



February 4, 2011

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VIA EMAIL

Elizabeth M. Murphy

Secretary

Securities and Exchange Commission

100 F Street, N.E.

Washington, D.C. 20549

Re: End-User Exception to Mandatory Clearing of Security-Based Swaps (No. S7-43-10)

Dear Ms. Murphy:

The American Federation of State, County and Municipal Employees (“AFSCME”) is the largest union in the AFL-CIO representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over \$1 trillion. In addition, the AFSCME Employees Pension Plan (the “Plan”) is a long-term shareholder that manages \$850 million in assets for its participants, who are staff members of AFSCME and its affiliates.

During consideration of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), AFSCME strongly supported the inclusion of provisions establishing the strongest possible market reforms, oversight and transparency for the “shadow markets” – principally the over-the-counter market that has grown to a size that dwarfs the other more transparent derivatives markets.

The Importance of Strong Derivatives Regulation is Undeniable

Before passage of Dodd-Frank, OTC derivatives – including interest rate swaps, foreign exchange contracts, equity swaps, commodity swaps, credit default swaps, and others - were described as bilateral agreements between sophisticated parties. As such, OTC derivatives were not subject to obligations to trade on regulated exchanges and clear the agreements through regulated clearing operations – obligations that apply to other segments of the derivatives markets. However, the need to bring OTC derivatives into these regulated markets is clear: The public record of analyses gathered in the months following crises in the financial industry, and in the economy overall, confirmed the same conclusion: “It is widely acknowledged that OTC derivatives contracts, and particularly CDS, played a

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significant role in the current financial crisis. Although OTC derivatives have been justified as vehicles for managing financial risk, they have also spread and multiplied risk throughout the economy in the current crisis, causing great financial harm.”¹

With the passage of Dodd-Frank – and strong implementation – standardized swaps, with some exceptions, will be traded or entered into on regulated exchanges or swap execution facilities. This will improve the extent to which buyers and sellers meet in an open marketplace where prices are publicly available. Standardized swaps will be cleared through a regulated clearinghouse charged with acting as intermediary to the transaction, collecting and protecting collateral from the parties, and mitigating counterparty risk for individual transactions as well as the possibility that systemic risk can build invisibly.

Strong Implementation of the Responsibility to Require Clearing is Vital

Strong rules regarding mandatory clearing are vital to the operation of a derivatives marketplace that earns investor confidence. To be most effective, the rules should be clear and specific. That will clearly be a challenge – the Dodd-Frank Act gives the CFTC the authority to regulate “swaps”, the SEC the authority to regulate “security-based swaps”, and both agencies the joint authority to regulate “mixed swaps”. Certainly the definitions put forward in other proposed rules, the procedures for determining what must be cleared (put forward in other proposed rules) and what must be exchange-traded (again, addressed in other proposed rules) – and many other components -- all must be seen as a whole in order to assess the effectiveness of the implementation of Dodd-Frank. This proposal regarding the end-user exception to mandatory clearing of security-based swaps is a particularly important component of the more transparent and regulated market Dodd-Frank envisioned.

Exceptions to Mandatory Clearing Must be Narrow, Well Defined, and Subject to Alternative Safeguards

Dodd-Frank provides that a security-based swap that is otherwise subject to mandatory clearing is not required to be cleared if:

- one party to the security-based swap is not a financial entity,
- the security-based swap is being used to hedge or mitigate commercial risk (the subject of comment under a separate proposal, we note), and

¹ “U.S. Financial Regulatory Reform: The Investors’ Perspective”, Investors Working Group, an Independent Taskforce Sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors, published in July 2009, submitted to the Federal Reserve Board September 22, 2010.

- the user gives the SEC notice of how it generally meets its financial obligations associated with non-cleared security-based swaps.

Financial entities under the statute, ineligible to invoke the end-user exception, include:

a swap dealer,
a security-based swap dealer,
a major swap participant,
a major security-based swap participant,
a commodity pool as defined in Section 1a(10) of the Commodity Exchange Act,
a private fund as defined in Section 202(a) of the Investment Advisers Act of 1940,
an employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974, and
a person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956.

Within these parameters, eligible counterparties may choose to invoke the end-user clearing exception – but are not required to do so.

Since the goal of increased exchange-trading and clearing is a marketplace that is more transparent and visible, one that is less conducive to the kind of unseen linkages that can threaten systemic risk, it is vital that end users understand as clearly as possible in advance which transactions are not eligible for the exception. Similarly, it is vital that they understand clearly the kind of specific analysis and documentation of financial risks associated with transactions believed to be eligible for the exception and the degree of detail to be specified – including how, when and by whom – in terms of reporting to the SEC their plans for meeting those financial obligations.

For example, it should be clear to whom in the executive office this responsibility falls, and that no blanket or general assertion of intent to monitor and fulfill derivatives-triggered financial obligations will suffice.

What kind of specifics should be required? We note that the Commission proposes requiring information about any credit support agreement or other agreement used to mitigate the counterparty credit risk of security-based swaps not centrally cleared. Additionally, the Commission proposes requiring information on collateral transfers, security interests in property, guarantees by persons or entities other than the counterparty, and more.

The Commission also specifically seeks comment on whether additional detailed information would be valuable. The answer is yes, additional information is needed, and more

than warranted here. While it's often asserted that many non-cleared derivatives are collateralized, it's hugely unclear just how much – if any – real security is provided by those practices. A paper on “Best Practices for the OTC Derivatives Collateral Process”, dated June 30, 2010, and developed by the International Swaps and Derivatives Association, Inc., (“ISDA”) offers the Principle that “Wherever possible an ISDA Master Agreement and Credit Support Annex (CSA) should be used to confirm collateral terms, if any, between counterparties.” “If any”? None are required. Yet the Commission shares in this proposal its preliminary belief that credit default swaps represent 85% of all security-based swap transactions. Given that predominance, given their troubled history and complexity, given the likelihood that many will continue to structure CDS transactions to be available for this exception from clearing, AFSCME believes strongly that the required “Financial Obligation Notice” should be strengthened to require, for example:

- information regarding the types of collateral provided by the end-user and the effect of the liquidity of that collateral on the end-user's ability to meet its financial obligations;
- information regarding whether the collateral requirements are unilateral or bilateral;
- information regarding whether there are contractual terms triggered by changes in the credit-rating or other financial circumstances of either of the counterparties;
- information describing whether any “third-party” guarantor of the end-user's obligations is a parent or affiliate of the person invoking the end-user exception; and
- information identifying any collateral agent or custodian or other entity involved in segregating collateral.

The Commission appropriately notes that “For a variety of reasons one or both of the counterparties to some non-cleared security-based swaps may choose not to mitigate credit risk and instead rely on the general creditworthiness of their opposite counterparty, given the circumstances and financial terms of the transaction.”² The Commission goes on to reference guidance issued by the Office of the Comptroller of the Currency addressing the importance of regulated institutions aggregating limits for derivatives with credit limits established by other activities including commercial lending. It seems clear that major regulators appreciate the importance of understanding and evaluating carefully derivatives that in essence – in fact – embody a loan to the end-user backed by its “general creditworthiness”. As the Commission notes, the kinds of financial resources that might be available to meet obligations triggered by uncleared security-based swaps may include “existing assets, investments and cash balances, cash flow from operations, short-term and long-term lines of credit and capital market sources of

² Footnote 28 of File No. S7-43-10.

funding.” It must be made clear that simple assertions of creditworthiness will not satisfy this disclosure obligation. Clarity of this kind might also help end-users thoroughly evaluate the merits of clearing transactions that might qualify for evoking the exception – but need not utilize it.

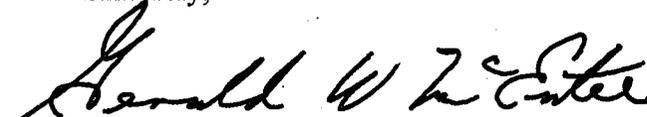
Alternative Standards for Small Financial Institutions should be Rigorously Scrutinized

The Dodd-Frank Act allows the Commission to consider whether to exempt small banks, savings associations, farm credit systems institutions and credit unions, including specifically those with assets of \$10 billion or less, from the definition of financial entities who are ineligible to elect the end-user exception from mandatory clearing. The Commission preliminarily concludes that such an exemption would be appropriate, that such entities “do not transact in securities-based swaps for hedging purposes in significant volume”. AFSCME looks forward to the responses on the Commission’s specific requests for information on the volume these institutions may engage in and preliminarily believes that, at a minimum, “small” financial institutions should be subject to the same kind of Financial Notice Obligations as other eligible end-users in order to make clear to regulators, depositors and others the kind of financial obligations those institutions are taking on.

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We appreciate the opportunity to express our views on this matter.

Sincerely,



GERALD W. McENTEE
International President