Meeting between staff of several prudential regulatory agencies and Representatives of the Coalition of Derivatives End-Users
November 22, 2010

Participants: Pat White, Michael Gibson, Stephanie Martin, Jeremy Newell and David Lynch (Federal Reserve Board); Anna Iacucci and John Kambhu (Federal Reserve Bank of New York); John Feid, Thomas Hearn, Ryan Clougherty, Dan Harty and Diana Nguyen (Federal Deposit Insurance Corporation); Richard Katz and Tim Nerdahl (Farm Credit Administration); and James Carley (Federal Housing Finance Agency)

Michael Bopp and Brian Callanan (Gibson, Dunn & Crutcher); Renuka Gupta and Mark Barber (GE); Dorothy Coleman (National Association of Manufacturers); Samuel Peterson and Luke Zubrod (Chatham Financial); Kirk Freeman (NAREIT); Matthew Miller (Financial Executives International); Nathan Graham (Procter & Gamble) and Vikas Huria (Ford)

Summary: Staff from several prudential regulatory agencies met with a group from the Coalition of Derivatives End-Users to discuss implementation issues related to margin requirements on non-cleared derivatives under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The group raised two issues and provided legal memoranda on both issues. These memoranda are attached.

First, the group argued that Title VII of the Dodd-Frank Act does not authorize regulators to impose margin requirements on existing swaps. They noted that other sections of Title VII, such as Section 731 mandating the reporting of swaps, have explicit language requiring that existing swaps be included, but no such language is included in the sections related to margin requirements. They noted that, in general, retroactive application requires clear statutory language, and that retroactive application could raise Constitutional issues under the Takings Clause.

The group also argued that Title VII does not give regulators the authority to impose margin requirements on end-users, nor does it give regulators the authority to impose margin requirements on regulated firms that would have the effect of requiring end users to post margin. The discussion of this issue addressed several related topics, including whether a "margin requirement" should be understood to cover both the posting and collecting of margin, the legislative history of the margin requirements, and the provision in Title VII that requires the margin requirements to "ensure the safety and soundness of the swap dealer or major swap participant."

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Memorandum

Date: November 2010

Re: Application of Margin to End-Users

Since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in June 2010, some observers have questioned whether the Act's new mandatory margin requirements apply to end-users. This memorandum answers that question in the negative: The derivatives title of the Act confers no authority to impose margin rules—directly or indirectly—on end-users. To do so would violate the plain language of Section 731 of the Act and effectively eviscerate the exemption for hedging that Congress included in the definition of "Major Swap Participant." A margin exemption for end-users is required by the text of the Act and is consistent with the Act's purpose and structure.

I. CONGRESS DEFINED AND LIMITED THE KEY REGULATED ENTITIES

The derivatives title of the Dodd-Frank Act begins by defining the key regulated entities. *See* § 721. The terms "major swap participant" (MSP) and "swap dealer," as defined in Section 721, are used throughout the derivatives title to identify *how* and *to whom* the Act's new reporting, clearing, capital, and margin requirements will apply. The scope of the operative provisions of the derivatives title is defined by these terms.

With few if any exceptions, the terms "major swap participant" and "swap dealer" exclude end-users. While the term "end user" is not defined in the Dodd-Frank Act, Congress clearly contemplated an exemption for end-users, and the Act treats end-users differently than other entities, particularly MSPs and swap dealers.[1]

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[1] *See, e.g.*, 156 CONG. REC. H5248 (June 30, 2010) (colloquy of Representatives Frank and Peterson) (Rep. Peterson: "[W]e have given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant. . . ." Rep. Frank: "[T]he gentleman is absolutely right. We do differentiate between end users and others."); 156 CONG. REC. S 5904 (July 15, 2010) (colloquy of Senators Lincoln and Dodd) (Senator Lincoln: "It is also important to note that few end users will be major swap participants . . . . I would ask Chairman Dodd whether he concurs with my view of the bill." Senator Dodd: "I agree with the Chairman's assessment.").

The Coalition for Derivatives End-Users has taken the position that the terms "major swap participant" and "swap dealer" do not include any end-user that enters into swaps to hedge risk associated with its business operations.[2] It remains to be seen whether regulators adopt the Coalition's interpretation of these terms, but the precise contours of the end-user exemption is unnecessary to the analysis in this memorandum. What is important is that the Dodd-Frank Act distinguishes between major swap participants and swap dealers on the one hand, and end-users on the other. This memorandum draws the same distinction.

II. THE ACT DOES NOT AUTHORIZE REGULATORS TO IMPOSE MARGIN REQUIREMENTS DIRECTLY OR INDIRECTLY ON END-USERS

A. The Unambiguous Language of Section 731 Applies Only to Major Swap Participants and Swap Dealers

The Act grants regulators the authority to impose margin on an important but *limited* class of regulated swap entities—major swap participants and swap dealers.[3] The plain text of the Act makes clear that end-users fall outside the new regulatory framework governing margin.

Margin requirements are addressed in Section 731, titled "Registration and Regulation of Swap Dealers and Major Swap Participants." That section unequivocally states that the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and bank regulators are authorized to set margin for MSPs and swap dealers only. Congress reiterated this limitation throughout Section 731—in a general grant of rulemaking authority, in the specific grants of authority to promulgate regulations setting margin requirements, and in the provisions identifying which entities must comply with the new margin requirements.

In the subsection titled "Rulemakings," the Act provides: "IN GENERAL.—The Commission shall adopt rules for persons that are registered as swap dealers or major swap

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[2] For a full elaboration on this point, *see* Comments of Coalition for Derivatives End-Users to Advanced Notice of Proposed Rulemaking, File No. S7-16-10, Release No. 34-62717, Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act (August 13, 2010).

[3] CFTC Chairman Gary Gensler has referred to MSPs and swap dealers as the "regulated swap entities," in recognition of the Act's distinction between these firms and those outside the Dodd-Frank regulatory scheme. *See* Gary Gensler, Chairman, CFTC, Remarks before the Practicing Law Institute's 42nd Annual Institute on Securities Regulation (Nov. 11, 2010), *available at* http://www.cftc.gov/pressroom/speechestestimony/opagensler-59.html.

participants under this section." § 731 [p. 336] (emphasis added).[4] Again, in the provision titled "CAPITAL AND MARGIN REQUIREMENTS," Congress identified which entities "shall meet" margin requirements set by the CFTC, SEC, and bank regulators:

> Each registered swap dealer and major swap participant . . . shall meet . . . minimum initial and variation margin requirements.

§ 731 [(e)(1)(A)-(B)] [p. 336] (emphasis added). This same formulation appears in the parallel provisions governing bank and non-bank entities. *Id.*

As if to emphasize the limitation, Section 731 goes on to state:

> [Regulators] shall jointly adopt [margin] rules for swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant.

§ 731 [(e)(2)(A)-(B)] [p. 336] (emphasis added). This formulation also appears in parallel provisions governing bank and non-bank entities. *Id.*

Section 731 grants the CFTC, SEC and bank regulators substantial power, but it does not authorize a roving commission to impose margin on any and all swap participants. "The best evidence of the scope of authority is found . . . in the language establishing the authority. Where, as here, that language unambiguously uses a statutorily defined term, that definition controls the scope of authority." *Wolverine Power Co. v. F.E.R.C.*, 963 F.2d 446, 451 (D.C. Cir. 1992). By repeatedly using statutorily defined terms—major swap participant and swap dealer—Congress could not have been more clear that margin requirements do not apply to parties not captured by those terms.

B. Exempting End-Users From Margin Rules Is Consistent With The Act's Structure, Purpose and Congressional Intent

The evidence of congressional intent leaves no doubt that the Act's drafters did not mean for Section 731 to apply to end-users. Senators Dodd and Lincoln explained in a June 30 letter to the House sponsors of financial reform that the Act "does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk." 156 CONG. REC. S 6192 (July 22, 2010). Echoing the Senate sponsors, Representatives Frank and Peterson were unequivocal in their position that margin cannot be imposed on the end-user side of any swap:

> Mr. PETERSON. [W]e have given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant.

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[4] All citations to the Act are by section and page number [in brackets] to the final conference report, *available at* http://banking.senate.gov/public/_files/ Rept111517DoddFrankWallStreetReformandConsumerProtectionAct.pdf.

> While the regulators do have authority over the dealer or MSP side of a transaction, we expect the level of margin required will be minimal. . . . I would ask Chairman Frank whether he concurs with my view of the bill.
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> Mr. FRANK of Massachusetts. . . . [T]he gentleman is absolutely right. We do differentiate between end users and others. The marginal requirements are not on end users.

156 CONG. REC. H5248 (June 30, 2010) (colloquy of Representatives Frank and Peterson).

These statements by the principal House and Senate authors of the Act merely confirm what the text makes clear: Regulators cannot impose margin on non-MSPs and non-dealers. Indeed, at a recent Senate hearing, Chairman Gensler acknowledged this unambiguous evidence that Congress intended to exempt end-users from margining. *See Financial Overhaul Law Implementation: Hearing of the Senate Comm. on Banking, Housing and Urban Affairs*, CQ Cong. Tr. (Sept. 30, 2010).

One of the central purposes of derivatives reform was to "reduce systemic risk," as the Treasury Department proposed in its initial blueprint for reform.[5] The margin provision itself states that margin standards should guard against risks to "the financial system." § 731 [(e)(3)(A)] [p. 337]. Congress recognized that application of new margin rules to end-users would ill-serve that purpose. As Senators Dodd and Lincoln wrote in their June 30 letter, "If regulators raise the costs of end user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth." 156 CONG. REC. S 6192. End-users do not pose the same gravity of risk that is introduced into our financial system by derivatives speculation. To the contrary, derivatives use by end-users actually reduces risk within companies and redistributes it more efficiently through the financial system.

The economic concerns that motivated the end-user exemption were well-founded. Studies have shown that margin requirements could tie up billions of dollars of funds that could otherwise be put to productive use. According to a 2010 Business Roundtable survey, without an end-user exemption, a 3% initial margin requirement would require publicly traded BRT companies that are not predominantly financial to set aside $33.1 billion in aggregate collateral—approximately $269 million per firm. If applied to the S&P 500 companies, the study estimated that the initial margin requirement could reduce capital spending by $5 to $6 billion per year, causing a loss of 100,000 to 120,000 jobs. This survey's assumptions were

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[5] U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation* 43 (2009) *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf; *see also id.* at 10, 13. This view was echoed throughout the financial regulatory reform debate, including in a colloquy between Senators Lincoln and Hagan, who noted that the definition of MSP is focused on "risk factors that contributed to the recent financial crisis." 156 CONG. REC. S 5907 (daily ed. July 15, 2010) (colloquy of Senators Hagan and Lincoln).

conservative—they did not contemplate the effects of a requirement to post variation margin, which would significantly increase the amount of funds required to be set aside to meet margin calls, likely resulting in even greater job losses. Indeed, the Natural Gas Supply Association and the National Corn Growers Association estimated that the liquidity costs of mandating central clearing and margining across the entire OTC derivatives market, including end-users, could reach as high as $700 billion.[6]

To be sure, the great majority of end-user trades are entered into with swap dealers. And it is not disputed that Section 731 permits regulators to require dealers or MSPs to post margin on *their* side of end-user trades. But nothing in the Act permits regulators to impose margin rules directly on end-users merely because they are counterparties to swaps held by a regulated entity. Such an extension of margin rules would eviscerate the exemption for end-users in the MSP definition, because virtually all end-user swaps are linked to a swap dealer counterparty. Senators Dodd and Lincoln made precisely this point in their June 30 letter: "Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end users. . . . [R]ules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction." 156 CONG. REC. S 6192 (emphasis added). Clearly, it would violate the intent of Congress to shoehorn end-users in the mandatory margin regime.

Indeed, throughout the drafting of the Act in the House and Senate, the question was not *whether* to exempt end-users but rather how *broad* the exemption for end-users would be. Prior to consideration of the Dodd-Frank Act in conference, the margin provisions in the bill initially passed by the Senate included a broad *transaction-based* exemption.[7] That exemption was not limited to the end-user side of swap, but rather applied to both sides of all "swaps in which 1 of the counterparties is" an end-user. Although conferees deleted this transaction-based exemption, they *preserved* the carve-out for end-users in the definitions of MSP and swap dealer. Senator Dodd and Senator Lincoln made this point in their June 30 letter:

> In harmonizing the different approaches taken by the House and Senate in their respective derivatives titles, a number of provisions were deleted by the Conference Committee to avoid redundancy. . . . However, a consistent Congressional directive throughout all drafts of this legislation, and in Congressional debate, has been to protect end users from burdensome costs associated with margin requirements and mandatory clearing. Accordingly, changes made in Conference to the section of the bill regulating capital and margin requirements for swap dealers and major swap participants should not be

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[6] *See* Press Release, Natural Gas Supply Association and the National Corn Growers Association (May 24, 2010) *available at* http://www.ngsa.org/Assets/docs/2010%20press%20releases/21-ngsa%20urges%20fix%20for%20derivs%20title%20in%20conference.pdf.

[7] The Senate-passed version of the Act stated that margin requirements would not apply to swaps in which one of the counterparties was not a swap dealer, major swap participant, or a counterparty eligible for and using the commercial end-user clearing exemption. S. 3739, § 731(e)(8).

> construed as changing this important Congressional interest in protecting end users.

156 CONG. REC. S 6192. As the Senators cautioned, revisions to margin provisions in conference were *not* intended to authorize the application of margin rules to end-users. The plain text of Section 731 bears this out. Congress settled on a limited but clear party-based exemption to shield end-users from the burdens of mandatory margining.[8]

C. The Act Confers No Implicit Authority To Impose Margin On End-Users

Against the plain text of the Act and these clear expressions of congressional intent, some observers have questioned whether various provisions of the Act might *implicitly* confer the power to impose margin rules on end-users. None of these arguments withstands scrutiny.

It has been suggested, for example, that the stated *goals* of the margin provision necessitate regulating all counterparties—including end-users. Specifically, Section 731(e)(3) provides in part:

> To offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared, the [margin and capital] requirements imposed under paragraph (2) 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.

§ 731 [(e)(3)(A)(i)] [337]. Some have argued that margin requirements cannot achieve the aims identified here—"offset the greater risk to the swap dealer or major swap participant and the financial system" and "help ensure the safety and soundness of the swap dealer or major swap participant"—unless the requirements are applied directly to the regulated entity's counterparties or the regulated entity is compelled to collect margin from its counterparties.

This argument does not hold up for several reasons. As an initial matter, it overlooks the fact that the "paragraph (2)" requirements referred to in Section 731(e)(3) apply only to "swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant." § 731 [(e)(2)] [p. 336]. That language limits the *means* that regulators can use to achieve these broad ends.

In addition, this strained interpretation rests on the false premise that an end-user exemption is incompatible with Section 731(e)(3)'s stated aims. To the contrary, "the [margin and capital] requirements imposed under paragraph (2)" certainly can "help ensure safety and

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[8] To be clear, we are not contending that Congress intended to exempt from margin requirements all transactions to which an end-user is a counterparty. We are simply noting that margin cannot be imposed directly on an end-user counterparty.

soundness of the swap dealer or major swap participant and the financial system" without imposing margin on end-users. § 731 [(e)(3)(A)(i)]. That is so, again, for several reasons.

First, 90 percent of swaps held by MSPs and swap dealers have as their counterparty *another* MSP, dealer, or other regulated entity. Even with a robust exemption for end-users, Section 731 gives regulators broad authority to apply margin rules to *both sides* of the *vast majority* of swaps held by MSPs and swap dealers, thereby "help[ing] ensure the safety and soundness" of those entities. *Id.* Second, as noted above, the blanket application of margin to end-users could *increase* systemic risk and destabilize companies that use derivatives to manage risks in connection with their day-to-day businesses. Third, requiring MSPs and swap dealers to post margin could *reduce* both systemic risk and the risk to the posting entity. For example, in the event of the failure of a systemically-significant swap dealer or MSP, to the extent that institution has posted margin on its trades, the credit markets will be less likely to freeze up as a result of the failure.

In any event, even if regulators believed that applying margin directly to end-user swaps would *more fully* effectuate certain goals, that is no basis for exceeding the limited grant of authority to set "[margin] rules <u>for swap dealers and major swap participants</u>, with respect to their activities <u>as a swap dealer or major swap participant</u>." § 731 [(e)(2)(A)-(B)] [p. 336] (emphasis added). "[N]either courts nor federal agencies can rewrite a statute's plain text to correspond to its supposed purposes." *Landstar Express America v. Fed. Maritime Comm'n*, 569 F.3d 493, 498 (D.C. Cir. 2009).

It may also be objected that if Congress intended to exempt end-users from margin provisions, it would have adopted an end-user exemption like the one that appears in the clearing provision. § 723 [(h)(7)(A)] [p. 310] (exempting swaps in which "1 of the counterparties to the swap" from the mandatory clearing regime). This objection is unfounded. It was necessary to explicitly exempt end-user swaps from the clearing requirement because that requirement, by its general terms, applied to "*any person* [who] engage[s] in a swap." § 732 [(h)(1)(a)] [p. 306] (emphasis added). By contrast, the margin requirements of Section 731 do not apply generally to *any person*, but rather are confined to "swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant." § 731 [(e)(2)(A)-(B)] [p. 336]. As a matter of law and logic, there is no need to fashion a specific exception to a general rule that does not apply in the first place. *See Raymond B. Yates, M.D., P.C. Profit Sharing Plan v. Hendon*, 541 U.S. 1, 13 (2004) ("Exemptions . . . would be unnecessary if [the exempt parties] could not qualify . . . in the first place."). Moreover, clearing by its nature necessitates a transaction-based exemption; it is not possible to clear *one side* of a transaction. By contrast, margin can be—and often is—imposed on only one side of a bilateral transaction.

Finally, some observers have suggested that the authority to impose margin on end-users is somehow implicit in the separate section that governs segregation of initial collateral. Specifically, Section 724 of the Act creates new segregation requirements for both cleared and uncleared swaps and authorizes the CFTC to regulate the use and investment of segregated funds. With respect to uncleared swaps, Section 724(c) provides that a swap dealer or MSP must, upon request of its counterparty, segregate with an independent third-party custodian any "funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty," except for variation margin. § 724(c) [p. 315].

Nothing in this provision recognizes or confers a power to impose margin on end-users, nor does it deputize MSPs and dealers to collect mandatory margin from end-users. Section 724(c) addresses how collateral should be *managed*, not when or by whom it should be posted. Significantly, Congress did not say "funds or other property *required to be supplied*" by counterparties. Instead, this provision merely recognizes that *if and when* a counterparty supplies funds or property to secure its obligations, that counterparty should have the option to require segregation of the collateral assets. It strains credulity to assert that Congress conveyed the broad, controversial authority to impose margin on hundreds of thousands of end-users by means of *subtle implication* in a provision entirely separate from Section 731's margin requirements. *Whitman v. Am. Trucking Ass'n*, 531 U.S. 457, 468 (2001) (noting that courts presume that Congress does not "alter fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes").[9]

If the Act's segregation provision is at all relevant to the question at issue, it is because that provision demonstrates that Congress knew how to identify "the counterparty of the swap dealer or major swap participant" when it wanted to. *See* § 724(c). The *failure* to identify those parties as regulated entities in Section 731 indicates that non-MSP and non-swap dealer counterparties are exempt from the mandatory margin rules. *See Duncan v. Walker*, 533 U.S. 167, 173-74 (2001) ("When Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.") (internal quotation marks omitted).

* * *

The drafters of the Dodd-Frank Act defined the key regulated entities and took care to exclude from those definitions parties that use swaps to hedge risks associated with their businesses. The margin provision of the Act, Section 731, repeatedly uses those defined terms—"major swap participants" and "swap dealer"—to limit the scope of the regulators' authority and to identify which parties are subject to the new mandatory margin regime. Statements by the key sponsors of the Act confirm what the text and structure of the Act make clear: Congress did not intend to authorize regulators to impose margin on end-users.

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[9] This straightforward reading of Section 724(c) is confirmed by the fact that the same segregation provision appeared in the earlier Senate version of the Act that expressly exempted all end-user swaps (*i.e.*, both sides to such transactions) from margining. *See* S. 3739, § 724(c). Obviously, if the language of Section 724(c) implied that margin rules apply to end-users, that earlier version of the bill would have been incoherent.

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Memorandum

Date: November 2010

Re: Retroactivity of Margin Requirements in Dodd-Frank Wall Street Reform and Consumer Protection Act

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") does not directly address whether its margin requirements apply to existing swap contracts entered into prior to enactment. The text is silent on that issue. Nor does the legislative history of the Act provide a clear expression of congressional intent to so regulate existing swaps contracts. If anything, it suggests that retroactivity was not intended.

The question, then, is whether the Act for the first time confers authority on the Commodity Futures Trading Commission and the Securities and Exchange Commission to impose margin requirements on existing swap contracts. This memorandum answers that question in the negative: The Act does not authorize regulators to impose margin requirements on the $600 trillion in over-the-counter derivatives transactions currently executed and outstanding.[1]

As a matter of statutory interpretation, the Act's silence concerning the retroactivity of margin rules means that such rules cannot apply to pre-enactment swaps, because retroactive rulemaking is impermissible absent express congressional authorization. Several aspects of the language and structure of the Act confirm this reading, including the deferred enactment date and the fact that where the drafters intended to regulate pre-enactment swaps, they did so *expressly* (in the reporting provision of the derivatives title). As noted, the legislative history relevant to this issue cuts against retroactivity. In any event, ambiguous evidence of legislative intent cannot overcome the judicial presumption against retroactive rulemaking.

A prospective-only interpretation is also necessary to avoid the serious constitutional difficulties that retroactive margin requirements would present. A retroactive rewriting of swap contracts to impose collateral obligations would be constitutionally suspect under the Takings Clause of the Fifth Amendment. Courts would be inclined to reject a retroactive interpretation of the Act's margin provision for this reason alone.

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[1] *See* Bank for International Settlements, *OTC derivatives market activity in the second half of 2009* at 1 (May 2010).

I. THE ACT DOES NOT AUTHORIZE REGULATORS TO IMPOSE RETROACTIVE MARGIN REQUIREMENTS

Section 731 and the parallel provision in the Act for security-based swaps, Section 764,[2] empower the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to impose "by rule or regulation" minimum margin requirements on non-bank "swap dealers and major swap participants." § 731 [p. 336].[3] It similarly empowers bank regulators to impose margin requirements on swap dealers and major swap participants that are depository institutions. *Id.*

The question is whether the Act authorizes regulators to apply margin requirements to swaps entered into before the enactment of this legislation. A two-step analysis guides that determination. First, a court would consider whether regulation of pre-enactment swaps triggers the judicial presumption against retroactivity. Second, the court would determine whether the presumption is overcome by an "express statutory grant" of retroactive rulemaking authority. *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208-09 (1988). As the analysis below demonstrates, the presumption clearly applies here, and the Act's silence concerning retroactive margin requirements is sufficient to bar regulators from imposing margin on pre-enactment swaps. The language of the Act as a whole and the legislative history confirm this interpretation.

A. Imposition of Margin Requirements on Pre-Enactment Swap Contracts Would Constitute Impermissible Retroactive Rulemaking

The law strongly disfavors retroactive rulemaking. "Even where some substantial justification for retroactive rulemaking is presented, courts should be reluctant to find such authority absent an express statutory grant." *Bowen*, 488 U.S. at 208-09; *Landgraf v. USI Film Prods.*, 511 U.S. 244, 265 (1994) (rule against retroactive lawmaking is "deeply rooted in our jurisprudence"). Courts apply the traditional presumption against retroactivity with particular vigor in the domain of agency rulemaking, because the Administrative Procedure Act itself "prohibits retroactive rulemaking." *Sierra Club v. Whitman*, 285 F.3d 63, 68 (D.C. Cir. 2002) (citing *Georgetown Univ. Hosp. v. Bowen*, 821 F.2d 750, 756-58 & n. 11 (D.C. Cir. 1987), *aff'd*, 488 U.S. 204 (1988)).[4] Consequently, "agencies do not have the authority to promulgate

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[2] Title VII of the Act includes parallel provisions applicable to swaps and security-based swaps, swap dealers and security-based swap dealers, and major swap participants and major security-based swap participants. As shorthand, we refer only to those provisions in Subtitle A, which apply to swaps markets, and not the parallel provisions in Subtitle B, which apply to security-based swaps markets.

[3] All citations to the Act are by section and page number [in brackets] to the final conference report, *available at* http://banking.senate.gov/public/_files/Rept111517DoddFrankWallStreetReformandConsumerProtectionAct.pdf.

[4] *See also Retail, Wholesale & Dep't Store Union v. NLRB*, 466 F.2d 380, 388 (D.C. Cir. 1972) (citing the APA, 5 U.S.C. § 551 (1982), which distinguishes a "rule" from an

[Footnote continued on next page]

retroactive rules unless Congress has expressly said they do." *Motion Picture Ass'n of Am., Inc. v. Oman*, 969 F.2d 1154, 1157 (D.C. Cir. 1992) (emphasis added); *Arkema Inc. v. E.P.A.*, No. 09-1318, 2010 WL 3363449, at *7 (D.C. Cir. Aug. 27, 2010) ("Generally, an agency may not promulgate retroactive rules without express congressional authorization.").

The presumption against retroactivity applies to the Act's margin requirement provision. A statute triggers the anti-retroactivity presumption if it would have an impermissible retroactive effect, "*i.e.*, [if] it would impair rights a party possessed when he acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed." *Landgraf*, 511 U.S. at 280. Under the "commonsense, functional" test for retroactivity, it is clear that a regulation requiring swap participants to post collateral on swap contracts entered into prior to enactment would "attach[] new legal consequences to events completed before [the law's] enactment." *Martin v. Hadix*, 527 U.S. 343, 357-58 (1999) (quoting *Landgraf*, 511 U.S. at 270). This is not a case in which a new regulation merely "alter[s] the value of existing assets" or disappoints economic expectations. *Bergerco Canada v. U.S. Treasury Dep't*, 129 F.3d 189, 192 (D.C. Cir. 1997). Instead, retrospective margin rules would impose "new burdens" on a consummated transaction. *Fernandez-Vargas v. Gonzales*, 548 U.S. 30, 46 (2006). Parties to uncollateralized swap agreements would be forced into burdensome and potentially destabilizing collateralized swap agreements to which they did not consent.

Courts commonly apply the anti-retroactivity presumption when, as here, the law "affect[s] contractual . . . rights, matters in which predictability and stability are of prime importance." *Landgraf*, 511 U.S. at 271 (collecting cases). For example, the D.C. Circuit has invoked the anti-retroactivity presumption to hold that a federal law prohibiting religious discrimination in termination of contracts did not apply to pre-enactment conduct. *See Gersman v. Group Health Ass'n, Inc.*, 975 F.2d 886, 889 (D.C. Cir. 1992). Likewise, the Sixth Circuit concluded that a statute prohibiting municipalities from granting exclusive franchise rights to cable operators could not be applied to nullify the exclusivity terms of a pre-enactment franchise agreement. *James Cable Partners, L.P. v. City of Jamestown*, 43 F.3d 277, 280 (6th Cir. 1995) ("If Congress had decided that some policy consideration justified the invalidation of existing contracts and the disruption of the parties' settled expectations, it would have stated its intent more clearly."). Similarly, the Fourth Circuit held that a South Carolina statute could not be applied to redefine the terms of insurance contracts entered prior to enactment. *Ward v. Dixie Nat'l Life Ins. Co.*, 595 F.3d 164, 173-74 (4th Cir. 2010); *see also Covino v. Reopel*, 89 F.3d 105, 107 (2d Cir. 1996) ("[A] presumption against retroactivity normally applies to new provisions affecting contractual or property rights."); *Scheidemann v. I.N.S.*, 83 F.3d 1517, 1522 (3d Cir. 1996) (noting that contract cases "represent perhaps the model context for application of the anti-retroactivity presumption"). In short, laws that effectively rewrite past contracts to impose new burdens trigger the presumption against retroactivity.

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"adjudication," and defines the former as "an agency statement of general or particular applicability and future effect" (emphasis added)).

It is undeniable that retrospective margin rules would disrupt existing swap contracts by nullifying a crucial, bargained-for contract term. Parties to thousands of existing swap contracts elected *not* to adopt margin terms, or to set margin at levels that may not satisfy new regulations. Those parties negotiated and agreed to pricing based on an understanding of their future obligations at the time the contract was executed. If a party to an existing swap contract made the lawful, commercially valid decision to require little or no margin, it came at a price; an uncollateralized swap can cost substantially more than a trade in which the party is obligated to post collateral. Such a party would have demanded a lower price—or may not have entered the contract—if it knew that it would be required to post collateral at some point in the future.[5]

Grafting margin requirements onto pre-enactment swap contracts would unfairly subject those parties to burdens that they neither agreed to nor could have anticipated when they entered into those contracts. Such a costly legal burden, imposed on a transaction entered into previously, without "fair notice," and contrary to the parties' "reasonable reliance and settled expectations," would necessarily trigger the presumption against retroactivity. *Landgraf*, 511 U.S. at 270.

B. The Text of the Act Confirms that Margin Requirements Are Prospective Only

The analysis next turns to the question whether the language of the Act can overcome the presumption against retroactivity. The Act's silence concerning retroactive margin requirements is sufficient to end the inquiry, because courts decline to find statutory authority for retroactive rulemaking "unless that power is conveyed by Congress in express terms." *PNC Fin. Servs. Group, Inc. v. C.I.R.*, 503 F.3d 119, 134 (D.C. Cir. 2007). The text and structure of the Act only *reinforce* the conclusion that regulators cannot impose margin on pre-enactment swaps.

First, the delayed enactment date of the derivatives subtitle signals prospective-only application of margin requirements. Section 754 defers the effective date for most provisions in the derivatives title to "360 days after the date of the enactment of this subtitle" or "60 days after publication of the final rule or regulation" implementing a particular provision, whichever is later. § 754 [p. 386-87]. When, as here, "Congress has delayed the effective date of a substantive statute that could in principle be applied to conduct completed before its enactment, [courts] presume the statute applies only prospectively." *Lytes v. DC Water & Sewer Auth.*, 572 F.3d 936, 941 (D.C. Cir. 2009); *see also Kaiser Aluminum & Chem. Corp. v. Bonjorno*, 494 U.S. 827, 838-39 (1990) (recognizing that a six-month delay in the effective date of the federal prejudgment interest statute suggested prospective-only application); *Bennett v. New Jersey*, 470 U.S. 632, 640-41 (1985) (according weight to future effective date in analyzing whether statutory

[5] For example, a 20 basis point credit charge on a 10-year, $100 million interest rate swap would cost a counterparty $1.8 million in present valued credit costs. If the counterparty knew that it would have to post collateral on this swap, it would have been able to secure a price that excluded this credit charge. The counterparty would not have entered into the swap at the higher price if it knew it would have to post collateral.

amendments were to be retroactive); *Kania v. Potter*, 358 Fed. App'x 338, 341 n.5 (3d Cir. 2009) (noting that a federal statute "appears to contain an 'express command' that it *not* apply retroactively, as Congress delayed its effective date by two months") (emphasis added); *Gay v. Sullivan*, 966 F.2d 1124, 1128 (7th Cir. 1992) (holding that "provision for a future effective date" is "strong evidence of a congressional rejection of retroactivity").

Second, where Congress intended other requirements of the derivatives subtitle to apply to pre-enactment swaps, it said so. In a provision titled "Transition Rules for Preenactment Swaps," Congress expressly extended the law's new reporting requirements to "[e]ach swap entered into before the date of enactment of [the Act], the terms of which have not expired as of the date of enactment of that Act." § 729 [p. 332]. The same provision also expressly authorizes the CFTC to promulgate reporting rules for pre-enactment swaps. *Id.* The "Transition" provision of Section 731—which covers margin rules—contains no equivalent grant of authority to set margin for pre-enactment swaps. This contrast confirms that the Act confers no authority to impose retroactive margin rules. *Duncan v. Walker*, 533 U.S. 167, 173-74 (2001) ("It is well settled that where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.") (internal quotation marks omitted).

Third, the language of the Act that confines margin-setting authority to *uncleared* swaps reinforces the conclusion that margin rules are strictly prospective. Under Section 731[(e)(2)(A) and (B)], margin requirements apply only to "swaps that are not cleared by a registered derivatives clearing organization." § 731 [p. 336]. That limitation is revealing. Congress' use of the present tense—"are not cleared"—suggests margin rules can apply only to swap contracts entered post-enactment. *Carr v. United States*, 130 S.Ct. 2229, 2237 (2010) ("Consistent with normal usage, [courts] frequently look[] to Congress' choice of verb tense to ascertain a statute's temporal reach."). For pre-enactment swaps, clearing would have occurred in the past. Yet the provision does not say "all swaps that *were not* cleared." This choice of words suggests "prospective orientation." *Gwaltney of Smithfield, Ltd. v. Chesapeake Bay Found., Inc.*, 484 U.S. 49, 57 (1987); *see also Carr,* 130 S. Ct. at 2236 (holding that use of present tense rather than past or present perfect tense "reinforces the conclusion that preenactment [conduct] falls outside the statute's compass"); *Gay v. Sullivan*, 966 F.2d at 1128.

In addition to its forward-looking language, the substance of Section 731[(e)(2)(B)] confirms that the margin provisions govern the same *class* of swaps as the clearing provisions—post-enactment swaps. Swaps required to be cleared must be submitted to a derivatives clearing organization and margin requirements apply only to swaps not cleared through a registered derivatives clearing organization. § 731 [p. 336]. The broader implication is that Section 731 governs the same class of swaps that are governed by the mandatory clearing provisions set forth in Section 723. That is significant because the "Clearing Transition Rules" provide that pre-enactment swaps fall entirely outside the Act's central clearing regime, so long as they are reported. *Id.* [p. 310] ("Swaps entered into before the date of the enactment of this subsection are exempt from the clearing requirements of this subsection if reported pursuant to paragraph (5)(A)."). Because pre-enactment swaps need not pass through the central clearing regime established by the Act, it makes sense that Congress would not have subjected those swaps to margin requirements.

In sum, the Act does not intimate, much less "express[ly] command," retroactive application of margin rules. *Landgraf*, 511 U.S. at 280. To the contrary, the text and structure of the Act signal prospective-only application.

C. The Legislative History Reveals No Reliable Congressional Intent With Respect to Retroactivity

The legislative history of the Act is ambiguous at best and cannot overcome the strong presumption against retroactivity. *Gersman*, 975 F.2d at 890-91.

One of the earliest statements concerning the effect of financial regulatory reform on existing swap contracts came in a December 2009 hearing of the Senate Agriculture Committee. In response to a question, Treasury Secretary Timothy Geithner expressed the Administration's view on how the new derivatives requirements should affect existing swap contracts. He testified: "A critically important issue, and as I said in my opening statement, the law needs to be crystal clear that it leaves in place existing contracts, does not change the legal nature, does not add to uncertainty about the legal nature of those claims."[6] Secretary Geithner went on to explain that the Administration was proposing "[o]ne exception . . . that for the existing stock of contracts that they be reported to a trade repository." As Secretary Geithner noted, such an "information-reporting" duty differs from the law's other requirements because it alters no contract terms and thus "creates no risk to legal certainty of these contracts." *Id.* Secretary Geithner concluded: **"But with that exception, our view is abuse reform should be prospective."** *Id.* This Administration position is consistent with the final law signed by the President, which carves out that "one exception" for the *reporting* of pre-enactment swap contracts. § 729 [p. 332].

To be sure, House and Senate managers of the financial reform legislation considered multiple approaches to achieve the "legal certainty" and prospective application that Secretary Geithner described. The introduced version of the House financial reform legislation exempted some pre-enactment swaps from margin requirements. *See* H.R. 4173, 111th Cong. § 3107 [533: 16-21] (2009). The House managers later stripped that language, with no public explanation. *See* Frank-Peterson Substitute Amdt. to H.R. 4173. Likewise, the initial Senate Agriculture Committee bill exempted all active pre-enactment swaps from margin requirements,[7] but the

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[6] OTC Derivatives Reform and Addressing Systemic Risk: Hearing Before the S. Comm. on Agric., Nutrition & Forestry, 111th Cong. 30-31 (Dec. 2, 2009) (testimony of Timothy F. Geithner, Secretary, U.S. Treasury Department).

[7] ‘‘(A) IN GENERAL.—Any swap entered into before the date of enactment of the Wall Street Transparency and Accountability Act of 2010, the terms of which have not expired as of the date of enactment, shall not be subject to the mandatory clearing or margin requirements under this Act." Chairman's Mark, S. Comm. on Agriculture, *Wall Street Transparency and*

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exemption was removed in reconciling that draft with the companion bill from the Senate Banking Committee—again with no apparent explanation.[8]

No discernable meaning emerges from this drafting history. The Supreme Court has recognized that Congress may reject or delete a provision in a bill "not necessarily because it disagreed with it" but because Congress "found [the provision] superfluous." *United States v. Rodgers*, 461 U.S. 677, 702 (1983). And as explained above, an express margin exemption would have been superfluous as a matter of statutory construction, because Congress does not have to say explicitly what default rules of construction *presume*. *See McNary v. Haitian Refugee Center, Inc.*, 498 U.S. 479, 496 (1991) (courts presume that Congress legislates against the backdrop of "basic rules of statutory construction").

Finally, in an important piece of legislative history, the Senate managers of the Act publicly addressed concerns that margin requirements could be applied retroactively to existing swaps. In a letter to the House managers of the bill, Senator Dodd and Senator Lincoln wrote:

> Congress recognized that the capital and margin requirements in this bill could have an impact on swaps contracts currently in existence. For this reason, we provided legal certainty to those contracts currently in existence, providing that no contract could be terminated, renegotiated, modified, amended, or supplemented (unless otherwise specified in the contract) based on the implementation of any requirement in this Act, including requirements on Swap Dealers and Major Swap Participants. It is imperative that we provide certainty to these existing contracts for the sake of our economy and financial system.

156 Cong. Rec. S6192 (daily ed. July 22, 2010) (Senator Lincoln) (quoting Dodd-Lincoln letter of June 30, 2010) (emphases added). The Dodd-Lincoln letter makes clear that the new margin rules cannot be applied to modify, amend or supplement "contracts currently in existence,"

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Accountability Act of 2010, 111th Cong. § 129 [185: 13:19], *available at* ag.senate.gov/site/ComLeg/ chairmansmark.pdf.

[8] In one public statement to reporters, Senator Dodd expressed his view that margin requirements should apply to pre-enactment swaps that have not been cleared. *See* Damien Paletta, *Democrats Deny Buffett on a Key Provision*, WALL ST. J., Apr. 27, 2010. That statement is hardly determinative. Media interviews are not a source of legislative history. Moreover, an isolated statement of opinion that is unsupported by the text of the Act and offered in response to a story that could have caused political embarrassment had Senator Dodd not responded as he did certainly cannot constitute the "express command" of retroactive effect that the law requires. *Landgraf*, 511 U.S. at 280. In any event, Senator Dodd later stated in a joint letter with Senator Lincoln that the final version of the Act *does* provide "legal certainty to those contracts currently in existence." 156 Cong. Rec. S6192 (daily ed. July 22, 2010) (Senator Lincoln) (quoting Dodd-Lincoln letter of June 30, 2010).

which no doubt includes uncollateralized swap contracts.[9] The Senators' statement refers to Section 739 of the Act, often referred to as the "Legal Certainty" provision, which generally bars application of the Act to disrupt pre-enactment contracts.[10] Although the language of Section 739 is opaque and could be read to restrict only the rights of the contracting parties, the Senators' letter makes clear that Section 739 was intended to restrict "the implementation of any requirement in this Act"—that is, the implementation by regulators. As contemporaneous press accounts reflect, this letter was understood as public confirmation that "new capital and margin regulations meant to offset risk in some trades should not apply retroactively to existing derivatives."[11]

This interpretation is in accord with the position that CFTC Chairman Gary Gensler and SEC Chairman Mary Shapiro recently articulated. At a September 30, 2010 hearing of the Senate Banking Committee, the chief regulators agreed that margin requirements should be "prospective, not retrospective."[12] As a matter of statutory interpretation and sound policy, Chairman Gensler and Chairman Shapiro are correct.

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[9] Senator Dodd and Senator Lincoln correctly noted that new margin and capital requirements may affect existing swap contracts. For example, as new requirements are imposed on future transactions, the liquidity impact could well hinder some parties' ability to meet their obligations on pre-enactment swaps. New margin requirements also would affect pre-enactment swaps to the extent that margin is imposed on a party's *net* position, which will necessarily be altered by future transactions (governed by new margin rules). Depending on the severity of the impact on any individual swap participant, that party could cite regulatory changes as a disruption event with respect to its *pre-enactment* contracts. Specifically, the party could invoke a force majeure provision like Section 5(b) of the 2002 International Swaps and Derivatives Association (ISDA) Master Agreement, which permits termination or non-performance based on, *inter alia*, major unanticipated "political or governmental" events that make performance "impossible or impracticable." It is not surprising, therefore, that the Dodd-Lincoln letter recognized that future margin and capital regulations could interfere with pre-enactment swaps, if only indirectly.

[10] (B) EFFECT ON SWAPS – Unless specifically reserved in the applicable bilateral trading agreement, neither the enactment of the Wall Street Transparency and Accountability Act of 2010, nor any requirement under that Act or an amendment made by that Act, shall constitute a termination event, force majeure, illegality, increased costs, regulatory change, or similar event under a bilateral trading agreement (including any related credit support arrangement) that would permit a party to terminate, renegotiate, modify, amend, or supplement 1 or more transactions under the bilateral trading agreement.

[11] Silla Brush, *Sens. Dodd, Lincoln issue letter easing worries on Buffett Wall Street provision*, THE HILL, July 1, 2010.

[12] *Financial Overhaul Law Implementation: Hearing of the Senate Comm. on Banking, Housing & Urban Affairs*, CQ Cong. Tr. (Sept. 30, 2010):

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II. A RETROACTIVE INTERPRETATION WOULD RAISE CONSTITUTIONAL DIFFICULTIES

A second judicial rule of statutory construction—the canon of constitutional avoidance—also counsels against a retroactive application of margin rules. The Supreme Court has held that when there is "substantial doubt" whether a statute's retroactive effects comport with the Fifth Amendment, a retroactive interpretation must avoided. *See United States v. Sec. Indus. Bank*, 459 U.S. 70, 78 (1982) (applying the canon of constitutional avoidance to render a bankruptcy statute prospective-only because it would have nullified pre-enactment liens). There is a strong case to be made that application of retroactive margin rules to pre-enactment swap contracts would work an uncompensated regulatory taking in violation of the Fifth Amendment.

The Fifth Amendment bars the taking of private property for public use without just compensation. A taking is not limited to outright acquisitions by the government for itself, but can also include economic regulations that transfer or burden property. *See Sec. Indus. Bank*, 459 U.S. at 78; *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982).

To establish a compensable taking based on retroactive margin requirements, the regulated parties would first have to show that the Act targets protected "property" within the meaning of the Takings Clause, and second, that the Act works a compensable "taking" of that property. With those two elements established, a court would then consider whether the taking was for public use, and whether the statute adequately provided for just compensation (here, clearly not).

1. Protected Property Interest

Swap participants have a property interest in their pre-enactment swap agreements. The Supreme Court has long held that "[v]alid contracts are property" protected by the Takings

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> Senator Johanns: Do you see any part of this legislation at all applying retroactively to derivative contracts that were entered into before the effective date of the legislation?
>
> Chairman Gensler: . . . [S]ome people have raised, what about the clearing requirement or margin requirement, so forth, and I'm just sharing one commissioner's view. I think that we should look that that should be prospective, not retrospective in that regard.
>
> Chairman Shapiro: I would really agree with that. We have heard the issue most frequently in connection with whether margins should—requirements should now apply. We also appreciate, though, that legal certainty is absolutely critical in this area. So while my commission hasn't dealt with this issue specifically, I think we would be hard pressed to suggest that there ought to be retroactive application of margin, but it's an issue we'll discuss extensively and also continue to take public comment on.

Clause, *Lynch v. United States*, 292 U.S. 571, 579 (1934), and legislation that "disregards or destroys existing contractual rights" can constitute an "illegal taking." *Connolly v. Pension Benefit Guar. Corp.*, 475 U.S. 211, 224 (1986); *see also, e.g.*, *Palmyra Pac. Seafoods L.L.C. v. United States*, 561 F.3d 1361, 1364-65 (Fed. Cir. 2009), *cert. denied*, 130 S. Ct. 2402 (2010) ("[C]ontract rights can be the subject of a takings action."). In *Lynch*, the Court concluded that the Fifth Amendment limits the government's ability to relieve itself of contract obligations by legislating them out of existence. 292 U.S. at 579. The Court went on to hold that Congress could not abrogate World War II-era risk insurance contracts without compensating the beneficiaries. *Id.* Although *Lynch* involved government contracts, the Court stated that contract rights are property within the meaning of the Takings Clause, "whether the obligor be a private individual [or a local, state or federal government entity]." *Id*; *see also Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1003 (1984) (citing *Lynch* for proposition that valid contracts are property under the Takings Clause); *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1, 19 n. 16 (1977) ("Contract rights are a form of property and as such may be taken for a public purpose provided that just compensation is paid."). Under the rule of *Lynch*, there is a strong argument that margin requirements that substantially diminish the value of pre-enactment swap contracts without compensation would violate the Fifth Amendment.

This argument finds further support in the reasoning and analogous facts of *United States v. Winstar Corp.*, 518 U.S. 839 (1996). There the Court considered a challenge by several savings and loan institutions ("thrifts") to changes in capital requirements and regulatory accounting rules imposed by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. 101-73, 103 Stat. 183. Before that statute's enactment, federal regulators encouraged healthy thrifts to merge with failing thrifts. Regulators successfully induced such "supervisory mergers" by promising, among other incentives, favorable accounting treatment designed to help newly-merged thrifts meet federal regulatory capital requirements. *Id.* at 851-852 (plurality op.). Years later, FIRREA mandated reversal of those regulatory indulgences and compelled regulators to apply uniform, stringent capital requirements to all thrifts. *Id.* at 857. As a result, the merged thrifts fell out of compliance with capital requirements and went into receivership. *Id.* On these facts, the *Winstar* plurality concluded that the favorable accounting treatment was the subject of an express agreement between the thrifts and the regulators, that FIRREA effected a breach of those contracts, and that the government was liable to the affected thrifts for damages. *Id.* at 843.

To be sure, *Winstar* was (formally) decided as a breach of contract case. But takings jurisprudence guided the plurality's analysis. The plurality explained that just as the Takings Clause bars the "Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be born by the public as a whole," the government is prohibited from simply "shift[ing] costs of legislation onto its contractual partners who are adversely affected by the change in the law, when the government has assumed the risk of such change." *Id.* at 883 (quoting *Dolan v. City of Tigard*, 512 U.S. 374, 384 (1994) (holding that a city requirement that a landowner dedicate a portion of her property for flood control and traffic improvements constituted an unconstitutional taking)) (internal citation and quotation marks omitted)). The same protection that the Takings Clause accords to private-party contracts was supplied, in *Winstar*, by the law of government contracts. Drawing on the reasoning of *Winstar*, swap participants would have a strong argument that just as the federal government cannot freely vitiate its contracts by imposing destructive capital requirements contrary to its own promises, neither can it substantially diminish the value of pre-enactment swaps by imposing margin requirements to defeat private parties' contractual arrangements.

2. Compensable "Taking"

It is clear that swap contracts are protected property. The next question—whether retroactive margin rules would effect a "taking" of that property—is guided by the three factors set forth in *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978): (1) "the economic impact of the regulation on the claimant"; (2) "the extent to which the regulation has interfered with distinct investment-backed expectations"; and (3) "the character of the governmental action." *Id.* at 124. It is difficult to apply this "ad hoc and fact intensive" inquiry with precision here, since we are dealing with future regulations of unknown scope and severity. *Eastern Enterprises v. Apfel*, 524 U.S. 498, 523 (1998). But it is likely that retroactive margin requirements would constitute a compensable taking action.

Economic impact. Requiring a party to post margin diminishes the market value of that party's derivative contracts. As a matter of basic accounting, imposition of a margin requirement on an existing trade would force the party posting collateral to mark down the recorded fair value of its trades.[13] The full extent of the impact would obviously depend on the *degree* to which the margin requirements diminish the economic value and utility of the swaps, and on degree to which the requirements so burden the holder of numerous swaps contracts as to render the obligations *collectively* unfeasible or destabilizing. Some swap participants simply would not have enough liquidity to meet new margin obligations on existing contracts. Others may not even be in a position to borrow cash to cover these unforeseen obligations, either because their assets are already pledged to lenders, because they are precluded from doing so by covenants in their debt agreements, or because they cease to be sufficiently creditworthy.

On the whole, there can be little doubt that the economic impact on swap participants would be considerable. A 2010 survey of Business Roundtable members offered an early glimpse of the potential effect of margin rules. Based on responses collected from major corporations based on their *existing* stock of OTC derivatives, the study reported that a 3-percent

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[13] Collateral requirements have implications for any firm that reports financial statements under Generally Accepted Accounting Principles. The fair value of a derivative must account for the impact of nonperformance risk. *See* Fin. Accounting Standards Bd., Accounting Standards Codification, *Topic 820: Fair-Value Measurements and Disclosures* (2009). This requirement stipulates that when a trade exposes one party to risk from its counterparty—that is, when a derivative contract is an asset to the holder—then the fair value of this asset must be reduced to account for the risk that the counterparty will *not* perform on its obligations. Correspondingly, when a derivative contract is a liability to the holder, then the fair value of this liability must be reduced to account for the party's own risk of nonperformance. These two adjustments to the fair value make up the net credit valuation adjustment and are used to adjust the settlement value to reflect the true fair value of the position.

margin requirement would impose an average $269 million in collateral obligations *per firm,* and $33 billion in drained liquidity on S&P 500 firms.[14]

Investment-backed expectations. Margin requirements would seriously disrupt swap participants' investment-backed expectations. The degree of retroactivity is a focal point of analysis under this second factor, *Eastern Enterprises*, 524 U.S. at 530, so an attempt by regulators to impose burdens based on years-old contracts would be suspect. It is also clear that swap participants lacked "sufficient notice" that swap transactions would come under regulatory scrutiny, *Connolly*, 475 U.S. at 227, given the traditionally limited regulation of OTC derivatives between sophisticated parties. *See, e.g.*, CFTC, Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989).

Character of the government's action. The contemplated government action does not resemble the physical invasion or permanent appropriation that typically operates as a regulatory taking. *Connolly*, 475 U.S. at 225. But a plurality of the Supreme Court held in *Eastern Enterprises* that a regulation can be so "usual," intrusive, and burdensome that it "implicates fundamental principles of fairness underlying the Takings Clause." *Eastern Enterprises*, 524 U.S. at 531. A strong argument can be made that retroactive margin requirements would be such a regulation, especially in light of the Legal Certainty provision (Section 739) of the Act. *See supra* note 10. That provision precludes contracting parties from using passage of the Act as a justification for, among other things, termination or non-performance of swap contracts. The combined effect of retroactive margin requirements and Section 739 would be to *rewrite* the terms of past swap contracts and then *nullify* the parties' right to amend or unilaterally terminate those contracts based on unforeseen regulatory change or illegality. A law that not only alters a key term of a past contract, but also locks a contracting party into the revised contract, may well be unprecedented. It would certainly be susceptible to a fundamental fairness attack under the Court's Takings Clause jurisprudence. *See Eastern Enterprises*, 524 U.S. at 531

Even if a court concluded that retroactive margin rules raise a close but unsettled constitutional question, the court would likely adopt a limiting construction to preclude retroactivity.

* * *

The Dodd-Frank Wall Street Reform and Consumer Protection Act cannot reasonably be construed to authorize retroactive margin rules. A regulatory attempt to require swap participants to post collateral on pre-enactment swap contract would set off a round of litigation that would result in judicial invalidation of those rules—and perpetuate uncertainty in the derivatives market in the meantime. The text does not warrant retroactivity, the legislative history does not support it, and there is substantial doubt whether retroactive margin rules would be consistent with the Takings Clause. Margin regulations promulgated under the Act should therefore be strictly prospective.

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[14] This analysis is quite conservative because it ignores the application of a variation margin requirement and ignores the impact on those companies not in the S&P 500.