BETTER MARKETS
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November 24, 2014

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Re: Margin and Capital Requirements for Covered Swap Entities (Docket ID OCC-2011-0008; RIN 1557-AD43; Docket No. R-1415; RIN 7100 AD74; RIN 3064-AE21; RIN 3052-AC69; RIN 2590-AA45)

Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the above-captioned joint proposed rule ("Proposed Rule") of the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve ("Board"), the Federal Deposit Insurance Corporation ("FDIC"), the Farm Credit Administration ("FCA"), and the Federal Housing Finance Agency ("FHFA") (collectively, "Prudential Regulators" or "Agencies").

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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## INTRODUCTION

### The 2008 financial crisis highlighted the need for reform in the derivatives markets.

The 2008 global financial crisis demonstrated that the size, interconnectedness, and opacity of over-the-counter ("OTC") derivatives exposures can amplify and spread financial stress across many markets, with devastating consequences for the U.S. and global economies. The cost of the crisis has been in the trillions and the economic wreckage has hurt tens of millions of Americans.[2] To strengthen the derivatives markets, enable them to withstand shocks, promote transparency, and limit the risk of contagion, U.S. and foreign regulators agreed to adopt two fundamental reforms:

1. requiring standardized OTC derivatives to be electronically-traded and cleared to the greatest possible extent; and

2. requiring non-cleared derivatives to be subject to explicit margin and capital requirements.

An early formulation of this approach was reflected in the G20 declaration issued by the Group of Twenty ("G20") Leaders following their 2009 summit held in Pittsburgh:

> "Improving over-the-counter derivatives markets: All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. **Non-centrally cleared contracts should be subject to higher capital requirements.**"[3]

In 2011, the G20 agreed to add margin requirements on non-centrally cleared derivatives to the derivatives reform program.[4]

In 2010, Congress passed the Dodd-Frank Act, which instituted a comprehensive new regulatory framework for the derivatives markets. Specifically with respect to non-centrally cleared derivatives, the law requires the imposition of new margin and capital requirements, to reduce systemic risk and to promote central clearing.

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2 *See* Better Markets, The Cost Of The Wall Street Collapse And Ongoing Economic Crisis Is More Than $12.8 Trillion (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf.

3 G20 Information Centre, *G20 Leaders Statement: The Pittsburgh Summit* (Sept. 24-25, 2009), *available at* http://www.g20.utoronto.ca/2009/2009communique0925.html (emphasis added).

4 G20 Information Centre, *Cannes Summit Final Declaration – Building Our Common Future: Renewed Collective Action for the Benefit of All* (Draft, Nov. 4, 2011), *available at* http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html.

**The Dodd-Frank Act requires the imposition of new capital and margin requirements for non-cleared swaps.**

Sections 731 of the Dodd-Frank Act prescribes capital and margin requirements applicable to swap dealers ("SDs") and major swap participants ("MSP's") (collectively, "Covered Entities"), and Section 764 of the Act prescribes similar requirements applicable to the related security-based swap market participants. Sections 731 and 764 explicitly state that prudential regulators shall adopt rules for SDs and MSPs imposing capital requirements and both initial and variation margin requirements as to **all swaps that are not cleared** by a registered derivatives clearing organization ("DCO").[5] With respect to SDs and MSPs for which prudential regulators are not the primary regulators, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") are required to promulgate margin and capital requirement rules, as appropriate.

Section 731 articulates both the overriding goal of these requirements and the principles that must guide their implementation:

> "STANDARDS FOR CAPITAL AND MARGIN.—
>
> (A) IN GENERAL.—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 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."[6]

Furthermore, Sections 731 and 764 outline the risk management procedures, information gathering provisions, and antitrust considerations that must be considered in the implementation of the margin and capital requirements.

**The Agencies are revising an initial proposal in light of comments received and recent international developments.**

The Agencies released the initial proposal for margin and capital requirements for uncleared swaps in May 2011,[7] which generated numerous extensive comments. Following the release of the initial proposal, global financial regulators continued their work on developing a globally consistent framework for margin requirements for non-centrally cleared derivatives. In 2011, the G20 reached a consensus that margin

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[5] 7 U.S.C. § 6s; 15 U.S.C. § 78o-10.
[6] 7 U.S.C. § 6s .
[7] Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 (May 11, 2011).

requirements on non-centrally cleared derivatives were an essential element of comprehensive financial reform.[8]

Accordingly, in September of 2013, the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO")[9] released a document outlining the key objectives, elements, and principles of the final margining framework for non-centrally cleared derivatives.[10] This document emphasizes that the two main benefits of such margin requirements are **reduction of systemic risk and promotion of central clearing**.

The international framework promotes "universal two-way margin" for all financial firms and systemically important non-financial entities, outlines the methodologies for calculating initial and variation margin, provides an overview of rigorous and robust dispute resolution procedures, specifies eligible collateral, and outlines suggestions for the interaction of national regimes in cross-border transactions, among other matters.

As explained in the release accompanying the Proposed Rule, the Agencies concluded that a number of changes to the 2011 proposal were warranted to help "achieve the 2013 international framework's goal of promoting global consistency and reducing regulatory arbitrage opportunities," and "to reflect certain comments received."[11]

## Overview of the Proposed Rule

The Proposed Rule is based on five main sources:

- The swaps-related provisions of Title VII of the Dodd-Frank Act, including sections 731 and 764, which are intended in general to reduce risk, increase transparency, promote market integrity within the financial system, and reduce the ability of firms to take on excessive risks through swaps without sufficient financial resources.
- Other Dodd-Frank provisions, such as the CFTC and SEC definitional rules[12], and the Treasury determination to exempt foreign exchange swaps and foreign exchange forwards from certain swap requirements, including margin requirements.
- The 2013 BCBS-IOSCO international framework on margin requirements for non-centrally cleared derivatives.

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8 G20 Information Centre, *supra* note 4.

9 BCBS members from the USA include the Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation. IOSOC Board members from the USA include the Securities and Exchange Commission and Commodity Futures Trading Commission.

10 Basel Committee on Banking Supervision, *Margin requirements for non-centrally cleared derivatives – final report issued by the Basel Committee and IOSCO* (Sept. 2, 2013), *available at* http://www.bis.org/press/p130902.htm.

11 Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348, 53 (Sept. 24, 2014), henceforth "Release."

12 Including, among others, definitions of "swap dealer," "MSP," "security-based swap dealer," "major security-based swap dealer," "swap," "security-based swap," "foreign exchange swap," and "foreign exchange forward."

- Banking risk-based capital rules.[13]
- The 2010 BCBS international framework for more resilient banks and banking system commonly known as "Basel III."[14]

The principal focus of the Proposed Rule is on margin requirements applicable to uncleared swaps.[15] It addresses a broad range of issues, include the following:

- initial and variation margin;
- bilateral nature of margin;
- methods of margin calculation (internal models and standardized look-up table);
- material swap exposure;
- treatment of FX swaps;
- segregation of margin;
- re-hypothecation of margin;
- margin netting arrangements;
- eligible collateral;
- custodian functions;
- cross-border margin application and substituted compliance;
- FHFA exemption;
- commercial end-users treatment;
- documentation.

Below, we highlight some positive aspects of the Proposed Rule, but we also address six specific areas in which the Proposed Rule must be strengthened to comply with the letter and intent of the Dodd-Frank Act.

## SUMMARY OF COMMENTS

The Proposed Rule provides a good general framework for imposing margin and capital requirements for SDs, MSPs, and other relevant counterparties as mandated in Section 731 of the Dodd-Frank Act. It represents a significant improvement over the 2011 proposal in three crucial respects. First, it mandates 2-way (collect-and-post) margin between Covered Entities, whereas the 2011 proposal focused on collection only. Second, the Agencies correctly maintain the provision in the 2011 proposal that limits the permissible form of variation margin to cash, thereby mitigating the potential for disputes over the value of variation margin collateral. Third, the proposal retains and strengthens the collateral segregation and documentation requirements.

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13 Including, among others, Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action and associated rules on risk-based capital, market risk adjustments, internal-ratings-based, and advanced measurement approaches.

14 *See* International regulatory framework for banks (Basel III), http://www.bis.org/bcbs/basel3.htm.

15 With respect to capital requirements relating to uncleared swaps, the Proposed Rule simply adopts preexisting prudential standards.

However, some of the proposals in the rulemaking fall far short of reaching the stated goals and must be strengthened. To satisfy the letter and the objectives of Section 731 of the Dodd-Frank Act, the following major deficiencies in the Proposed Rules must be addressed.

1. **The Proposed Rule should contain no exemptions to the universal two-way margining requirements.**

The Proposed Rule provides Covered Entities with the right, but not the obligation, to collect initial and variation margin from counterparties that are not Covered Entities or financial end-users ("Other Counterparties"), at the Covered Entity's discretion, without the obligation to post margin to such counterparties under any circumstances. That is directly inconsistent with the law as set forth in Section 731, which imposes "both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization."[16]

The Agencies may have been motivated by a concern that certain small commercial end-users would need relief from margin requirements. However, the discretionary one-sided imposition of a margin requirement by a Covered Entity on its counterparty provides no predictable assurance for end-users that they will be excused from the margin obligation. Moreover, it endows Covered Entities with a dangerous and arbitrary power to issue margin calls. This could lead to the unintended consequence of Covered Entities issuing unexpected margin calls during a liquidity shortage, precisely when small end-users will have the hardest time raising extra cash. That could immediately exacerbate instability in the financial markets, potentially creating harmful shocks to the real economy.

2. **The commercial end-user exemption should be narrowly tailored instead of broadly applied to a wide range of "Other Counterparties."**

The Agencies must narrowly define what constitutes a commercial end-user. The current classification applied to commercial end-users is unclear, ambiguous, and often misleading, potentially allowing, indeed incentivizing, financial entities, including Covered Entities, to define or redefine themselves as commercial end-users.

While it may be challenging to clearly delineate who is a bank holding company, Covered Entity, other entity, or commercial end-user when applying exemptions to capital and margin rules, the Proposed Rule should adopt the CFTC concept of the "end-user exemption" to the clearing requirements for swaps.

[16] 7 U.S.C. § 6s.

**3. Financial regulators must not outsource their rulemaking, interpretative, and dispute resolution functions to particular private sector groups, such as ISDA.**

The Proposed Rule relies on private law constructs, such as "eligible master netting agreements," to permit a Covered Entity to calculate initial margin requirements for swaps with a counterparty on a portfolio basis or to calculate variation margin requirements. In practice, however, the overwhelming majority of existing netting agreements for derivatives transactions are governed by a much larger Master Agreement published by the International Swaps and Derivatives Association ("ISDA"), whose membership is primarily comprised of SDs and MSPs. Those master netting agreements include a number of provisions, such as mandatory arbitration covenants, which may be counter to the interests of the counterparties. Endorsing their use for regulatory purposes not only surrenders oversight to private parties, it also promotes the imposition of onerous obligations on counterparties.

Effectively, the Proposed Rule could be seen to outsource key provisions of the rulemaking authority to a private law construct that favors a specific class of market participant (Covered Entities) over others (small commercial end-users). To remedy this, the Agencies must prepare a framework for swap netting as part of a rulemaking where the interests of end-users, commercial entities, and other non-SDs are duly reviewed and protected and where the process is public and therefore transparent.

**4. Certain definitions in the proposed rulemaking are not appropriate to achieve the goal of the regulation.**

*"Affiliate" and "Control"*

The Proposed Rule defines the term "affiliate" to mean any company that controls, is controlled by, or is under common control with another company.[17] As the Agencies rightfully indicated, the definition of "affiliate" is meaningless without the definition of "control." However, the proposed definition of control to be used for this supervisory purpose,[18] as borrowed from the Bank Holding Company Act, is outdated and inappropriate. It will not achieve the sound risk management goals that Congress intended for uncleared swaps.

Certainly, some of the control tests in the Proposed Rule are appropriate, including a 25 percent voting right and control of the election of a majority of directors and trustees. However, they do not capture the complexity of modern corporate models and do not reflect the current market structure and business organizations in the swaps markets. Regulators should incorporate the concept of "effective control" as developed by the Financial Accounting Standards Board ("FASB"). That will allow the regulation to cover structures like "variable interest entities," "special purpose entities," and others in the margin and capital framework required by Dodd-Frank Act.

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[17] Release at 89.
[18] *Id.*

*"Investment Fund"*

When applied to investment funds, the Proposed Rule's definition of control conflicts with the Dodd-Frank Act and the international framework. The Agencies should be concerned that the proposed exclusion of investment funds from consolidation requirements, without a clear definition of an investment fund, will promote the inclusion of investment funds into larger corporate structures to achieve a particular regulatory outcome.

The Agencies must introduce an investment fund "separateness test." The "separateness test" would evaluate whether an investment fund is a legal entity or not. If a fund is not a legal entity, it must be consolidated; if it is a legal entity, the analysis of its funding, income/revenue distribution, guarantees, buy-back provisions, and other elements must be reviewed to ensure that any outstanding liabilities and potential losses are circumscribed within the fund by appropriate legal barriers.

**5. The Proposed Rule must further restrict the permissible forms of initial margin collateral and institute a mandatory annual review of all permitted asset classes and any corresponding haircuts.**

The release explains that the Proposed Rule would "permit a broader range of collateral to be pledged to satisfy the initial minimum collateral requirements."[19] Included among the additional forms of collateral are "any major currency," a "publicly traded debt security," and a "publicly traded common equity" included in a variety of indices. The agencies propose to exclude "any corporate securities (equity or debt) issued by the counterparty or any of its affiliates," as well as the securities of various other domestic and foreign financial institutions."[20]

Even with the exclusion, this expansion goes well beyond the initial proposal, which limited the permissible forms of initial margin collateral to cash, obligations issued or fully guaranteed by the U.S., or senior debt obligations issued by the GSEs.[21] While cash and cash equivalents may be the optimal and desirable forms of margin collateral from one standpoint, limiting the universe of permitted margin collateral so narrowly, as in the initial proposal, could have undesirable effects, given market realities. Therefore, the expansion in the Proposed Rule is appropriate, subject to two conditions. First, no equity securities should be eligible for initial margin, as they are tied to the idiosyncratic risks associated with specific companies. Second, the Agencies should implement a mandatory annual review for all non-cash and non-cash equivalent margin collateral and haircuts ("Collateral Annual Review"), as discussed further below.

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[19] Release at 71.
[20] Release at 71-72.
[21] Release at 70.

**6. The Foreign operations of U.S. Covered Entities and counterparties and U.S. operations of the foreign Covered Entities and counterparties should be subject to the margin and capital requirements.**

The Proposed Rule relies too heavily on foreign regulatory frameworks. Moreover, it allows for circumstances where foreign subsidiaries of U.S. financial institutions will not be subject to the margin rules altogether. In light of the global nature of swap operations by U.S. Covered Entities and their counterparties, outsourcing the U.S. margin and collateral framework for uncleared swaps to foreign regulators promotes regulatory arbitrage and increases systemic risk both in the U.S. and globally. Thus, the Agencies should exercise their general safety and soundness authority to apply margin rules to foreign subsidiaries, entities that otherwise could avoid the U.S. margin regime for non-cleared swaps.

In particular, the approach in the Proposed Rule raises three concerns:

- *Mis-calculation of the material exposure of the Covered Entity.* Exclusion of foreign aspects of the Covered Entity's uncleared swap business could artificially bring the would-be Covered Entity below the material exposure threshold. The Agencies should require that all locations and types of activities in uncleared swaps should be consolidated for the purpose of this rule and, in particular, the material exposure calculation.

- *Conflict with the FBO rule.* The margin requirement exclusion for foreign institutions operating in the U.S. contradicts the spirit of the foreign banking organization ("FBO") rule.[22] The February 18, 2014 FRB press release regarding the FBO rule emphasizes the importance of the U.S. operations of foreign banking organizations and the need to promote a level playing field among all banking firms operating in the United States. The margin requirements for uncleared swaps should be consistent with the spirit of FBO regulation. Consequently, all U.S. activities of foreign entities in uncleared swaps should be subject to the margin and capital requirements for Covered Entities.

- *Avoidance of the margin regime by foreign subsidiaries of U.S. insured depository institutions.* The Agencies acknowledge a concern that "a foreign subsidiary of a U.S. insured depository institution. . . may engage in non-cleared swaps activities abroad, without having to register with the CFTC and SEC, and accordingly without being covered by the margin rules being proposed."

[22] Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17240 (Mar. 27, 2014).

**COMMENTS**

1. **The Proposed Rule should contain no exemption to the universal two-way margining requirements.**

As outlined in Section 731 of the Dodd-Frank Act, the Agencies must adopt rules for SDs and MSPs, with respect to their activities as an SD or MSP, that impose both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization.[23] However, the rules appear to provide SDs and MSPs with significantly more robust margin protection than the protection afforded to Other Counterparties. The Proposed Rule raises three scenarios involving the collection and posting of initial and variation margin:

- Covered Entities with other Covered Entities: Both counterparties are required to collect and post margin on all trades.
- Covered Entities with Financial End-Users (for example, large pension funds, insurance companies, investment companies, hedge funds, private equity, etc.): Both counterparties are required to collect and post margin on all trades, provided the financial end-user's total swaps exposure exceeds a threshold.
- Covered Entities with Other Counterparties (for example, commercial companies like utilities, municipal banks, small pension funds, insurance companies, etc.): Neither counterparty is required to collect and post margin on any trade, but Covered Entities may require an Other Counterparty to post margin, at the sole discretion of the Covered Entity, as it deems appropriate.

As noted by the Agencies, "under the proposed rule, a covered swap entity is not required as a matter of course to collect initial margin with respect to any uncleared swap with a counterparty other than a financial end-user with material swaps exposure or a swap entity, but shall collect initial margin at such times and in such form and amount (if any) that the covered swap entity determines appropriately addresses credit risk posed by the counterparty and the risk of such swap."[24] This provision raises a number of fundamental questions because of conflicts with the language and intent of the statutory margin regime.

*It has no basis in the statutory language.*

First, the selective one-way margining option has no support in the statute. Section 731 simply provides for the imposition of "both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization."[25]

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[23] 7 U.S.C. § 6s.
[24] Release at 68.
[25] 7 U.S.C. § 6s(e)(2)(A)(ii).

*It threatens to aggravate rather than mitigate systemic instability.*

While the Agencies ostensibly attempted to provide relief to small end-users through this provision, the voluntary one-sided imposition of margin by a Covered Entity on Other Counterparties does not provide for such relief but rather introduces a unilateral power in Covered Entities to arbitrarily make margin calls. The exercise of this power could have highly destabilizing and unfair effects.

One significant consequence of this provision will be prominent during times of liquidity shortages. The provision allows for margin calls by Covered Entities to Other Counterparties precisely when raising additional cash is most difficult. This could immediately and dramatically propagate a financial market shock into the real economy. That is why the "universal two-way margin," the **mandatory** exchange of both initial and variation margin among parties, is the internationally supported model, and the approach required under the Dodd-Frank Act.

*It is fundamentally unfair and anticompetitive.*

The open-ended, non-reciprocal right given to SDs and MSPs violates the antitrust considerations of Section 731. The provision of the Proposed Rule that grants Covered Entities the option to collect margin from exempt counterparties, creates a perfect environment for discriminatory trading practices by Covered Entities towards exempt entities. Moreover this provision is at odds with the antitrust considerations of Section 731, which that states "a swap dealer or major swap participant shall not adopt any process or take any action that results in any unreasonable restraint of trade; or impose any material anti-completive burden on trading and clearing."[26]

Because many SDs are either owners or are affiliated with commercial enterprises, it is realistic to expect that the discretionary ability to impose additional costs on some end-users but not others could change market structure: Unaffiliated commercials may be required to pay higher prices for services while in-house commercial activities will receive exempt status. This provision will lead to a fundamental shift in the market structure and trading of commodities, similar to the effect of the Enron loophole that exempted most over-the-counter energy trades and trading on electronic energy commodity markets from government regulation.

To address all of these problems, the Prudential Regulators should adopt a practice similar to that proposed by the CFTC in its corresponding rule on Margin for Uncleared Swaps:

> "the rules would require [Covered Swap Entities] to enter into certain documentation with all counterparties, including non-financial entities, to provide clarity about the parties' respective rights and obligations. CSEs and non-financial entities would be free to set initial margin and variation margin

[26] 7 U.S.C. § 6s(j)(6)(A)-(B).

requirements, if any, in their discretion and any thresholds agreed upon by the parties would be permitted."[27]

This simple documentation requirement limits the ability of Covered Entities to demand margin from Other Counterparties only according to pre-agreed circumstances and thresholds. This maintains the ability of Covered Entities to perform sound risk-mitigating margin calls, while removing the potential to exacerbate systemic risk by unexpectedly demanding margin in times of stress.

**2. The commercial end-user exemption should be narrowly tailored instead of broadly applied to a wide range of "Other Counterparties."**

The Agencies must narrowly define what constitutes a commercial end-user. The recent testimony of Professor Saule Omarova from University of North Carolina at Chapel Hill provided evidence that the current classification applied to commercial end-users is unclear and often misleading, potentially allowing—indeed incentivizing—financial entities, including Covered Entities, to define or re-define themselves as commercial end-users.[28]

It is important to recognize that it may be difficult or impossible to clearly delineate who is a bank holding company, Covered Entity, other entity, or commercial end-user when

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[27] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Proposed Rule, 79 Fed. Reg. 59898, 06-07 (Oct. 3, 2014).

[28] Testimony of Saule T. Omarova before the Subcommittee on Financial Institutions and Consumer Protection, Committee on Banking, Housing, and Urban Affairs, *Examining Permissible Banking Activities Under the Bank Holding Company Act*, S. Hrg. 113-67 (July 23, 2013).

For example, Professor Omarova says "in 2006, Morgan Stanley acquired full ownership of Heidmar Inc., a Connecticut-based global operator of commercial oil tankers…In September 2006, Morgan Stanley acquired, in a leveraged buyout, the full ownership of TransMontaigne Inc., a Denver-based oil-products transportation and distribution company. TransMontaigne markets "unbranded gasoline, diesel fuel, heating oil, marine fuels, jet fuels, crude oil, residual fuel oils, asphalt, chemicals and fertilizers." The company is affiliated with a fuel terminal facility operator, TransMontaigne Partners L.P., which operates oil terminals in several U.S. states and Canada… Both Heidmar and TransMontaigne are subsidiaries of Morgan Stanley Capital Group Inc. ("MS Capital Group"), Morgan Stanley's commodities and energy trading arm through which it holds equity stakes in multiple commodity businesses….

Goldman reportedly made significant acquisitions in the oil and gas sector, including a significant stake in Kinder Morgan, Inc. ("KMI"), a major oil transportation and terminaling company that controls approximately 37,000 miles of pipelines and 180 terminals handling crude oil, natural gas, and refined petroleum products. According to KMI's SEC filings, at the end of 2011, Goldman owned (through several controlled funds) 19.1% of the company's common stock. In addition, the report listed each of the two managing directors of Goldman who also served on KMI's board of directors as holders of 19.1% of the company's common stock. It appears that Goldman has similarly structured private equity investments in other energy companies, including Cobalt International Energy Inc. ("CIE"), a Houston-based deep-water oil exploration and production company…. Goldman's subsidiary, GS Power Holdings LLC, holds another prized asset in Goldman's commodities empire: Metro International Trade Services LLC ("Metro"). Metro is a metals warehousing company that owns and operates nineteen warehouses in the Detroit metropolitan area, as well as warehousing facilities in Europe and Asia."

applying exemptions to capital and margin rules. One way to make this distinction clear is by adopting the CFTC concept of the "end-user exemption" to the clearing requirements for swaps. That approach, already adopted by the CFTC, establishes criteria for determining whether an entity's swap portfolio is "hedging or mitigating commercial risk" and therefore eligible for the end-user exception. It also provides an exemption for small financial institutions such as banks, saving associations, farm credit system institutions, and credit unions with total assets of $10 billion or less to qualify for the end-user exception.

Consequently, the Agencies should require 2-way exchange of margin for all swaps, except those with a member of a narrow and well-defined group of commercial end-users.

**3. Financial regulators cannot and must not outsource rulemaking, interpretation, and dispute resolution to particular private sector groups such as ISDA.**

The Proposed Rule relies on certain private law constructs, referred to in the rule as an "eligible master netting agreement," to permit a Covered Entity to calculate initial and variation margin requirements for swaps with its counterparty on a portfolio basis. This amounts to an unacceptable outsourcing of regulatory responsibly to a private industry group agreement.

"Nearly all over-the-counter derivative transactions are [currently] documented under a standardized, pre-printed Master Agreement (the "ISDA Master Agreement") published by the International Swaps and Derivatives Association, Inc. ("ISDA")."[29] The ISDA Master Agreement was initially released in 1987, followed by modified versions in 1992 and 2002. It was written with the interests of dealers foremost in mind, including for example, provisions dealing with calculation agents and dispute resolution mechanisms.

When the agreement was originally developed, the ISDA "membership in the organization was limited to institutions that acted as dealers in the swaps market. Entities that participated in the swaps markets solely for risk hedging or asset/liability management (i.e. end-users) were not eligible for membership."[30] At a later stage, the association developed a tiered membership system: primary members, associated membership, and subscriber members.[31] Yet dealers still dominate the organization. The

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[29] Seth H. Poloner, *Negotiating ISDA Master Agreement schedules on Behalf of Foreign Hedge Funds*, 113 J. Tax. (Oct. 2010).

[30] Sean M. Flanagand, *The Rise of Trade Association: Group Interactions with the International Swaps and Derivatives Association*, Harvard L. Rev. 6 (2001).

[31] *See* http://www2.isda.org/membership/member-types/primary-members/. ("According to the Association's by-laws, every investment, merchant or commercial bank or other corporation, partnership or other business organization that, directly or through an affiliate, as part of its business (whether for its own account or as agent), deals in derivatives shall be eligible for election to membership in the Association as a Primary Member, provided that no person or entity participates in derivatives transactions solely for the purpose of risk hedging or asset or liability management."); *see also* By-Laws of International Swaps and Derivatives Association, Inc. (As Amended through June 4, 2014), *available at* https://www.isdadocs.org/membership/bylaws.pdf (Following the introduction of three categories of membership the by-laws of the association were modified so that the eligibility to become a director was limited to primary members only: "Each member of the Board of Directors

agreement is an inappropriate basis for imposing regulatory requirements on the very industry that drafted it.

Instead, the Agencies should provide for netting arrangements that are separate from ISDA Master Agreements. Regulators should develop requirements for netting agreements that achieve regulatory objectives through an open and transparent process. Those netting agreement requirements should be developed and implemented as part of the regulatory process: in a fair and transparent manner, and resulting in standards that do not carry with them bundled or packaged contract terms. In short, the Agencies must prepare a framework for swap netting as part of a rulemaking where the interests of end-users, commercial entities, and other non-SDs are duly considered and appropriately protected.

**4. The definitions should be clarified and strengthened.**

*The definition of "Affiliate" and "control"*

The term "affiliate" means any company that controls, is controlled by, or is under common control with another company.[32] As the Agencies rightfully indicated, central to the definition of an "affiliate" is the definition of "control."[33]

However, the proposed definition of control to be used for this supervisory purpose, as borrowed from the Bank Holding Company Act, is outdated and inappropriate to achieve sound risk management for swaps in general, and uncleared swaps in particular. The 25 per cent voting right, and control over the election of a majority of directors and trustees (as set forth in the control definition), are important initial considerations, but they do not capture the complexity of the prevailing corporate models and do not reflect the current market or business organization structures in the swaps markets.

The Agencies should consider and incorporate the following conceptual approaches in developing a more robust definition of "control" in the context of the margin requirements:

- The Joint Forum[34] principles for the supervision of financial conglomerates are useful in addressing the question of control.[35]

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elected in accordance with the procedures set forth in Section 4(b) of this Article [of by-laws] must be an officer, partner, principal or employee of a Primary Member or of the affiliate through which a Primary Member conducts its business in DERIVATIVES.").

32 Release at 89.

33 *Id.*

34 The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors ("IAIS") to deal with issues common to the banking, securities, and insurance sectors, including the regulation of financial conglomerates. The Joint Forum is comprised of an equal number of senior bank, insurance, and securities supervisors representing each supervisory constituency. The Federal Reserve and the OCC are current U.S. representatives in the group. *See* Mandate of the Joint Forum, *available at* http://www.bis.org/bcbs/jfmandate.htm.

- The U.S. GAAP approach to evaluating "control" also serves as a useful framework. In U.S. GAAP, control would normally be based on the majority ownership of voting shares. However, "over the years, the Financial Accounting Standards Board ("FASB") has been trying to move forward an accounting consolidation requirement utilizing **'effective' control, defined as an ability to direct the policies of another entity even though majority ownership could be lacking.**"[36]

  To achieve the implementation of an "effective control" test, the FASB introduced a so-called VIE rule, addressing both "variable interest entities" ("VIEs") and "special purpose entities" ("SPVs"). Under this framework, VIEs and SPVs are reviewed to capture investment relationships in which a controlling financial interest is not indicated by voting rights, but is indicated by a residual interest in risks and benefits.

- The concept of "effective control" as developed by FASB should also be incorporated. That would allow the Proposed Rule to "capture" structures like VIEs and SPVs in the margin and capital framework required by Dodd-Frank Act.

The current consensus among experts when dealing with complex financial institutions is that effective control over on-balance sheet or off-balance sheet entities is essential for capturing the control relationship among financial institutions and should be adopted in the Proposed Rule.

*"Investment Fund"*

Investment fund treatment represents a separate category of issues when dealing with consolidation. The 2013 international framework notes in footnote 10 that "investment funds that are managed by an investment advisor are considered distinct entities that are treated separately when applying the threshold as long as the **funds are distinct legal entities that are not collateralized by or are otherwise guaranteed** or supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy."[37]

FASB topic 946 "Financial Services – Investment Companies" evaluates both a definition of, and the "separateness" of, investment funds. Under Accounting Standard

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[35] Irina S. Leonova and Nigel Jenkinson, *Relationship Data: The Missing Link of the Current Financial Infrastructure* (Aug. 29, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2504167 ("The principles place particular importance on taking account of companies; unregulated parent companies and subsidiaries; and special purpose entities. In the assessment of risks from unregulated entities, moreover, the principles also set out the importance of taking a wide view of the following characteristics, and their influence on the regulated sector: (direct or indirect) participation, influence and/or other contractual obligations; interconnectedness; risk exposure; risk concentration; risk transfer; risk management; intra-group transactions and exposures; strategic risk; and reputational risk. Many of these elements highlight different facets of risk relationships within large complex financial firms.").

[36] *Id.* at 3.

[37] Basel Committee on Banking Supervision, *supra* note 10.

Update (ASU) 2013-08, in order to be considered an investment company, an entity must meet the following fundamental characteristics:

- An entity must obtain funds from one or more investors and provide the investor(s) with investment management services;
- It must commit to its investor(s) that its business purpose and only substantive activities are investing the funds solely for return from capital appreciation, investment income, or both.
- Additionally, the entity or its affiliate cannot obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

If those criteria are met, then additional characteristics are assessed, to determine whether:

- it has more than one investment;
- it has more than one investor;
- it has investors that are not related parties of the parent entity (if there is a parent) and the investment manager;
- it has ownership interest in the form of equity or partnership interests;
- it manages substantially all of its investments on a fair value basis.[38]

The Agencies should adopt this framework in dealing with investment funds.

Furthermore, the Agencies' discussion does not focus on the essential aspect of the international framework: the "distinct legal entity" requirement for the purpose of exclusion for consolidation. This is an important criterion in the evaluation of investment funds when determining the consolidation requirements.

Only legally distinct entities regardless of what collective scheme and structure is used should be treated separately. That means any sub-funds in the fund umbrella structures, all non-self-managed funds, and all other fund structures that are not legally distinct should be consolidated into the legal entity that holds/represents those investment funds for the purpose of margin and capital requirements.[39] We understand the appeal of the traditional banking criteria of 25 percent of voting rights or the election of a majority of

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[38] *See* PWS note No.2013-14 (June 25, 2013) ("Investment companies, FASB modifies definition of an 'investment company' for a concise but comprehensive review of the challenges associated with investment companies.").

[39] *See* Jerome De Lavenere Lussan, *Financial Times Guide to Investing in Funds: How to Select Investments, Assess Managers and Protect Your Wealth*, FINANCIAL TIMES GUIDES (July 13, 2012).

directors and trustees, but this is not meaningful in assessing investment companies and their organization given the structure of the investment industry.

The Agencies should introduce the investment fund "separateness test." The "separateness test" would evaluate whether an investment fund is a legal entity or not. If a fund is not a legal entity, it must be consolidated; if it is a legal entity, the analysis of its funding, income/revenue distribution, guarantees, buy-back provision, etc. should be reviewed for the purpose of identifying the ultimate legal barrier against any outstanding liabilities and potential losses.

**5. The Proposed Rule must further restrict the permissible forms of initial margin collateral and institute a mandatory annual review of all permitted asset classes and any corresponding haircuts.**

The Release explains that the Proposed Rule would "permit a broader range of collateral to be pledged to satisfy the initial minimum collateral requirements."[40] Included among the additional forms of collateral are "any major currency," a "publicly traded debt security," and a "publicly traded common equity" included in a variety of indices.[41] The Agencies propose to exclude "any corporate securities (equity or debt) issued by the counterparty or any of its affiliates, a bank holding company, a saving and loan holding company, a foreign bank, a depository institution, a market intermediary, or any company that would be one of the foregoing if it were organized under the laws of the United States or any State, or an affiliate of one of the foreign institutions."[42]

Even with the exclusion, this expansion goes well beyond the initial proposal, which limited the permissible forms of initial margin collateral to cash, obligations issued or fully guaranteed by the U.S., or senior debt obligations issued by the GSEs.[43]

While cash and cash equivalents may be the optimal and desirable forms of margin collateral from one standpoint, a more balanced approach is necessary, given market realities. On the one hand, limiting the universe of permitted margin collateral so narrowly

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40 Release at 71.

41 It should be noted that in developing the international framework, the BCBS and IOSCO have considered the types of collateral that should be deemed eligible for use in meeting the margin requirements, evaluating several different approaches. One approach would be to restrict eligible collateral to the most liquid top-quality assets, such as cash and high-quality sovereign debt, on the grounds that doing so would best ensure that the value of collateral held as margin could be fully realized in a period of financial stress. Another approach would be to permit a broader set of eligible collateral, including assets such as liquid equity securities and corporate bonds, and address the potential volatility of such assets through the application of appropriate haircuts to their valuation for margin purposes. Potential advantages of the latter approach would include (i) a reduction of the potential liquidity impact of the margin requirements by permitting firms to use a broader array of assets to meet margin requirements and (ii) better alignment with central clearing practices, in which CCPs frequently accept a broader array of collateral, subject to collateral haircuts. After evaluating each of these alternatives, the BCBS and IOSCO have opted for the second approach (broader eligible collateral). Basel Committee on Banking Supervision, *Margin requirements for non-centrally cleared derivatives – final report issued by the Basel Committee and IOSCO* (Sept. 2, 2013), *available at* http://www.bis.org/press/p130902.htm.

42 Release at 71-72.

43 Release at 70.

could have undesirable effects. For example, care must be taken to ensure that there are no bottleneck shortages for eligible collateral that could lead to risk contagion during a crisis period. At the same time, however, care must be taken to ensure that eligible collateral, after application of appropriate haircuts, retains sufficient value long enough to prevent the contagion risk to the counterparty.

Therefore, the expanded list of permitted forms of initial margin collateral in the Proposed Rule is appropriate, subject to two conditions. First, the expansion of the eligible collateral to include equity securities should be reversed. Equity securities present the idiosyncratic risks of a particular company, and their value and price resiliency depend on a host of variable factors, including the business activities of the company, its management, prevailing and changeable market conditions, and others. Consequently, their quality is not sufficiently reliable and predictable to warrant their treatment as permitted initial margin collateral. No equity security should be eligible for initial margin.[44]

Second, the Agencies should implement a mandatory annual review for all non-cash and non-cash equivalent margin collateral ("Collateral Annual Review"). The Collateral Annual Review must include an analysis of how all such non-cash and non-cash equivalents performed during the prior year under whatever the prevailing market conditions were as they changed from time-to-time throughout the year. The Collateral Annual Review must then compare the performance of such non-cash and non-cash equivalents to the haircuts imposed on each such non-cash and non-cash equivalents throughout the year as they may have changed from time-to-time throughout the year.

Given the lack of robust, actual market data and analysis of the performance of such non-cash and non-cash equivalents as well as the significant estimates and judgments involved in determining the haircuts for such non-cash and non-cash equivalents, a Collateral Annual Review is essential to determine if the acceptance of the full range of proposed non-cash and non-cash equivalents is appropriate and whether or not the haircuts applied to such non-cash and non-cash equivalents are also appropriate and supported by actual market conditions and data.

Only such an annual review will provide information on the liquidity risk of those instruments and attempt to ensure that the proposed acceptable collateral provides sufficient protection to ensure the financial stability of the U.S. under actual market conditions. However, even a robust Collateral Annual Review will have its limitations, given that the evaluated collateral performance will likely be during periods of more-or-

[44] The BIS study "Mind the gap? Sources and implications of supply demand imbalances in collateral asset markets" notes that the collateral availability studies adopted the concept of"high-quality assets" (HQA) for the purpose of estimating the available collateral balances. HQA term includes all assets that market participants can use to meet collateral requirements in derivative transactions. Notwithstanding regulatory guidance on eligibility criteria (eg BCBS–IOSCO (2013) for non-centrally cleared derivatives), the boundaries of the HQA set are largely determined by market practice and may, for example, be subject to cyclical developments or competitive pressures to broaden eligibility criteria among CCPs. HQA are close to "broader eligible collateral" used in the international framework but generally limits the use of equities for collateral."

less normal range market fluctuations rather than extreme, broad-based market stress similar to an emerging or actual financial crisis or crash. Therefore, a Collateral Annual Review of the type proposed herein is all the more important, including in particular a vigorous analysis of the sufficiency of the haircuts.

**6. Foreign operations of U.S. Covered Entities and counterparties and U.S. operations of the foreign Covered Entities and counterparties should be subject to this margin and capital requirement.**

The Release makes clear that certain entities and transactions with a close nexus to the U.S. would nevertheless fall outside the proposed margin rules. According to the release—

> "foreign swaps of foreign covered swap entities would not be subject to the margin requirements of the proposed rule. In addition, certain covered swap entities that are operating in a foreign jurisdiction and covered swap entities that are organized as U.S. branches of foreign banks may choose to abide by the swap margin requirements of the foreign jurisdiction if the Agencies determine that the foreign regulator's swap margin requirements are comparable to those of the proposed rule."[45]

We understand the intent of the regulators to rely on foreign regulatory frameworks when appropriate in the areas of direct supervision. However, in light of the global nature of swap operations by U.S. Covered Entities and their counterparties, outsourcing the U.S. margin and collateral framework for a significant number of uncleared swaps to foreign regulators promotes regulatory arbitrage and increased systemic risk both in the U.S. and globally.

Crucially, this provision will lead to miscalculations in the material swaps exposure of the Covered Entity. Excluding foreign aspects of the Covered Entity's uncleared swap business could artificially bring the would-be Covered Entity below the Covered Entity threshold and would effectively become a means of regulatory evasion. The same rationale applies to the exclusion for affiliated investment funds from the Covered Entity consolidation.

The Agencies should require that all locations and type of activities in uncleared swaps should be consolidated for the purpose of this rule and, in particular, material exposure calculation. There should be no "deductions" in the threshold for qualification as a Covered Entity.

Furthermore, the proposed regime conflicts with the FBO rule. The February 18, 2014 FRB press release regarding the FBO rule explicitly states that—

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[45] Release at 55.

> "for foreign financial institutions, the final rule recognizes that the U.S. operations of foreign banking organizations have become more complex, interconnected, and concentrated in recent years. The requirements in the final rule will bolster the capital and liquidity positions of the U.S. operations of foreign banking organizations and promote a level playing field among all banking firms operating in the United States."

The margin requirement exclusion for foreign institutions operating in the U.S. contradicts the spirit, if not the letter, of the FBO rule. Moreover, it violates the intent of the Dodd-Frank Act, as an exemption from margin requirements for foreign entities operating in the U.S. threatens rather than preserves the stability of the U.S. financial system. Consequently, all U.S. activities of foreign entities in uncleared swaps should be subject to the margin and capital requirements for Covered Entities.

The Proposed Rule provides for circumstances where foreign subsidiaries of U.S. financial institutions will not be subject to the margin rules altogether. The Agencies themselves express concern that "a foreign subsidiary of a U.S. insured depository institution . . . may engage in non-cleared swaps activities abroad, without having to register with the CFTC and SEC, and accordingly without being covered by the margin rules being proposed." We share the concern of the Agencies and find this situation unacceptable. The Agencies should employ their general safety and soundness and other authority to foreign subsidiaries to impose margin rules on entities which otherwise could avoid the U.S. margin regime for non-cleared swaps.

**CONCLUSION**

We hope these comments are helpful as the Agencies strengthen the Proposed Rule, so that the final rule provides for a broad, comprehensive margin regime for all uncleared swaps.

Sincerely,

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