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Jennifer J. Johnson, Secretary
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Office of the Comptroller of the Currency
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Washington, DC 20219

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
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Alfred M. Pollard, General Counsel
Attention: Comments/RIN 2590-AA45
Federal Housing Finance Agency
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Gary K. Van Meter, Acting Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102

Re: Swap Margin Proposals

Ladies and Gentlemen,

We are submitting this letter in response to the request by several regulatory agencies[1] (the "Agencies") for comments on proposed rules (the "Proposed Rules")[2] under Sections

[1] The Commodity Futures Trading Commission (the "CFTC"), the Board of Governors of the Federal Reserve System (the "Board"), the Office of the Comptroller of the Currency (the "OCC"), the Federal Deposit Insurance Corporation (the "FDIC"), the Federal Housing Finance Agency (the "FHFA") and the Farm Credit Administration (the "FCA").

731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act governing margin and capital requirements applicable to swap dealers and major swap participants (together, "swap entities").

In particular, we are writing to express concern about the proposal to designate foreign sovereigns as "financial end users" or "financial entities" in the Proposed Rules. We believe that this designation is neither appropriate nor necessary to achieve the stated objectives of the Proposed Rules. Transactions with foreign sovereigns do not generally pose the type of risk to the safety and soundness of swap entities that would justify the categorical application of margin requirements to them. To be sure, some foreign sovereigns are risky counterparties, but the same can be said for many corporate end users and U.S. states and municipalities. Moreover, as a matter of international comity, it is simply inappropriate for the United States to impose limits on the credit available to foreign sovereigns, especially when such limits are based solely on sovereigns' "foreign" status, rather than any objective, risk-based criteria.

As a result, we respectfully propose that the Agencies modify the Proposed Rules so as to exclude non-cleared swap transactions involving foreign sovereign counterparties or, in the alternative, to treat foreign sovereign counterparties as non-financial end users.

Our Firm has substantial experience in representing foreign governments and their agencies and instrumentalities in international financial transactions, including derivatives. We represent or have represented more than 30 foreign sovereigns[3] on external financial transactions over the past several decades. Through these representations, we have become keenly aware of the unique issues applicable to international financial transactions involving sovereigns, as well as the variety of type of sovereign entities, such as governments, ministries, central banks, sovereign wealth funds and other agencies and instrumentalities.

The Agencies have proposed to classify foreign sovereigns as "financial end users" based on their preliminary belief that:

> the financial condition of a sovereign will tend to be closely linked with the financial condition of its domestic banking system, through common effects of the business cycle on both government finances and bank losses, as well as through the safety net that many sovereigns provide to banks. Such a tight link with the health of its domestic banking system, and by extension with the broader global financial system, makes a sovereign counterparty similar to a financial end user both in the nature of the systemic risk and the risk to the safety and soundness of the covered swap entity.[4]

We respectfully submit that this general characterization is in many (and perhaps most) cases inaccurate. While sovereign risk has proved to be closely tied to banking system risk in a

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2 The Proposed Rules are included in Margin and Capital Requirements for Covered Swap Entities, Board Docket No. R-1415, Docket No. OCC-2011-0008, FDIC RIN 3064-AD79, FHFA RIN 2590-AA45, FCA RIN 3052-AC69, 76 Fed. Reg. 27654 (May 11, 2011)(the "PR Release") and Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, CFTC RIN3038-AC97, 76 Fed. Reg. 23732 (April 28, 2011) (the "CFTC Release").

3 We have worked on international financial transactions for foreign governments, agencies and instrumentalities of Abu Dhabi, Argentina, Belgium, Cameroon, Chile, Colombia, Congo (Brazzaville), Costa Rica, Dominica, Dominican Republic, Ecuador, Gabon, Grenada, Guatemala, Guyana, Indonesia, Iraq, Ivory Coast, Kenya, Korea (Republic of), Liberia, Madagascar, Malaysia, Mexico, Nicaragua, Nigeria, Peru, the Philippines, Russia, Slovenia, Tanzania and Uruguay. We have also represented multilateral financial organizations such as African Development Bank, the Asian Development Bank, the Bank for International Settlements, the Council of Europe Development Bank and the European Investment Bank.

4 PR Release at 27571; CFTC Release at 27376.

few high profile cases (most notably, Iceland), the link between the soundness of a banking system and the credit profile of a sovereign is often tenuous, and may in some cases lack any discernible correlation. For example, the credit of countries with substantial natural resource wealth will typically be much more sensitive to commodity prices than to domestic bank performance. Large industrialized countries – even those that provide support to their domestic banking systems – have tax bases that include a variety of industries, including some that are countercyclical to banking industry tendencies. Export-driven economies provide their governments with sources of revenues that generally are not correlated to the strength of their domestic banks.

We also believe that the derivatives activities of sovereigns rarely resemble those of swap dealers and other financial counterparties. In our experience, sovereigns typically enter into derivatives for hedging purposes – covering borrowing costs, commodity price fluctuations, long-term investments, foreign exchange risk and the like. Even where this is not the case, derivatives are used in long-term investment strategies, rather than the type of leveraged arbitrage strategies employed by hedge funds and other financial end users. Sovereigns are not "interconnected" and thus do not pose the type of systemic risk cited by the Agencies in proposing to impose stringent margin requirements for transactions involving financial end users.[5] Similarly, we are not aware of any evidence that sovereigns present the type of increased default risk during periods of financial stress cited by the Agencies as a reason for greater vigilance with respect to financial counterparties.[6] To the contrary, we would expect the default risk of sovereigns in times of financial stress to resemble that of non-financial end users more than that of financial end users, given the diverse range of long- and short-term funding sources available to them and their use of derivatives primarily for hedging, rather than speculative, purposes.[7]

More fundamentally, it would be extraordinary for the United States to adopt rules that effectively require sovereigns to pledge their assets to support United States financial institutions.[8] It is difficult to imagine the United States accepting a similar requirement imposed by a foreign government for transactions between banks in the foreign state and U.S. government agencies and instrumentalities. Such a requirement is inconsistent with basic principles of international comity.

There are also numerous unique issues that should be considered as part of the analysis of the swap margin rules as applied to foreign sovereigns:

- Some foreign sovereigns are subject to negative pledge restrictions imposed by multilateral lending institutions (such as the World Bank), which prohibit them from pledging their assets.[9]

- Legislative action might be needed in order for some sovereigns to pledge assets or to increase the amounts of their pledged assets to meet margin calls.

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5 PR Release at 27571.

6 Id.

7 See CFTC Release at 23736 (describing the difference between financial and nonfinancial entities).

8 Of course, some sovereigns would not do so, transferring their business to non-U.S. counterparties. However, given the importance of U.S. financial institutions in the international markets, many sovereigns are effectively required to conduct substantial business with U.S. institutions. The swap margin rules, if adopted in their current form, would effectively impose margin requirements on these sovereigns.

9 In contrast, negative pledge clauses applicable to most private counterparties do not apply to derivatives transactions, or contain exceptions sufficient to allow compliance with margin requirements.

- Pledged assets eligible to be returned to sovereigns could be subject to attachment by creditors of sovereigns, including in cases where the United States is working to assist sovereigns to avoid the risk of attachment.[10]

- The limitation of permissible margin to cash and U.S. government securities might effectively require foreign sovereigns to incur foreign exchange risk where their derivatives transactions are denominated in other currencies.

- Foreign sovereigns typically do not have existing custodial relationships that could easily be used to manage margin requirements. The Proposed Rules would effectively impose on a sovereign an obligation to put in place a custodial relationship with a bank (which ironically would increase the sovereign's exposure to the banking system).

We respectfully submit that transactions with foreign sovereigns should not be subject to the swap margin requirements. Swap entities engaging in transactions with foreign sovereigns would, of course, monitor their credit exposure to sovereigns and hold appropriate levels of capital against those exposures, just as they would in connection with their lending business to sovereigns. Given that sovereigns do not present the type of financial system risk observed at financial counterparties, and that they present issues of comity as well as the other special issues described above, we believe that an exception is the most appropriate treatment.

If the Agencies, despite the reasoning presented above, decide that swap margin rules should apply to transactions with sovereign counterparties, we believe that sovereigns should be treated as non-financial end users, so that swap entities may determine the level of margin to require on the basis of their assessment of sovereign credit risk. We emphasize, however, that we believe this to be a second-best solution, and that a full exception is the most appropriate outcome.

We appreciate the opportunity to participate in this process, and hope that the Agencies will find our thoughts to be useful as they consider the scope of the final swap margin rules.

Sincerely,

Andrew A. Bernstein

cc: Edward J. Rosen, Esq.

[10] For example, the United States has supported United Nations Security Council Resolution 1483 and successor resolutions, which have provided protection from creditors to the Republic of Iraq during the country's ongoing reconstruction period.