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THE NEW THREAT TO FINANCIAL REFORM: THE END-USER EXCEPTION TO DODD-FRANK MANDATORY SWAP CLEARANCE

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I. INTRODUCTION

What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers.\footnote{Milton Friedman, The Social Responsibility of Business is to Increase its Profits, N.Y. TIMES MAGAZINE, Sept. 13, 1970, at SM17, available at http://select.nytimes.com/gst/abstract.html?res=F1OF11FB3E5810718EDDAE0994D14058B00&scp=1&sq=The+Social+Responsibility+is+to+Increase+its+Profits&st=p#. Friedman goes on to state: For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment.} Milton Friedman

A. The Law Has Been Signed but the Battle Continues

"It's done," and with that President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) into law.\footnote{Brady Dennis, Obama Ushers in New Financial Era; Landmark Law is Signed President Says Work Still Lies Ahead for Regulators, WASH. POST, July 22, 2010, at A13.} The signing ceremony, which occurred in front of a crowd of more than four hundred supporters, was a public end to an over yearlong legislative battle.\footnote{See id. (stating that "[t]he landmark legislation . . . came after more than a year of legislative wrangling and intense lobbying . . . ").} However, the ceremony was by no means the end of financial reform.\footnote{Id.} Instead,
the spotlight has shifted to regulatory agencies where they have begun the post-enactment process of creating the rules and regulations necessary to give effect to Dodd-Frank.\(^5\) As a result of Dodd-Frank, regulatory agencies must propose and finalize more than two hundred rules and regulations.\(^6\) The impact of the rules and regulations creation process will have an impact on numerous industries, as is evidenced by diverse groups that have contacted the regulatory agencies in an attempt to voice their opinions on the rule-making process.\(^7\)

This Comment will focus on the regulatory decisions that must be made to effectuate the end-user exception to mandatory swap clearance. Part II will discuss the over-the-counter (OTC) swap market before and after the passage of Dodd-Frank. Part III will present the arguments for and against a limited end-user exception. Part IV will set forth a regulatory solution that balances the interests of end-users without undermining the intended investor protections of the bill.

II. BACKGROUND

The financial crisis of the late 2000s revealed many flaws in the regulatory framework of the securities industry. Congress addressed a number of the faults in the financial system with the


\(^{6}\) OVERDAHL, supra note 5.

\(^{7}\) See Commentary—Battle Over Banking (PBS Nightly Business Report television broadcast Sept. 16, 2010), \textit{available at} http://www.pbs.org/nbr/site/onair/transcripts/battle_over_banking_reform_100916/ (discussing the continued influence of the banking lobby). \textit{See also}, COMMODITIES FUTURES TRADING COMM’N, http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC_11_EndUser.htm1 (last visited Sept. 29, 2011) (documenting the comments received from and agendas for meetings with the parties who shared their opinions on a proposed rule or area of concern). In this case, the area of concern is the end-user exception of Dodd-Frank. \textit{Id}. The range of interested parties includes organizations representing power companies, farmers, and pension plans. \textit{Id}. \textit{See, e.g.}, Press Release, Coalition for Derivatives End-Users Views, Senate Discussion Draft as Significant Step Backward Legislation Would Drive Capital Away From Job Creation and Economic Growth (Nov. 10, 2009), \textit{available at} http://www.reit.com/PolicyPolitics/CreditMarketChallengesChanges~/media/Portals/0/PDF/Dodd%20Discussion%20Draft%20Release.ashx (explaining that the Coalition is a broad-based group representing American businesses that uses over-the-counter (OTC) derivatives to manage business risks, including fluctuating currency exchange and interest rates, and commodity prices). The Coalition's primary goal is to ensure continued access to OTC Derivatives for business end-users, while protecting U.S. competitiveness and promoting economic growth. \textit{Id}.\n
The New Threat to Financial Reform

The passage of Dodd-Frank. However, Dodd-Frank exempts certain end-users from mandatory swap clearance and gives them the option to continue to transact in the OTC derivatives market. As such, the pre-Dodd-Frank OTC derivatives market must be looked at before discussing the merits of excluding certain entities from mandatory swap clearance. Additionally, the proceeding discussion of the credit default swap (CDS) market should not be viewed in isolation, but rather should be viewed with the knowledge that CDSs are merely one of several forms of swaps; and while CDSs are unique in their form and function, the manner in which they trade on the OTC market is not unique.

At the core of the financial crisis was the multi-trillion dollar OTC derivatives market. An OTC derivative is "a bilateral, privately-negotiated agreement that transfers risk from one party to the other." While the term encompasses numerous financial products, the OTC derivative most often associated with the financial crisis is the CDS.

A CDS is a credit derivative contract in which one party (protection buyer) pays a periodic fee to another party (protection seller) in return for compensation for default (or similar credit event) by a reference entity. The reference entity is not a party to

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9. See Wall Street Transparency and Accountability Act of 2010 § 723, 7 U.S.C. 2(a)(1) (West 2010) (explaining that "[t]he application of the clearing exception . . . is solely at the discretion of the counterparty to the swap that meets the conditions . . . .").
10. See id. § 721 (stating that the act sets forth twenty-two different types of swaps). Subsequent sections contain a discussion of swaps and how they are used by end-users to mitigate risk. Id. See also Product Descriptions and Frequently Asked Questions, INT'L SWAP DEALERS ASS'N, http://www.isda.org/educat/faqs.html#9 (last visited Sept. 29, 2011) (providing industry definitions for many of the swaps listed within the act).
11. See Gary Gensler, Chairman, Commodities Futures Trading Comm'n, Testimony Before the Financial Crisis Inquiry Comm'n (July 1, 2010), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/opagensler-48.html (stating, "I believe that derivatives played a central role in the 2008 financial crisis. Some have argued that the role of derivatives is limited to AIG or credit default swaps. I think it is broader than that. I also think we cannot just look to solve the immediate proximate causes of the last crisis.").
13. See Gensler, supra note 11 (stating some believe credit default swaps were the cause of the financial crisis).
14. INT'L SWAP DEALERS ASS'N, supra note 10. See also CHRISTIAN WEISTROFFER, CREDIT DEFAULT SWAPS: HEADING TOWARDS A MORE STABLE SYSTEM 4 (Dec. 21, 2009), available at http://www.dbresearch.com/PROD/DBRINTERNET_EN-PROD/PROD000000000252032.pdf (explaining that, in addition to default, credit events which would trigger the credit default swap include bankruptcy, obligation acceleration, failure to pay,
the credit default swap. The amount of compensation received in the event of a reference entity default is referred to as the notional amount (or value) of the CDS. While similar to an insurance contract against the risk of a credit event, a CDS does not require the protection buyer to have an insurable interest in the reference entity. As such, the protection buyer is able to take a short position on the credit risk of the underlying entity through the purchase of a CDS.

The terms of a CDS, like all OTC derivatives, are negotiated directly between the protection buyer and protection seller. The parties to an OTC derivatives contract are either end-users or dealers. (Note: the term end-user in this context does not

repudiation/moratorium, and restructuring; however, restructuring was eliminated as a credit event in U.S. contracts in 2009).

15. INT'L SWAP DEALERS ASS'N, supra note 10.


A credit default swap can be viewed as an insurance contract that provides protection against a specific default. CDS contracts provide protection against the default of a corporation, sovereign nation, mortgage payers, and other borrowers. The buyer of protection makes periodic payments, analogous to insurance premiums, at the CDS rate specified in the contract. If the named borrower defaults, the seller of protection must pay the difference between the principal amount covered by the CDS and the market value of the debt.

18. See MENGLE, supra note 16, at 2 (stating that "[T]he risks assumed in a credit default swap by the protection buyer and protection seller are not symmetrical. The protection buyer effectively takes on a short position in the credit risk of the reference entity, which thereby relieves the buyer of exposure to default." (footnote omitted)).

19. See WEISTROFFER, supra note 14, at 20 (explaining, while the general terms of the agreement are typically memorialized in an ISDA master agreement that will apply to all swap transactions the parties enter, the specific terms of each negotiated transaction are set forth in the swap confirmation). See also MENGLE, supra note 16, at 4-5 (explaining such terms include the reference entity, the payment to be paid to the protection buyer in case of default, and the periodic fee to be paid to the protection seller); Austin Murphy, The Largest Pyramid Scheme of All Time: The Effect of Allowing Unregulated Credit Default Swaps 3 (Oakland Univ. Sch. of Bus. Admin., Working Paper Series, 2010), available at http://ssrn.com/abstract=1588089 (stating that in order to determine the period fee, brokers traditionally relied heavily upon statistical models, which resulted in the gross mispricing of CDSs and became apparent during the financial crisis).

necessarily refer to the same group of derivative users as "end-users" under Dodd-Frank.)

Dealers are either large commercial banks or broker-dealers that make a market in OTC derivatives. On the other hand, end-users are government entities, private or institutional investors, large corporations, or pension funds that use derivatives to hedge risks or speculate. The result is a bifurcated market in which there is an interdealer market and a dealer-to-customer market.

In OTC dealer-to-customer transactions, the dealer plays the role of either protection buyer or seller. One of the most infamous players in the dealer-to-customer market during the financial crisis was AIG. AIG falls into the institutional investor category of end-user. AIG is noteworthy due to the substantial un-hedged position it took in the CDS market and because it accomplished this feat by merely being the first company to use its AAA rating to take a highly leveraged position in the CDS market.

In contrast, the interdealer market is used to transfer part of the risks incurred by dealers in their transactions with customers.

discussion can be further broken down into end-users, which "consist of parties who purchase or sell derivatives primarily for hedging, notably private companies and state and local governmental entities," and "[b]uy-side participants includ[ing] institutional investors (insurance companies and pension funds) and hedge funds," who use derivatives to hedge and speculate; FIN. CRISIS INQUIRY COMM’N, PRELIMINARY STAFF REPORT OVERVIEW ON DERIVATIVES 9 (June 29, 2010), available at http://www.fcic.gov/reports/pdfs/2010-0630-psr-derivative-overview.pdf.

21. See LITAN, supra note 20, at 3 (discussing derivatives users who fall under the end-user category); but see infra Part III.
22. Id. at 9.
23. Id. at 10.
24. Id.
25. Id.
26. See Gensler, supra note 11 (stating some believe the actions of AIG were the cause of the financial crisis).
27. WEISTROFFER, supra note 14, at 6. See also, LITAN, supra note 20, at 17 (explaining that American Insurance Group is an insurance company and therefore falls under the institutional investor category).
28. See René M. Stulz, Credit Default Swaps and the Credit Crisis, 24 J. OF ECON. PERSPECTIVES 83 (2010), available at http://www.cob.ohio-state.edu/fin/faculty/stulz/publishedpapers/jep%2024%201.pdf (explaining that AIG provided credit default swaps on AAA tranches in securitizations on an extremely large scale). As of June 30, 2008, it had written a net amount of $411 billion notional of credit derivatives on super-senior tranches of securitizations. Id. Included among these were derivatives on super-senior tranches with subprime collateral for a notional amount of $55.1 billion. Id. See also, MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 78-79 (W. W. Norton & Co., 1st ed. 2010) (stating there was nothing particularly special about AIG). In theory, any large AAA rated company could have aggressively sold CDSs and many did. Id. As a result of their AAA credit rating, companies such as Zurich, Credit Swiss, as well as other insurance companies were able to take on the tremendous risk that is associated with the issuance of large quantities of CDSs. Id.
onto other dealers. Interdealer transactions account for eighty percent of all CDS positions. The process begins by brokers using their positions as one of the few market makers in swaps to leverage favorable prices from customers. In turn, brokers decide whether to remain entirely exposed to the acquired customer risk or pass it off to other brokers by entering into opposite contracts with other dealers. Dealers profit from such transactions by collecting a higher periodic fee from their customers than the amount paid to the broker counterparty. The result is a highly interconnected system in which only a few dealers are engaged in the bilateral trading of CDSs.

While the dealer market is composed of more than twenty-five banks, five of the largest dealers account for eighty-eight percent of the total notional amount bought and sold in the interdealer CDS market. With such few participants in the market, dealers are able to net the many offsetting transactions they have with one another.

The net risk exposure represents a broker's individual credit risk. In contrast, gross notional exposure indicates a broker's utmost risk exposure in that they will only experience such risk exposure if all hedging counterparties fail. However, due to the significant dollar amounts involved, it would not take the failure of all hedging counterparties to trigger a catastrophic financial

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29. See LITAN, supra note 20, at 3 (stating that "the dealer banks, in turn, transact heavily with each other, to hedge the risks from their customer trades and somewhat less frequently, to trade for their own accounts.").

30. See id. at 14 (stating that "in the CDS market, for example, such dealer-to-dealer transactions account for about 80 percent of all positions, and most of these net out against each other.").

31. See id. at 17 (explaining that "end-users are totally dependent on their dealers—often a particular dealer with whom they regularly conduct business—to get the best price they can for their customers."). Furthermore:

End-users and buy-side participants cannot know whether that price is the best one, since there is no pre or post trade transparency: they don't know what other parties are willing to pay or to sell at, nor do they have comparable real-time price data against which to compare the price of their particular trade.

Id.

32. Id. at 14.

33. See LEWIS, supra note 28, at 76-77 (documenting that Goldman Sachs sold CDS protection to a customer for a periodic fee of 2.5 percent and purchased protection for the same swap from AIG for 0.12 percent; as such, Goldman made two percent risk free).

34. See WEISTROFFER, supra note 14, at 6 (documenting in Chart 4 a visual depiction of the relationship between end-users and dealers as well as the interconnectivity of the dealer banks).

35. Id.

36. LITAN, supra note 20, at 14.

37. WEISTROFFER, supra note 14, at 13.

38. See id. at 13 (discussing why a large gross notional exposure does not equate to a substantial credit risk).
event. The net exposure of dealers, as a result of interdealer transactions, is $3 trillion, in contrast, to a gross notional interdealer total of $23 trillion. To put such large numbers in context, the gross domestic product of the United States in 2009 was $14.25 trillion. As a result, the failure of one of the five major bank-dealers would have a domino effect on the economy, which would result in a financial meltdown.

Despite the systemic risk posed by the OTC derivatives market, prior to the passage of Dodd-Frank, regulators had virtually no regulatory authority over the market. In response, Congress passed Title VII of Dodd-Frank, The Wall Street Transparency and Accountability Act of 2010 (the Act). The Act provides a “comprehensive framework for the regulation of the OTC swaps markets.” Under the Act, the Commodity Futures Trading Commission (CFTC) has jurisdiction over the regulation of swaps, the Securities and Exchange Commission (SEC) has jurisdiction over the regulation of securities-based swaps, and the SEC and CFTC (together known as the Commissions) have co-jurisdiction over mixed swaps. The purpose of the Act is to

39. LITAN, supra note 20, at 14.
41. See Murphy, supra note 19, at 5 (explaining that as a result of the systemic risk posed by the failure of one of the major dealers, investors assume the government will not allow the institutions to fail; as a result, the CDSs issued by the major brokers are virtually guaranteed). Therefore, there is a great incentive on the part of investors and brokers to continue to issue CDSs. Id.
42. See FIN. CRISIS INQUIRY COMM’N, supra note 20, at 19-20 (stating that the first major step towards deregulating the OTC derivatives market occurred in 1993 when the CFTC Chair promulgated a new rule which exempted OTC derivatives from the Commodities Exchange Act (CEA), except for prohibitions against fraud and manipulation, so long as they met certain conditions). “These conditions included that they not be perfectly standardized, that they expose market participants to counterparty credit risk, that they not be multilaterally traded, and that both counterparties are sophisticated investors.” Id. In December of 2000, Congress exempted OTC swap derivatives from the CEA when the Commodity Futures Modernization Act was passed as a rider to the Omnibus Appropriations bill for fiscal year 2001. Id. Congress did, however, permit “the Securities and Exchange Commission to retain anti-fraud authority over securities-based OTC derivatives such as stock options.” Id. As such, the financial regulatory agencies lacked the authority to regulate the OTC swap markets in the years leading up to and during the financial crisis. Id.
reduce systemic risk, increase market transparency, and promote market integrity within the financial system. These goals are accomplished, in part, by mandating the clearance of qualified swaps. Qualified swaps will be cleared by a registered clearinghouse.

The clearinghouse functions as a third party who guarantees the financial obligations of the parties to the swap. This is accomplished by requiring parties to post margin, or collateral, at the outset of the transaction and on daily losses. The level of required margin will be determined by the clearinghouses and the Commissions.

In the past, many OTC derivatives contracts required the parties to post margin. However, the levels were often insufficient to adequately guarantee compliance with the contractual obligations in the event of counterparty default.

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47. Wall Street Transparency and Accountability Act of 2010 § 723.
48. See MARK JICKLING & KATHLEEN ANN RUANE, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: TITLE VII, DERIVATIVES 3 n.5 (Aug. 30, 2010), available at http://www.ilsd.org/attachments/files/239/CRS-R41398.pdf (stating that clearinghouses are “also referred to as a central counterparty or as a derivatives clearing organization (DCO)”).
49. See id. (explaining that “once the trade is made, it goes to the clearinghouse, which guarantees payment to both parties.”).
50. See id. (stating that prior to entering into the trade, the swap counterparties “deposit an initial margin payment with the clearinghouse to cover potential losses.”).
51. See id. at 2 (explaining that because swap dealers and major swap participants must trade their swaps on an exchange regulated by either the SEC or CFTC, they will be subject to margin requirements above and beyond those of the clearinghouse).
52. See id. at 4 (explaining that in the past some parties included margin requirements in their swap contracts). “[T]he International Swap Dealers Association published best practice standards for use of collateral.” Id. However, because compliance with the standards was not mandatory and all terms of the swap contracts were negotiable, the terms of the margin provisions, when actually included in the contracts, varied greatly. Id.
53. See id. at 5 (stating, for example, in the case of AIG, many of the contracts required it to post collateral with the occurrence of certain credit events, such as a decline in the credit quality of the underlying referenced securities or AIG’s own credit rating). However, as a result of AIG’s triple-A credit rating, counterparties did not require AIG to post initial margin. Id. “As the subprime crisis worsened, AIG faced margin calls that it could not meet.”
did the bilateral margin levels reflect the systemic risk posed by
the default of one of the parties.\textsuperscript{54} The clearing and margin
requirements address these issues by limiting the size of a firm’s
cleared position to their ability to post margin to cover their
losses.\textsuperscript{55}

Upon clearance, the Act mandates that certain swap data,
such as price and volume, be publicly reported in real-time.\textsuperscript{56} The
reporting requirement is consistent with the intent of the act in
that it enhances price discovery.\textsuperscript{57}

With some limited exceptions, swaps that are required to be
cleared must also be exchange traded.\textsuperscript{58} In such cases, the parties

\textit{Id.} But for the intervention of the Federal Reserve and Treasury, AIG would
have declared bankruptcy and triggered a global financial meltdown. \textit{Id.}

54. \textit{See Litman, supra} note 20, at 16 (explaining that in the OTC interdealer
swap market, dealers were not required to post margin due to their high credit
ratings). Additionally, the netting of transaction further reduced any apparent
need for the posting of margin. \textit{Id.} After the financial crisis of 2008, but before
the passage of Dodd-Frank, brokers began to require trades to be cross-
marginned, however, the terms of these margin agreements were negotiated
and thus it is uncertain whether the margin was sufficient. \textit{Id.} at 14. Further
complicating the margin requirements in the OTC system is the fact that,
when asking for collateral, parties do not consider the “potential cascade of
losses that one party’s default could impose directly on other parties, as well
as the potential indirect impacts of these losses on the counterparties of other
buyers.” \textit{Id.} at 16.

55. \textit{See Jickling \\& Ruane, supra} note 48 (explaining that the “intended
effect of margin requirements is to eliminate the possibility that any firm can
build up an uncapitalized exposure so large that default would have systemic
consequences.”).

56. Wall Street Transparency and Accountability Act of 2010 § 727. \textit{See also
Jickling \\& Ruane, supra} note 48, at 11 (“Real-time reporting means to report
data relating to a swap transaction, including price and volume, as soon as
technologically practicable after the time at which the swap transaction has
been executed.”).

57. \textit{See Pricing and Price Discovery Issues, OKLA. STATE UNIV.,
http://agecon.okstate.edu/pricing/} (last visited Sept. 29, 2011) (explaining that
as a derivative, swap price, volume, and volatility aid in the price discovery of
the underlying asset). Price discovery is the process by which buyers and
sellers arrive at a transaction price for a given quantity and price of an asset.
\textit{Id.} “It involves several interrelated concepts, among them market structure
(number, size, location, and competitiveness of buyers and sellers); market
behavior (buyer procurement and pricing methods); market information and
price reporting (amount, timeliness, and reliability of information); and
futures markets and risk management alternatives.”); see, \textit{e.g.,} DAVID
Mengle, INT’L SWAP DEALERS ASS’N RESEARCH NOTES - TRANSPARENCY
AND OVER-THE-COUNTER DERIVATIVES: THE ROLE OF TRANSACTION TRANSPARENCY
7 (2009), \textit{available at http://www.isda.org/researchnotes/pdfs/ISDA-Research-
Notes1.pdf} (explaining that in the corporate bond and bank loan markets
where there is very little price transparency, the price, volume, and volatility
of the credit default swaps on the underlying bond or loan provides guidance
for pricing the credit portion of the asset price).

58. \textit{See Jickling \\& Ruane, supra} note 48 (explaining that while the
clearance and exchange trading requirements are distinct, a swap that must
to the swap agree to the transaction on either a trading floor or electronic platform. The goal of the exchange-trading requirement is to enhance pre-trade price transparency.

However, the Act presumes some swaps will continue to be traded OTC. For example, swaps that fall under the end-user exception will have the option to be traded OTC. A transaction qualifies for the end-user exception if one of the counterparties to the swap "is not a financial entity; is using swaps to hedge or mitigate commercial risk; and notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps."

While the exception may appear complete, much has been left to the Commissions to decide. While Congress has provided a framework in which the debate over the proper scope of the end-user exception will occur, the Commissions are charged with defining the scope of the exception.

be cleared must also be exchanged traded under all but a few circumstances). There are two ways in which a swap may be required to be exchanged traded. First, the Commissions are required to engage in an ongoing review of the products they have jurisdiction over to determine whether a particular swap should be subject to the clearing requirement. Second, a swap may be subjected to the exchange trading requirement upon submission to the CFTC or the SEC.

59. See id. at 7 (stating that exchange trading will "be executed on a regulated exchange or on a trading platform defined in the act as a swaps execution facility (SEF) or a security-based swaps execution facility (SBSEF)."

60. See id. (explaining that the exchange trading requirement corrects the opaqueness of the OTC market, where "complete price information was available only to dealers, and swaps customers were limited in their ability to shop for the best price or rate.").

61. Id. at 5.
63. Id.
64. See Letter from the Coalition of Derivatives End-Users, to Elizabeth Murphy, Sec'y, SEC, and David A. Stawick, Sec'y, U.S. Commodity Futures Trading Comm'n (Sept. 20, 2010), available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsmission/dfsmission_092810105_0.pdf (explaining that "the Commissions' interpretation of the terms set out in the ANPR . . . could affect Coalition members' businesses significantly."). "At stake is the liquidity of the end-user community, as margin requirements could tie up billions of dollars of funds that otherwise could be put to productive use."

65. See External Meetings, U.S. COMMODITIES FUTURES TRADING COMM'N, http://cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm (last visited Nov. 3, 2011) (listing the meetings various members of the CFTC have had with the various groups and businesses in which portions of Dodd-Frank have been discussed). See also Letter from the Coalition of Derivatives End-Users, supra note 64, at 3 (explaining that the definition of major swap participant, substantial position, substantial counterparty exposure, and commercial risk, will play a major role in the establishment of the scope of the
The New Threat to Financial Reform

III. ARGUMENT

The struggle to define the scope of the end-user exception is one with tremendous consequences. A definition that is too narrow could have a significant impact on corporate hedging activities and potentially result in job losses. A definition that is too broad could undermine the intent of the Act and result in the creation of the next financial crisis.66

While Congress clearly decided some groups of derivatives end-users should be exempted from the swap clearance, it did not provide a clear indication of the scope of the exception.67 Therefore, it is up to the Commissions to determine where the arguments for and against end-user swap clearance fit with the intent of Congress. This discussion will begin by addressing the arguments for a broad end-user exception. It will then turn to the arguments made by those in favor of a narrow exception.

A. The Scope of the End-User Exception Should Be Broad

Advocates of a broad end-user exception contend the costs associated with clearance are disproportionate to the risks related to the use of swaps for hedging by end-users.

1. The Use of Swamps by End-Users for Hedging Purposes Improves Corporate and Systemic Stability.

A central purpose of the Act is to prevent systemic risk, which was a problem at the center of the financial crisis.68 Proponents of

66. See Keybridge Res., An Analysis of the Business Roundtable’s Survey on Over-the-Counter Derivatives (Apr. 14, 2010), available at http://businessroundtable.org/uploads/studies-reports/downloads/An_Analysis_of_the_Business_Roundtables_Survey_on_Over-the-Counter_Derivatives.pdf (documenting seventy-two percent of survey respondents, of which sixty-two percent were non-financial firms, reported that a margin impact would have a significant impact on their hedging activities). The report also states that the imposition of a three percent margin requirement would result in the loss of between 100,000 and 120,000 jobs. Id. See also Lewis, supra note 28, at 78-79 (discussing the fact that AIG was not unique, but rather it was because of its AAA credit rating that it was able to accumulate such a substantial unhedged CDS position). As a result, should the scope of the end-user exception not be sufficiently narrow, the door remains wide open for the creation of another AIG. Id. at 80.

67. See Jickling & Ruane, supra note 48, at 12-13 (explaining that the scope of the end-user exception will in part depend upon the number of firms that are named major swap participants which in the end will be determined by SEC and CFTC rulemakings).

68. See Agricultural Swaps, supra note 46, at 59667 (explaining that “the legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system.”). See also 156 Cong. Rec. S3569, 3601 (daily ed. May 12, 2010) (statement of Sen. Christopher Dodd) (stating the bill includes “tough requirements for central clearing, exchange
a broad end-user exception contend swaps used for hedging pose a far lower degree of risk than swaps used for speculating.69

The primary function of OTC derivatives is to transfer risk.70 By definition under the Act, end-users use swaps to hedge commercial risks.71 Should an end-user enter into a swap transaction for speculative purposes, then that end-user will likely lose the exception.72 Further, when end-users transact in swaps to hedge, they do so to reduce or eliminate risks, as a result, the value of the company is not impacted by the use of the swaps.73 This is true because when an end-user's hedges are down, the underlying hedged item is up, and vice versa.74

Through the use of negotiated swaps, end-users are able to tailor their hedges to their unique risks.75 As a result, end-users do not experience basis risk, which is the assumption of additional risk that results from the use of instrumentalities that do not perfectly address the risks of end-users.76 Therefore, the use of trading, capital margin, and reporting that they are critical to reducing systemic risk and ensuring that taxpayers would not have to clean up the mess resulting from another AIG implosion.

69. See Letter from the Coalition of Derivatives End-Users, supra note 64, at 8 (explaining that by definition hedges are used to reduce risk whereas speculation increase risk).

70. See MENGLE, supra note 57, at 2 (stating “in the case of OTC derivatives, the primary function of the market is the transfer of risk and not the transfer of debt or equity.”).

71. See Wall Street Transparency and Accountability Act of 2010 § 712, 15 U.S.C. § 8302 (stating one of the requirements of the exception is the party must use swaps “to hedge or mitigate commercial risk”).

72. See id. (stating an end-user may not be a financial entity, and the definition of a financial entity includes a major swap participant). See also Wall Street Transparency and Accountability Act of 2010 § 721, 7 U.S.C. § 1a (defining major swap participant as an entity “who maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding . . . positions held for hedging or mitigating commercial risk.”). As such, while much depends upon how the Commissions define substantial position and hedging, what is certain is that the use of swaps for purposes other than hedging could jeopardize an end-user's qualification for the exception. Id.

73. See Letter from the Coalition of Derivatives End-Users, supra note 64, at 8 (stating that “the enterprise value of a firm that enters into swaps only for the purposes of hedging—as opposed to speculation—is not impacted by its use of derivatives.”).

74. Id.

75. See, e.g., COMMODITIES FUTURES TRADING COMM’N, STAFF REPORT: COMMODITY SWAP DEALERS & INDEX TRADERS WITH COMM’N RECOMMENDATIONS 11 (Sept. 2008), available at http://www.cftc.gov/ucm/groups/public@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf (explaining that swaps allow airlines to hedge future jet fuel prices because a futures contract for jet fuel does not exist). Without the availability of swaps, airlines would need to enter into contracts for crude oil and heating oil. Id.

76. See id. at 11-12 (explaining while contracts for crude and heating oil provide some hedge for jet fuel, the prices of crude and heating oil do not move...
Swaps by end-users decreases the likelihood of bankruptcy and, as such, increases systemic stability.77 Swaps are most commonly used by end-users to hedge against interest-rate and currency risks.78 The use of such swaps creates little counterparty risk while maintaining corporate stability. Interest-rate swaps are regularly used by corporations to hedge against fluctuations in interest rates on outstanding variable-rate loans.79

For example, a manufacturer who wants to convert a floating interest-rate loan into a fixed interest-rate loan would use an interest-rate swap.80 This is accomplished by entering into a separate contract with a financial institution in which the manufacturer agrees to pay a flat rate of interest in return for the payment of a floating rate of interest.81 As a result, the manufacturer is left with a fixed interest rate because the floating interest rate on the loan is offset by the floating interest rate paid by the financial institution.82 Notably, the manufacturer and the financial institution do not exchange the principal on which the payments are based.83 As such, the risk to the counterparties in the case of default is limited to the cost of finding a new swap to fix the broken one because the counterparties will discontinue the payments that were due to the counterparty under the contract.84

Similarly, currency swaps pose little risk to swap

perfectly together with the price of jet fuel and, as a result, airlines experience additional risk known as basis risk).

77. See DON M. CHANCE, AN INTRODUCTION TO DERIVATIVES AND RISK MANAGEMENT 346 (Thomson S.-W. 6th ed. 2004) (stating that by hedging, firms reduce risks including the probability of bankruptcy); see also 156 CONG. REC. S3569, 3602 (daily ed. May 12, 2010) (statement of Sen. Christopher Dodd) (explaining that the use of swaps as hedges is crucial in making sure companies do not fail for reasons unrelated to their own difficulties).

78. See KARSTEN VON KLEIST & CARLOS MALLO, BANK FOR INT'L SETTLEMENTS OTC DERIVATIVES MARKET ACTIVITY IN THE SECOND HALF OF 2009 7-8 (May 2010), available at http://www.bis.org/publ/otec_hy1005.pdf (providing a chart of the interest-rate and currency swap markets in 2009). Notably, the number of outstanding interest-rate swaps substantially exceeds all other swaps. Id.

80. Letter from the Coalition of Derivatives End-Users, supra note 64, at 12.

81. Id.

82. Id.

83. See CHANCE, supra note 77, at 425, 428 (explaining an exchange of notional principal is not necessary because the parties would simply be exchanging the same amount of money).

84. See LITAN, supra note 20, at 15 (explaining that the costs to the interest rate swap counterparty in case of a default would be limited to the cost of finding a replacement for the failed swap).
counterparties while providing end-users a hedge for transactions based in foreign currencies. The means by which this is accomplished vary depending upon the type of transaction that is being hedged.

In one scenario, an American technology company (Techo) seeks to expand its operations in Europe, which will cost €10 million. Rather than taking out a loan denominated in euro, Techo borrows the equivalent in dollars ($13 million) from an American bank and then enters into a currency swap with a swap dealer (JAL). The terms of the swap provide that Techo will initially pay $13 million to JAL which will in turn pay Techo the €10 million it needs for expansion. The parties will then periodically pay each other a simulated interest rate. Techo, using revenues from its European operations, pays JAL in euros and JAL pays Techo in dollars. At the conclusion of the contract, Techo will pay JAL €10 million and JAL will pay Techo $13 million, which it will then use to pay off the dollar-denominated loan.

As a result of the swap, Techo hedged against fluctuations in the dollar-euro exchange rate for the period of the contract. By converting its European revenues to dollars at a fixed rate, Techo is able to use its European revenues to pay the dollar-denominated loan interest payments without bearing the risk of volatility in the foreign-exchange market. Once again, the counterparties face

85. See id. (explaining that, like interests rate swaps, currency swaps pose little systemic or counterparty risk due to the availability of replacement swaps in the event of counterparty default).

86. See CHANCE, supra note 77, at 447, 449 (explaining that, in addition to using a currency swap to convert a dollar denominated loan into a foreign currency, a party may use a currency swap to hedge a stream of foreign cash flows). Meaning, a corporation who has foreign operations that derive revenues in the local currency may use a currency swap to convert the local currencies into dollars at a fixed rate of exchange. As a result, the corporation has hedged against volatility in the foreign exchange market. Under this arrangement, the corporation does bear the risk that the revenues generated by its foreign operations will be less than the amount contracted to under the swap. However, this risk is inherent to the hedging of foreign cash flows and is assumed irrespective of the type of derivative used to hedge.

87. See id. at 442 (explaining that this initial exchange of currency has zero value).

88. See id. at 439, 443 (explaining how the value of the period payments to each party are calculated). The intent of the interest payment is to mimic the interest rate of a bond denominated in either euros or dollars.

89. Id.

90. See id. at 441 (explaining that at the end of the life of the swap, the dollar euro exchange rate will not be the same as it was upon initiation of the transaction and, as a result, the parties will experience gains and losses).

91. Id.

92. See id. at 447 (explaining that the relationship allows the American counterparty to essentially take out a loan in dollars and repay using profits denominated in euros).
only minimal risk in the event of counterparty default.93

Further, it is argued by supporters of a broad exception that even if an end-user were to default, that end-user is not so interconnected that a default would trigger a systemic collapse.94 The typical end-user has counterparties numbering in the low double digits, as compared to Lehman Brothers, which transacted with over 8000 parties.95 As such, it is highly unlikely that a typical end-user would be the source of systemic “contagion.”96

Additionally, some advocates are quick to point out that end-users, by definition, cannot accumulate such a swap position that their failure would create systemic risk.97 Before an end-user could accumulate such a substantial position, it would become a major swap participant and, as such, would no longer be exempt from clearing.98

2. The Financial Costs of Clearance Are Not Justified by the Risk Posed by End-Users.

Supporters of a broad exception also argue that because the use of swaps by end-users pose such little risk, end-users should not be subjected to the same transaction costs as those who use swaps to speculate, which by definition creates risk.99

Additionally, end-users were not the cause of the financial crisis.100 Therefore, advocates of a broad exception contend that

93. See id. at 448 (stating that the American company that borrows in dollars assumes the risk of default of the swap dealer). Should the dealer default the company will be exposed to exchange rate volatility while it searches for a replacement swap. Id. See also LIITAN, supra note 20, at 15 (stating that there are systemic risks in the interest rate and currency swap markets, which include all swap users, but the risks are less dangerous than those in the CDS market).

94. See Letter from the Coalition of Derivatives End-Users, supra note 64, at 8 (discussing the fact that “[e]xcessive interconnectedness is not a condition that afflicts end-users.”).

95. Id.

96. Id.


98. Id.

99. See Letter from the Coalition of Derivatives End-Users, supra note 64, at 9 (explaining that because swap dealers and major swap participants use swaps for speculative purposes they add risk). As such, the argument is that it is unjustified to subject those who have an arguably stabilizing effect on the economic system to the same economic costs as those who have a potentially destabilizing effect on the system. Id.

100. See Letter from the Coalition of Derivatives End-Users, supra note 64, at 2 (stating “[m]oreover, end-users, who did not contribute to the financial markets crisis, should not be subjected to the same regulatory structure as swap dealers and those who do not use derivatives to reduce risks associated
end-users should neither be subjected to the same costs as those entities that caused the financial crisis, nor should they be forced to pay for the increased reserves to back the system, through margin requirements. As Senator Saxby Chambliss stated during debate on Dodd-Frank: “Why is Congress considering slapping an additional cost on [end-users] in the form of a clearing mandate? This does not make sense, when these individual companies are the true end-users of the products they are trading in, and they were absolutely not the cause of the financial meltdown.”

3. The Costs Associated with a Narrow Definition Far Exceed Any Benefit.

In addition, advocates of a broad definition argue a narrow definition of end-user would deter hedging and cause job losses.

The vast majority of swap users report that mandatory centralized clearing by financial institutions will increase their hedging costs. These costs will be far greater if a narrow definition of end-user was adopted. As a result of the increased costs, end-users will be likely to hedge less and, as a result, be exposed to greater volatility.

Further, the additional costs will require end-users to set aside a substantial amount of capital. As a result, it is estimated that capital spending will be dramatically reduced and lead to the loss of 100,000 to 120,000 jobs.

with their businesses.

See also, Joe Miller & Brooks Jackson, Who Caused the Economic Crisis?, FACTCHECK.ORG (Oct. 1, 2008), http://www.factcheck.org/elections-2008/who_caused_the_economic_crisis.html (listing the causes of the financial crisis and notably absent from the list is corporate users of swaps to hedge risk).

LITAN, supra note 20, at 15.


103. See GREENWICH ASSOCs., GLOBAL COMMODITIES: DERIVATIVES RULES TO INCREASE HEDGING COSTS 2 (Sept. 2010), available at http://www.greenwich.com/WMA/greenwich_reports/show_reports/1,1624,,00.html?prodCatId=4&regionId=6&rtOrigin=S&vgnvisitor=eKObm6Olopo= (stating that, according to their survey, seventy-seven percent of respondents see the margin requirement and costs associated as a potential drawback to central clearing).

104. Id. at 1 (explaining that “companies fear even more damaging consequences if regulators were to adopt a narrow definition of the 'end-user' exception that limited the type of user that could qualify.”).

105. See Letter from the Coalition of Derivatives End-Users, supra note 64, at 2 (stating that the increased costs in swaps could result in companies moving their swap operations overseas or cause them to forgo hedging altogether).

106. See id. (stating that according to a survey by the Business Roundtable, a three percent margin requirement would require firms to set aside $33.1 billion in aggregate collateral).

107. See id. (explaining that “the initial margin requirement could reduce
Additionally, because of the added costs to end-users, Chairman Dodd and Chairman Lincoln explicitly stated it was not the intent of Congress to impose margin requirements on end-users.\textsuperscript{108} As such, regulators may not impose margin and capital requirements on end-users.\textsuperscript{109} In order to ensure margin costs are not passed onto end-users, financial entities that enter into uncleared swaps with qualified end-users should also enjoy the exception.\textsuperscript{110}

**B. The Scope of the End-User Exception Should Be Narrow**

Advocates of a narrow end-user exception argue a broad definition could be easily exploited, undermining the integrity of the bill and exposing end-users to unjustified risks.

1. **A Broad End-User Exception May Be Exploited by End-Users and Undermine the Intent of the Bill.**

Advocates for a narrow definition of end-user argue that a broad end-user exception will create a giant regulatory loophole that could be exploited by financial institutions.\textsuperscript{111} The ability and willingness of financial institutions to quickly and substantially adjust to advantageous changes in the procedural and regulatory environment is exemplified by the CDS market between 1997 and 2005 when it grew from $18 billion notional to $17 trillion.\textsuperscript{112}
Therefore, it is foreseeable that if the scope of the end-user exception is broad, financial institutions will purchase companies for the purpose of exploiting the end-user exception.\textsuperscript{113}

Further, advocates of a narrow exception claim end-users could use their AAA credit rating and the end-user exception to secretly acquire substantial derivatives positions.\textsuperscript{114} It was the AAA credit ratings of AIG and Enron that permitted the companies to acquire the substantial derivatives positions that ultimately led to the failure of the companies.\textsuperscript{115} If the scope of the exception is broad enough that it permits another AIG to arise, the intent of Dodd-Frank will be undermined and real reform will not be achieved.\textsuperscript{116}

2. By Not Posting Margin, End-Users Are Exposed to Risks That Are Not Justified by Any Cost Savings.

The end-user exception allows banks to continue to determine if and when end-users should post collateral and the amount required.\textsuperscript{117} Therefore, the exception does not eliminate the credit exposure that results from the risk of end-user default.\textsuperscript{118} In the

\textsuperscript{113} See Orol, supra note 111 (quoting Simon Johnson who states "investment banks will buy non-financial corporations so they can take their transactions off of clearinghouses.").

\textsuperscript{114} See Steven Pearlstein, Big Business Pleads for Loopholes in Financial Regulatory Reform, WASH. POST, Apr. 30, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2010/04/29/AR2010042904698.html (discussing how, as a result of AAA credit ratings, firms are allowed to acquire substantial swap positions without putting down margin).

\textsuperscript{115} See id. (citing the secret use of swaps and derivatives by AIG and Enron resulted in the derivatives divisions controlling the firm). See also LEWIS, supra note 28 (discussing how AIG was not unique, but rather they were the first AAA firm to begin to take a substantial position in the CDS market).

\textsuperscript{116} See 156 CONG. REC. S3569, 3598 (daily ed. May 12, 2010) (statement of Sen. Blanche Lincoln) (stating "If we do not capture the AIGs of the world, we cannot claim to have real reform.").

\textsuperscript{117} See JICKLING & RUANE, supra note 48, at 4-5 (stating that the end-user exception allows the parties to continue to trade OTC and part of the OTC framework was the ability of banks to determine when and how much margin was to be required).

\textsuperscript{118} See Wallace C. Turbeville, Dangerous Trader Mentality and Financial Reform, NEW DEAL 2.0 (May 4, 2010, 10:09 AM), http://www.newdeal20.org/2010/05/04/dangerous-trader-mentality-and-financial-reform/10393/ (stating "every trade involves credit exposures, risks that losses will be experienced if the opposing party defaults.").
absence of collateral, banks bear the credit exposure.\textsuperscript{119} Because banks have a finite capacity for credit exposure to any single end-user, the use of the credit exposure to cover trading deficits takes away from the end-user’s credit capacity to invest and manage cash flow variances.\textsuperscript{120} As such, end-user trading activities expose the company to the risk that they will be unable to manage incidents such as those seasonal differences in income.\textsuperscript{121} Additionally, when end-users post margin, the bilateral contracts do not require banks to reciprocate.\textsuperscript{122} As such, end-users remain exposed to the risk of default by the banks.\textsuperscript{123}

Further, the assumption of these risks is not justified by any cost savings. Carrying credit exposure risk is the same as making a loan.\textsuperscript{124} So long as the parties are correctly pricing the transaction, there is a cost associated with making the loan.\textsuperscript{125} Also, the cost of posting collateral is not the cost of the collateral because it is returned so long as there is no default.\textsuperscript{126} Therefore, the true cost of posting margin is “the difference between the cost of borrowing the funds used as collateral and the investment return on the collateral while it is posted.”\textsuperscript{127}

IV. PROPOSAL

The SEC and CFTC face the “daunting task” of promulgating the rules and definitions that will determine the legal scope of the end-user exception.\textsuperscript{128} The result of this process should be an end-user exception that complies with the intent of the Act. This

\textsuperscript{119} See id. (explaining that “[c]redit exposures created by bi-lateral trading can be addressed in one of two ways: a party can post cash or collateral to cover the exposure, or the counterparty whose position has increased in value can forego [sic] posting and simply bear the credit exposure.”).

\textsuperscript{120} See id. (stating that due to a bank’s capacity for credit exposure, there is a proportional relationship between the credit capacity used for trading activities, such as swap transactions, and the capacity available to lend for other purposes).

\textsuperscript{121} See id. (citing seasonal differences in income as an example of a cash flow variance).

\textsuperscript{122} See LITAN, supra note 20, at 14 (explaining that banks often require customers to post margin, but they do not in turn post initial margin to customers).

\textsuperscript{123} See Wallace C. Turbeville, The End (User) Game, NEW DEAL 2.0 (May 5, 2010, 11:42 AM), http://www.newdeal20.org/2010/05/05/the-end-user-game-10497/ (stating that end-users do not have the market power to demand that financial institutions post collateral, despite the necessity of such a requirement as was exhibited by the failure of Lehman Brothers).

\textsuperscript{124} Id.

\textsuperscript{125} Id.

\textsuperscript{126} Id.

\textsuperscript{127} Id.

\textsuperscript{128} See S. Rep. No. 111-238, at 81, 118 (detailing the many new duties placed upon the agencies, calling the CFTC’s task daunting and stating the SEC’s increase in responsibilities is significant).
section begins by setting forth the proper scope of the exception. It then addresses the methods for achieving and maintaining an exception of proper scope.

A. The Proper Scope of the End-User Exception Is Found Within Dodd-Frank

The ultimate intent of Article VII of the Dodd-Frank Act is to prevent another global financial meltdown by lowering systemic risk and increasing the transparency of financial markets. This is partially accomplished through clearance and exchange trading of swaps. At the same time, Dodd-Frank exempts end-users from mandatory clearance. Because legitimate end-users do not create systemic risk the exception is consistent with the intent of the Act. Additionally, in creating the exception, Congress decided that because end-users were not responsible for the crisis they should not be subjected to increased hedging costs. Therefore, the end-user exception must be sufficiently narrow to exclude all parties who increase systemic risk and who were the cause of the crisis, namely, speculators, while at the same time is broad enough to encompass all end-users.

129. See Gary Gensler, Chairman, Commodities Futures Trading Comm’n, Remarks Before FIA Futures and Options Expo (Nov. 3, 2010), available at http://www.cftc.gov/pressroom/speechestestimony/opagensler-57.html (stating that the CFTC will comply with the intent of Dodd-Frank, which is the reduction of systemic risk and increase in transparency, when engaging the rule-making process).

130. See Wall Street Transparency and Accountability Act of 2010 § 723 (mandating that all nonexempt trades are cleared and all nonexempt standardized swap transactions are carried out on an exchange).

131. Id. at § 712.

132. See Letter from the Coalition of Derivatives End-Users, supra note 64, at 2, 8 (explaining, that by definition, hedges are used to reduce risk whereas speculation increases risk). Therefore, end-users should not be subjected to any increase in hedging costs and any increase will likely result in end-users hedging less or not hedging at all. Id.

133. Letter from Christopher Dodd, supra note 108.

134. See Gary Gensler, Chairman, Commodities Futures Trading Comm’n, Remarks Before the Exchequer Club of Washington: OTC Derivatives Reform (Nov. 18, 2009), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/opagensler-20.html (discussing the clearance and exchange trading requirements are not intended to punish but rather prevent another financial crisis by reducing systemic risk). When viewed in isolation, a single un-cleared transaction by a financial entity or major swap participant does not create systemic risk; however, when viewed in the aggregate, the failure to include such a transaction would undermine the intent of the bill. Id.

135. See Bart Chilton, Comm’r, Commodities Futures Trading Comm’n, Address to the National Supply Summit: House Money (Oct. 25, 2010), available at http://www.cftc.gov/pressroom/speechestestimony/opachilton-33.html (explaining that the CFTC will promulgate rules that will be carefully tailored to ensure that end-users who are legitimate hedgers do not fall into...
The CFTC has drafted a series of proposed rules which appear to satisfy both requirements.136

1. Defining the End-User

Under Dodd-Frank, a party qualifies for the end-user exception if it is not a "financial entity" and it uses "swaps to hedge or mitigate commercial risk."137 As such, the definitions of financial entity and commercial risk will determine whether a party qualifies for the end-user exception. The Act defines financial entity by providing nine categories of swap users.138 The categories of financial entity most relevant to end-users are "swap dealer" and "major swap participant."

a. Swap Dealer

A party is a "swap dealer," under the proposed rules, if the party "(r)egularly enters into swaps with counterparties as an ordinary course of business for its own account."139 However, an exception is made for "a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of regular business."140

Additionally, the proposed provides for a "de minimis exception" for persons who satisfy three requirements.141 The first requirement is that a person's annual aggregated gross notional

the categories of "swap dealer" or "major swap participant").


137. Wall Street Transparency and Accountability Act of 2010 § 723.

138. See Wall Street Transparency and Accountability Act of 2010 §§ 723, 763 (defining financial entity as a party who is a swap dealer, a security-based swap dealer, a major swap participant, a major security-based swap participant, a commodity pool, a private fund, an employee benefit plan, or a person predominantly engaged in activities that are in the business of banking or in activities that are financial in nature). However, the Act requires the CFTC and SEC to consider whether to exempt small banks, savings associations, farm credit systems institutions, and credit unions from the definition of financial entity in this section. Id. Such a conclusion would qualify them for the exception. Id.


In general. The term "swap dealer" means any person who: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.

140. Id.

141. Id.
amount of swap positions is no more than $100 million.\textsuperscript{142} Second, the person must not have entered into swaps with more than fifteen nonswap dealer counterparties.\textsuperscript{143} Finally, the person must not have entered into more than twenty swaps over the course of the preceding twelve months.\textsuperscript{144} If all three requirements are satisfied then the person is exempt from the definition of swap dealer.

As written, the definition of “swap dealer” with the exceptions should be sufficiently narrow to exclude all end-users. However, it is foreseeable that a question will arise as to whether an end-user should fall under the swap-dealer exception for persons who enter into swaps for their own accounts.

The resolution to such a question will be determined by the interpretation of the phrase “regular business.” If such a question were to arise, then the courts should heed the guidance of the Commission and determine that a person is in the regular business of entering into swaps if it is the function of the swap transaction to “accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties.”\textsuperscript{145} End-users by nature engage in swap transactions to hedge their own commercial risks rather than to accommodate an interest expressed by another party. Therefore, by adopting such a definition of regular business, the courts will ensure that legitimate end-users will not fall under the definition of swap dealer.

b. Major Swap Participant

The second category of “financial entity” that has the potential to be defined in a manner that would cause end-users to fall within its scope is “major swap participant.” In general, the definition as proposed by the Commission is sufficiently broad to ensure that all end-users fall within the definition while narrow enough to exclude speculators.\textsuperscript{146}

To qualify as a major swap participant a person must satisfy a two-prong test.\textsuperscript{147} The first prong is that the person must not be a swap dealer. The second prong can be satisfied by meeting one of three tests.

\textsuperscript{142} See id. at 80180 (stating that if the counterparty is considered a special entity for a category of swaps than the limit is $25 million rather than the standard $100 million). Additionally, if the stated notional amount is leveraged or enhanced, then the $100 million exception is to be based upon the effective notional amount rather than the stated notional amount. Id.
\textsuperscript{143} Id.
\textsuperscript{144} Id.
\textsuperscript{145} Id. at 80177.
\textsuperscript{146} See generally id. at 80212-80213 (defining the relevant components of the major swap participant classification).
\textsuperscript{147} Id. at 80212.
The first test is that a person maintains a substantial position in swaps excluding positions held for hedging or mitigating commercial risk. The proposed rules have defined substantial position in a manner such that its reasonableness is contingent upon the definition of hedging or mitigating commercial risk. As such, the crux of the test is the definition of hedging or mitigating commercial risk.

The Commission has proposed a definition of hedging or mitigating commercial risk that provides for a wide range of transactions that are considered for the purpose of hedging or mitigating. At the same time, the definition explicitly excludes swap positions that are for the purpose of speculation, trading, and investigating. The proposed rule also excludes positions that are used for hedging swaps. As a result, the definition of hedging or mitigating commercial risk is broad enough that it will cover the vast majority of end-user swap transactions, and at the same time is narrow enough to exclude all speculative positions. Because the vast majority of end-users will engage in transactions that fall under the definition of hedging or mitigating commercial risk, end-users should not have a problem keeping their swap positions below the "substantial position" threshold.

In proposing the second test, the Commission did not lose sight of the ultimate goal of Dodd-Frank, which is to limit systemic risk. The second test includes all persons “[w]hose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.” The Commission

148. Id.
149. See id. at 80213:
For purposes of Section 1a(33) of the Commodity Exchange Act and § 1.3(qqq), the term substantial position means swap positions, other than positions that are excluded from consideration, that equal or exceed any of the following thresholds in the specified major category of swaps:(i) For rate swaps: (A) $3 billion in daily average aggregate uncollateralized outward exposure; or (B) $6 billion in: (1) Daily average aggregate uncollateralized outward exposure plus (2) Daily average aggregate potential outward exposure. (ii) For credit swaps: (A) $1 billion in daily average aggregate uncollateralized outward exposure; or (B) $2 billion in: (1) Daily average aggregate uncollateralized outward exposure plus (2) Daily average aggregate potential outward exposure.
Because substantial position is determined after swaps that are used for hedging or mitigating commercial risk, the position amount threshold is irrelevant in the absence of a definition of hedging or mitigating commercial risk. Id.
150. See id. at 80214-15 (setting forth the criteria for hedging or mitigating commercial risk).
151. Id. at 80215.
152. Id.
153. Gensler, supra note 129.
has proposed several threshold amounts to satisfy the test. Notably, the definition does not provide for an offset for hedged transactions. However, this should not be an issue for end-users because the proposed thresholds are of sufficient size that end-users should be able to easily maintain swap positions that are less than the threshold amount.

Finally, the third test ensures that persons who are highly leveraged relative to the amount of capital they hold and maintain a substantial position in swaps are considered major swap participants. Like the second test, the third test does not provide an offset for swaps that are used for hedging. Because the conduct that would cause a person to fall within the scope of the third test is similar to the conduct of the persons who caused the financial crisis, the Commission has correctly denied such persons, traditional end-user or not, the option of exempting their trades from exchange trading.

Therefore, because the proposed definitions of “swap dealer” and “major swap participant” are wide enough to cover speculators but narrow enough to avoid encompassing end-users, the Commission’s proposed definition of “financial entity” is of a proper scope.

2. Hedge or Mitigate Commercial Risk

While, the proposed scope of the term “financial entity” is appropriate, the scope of end-user is also contingent upon the definition of “hedge or mitigate commercial risk.” Fortunately, the Commission has decided to propose a definition of “hedge or mitigate commercial risk” that is nearly identical to the definition used in the definition of “major swap participant.” As a result, the definition of “hedge or mitigate commercial risk” for the purposes of determining whether a person is a major swap participant is of a sufficient scope for the purposes of determining whether a person is an end-user.

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155. Id. at 80215:
(uuu) Substantial counterparty exposure. (I) In general. For purposes of Section 1a(33) of the Act and § 1.3(qqq), the phrase substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets means a swap position that satisfies either of the following thresholds: (i) $5 billion in daily average aggregate uncollateralized outward exposure; or (ii) $8 billion in: (A) Daily average aggregate uncollateralized outward exposure plus (B) Daily average aggregate potential outward exposure.

156. Id.

157. Id. at 80212.

158. See id. at 80753 (discussing the parallel approach to rule making).
B. Treatment of Financial Entity Counterparties

While the Commission has proposed a definition of end-user that is of a proper scope, an additional loophole for financial entities continues to exist.

Financial entities who are counterparties to swap transactions with qualified end-users should not fall under the end-user exception. The exception provides parties to a swap contract with the option of exempting the end-users' swaps from the exchange trading and clearance requirements. As such, the decision whether to require exchange trading and clearance remains with the parties. However, such freedom to contract only works when the parties operate on a relatively level playing field. The experience of end-users in the OTC markets has shown that end-users do not have the negotiating power to demand that financial entities post sufficient margin to protect end-users from the risk of default by the financial entity. Because end-users are not in a position to require financial entities to post margin that accurately reflects counterparty risk, it should be left to the clearing houses and the appropriate Commission to fill this void.

Because not all OTC swap transactions pose the same degree of risk to the end-user, any margin requirement should be of a minimally adequate level to address the risks created. At the same time, it is not the intent of the Act to expose end-users to the

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159. See Letter from the Coalition of Derivatives End-Users, supra note 64 (presenting the position of supporters of a broad definition that there should be a blanket exception for financial entity counterparties to swap transactions with exempt end-users).

160. See Wall Street Transparency and Accountability Act of 2010 § 712, 15 U.S.C. § 8302 (explaining that “[t]he application of the clearing exception ... is solely at the discretion of the counterparty to the swap that meets the conditions ...”).

161. See Turbeville, supra note 118 (stating that end-users do not have adequate negotiating power to require financial swap counterparties to post sufficient margin to protect the end-users in the case of default). Therefore, when financial entities do not post margin, end-users are exposed to the risk that in the event of default the financial entity will not be able to hold up its end of the bargain. Id. As a result, the end-user will be fully exposed to the risk they were seeking to hedge against. Id. In the past, it was thought that financial entities were not capable of default given their position in the marketplace, however, the collapse of Lehman Brothers proved that presumption wrong. Id.

162. See Letter from Christopher Dodd, supra note 108 (stating that, while regulators may not impose margin requirements on end-users, margin requirements placed on swap counterparties should reflect the counterparty risk).

163. See id. (stating that all risks are not the same and therefore margin and collateral requirements should reflect the specific risk posed by the transaction).

164. Id.
costs of exchange trading and clearance.\textsuperscript{165} Therefore, the margin requirements placed upon financial entities must not be so financially onerous that they will be left with no option but to insist that margin be posted by end-users.\textsuperscript{166}

Advocates of a broad exception contend financial entities will react to the imposition of any margin requirement by requiring end-users to post margin.\textsuperscript{167} Assuming such a contention is correct, all financial entities, including those who are counterparties to swap transactions with end-users, should nonetheless be subjected to the clearing requirements of the Act. The primary intent of the Act is to reduce risks and prevent the occurrence of another financial crisis.\textsuperscript{168} As such, shielding end-users from an increase in hedging costs is only a secondary effect of the Act.\textsuperscript{169} While there are many end-users, there are only a few swap dealers. Consequently, the systemic risk posed by end-user-financial-entity swap transactions is only revealed when the transactions are aggregated.\textsuperscript{170} As a result, financial entity counterparties to swap transactions with end-users must be required to post minimally

\textsuperscript{165} See id. (stating that it is not the intent of the Act to expose end-users to the burdensome costs associated with clearance, which includes the posting of margin).

\textsuperscript{166} See id. (discussing the proper balance between the level of risk presented by the uncleared transaction and the purpose of the end-user exception, which was to prevent end-users from being subjected to the costs of posting margin).

\textsuperscript{167} See Letter from Dolan, supra note 110 (stating that any imposition of margin on financial entity swap counterparties will result in margin being placed on end-users).

\textsuperscript{168} See Gensler, supra note 134 (stating that the primary purpose of the Act is to reduce risk).

\textsuperscript{169} See John Carney, \textit{Will the CFTC Kill the End-User Exception?}, CNBC (Oct. 4, 2010, 5:19 PM), http://www.cnbc.com/id/39506763/Will_The_CFTC_Kill_The_End_User_Exception (stating the final draft does not contain an explicit end-user exception). See generally Wall Street Transparency and Accountability Act of 2010 (showing the exception is created through the piecing together of several different provisions). As such, it would be inappropriate for an exception that is not explicitly created to trump the primary intent of the Act. Id.

\textsuperscript{170} See Gensler, supra note 134 (discussing that, when aggregated, the swap transactions of financial entities pose a risk to the financial system). In this case, while the transaction remains OTC, the same principal applies. Id. The posting of margin by financial entities reduces risk. Id. See also WEISTROFFER, supra note 14, at 14 (discussing the small number of financial entities involved in the swap market). As such, only a small number of financial entities are counterparties to OTC end-user swap transactions. Id. Therefore, when viewed in the aggregate, a pattern emerges where a small group of financial entities repeatedly enter into OTC swap transactions with qualified end-users. Id. As a result, in the absence of a margin requirement, end-users are exposed to a great deal of risk in the event of default by one of the financial entities. Id.
adequate margin.\footnote{See James Hamilton, \textit{Senators Dodd and Lincoln Clarify the End User Exemption in the Derivatives Title of Dodd-Frank}, WOLTERS KLUWER FIN. REFORM NEWS CTR. (July 2, 2010, 7:14 AM), http://financialreform.wolterskluwerlb.com/2010/07/senators-dodd-and-lincoln-clarify-the-end-user-exemption-in-the-derivatives-title-of-dodd-frank.html: In cases where a Swap Dealer enters into an uncleared swap with an end-user, margin on the dealer side of the transaction should reflect the counterparty risk of the transaction. Congress strongly encourages regulators to establish margin requirements for such swaps \ldots in a manner that is consistent with the Congressional intent to protect end-users from burdensome costs. Therefore, it is consistent with the intent of Congress to require minimally adequate margin, which is customized based upon the risk created, even if it will result in the imposition of a margin requirement on end-users. \textit{Id.}}

V. CONCLUSION

After operating in the shadows for years, Dodd-Frank has brought much needed transparency to the OTC derivatives market. The end-user exception seeks to strike a balance between providing maximum market transparency while minimizing the impact on hedging costs for end-users. Maintaining this delicate balance will be the key to the future success of the end-user exception.