GIBSON DUNN

Gibson, Dunn & Crutcher LLP

1050 Connecticut Avenue, N.W.
Washington, DC 20036-5306
Tel 202.955.8500
www.gibsondunn.com

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]

---

[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

[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.

---

[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.
>
> 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

[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 <u>not</u> 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

---

[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

---

[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.

---

[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.