BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

February 4, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rules Governing the End-User Exception to Mandatory Clearing of Security-Based Swaps – File Number S7-43-10

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules ("Proposed Rules") of the Securities and Exchange Commission ("Commission"). In accordance with Section 763 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Proposed Rules would require disclosure from parties invoking the end-user exception from the mandatory clearing requirement for transactions in security-based swaps ("SBS"). This reporting is intended to accomplish three goals: (1) enable market participants to invoke the end-user exception; (2) provide the statutorily required information on how such market participants will meet their obligations arising from non-cleared SBS; and (3) enable the Commission to comply with its statutory mandate to prevent abuse of the end-user exception.

Introduction

Mandatory clearing of swaps is the centerpiece of reform embodied in Title VII of the Dodd-Frank Act. It is one of the core protections intended to prevent another financial crisis and taxpayer bailout. Thus, the end-user exception from this mandatory clearing requirement is, by design, very narrow and expressly limited.

The exception is solely for actual end-users and solely for them to hedge or mitigate genuine commercial risk, provided they have the ability to satisfy their obligations under the non-cleared SBS.

The Proposed Rules are intended to ensure that this narrow and limited exception in the law is implemented properly, but the proposed disclosures are insufficient and will not ensure

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

compliance with the statutory requirements of the Dodd-Frank Act. For example, the Proposed Rules only require an end-user to state **whether** it expects to use one of four listed methods for meeting its financial obligations, but nothing else. Another example is that the Proposed Rules only require an end-user to state **whether** an SBS is being used to hedge or mitigate commercial risk, but nothing else. This approach would enable market participants who claim the exception based on questionable or evasive practices to conceal illegal conduct. Not only would this violate the law in a way that is virtually impossible to detect, but it would also harm bona fide end-users by allowing unseen speculation to distort the market.

The financial collapse of 2008 made clear that such minimal disclosure will be inadequate to protect the markets from excess or, in turn, the public from those excesses. Indeed, a weak disclosure regime combined with too much reliance on self-regulation by financial market participants has proven to be an abysmal failure, one that has cost the American people trillions of dollars and so much more.

As happened in the years before 2008, requiring such minimal disclosure will also prevent regulators from having sufficient information to ensure compliance with the law and fulfill their essential oversight role. The Dodd-Frank Act was written to require new and critically important disclosures from market participants so regulators would have the informational tools they need to conduct meaningful oversight.

Moreover, a failure to implement the letter and spirit of these new disclosure standards will invite further abuses by turning limited and narrow exceptions in the law into gaping loopholes. Below, we identify just one such potential loophole: an SBS that hedges a commercial risk but includes additional, speculative risks beyond the hedge. There can be no doubt that, in very little time, creative market participants will devise many more ways to take advantage of the minimal disclosure regime reflected in the Proposed Rules, twisting the end-user exception beyond recognition and defeating one of the statute's most important intended purposes.

The Proposed Rules rely too much on trust and leave too much room for abuse. The changes suggested below will require sufficient disclosure to allow for real regulatory verification and oversight, which will greatly enhance compliance with the law. After all our country has gone through, it is the absolute least we must do.

Summary of Comments

The reporting requirements in the Proposed Rules focus on two areas: information relating to the end-user's ability to meet its obligations associated with non-cleared SBS, and information required to prevent abuse of the end-user exception.

The Proposed Rules must approach the issues associated with how the end-user is to meet its obligations with a focus on market realities. Specifically, the common use of Credit Support Annexes, in which dealer banks forbear from requiring posted collateral, creates enormous, poorly disclosed risks to end-users and those who are exposed to end-users. Therefore, there must be greater disclosure regarding these arrangements.

Furthermore, efforts to prevent abuse of the exception must focus more specifically on its core requirements: the SBS transaction must be used for hedging or mitigating commercial risk. The correlation between the SBS and the hedged risk must be tight, clearly cataloged, and reported. Without this specificity, abuse of the exception is a virtual certainty. In addition, the SBS must not involve any risks (commercial or otherwise) beyond those it is intended to hedge. This is the only way to prevent market participants from piggybacking speculative transactions onto those which might otherwise qualify for the exception.

Discussion

The Proposed Rules Must Require More Reporting About How the End-User Expects to Satisfy Its Financial Obligations Associated with the Non-Cleared SBS Transaction.

Section 763(a) of the Dodd-Frank Act[2] **requires** a party invoking the end-user exception to provide an SBS data repository ("SDR") with information regarding how the party meets its financial obligations associated with non-cleared SBS transactions. This information is critically important for risk assessment purposes. As noted in the proposing release[3] ("Release"), non-cleared SBS transactions are not subject to uniform margin and collateral requirements, which apply to all cleared SBS and which mitigate the consequences of default in SBS transactions. Release at 80006.

It is therefore necessary for the Commission to determine whether a party relying on the end-user exception is taking adequate steps to mitigate the credit risks associated with non-cleared SBS. To make this determination, the Commission must have access to sufficient information about how the party expects to meet its financial obligations under the SBS. That information must include not only the generic types of arrangements that the end-user intends to use, but the terms of those arrangements as well.

The Proposed Rules fail to require the disclosure of essential information, and, therefore, the Commission will be unable to discharge its duty of risk assessment with respect to non-cleared SBS. Proposed Rule 240.3Cg-1(5) merely requires a party invoking the end-user exception to designate **whether** it expects to use one of four listed methods for meeting its financial obligations under a non-cleared SBS transaction. Those four methods are identified as credit support agreements, agreements to pledge or segregate assets, third-party guarantees, or the party's own financial resources.

However, the Proposed Rules do not require disclosure of **any** information regarding the substantive terms of those arrangements. In the context of actual market practices, the designation of these methods, without any accompanying detail, is meaningless.

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2 Section 3C(g)(1)(C) of the Securities Exchange Act.

3 *See* Exchange Act Release No. 34-63556 (Dec. 15, 2010), 75 Fed. Reg. 79992 (Dec. 21, 2010).

Margining Arrangements

In practice, there are two categories of contractual arrangements for bi-lateral SBS obligations: those which are governed by ISDA Credit Support Annexes to Master Swap Agreement ("CSA") and those in which margining arrangements are established in less formal short-form confirmations. The most significant are those governed by CSAs. The reporting obligations under the Proposed Rules must reflect and address the material obligations under the CSAs if the required disclosure is to be meaningful.

The CSAs typically establish the procedures for collateralizing credit exposures. CSAs apply to all swaps between the parties rather than individual swaps. Exposures are measured on a net portfolio basis by mark-to-market calculations, plus (in some, but by no means all, cases) an "additional amount" that serves as a rough analog to initial margin.

In many instances, counterparties forbear from collecting collateral up to a cap. Such forbearance arrangements are the most significant obligations that end-users must meet because they almost invariably include "credit triggers," which are generally based on credit ratings. **If a credit trigger is tripped, the end-user is required to fully fund collateral that has been previously forborne, at the very time it is most difficult to do so.** Because these forbearance arrangements can have such a dramatic and debilitating impact on an end-user, they must be a primary focus of the Proposed Rules.

The use of forbearance under a CSA between a dealer and an end-user can be usefully understood as a revolving loan of funds from the dealer to the end-user to provide required collateral, where the "loan" can be called for repayment upon the occurrence of a credit trigger event. In fact, the practice by dealers is to estimate the average daily outstanding (but uncollected) collateral (i.e., principal) over the expected life of the SBS (i.e., loan term) and calculate an appropriate charge for extending the credit (i.e., interest). That charge is then added to and embedded unseen into the cost of the SBS to the end-user.

Confirming this view, the Comptroller of the Currency requires that bank dealers aggregate amounts of forborne collateral with commercial loans extended by the bank dealer to the same entities. And, of course, bank dealers typically decrease lending capacity by such amounts.

This analysis is important in identifying the information that the Commission must collect if it is to determine how the end-user will meet its obligations under the non-cleared SBS.[4] Thus, the Proposed Rules must be tailored to reflect these market realities by requiring the following disclosure:

[4] This analysis also shows that end-users are already paying for margin and collateral. Those costs are just concealed from end-users and the public because dealers do not break out the costs they charge for swaps. This dealer practice also prevents end-users from shopping for better prices. Thus, the argument that requiring the posting of margin or collateral will result in a major incremental cost to end-users is baseless. Indeed, there are strong arguments that requiring end-users to post margin and collateral will actually decrease their costs.

- Each Master Swap Agreement and CSA must be filed in a library maintained by either the SEC or an SDR. Margin forbearance and credit trigger provisions should be separately disclosed in a linked file that is periodically updated to provide the current usage of capped forbearance. Each SBS entered under a Master Swap Agreement and CSA should be cross-referenced.

- The end-user must describe its ability to fund margin fully if all credit triggers are tripped, specifying its access to liquidity. Any other mechanism for disclosing how an end-user will meet its obligations is of minimal importance compared with this requirement.

- The end-user must report whether collateral requirements are unilateral or bilateral, and must disclose the protections afforded to the end-user in the event that the financial condition of a bank or other counterparty deteriorates.

- The identity and financial condition of any guarantor of the end-user must be provided.

Other Forms of Collateral

The Release recognizes that collateral other than cash and securities may be transferred to the end-user's counterparty to secure the obligations under the SBS. These types of arrangements are typically "right way risk transactions" in which margin obligations under a CSA are secured by an asset the value of which is, in theory, inversely related to the amount of the margin obligation. The reporting to the Commission or the SDR relating to CSAs must include information on such collateral, specifically:

- a description of the collateral and its value in relation to the obligations it secures;

- the sufficiency of the collateral to cover such obligations, especially considering the liquidity and volatility of the amount of the obligations, on the one hand, and the collateral on the other;

- other liens on the collateral, including amount and priority; and

- disclosure of the right-way risk transactions to investors, bondholders, and lenders.

Segregation and Re-hypothecation

The CSA provisions relating to segregation and re-hypothecation also need to be disclosed. These provisions are especially important, since they involve protections for the benefit of the end-user if the counterparty's credit quality deteriorates and collateral has been re-hypothecated. The reports must therefore include a description of provisions designed to limit the adverse consequences of re-hypothecation.

A related issue is the obligation of the counterparty to post collateral for the protection of the end-user under the CSA. For example, such collateral can offset the consequences of re-hypothecation of additional amounts, otherwise known as initial margin. This also should be disclosed in the required reports.

Catchall Provision

The Proposed Rules contain a catchall provision, which requires the party to indicate **whether** it expects to rely on "means other than those" set forth in the Proposed Rules to meets its financial obligations under a non-cleared SBS transaction. Proposed Rule 240.3Cg-1(a)(5)(v). This too will be meaningless disclosure unless the rule also requires the details regarding such "other" means.

The catchall provision should expressly require each party to describe the specific method or methods it will use to meet its financial obligations under the non-cleared SBS, if its chosen method is not among those listed in the Proposed Rules. This additional information is necessary to satisfy the explicit requirements of the Dodd-Frank Act. Section 763(a) of the Dodd-Frank Act[5] makes clear that the party invoking the end-user exception must notify the Commission of "**how**" it meets its financial obligations with respect to non-cleared SBS. A mere indication that the party expects to use some unspecified method, "other" than the ones listed in the Proposed Rule, clearly does not satisfy this statutory requirement. Nor would such minimal information enable the Commission to conduct meaningful risk assessment as to end-users entering non-cleared SBS.

The catchall provision in the Proposed Rules would also prevent the Commission from achieving its other regulatory objectives. For example, the Release indicates that the catchall provision is intended in part "to separately categorize all other methods that may be used in the markets today or that may develop in the future" for meeting obligations associated with SBS transactions. Release at 79995. According to the Release, this, in turn, will enable the Commission to determine if more "granular" rules are necessary concerning the manner in which end-users are meeting their financial obligations. *Id.* Without any information regarding the other means that a party is using to meet its financial obligations, the Commission will be unable to achieve these regulatory objectives.

In summary, the Commission cannot meaningfully assess whether a party claiming the end-user exception is taking adequate steps to meet its financial obligations under non-cleared SBS transactions unless the Proposed Rules require parties to report much more detailed information, as described above.

The Proposed Rules Should Also Require More Disclosure To Prevent Abuse of the End-User Exception.

Section 763(a) of the Dodd-Frank Act[6] authorizes the Commission to prescribe rules, issue interpretations, or request information from those who invoke the end-user exception, to

[5] Section 3C(g)(1)(C) of the Securities Exchange Act.
[6] Section 3C(g)(6) of the Securities Exchange Act.

prevent abuse of the exception. This explicit authority reflects Congress's concern that this narrow exception to the clearing requirement could become a loophole used to undermine one of the fundamental goals of the new regulatory regime governing derivatives: central clearing of virtually all SBS transactions.

To protect against potential abuses, the Commission must have sufficient information to confirm that parties invoking the exception are doing so legitimately and in accordance with the applicable requirements. That is the basis for the statutory requirement that the Proposed Rules must implement.

One of the core prerequisites for the end-user exception is that the party invoking it must be using the SBS "to hedge or mitigate **commercial** risk." Section 763(a) of the Dodd-Frank Act[7] (emphasis added). This requirement is a fundamentally important limitation on the exception, but it is also one of the most difficult elements to police **unless** the Commission requires sufficient disclosure. To ensure that this narrow, limited exception is properly invoked, parties must be required to report information regarding the risks that the party is hedging and the manner in which the SBS addresses those risks.

On this issue, the Proposed Rules do not go far enough. They only require the party invoking the exception to report "**whether**" the SBS is being used to hedge or mitigate commercial risk. Proposed Rule 240.3Cg-1(a)(4). This representation, without more, does virtually nothing to ensure that the exception is being used legitimately.[8]

To satisfy both the letter and spirit of the Dodd-Frank Act, the Proposed Rules must require parties not only to represent that they are hedging or mitigating commercial risk, but also to provide disclosure concerning those hedging activities. That information must include identification of the assets, liabilities, or services they seek to protect against a change in value, and the manner in which the specific SBS being entered will mitigate those risks.

This disclosure is essential to prevent another form of abuse: parties may seek to employ the end-user exception in situations where their primary purpose is speculation by entering SBS transactions that have only a limited hedging component. For example, an exposure to the credit risk of Corporation X could be "hedged" by entering into an indexed credit default swap ("CDS") that covers Corporation X along with a number of other corporations. Such a CDS would expose the end-user to the credit values of the other corporations in the CDS market basket, which are speculative and not eligible for the exception.

This transaction would be nothing more than an attempt to camouflage what is predominantly a speculative activity through a minor hedge position, which would violate

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7 Section 3C(g)(1)(B) of the Securities Exchange Act.

8 The Proposed Rules incorporate the definition of "hedging or mitigating commercial risk" by reference to a separate proposal on the definition of "major security-based swap participant." *See* Exchange Act Release No. 34-63452, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," (Dec. 7 2010), 75 Fed. Reg. 80173 (Dec. 21, 2010). That definition requires parties who wish to be considered bona fide hedgers to follow certain **internal** protocols for assessing the effectiveness of SBS as a hedge, but it imposes no affirmative reporting obligations on the parties.

the statute. Concrete disclosure about the risks being hedged, and the correlation between those risks and the SBS transaction, is essential to guard against this abuse of the limited, narrow exception. Finally, any party seeking to invoke the exception should be required to represent that the SBS is **not** entered for a speculative purpose, either **in whole or in part**.

Only with these additional reporting obligations will the Proposed Rules enable the Commission to discharge its duty to ensure that the end-user exception is only used as provided for in the Dodd-Frank Act.

The Proposed Rules Should Require Issuers of Registered Securities and Issuers Subject to Reporting Requirements Under the Securities Exchange Act to Provide Additional Information and to Certify the Accuracy of their Reports.

The Dodd-Frank Act appropriately requires issuers of registered securities and issuers subject to reporting requirements under the Securities Exchange Act ("Issuers") to provide additional information as a condition to reliance on the end-user exception. Specifically, a committee of the Issuer's board or governing body must review and approve the Issuer's decision to enter the SBS transaction that is the subject of the claimed exception. Section 763(a) of the Dodd-Frank Act[9]. The Proposed Rules mirror this requirement. Proposed Rule 240.3Cg-1(6)(ii). Although this is an important measure aimed at deterring abuse of the end-user exception, it is insufficient to ensure compliance with the law. The following additional disclosures are necessary.

First, the Proposed Rules must require Issuers to include additional information in their reports to ensure that the relevant board committee conducts a substantive and meaningful review of each SBS transaction and its role in hedging the Issuer's risk. As currently framed, the Proposed Rules merely require the Issuer to report "**whether**" an appropriate committee of the board of directors or equivalent body has reviewed and approved the decision to enter into the SBS subject to the clearing exception. Proposed Rule 240.3Cg-1(a)(6). This simple disclosure—like the other minimal disclosures discussed above—is inadequate to satisfy the requirements of the law.

- The rules should also require the appropriate committee to set forth the justification for each non-cleared SBS transaction, including:
- the specific risks being hedged and the rationale for selecting the particular SBS at issue as the method for addressing those risks;
- the costs of credit extended under collateral forbearance arrangements set forth in CSAs;
- a statement of how the end-user is to meet its obligations under its SBS, including obligations related to credit triggers in CSAs; and

[9] Section 3C(i) of the Securities Exchange Act.

- a statement that the risks associated with obligations under CSAs related to SBS transactions entered into under the end-user exception have been adequately disclosed in public filings.

Second, the Proposed Rules should impose another requirement that will vastly increase the reliability of a board committee's review and approval of an Issuer's non-cleared SBS transactions. Following the model of the Sarbanes-Oxley Act of 2002, the Proposed Rules should require the CEO and CFO of the Issuer to certify that they have reviewed the board committee's report on the Issuer's non-cleared SBS and that it is accurate in all material respects.

All of these disclosure requirements will help ensure that the committee's role in overseeing an Issuer's transactions in non-cleared SBS will be more than a mere formality.

The Proposed Rules Should Require Submission of Reports Regarding the End-User Exception Directly to the SEC, in Addition to the SDR.

The Dodd-Frank Act requires that information regarding how an end-user meets its obligations under non-cleared SBS transactions must be provided **to the Commission**. Section 763(a) of the Dodd-Frank Act[10]. Similarly, information necessary to prevent abuse of the end-user exception is to be requested **by the Commission.** Section 763(a) of the Dodd-Frank Act[11]. The Proposed Rules implement these provisions by requiring end-users to submit their reports **to registered SDRs**, and to the Commission only if no SDR is available to accept the information. Proposed Rule 240.3Cg-1(a).

These requirements may have a certain logic, insofar as SDRs will be established to collect, store, and disseminate transaction data regarding both cleared and non-cleared SBS transactions. Therefore, SDRs will presumably be equipped to handle the additional reports regarding compliance with the end-user exception.

Far more important than these issues surrounding reporting mechanics, however, is ensuring that the **Commission** receives complete and timely information regarding reliance upon the end-user exception in SBS transactions. The only way to achieve this goal is to require that reports relating to the end-user exception be submitted directly to the Commission, in addition to the SDRs. Otherwise, the Commission will be left to collect reports from different SDRs, a time-consuming and burdensome process.

Such a parallel reporting requirement would not be necessary if the Commission were to establish a system for aggregating all SBS transaction data collected by the SDRs and disseminating it to the Commission. However, the Commission's current rule proposals, including proposed Regulation SBSR, do not provide for such a data handling mechanism. Unless and until the Commission adopts that approach, reports from parties invoking the end-user exception must be submitted directly to the Commission.

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10 Section 3C(g)(1)(C) of the Securities Exchange Act.
11 Section 3C(g)(6) of the Securities Exchange Act.

Conclusion

Clearing swaps is the centerpiece of reform embodied in Title VII of the Dodd-Frank Act. The law allows only a very few, narrow, and limited exceptions to that core principle.

In keeping with this approach, the exception for end-users is strictly limited to actual end-users and solely for them to hedge or mitigate commercial risk. The law requires sufficient disclosure to ensure that only legitimate end-users invoke the exception, that they have the ability to meet their obligations, and that they are engaged in bona fide hedging activities. To oversee and enforce compliance with all of these requirements, the Commission must have the additional information proposed here.

We hope that our comments will assist the Commission as it finalizes its regulations.

Sincerely,

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