UNIVERSITY OF MARYLAND
SCHOOL OF LAW

February 22, 2011

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: End-User Exception to Mandatory Clearing of Swaps, RIN 3038-AD10

Dear Mr. Stawick:

These comments are submitted in response to the Notice of Proposed Rulemaking[1] issued by the Commodity Futures Trading Commission ("CFTC" or "Commission") pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] (the "Dodd-Frank Act"). The Dodd-Frank Act amends Section 2(h)(1) of the Commodity Exchange Act[3] ("CEA"), making it unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization if the swap is required to be cleared with limited exceptions.[4] One of the exceptions to mandatory clearing is the end-user exception.

Specifically, Section 2(h)(7) provides that a swap otherwise subject to mandatory clearing is eligible for an end-user exception, if a party to the swap (i) is not a financial entity,[5]

[1] End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80747 (proposed Dec. 23, 2010) [hereinafter "Proposed Rules"].

[2] Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[3] 7 U.S.C. 1 *et seq*.

[4] *See* § 723 of the Dodd-Frank Act; *see also* Process for Review of Swaps for Mandatory Clearing, 75 Fed. Reg. 67277 (proposed Nov. 2, 2010).

[5] The term financial entity is defined in CEA Section 2(h)(7)(C)(i), and includes the following eight entities: (i) A swap dealer ("SD"); (ii) a security-based swap dealer; (iii) a major swap participant ("MSP"); (iv) a major security-based swap participant; (v) a commodity pool as defined in CEA Section 1a(10); (vi) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)); (vii) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); or (viii) a person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)). *See* Proposed Rules, *supra* note 1.

(ii) is using swaps to hedge or mitigate commercial risk, (iii) and notifies the Commission how it generally meets its financial obligations associated with entering into non-cleared swaps.[6] As CFTC Chairman Gary Gensler has said, the "exception should be narrowly defined to include only nonfinancial entities that use swaps as an *incidental part of their business* to hedge actual commercial risks. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system."[7] In addition, Dodd-Frank imposes the reporting requirements on the non-financial entity that elects to use the end-user exception to deliver specified information to a Swap Data Repository.[8]

The Commission's proposed rules on the end-user exception are consistent with the legislative intent, which is not to impose "the clearing and exchange trading requirement on commercial end-users[,which] could raise transaction costs where there is a substantial public interest in keeping such costs low."[9] In light of this, the following proposed rules and the Commission's underlying rationale fulfill Congressional intent:

- The proposed rule, § 39.6(b)(6)(ii), correctly requires confirmation that an appropriately authorized committee of the board of directors has reviewed and approves the decision of the end-user not to clear the swap being reported.[10] When the decision is made at the board level, the chances are best that the end-user will have considered the overall risks of entering into an activity lacking the financial protections of clearing and transparency of an exchange or execution facility.
- The proposed rule, § 39.6(c)(1)(ii), correctly includes swaps that are recognized as hedges if the swaps meet hedging rules defined in federal commodities laws or hedging accounting treatment under Financial Accounting Standard Board Accounting Standards Codification Topic 815, "Accounting for Derivatives Instruments and Hedging Activities."[11]
- The proposed rule, §§ 39.6(c)(1)(iii), correctly defines what activities qualify as hedging by assuring that if a swap qualifies for the bona fide hedge exemptions from positions limits, the swap also qualifies for the end-user exception.[12]

---

[6] *See* § 723.

[7] Gary Gensler, Chair of the CFTC, Remarks at Exchequer Club of Washington, (Nov. 18, 2009), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/opagensler-20.html (emphasis added).

[8] *See* Proposed Rules at 80757, *supra* note 1.

[9] *See* 156 Cong. Rec. S6192 (July 22, 2010).

[10] *See* Proposed Rules at 80750, *supra* note 1.

[11] *See* Proposed Rules at 80757, *supra* note 1.

[12] *Id.*

However, the proposed rules on notifying the Commission about the use of the end-user exemption should be enhanced. In particular, § 39.6(b)(5) requires a party relying on the end-user clearing exception to provide additional information regarding the methods used to mitigate credit risk in connection with non-cleared swaps. However, the "check-the-box approach"[13] as proposed as the method of notifying the Commission, in and of itself, is inadequate. Under the Cost-Benefit section of the proposal, the Commission states that the check-the-box approach would "simply require an indication of each method used to mitigate the credit risk associated with non-cleared swaps."[14] Reporting of this nature almost certainly will be unreliable because the Commission will not have the necessary information to monitor and prevent the potential abuse of the end-user exception. For example, if a reporting party simply checks off the box for "Collateral," the Commission will be informed only to the extent that the reporting party has put aside collateral to meet the financial obligation. However, information on whether the collateral already has multiple liens attached or the value of such collateral will not be provided to the Commission. In light of this, the proposed rules on notifying the Commission on how an end-user would meet its financial obligations must be improved so that the disclosed information will be sufficient for the Commission to make a well-informed judgment whether the end-user is taking adequate steps to mitigate the financial risks associated with non-cleared swaps, especially lack of adequate capitalization. On this point, I incorporate the comment letter submitted to the SEC for the end-user rules on security-based swaps on February 4, 2011 by Better Markets.[15]

Furthermore, under the proposed rules, the reporting party would "be required to check a box in order to indicate whether the swap was being used to hedge or mitigate commercial risk."[16] The aforementioned concern about inadequate information applies here as well. The party electing to use the end-user exception must be subject to reporting requirements ensuring that the calculation methodology and the effectiveness of the hedged position is well documented, and that the party has established policies and procedures to monitor regularly the effectiveness of the hedged position. These enhanced notifying obligations are set forth in detail in the comment letters filed by Americans for Financial Reform[17] and the American Federation of State, County and Municipal Employees on February 4, 2011 with the SEC as it relates to the

[13] *See* Proposed Rules at 80755, *supra* note 1.

[14] *Id.*

[15] *See* Comment Letter by Dennis Kellerher, President and CEO, Stephen Hall, Securities Specialist, and Wallace Turbeville, Derivatives Specialist, Better Markets, Inc., to Elizabeth Murphy, Secretary, Securities and Exchange Commission, *Proposed Rules Governing the End-User Exception to Mandatory Clearing of Security-Based Swaps – File Number S7-43-10* (Feb. 4, 2011).

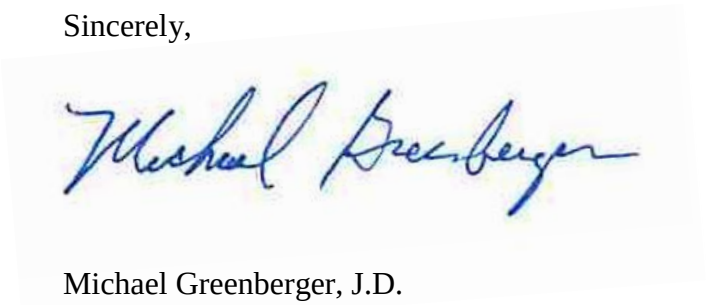
[16] *See* Proposed Rules at 80755, *supra* note 1.

[17] *See* Comment Letter by Americans for Financial Reform ("AFR"), to Elizabeth Murphy, Secretary, Securities and Exchange Commission, *File Number S7-43-10 – End-User Exception to Mandatory Clearing of Security-Based Swaps* (Feb. 4, 2011).

end-user exemption for security-based swaps.[18] Again, I incorporate and fully endorsed those letters.

Lastly, § 39.6(c) appears to be undermining the primary purpose of the end-user exception because it allows entities to engage in speculative trading. In particular, the proposed rule states "a swap shall be deemed to be used to hedge or mitigate commercial risk when [s]uch swap is [n]ot used to hedge or mitigate the risk of another swap or securities-based swap, *unless that other swap itself is used to hedge or mitigate commercial risk as defined by this rule* […]."[19] This proposed rule suggests that a party can elect to use the end-user exception to hedge its already hedged position. Because the secondary hedging on a well-hedged position is speculative in nature, the Commission should not allow this kind of transaction to be deemed hedging of commercial risk.

Sincerely,



Michael Greenberger, J.D.
Law School Professor
University of Maryland School of Law

[18] *See* Comment Letter by Gerald W. McEntee, International President, The American Federation of State, County and Municipal Employees ("AFSCME"), to Elizabeth Murphy, Secretary, Securities and Exchange Commission, *End-User Exception to Mandatory Clearing of Security-Based Swaps (No. S7-43-10)* (Feb. 4, 2011).

[19] *See* Proposed Rules at 80757, *supra* note 1.