sifma
Invested in America

February 22, 2011

By electronic submission to www.cftc.gov
By electronic submission to www.sec.gov

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

Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Proposed Rules for End-User Exception to Mandatory Clearing of Swaps (CFTC File: RIN 3038-AD10 and SEC File: No. S7-43-10)

Dear Mr. Stawick and Ms. Murphy:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to submit this letter to provide comments on proposed rules under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") recently published by the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC", and together with the CFTC, the Commissions") in respect of the application of the exception to mandatory clearing of swaps and security-based swaps (individually, the "CFTC Proposed Rule" and the "SEC Proposed Rule" and, together, the "Proposed Rules").[2] This letter reflects the views of SIFMA's Municipal Financial Products Committee.

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80747 (Dec. 9, 2010) (issuing the CFTC Proposed Rule, the "CFTC Proposing Release"); End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. 79992 (Dec. 15, 2010) (issuing the SEC Proposed Rule).

For more than twenty years, swaps[3] have been used in the municipal market by governmental borrowers ("Governmental Borrowers"),[4] as well as non-profit borrowers of tax-exempt bond proceeds ("Non-Profit Borrowers" and together with Governmental Borrowers, "Borrowers"). Many of the market's leading Borrowers have used swaps, including several of the largest cities, governmental agencies, non-profit healthcare institutions and non-profit higher educational institutions. Typically, Borrowers enter into swaps in connection with, or to offset payment obligations on, related debt obligations.[5] Borrowers most frequently use SIFMA Index or LIBOR fixed payer, fixed receiver, interest rate caps and basis swaps to hedge or lower their borrowing costs on new, outstanding or anticipated debt. Governmental Borrowers are subject to GASB and Non-Profit Borrowers to FASB.

I. An Exception to the Clearing Requirement May Be Critical To Municipal Market Borrowers' Ability to Access the Interest Rate Swap Market

We respectfully submit that in the absence of an exception to the clearing requirement, many Borrowers may not have access to the municipal swap market. Many Borrowers may not be able to execute swaps that comply with, and are subject to, a clearing requirement;[6] those that can comply would, as described below, have to bear potentially overly burdensome costs.

Most swaps in the municipal market are uniquely structured. Pricing, term, amortization, timing and frequency of payments, source of payment and security provisions and other particulars of municipal market swap transactions are frequently affected by, if not mandated by: applicable U.S. Federal tax law, specifically the tax-exempt bond hedge regulations that permit the "integration" of a swap and a tax-exempt bond for yield calculation purposes;[7] state and local law; Borrower-adopted swap and debt management policies; and indenture and other financing and credit document specifications.

---

[3] Unless otherwise specified, all references to "swap," herein are to "swap" and "security based swap" as defined in the Act. All citations herein are to the Commodity Exchange Act (the "CEA") and the Securities Exchange Act of 1934 (the "Exchange Act"), as modified by the Act.

[4] A Governmental Borrower means "a State, State agency, city, county, municipality, or other political subdivision of a State" as defined in clause (ii) of the definition of the term "Special Entity" included in the Act. CEA § 4s(h)(2)(C); Exchange Act § 15F(h)(2)(C).

[5] Borrowers have used a variety of swaps including, among others, currency, credit and commodity swaps. The focus of this letter, however, is principally the use by Borrowers of interest rate swaps in connection with debt offerings.

[6] For example, the CFTC has proposed to adopt regulations to implement core principles, including risk management requirements, for derivatives clearing organizations (DCOs). See 76 Fed. Reg. 3698 (Jan. 20, 2011).

[7] Treasury Regulations § 1.148-4(h) permits a tax-exempt bond issuer to "integrate" swap payments and receipts with payments made on the hedged bonds in some circumstances. In general terms, these regulations require that the timing, source and payments on the swap closely correspond to the payment on the bond, if integration is sought (and other requirements apply if integration is not sought). For example, to integrate a swap with a tax-exempt bond, the tax-exempt bond hedge regulations require that, by treating all payment on (and receipt from) a swap as additional payment on (or receipts from) the hedged bond, the resulting "synthetic bond" must be substantially similar to a fixed rate bond or a narrow class of variable rate debt obligations. 26 C.F.R. § 1.148-4(h)(2)(v)(B).

The authority for the execution of a municipal market swap, particularly in the case of Governmental Borrowers, is a case-by-case determination, made on the basis of state constitutional, statutory and/or judicial law, which establish requirements for swap agreements that must be satisfied for such swaps to be lawfully executed.[8] Governmental Borrowers, in particular, may be legally barred by state constitutional and statutory debt principles from posting collateral.[9]

Moreover, governmental finances are not managed like corporate finances. Governmental Borrowers do not carry large cash balances, thereby minimizing taxes. Governmental Borrowers and Non-Profit Borrowers, borrowing on a "revenue" basis, are also, similarly frequently constrained in the size of their cash balances, as their financing structures typically, by design, produce limited amounts of excess cash. As a result, most Borrowers, while highly credit-worthy, would not be in a position to post collateral at levels required for clearing. For many Borrowers, the posting of collateral is subject to the limitations of pre-existing indenture or credit agreement lien covenants.

Congress, when enacting Dodd-Frank, "acknowledged that clearing may not be suitable for every transaction or every counterparty. End-users who hedge their risks may find it challenging to use standard derivative contracts to exactly match up their risks with counterparties willing to purchase their specific exposures. Standardized derivatives contracts may not be suitable for every transaction."[10] Standardization of municipal market swaps in order to fulfill clearing requirements not only would have the effect of making such swaps less useful to Borrowers, but also, in many instances, would render them non-compliant with U.S. Federal tax law, state law, Borrower-adopted swap and debt management policies and indenture and other financing document requirements. An attempt to standardize municipal market swaps would inappropriately burden Borrowers and significantly limit the value of swaps as a hedging tool.

---

[8] For example, under the laws of the State of Washington, "no governmental entity may enter into a payment agreement" unless: the counterparty meets the ratings requirements, or is guaranteed by an entity which meets the ratings requirements, described in the statute and unless the counterparty posts collateral to the government entity upon its downgrade; "the notional amount of the payment agreement does not exceed the principal amount of the obligations with respect to which the payment agreement is made;" and "the term of the payment agreement does not exceed the final term of the obligations with respect to which the payment agreement is made." Rev. Code Wash. ARCW § 39.96.040 (2011). A governmental unit in Illinois "whose aggregate principal amount of bonds outstanding or proposed exceeds $10,000,000" is authorized to enter into interest rate swaps that meet the criteria described in the statute, including those as to: termination payments payable to a counterparty, which shall be calculated based upon "provisions using market quotations" or a "reasonable fair market value determination…made in good faith" by either the governmental unit or the counterparty; term, which "shall not exceed the term of any currently outstanding bonds identified to such swap, or, for bonds to be delivered, not greater than 5 years plus the term of years proposed for such bonds to be delivered, but in no event longer than 40 years;" choice of law with respect to the governmental unit, which shall be the law of the State of Illinois; and waiver of sovereign immunities, as governmental units "in entering into swaps, may not waive any sovereign immunities…as to jurisdiction, procedures and remedies…." 30 ILCS 305/7 (2011).

[9] See State ex rel Kane v. Goldschmidt, 308 Ore. 573 (discussing the creation of debt within the meaning of Or. Const. art XI, § 7; See also Brown v. City of Stuttgart, 312 Ark. 97 (discussing the creation of debt within the meaning of Ark. Const., art. 16 § 1).

[10] 156 Cong. Rec. H5,248 (daily ed. June 30, 2010) (Letter from Sen. Christopher Dodd and Sen. Blanche Lincoln to Rep. Barney Frank and Rep. Collin Peterson) (the "Dodd-Lincoln Letter") at 2.

Borrowers' execution of swaps that are not subject to a clearing requirement should neither increase systemic risk nor compromise financial stability.[11] Municipal market swaps are used for limited, specialized purposes -- to offset or hedge payment obligations by Borrowers in connection with their debt issuances. Borrowers typically enter into swaps with the expectation that swaps will remain outstanding to term; Borrowers do not typically expect to trade in and out of positions. Municipal market swaps are intended to be non-speculative: state statutes frequently forbid speculation in swaps by Governmental Borrowers;[12] many Borrower-adopted swap and debt management policies specify that swaps cannot be executed for purposes of speculation; Borrowers typically adopt authorizing resolutions for swaps specifying the obligations being hedged; and Borrowers customarily execute non-speculation representations in connection with their municipal market swaps.[13] While the market for municipal swaps is robust, the incidence of default is low and the notional volume of municipal market swaps is a relatively small piece of the broader interest rate swap market.

II. Borrowers Should Be Eligible to Elect to Use The End-User Exception to Mandatory Clearing

A swap will be exempt from the mandatory clearing and exchange trading requirements described in Dodd-Frank if one of the counterparties to the swap: (i) is not a "financial entity;" (ii) is using swaps to "hedge or mitigate commercial risk;" and (iii) "notifies the Commission how it meets its financial obligations associated with entering into non-cleared swaps."[14]

A. Municipal Market Swaps Are Used To "Hedge or Mitigate Commercial Risk"

Municipal market swaps have been a valuable tool for Borrowers in hedging, mitigating and managing interest rate risk.[15] We support the inclusion of the various prongs[16] of the CFTC definition of "hedge or mitigate commercial risk" included in the CFTC

---

[11] See Hearing to Review Implementation of Title VII of Dodd-Frank Before House Committee on Agriculture 112th Cong. (2011) (statement of CFTC Chairman Gary Gensler, that "Congress recognized the different levels of risk posed by transactions between financial entities and those that involve non-financial entities, as reflected in the non-financial end-user exception to clearing. Transactions involving non-financial entities do not present the same risk to the financial system as those solely between financial entities. . . Consistent with this, proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users.")

[12] For example, in North Carolina, "no governmental unit shall enter into a swap agreement . . . other than for the primary purpose of managing interest rate risk on or interest rate costs of its obligations." N.C. Gen. Stat. § 159-194 (2010).

[13] See, e.g., U.S. Municipal Counterparty Schedule to the Master Agreement (for use with the 1992 ISDA Master Agreement (Local Currency – Single Jurisdiction).

[14] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, §§ 723(a), 763(a), 124 Stat. 1376, 1679, 1765 (adding CEA § 2(h)(7) and Exchange Act § 3(C)(g)).

[15] The Dodd-Lincoln Letter, in discussing the imposition of margin or capital requirements on certain end users under the Act, used the phrases "hedge or mitigate" and "hedge or manage" interchangeably. See Dodd-Lincoln Letter at 2.

[16] Section 39.6(c)(1) of the CFTC Proposed Rule provides, in pertinent part, that "a swap shall be deemed to be used to hedge or mitigate commercial risk when: (1) Such swap: (i) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from: . . . (B) The potential change in the value of liabilities that a person has incurred or reasonably anticipates

Proposed Rule which would support the conclusion that municipal market swaps "hedge or mitigate commercial risk" within the meaning of Dodd-Frank. The effect of a municipal market swap is to convert, from a Borrower's financial perspective, the rate on its related debt from fixed to floating, from floating to fixed, or to a combination of fixed and floating rates.

In addition, we support the CFTC's position that it "preliminarily believes the question whether an activity is commercial should not be determined solely by an entity's organizational status as a for-profit company, a non-profit organization, or a governmental entity. Instead, the determinative factor should be whether the underlying activity to which the swap relates is commercial in nature."[17] Both Governmental Borrowers and Non-Profit Borrowers enter into swaps to hedge, mitigate and manage the financial risk related to their costs of borrowing, which are commercial activities. We recommend that the Commissions specify that "commercial risk" includes financial risk incurred by Borrowers in connection with their financing activities. The intent of Congress in providing the end-user exception was to create a broad exception from clearing for swaps entered into in order to hedge risks to which non-financial entities are exposed in connection with their commercial activities.[18]

B. Swaps Eligible For Hedge Accounting Treatment Under GASB Should be Included

The CFTC has stated that the CFTC Proposed Rule "assure[s] counterparties that . . . if their swap qualifies for hedge accounting treatment under the FASB hedge accounting standards, the swap also qualifies for the clearing exception."[19] We respectfully recommend that, to parallel the provisions currently included in the CFTC Proposed Rule and further clarify the availability of the exception for Governmental Borrowers, the Commissions add a reference to a qualification "for hedging treatment under Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments," with the effect that any swap that qualifies for hedging treatment under GASB, and meets the additional criteria specified in the Proposed Rules, is eligible for the end-user exception.

---

incurring in the ordinary course of business of the enterprise; or . . . (D) 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; . . . or (F) Any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities; or . . . (iii) Qualifies for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133)."

[17] CFTC Proposing Release at 80753.

[18] See Dodd-Lincoln Letter.

[19] CFTC Proposing Release at 80753.

* * *

SIFMA appreciates the opportunity to provide comments on the Proposed Rules. We would be pleased to discuss any of our recommendations with you. Please contact us with any questions regarding the recommendations contained herein.

Respectfully submitted,

_____

Kenneth E. Bentsen, Jr.
Executive Vice President, Public Policy and Advocacy

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner
Commodity Futures Trading Commission

Honorable Mary L. Schapiro, Chairman
Honorable Kathleen L. Casey, Commissioner
Honorable Elisse B. Walter, Commissioner
Honorable Luis A. Aguilar, Commissioner
Honorable Troy A. Paredes, Commissioner
Securities and Exchange Commission

Lynette Hotchkiss, Executive Director
Municipal Securities Rulemaking Board