RIVERSIDE Risk Advisors

February 22, 2011

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

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: CFTC File: RIN 3038-AD10 and SEC File: No. S7-43-10
Implementation of Certain Provisions Related to the End-User Exception of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Ms. Murphy and Mr. Stawick:

We appreciate the opportunity to provide comments on proposed rules under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") 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") governing the application of the exception to mandatory clearing of swaps and security-based swaps, often referred to as the "end-user" exception.

Our firm, Riverside Risk Advisors LLC ("Riverside") is an advisory boutique specializing in derivatives and structured financial products. We bring expertise and advice to our clients without conflicts of interest, resulting in transparency, better understanding of risks and improved pricing and transaction terms. Our professionals have extensive experience as derivatives structurers, traders and marketers at some of the world's largest derivatives dealers. Our interest in providing commentary is in promoting the proper functioning of the derivatives markets by increasing access, transparency, innovation and sound decision-making, and not to serve the narrow interests of any particular constituency.

The purpose of this letter is to ask the Commissions to consider expansion of the end-user exception to the Act's margin and clearing requirements. Our specific proposal and rationale are outlined below.

Background

The Act authorizes the Commissions to enact rules with respect to the (a) mandatory clearing of certain derivative transactions, and (b) margin requirements for derivative transactions that are subject to clearing as well as those that are not.

The Act further authorizes the Commissions to create an exception to mandatory clearing for derivative transactions that are entered into by certain end-users where the purpose of the derivative is to hedge commercial risk (the "end-user exception"). Counterparties eligible for the end-user exception include non-financial entities (including certain "captive" finance affiliates) and "small banks, savings associations, farm credit system institutions and credit unions."[1]

This leaves many entities, whose business is financial in nature, potentially ineligible for the end-user exception, whether or not they act as end-users and whether or not the derivatives hedge the ordinary risks of their businesses. Moreover, under a narrow interpretation, no derivative transaction entered into for investment purposes qualifies for the end-user exception, even if the dealer involved is hedging one of the ordinary risks of its banking business.

Lastly, as written in the Act, the end-user exception applies only to the clearing requirement. The text of the Act itself creates no end-user exception to the margin requirements for derivative transactions that are not subject to clearing.

With respect to this last issue, the Dodd-Lincoln letter[2] clarifies the authors' intent, as well as the intent of many other members of Congress[3], for the end-user exception to cover not only clearing, but also the margin requirements for transactions that are not subject to clearing. In his testimony of February 10, 2011, CFTC Chairman Gensler indicated his agreement, stating that "proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users."[4] Based on these comments it appears likely that the regulations will clarify this critical component of the end-user exception.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, §§ 723(a) and 763(a).

[2] Letter from Senators Christopher Dodd and Blanche Lincoln to Chairman Barney Frank and Colin Peterson (June 30, 2010), available at http://online.wsj.com/public/resources/documents/dodd-lincoln-letter070110.pdf.

[3] See for example, the February 8, 2011 letter from Senators Pat Roberts, Thad Cochran, Ron Johnson, David Vitter, Mike Crapo, Kay Bailey Hutchison, Roger Wicker, John Boozman, Jerry Moran, Mike Johanns, Max Baucus, Herb Kohl and Jon Tester to Secretary Timothy Geithner and Chairmen Ben Bernanke, Gary Gensler and Mary Schapiro, available at http://www.johanns.senate.gov/public/?a=Files.Serve&File_id=600d4fd6-349d-4105-b74b-c7e99f5d7796. Another example is the December 16, 2010 letter from Representatives Spencer Bachus and Frank Lucas to Secretary Timothy Geithner and Chairmen Gary Gensler, Mary Schapiro and Ben Bernanke, available at http://sec.gov/comments/s7-39-10/s73910-5.pdf.

[4] Testimony of Chairman Gary Gensler before the House Committee on Agriculture (February 10, 2011), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-68.html.

Our Proposal Regarding the End-User Exception

With that said, we believe that the currently-contemplated end-user exception is unjustifiably narrow in scope. We therefore ask the Commissions to consider:

(a) Expanding the exception to include all end-users, even financial entities, that are not Major Participants,[5] and
(b) Eliminating the "hedging" requirement, thereby allowing transactions entered into for investment purposes to qualify for the exception.

In effect, we propose that only transactions between Dealers[6] and Major Participants be subject to mandatory clearing and margin rules prescribed by the Commissions. Any transaction in which at least one counterparty is neither a Dealer nor a Major Participant would be exempt.

In the alternative, should the Commissions not adopt this recommendation, we would ask that the Commissions consider an exception covering all transactions in which 1) at least one counterparty is neither a Dealer nor a Major Participant and 2) the Dealer or Major Participant involved is hedging or mitigating one of the commercial risks of its business.

Authority Under the Act

While we are not practicing legal professionals, given our commercial reading of the Act we believe it authorizes the Commissions to expand the end-user exception as we suggest with respect to both mandatory margin and mandatory clearing.

Under Section 731 of the Act, "Standards for Capital and Margin," the relevant requirements shall "(i) help ensure the safety and soundness of the swap dealer or major swap participant; and (ii) be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant." As discussed below, we do not think extension of margin requirements to end-users who are not Major Participants on balance helps to ensure the safety and soundness of Dealers and Major Participants. Nor do we believe extension of mandatory margin requirements to such end-users is "appropriate for the risk associated with … non-cleared swap(s) held" by Dealers and Major Participants.

With respect to clearing, even before getting to the specified exemptions, the Commissions are given broad authority to determine which Swaps are "required to be cleared." Included in the criteria for such determination is "the effect on the mitigation of systemic risk." Based on this, it appears to us there is nothing precluding an exception for all non-Major-Participant end-users, should the Commissions determine that excluding such parties from mandatory clearing would not pose a serious systemic risk.

[5] As used herein "Major Participants" means Major Swap Participants and Major Security-Based Swap Participants under the Act.

[6] As used herein "Dealers" means Swap Dealers and Security-Based Swap Dealers under the Act.

Rationale

1) Expanding the current end-user exception is unlikely to increase systemic risk.

Underlying the clearing and margin requirements of the Act is the basic understanding that most derivative transactions involve an extension of credit. The clearing and margin requirements in effect regulate the terms of the credit relationship between counterparties.

As a general rule, the federal government does not dictate the terms of the credit relationship between major banks and their corporate or financial customers. In general banks and their corporate customers are free to negotiate the terms (e.g., rates, amortization, maturity, collateral, covenants, enforcement rights, etc.) that best suit their mutual needs. Through the imposition of clearing and margin requirements, the Act singles out the credit exposure implicit in derivatives transactions for an exceptional degree of government-mandated standardization.

Exceptions to the general rule of freedom of contract in credit agreements between sophisticated business entities should be narrowly crafted to meet clearly-identified, legitimate public policy goals. In this case, the policy objective behind the clearing and margin requirements is mitigating the risk of a systemic market collapse.[7] It is not clear that the extension of these rules beyond the dealers and the largest non-dealer market participants furthers that goal.

It is generally believed that the failure or near-failure of a handful of entities was at the center of the financial crisis in 2008. These entities include Bear Stearns, Lehman Brothers, several of the other major banks and securities firms and AIG. All of these entities would have been classified as either Dealers or Major Participants. While there were failures of several entities that may not have been classified as Dealers or Major Participants, these failures did not threaten the health of the financial system overall.[8]

Rather than reducing overall risk in the system, the narrow end-user exception may in fact discourage risk-reducing transactions, thereby increasing risk, as discussed below.

[7] As an aside, not all informed market participants are convinced that the mandatory clearing requirements, as imposed by the Act and as proposed in other jurisdictions, will serve to mitigate, rather than exacerbate, systemic risk. See, for example, pages 62-63 of Jones Day White Paper "More Than Just Financial Reform: Analysis and Observations on the Dodd-Frank Wall Street Reform and Consumer Protection Act", available at http://www.jonesday.com/newsknowledge/publicationdetail.aspx?publication=d7d71bc5-6ee4-4144-9a0b-91b6d95cb2a9&RSS=true. We, too, are concerned that the concentration of derivatives risk to a small number of clearinghouses will increase the likelihood and, more ominously, the severity of a systemic market collapse. Since this concern has been well articulated by others, we do not analyze it in this statement.

[8] And even in the ten years before the recent crisis, the failures of two notable large derivatives users, LTCM and Enron, both of which would likely have been Major Participants (and Enron a Dealer in some products), were also resolved without a major threat to the survival of the banking system.

2) Excluding financial firms from the end-user exception will discourage appropriate hedging of commercial risks.

The main rationale offered for the proposed end-user exception in respect to margin is that meeting these requirements would tie up capital and increase costs to entities which would use derivatives to hedge commercial risks, thereby discouraging risk-reducing transactions. This rationale also applies to financial entities. Finance companies, regional banks and pension funds, for example, use interest rate swaps to manage duration mismatches between their assets and liabilities.

By discouraging such asset-liability-management activity, the margin rules may encourage financial firms to operate with larger duration mismatches since the costs of actively managing such risks are high. A return to widespread duration mismatches would increase the risk of a repeat of the first savings and loan crisis in the event of a significant change in interest rates.[9] It may also discourage liability hedging by pension funds, thereby contributing to the underfunded liability problem should we see a decline in interest rates combined with a decline in the value of non-fixed income assets.

3) Excluding investment-motivated transactions from the end-user exception will impede banks' ability to hedge credit risk.

Credit default swaps ("CDS") were initially used by banks as tools to facilitate the distribution of loan-portfolio credit risk to various investors in the capital markets. Riverside's partners were involved in the development of these early transactions. Deals were customized to suit the risk-transfer and capital needs of the banks while at the same time catering to the risk tolerances and return objectives of the investors. Sometimes the typical inter-dealer collateral arrangement, with initial margin and daily maintenance margin, was not the optimal credit risk mitigant for both parties. In this case, the parties were free to structure their transactions without a margin requirement and adjust pricing accordingly.

Today, as banks across the globe are under pressure to reduce risk and meet the increased capital requirements expected under Basel III, the marketplace is potentially at the cusp of a new wave of risk distribution products. Structures that allow banks to protect against defaults in their middle-market loan portfolios, and to protect against their customers defaulting on hedge-motivated derivative contracts, for example, are in the works. An unintended consequence of the Act's narrow end-user exception is that it may serve as an impediment to much-needed transfer of credit risk from the largest US banks to a dispersed group of smaller capital market investors.
For a very simple illustration, suppose Bank A has made a loan to XCorp, a single-B rated borrower, at a rate of LIBOR plus 5.00%. Now suppose FinanceCo (a medium-sized financial firm whose default would not materially impact the overall condition of any of its creditors) wishes to invest in XCorp through a CDS contract. FinanceCo is rated single-A and its unsecured obligations trade at a yield of LIBOR plus 1.00%. FinanceCo is comfortable with the

[9] The first savings and loan crisis, circa 1980-1982, was caused by the combination of a large system-wide duration mismatch (long term-loans funded with short-term liabilities) and sharply rising interest rates.

default risk of XCorp but does not wish to take the liquidity risk inherent in meeting margin calls based on fluctuations in the price of XCorp's debt.

If Bank A were to buy CDS protection on some portion of its loan to XCorp from FinanceCo (without any margin arrangement) it would effectively upgrade a single-B risk to a single-A risk for that portion of the loan. This is because it would require a default of FinanceCo, a single-A credit, for Bank A to suffer a loss (so long as FinanceCo performs on its obligations under the CDS, Bank A is protected against the default of XCorp). Alternatively, using credit spread as the measure of credit quality, it would upgrade a LIBOR plus 5.00% risk to something less risky than LIBOR plus 1.00%.[10] Arguably this sort of transaction should be encouraged, as it reduces risk for the banking sector. As currently written, however, the Act authorizes the Commissions to make this contract illegal.

Meanwhile, there is no law prohibiting Bank A from making an unsecured loan to FinanceCo, which would enable FinanceCo to purchase the XCorp loan from Bank A. The Act targets the CDS contract for mandatory margin while leaving Bank A and FinanceCo free to negotiate the terms of the loan in a way that best suits their needs. But as between these two alternatives, the unsecured loan is actually the more risky exposure for Bank A.[11]

Conclusion

A narrow end-user exception would result in the extension of mandatory clearing and margin rules beyond their usefulness. This could serve to increase rather than reduce systemic risk, contrary to the broader objectives of the Act. We therefore propose broadening the end-user exception as discussed herein.

We would be pleased to discuss our recommendations in more detail, or to suggest specific operative language, should the Commissions so desire. Thank you again for this opportunity to comment.

Respectfully submitted,

Frank Iacono
Partner
Riverside Risk Advisors LLC

[10] Bank A suffers a loss if both XCorp and FinanceCo default, and Bank A's recovery is the sum of its recovery from the XCorp loan and from FinanceCo under the CDS contract. Clearly this risk is no worse than, and is almost certainly better than, the risk of an unsecured exposure to FinanceCo.

[11] See the previous note. This assumes (a) the loan and CDS have the same maturity and (b) the CDS notional and loan par amount are the same. In fact, Bank A's risk under the CDS would be comparable to a loan to FinanceCo secured by the XCorp loan.