



UNIVERSITY OF MARYLAND  
SCHOOL OF LAW

April 9, 2011

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

**Re: Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants**

Dear Mr. Stawick:

These comments are submitted in response to the Notice of Proposed Rulemaking<sup>1</sup> issued by the Commodity Futures Trading Commission (“CFTC” or “Commission”) to implement the new section 4s of the Commodity Exchange Act<sup>2</sup>, amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>3</sup> (the “Dodd-Frank Act”).

The economic devastation caused by the recent financial crisis demonstrates the need for stringent regulation of over-the-counter (“OTC”) derivatives transactions.<sup>4</sup> In drafting the proposed rules, the Commission attempts to increase market transparency and promote financial integrity, which are essential goals put forth in the Dodd-Frank Act. As a result, I support the

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<sup>1</sup> Swap Trading Relationship Documentation Requirements For Swap Dealers and Major Swap Participants, 76 Fed. Reg. 6715 (Feb. 8, 2011) [hereinafter “Proposed Rules”].

<sup>2</sup> 7 U.S.C. 1 et seq.

<sup>3</sup> Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>4</sup> See Ben Moshinsky, *Stiglitz Says Banks Should Be Banned From CDS Trading*, BLOOMBERG.COM (Oct. 12, 2009), <http://noir.bloomberg.com/apps/news?pid=newsarchive&sid=a65VXsl.90hs>; Alan S. Blinder, *The Two Issues to Watch on Financial Reform — We Need an Independent Consumer Watchdog and Strong Derivatives Regulation. Industry Lobbyists are Trying to Water Them Down*, WALL ST. J., Apr. 22, 2010, available at <http://online.wsj.com/article/SB10001424052748704133804575197852294753766.html>; Henry T. C. Hu, *Empty Creditors and the Crisis*, WALL ST. J., Apr. 10, 2009, at A13; MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* (2010); SIMON JOHNSON & JAMES KWAK, *13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN* (2011); MICHAEL HIRSH, *CAPITAL OFFENSE: HOW WASHINGTON’S WISE MEN TURNED AMERICA’S FUTURE OVER TO WALL STREET* (2010); BETHANY McLEAN & JOE NOCERA, *ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS*; FINANCIAL CRISIS INQUIRY COMMISSION, *THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES* xxiv (Jan. 2011), available at <http://www.fcic.gov/report>.

proposals on swap valuation process<sup>5</sup> and segregation of variation margin funds<sup>6</sup> as well as the rationales behind them. However, the Commission is urged to reconsider the recommended provisions on the following aspects of the proposed rules.

## **I. End-User Documentation Requirements Should be Strengthened.**

The proposed rules require a Swap Dealer (“SD”) or Major Swap Participant (“MSP”) to obtain documentation sufficient to provide a “reasonable basis” on which to believe that their counterparty meets the statutory and regulatory requirements for the end-user exception.<sup>7</sup> In other words, an SD or MSP would need to determine whether the counterparty is hedging commercial risk, and hence, may claim the exemption afforded by the law based on information provided by the counterparty.

The proposed rules will work in conjunction with Section 2(h)(7) of the Dodd-Frank Act<sup>8</sup> that lays out the criteria to grant the end-user exemption. The standard prescribed by the Commission to interpret Section 2(h)(7) must be reconsidered because the notification proposal lacks stringent application of the exception by adopting a “user-friendly, check-the-box approach to determine end-user qualifications.”<sup>9</sup> As Chairman Gary Gensler has articulated, the purpose behind the suggested revision of the end-user designation is that, “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.”<sup>10</sup> Therefore, in order to be an effective rule, the proposed criteria must incorporate enhanced reporting requirements ensuring that the calculation methodology and the effectiveness of the hedged position are well documented.<sup>11</sup> As such, I incorporate by reference my comment letter on End-User Exemption to Mandatory Clearing of Swaps submitted on February 22, 2010 elaborating the reasons to define the end-user exemption narrowly.<sup>12</sup>

## **II. Standardization of Documents Should Include Terms and Conditions for Credit Extension and Transaction Fee Structure.**

The proposed rules encourage SDs and MSPs to “maintain standard templates for documenting their trade relationships.”<sup>13</sup> The recommendation is properly designed to better

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<sup>5</sup> Proposed Rules at 6718, *supra* note 1.

<sup>6</sup> *Id.*

<sup>7</sup> Proposed Rules at 6725, *supra* note 1.

<sup>8</sup> *See* § 723 of the Dodd-Frank Act.

<sup>9</sup> End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80747, 80755 (proposed Dec. 23, 2010).

<sup>10</sup> 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>.

<sup>11</sup> Comment Letter by Michael Greenberger, Law School Professor, University of Maryland School of Law, to David A. Stawick, Secretary, Commodity Futures Trading Commission (Feb. 22, 2011) (cites 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)) [hereinafter as Comment Letter by Michael Greenberger].

<sup>12</sup> *Id.*

<sup>13</sup> Proposed Rules at 6718, *supra* note 1.

facilitate transactions between contracting parties by shedding light on the terms of a specific transaction such as cross-product netting<sup>14</sup> as well as on various other complex yet important aspects of the relationship between the parties involved.

The proposed rules on documentation, however, do not require that parties document the terms and conditions for credit extension scenarios. The rules are also silent on the structure of the transactional fees a swap dealer may charge to counterparties. It is well settled that the proposed rules attempt to bring transparency to the financial markets. However, leaving terms and rules regarding credit extension and transactional fees to subjective desires of market participants will surely be counterproductive. As indicated in my previous End-User Exemption comment letter to the Commission, I support the comment letter by Better Markets, Inc., which urges the Commission to propose definitive rules on the aforementioned topics.<sup>15</sup>

### **III. Audit and Compliance Period Requirements Need Not Be So Relaxed.**

On an annual basis, the rules require SDs and MSPs to have an independent internal or external auditor examine at least five percent of their trading relationship documentation created during the prior twelve months.<sup>16</sup> However, allowing an entity to have the examination done by an *internal* auditor could potentially undermine transparency and accountability hindering the regulators' honest efforts to curtail yet another financial crisis.

The Commission solicits comments on an appropriate compliance period within which existing trading relationship documentation will be brought into compliance with the proposed rules. The Commission concedes in the "cost-benefit analysis" section that the benefits far outweigh the associated costs of compliance because many SDs and MSPs execute and maintain the trading relationship documentation of the type required by the proposed rules.<sup>17</sup> This abates the need to allow an unnecessarily long period of time to ensure compliance. As such, allowing a maximum of thirty days to comply with the eventually adapted rules should suffice.

Sincerely,



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Law School Professor  
University of Maryland School of Law

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<sup>14</sup> *Id.*

<sup>15</sup> Comment Letter by Michael Greenberger, *supra* note 11.

<sup>16</sup> Proposed Rules at 6726, *supra* note 1.

<sup>17</sup> Proposed Rules at 6725, *supra* note 1.