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June 16, 2009

Via E-Mail

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

Re: Comments on Swap Hedge Exemption Concept Release

Dear Mr. Stawick:

The Committee on Futures and Derivatives Regulation (the "Committee") of the New York City Bar Association (the "Association") is writing to submit comments on the "Concept Release on Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption from Speculative Position Limits" that was published in the Federal Register on March 24, 2009.

The Association is an organization of over 23,000 members. Most of its members practice in the New York City area. However, the Association also has members in nearly every state and over 50 countries. The Committee consists of attorneys knowledgeable about the trading and regulation of futures contracts and of over-the-counter derivative products such as credit default swaps and it has a practice of publishing comments on legal and regulatory developments that have a significant impact on futures and derivatives markets.

Our Committee generally supports regulatory initiatives that will improve market transparency and reduce systemic risk. In this case, however, we feel that the regulatory changes described in the Concept Release do not strike an appropriate balance between the market benefits and regulatory efficiency to be achieved and the negative effects and burdens that will be imposed on market participants. The elimination of the *bona fide* hedge exemption for swap activity is a drastic step that should not be undertaken unless there is conclusive proof of a problem that would be solved by such action.

As an initial matter, any action taken by the Commission should take appropriate account of the significant difference between the legal relationship of a swap dealer with its counterparty and that of a futures commission merchant ("FCM") to its clients. Unlike FCMs, which traditionally have acted as agents for their clients, swap dealers act as principals in an arms length relationship with counterparties who in many instances carefully limit the information they provide to the dealer. The very nature of this different legal relationship makes it both impractical and inappropriate to put the swaps dealer in the position of policing or even obtaining its counterparty's market positions, and could result dealers being required to categorize the activities of its swap counterparties on the basis of motivations and circumstance that may not be readily apparent.

In addition, most swaps dealers are banks, broker dealers, or their affiliates, who are currently subject to prudential supervision. Recent market events have driven home the need for such institutions to maintain strong and effective risk management practices. Elimination of the *bona fide* hedge exemption will make it more difficult for these institutions to use the ready liquidity and comparative high degree of transparency of the futures markets as part of their risk management, and may lead to less effective or more expensive risk management at time when the regulatory system should be encouraging exactly the opposite.

We have also set forth below some comments to the numbered questions in the Concept Release:

1. Should swap dealers no longer be allowed to qualify for exemption under the existing *bona fide* hedge definition?

   No. Derivatives are a legitimate business activity of financial institutions and should give rise to a substantive exemption for relevant hedging activity. If there is a need for greater regulation of positions in the relevant commodity markets, it should be imposed across the board on all parties making use of *bona fide* hedge exemptions, not just parties engaged in swap transactions. In addition, in view of the Treasury legislative proposal for the regulation of over-the-counter derivatives, any changes of this magnitude should be incorporated into any legislative proposal implementing the Treasury program.

2. If so, should the Commission create a limited risk-management exemption for swap dealers based upon the nature of their clients (e.g., being allowed an exemption to the extent a client is a traditional commercial hedger)?

If the Commission were to eliminate the ability of swap dealers to qualify for the *bona fide* hedging exemption, then a broad and flexible risk management exemption should be adopted. In that case, if the swap dealer's client represents in writing to the swap dealer that it is a commercial hedger in respect of the underlying commodity, or a representation that it is an eligible commercial entity in respect of the underlying commodity, the swap dealer should be able to rely on the representation and thereby qualify for a risk management exemption. Given that the relationship between a swap dealer and its client is an arms-length principal relationship, no additional due diligence should be required of the swap dealer to verify the client's representation.

3. If the *bona fide* hedge exemption were eliminated for swap dealers, and replaced with a new, limited risk management exemption, how should the new rules be applied to existing futures positions that no longer qualify for the new risk-management exemption? For example, should existing futures positions in excess of current Federal speculative position limits be grandfathered until the futures and option contract in which they are placed expire? Should swap dealers holding such position be given a time limit within which to bring their futures position into compliance with Federal speculative limits? Should swap dealers holding such positions be required to bring their futures positions into compliance with the Federal limits as of the effective date of the new rules?

To avoid confusion in the market place and needless market volatility resulting from swap dealers simultaneously adjusting their positions en masse, we think that it would be prudent to grandfather existing futures positions in excess of Federal position limits until the futures and option contracts in which they are placed expire. We do not believe that imposing an arbitrary time horizon is necessary.

4. The existing *bona fide* hedge exemptions granted by the Commission extend only to those agricultural commodities subject to Federal speculative position limits. Should the reinterpretation of *bona fide* hedging and any new limited risk management exemption extend to other physical commodities, such as energy and metals, which are subject to exchange position limits or position accountability rules.

We do not believe that the reinterpretation of *bona fide* hedging and any new limited risk management exemption extend to other physical commodities. To the contrary, we think that it would be in the public interest for the existing *bona fide* hedge exemptions to be extended to all commodities and not be limited to those agricultural commodities that are subject to Federal speculative position limits. This will render regulatory certainty to the application of the *bona fide* hedge exemptions across all markets and commercial traders.

5. If a new limited risk management exemption were to be permitted to the extent a swap dealer is taking on risk on behalf of commercial clients, how should the rules define what constitutes a commercial client?

If a decision is made to create a new limited risk management exemption, the definition of a "commercial client" should include an individual or entity that either (i) produces, processes, merchandises, manufactures or consumes (on a commercial basis) the commodity, (ii) incurs risks, in addition to the price risk, relating to the commodity in conjunction with its line of business, or (iii) regularly enters into commercial transactions to purchase or sell the commodity in conjunction with a line of its business.

6. How should the Commission (and, if applicable, the responsible industry self-regulatory organization (SRO)) and the swap dealer itself verify that a dealer's clients are commercial? Is certification by the dealer sufficient or would something more be required from either the dealer or the client? If so, what should be reported and how often—weekly, monthly, etc.?

Given the arms-length relationship between swap dealers and their counterparties, it would be an undue burden to require a swaps dealer to verify the commercial nature of its client. Similar to a swap dealer being able to rely on other written representations contained in its contractual agreement with its client, a swap dealer should be permitted to rely on a written representation by its client that it is a commercial hedger in respect of the underlying commodity. Further, the Commission, through its market oversight and surveillance functions is better suited than swap dealers to verify (and where necessary, investigate) the status of entities holding themselves out as *bona fide* hedgers.

We do not believe that the public interest necessitates requiring individuals or entities who hold themselves out as hedgers to register with the Commission or be subject to reporting requirements. This would be extremely burdensome on the commercial hedgers as well as the Commission's resources.

7. For a swap dealer's noncommercial clients, should the rules distinguish between different classes of noncommercials—for example: (1) Clients who are speculators (e.g., a hedge fund); (2) clients who are index funds trading passively on behalf of many participants; and (3) clients who are intermediaries (e.g., another swap dealer trading on behalf of undisclosed clients, some of whom may be commercials)?

The rules do not need to distinguish between different classes of noncommercials. However, we believe that index funds that trade passively on behalf of many participants should be included as a subcategory of a commercial hedger. Similarly, a swap dealer trading on behalf of undisclosed commercial clients should also be included as a subcategory of a commercial hedger.

8. If a swap dealer were allowed an exemption for risk taken on against index-fund clients, how would the dealer satisfy the Commission that the fund is made up of many participants and is passively managed? Is certification by the dealer or fund sufficient or should the dealer or fund be required to identify the fund's largest clients?

In the past few years index funds traded on regulated securities exchanges have become an important investment vehicle for the public. These are highly regulated and transparent investment vehicles that add to the market's liquidity, thereby facilitating the orderly functioning of the markets as well as the hedging activity of commercial entities.

Index funds that trade on behalf of passive public investors, are listed on regulated exchanges and that are operated by registered commodity pool operators, should be characterized as either *bona fide* hedgers or "index fund risk management traders" and thereby qualify for the limited risk management exemption. (This position is not dissimilar to the Commission's 1987 interpretation that clarified the hedging definition to include "long" strategies of institutional investors to hedge against interest rate exposure. 52 Federal Register 27195 (CFTC, July 20, 1987).)

As pointed out in prior responses, a dealer should be allowed to rely on a status representation from its counterparty and should not be required to satisfy the CFTC concerning the make-up and investment intent of the counterparty.

9. If a swap dealer were allowed an exemption for risk taken on against another intermediary, how would the dealer satisfy the Commission that its intermediary client does not in turn have noncommercial clients that are in excess of position limits? Is certification by the dealer or second intermediary sufficient or should the dealer or intermediary be required to separately identify the intermediary's largest clients?

The dealer or second intermediary should not be routinely required to identify its clients. Their identities should be disclosable to the Commission upon request, in which case the CFTC could then aggregate client positions across markets and dealers as required.

10. What futures equivalent position level should trigger the new limited risk management exemption reporting requirement? For example, under the rules of the on-going special call to swap dealers and index funds described earlier, a swap dealer must report any client in any individual month that exceeds 25% of the spot month limit, or the net long or short position of a client that in all months combined exceeds 25% of the all-months-combined limit.

No response.

11. If none of a swap dealer's clients exceed required reporting levels in a given commodity, or none of such clients exceed reporting levels in any commodity, what type of report should be filed with the Commission—e.g., a certification by the swap dealer to the Commission to that effect?

Simple certification should be sufficient.

12. Should there be an overall limit on a swap dealer's futures and option positions in any one market regardless of the commercial or noncommercial nature of their clients? For example, "A swap dealer may not hold an individual month or all-months-combined position in an agricultural commodity named in § 150.2 in excess of 10% of the average combined futures and delta-adjusted option month-end open interest for the most recent calendar year."

Placing a hard cap on a swap dealer's position limits would only result in clients shifting their hedging transactions to other swap dealers, needlessly penalizing the original dealer without limiting the activity in the aggregate.

13. If a new limited risk-management exemption for swap dealers is created, what additional elements, other than those listed here, should be considered by the Commission in developing such an exemption?

The Commission could require swap dealers to make their books and records available to the Commission for inspection upon request.

14. How should the two index traders who have received no-action relief from Federal speculative position limits (see footnote 15) be treated under any new regulatory scheme as discussed herein?

The index traders who have been granted no-action relief from Federal speculative position limits have relied in good faith on such relief. To our knowledge, their trading has not caused any disruption in the markets. Rescinding or revising the relief that the Commission previously granted is not in the public interest and may have an unnecessary disruptive effect on the beneficiaries of these letters and their public investors.

15. What information should be required in a swap dealer's application for a limited risk management exemption?

The swap dealer's application for a limited risk management exemption should contain compliance and internal audit procedures, and confirmation that it will obtain written representations from each of its clients in respect of their commercial hedging status.

Any questions you may have about these comments should be directed to the undersigned.

Very truly yours,

Michael Sackheim

Michael S. Sackheim
Chair, Committee on Futures and Derivatives Regulation

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¶These members of the Committee did not participate in this comment letter.
*These members comprise the Ad Hoc Concept Release Working Group.