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February 22, 2011

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

Re: End-User Exception to Mandatory Clearing of Swaps (RIN number 3038-AD10)

Dear Mr. Stawick:

The American Federation of State, County and Municipal Employees ("AFSCME") is the largest union in the AFL-CIO representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over $1 trillion. In addition, the AFSCME Employees Pension Plan is a long-term shareholder that manages $850 million in assets for its participants, who are staff members of AFSCME and its affiliates.

During consideration of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), AFSCME strongly supported the inclusion of provisions establishing the strongest possible market reforms, oversight and transparency for the "shadow markets" – principally the over-the-counter market that has grown to a size that dwarfs more transparent markets.

The Importance of Strong Derivatives Regulation is Undeniable

Before passage of Dodd-Frank, OTC derivatives – including interest rate swaps, foreign exchange contracts, equity swaps, commodity swaps, credit default swaps, and others - were described as bilateral agreements between sophisticated parties. As such, OTC derivatives were not subject to obligations to trade on regulated exchanges and clear through regulated operations – obligations that apply to other segments of the derivatives markets. However, the need to bring OTC derivatives into these regulated markets is clear: The public record of analyses gathered in the months following the crisis confirmed the same conclusion: "It is widely acknowledged that OTC derivatives contracts, and

American Federation of State, County and Municipal Employees, AFL-CIO
TEL (202) 429-1000 **FAX** (202) 429-1293 **TDD** (202) 659-0446 **WEB** www.afscme.org 1625 L Street, NW, Washington, DC 20036-5687

particularly CDS, played a significant role in the current financial crisis. Although OTC derivatives have been justified as vehicles for managing financial risk, they have also spread and multiplied risk throughout the economy in the current crisis, causing great financial harm."[1]

With the passage of Dodd-Frank – and effective implementation – standardized swaps, with some exceptions, will be traded or entered into on regulated exchanges or swap execution facilities. This will improve the extent to which buyers and sellers meet in an open marketplace where prices are publicly available. Standardized swaps will be cleared through a regulated clearinghouse charged with acting as intermediary to the transaction, collecting and protecting collateral on behalf of the parties, and mitigating counterparty risk for individual transactions. Such market transparency will also guard against the systemic risk that can build invisibly.

Strong Implementation of the Responsibility to Require Clearing is Vital

Strong rules regarding mandatory clearing are vital to the operation of a derivatives marketplace that earns investor confidence. To be most effective, the rules should be clear and specific. Any exceptions should be narrowly drawn, and well-justified. Exceptions should be closely monitored by the Commission as part of its duty to perform an ongoing review of swaps that are not cleared.

This will clearly be a challenge as the Dodd-Frank Act gives the CFTC the authority to regulate "swaps", the Securities and Exchange Commission (SEC) the authority to regulate "security-based swaps", and both agencies the joint authority to regulate "mixed swaps". The definitions, the procedures for determining what must be cleared, and determination of what must be exchange-traded are each addressed in other proposed rules as well as many other components. This framework must be seen as a whole in order to assess the effectiveness of the implementation of Dodd-Frank. Nevertheless, recent Congressional testimony confirmed that 95% of the over-the-counter derivatives market will fall within the Commission's jurisdiction. This proposal regarding the end-user exception to mandatory clearing of swaps is a particularly important component of the more transparent and regulated market Dodd-Frank envisioned.

Exceptions to Mandatory Clearing Must be Narrow, Well Defined, and Subject to Alternative Safeguards

[1] "U.S. Financial Regulatory Reform: The Investors' Perspective", Investors Working Group, an Independent Taskforce Sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors, published in July 2009, submitted to the Federal Reserve Board September 22, 2010.

Dodd-Frank provides that a swap that is otherwise subject to mandatory clearing is not required to be cleared if:

- one party to the swap is not a financial entity;
- the swap is being used to hedge or mitigate commercial risk; and
- the swap user notifies the Commission of how it generally meets its financial obligations associated with non-cleared swaps.

Financial entities under the statute, ineligible to invoke the end-user exception, include:

- swap dealer;
- security-based swap dealer;
- major swap participant;
- major security-based swap participant;
- commodity pool as defined in Section 1a(10) of the Commodity Exchange Act;
- private fund as defined in Section 202(a) of the Investment Advisers Act of 1940;
- employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974; and
- 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.

Within these parameters, eligible counterparties may choose to invoke the end-user clearing exception – but are not required to do so.

Since the goal of increased exchange-trading and clearing is a marketplace that is more transparent and visible, one that is less conducive to the kind of unseen linkages that can threaten systemic risk, it is vital that end users understand as clearly as possible in advance which transactions are not eligible for the exception. Similarly, it is vital that they understand clearly the kind of specific analysis and documentation of financial risks associated with transactions believed to be eligible for the exception and the degree of detail to be specified – including how, when and by whom – in terms of reporting to the Commission their plans for meeting those financial obligations. Finally, given that "the Commission preliminarily believes that whether a position is used to hedge or mitigate commercial risk should be determined by the facts and circumstances at the time the swap is entered into", then the factual basis appropriate to bypass the clearing route should be more specifically outlined by the Commission, and well-documented by those electing the exemption.

For example, it should be clear to whom in the executive office this responsibility falls, and that no blanket or general assertion of intent to monitor and fulfill derivatives-triggered financial obligations will suffice.

What kind of specifics should be required? We note that the Commission proposes requiring information about any credit support agreement or other agreement used to mitigate the counterparty credit risk of security-based swaps not centrally cleared. Additionally, the Commission proposes requiring information on collateral transfers, security interests in property, guarantees by persons or entities other than the counterparty, and more.

The Commission also specifically seeks comment on whether additional detailed information would be valuable. The answer is yes; additional information is needed, and more than warranted here. While it is often asserted that many non-cleared derivatives are collateralized, it is unclear just how much – if any – real security is provided by those practices. A paper on "Best Practices for the OTC Derivatives Collateral Process", dated June 30, 2010, and developed by the International Swaps and Derivatives Association, Inc., ("ISDA") offers the Principle that "Wherever possible an ISDA Master Agreement and Credit Support Annex (CSA) should be used to confirm collateral terms, if any, between counterparties." However, no collateral is required.

Given the likelihood that many dealers will continue to structure transactions intended for end users who elect to forgo clearing, AFSCME recommends that the required "Financial Obligation Notice" be strengthened to require, for example:

- information regarding the types of collateral provided by the end-user and the effect of the liquidity of that collateral on the end-user's ability to meet its financial obligations;

- information regarding whether the collateral requirements are unilateral or bilateral;

- information regarding whether there are contractual terms triggered by changes in the credit rating or other financial circumstances of either of the counterparties;

- information describing whether any "third-party" guarantor of the end-user's obligations is a parent or affiliate of the person invoking the end-user exception; and

- information identifying any collateral agent or custodian or other entity involved in segregating collateral.

The SEC's proposal addressing end users' elections to bypass clearing appropriately noted that "For a variety of reasons one or both of the counterparties to some non-cleared security-based swaps may choose not to mitigate credit risk and instead rely on the general creditworthiness of their opposite counterparty, given the circumstances and financial terms of the transaction."[2] The SEC referenced guidance issued by the Office of the Comptroller of the Currency addressing the importance of aggregating limits for derivatives by regulated institutions with credit limits established by other activities including commercial lending. It seems clear that regulators appreciate the importance of understanding and evaluating carefully derivatives that embody a loan to the end-user backed by its "general creditworthiness". As both Commissions note, the kinds of financial resources that might be available to meet obligations triggered by uncleared security-based swaps may include "existing assets, investments and cash balances, cash flow from operations, short-term and long-term lines of credit and capital market sources of funding." It must be clarified that simple assertions of creditworthiness will not satisfy this disclosure obligation. This degree of transparency would also help end-users thoroughly evaluate the merits of clearing transactions that might qualify for the exception – but where they need not utilize it.

Clarity of this kind is also essential to revealing another important point – that is, clearing more transactions is not a move from zero collateral to full collateral, although opponents of clearing seem to portray it that way. Instead, a more transparent market, with more clearing and less invisible aggregation of risk, means moving from transactions that embody loans not recognized and booked appropriately by either borrower or lender, to a transaction that is correctly accounted for, with up-front recognition of costs and liabilities that can be compared and bargained over, rather than hidden obligations that have to be unraveled in a crisis.

"Hedging or Mitigating Commercial Risk" Must be Carefully Defined, Well-Documented and Reviewed

Unlike the SEC's proposed end user exemption[3], the CFTC's proposal includes a definition of "hedging or mitigating commercial risk" and deems the use of swaps to be hedging in three circumstances:

- swaps that are recognized as hedges for accounting purposes according to FASB;

[2] Footnote 28 of File No. S7-43-10.

[3] The Commission notes that the Joint Definitions put forward in File No. S7-39-10 propose a somewhat different definition of "hedging or mitigating commercial risk" for purposes of defining major swap participants.

- swaps that are recognized as bona fide hedging for purposes of an exemption from position limits under the Commodities Exchange Act; and

- swaps that used to hedge or mitigate business risks as defined by six proposed categories, regardless of how they are treated under accounting guidelines or the bona fide hedging exemption for position limits.

Swaps will not be deemed to be hedging or mitigating commercial risk if (i) used for a purpose that is in the nature of speculation, investment, or trading; or (ii) used to hedge or mitigate the risk of another swap or security-based swap, unless that other swap itself is used to hedge or mitigate commercial risk.

Swaps that are proposed to be deemed to be used to hedge or mitigate commercial risk are those that are "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from" specifically enumerated components that ultimately comprise "the ordinary course of business of the enterprise." For example, one of the categories of risks is "The potential change in the value of assets, services, inputs, products, or commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of business of the enterprise." AFSCME recognizes the effort to be specific about the kinds of "hedges" that will be considered to address "commercial risk" and to be eligible for the end user's option to elect an exemption from clearing. We anticipate that those selling to end users will have a list of other risks that must be included in the swaps that need not clear in order to better serve end users. We look forward to reviewing those submissions and discussing this further as the Commission's work proceeds.

AFSCME notes with particular concern two other categories of "deemed commercial hedges":

> "Any potential change in value related to the forgoing" (e.g., value of assets, services, inputs, products or commodities owned, manufactured, and so on) "arising from foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or
>
> "Any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities."

AFSCME has repeatedly joined with other concerned voices to highlight abusive foreign exchange ("FX") transactions. State pension funds in Virginia, California and Florida are pursuing allegations that their plans were systematically overcharged by hundreds of millions of dollars by financial institutions manipulating the reporting prices of currency trades. Major investment managers like BlackRock and Fidelity Investments are alleging

that they too have been overcharged by custody banks they trusted to perform their FX transactions. When abuses this large and widespread can challenge some of the most experienced players in the spot FX market, it is clear that FX derivatives should be approached with even greater caution.

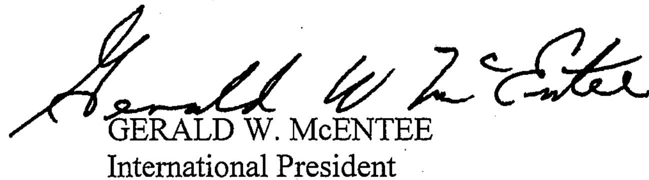
Alternative Standards for Small Financial Institutions should be Rigorously Scrutinized

The Dodd-Frank Act allows the Commission to consider whether to exempt small banks, savings associations, farm credit systems institutions and credit unions, including specifically those with assets of $10 billion or less, from the definition of financial entities who are ineligible to elect the end-user exception from mandatory clearing. AFSCME looks forward to the responses on the Commission's requests for information on the volume and type of transactions these institutions may engage in and the role of other supervisory regimes that may be put forward as adequate sources of oversight and protection. AFSCME preliminarily believes that, at a minimum, "small" financial institutions should be subject to the same kind of Financial Notice Obligations as other eligible end-users in order to make clear to regulators, depositors and others the kind of financial obligations those institutions are taking on.

* * *

We appreciate the opportunity to express our views on this matter. Please contact Lisa Lindsley at (202) 429-1275 if you have questions regarding our comments.

Sincerely,



GERALD W. McENTEE
International President