Rel. No. 34-62717, 75 FR 51429 (Aug. 20, 2010). The comment period for the ANPRM closed on September 20, 2010.

The proposed rule would not duplicate existing regulatory requirements. Moreover, we understand from our staff's discussions with industry participants that the entities that have security-based swap positions and exposures of a magnitude that they could potentially be deemed to be major security-based swap participants and thus have a need to take advantage of the exclusion provided in the proposed rule may currently create and maintain the documentation proposed rule 3a67-4 would require, as part of their ordinary course business and risk management practices.<sup>3</sup>

## 5. Reducing the Burden on Small Entities

For purposes of SEC rulemaking in connection with the Regulatory Flexibility Act, a small entity includes: (i) when used with reference to an "issuer" or a "person," other than an investment company, an "issuer" or "person" that, on the last day of its most recent fiscal year, had total assets of \$5 million or less,<sup>4</sup> or (ii) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act,<sup>5</sup> or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.<sup>6</sup> Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (i) for entities engaged in credit intermediation and related activities, entities with \$175 million or less in assets;<sup>7</sup> (ii) for entities engaged in non-depository credit intermediation and certain other activities, entities with \$7 million or less in annual receipts;<sup>8</sup> (iii) for entities engaged in financial investments and related activities, entities with \$7 million or less in annual receipts;<sup>9</sup> (iv) for insurance carriers and entities engaged in related activities, entities with \$7 million or less in annual receipts;<sup>10</sup> and (v) for funds, trusts, and other financial vehicles, entities with \$7 million or less in annual receipts.<sup>11</sup>

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<sup>3</sup> Some entities follow these types of procedures so that their hedging transactions will qualify for hedge accounting treatment under generally accepted accounting principles, which requires procedures similar to those in proposed rule 3a67-4. We believe that all of the estimated 10 entities that have security-based swap positions of a magnitude that they could potentially be deemed to be major security-based swap participants already identify and document their risk management activities (including their security-based swap positions used to hedge or mitigate commercial risks) and assess the effectiveness of those activities as a matter of their ordinary business practice – even if they are not seeking hedge accounting treatment.

<sup>4</sup> See 17 CFR 240.0-10(a).

<sup>5</sup> See 17 CFR 240.17a-5(d).

<sup>6</sup> See 17 CFR 240.0-10(c).

<sup>7</sup> See 13 CFR 121.201 (Subsector 522).

<sup>8</sup> See *id.*

<sup>9</sup> See *id.* at Subsector 523.

<sup>10</sup> See *id.* at Subsector 524.

<sup>11</sup> See *id.* at Subsector 525.

Based on feedback from industry participants about the security-based swap markets, the SEC preliminarily believes that the entities that would potentially qualify as major security-based swap market participants and seek to exclude positions held for hedging or mitigating commercial risk from the substantial position calculation exceed the thresholds defining “small entities” set out above. Thus, the SEC believes it is unlikely that the proposed rules would have a significant economic impact on any small entity.

#### 6. Consequences of Not Conducting the Collection

The collections of information in proposed rule 3a67-4 are designed to help prevent abuse of the exclusion and to help ensure that the exclusion is only available to those entities that are engaged in legitimate hedging or risk mitigating activities. We preliminarily believe that without such proposed requirements, there is a possibility that the exclusion for positions held for “hedging or mitigating commercial risk” may be abused or potentially used by entities that are not engaged in legitimate hedging or risk mitigating activities.

#### 7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)

This collection is consistent with the guidelines in 5 CFR 1320.5(d)(2), except potentially with respect to the confidentiality of information. There is no proposed requirement that the collections of information in proposed rule 3a67-4 be provided to the SEC or a third party on a regular, ordinary course basis. However, such information may be considered proprietary financial information regarding an entity’s security-based swap transactions, and thus confidentiality concerns may arise where the SEC has obtained the information. In a situation where the SEC has obtained this information, the SEC would consider requests for confidential treatment of such information on a case-by-case basis.

#### 8. Consultations Outside the Agency

The CFTC and the SEC issued a joint ANPRM on August 13, 2010, requesting public comment regarding the definitions of “swap,” “security-based swap,” “security-based swap agreement,” “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” and “eligible contract participant” in Title VII of the Dodd-Frank Act.<sup>12</sup> Any comments received on the ANPRM are posted on the Commission’s public website, and made available through <http://www.sec.gov/rules/other/otherarchive/other2010.shtml>.

The SEC worked very closely with the CFTC on the development and drafting of the December 7, 2010 proposing release.<sup>13</sup> In addition, the SEC and CFTC consulted and

<sup>12</sup> See Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, Exchange Act Rel. No. 34-62717, 75 FR 51429 (Aug. 20, 2010).

<sup>13</sup> We note that there are two different proposed definitions of “hedging or mitigating commercial risk”, reflecting the different uses of swaps and security-based swaps for hedging. These differences are also reflected in the respective PRA analyses.

coordinated with representatives from the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Farm Credit Administration, and the Federal Housing Finance Agency.

Furthermore, the SEC and CFTC consulted with industry participants and other interested parties. Any comments or materials received by the Commission from industry participants and other interested parties relating to the development of the December 7, 2010 proposing release are posted on the SEC's public website, and made available through <http://www.sec.gov/rules/proposed.shtml><http://www.sec.gov/spotlight/regreformcomments.shtml>.

Additionally, in the December 7, 2010 proposing release, the SEC solicited comment on the new "collection of information" requirements and associated paperwork burdens. A copy of the release is attached. Comments on SEC releases are generally received from registrants, investors, and other market participants. In addition, the SEC and staff participate in ongoing dialogue with representatives of various market participants through public conferences, meetings and informal exchanges. Any comments received on this proposed rulemaking will be posted on the SEC's public website, and made available through <http://www.sec.gov/rules/proposed.shtml>. Based on early feedback from the public relating to the proposing release, we preliminarily believe that there may be forthcoming public input relating to the proposing release's "collection of information" requirements and associated paperwork burdens. The SEC will consider all comments received prior to publishing the final rule, and will explain in any adopting release how the final rule responds to such comments, in accordance with 5 C.F.R. 1320.11(f).

9. Payment or Gift

There are no payments or gifts to respondents in the information collection.

10. Confidentiality

There is no proposed requirement that the collections of information in proposed rule 3a67-4 be provided to the SEC or a third party on a regular, ordinary course basis. No assurances of confidentiality are provided in the rule. In a situation where the SEC has obtained the information, the SEC would consider requests for confidential treatment on a case-by-case basis.

11. Sensitive Questions

Not applicable; no information of a sensitive nature is required under the rule.

12. Burden of Information Collection

We believe that only highly sophisticated market participants would potentially meet the proposed thresholds for the major security-based swap participant designation

and thus have a need to take advantage of the exclusion for positions held for hedging or mitigating commercial risk (and be required to meet the attendant collection requirements).

Based on the current market, we estimate that approximately 10 entities have security-based swap positions of a magnitude that they could potentially reach the major security-based swap participant thresholds. Accordingly, we estimate that approximately 10 entities would seek to avail themselves of the exclusion from the substantial position calculation for security-based swap positions held for hedging or mitigating commercial risk.

We understand from our staff's discussions with industry participants that the entities that have security-based swap positions and exposures of this magnitude may currently create and maintain the documentation proposed to be required in rule 3a67-4, as part of their ordinary course business and risk management practices. Thus, we do not believe that any new burdens will be imposed on the approximately 10 entities that may seek to use the exclusion. We estimate the total annual reporting and recordkeeping burden associated with proposed rule 3a67-4 to be minimal.

### 13. Costs to Respondents

As described above, we believe that only highly sophisticated market participants would potentially meet the proposed thresholds for the major security-based swap participant designation and thus have a need to take advantage of the exclusion for positions held for hedging or mitigating commercial risk (and be required to meet the attendant collection requirements). We understand from our staff's discussions with industry participants that the entities that have security-based swap positions and exposures of this magnitude may currently create and maintain the documentation proposed to be required in rule 3a67-4, as part of their ordinary course business and risk management practices. Thus, we do not believe that any new costs will be imposed on the approximately 10 entities that may seek to use the exclusion. We estimate the total annual reporting and recordkeeping cost associated with proposed rule 3a67-4 to be minimal.

14. Costs to Federal Government

There are no estimated operation costs to the federal government associated with this proposed rule.

15. Reason for Change

Not applicable.

16. Information Collection Planned for Statistical Purposes

Not applicable; there is no intention to publish the information for any purpose.

17. Display of OMB Approval Date

Not applicable.

18. Exceptions to Certification for Paperwork Reduction Act Submissions

Not applicable.

B. Collection of Information Employing Statistical Methods

The collection of information does not employ statistical methods, nor would the implementations of such methods reduce the burden or improve the accuracy of results.