July 11, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Gary K. Van Meter
Acting Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Department of the Treasury
Office of the Comptroller of the Currency
250 E Street SW, Mail Stop 2-3
Washington, DC 20219

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Attention: Comments/RIN 2590-AA45
1700 G Street NW, Fourth Floor
Washington, DC 20552

Via agency website

***Re: "Margin and Capital Requirements for Covered Swap Entities" / File Numbers* RIN 1557–AD43, RIN 7100 AD74, RIN 3064–AD79, RIN 3052–AC69, and RIN 2590–AA45**

I. Introduction and Summary of Comments

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comments by the Prudential Regulators[1] regarding the notice of proposed rulemaking entitled "Margin and Capital Requirements for Covered Swap Entities." The Coalition represents companies that use derivatives predominantly to manage risks. Hundreds of companies have been active in the Coalition throughout the legislative and regulatory process, and our message is straightforward: Financial regulatory reform measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users, who did not contribute to the

---

[1] The "Prudential Regulators" consist of the Department of the Treasury Office of the Comptroller of the Currency ("OCC'), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation ("FDIC"), the Farm Credit Administration ("FCA"), and the Federal Housing Finance Agency ("FHFA").

financial crisis, would create more economic instability, restrict job growth, decrease productive investment, and hamper U.S. competitiveness in the global economy.

We are pleased to offer comments focused on ensuring that the proposed rule helps to regulate effectively the derivatives markets, does not pose undue burdens on the business community, and accurately reflects both the letter of the statute and legislative intent.

Our comment letter is structured as follows:

- Section II explains why parts of the proposed rule would unnecessarily burden end-users and offers alternative formulations that comport with the statute while imposing less financial hardship on the business community. Specifically, we believe that
  - high margin requirements for uncleared swaps create unnecessary incentives to use cleared swaps;
  - requiring the use of credit support arrangements does not simply codify the status quo;
  - margin lending facilities are not an effective solution to issues raised by the proposed rule;
  - the proposed rule overly-restricts the use of non-cash collateral;
  - the proposed rule may not adequately account for the benefits of credit hedging;
  - end-users will face unnecessary micromanagement of their counterparty relationships; and
  - the proposed rule would reduce the competitiveness of American firms.

- Section III examines how portions of the proposed rule conflict with the stated goals underlying the derivatives title of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")—namely, to mitigate systemic risk—and offers ways for the conflict to be resolved.

- In Section IV we discuss policy and economic reasons why financial end-users should not be treated differently under the new regulatory structure and subjected to margin requirements.

- Section V explains why the extraterritorial reach of the proposed margin rules extends too broadly and exceeds the authority of the Dodd-Frank Act.

- In Section VI, we discuss the treatment of pre-effective date swaps.

- Section VII establishes why margin requirements should not be imposed on inter-affiliate swaps between entities within a single corporate group because of the economic reality of these swaps.

- In Section VIII, we explain why end-user subsidiary entities that are affiliated with a parent entity should qualify as end-users regardless of their affiliation with the parent.

- Section IX analyzes how the Dodd-Frank Act conveys margin authority and explains that the Act does not permit regulators to impose margin on end-users, either directly or indirectly. We again provide an alternative formulation that reflects both relevant statutory provisions and legislative intent.

- Section X discusses the required analyses the Prudential Regulators are required to undertake as part of their rulemaking process, specifically under the Regulatory Flexibility Act and the Unfunded Mandates Reform Act of 1995. We discuss also the need for the Prudential Regulators to conduct a cost-benefit analysis to understand fully the impact of the proposed regulation on end-users and other market participants.

The Coalition believes Congress communicated repeatedly both throughout the legislative process and in the text of the Dodd-Frank Wall Street Reform and Consumer Protection Act that end-users should not be subject to margin requirements. This intent reflects policymakers' collective judgment that end-users do not meaningfully contribute to systemic risk and that imposing margin requirements on end-users would unnecessarily impede their ability to efficiently and effectively manage their risks. As proposed, however, we believe that elements of the Prudential Regulators' margin rule do not accord with Congressional intent and indeed ignore explicit and implicit standards for promulgating margin rules that Congress set forth in the Dodd-Frank Act.

Not only are rules imposing margin—either directly on end-users or indirectly through collection mandates on swap dealers ("SDs") and major swap participants ("MSPs")—unauthorized by statute and unintended by Congress, but the rules that have been proposed are more expansive than needed to achieve stated ends and would work unnecessary hardship on U.S. businesses. In this comment letter, we identify ways in which the proposed rules are overbroad and harmful to businesses and suggest ways to make them less so. These suggestions should not be read as a retreat in any respect from the Coalition's fundamental belief that rules, as proposed, are not authorized by the Dodd-Frank Act. That is our primary position and we therefore urge the Prudential Regulators to create a true exemption from margin requirements for all trades that include an end-user, financial or non-financial.

The Coalition represents both financial and non-financial end-users. We believe that all end-users, both non-financial and financial, should be exempted from the margin requirements. Financial end-users include entities such as, pension plans, captive finance affiliates, mutual life insurance companies, and commercial companies with non-captive finance arms. These entities do not pose systemic risk to the financial system and use derivatives predominantly to hedge risks associated with their businesses; in short, they use derivatives the same way non-financial end-users do. As such, we believe that margin should not be required for all end-users, whether financial or non-financial.

II. The Proposed Margin Framework Places an Unnecessary Burden on End-Users

A. High Margin Requirements Distort the Incentive to Use Standardized Swaps

The Coalition is concerned that the proposed rule will create artificial incentives for companies to use standardized hedges, even if these hedges are not the most effective way to manage underlying commercial risks. Currently, companies weigh the trade-offs between standardized hedges that may be more efficiently priced, and customized hedges that are specifically tailored to address a company's idiosyncratic risks. Economic incentives that deter companies from using tailored products will create at least two adverse consequences. First, companies will be exposed to basis risk between their desired customized hedge and the standardized hedge that they actually use to hedge their commercial risk. Second, companies will realize accounting volatility from the economic mismatch created by the basis risk.

In particular, the Coalition believes that the proposed margin rule creates an economic incentive for end-users to abandon customized hedges in favor of standardized hedges because standardized hedges will have lower margin costs overall. This cost difference has at least two sources. First, the proposed rule requires more stringent margin calculations for uncleared swaps. For example, margin for cleared swaps is typically calculated by accounting for all price variations over a three to five day period. The proposed margin rule for uncleared swaps, however, requires margin calculation models to account for all price changes over a ten-day period.[2] Second, end-users will face higher margin costs for uncleared swaps because the proposed margin rules will lead to increased bilateral transactions costs. For example, the requirement to execute credit support arrangements for every counterparty relationship and the initial margin requirements imposed on SDs and MSPs (when they execute trades to hedge market risk associated with end-user trades) will each impact end-user costs.

Recommendations:

The Coalition recommends that the required criteria for calculating margin on uncleared swaps should not be set to result in margin requirements that are unnaturally higher for uncleared swaps. Setting higher margin requirements for uncleared swaps would drive end-users toward cleared swaps, a result that was not contemplated by Congress in passing the Dodd-Frank Act and constitutes an unwanted and unnecessary intrusion into business decision-making.

B. Imposing Margin Requirements on End-Users Will Slow Growth and Cost Jobs

Imposing margin requirements on end-users would cause negative practical consequences for end-users. These consequences range from increased hedging costs because all market participants will be forced unnecessarily to enter into credit support arrangements, to needlessly locking-up working capital that certain business owners rely on to grow their operations and create jobs.

---

2 76 Fed. Reg. 27590 (May 11, 2011).

1. Because the proposed margin rule does not simply codify the status quo by requiring all market participants to enter into credit support arrangements, it further strengthens the advantage to SDs and MSPs in their negotiations with end-users, while also increasing administrative costs for end-users.

The Coalition appreciates the intent of the Prudential Regulators to codify market practice, but the provisions in the proposed rule that require credit support arrangements for all end-user transactions do not accomplish this goal. Today's marketplace does involve bilateral margin agreements, but to a limit. According to a survey of Coalition members, only 61% of all end-users employ bilateral margin agreements.[3] The proposed margin rule would force the other 39% to adopt new practices.[4] Even the 61% that already transact with bilateral margin agreements currently have wide latitude in negotiating the terms of those agreements. The proposed rule would impose new regulatory oversight onto every counterparty relationship. This is not a simple codification of current practice. Instead, the proposed margin rule creates real, tangible costs for end-users through government intervention into what are negotiated agreements between businesses.

In fact, the requirement that all transactions be subjected to credit support arrangements that conform with the requirements proposed by the Prudential Regulators could weaken an end-user's ability to negotiate the best economic terms for its transactions. As currently drafted, the requirement that SDs and MSPs determine the terms for, and establish and calculate the amounts of, both initial and variation margin for all swaps entered into with a given counterparty, gives these covered swap entities an advantage over the end-users with whom they transact.

For example, the proposed rule implies that it is at the sole discretion of the covered swap entity whether or not they will include in their initial margin calculations an end-user's pre-effective date swap positions.[5] By allowing an SD or MSP to choose to include pre-effective

---

[3] An analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives (Feb. 11, 2011), *available at*: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Coalition-for-Derivatives-End-Users-OTC-Derivatives-Survey_Final-Version-2-11-11.pdf.

[4] An analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives (Feb. 11, 2011), *available at*: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Coalition-for-Derivatives-End-Users-OTC-Derivatives-Survey_Final-Version-2-11-11.pdf.

[5] The NPRM states: "Applying the new margin rules…would, in some cases, have the effect of applying the margin rules retroactively to pre-effective-date swaps under the master agreement. Accordingly, in the case of initial margin, a covered swap entity using an initial

[Footnote continued on next page]

date swaps in their margin calculations, the proposed rule may provide covered swap entities with an incentive to maximize the margin collected from end-users, regardless of the original documents in place between counterparties and without regard to the true risk of the counterparty.

Similarly, there may be some end-users who, if subjected to margin requirements by their covered swap entity counterparty on future trades, may themselves wish to demand margin payments to cover the risk of loss in the event of counterparty default. Such end-users, when weighing the trade-offs between cost and counterparty credit risk mitigation, would prioritize the mitigation of counterparty credit risk. Yet the proposed rule does not provide end-users with the ability to require reciprocal margin-posting if they determine it would be in their own best interest.

Additionally, the proposed rule, through its requirements 1) that initial margin amounts be determined either by Appendix A or through conforming margin models, 2) that margin payments meet specific minimum transfer amounts and 3) that they be transferred within certain periods of time, further undermines the ability of end-users and their counterparties to negotiate the best terms for a given transaction.

> Neither of the two alternatives for determining initial margin amounts—referring to appendix A or using approved models—would allow end-users to set off derivatives positions under a master netting agreement across broad risk categories, as many end-users currently do.[6] Such offsetting allows counterparties trading under master netting agreements to calculate their true exposure to each other, and limiting this practice could unnecessarily increase the margin requirements on end-users. Further, while current practice allows counterparties to determine minimum transfer amounts and the timing of both initial and variation margin payments for their transactions, the proposed rules would require a minimum transfer amount of no greater than $100,000 and that covered swap entities must collect these payments at least once a day from financial end-users, and at least once a week from nonfinancial end-users.[7] Such new requirements will reduce the ability of counterparties to customize the terms of their transactions, which will generally advantage the covered swap counterparties and drive up the administrative and margin costs for end-users.

[Footnote continued from previous page]
margin model would be permitted, at its option, to calculate the initial margin requirements on a portfolio basis but include only post-effective-date derivatives in the relevant portfolio." 76 Fed. Reg. 27569 (May 11, 2011).

6 Proposed Margin and Capital Requirements for Covered Swap Entities §___.8 (d)(3).

7 Proposed Margin and Capital Requirements for Covered Swap Entities §____.3 (b), (c) and §____.4 (b), (c).

Requiring credit support arrangements to be negotiated in every counterparty relationship will create new legal costs, especially for those that hedge infrequently but would still have to incur the requisite negotiation costs. By using the Commodity Futures Trading Commission's ("CFTC") estimate for the number of end-users affected, the Coalition estimates that these legal costs could be substantial. As shown in Figure A, making assumptions about the time it takes to negotiate a credit support arrangement and any third party account agreements, the number of counterparty relationships per end-user, and the legal cost to negotiate, one could easily estimate costs rising to hundreds of millions of dollars.

	Assumptions[8]
End-Users	**30,000**
% End-Users with No CSAs	**39%**
Adjusted End-users	**11,700**
Attorney Hours Per CSA	**5**
CSA's per end-user	**11**
Cost per Attorney Hour	**$300**
Total Cost for End-Users	**$193,050,000**

Figure A. Estimated legal costs associated with mandatory credit support arrangements ("CSAs")

2. The initial margin requirement is a new and costly requirement for most end-users, while the variation margin requirements may undermine the ability of an end-user to negotiate the best terms for a swap.

For many market participants, and especially for end-users, an initial margin requirement would be a new economic cost that is not normally applicable to the bilateral over-the-counter ("OTC") market. A recent Coalition survey found that 3% initial margin requirement on the S&P 500 companies could be expected to reduce capital spending by $5.1 billion to $6.7 billion.[9] The United States would lose 100,000 to 130,000 jobs from both direct and indirect

---

[8] Where possible, these assumptions were drawn from data in the Coalition's survey of end-users. (An analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives (Feb. 11, 2011), *available at*: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Coalition-for-Derivatives-End-Users-OTC-Derivatives-Survey_Final-Version-2-11-11.pdf.). We would note that actual costs could be higher, as we have not taken into account the cost associated with new credit support arrangements entered into to ensure margin requirements are not retroactively applied to pre-existing contracts and CSAs entered into as a result of Section 716 of the Act.

[9] An analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives (Feb. 11, 2011), *available at*: http://www.centerforcapitalmarkets.com/wp-

[Footnote continued on next page]

effects.[10] The analysis illustrates that the strength of the economy and people's livelihoods are at stake.

Although much of the liquidity impact of the proposed rule will be focused on SDs and MSPs, all market participants, including end-users, will be impacted by the significant liquidity burdens placed on these market participants.

Because all market participants will bear the cost of increased system-wide margin requirements, the Coalition believes that the margin requirements must be set at levels consistent with historical loss experience. Since inception of the financial crisis, U.S. financial institutions have reported $1.262 trillion[11] in losses in their financial statements. Of this amount, only $49 billion resulted from derivatives. More than half was attributable to AIG and was made up of mortgage-related credit default swaps, which end-users typically do not use. The remaining losses from the $1.262 trillion came from non-derivatives products, including loans.

This derivatives loss data offers a useful point of comparison to evaluate whether setting aside the substantial cash resources required by the proposed rule is appropriate. In its economic analysis of the Prudential Regulators' rule for bank SDs and MSPs, the OCC estimated the cash resources that would be required to satisfy the initial margin requirements of the Act on 74 OCC regulated banks. It concluded that $2.05 trillion would be required to be set aside to satisfy the initial margin requirements of the rule. Specifically, the analysis counsels that (1) a quantitative analysis of the proposed rule is feasible, (2) that the results of such an analysis suggest the margin requirements are quite significant and (3) that the results, if accurate, are presently disconnected from the historical loss experience in the derivatives market.

It is worth noting that there is a simple and compelling reason that explains why initial margins have historically been applied universally for central clearing, but often inapplicable to bilateral end-user hedges. In central clearing, the central clearing party must guarantee a contract's performance even if one of the two counterparties defaults. This guarantee requires the central clearing party to perform a close-out process with the defaulting party and replace the defaulting contract with a new one. The new contract's cost should theoretically equal the variation margin already collected. If the close-out occurs over a longer time period, however,

---

[Footnote continued from previous page]
content/uploads/2010/04/Coalition-for-Derivatives-End-Users-OTC-Derivatives-Survey_Final-Version-2-11-11.pdf.

[10] An analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives (Feb. 11, 2011), *available at*: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Coalition-for-Derivatives-End-Users-OTC-Derivatives-Survey_Final-Version-2-11-11.pdf.

[11] Writedowns and credit-market losses, as determined through the Bloomberg WDCI function as of 6/3/2011.

any adverse movement in the replacement contract's cost can be covered by the initial margin. In contrast, a non-defaulting SD counterparty in a bilateral situation has no obligation to replace the defaulted contract with a new one. In fact, SDs may only need to terminate offsetting hedges that are more liquid than the customer OTC transactions.

Punitive initial margin assumptions within the proposed margin rule will also raise the potential costs to end-users. The proposed rule calls for an initial margin model that covers with a 99% confidence price movements over a ten-day period using historical data based on stressed market conditions. In typical practice, however, SDs have the contractual ability to close-out a defaulted derivative contract in much shorter time frames. The closeout periods for default in ISDA agreements, for example, for bilateral trades typically allow for trade termination within two to five business days of a default—a timeframe similar to that used by derivatives clearing organizations when closing out cleared derivative transactions. Typically, any market hedges or collateral that needs to be terminated or sold when an end-user defaults could be done so well within a one-day period. This is especially true when contemplating the limited set of collateral types the Prudential Regulators have set forth in their proposed rule. There may be circumstances in which illiquid transactions are in some way connected to the close-out process – such as when a derivative is associated with subprime mortgage. But the vast majority of end-user hedges involve closeouts that can be handled expeditiously. The required ten-day period is thus disconnected from the reality of the bilateral close-out process. Importantly, this punitive assumption could deter market participants from hedging their business risks or make it very costly to do so.

3. The costs that would be imposed by the proposed rule are not effectively mitigated by the use of margin lending facilities.

Margin lending facilities would not provide a potential solution to end-user concerns with margin requirements.[12] Instead, they would simply force more complexity and regulatory burden onto end-users without reducing systemic risk by increasing costs both directly and through exposure to new types of risk. First, end-users need certainty and liquidity to manage their balance sheets. But the amount of margin borrowed and costs associated with a margin lending facility cannot be known upfront. The amount cannot be known because it depends on market fluctuations. The costs cannot be known because lenders typically base credit fees on a floating interest rate, plus credit spread. Thus, the total costs of a margin lending facility vary based on the unpredictable amount needed to be borrowed and the unpredictable interest costs of that borrowing.

Second, lenders will typically limit how much can be borrowed, much like a credit limit on a consumer credit card. The exact limit must be high enough to cover at least two or three standard deviations worth of potential price movements in the underlying derivatives portfolio.

---

12 The borrower could enter into an unsecured credit facility, or a facility secured by less liquid collateral, and use the funds to satisfy cash margin requirements.

Lenders, however, will want to pass on the higher costs associated with offering high limits. This creates an incentive for both lenders and end-users to agree on a lower limit that covers mark-to-market movements typically observed in normal market conditions. Should the margin requirement ever exceed the limit, however, as might occur in stressed market conditions, end-users will still face unfunded margin requirements that margin lending facilities cannot cover.

Third, lending facilities may not offer the same maturity term as the supported swaps. Floating rate lending facilities typically have a maturity range of one to five years. In contrast, interest rate swaps with maturities exceeding five years are not exceptional. These term differences expose end-users to maturity mismatches and "roll-risk," requiring end-users to periodically renew or secure new sources of margin lending facilities. This would place an additional risk and burden that today's end-users do not face. Periodic refinancing could also be especially difficult to obtain during periods of market stress, when lenders reduce lending capacity.

Fourth, end-users would face costs unrelated to risk. Any credit facility offered by a bank generally comes with new fees. These fees could include commitment fees, unused facility fees, or maintenance fees in the ordinary course of business. Lenders may also charge termination fees.

Even if lending facilities came free of charge, they still would serve little or no role in mitigating systemic risks. Margin lending facilities offered by banks (and especially if offered by SDs or MSPs), would merely re-allocate and re-label risk, but not materially reduce it. What was formerly derivatives exposure risk would be converted into a lending facility risk. A counterparty default from a derivatives obligation would have the same impact on a bank as a default on a margin lending facility obligation. In other words, changing the *form* of the obligation does not eliminate the risk.

4. The proposed rule unnecessarily restricts the use of non-cash collateral.

For end-users, the proposed rule radically narrows the universe of eligible collateral to "limited types of highly-liquid, high-quality debt securities."[13] This is a major change from current market practice, which allows parties to use many other types of liquid collateral. For example, parties can currently negotiate and agree to use any of the following types of securities to satisfy margin requirements today:

- Agency pass-through securities;
- Callable and non-callable agency debt;
- Municipal securities issued by state and local governmental authorities and agencies;
- Oil and gas properties;

---

13 76 Fed. Reg. 27578 (May 11, 2011).

- Right-way risk collateral;
- Physical assets and commodities;
- Highly-rated corporate debt;
- Highly-rated commercial paper;
- Certain foreign government bonds;
- Letters of credit from highly-rated banks or insurance companies;
- Any other collateral used to secure a commercial loan, including equity interest in subsidiaries or priority interest in the cash flow of subsidiaries; and
- Other forms of collateral as the parties may agree on.

Existing market practice further allows for non-cash collateral as negotiated by the parties, which could include physical real estate, physical plants, or physical commodities. This is particularly important for end-users that carry limited cash or liquid securities on their balance sheets. Such collateral may be pledged in connection with a commercial or real estate loan and may secure both the loan and the swap. Congress recognized the inherent benefits of these loan and swap arrangements in crafting the insured depository institution carve-out to the SD definition.[14] This carve-out exempts banks from the SD definition when they offer swaps in connection with originating a loan and acknowledges the important role swaps play in reducing risks inherent in commercial borrowing and lending. Further, such swaps are offered generally by one member of a lender's group and the lack of these hedges could reduce the ability of banks to offer asset-backed loans, as the commercial price risk exposed by the borrower impacts the future revenue predictability.

The carve-out provision also confirms that depository institutions' practice of offering swaps in connection with loan originations and using non-cash collateral does not carry the risks that the Dodd-Frank Act is intended to address. Indeed, the market currently manages the lower liquidity inherent in non-cash collateral by applying haircuts instead of banning its use.[15] This practice accounts for relative liquidity differences. Parties customize and agree to haircuts as part of their credit support arrangements based on credit health and the liquidity of the collateral being posted.

Some have suggested that end-users that traditionally pledge non-cash collateral could continue their operations by using a secured financing facility. Like the margin lending facility

---

[14] Dodd-Frank Act § 716(b)(2)(B).

[15] Note that it is not customary to apply haircuts to physical assets such as property. For example, when a bank makes a floating rate commercial loan together with an interest rate swap to a commercial property owner, the lender conceives of its collateral needs as being no greater than that which would be required for a fixed rate loan. Just as the property collateral pledged against the fixed rate loan is sufficient to satisfy the lender, so is it also sufficient to satisfy collateral requirements for the floating rate loan and swap combination.

discussed earlier in Section II.B.3, a secured financing facility does little or nothing to remove risks from the system. Instead, it simply changes the name of the risk from derivatives exposure to financing facility exposure. Additionally, in the case of end-users that typically pledge real property as collateral for a swap, these entities may be limited in their ability to pledge their property as collateral to a margin lending facility because of the terms of the property's financing. While many lenders are willing to allow a borrower to pledge the same property as collateral on a swap used to hedge the interest rate risk of a loan secured by that property, pledging that property as collateral for a margin lending facility may violate the loan's restrictions against additional indebtedness.

The restrictions on the use of non-cash collateral may also affect the ability of end-users to receive credit for the full value of physical assets that they pledge to an asset-backed lending facility.

The Dodd-Frank Act requires that regulators "*shall* permit the use of noncash collateral" so long as doing so is consistent with preserving the financial integrity of swap markets and the stability of the U.S. financial system.[16] Congress thus directs regulators to promulgate non-cash collateral requirements according to systemic risk and not other factors. To avoid violating Congressional intent, we urge the Prudential Regulators to distinguish between systemically significant entities and other entities, such as end-users, regarding use of non-cash collateral. We agree that limiting the use of non-cash collateral for SDs and MSPs is worthy of consideration. However, prohibiting the use of most forms of non-cash collateral for all end-users as well ignores both the text of the Dodd-Frank Act and economic reality, leaving end-users to pay an unnecessary price.

Recommendations:

The Coalition urges the Prudential Regulators not to impose margin on non-cleared trades entered into by end-users. If, however, the Prudential Regulators do impose margin on end-users, we recommend the following:

- For all end-users, the final rule should allow SDs and MSPs to adopt internally determined credit exposure limits without necessarily requiring legal documents and arrangements to codify these limits. This approach would provide regulators with the comfort that SDs are not extending credit to an excessive degree to a given end-user, while eliminating the need for a formal credit support arrangement that imposes unnecessary costs and burdens.

- The Prudential Regulators should conduct a study to analyze the quantitative impact of the rule and the historical losses in the derivatives market. We urge the Prudential Regulators to use this analysis to calibrate its margin rules to be proportional to the historical loss experience in the derivatives market.

---

16 7 U.S.C. § 4r(e)(3)(C); Dodd-Frank Act § 731.

- SDs and MSPs should not be allowed to include in the calculation of margin amounts those swaps entered into with an end-user before the effective date of the final margin rules without the agreement of the end-user.

- End-users should be able to demand margin from the SDs or MSPs with which they transact if the end-user decides that doing so would be appropriate. However, each end-user should have the discretion to determine whether the additional costs posed by such demands are appropriate. That is, SDs and MSPs should not be required to post collateral to end-users in every case.

- Initial margin requirements should allow end-users to offset exposures across risk categories, as opposed to exclusively within these categories.

- Covered swap entities should be allowed to establish minimum transfer amounts of up to $250,000.

- All end-users, including financial end-users, should be allowed to bilaterally agree upon the frequency with which margin payments must be exchanged, so long as such payments occur at least weekly.

- The period upon which the statistical standard for calculating initial margin is based should be reduced from ten days to no more than four days. In the unusual circumstances that the characteristics of the transactions that would need to be terminated are materially illiquid, regulators might consider whether it is appropriate to contemplate a longer liquidation horizon in such limited circumstances.

- Commonly accepted forms of collateral subject to appropriate haircuts should be allowed for trades involving end-users, including the following:
    - Agency pass-through securities;
    - Callable and non-callable agency debt;
    - Municipal securities issued by state and local governmental authorities and agencies;
    - Oil and gas properties;
    - Right-way risk collateral;
    - Physical assets and commodities;
    - Highly-rated corporate debt;
    - Highly-rated commercial paper;
    - Certain foreign government bonds;
    - Letters of credit from highly-rated banks or insurance companies;
    - Any other collateral used to secure a commercial loan, including equity interest in subsidiaries or priority interest in the cash flow of subsidiaries; and
    - Other forms of collateral as the parties may agree on.

- Assets that are not securities should be allowed for use as collateral by end-users, including the following:

- Physical real estate;
- Plants; and
- Physical commodities.

C. The Proposed Rule Imposes New Regulatory Interference into *Every* Counterparty Relationship

The proposed rule imposes a broadly applicable requirement that each market participant "execute trading documentation with each counterparty regarding credit support arrangements."[17] While the proposed rule currently allows some latitude for SDs and MSPs to set the "appropriate" thresholds in agreements with certain end-users, the Coalition is concerned that the proposed rule's wording gives regulators supervisory authority to determine, review, and modify the terms of any credit support arrangement. The use of the term "appropriate," although seemingly innocuous, allows for an arbiter to determine which practices are "appropriate." We believe regulators could use this self-granted authority to the detriment of end-users. For example, during periods of market stress, regulators could decide that bank-set thresholds are too high and demand that these thresholds be lowered. This could not happen at a worse time for end-users. Preserving cash resources in times of crisis is essential. Actions that would diminish the availability or potential availability of cash resources would pose significant liquidity risks for end-users. Additionally, the proposed rule grants regulators substantial authority over bank models used to calculate initial margin. For example, the proposed rule allows regulators to "collect a greater amount of initial margin than that determined by the covered swap entity's initial margin model." Such broad authority puts end-users in a needlessly uncertain position: Faced with the constant threat that their margin costs and requirements could suddenly increase at any time, end-users may become more hesitant to grow their businesses or hire new workers.

Recommendations:

The Coalition appreciates the Prudential Regulators' efforts to acknowledge the lower risk posed by end-users by giving SDs and MSPs partial latitude to set some of the terms of the credit support arrangements. We believe, however, that the supervisory authority over end-user margin levels implied by the appropriateness standard was not intended by Congress and are unnecessary for the mitigation of systemic risk. We thus urge the Prudential Regulators to clarify that they do not have a supervisory role over thresholds mutually agreed to by an SD or MSP and an end-user.

D. The Proposed Rule Reduces the International Competitiveness of American Firms

The Coalition represents thousands of American companies that form the bedrock of our economy and its global competitive position. Imposing margin requirements that are disproportionate to crisis-level loss experience will undermine our companies' ability to compete effectively with foreign competitors. Senate Agriculture Chairman Stabenow and Ranking

---

[17] 76 Fed. Reg. 27589 (May 11, 2011).

Member Roberts acknowledged this when they urged regulators to accept end-user concerns, "so that [end-users'] costs of risk management allow them to remain competitive."[18] A bipartisan group of Senators also emphasized this point in a letter to regulators: "An overly prescriptive derivatives market in the U.S. would no doubt encourage market participants to take advantage of less punitive derivatives marketplaces abroad. Instead, regulators should be working to implement Title VII in a way that is consistent with international standards to avoid putting the U.S. market at a competitive disadvantage."[19]

No other G-20 nation has discussed or proposed a comparable margin requirement on end-users, nor did the G-20 leaders mandate an end-user margin requirement in Pittsburgh. Notably, in Europe, the European Market Infrastructure Regulation ("EMIR") proposed by the European Commission ("EC") and the current European Parliament and European Council texts do not include a margin requirement for non-financial end-users, except for end-users whose derivatives use poses systemic risk. For example, the EC text states that entities that require central clearing would have to have "appropriate exchange of collateral *or* capital requirements"[20] for uncleared derivatives. The EU's approach is important in two respects. First, the legislative text focuses on entities that have a mandatory clearing requirement, namely financial entities and non-financial entities with positions that exceed a clearing threshold.[21] Second, the legislative text comports with the Coalition's view that capital requirements adequately address the systemic risk related to uncleared derivatives without needing a duplicative margin requirement. In light of the EU's approach, a U.S. margin requirement undoubtedly disadvantages U.S. companies against their European competitors.

---

18 Letter from Senator Stabenow to Chairman Gensler (Feb. 22, 2011), *available at*: http://www.chathamfinancial.com/wp-content/uploads/2011/03/Stabenow-Letter-to-Gensler-022211.pdf.

19 Letter to Secretary Geithner and Chairmen Bernanke, Gensler and Shapiro (Feb. 8, 2011), *available at:* http://www.johanns.senate.gov/public/?a=Files.Serve&File_id=600d4fd6-349d-4105-b74b-c7e99f5d7796. As Treasury Secretary Geithner recently stated: "We live in a global financial marketplace, with other financial centers competing to attract a greater share of future financial activity and profits." Remarks by Treasury Secretary Tim Geithner to the International Monetary Conference (Jun. 6, 2011), *available at:* http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx.

20 Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories, 27 (Sept. 15, 2010), *available at*: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0484:FIN:EN:PDF (emphasis added).

21 These entities are roughly equivalent to entities that would be classified as MSPs under the Dodd-Frank Act.

With the growing prominence of Asian economies, it is also important to examine the derivatives regulatory landscape in these countries. While Japan did pass derivative legislation, it remains unclear when or in what form regulations will be designed and implemented in China, Hong Kong, and South Korea. There is as yet no indication, however, that a margin requirement is being contemplated at this stage. Singapore and Australia have made little movement toward regulating their derivatives markets. Given the legislative history of the Dodd-Frank Act's margin requirement and the repeated admonition of many members of Congress not to impose margin on end-users, foreign governments are unlikely to deem that the imposition of margin requirements on end-users is a necessary feature of a harmonized global regulatory framework.

Dan Berkovitz, the CFTC's general counsel, has emphasized that the CFTC is working with both foreign jurisdictions and other U.S. agencies to resolve differences and avoid regulatory arbitrage.[22] The regulators' current approach, however, would not accomplish this goal. Rather, the proposed rule would provide a regulatory incentive for U.S. and foreign companies to flee American shores and set-up shop in jurisdictions where end-users will not be subject to the same onerous and unnecessary margin requirements.

Recommendations:

Taking stock of the global regulatory initiatives, it is feasible that the U.S. could be the sole country applying mandatory margin requirements to end-users. Because of the economic impact the proposed margin rule could have on U.S. companies' competitiveness, we strongly urge regulators to adopt a framework that is consistent with what foreign governments will likely adopt. We do not expect foreign governments to apply margin requirements to end-users, and we urge the Prudential Regulators to adopt the same approach.

The Coalition also asks that the Prudential Regulators prioritize the undertaking of a quantitative cost-benefit analysis with specific considerations for the impact on end-users. An analysis is especially important because the proposed margin rule will have a considerable quantitative impact on the U.S. economy. We note that although no quantitative cost-benefit analysis accompanied the proposed margin rule, the OCC has independently produced an economic analysis that could be used as the basis for a more robust analysis.[23] We urge that, in such an analysis, the Prudential Regulators consider the issue of international competitiveness of U.S. corporations in a scenario where the United States is the only jurisdiction imposing a margin requirement.

---

[22] Dan Berkovitz, General Counsel, CFTC, Speech to the Natural Gas Roundtable Members and Friends Luncheon, May 24, 2010.

[23] Office of the Comptroller of the Currency, Economics Department, Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule, 7 (April 15, 2011).

III. The Dodd-Frank Act Directs Regulators to Use Systemic Risk for Setting Margin Requirements, Yet the Proposed Rule is Based on a Different Justification

A. The Proposed Rule Focuses on Risks in General Instead of Focusing On Systemic Risks

The Dodd-Frank Act's margin provisions[24] rightly focus on regulating systemic risk related to SDs and MSPs. The structure of the Dodd-Frank Act's margin provisions and the "Standards for Capital and Margin" indicate that Congress intended regulators to focus on systemic risk as a primary criterion for establishing margin requirements. By their terms, these sections apply only to entities that pose systemic risk to the financial system: "swap dealers" and "major swap participants."[25]

The financial crisis, without doubt, was closely associated with the failure of systemically significant institutions that had accumulated excessive risks through their transactions with other systemically significant institutions. The Coalition believes that the Prudential Regulators should respect Congress's specific focus on systemic risk and should not divert their attention to end-user hedging activities.

As Congress correctly recognized,[26] end-users' use of derivatives to hedge or mitigate their commercial risks did not cause the financial crisis. Chairman Bernanke agrees: "The [Federal Reserve] Board does not believe that end-users other than major swap participants pose the systemic risk that [the Dodd-Frank Act] is intended to address."[27] Any argument to the contrary—that the simultaneous failure of many end-users, each posing a small amount of risk, could cause the failure of an SD or MSP—stretches the bounds of reason. Historical evidence and available data simply do not support such an argument. The latest market activity report

---

[24] Dodd-Frank Act § 731, 764.

[25] Dodd-Frank Act § 731. Section 764's parallel structure applies to "security-based swap dealers" and major security-based swap participants." Dodd-Frank Act § 764.

[26] During debate of the Dodd-Frank Act, Representative Collin Peterson explained that "End Users did not cause the financial crisis of 2008. They were actually the victims of it." 156 CONG. REC. H5245 (daily ed., June 30, 2010). As noted by Senate Agriculture Chairman Stabenow and Ranking Member Roberts, end-users "really had nothing to do with the financial crisis." Letter from Senator Stabenow to Chairman Gensler (Feb. 22, 2011), *available at*: http://www.chathamfinancial.com/wp-content/uploads/2011/03/Stabenow-Letter-to-Gensler-022211.pdf.

[27] Letter from Federal Reserve Chairman Bernanke to Senator Crapo (on file with author).

from the Bank for International Settlements ("BIS") confirms that non-financial end-users[28] represent only 8.4% of the OTC derivatives market.[29] This small portion of the market is spread across tens of thousands of end-users, making any individual end-users' exposure quite small relative to the overall market and making it extremely unlikely that an end-user could cause an SD or MSP to fail.

In light of the evidence, requiring any margin collection from end-users would be for the purpose of shoring-up the safety and soundness of SDs and MSPs whose systemic risks arise from their transactions with other SDs and MSPs, not from transactions with end-users. This would be equivalent to instituting a financial subsidy for SDs and MSPs, funded by end-users.

Recommendations:

The Coalition recommends that the final rule impose margin requirements, either direct or indirect, solely on entities that contribute to systemic risk—not end-users, whether financial or non-financial. Only those entities that could reasonably cause future systemic failures, SDs and MSPs, should bear the costs and burdens associated with margin requirements.

B. Margin Requirements Were Not Meant to Increase Transparency

The Prudential Regulators mistakenly believe that Congress intended the margin provisions of the Dodd-Frank Act to increase transparency.[30] The Dodd-Frank Act's margin provisions, however, explicitly focus on risk reduction, not transparency. Although other sections of the Dodd-Frank Act, including the real-time reporting, trading, and business conduct requirements sections, explicitly reference transparency or disclosure, these terms do not appear in Section 731. Section 731 does, however, refer to "risk" numerous times. In fact, Section 731's purposes are characterized exclusively in terms of risk. The section states that its purpose is "[t]o offset the greater risk…" and further notes that capital and margin requirements should

---

[28] In the market activity report, the non-financial end-users category includes financial subsidiaries of commercial firms.

[29] Bank for International Settlements, OTC derivatives market activity in the second half of 2010 (May 18, 2011), *available at* http://www.bis.org/publ/otc_hy1105.htm.

[30] The Prudential Regulators assert in the proposed margin rule that "[t]he comprehensive derivatives related provisions of title VII of the Dodd-Frank Act, including sections 731 and 764, [the margin provisions] are intended in general to reduce risk, *increase transparency*, promote market integrity within the financial system, and, in particular, address a number of weaknesses in the regulation and structure of the derivatives markets that were revealed during the financial crisis experienced." 76 Fed. Reg. 27567 (May 11, 2011) (emphasis added).

be "appropriate for the risk."[31] In the section on non-cash collateral, the Dodd-Frank Act emphasizes that use of non-cash collateral should be consistent with "the stability of the United States financial system." It is thus clear that margin requirements were (1) not intended as a policy tool oriented toward increasing transparency and (2) intended as a policy tool oriented toward mitigating risk. The Coalition has long supported efforts to increase access to market data, but we cannot agree that margin requirements should be used to accomplish this worthy goal.

Recommendations:

Margin requirements should not be used for increasing market transparency. Congress provided numerous other mechanisms to increase transparency, including trading, reporting, and business conduct standard requirements.

C. The Dodd-Frank Act Directs Regulators to Address Systemic Risk, Not Excessive Risk or Transparency Issues

As noted above, the Dodd-Frank Act's margin provisions focus on controlling *systemic* risk. Yet, in their proposed margin rule, the Prudential Regulators mistakenly concentrate on "excessive" and "significant" risk.[32] These other types of risk are *not* equivalent to systemic risk. For example, if a non-systemically significant entity took on excessive risks, relative to its resources, it could fail. But its failure, by definition, would not cause cascading failure in the financial system. SDs and MSPs, however, present an entirely different scenario. Their failure from excessive risk-taking could have potentially far-ranging consequences. We thus urge the Prudential Regulators to recognize this important distinction and to promulgate rules that clearly differentiate between the excessive risks taken by SDs and MSPs, and those taken by non-systemically significant entities.

Even if Dodd-Frank directed regulators to address excessive risk, end-users should still be exempted from margin requirements. End-users use derivatives for a very limited purpose: to hedge the specific, commercial risks of their business enterprises. End-users *cannot* accumulate excessive risks by hedging commercial risks with derivatives. We appreciate the Prudential Regulators' acknowledgment as to the benefits of derivatives used to hedge risk and urge the Prudential Regulators to account fully for this logic in their proposed rule: "[P]ersons using derivatives predominantly to hedge or mitigate risks arising from their business, rather than to

---

31 Dodd-Frank Act § 731(e)(3).

32 "By imposing a minimum margin requirement on non-cleared derivatives, sections 731 and 764 of the Dodd-Frank Act will reduce the ability of firms to take on *excessive* risks . . ." "Because the Dodd-Frank Act requires that the margin requirements be based on the risks posed by the non-cleared derivatives and derivatives counterparties, firms that take *significant* risks through derivatives will face more stringent margin requirements . . ." 76 Fed. Reg. 27567 (May 11, 2011). "

speculate for profit, are likely to pose less risk to the covered swap entity (e.g., because losses on a hedging-related swap will usually be accompanied by offsetting gains on the related position that it hedges)."[33]

Recommendations:

Instead of imposing a less stringent margin requirement on end-users, entities should not be subject to margin requirements unless the entity's failure would have systemically significant consequences.

D. Capital Requirements Already Succeed in Addressing the Systemic Risk Associated with Uncleared Swaps.

Capital requirements play a major role in offsetting the risk posed by uncleared swaps to SDs and MSPs and the financial system. Existing capital requirements for banks already require those entities to set aside high quality and liquid capital to offset both market risks and counterparty credit risks from their derivative positions. As the Prudential Regulators acknowledge, "these capital rules sufficiently take into account and address the risks associated with the derivatives positions that a covered swap entity holds and the other activities conducted by a covered swap entity."[34]

Margin requirements provide overlapping regulation to solve a problem that, by the Prudential Regulator's own admission, capital requirements already adequately address. Both capital and margin requirements are suitable alternatives for addressing counterparty credit risk in the derivatives market and for increasing the safety and soundness of large institutions. But applying both of these requirements concurrently is unnecessary. Although margin requirements reduce the amount of capital a large institution must hold, end-users strongly prefer to address counterparty credit risk through capital requirements. It is true that capital requirements often do increase transaction cost for end-users, but they also avoid burdening end-users with unpredictable liquidity constraints. End-users hedge primarily to avoid these constraints. Thus, any hedging transaction that removes unpredictable exposures to interest rates or currency exchange rates, but simultaneously adds unpredictable liquidity burdens, diminishes an end-user's incentive to hedge and may cause some end-users to avoid hedging altogether.

End-users also generally have limited internal capacity and resources for managing constantly changing liquidity requirements. Large financial institutions are generally much better equipped to manage these administrative burdens.

---

33 76 Fed. Reg. 27572 (May 11, 2011).

34 76 Fed. Reg. 27582 (May 11, 2011). The Prudential Regulators also note that "the capital rules incorporated by reference into the proposed rule already address, in a risk-sensitive and comprehensive manner, the safety and soundness risks posed by a covered swap entity's derivatives positions." *Id.*

In response to the financial crisis, recent recommendations by the Basel Committee on Banking Supervision, known as the Basel III capital adequacy standards, will introduce significantly higher capital requirements for banks and, in particular, higher capital requirements for counterparty credit risks related to derivatives. These newly-heightened capital requirements will mitigate systemic risk and serve as potent insurance against a future financial crisis. Treasury Secretary Tim Geithner recently confirmed that the new Basel III capital requirements have been set "at a level designed to allow institutions to absorb a level of losses comparable to what we faced at the peak of this crisis."[35] Basel III would introduce a requirement to cover paper losses for the first time. Uncleared derivatives could require many more times the capital than required by pre-crisis regulations. According to one analysis, the expected U.S. adoption of Basel III's heightened capital requirements would require an additional $870 billion in Tier 1 capital, $800 billion in short-term liquidity, and $3.2 trillion in long-term funding.[36] In this regulatory environment, imposing margin requirements, especially on those that pose no meaningful threat to financial stability, is unnecessary given the robust new capital framework applicable to derivatives.

Further, banks are able to reduce credit exposure to end-users through credit hedging. If a bank's exposure to an end-user grows beyond acceptable internal limits—which could, for example, occur when those limits are lowered—banks are often able to enter into credit default swaps that compensate them in the event of an end-user's default. In such situations, whether or not its positions with the end-user are collateralized, the banks' hedged losses are offset. Such offsets can thus reduce negative outcomes associated with counterparty credit losses. The benefits to bank safety and soundness are contemplated also in capital requirements recommended by Basel III. Specifically, hedged credit risk reduces a bank's derivatives-related capital requirements. Similarly, margin rules should account for the lower risk posed to the system when credit risks are hedged. The Prudential Regulators should clarify that the benefits associated with credit hedging may be contemplated by SDs and MSPs when those entities establish and subsequently modify thresholds above which collateral must be posted by end-users.

Recommendations:

The Coalition recommends that Prudential Regulators consider the impact of the Basel capital requirements and take these capital requirements into account during the finalization of

---

35 Remarks by Treasury Secretary Tim Geithner to the International Monetary Conference (Jun. 6, 2011), *available at*: http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx.

36 McKinsey & Company, Basel III and European banking: Its impact, how banks might respond, and the challenges of implementation (Nov. 2010), *available at*: http://www.mckinsey.com/clientservice/Financial_Services/Knowledge_Highlights/~/media/Reports/Financial_Services/Basel%20III%20and%20European%20banking%20FINAL.ashx.

the proposed margin rule. Exposures that are subject to Basel capital requirements should not be subject to margin requirements or should be subject to substantively less onerous margin requirements than have been proposed by the Prudential Regulators, especially those margin requirements applicable to end-users.

IV. Financial End-Users Should Not Be Subject to Margin Requirements

A. Distinctions between Financial and Non-Financial End-Users in the Margin Context are Supported Neither by Logic nor the Statute

The trade associations represented in the Coalition represent thousands of American businesses, including non-financial end-users, as well as many of financial end-users. Many non-financial companies also have subsidiary entities that are financial in nature. For example, some non-financial companies centralize their treasury operations in entities that facilitate financing and hedging activities on behalf of affiliates under the same corporate umbrella. Other companies have captive finance units that provide financing to facilitate selling the parent company's products. The pension funds of non-financial firms will also be designated as financial entities and subject to clearing, trading and margin requirements even though they use derivatives to manage risk in ways that do not add risk to the financial system. All of these financial end-users predominately hedge commercial risks, just as their non-financial counterparts do. They all work to preserve liquidity, and they all use customized derivatives to hedge idiosyncratic risks. The Coalition has concerns that the proposed margin rule will disproportionately burden these financial end-users.

We believe that modifying the margin requirements for financial end-users without meaningfully increasing systemic risks is possible. A recent economic analysis performed by the OCC's economics department on the corresponding rule for bank SDs and MSPs supports our position.[37] The OCC analysis looked at the 74 OCC regulated banks that had more than $100 million in swaps as of December 31, 2010. The notional amount of swaps held by these 74 institutions totaled $179.49 trillion. The OCC then considered the impact of increasing the $100 million threshold to see the swap notional that would be outstanding when considering a smaller group of banks in the sample. Although raising the threshold from $100 million to $10 billion reduced the number of banks in the sample from 74 to 22, the outstanding notional for the remaining 22 banks remained virtually unchanged. The aggregate notional amount for the 22 largest institutions amounted to $179.44 trillion.

The OCC explains this phenomenon as follows: "Because total swap amounts are concentrated in a relatively small number of institutions, varying this threshold has little impact on the dollar amount of swaps affected by the proposed rule. Varying the threshold does, however, affect the number of institutions that would be subject to the proposed rule." Because

---

[37] Office of the Comptroller of the Currency, Economics Department, Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule (April 15, 2011).

of the concentration of swaps exposures within a small number of market participants, addressing systemic risk concerns is substantially a function of subjecting only those institutions to the salient aspects of regulation.

Subjecting end-users to margin requirements when those entities are not systemically risky and when they use derivatives to mitigate business risks makes only a fractional contribution to systemic risk reduction, while subjecting these entities to substantial economic burdens. These burdens may have far-ranging economic consequences. For example, pension funds, which played no role in the financial crisis and that make no meaningful contribution to systemic risk, nonetheless would be subject to costly new margin requirements, which could affect risk management practices and, as a result, retirement security generally.

During the debate over the margin provisions of the Dodd-Frank Act, the bill's managers did not distinguish between financial and non-financial end-users. For example, House Agriculture Committee Chairman Peterson stated that Congress had "given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant."[38] In response, House Financial Services Committee Chairmen Frank agreed, saying that "the gentleman is absolutely right. We do differentiate between end-users and others."[39] This colloquy was carefully crafted to emphasize that Congress wanted margin requirements to apply to SDs and MSPs, not financial or non-financial end-users. The text of the Dodd-Frank Act underscores the fact that no distinction between financial and non-financial end-users was intended with respect to margin requirements. There simply is no textual support for such a distinction in the statute.

B. The Proposed Rule does not Appropriately Distinguish between High Risk and Low Risk Financial Entities

The Coalition appreciates the Prudential Regulators' acknowledgement that not all financial entities pose a high risk to the financial system and that multiple factors must be considered to evaluate risk. However, we believe the criterion used by the Prudential Regulators to determine which entities are low risk do not account for important factors that we believe the Prudential Regulators should employ to distinguish the relevant risk characteristics of a particular entity. For example, the Treasury Department explained in a whitepaper that "[a]ny financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed…should be subject to robust consolidated supervision and regulation, regardless of whether the firm owns an insured depository institution."[40] The

---

38 156 CONG. REC. H5248 (June 30, 2010) (colloquy of Representatives Frank and Peterson).

39 156 CONG. REC. H5248 (June 30, 2010) (colloquy of Representatives Frank and Peterson).

40 Department of the Treasury, Financial Regulatory Reform: A New Foundation, *available at*: http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf.

Treasury Department's analysis establishes that the size of a derivatives portfolio, leverage, and interconnectedness must be considered *together* to determine whether an entity could pose a threat to the financial system. In other words, no single factor alone is sufficient to determine whether an entity should be classified as "high risk."

Although the proposed rule appropriately recognizes that not all financial entities are high risk, it focuses narrowly on regulatory capital requirements to distinguish between high risk and low risk entities. This criterion does not adequately capture each financial entity's true risk profile, which would be more appropriately assessed through an examination of its uncollateralized exposure to other market participants. As drafted, the proposed rule, would improperly classify many low risk entities as high risk. In fact, many entities classified as "high risk" could have materially lower risk characteristics than entities classified as "low risk." The Prudential Regulators therefore should take a more nuanced approach in defining "low risk" that takes into account all of the following criteria:

- The quantity of the entity's uncollateralized credit exposure to SDs and MSPs;
- Whether the derivative is used for hedging or speculative purposes;
- The entity's degree of leverage;
- The entity's dependence on substantial quantities of uncollateralized short-term funding; and
- The quantity of an entity's derivative counterparties or derivative transactions.

Being classified as a high risk financial end-user will impose high burdens on an end-user, as these entities must over-collateralize their derivatives exposures. The majority of low risk financial end-users, however, also face punitive margin requirements. The maximum threshold SDs and MSPs are permitted to set for financial end-users is proposed to be approximately $30 million.[41] This threshold is too low as the failure of an entity with much more material exposures could still have little or no impact on financial market stability. For many financial end-users, such a low and inflexible threshold system will not provide a meaningful relief from the burdens imposed by the proposed rule.

The proposed rule also defines low risk financial end-users as those that, among other things, "do not have a significant swaps exposure." It further defines significant swaps exposure as swap positions exceeding $2.5 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure. The Coalition believes the Prudential Regulators are justified in setting these thresholds at the level that determines which entities qualify as an MSP. We believe that levels set below such thresholds are unwarranted and urge the Prudential Regulators to adjust the thresholds for margin purposes accordingly.

---

41 76 Fed. Reg. 27587 (May 11, 2011).

C. At a Minimum, Financial End-User Swaps that Do Not Contribute to Systemic Risk Should Not be Subject to Margin Requirements

As Section IX below confirms, the Dodd-Frank Act does not give regulators the authority to impose margin on any swaps to which an end-user is a party.[42] If, however, the Prudential Regulators disregard the text of the Dodd-Frank Act and Congressional intent by imposing margin requirements on swaps that involve financial end-users, the Prudential Regulators should exempt specific classes of swaps from margin requirements that do not increase systemic risk.[43]

There are many classes of swaps that should rightly be exempt from the Dodd-Frank Act's margin requirements because they are used to hedge or mitigate commercial risk and do not contribute to systemic risk. We urge the Prudential Regulators to exempt from margin requirements all swaps entered into by end-users for these purposes. Further, we appreciate that the SEC and CFTC, in their proposed definition of those positions, "established to hedge or mitigate commercial risk," have relied upon a standard of "economic appropriateness" rather than a hedge accounting standard.

However, if the Prudential Regulators continue to believe that a different standard should be used for financial end-users than for non-financial end-users, we believe they should still exempt from margin requirements those swaps entered into by financial end-users that meet the highest standards for demonstrating that they are used to mitigate commercial risk. These include, for example, swaps that qualify for hedge accounting treatment pursuant to Accounting Standards Codification Topic 815, Derivatives and Hedging ("Topic 815"), previously known as Statement of Financial Accounting Standards No. 133. Because these hedges meet the highest standards for demonstrating that they are used to mitigate commercial risk, the likelihood that they will meaningfully contribute to systemic risk is remote. The purpose of hedge accounting under Topic 815 is to determine if a swap is "highly effective" at hedging a particular commercial risk, and if so, limit the end-user's accounting income volatility to actual operational performance. A hedge is deemed "highly effective" under Topic 815 when an end-user has demonstrated that a movement in or out of the money on the designated swap is offset by a corresponding opposite change in the entity's underlying cash flow or fair value. The result of a "highly effective" hedge for an end-user is that losses on the swap are offset by gains on the hedged item. These gains and excess cash flows are available to settle the trade with the counterparty. Thus, the offsetting nature of the cash flows that exist when taking into account

---

42 *See* Section IX *infra*. *See also* 7 U.S.C. § 4s(a)-(e); Dodd-Frank Act § 731.

43 We acknowledge that the Dodd-Frank Act directs the Prudential Regulators to impose margin requirements on swaps between Covered Swap Entities. Thus, if the Prudential Regulators exempted a specific class of swaps from margin requirements, we acknowledge that swaps within that class that are between Covered Swap Entities would still be subject to margin requirements.

both the hedge and the hedged item help reduce or eliminate the likelihood that such trades will pose a risk to financial stability.

An entity demonstrates the "effectiveness" of a swap via a comprehensive, rigorous process. First, the entity must comply with strict documentation requirements, including a declaration in writing upfront that the swap is intended to hedge a specific commercial risk. Next, the entity must perform effectiveness testing at the inception of a hedging relationship, conducting up to four statistical analyses using historical data to demonstrate a statistically significant correlation between the sales price of the underlying asset, such as a commodity, and the index from which the swap is priced. Finally, the entity must periodically re-perform these statistical tests over the life of the swap to demonstrate the continuing validity of the relationship. A swap can only qualify for hedge accounting treatment if all criteria are met. Given the rigorous requirements of hedge accounting, it would be inappropriate and unnecessary to apply margin requirements to swaps formally designated as hedging instruments.

Further, for derivatives positions held by financial end-users that may not meet the requirements of FAS 133, but that do meet the final definition of "positions established to hedge or mitigate commercial risk," the Coalition urges the Prudential Regulators to, at a minimum, allow for lower margin requirements than would be applied to speculative trades.[44] Such an approach matches current market practice in the futures market and would acknowledge the lower risks posed by derivatives used to mitigate commercial risk.

D. At a Minimum, Entities Exempt from Clearing Should be Exempt from Margin

Although we believe all financial and non-financial end-users should be exempt from margin requirements, we believe that, at a minimum, any entity that is exempt from clearing should also be exempt from margin requirements. There are two classes of entities that Congress exempted from the clearing requirement that Prudential Regulators, at a minimum, should exempt from margin requirements.

In particular, it is not clear whether the Prudential Regulators intended to classify captive finance units as financial end-users or as non-financial end-users. We note that the term "commercial end user" is "generally understood to mean a company that is eligible for the exception to the mandatory clearing requirement. . . ."[45] Because captive finance units are eligible for the exception to mandatory clearing, it could be concluded that they are commercial end-users. However, we urge Prudential Regulators to clarify that this is their intent.

---

[44] The CME Group's margin requirements on futures contracts allow for a lower margin requirement for hedges, *available at*: http://www.cmegroup.com/clearing/risk-management/historical-margins.html and http://www.cmegroup.com/clearing/risk-management/files/26_2008_to_december_2010.pdf.

[45] 15 U.S.C. § 78c-3(g).

Additionally, although the CFTC is required to consider whether to exempt small banks, farm credit system institutions, and credit unions from the clearing requirements, the Prudential Regulators have not made clear that such institutions are exempt from margin requirements. We urge them to do so in the final margin rule.

Recommendations:

In addition to the recommendation concerning swaps that are compliant with hedge accounting standards, if Prudential Regulators apply margin requirements to financial end-users, the Coalition recommends the following:

- Prudential Regulators should clarify that captive finance units are not intended to be classified as financial end-users.
- Contingent on the CFTC's decision to exempt small banks, farm credit system institutions, and credit unions, the Prudential Regulators should exempt these institutions from margin requirements.
- The definition of low risk financial end-user should remove the criterion referring to regulatory capital requirements.
- Classification as a high risk financial entity should be predicated on a combination of factors that include the following:
    - The quantity of the entity's uncollateralized credit exposure to SDs and MSPs;
    - Whether its derivatives are used for hedging or speculative purposes;
    - The entity's degree of leverage;
    - The entity's dependence on substantial quantities of uncollateralized short-term funding; and
    - The quantity of an entity's derivatives counterparties or derivatives transactions.
- The maximum threshold available to low risk financial end-users should be higher, be risk-based, and be commensurate with the amount of uncollateralized exposure that has systemic significance. Thresholds that would trigger classification as an MSP are a useful proxy for systemically significant exposures.
- The significant swaps exposure definition should reflect thresholds no lower than those that would qualify an entity as an MSP.
- At a minimum, financial end-users that use derivatives that qualify as hedges under Accounting Standards Codification Topic 815, *Derivatives and Hedging*, previously known as Statement of Financial Accounting Standards No. 133, should qualify for the same margin requirements as non-financial end-users.

V. Extraterritorial Scope of the Proposed Margin Rule

As the Prudential Regulators rightly point out,[46] numerous questions surround the extra-territorial reach of the margin regulations. The questions posed by the Prudential Regulators include the following:

- The permissible territorial scope of the proposed rule;
- The possibility of subjecting transactions to multiple, potentially conflicting, margin requirements established by U.S. and foreign regulators; and
- The potential distortion of competitive equality among U.S. and foreign covered swap entities.

To this list, the Coalition suggests adding several more questions and concerns from end-users about extra-territoriality. In particular, we urge the Prudential Regulators to clarify the potential for liquidity, price transparency, and availability of credit to be undermined by the proposed rule. We also believe that more information is needed about the uncertain statutory authority and applicability of the margin rule in foreign jurisdictions.

As proposed, few exceptions exist to the rule's extra-territorial reach. Our analysis in Figure B demonstrates that the margin requirements apply in 35 out of 36 possible scenarios. The proposed margin rule could touch almost every transaction, including transactions between entities with extremely tenuous ties or potential to affect the United States. Applying the proposed margin rule in this broad manner to foreign jurisdictions is unnecessary. Foreign covered swap entities will already have foreign capital, regulatory, and governance requirements. Overlapping and potentially conflicting regulations from multiple jurisdictions applying to the same swap may result. The compliance issues could also have a deleterious effect on the ability of end-users to administer effective and efficient risk management programs.

---

[46] 76 Fed. Reg. 27580 (May 11, 2011).

		U.S. SD or MSP		
		U.S. Branch	Foreign branch under U.S. law	Foreign subsidiary under foreign law
Counterparty	U.S. Corporation U.S. Branch under U.S. law	Fails (b)(1)(i), (iii) Fails (c)(1)	Fails (b)(1)(i), (iii) Fails (c)(2)	Fails (b)(1)(i), (iii) Fails (c)(2)
	U.S. Corporation Foreign branch under U.S. law	Fails (b)(1)(i), (ii) Fails (c)(1)	Fails (b)(1)(i), (ii) Fails (c)(2)	Fails (b)(1)(i), (ii) Fails (c)(2)
	U.S. Corporation Foreign subsidiary under foreign law	Fails (b)(1)(ii) Fails (c)(1)	Fails (b)(1)(ii) Fails (c)(2)	Fails (b)(1)(ii) Fails (c)(2)
	Foreign Corporation Foreign Branch under foreign law	Passes (b) Fails (c)(1)	Passes (b) Fails (c)(2)	Passes (b) Fails (c)(2)
	Foreign Corporation U.S. branch under foreign law	Fails (b)(1)(iii) Fails (c)(1)	Fails (b)(1)(iii) Fails (c)(2)	Fails (b)(1)(iii) Fails (c)(1)
	Foreign corporation U.S. subsidiary under U.S. law	Fails (b)(1)(i), (iii) Fails (c)(1)	Fails (b)(1)(i), (iii) Fails (c)(2)	Fails (b)(1)(i), (iii) Fails (c)(2)

		Foreign SD or MSP		
		U.S. subsidiary under U.S. law	U.S. branch under foreign. law	Foreign branch
Counterparty	U.S. Corporation U.S. Branch under U.S. law	Fails (b)(i), (iii) Fails (c)(1)	Fails (b)(i), (iii) Fails (c)(3)	Fails (b)(1)(i), (iii) Passes (c)
	U.S. Corporation Foreign branch under U.S. law	Fails (b)(1)(i), (ii) Fails (c)(1)	Fails (b)(1)(i), (ii) Fails (c)(3)	Fails (b)(1)(i), (ii) Passes (c)
	U.S. Corporation Foreign subsidiary under foreign law	Fails (b)(1)(ii) Fails (c)(1)	Fails (b)(1)(ii) Fails (c)(3)	Fails (b)(1)(ii) Passes (c)
	Foreign Corporation Foreign Branch under foreign law	Passes (b) Fails (c)(1)	Passes (b) Fails (c)(3)	Passes (b) Passes (c)
	Foreign Corporation U.S. branch under foreign law	Fails (b)(1)(iii) Fails (c)(1)	Fails (b)(1)(iii) Fails (c)(3)	Fails (b)(1)(iii) Passes (c)
	Foreign corporation U.S. subsidiary under U.S. law	Fails (b)(i), (iii) Fails (c)(1)	Fails (b)(i), (iii) Fails (c)(3)	Fails (b)(1)(i), (iii) Passes (c)

Figure B. Extraterritorial Application of Proposed Margin Rules[47]

[47] "Fails" or "Passes" denotes whether the swap transaction would qualify for the exemption under § ___.9 of the proposed rule. The first reference to "fail" or "pass" indicates whether the *counterparty* would qualify under the proposed exemption; the second reference indicates whether the *SD or MSP* would qualify. The transaction must "pass" both the counterparty and SD/MSP requirements in order to qualify for the proposed exemption. The subsections referenced are to § ___.9 of the proposed rule.

A. The Proposed Extraterritorial Application Would Diminish Access to Pricing Sources and Market Participants

U.S. companies that compete globally may have foreign branches, or foreign incorporated subsidiaries that hedge commercial risks. Historically, these foreign branches or subsidiaries have enough dealer counterparties to transact with, including foreign swap dealers and foreign branches or subsidiaries of U.S. swap dealers. Having access to a range of dealer counterparties provides multiple benefits—including more liquidity and more competition—which improves the cost of hedging. An overly-broad extraterritorial application of the Prudential Regulators' proposed margin rule could diminish access to a robust pool of pricing sources and market participants, including U.S. swap dealers operating a foreign branch or U.S. swap dealers operating a foreign incorporated subsidiary. This could reduce liquidity and market competition, leading to a potential decrease in price transparency and worse pricing than available today.

B. The Prudential Regulator's Extraterritorial Application of the Proposed Margin Rule Exceeds Their Statutory Authority

The Dodd-Frank Act explicitly restricts the extraterritorial application of rules promulgated under Title VII. Section 722 requires that "any rule prescribed or regulation promulgated under [Title VII] *shall not apply* to activities outside the United States. . . ."[48] For rules promulgated by the Prudential Regulators under Title VII, including the margin rule, the Dodd-Frank Act provides a single, specific exception to this prohibition on extraterritorial application: Title VII rules may apply to activities outside of the United States only if those activities "have a direct and significant connection with activities in, or effect on, commerce of the United States."[49] Section 722 does contain an additional anti-evasion provision that allows for further extraterritorial application of Title VII rules promulgated by the CFTC.[50] But only the CFTC has this additional anti-evasion authority. Any rules promulgated by the Prudential Regulators under Title VII cannot apply to activities outside of the United States for anti-evasion purposes. Therefore, the Dodd-Frank Act allows the Prudential Regulators' proposed margin

---

48 7 U.S.C. § 2(i); Dodd-Frank Act Section 722(d).

49 7 U.S.C. § 2(i); Dodd-Frank Act Section 722(d).

50 Section 722(d) of the Dodd-Frank Act provides that rules promulgated under Title VII may apply to activities outside the United States if those activities "contravene such rules or regulations as the *Commission* may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [Title VII]." 7 U.S.C. § 2(i); Dodd-Frank Act Section 722(d)(emphasis added). The term "Commission" refers solely to the Commodity Futures Trading Commission. It does not include the Prudential Regulators.

rule to apply to activities outside of the United States only if those activities have a "direct and significant connection with activities in, or effect on, commerce of the United States."

The proposed extraterritorial application of the margin rule exceeds the authority granted to the Prudential Regulators by the Dodd-Frank Act because the proposed rule applies margin requirements on activities that have no significant connection with U.S. commerce. The proposed rule places an inappropriately heavy focus on U.S. end-users' transactions with foreign operations by applying the margin rule on the hedging activities of these foreign operations. As Figure B shows, the margin rule would apply to numerous activities that would lack a significant connection with the United States, such as a trade between the foreign branch of a foreign bank and the foreign subsidiary of a U.S. company or commercial end-user. Even if a default occurred, it would have little or no impact, and definitely no significant impact, on U.S. SDs and MSPs. This kind of default would also not threaten the stability of the U.S. financial system.

Recommendations:

- We recommend that the guarantee language in the proposed rule should apply only if the counterparty guaranteeing performance of a foreign affiliate is an SD or MSP. Only in these cases would the guarantee language accomplish the statutory goal of the Dodd-Frank Act's margin provisions to ensure the safety and soundness of systemically significant institutions.
- We recommend that the Prudential Regulators look to where the locus of an entity's capital and regulatory requirements is located to determine whether the extraterritorial application of the proposed margin rule is appropriate and allowed by Title VII. If an entity's locus of capital and regulatory requirements is in a foreign jurisdiction, then the foreign regulator and foreign central bank should regulate that entity. U.S. regulators do not have statutory authority to ensure the safety and soundness of a foreign swap entity. Even if a foreign swap entity trades with a U.S. end-user, the transaction should not automatically be subject to the proposed margin rule.

VI. Treatment of Pre-Effective Date Swaps

The Coalition appreciates that the proposed margin rule does not generally apply to pre-effective date swaps. We note, however, the proposed rule may have an effect on pre-effective date swaps in the context of calculating margin under master netting agreements. The proposed rule states that an SD or an MSP "would be permitted, *at its option*, to calculate initial margin requirements on a portfolio basis but include only post-effective date derivatives in the relevant portfolio."[51] The Coalition is concerned that giving the option to the SD or MSP about whether to include pre-effective date swaps provides an incentive for the SD or MSP to choose whichever approach would maximize the amount of margin they collect. The rule could be construed to allow SDs or MSPs to make this decision without regard to the original documents in place between the counterparties and without regard to the risk posed by a counterparty. The Coalition

---

51 76 Fed. Reg. 27569 (May 11, 2011) (emphasis added).

requests that the Prudential Regulators clarify that there must be mutual agreement between the SD or MSP and its counterparty about whether to include pre-effective date swaps for netting purposes.

VII. Inter-Affiliate Swaps between Entities in a Single Corporate Group

The Coalition urges the Prudential Regulators to confirm that certain requirements regarding margin, central clearing and execution, and real-time reporting, that are applicable to street-facing swap transactions requirements, do not apply to inter-affiliate swaps. As a unique swap class, inter-affiliate swaps do not implicate concerns about the systemic risk, transparency, and market stability that Congress enacted the Dodd-Frank Act to address. Instead, efficient inter-affiliate swaps encourage commercial end-users to adopt centralized hedging practices, which reduce risk and lower costs.

Without clarification from regulators, the Dodd-Frank Act could be misunderstood to require commonly-controlled affiliates to post margin to other entities in the same corporate group. Such unnecessary requirements would require artificial and inefficient capital allocations for end-users, increase consumer costs, and undermine efficiencies that end-users currently realize through their centralized hedging affiliates.

A. Definition of "Affiliate"

The Dodd-Frank Act relies on the Federal Deposit Insurance Act's ("FDI Act") definition of control.[52] The Dodd-Frank Act cautions, however, that if "context otherwise requires," then the term "control" should be interpreted differently than in the FDI Act.[53] The Coalition agrees that determining what constitutes control in any given situation should take into account that situation's context. Specifically, we believe that any interpretation of the term "control" should reflect the economic reality of a given situation. This flexible approach would be preferable to instituting a single definition of "control," which may function well in many situations, but be inappropriate in others.

For the purposes of the SD and MSP definitions, the Coalition believes that the definition of control described in our comment letter regarding entity definitions is appropriate and matches

---

[52] Dodd-Frank Act, § 2(18). "(2) Any company has control over a bank or over any company if—(A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company; (B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or (C) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company." 12 U.S.C. § 1841(a)(2).

[53] Dodd-Frank Act § 2.

the economic reality of that situation.[54] In the context of inter-affiliate swap transactions, entities should be considered to be affiliates of a parent entity not only when those entities are wholly-owned, but also when the parent entity manages and has day-to-day control over the entity. In other words, if a parent and subordinate entity are treated as a single entity for all or almost all other purposes, the group should be treated as a single entity for purposes of swap transactions as well.

B. The Economic Reality of Inter-Affiliate Swaps

Regulation of inter-affiliate swaps should square with a simple economic reality: They do not increase systemic risk. Instead, inter-affiliate swaps merely allocate risk within a corporate group. For example, many end-users execute a significant portion of their swap transactions through wholly-owned central hedging centers. In this common organizational model, the hedging center may structure transactions to offset risk for the parent company and its affiliates or follow specific hedging instructions from affiliated entities within the corporate group. Although variation in the structure of trades exists, the hedging center typically serves as the primary street-facing entity for the entire corporate group, entering both into transactions with affiliated entities and into corresponding hedge positions with unaffiliated SDs.

Thus, under this and similar organizational models that use inter-affiliate swaps, the swaps serve as an internal allocation of risk—not speculative trades that create risk. In effect, affiliate swaps are largely equivalent to inter-company loans, which merely shift capital and risk among entities in the same corporate group.

Instead of increasing risk, to the contrary, the centralized hedging model not only serves to reduce risk, but also benefits both end-users and consumers in other ways. From a risk perspective, the model centralizes trade expertise and execution in a single entity. This concentration of trade execution talent improves a corporate group's ability to accurately evaluate the credit risk profile of counterparties it faces and allows it to be more discerning about which counterparties it trades with. The centralized model also allows for the central hedging affiliate to manage risk across the entire corporate group, leading to increased efficiency and more comprehensive risk management.

The centralized model has the added benefit of being able to net positions across an entire corporate group, which lowers the overall credit risk a corporate group poses to the market generally. It also provides a broader base for the netting of counterparty-facing transactions. Without the centralized model, costs would increase for all entities across the board. For example, affiliates could lose the benefit of their parent's corporate credit rating if they hedged

---

[54] The Coalition for Derivatives End-Users, Comment Letter Regarding Entity Definitions, 15 (Feb. 22, 2011), *available at*: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27971&SearchText=coalition%20for%20derivatives%20end-users.

as stand-alone entities. There would also be increased duplication of functions in in execution, accounting, settlement, compliance, risk management, and reporting, including mandatory filings.

We urge the Prudential Regulators to acknowledge the economic reality of inter-affiliate swaps and exempt them from the Dodd-Frank Act's margin, requirements.

C. Regulating Inter-Affiliate Swaps Interferes with Corporate Business and Risk Decisions

Many of the benefits and opportunities for risk reduction provided by the centralized hedging model would disappear, however, if regulators imposed the same requirements on both external and inter-affiliate swaps. The increased costs associated with full regulation of inter-affiliate swaps would push firms away from centralized hedging and back to a decentralized model. Full inter-affiliate swap regulation would substitute corporate business judgment with a government mandate and could put economic pressure on companies to stop using a successful business model that has many benefits.

D. Inter-Affiliate Swaps Should Not Be Subject to Margin Requirements

Without clarification from the Prudential Regulators, the Dodd-Frank Act could be misunderstood to require commonly-controlled affiliates to post margin to other entities in the same corporate group. Such unnecessary requirements would require artificial and inefficient capital allocations for end-users, increase consumer costs, and undermine efficiencies that end-users currently realize through their centralized hedging affiliates.

Congress established margin requirements to offset the systemic risk posed by uncleared swaps to the "swap dealer or major swap participant and the financial system."[55] To this end, the Dodd-Frank Act requires the Prudential Regulators to adopt margin regulations that meet two, specific criteria: Any margin regulations must both "help ensure the safety and soundness of the swap dealer or major swap participant" and "be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."[56] In other words, Congress requires regulators to use systemic risk as a gauge for calibrating the appropriate level of margin.

The Coalition believes that imposing margin requirements on inter-affiliate trades would cut against these explicit, systemic risk-based standards set forth in the Dodd-Frank Act for promulgating margin rules. As a unique class, inter-affiliate swaps do not increase systemic risk, and, as described above, instead help lower risk by allowing end-users to adopt centralized hedging practices. Imposing margin requirements on inter-affiliate trades would merely cause

---

55 7 U.S.C. § 4s(e)(3)(A); Dodd-Frank Act § 731.

56 7 U.S.C. § 4s(e)(3)(A); Dodd-Frank Act § 731.

margin to be transferred between affiliates that operate and are treated as a single entity. Inter-affiliate trades also could not somehow be used to transfer risk without adequate margin because all affiliates within a corporate group are consolidated for financial accounting and reporting purposes. Margin requirements would thus ignore both economic reality and the Dodd-Frank Act's requirement that margin be set according to systemic risk. Because inter-affiliate swaps pose no systemic risk, they should not be subject to margin.

The Dodd-Frank Act's margin provisions give the Prudential Regulators broad discretionary authority for how they promulgate margin rules. Nothing in the Dodd-Frank Act explicitly or implicitly directs the Prudential Regulators to impose margin requirements on inter-affiliate swaps specifically. For inter-affiliate swaps that involve end-users, the argument is simple: As Section IX below confirms, the Prudential Regulators do not have the authority to impose margin on any end-user swaps, which includes end-user inter-affiliate swaps. In all other situations, including one in which the Prudential Regulators do not follow the text and Congressional intent of the Dodd-Frank Act and impose margin requirements on end-users, regulators still have authority to prevent margin from being paid or collected for inter-affiliate swaps.

First, the Dodd-Frank Act states only that regulators must impose margin "requirements" on all swaps between SDs and MSPs. The Prudential Regulators could thus impose "requirements" that allow unlimited margin thresholds for calculating margin for inter-affiliate swaps. This approach would satisfy the statute because there would be a margin requirement, but still allow the parties to inter-affiliate trades to escape actually having to pay margin in practice. Second, as already explained, Congress requires regulators to set their margin requirements to ensure "the safety and soundness of the swap dealer or major swap participant," and to "be appropriate for the risk associated with the uncleared swaps held as a swap dealer or major swap participant."[57] Because inter-affiliate swaps, by nature, do not pose systemic risk, excepting them from margin requirements easily satisfies these two criteria.

E. Inter-Affiliate Swaps Should Not Be Subject to Clearing and Execution Requirements

Legislative history confirms that Congress did not want clearing and execution requirements to apply to inter-affiliate swaps. Senator Lincoln, Chairman of the Senate Agriculture Committee and one of the Dodd-Frank Act's chief architects, explained during debate that "[w]hile most large financial entities are not eligible to use the end-user clearing exemption for standardized swaps entered into with third parties, it would be appropriate for regulators to exempt from mandatory clearing and trading inter-affiliate swap transactions which are between wholly-owned affiliates of a financial entity."[58]

---

57 7 U.S.C. § 4s(e)(3)(A); Dodd-Frank Act § 731.

58 156 CONG. REC. S5921 (July 15, 2010).

Congress took this position for good reason: Subjecting inter-affiliate swaps to clearing and execution requirements would double regulate many transactions and destroy the efficiency of centralized hedging for end-users. Regulating a street-facing swap as well as its allocation within a corporate group could require companies that are subject to the mandatory clearing requirements to clear the same swap twice. This excessive clearing would drive up costs and deter end-users from using centralized hedging, which requires efficient, inexpensive inter-affiliate swaps. Also, inter-affiliate trades do not need the protection against the pitfalls of unfair or off-market pricing or direct bilateral credit risk implicated by non-affiliate swaps.

F. Inter-Affiliate Swaps Should Not Be Subject to Real-Time Reporting Requirements

The Dodd-Frank Act's real-time reporting requirements aim to increase market liquidity and enhance price discovery.[59] Reporting real-time transaction data for inter-affiliate swaps, however, would accomplish neither goal. It could instead misrepresent market liquidity by double-counting transactions and flood the market with irrelevant pricing data. In a public swaps market, a swap's price reflects costs associated with trading of the swap such as hedging costs, administrative costs, and possible credit costs. Real-time reporting data of prices that do not include these costs does not provide market participants with better information about the market than they could otherwise obtain. Because inter-affiliate swaps occur between entities that are commonly controlled, the prices and other transaction details of these swaps do not reflect the prices, trading volume, or other characteristics that the swap would have were it traded in a public market. Thus, the real-time reporting of inter-affiliate trades will not enhance price discovery for market participants. In fact, it is feasible that such information could distort public perception about market prices, by double counting that arises through examination of both the marketing facing and inter-affiliate trades.

G. A Regulatory Exemption for Inter-Affiliate Swaps Would Not Lead to Abuse

Because inter-affiliate trades merely allocate risk within a corporate group, they do not mitigate external counterparty credit risk. No matter how many inter-affiliate trades a corporate group executes among its affiliates, the exposure created by external swaps would not change. Similarly, a series of internal trades, no matter how long, would not serve to lay risk off from an entity to the market. Hence, there is no compelling reason to believe that inter-affiliate swaps would be used to avoid requirements imposed on external swaps, as one is not an economic substitute for the other. In any event, Section 721(c) of the Dodd-Frank Act gives regulators explicit anti-evasion authority to respond to and prevent any possible abuse as needed.

---

[59] Dodd-Frank Act § 727.

H. Title II Provides a Framework for Resolving Inter-Affiliate Swaps

Instead of simplifying the resolution of a default scenario, imposing the full force of derivative regulations on inter-affiliate swaps would complicate the unwinding process by discouraging use of the centralized hedging model. Unwinding a bankrupt company that employs centralized hedging is thus both more streamlined and less risky. For one thing, affiliate trades are facilitated through a centralized trade execution model, and such a model streamlines the resolution of a failed or failing company. Centralization means that ISDA contracts are consolidated within one or few entities and that, through netting, the number of exposures to the bankruptcy estate can be limited.

In bankruptcy, systemically-significant entities will be regulated under the resolution authority provisions of Title II of the Dodd-Frank Act. Among other things, these companies will have to develop "living wills" that ensure smooth and efficient resolution of any default.

VIII. End-User Status of Affiliated Entities that Engage in Street-Facing Swaps

The Coalition believes that all individual legal entities should stand on their own individual characteristics for purposes of determining whether an entity qualifies for end-user treatment. In particular, we urge the Prudential Regulators to avoid classifying entities based on their affiliation with a parent company, other affiliates in the same corporate group, or joint venture relationships. An affiliate's relationship to its parent company, to other affiliates of the parent company, and to other entities involved in a joint venture should not affect whether the affiliate qualifies as an end-user.

The Coalition also urges the Prudential Regulators to regulate swaps according to the specific entity where a swap resides. For example, if an end-user affiliate or end-user joint venture enters into a swap, the swap should be treated as an end-user swap. The swap should not be regulated as if it had been entered into by the affiliate's parent or by one of the partners of the joint venture. A swap at the end-user level is not adding to systemic risk because the end-user owns the underlying asset if it is hedging. Any changes in the value of the swap are offset by the opposite change in the value of the asset. In fact, by entering into a swap, the end-user affiliate may actually be lowering the risk level of the parent (on a per dollar invested level) or keeping the risk level of the parent neutral (on a total dollar risk level) because the alternative would be to forego the hedge and subject the parent to additional commercial risk.

The drafters of the Dodd-Frank Act did not intend for end-users to be classified and regulated as MSPs.[60] Thus, subjecting entities that would otherwise be classified as end-users to

---

60 "Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simple because they use swaps to hedge risk in their ordinary course of business. Congress does not intend to regulate end-users as Major

[Footnote continued on next page]

enhanced regulation simply because of the corporate structure in which the entity resides would be contrary to the Dodd-Frank Act.

A. The Existence of a Guarantee Should Not Change an Affiliate's End-User Status

A credit support provider's entity classification should not affect the classification of the entity receiving credit support. When entering into a swap to hedge or mitigate commercial risk, an affiliate or subsidiary that would otherwise qualify as an end-user may rely on credit support from an MSP parent entity. In such a situation, the affiliate or subsidiary should still be classified as an end-user, regardless of its reliance on the parent entity for credit support. The issuance of such guarantees does not increase or alter the risk profile of the parent guarantor because the underlying commodity or other position of the subsidiary provides offsetting collateral.

B. Subsidiaries of a Parent Company Should Not Automatically Acquire the Same Classification as Their Parent Companies

Subsidiaries of a parent company should also be classified based on their own characteristics. For example, a parent company that is primarily financial in nature may be designated as an MSP because it uses swaps for financial reasons other than reducing risks associated with its business. Although the parent company is primarily financial in nature, it also acts as a holding company and wholly or partially owns several subsidiaries. These subsidiaries could include, for example, manufacturing businesses, which make and supply tangible goods to consumers. The manufacturing subsidiaries, by practice, agree to deliver materials to customers and receive payment for those materials at a later date. After delivering the materials, the manufacturers might enter into credit hedges to mitigate the risk of not receiving payment from their customers.

Here, the manufacturing subsidiaries are end-users of swaps, using them to hedge or mitigate their commercial risks associated with the manufacturing business. They would each be classified as end-users if they were not wholly or partially owned by a holding company that is primarily financial in nature, or that has MSP classification. The fact of the affiliate companies being owned by a financial parent entity should not change the manufacturer's classification as end-users. The manufacturers' reasons for using these swaps are the same—to hedge or mitigate commercial risk—regardless of the corporate form and their parent's classification.

Similarly, a non-consolidated joint venture, regardless of who the joint venture partners are, should be treated as an end-user if a swap is entered into by the joint venture and not by one of the partners, and the joint venture uses derivatives to hedge risks associated with its business

---

[Footnote continued from previous page]

Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business." 156 CONG. REC. S6192 (July 22, 2010).

activities. Smaller companies may receive less capital from larger companies if a larger company's status as an SD, MSP, or financial entity, requires a joint venture to post margin.

These and many other possible examples demonstrate the same point: the mere fact that an end-user is affiliated with a parent does not make the affiliate's swaps more risky. It is imperative to keep in mind the Dodd-Frank Act's overarching goal: to reduce systemic risk. A counterparty's true exposure and the risk it poses to the system can be determined only by looking at offsetting positions, the purpose behind its trades, and the potential it has to affect other parties in the system. Thus, because systemic risk is not increased when an end-user is an affiliate of a financial parent entity, end-users should be regulated in the same manner as if they were not so affiliated.

IX. Prudential Regulators do not have authority to impose margin requirements on end-users.

A. The Prudential Regulators' Proposed Margin Rules Do Not Give Effect to the Unambiguous Intent of Congress, as Required Under the *Chevron*

The Dodd-Frank Act does not authorize the regulators to impose margin on end-users. Hence, the proposed margin regulations go beyond the authority granted by the Dodd-Frank Act. In crafting the margin framework for uncleared swaps, the Prudential Regulators are required to give effect to the clear intent of Congress that end-users not be subject to the margin framework mandated by the Dodd-Frank Act.[61] The proposed margin regulations do not give effect to the plain intent of Congress and, as such, are an impermissible interpretation of the Dodd-Frank Act.

To determine whether an agency's interpretation of a statute is permissible, courts use the *Chevron* two-step analysis. Under *Chevron*, the courts will determine first whether Congress has directly spoken to the precise question at issue. "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[62] If the court determines that Congress has not directly addressed

---

[61] *See e.g.*, Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843 (1984).

[62] Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842–43 (1984); *See also*, Catawba County, N.C. v. E.P.A., 571 F.3d 20, 35 (D.C. Cir. 2009) ("[A] statute may foreclose an agency's preferred interpretation despite such textual ambiguities if its structure, legislative history, or purpose makes clear what its text leaves opaque."); Bell Atlantic Tel. Cos. v. F.C.C., 131 F.3d 1044, 1047 (D.C. Cir. 1997) ("Under the first step of Chevron, the reviewing court must first exhaust the 'traditional tools of statutory construction' to determine whether Congress has spoken to the precise question at issue. The traditional tools include examination of the statute's text, legislative history, and structure, as well as its purpose. . . . If this search yields a clear result, then Congress has expressed its

[Footnote continued on next page]

the precise question at issue, the court will determine whether the agency's interpretation is based on a reasonable reading of the statute.[63]

Here, the precise question at issue is whether Congress intended for end-users to be subject to margin requirements. The intent of Congress is clear on this question—Congress intended that end-users should be exempted from the margin framework mandated by the Dodd-Frank Act. Under step one of the *Chevron* analysis, to determine whether Congress has addressed the issue, courts use "traditional tools of statutory construction," which include "examination of the statute's text, legislative history, and structure, as well as its purpose."[64] As demonstrated in greater detail in the subsections below, using the tools of statutory construction it is evident not only that Congress addressed the issue at hand, but that its intent was unambiguous. The structure, legislative history, and purpose of the Dodd-Frank Act all evidence that Congress did not intend for end-users to be subject to margin requirements and the Prudential Regulators' implementation of the margin regulations to the contrary is beyond the authority granted to them.

The Prudential Regulators' proposed margin regulations do not "give effect to the unambiguously expressed intent of Congress."[65] As Section IX.B discusses, the structure of Title VII of the Dodd-Frank Act, particularly Section 731, authorizes the Prudential Regulators to impose margin only on SDs and MSPs. This limited scope of authority does not permit the regulators to fashion the margin framework that they have proposed and, in so doing, they have exceeded their statutory authority.

Further, as shown Section IX.C, the legislative history of the Dodd-Frank Act leaves no doubt that it was Congress' intent to exempt end-users from margin requirements. The statements of numerous members of Congress during the debates surrounding the Dodd-Frank Act, including, importantly, the managers of the Dodd-Frank Act in both the House and the Senate— Congressmen Frank and Peterson and Senators Dodd and Lincoln, respectively— confirm that Congress did not intend that the Dodd-Frank Act would result in end-users being subject to margin requirements.

The Dodd-Frank Act was enacted to address systemic risk and to ensure the safety and soundness of SDs and MSPs, as discussed in IX.D. These goals do not mandate that the regulators impose margin on end-users. In fact, by imposing margin on end-users, the regulators

---

[Footnote continued from previous page]
intention as to the question, and deference [to the agency's interpretation] is not appropriate").

63 Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843 (1984).

64 Bell Atlantic Tel. Cos. v. F.C.C., 131 F.3d 1044, 1047 (D.C. Cir. 1997).

65 F.D.A. v. Brown & Williams Tobacco, 529 U.S. 120, 125-126 (2000).

are increasing systemic risk by limiting the liquidity of end-users and subjecting them to burdensome requirements. The proposed margin requirements hinder the purpose of the Dodd-Frank Act and, as such, are contrary to the clear intent of Congress. Under the *Chevron* analysis, therefore, the Prudential Regulators' proposed regulations are not "based on a permissible construction of the statute"[66] as they "contravene the unambiguously expressed intent of Congress."[67] As such, the Dodd-Frank Act "foreclose[s] [the regulators'] preferred interpretation despite such textual ambiguities [as] its structure, legislative history, or purpose makes clear what its text leaves opaque."[68]

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

Section 731 of the Dodd-Frank Act amends the Commodity Exchange Act, 7 U.S.C. § 1 et seq. ("CEA") to add a new section 4s, entitled "Registration and Regulation of Swap Dealers and Major Swap Participants." This new section states that the Prudential Regulators are authorized to establish margin requirements *only* for SDs and MSPs that are banks. This limitation is reiterated throughout Section 731 of the Dodd-Frank Act, in a general grant of rulemaking authority, in the specific grants of authority to promulgate the regulations setting margin requirements, and in provisions identifying which entities must comply with the new margin requirements.

The Dodd-Frank Act defines the terms "swap dealer" and "major swap participant," the key regulated entities under Title VII, to identify *how* and *to whom* the Dodd-Frank Act's new reporting, clearing, capital, and margin requirements will apply. The scope of Section 731's operative provisions is thus defined by these terms.

Section 731 of the Dodd-Frank Act grants the Prudential Regulators the authority to impose margin on an important, but limited class of regulated swap entities—MSPs and SDs. The NPRM reads as follows: "The plain language of [Section 731] provides that the Agencies adopt rules for covered swap entities imposing margin requirements on *all non-cleared swaps*."[69] From this, the NPRM claims authority to impose margin on the uncleared swaps of MSPs and SDs, including swaps that are with end-user counterparties. But this interpretation of authority is supported neither by a close reading of the text of the statute nor its legislative history.

---

66 Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842–43 (1984).

67 NationsBank of N.C. v. Variable Annuity Life Ins. Co., 53 U.S. 251, 257 (1995).

68 Catawba County, N.C. v. E.P.A., 571 F.3d 20, 35 (D.C. Cir. 2009).

69 76 Fed. Reg. 27569 (May 11, 2011) (emphasis in original).

Subsection 731(e)(2)(A) requires that the Prudential Regulators "adopt rules *for* swap dealers and major swap participants, *with respect to their activities as a swap dealer and a major swap participant*."[70] The NPRM interprets this language as granting the Prudential Regulators authority to deputize swap entities *to collect* margin from their counterparties, including end-users. But the statute does not say that Prudential Regulators are authorized to adopt rules "for" swap entities to "collect" margin from end-users and others; it says that the rules are to impose margin on the swap entities themselves. Indeed, referencing subsection 731(2)(A), the immediately preceding text, subsection 731(e)(1)(A), requires that each swap entity "*shall meet* . . . such minimum initial and variation margin requirements as the prudential regulator shall by rule or regulation prescribe under paragraph (2)(A)."[71] If subsection 731(e)(2)(A) were intended to authorize the Prudential Regulators to deputize swap entities to *collect* margin from end-users and others, subsection 731(e)(1)(A) would not have framed the authority solely in terms of swap entities "meeting" margin requirements. Instead, the statute would have referred also to swap entities' responsibilities to "collect" margin or "execute" margin collection requirements. But the statute includes no such text. This absence of explicit authority to impose margin collection requirements on SDs and MSPs is entirely consistent with the Dodd-Frank Act's legislative history, which makes clear that Congress never intended for margin to be imposed on end-users.

The plain text of the Dodd-Frank Act also makes clear that end-users are not within the regulatory framework governing margin. First, Section 731 by its title, "Registration and Regulation of *Swap Dealers and Major Swap Participants*,"[72] limits its applicability only to MSPs and SDs. The focus of Section 731 is on MSPs and SDs and all requirements therein apply to MSPs and SDs and their activities as MSPs and SDs. Similar to the margin requirements subsection, the other subsections of Section 731 on recordkeeping and reporting, real-time reporting, and business conduct standards all deal with the regulation of MSPs and SDs and specify, when applicable, other entities to which the rules apply.[73] Consequently, if Congress wanted to grant the Prudential Regulators authority to impose margin requirements on other entities it would have identified these entities in the margin requirements subsection, as it did in other subsections of Section 731.

The NPRM states that Section 731, by its terms, does not "exclude a swap with a

---

[70] Dodd-Frank Act § 731(e)(2) (emphasis added).

[71] Dodd-Frank Act § 731(e)(1)(A) (emphasis added).

[72] Emphasis added.

[73] For example, Dodd Frank Act § 731(g)(1) requires SDs and MSPs to maintain daily trading records for their swaps and Dodd-Frank Act § 731(g)(3) specifies the maintenance of daily trading records for the counterparties of SDs and MSPs.

counterparty that is a commercial end user."[74] What is more important, however, is that Section 731 does not *include* end-users among the regulated entities for which the Prudential Regulators may set margin requirements. The Dodd-Frank Act does not authorize the Prudential Regulators to impose margin, directly or indirectly, on end-user counterparties. It is thus not necessary for end-users to be explicitly excluded from the margin requirements: Section 731 consistently and exclusively identifies MSPs and SDs as the entities subject to margin, and end-users do not fall within the statutory definition of MSPs or SDs.[75] Section 723, which prescribes clearing obligations, applies to "any person [who] engage[s] in a swap," whereas Section 731 specifically applies to "swap dealers and major swap participants." Because of this, Section 723 includes an exemption for certain end-users from the mandatory clearing requirement; however, Section 731 does not have a similar exemption as its scope is restricted to MSPs and SDs already.

Because the text and history behind Section 731 together produce a plain meaning contrary to that assumed in the NPRM, we do not believe the proposed rule can stand because it imposes margin requirements on end-users.[76] We thus urge the Prudential Regulators to interpret Section 731 as authorizing the imposition of margin only on trades in which an SD or MSP is a counterparty and an end-user is not.

C. Exempting End-Users from Margin Rules is Consistent with the Legislative History of the Dodd-Frank Act

The legislative history also confirms, leaving no doubt, that the Dodd-Frank Act's drafters did not mean for Section 731 to apply to end-users. One of the main topics during the discussions and debates surrounding the Dodd-Frank Act was exemption of end-users from certain provisions. Throughout the drafting process 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. Before consideration of the Dodd-Frank Act in conference, the margin provisions in the bill

---

74 76 Fed. Reg. 27569 (May 11, 2011).

75 Indeed, Senators Dodd and Lincoln in their letter to Congressmen Frank and Peterson explicitly stated that amendments to Section 731, which removed the margin exemption for end-users, were made "to eliminate redundancy." 156 CONG. REC. S6192 (July 22, 2010). *See* Section IX.C *infra* for further discussion.

76 *See, e.g.,* Chevron U.S.A., Inc. v. Natural Resource s Defense Council, Inc., 467 U.S. 837, 843 (1984) ("If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect."); *see also* Section IX.A *supra*.

initially passed by the Senate included a broad transaction-based exemption.[77] This exemption was not limited to the end-user side of a swap, but instead 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 SD and MSP.

Importantly, although the transaction-based exemption was removed, members of Congress were, nonetheless, unequivocal in their position that the Prudential Regulators lacked the authority to impose margin a swap to which an end-user is a counterparty. During the final conference report discussions, Representative Peterson stated:

> Now, that has been of some concern and, frankly, a misinterpretation of the conference report's language regarding capital and margin requirements by some who want to portray these requirements as applying to end users of derivatives. This is patently false.
>
> The section in question governs the regulation of major swap participants and swap dealers, and its provisions apply only to major swap participants and swap dealers. Nowhere in this section do we give regulators any authority to impose capital and margin requirements on end users. . . . One of the sources of financial instability in 2008 was that derivative traders like AIG did not have the resources to back up their transactions. If we don't require these major swap participants and swap dealers to put more backing behind their swap deals, we will only perpetuate this instability. That is not good for these markets, and it is certainly not good for end users.[78]

This statement by Representative Peterson, a principal House author of the Dodd-Frank Act, makes clear that it was not the intent of Congress that the margin requirements would be imposed on end-users, either directly or indirectly. Rather, in establishing margin requirements for uncleared swaps, Congress authorized the Prudential Regulators to impose margin requirements on SDs and MSPs to prevent instability of these entities, thereby protecting the market and end-users.

A later exchange between Representatives Frank and Peterson further emphasizes this point:

> Mr. PETERSON. [W]e have given the regulators no authority to impose

---

[77] The Senate-passed version of the Act stated that margin requirements would not apply to swaps in which one of the counterparties was not an SD, MSP, or a counterparty eligible for and using the commercial end-user clearing exemption. S. 3217, § 731(e)(8).

[78] 156 CONG. REC. H5245 (June 30, 2010) (colloquy of Representative Peterson).

> margin requirements on anyone who is not a swap dealer or a major swap participant. 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. . . . That margin will be important, however, to ensure that the dealer or major stock [sic] participant will be capable of meeting their obligations to the end-user. . . . 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. They are only on the financial and major swap participants.[79]

Statements by other members of Congress regarding the Dodd-Frank Act leave no doubt that Congress did not draft the margin requirements with the intention that end-users would be subject to margin. For example, Representative Peters stated: "… because commercial end users, who are those who use derivatives to hedge legitimate business risks, do not pose systemic risk and because they solely use these contracts as a way to provide consumers with lower cost goods, they are exempted from clearing and margin requirements."[80] Similarly, Representative Perlmutter stated: "[The Dodd-Frank Act] also recognizes the important role that derivatives play in actually reducing systemic risk for our end user companies and in increasing the flow of credit throughout our economy. . . . These end-user companies pose little or no systemic risk to our economy, and this bill protects them from unnecessary and burdensome margin and clearing requirements."[81] These statements help demonstrate that it was not Congress's intent for margin to be imposed on end-users. Members of Congress reiterated repeatedly that under the Dodd-Frank Act, end-users are exempt from margin requirements.

Senators Dodd and Lincoln submitted a June 30, 2010 letter to the House sponsors of the Dodd-Frank Act, which addressed the treatment of end-users under the Act. As Senators Dodd and Lincoln explained in this letter, 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."[82] The Senators go on to state:

> Congress clearly stated in [the Dodd-Frank Act] that the margin and capital requirements are not to be imposed on end users, nor can the

---

79 156 CONG. REC. H5248 (June 30, 2010) (colloquy of Representatives Frank and Peterson).

80 156 CONG. REC. H5244 (June 30, 2010) (colloquy of Representative Peters).

81 156 CONG. REC. H5230 (June 30, 2010) (colloquy of Representative Perlmutter).

82 156 CONG. REC. S6192 (July 22, 2010).

> regulators require clearing for end user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, *but rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction*.[83]

The June 30, 2010 letter addresses directly the margin regime that the Prudential Regulators have proposed, *i.e.* one in which margin is imposed on end-user counterparties. It states unequivocally that the Prudential Regulators do not have the authority to create this type of regime.

The Senators in their June 30, 2010, letter go on to explain that changes to the Dodd-Frank Act with regard to margin requirements were not meant to remove the exemption for end-users from margin requirements:

> 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 [the Dodd-Frank Act], 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 [Dodd-Frank Act] regulating capital and margin requirements for Swap Dealers and Major Swap Participants should not be construed as changing this important Congressional interest in protecting end users. *In fact, the House offer amending the capital and margin provisions of Sections 731 and 764 expressly stated that the strike to the base text was made "to eliminate redundancy."*[84]

As the Senators noted, revisions to margin provisions in conference were *not* intended to authorize the application of margin rules to end-users. These statements by the Senate sponsors of the Dodd-Frank Act confirm what the text makes clear: The Prudential Regulators are not authorized to impose margin on non-MSPs and non-SDs. And the fact that the margin section of Title VII does not include a specific exemption for end-users reflects the fact that a specific exemption would be a "redundancy." Indeed, the Prudential Regulators acknowledge that Congress intended for end-users to be exempt from margin requirements.[85] Yet, instead of

---

83 156 CONG. REC. S6192 (July 22, 2010) (emphasis added).

84 156 CONG. REC. S6192 (July 22, 2010) (emphasis added).

85 "In addition, statements in the legislative history of [Section 731]… suggest[s] that Congress did not intend, in enacting [this] section, to impose margin on … end users engaged in

[Footnote continued on next page]

adhering to the expressed intent of all four of the bill's managers, the Prudential Regulators have constructed a regulatory framework that not only allows for margin to be imposed on end-users, but provides regulators with authority to require, on a case-by-case basis, that SDs and MSPs collect margin from end-user counterparties.

To be sure, the great majority of end-user trades are entered into with swap dealers. It is also not disputed that Section 731 permits, but does not require, the Prudential Regulators to require SDs or MSPs to post margin. But nothing in the Dodd-Frank Act permits the Prudential Regulators to require the collection of margin from end-user counterparties in swaps with SDs and MSPs. Such an extension of margin rules would eviscerate the exemption for end-users in the SD and MSP definition, because virtually all end-user swaps are linked to an SD or MSP counterparty. Senators Dodd and Lincoln made precisely this point in their June 30, 2010 letter:

> This is . . . why we narrowed the scope of Swap Dealer and Major Swap Participant definitions. . . . In implementing Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in the ordinary course of their business. Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business.[86]

The Prudential Regulators' proposed margin regime would do just this—it allows for the application of margin requirements to end-users solely because they enter into swaps with SDs and MSPs. This violates the intent of Congress and shoehorns end-users into the margin regime, which was intended to apply only to SDs and MSPs.

D. The Goals of the Dodd-Frank Act Do Not Confer Implicit Authority to Impose Margin on End-Users

Against the plain text of the Dodd-Frank Act and these clear expressions of congressional intent, the Prudential Regulators have asserted that the stated goals of the margin provision require regulating all counterparties, including end-users.[87] 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

---

[Footnote continued from previous page]
hedging activities, even in cases where they entered into swaps… with swap entities." 76 Fed. Reg. 27569 (May 11, 2011).

86 156 CONG. REC. S6192 (July 22, 2010) (emphasis added).

87 76 Fed. Reg. 27569 (May 11, 2011).

> [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.[88]

Contrary to the Prudential Regulators' interpretation, this language does not constitute license to "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" by authorizing (and possibly requiring) SDs and MSPs to collect margin on end-users. Rather, Section 732(e)(3) articulates statutory goals that *do not* expand the scope of the Prudential Regulators' authority to impose margin requirements on end-users, but apply (by the terms of Section 731(e)) only to "swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant."[89] Section 731(e)(3) limits the *means* that the Prudential Regulators can use to achieve these broad ends; it does not obliquely expand the terms of the margin section to authorize the collection of margin from end-users. And if there is any doubt as to meaning of the statutory language, the clear legislative history of that language puts such doubt to rest. There is simply no indication, either in the statute or its legislative history, that Congress meant to authorize regulators to deputize SDs or MSPs to collect margin from end-user counterparties.

But the proposed rule takes the argument a step further into unintended territory. The Prudential Regulators posit that they are to "adopt rules for covered swap entities imposing margin requirements on *all non-cleared swaps*," including swaps in which an end-user is a counterparty.[90] This interpretation cannot be squared with the unambiguous legislative history of the statute. But there is another interpretation that is entirely consistent with the managers' intent. If the requirement to adopt rules imposing margin on "all swaps that are not cleared" is not read in isolation and, instead, is interpreted in the context of the subparagraph in which it resides,[91] as well as the legislative history surrounding the language, then it becomes clear that the statute is meant to apply to swaps between swap entities, and not to swaps in which an end-user is a counterparty.

Moreover, this interpretation is consistent with one of the central purposes of derivatives reform, which is to reduce systemic risk. The margin provision of the Dodd-Frank Act states that

---

88 Dodd Frank Act § 731 (e)(3)(A)(i).

89 Dodd Frank Act § 731 (e)(2).

90 76 Fed. Reg. 27569 (May 11, 2011) (emphasis in original).

91 Dodd-Frank Act § 731(e)(2)(A).

margin standards should guard against risks to "the financial system."[92] Congress recognized that application of new margin rules to end-users would not serve that purpose. As Senators Dodd and Lincoln wrote in their June 30, 2010 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."[93] End-users do not pose the same gravity of risk 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 Prudential Regulators agree and acknowledge this in the proposed margin rule.[94]

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 Coalition survey conducted earlier this year,[95] without an end-user exemption, a 3% initial margin requirement on the S&P 500 companies could be expected to reduce capital spending by $5.1 billion to $6.7 billion, causing a loss of 100,000 to 130,000 jobs. This survey's assumptions were 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.[96]

---

[92] Dodd-Frank Act § 731 (e)(3)(A).

[93] 156 CONG. REC. S6192 (July 22, 2010).

[94] "The Agencies preliminarily believe that [not requiring a swap entity to collect initial or variation margin from a nonfinancial end-user in certain instances] is consistent with the statutory requirement that the margin requirements be risk-based, and is appropriate in light of the minimal risks that nonfinancial end users pose to the safety and soundness of covered swap entities and U.S. financial stability." 76 Fed. Reg. 27570 (May 11, 2011).

[95] An analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives (Feb. 11, 2011), *available at*: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Coalition-for-Derivatives-End-Users-OTC-Derivatives-Survey_Final-Version-2-11-11.pdf.

[96] *See* Press Release, Natural Gas Supply Association and the National Corn Growers Association (May 24, 2010), *available at*:

[Footnote continued on next page]

Furthermore, the OCC's impact analysis estimates that, assuming no clearing, under the proposed margin rules, initial margin may total $2.56 trillion in the first year alone.[97] The study estimates that $2.05 trillion will be collected in initial margin and that the opportunity cost of the initial margin requirement would be $25.6 billion.[98] Although the calculations in the OCC's analysis are focused on OCC regulated banks, the impact of these requirements on banks will impact end-users, which will bear the cost of higher requirements imposed on banks. These costs are staggering and significantly disproportionate to the impact that end-users have on the financial system.

Margin requirements can "help ensure safety and soundness of the swap dealer or major swap participant and the financial system" without imposing margin on end-users. First, 90% of swaps held by SDs and MSPs have as their counterparty another SD, MSP, or other regulated entity.[99] Even with a robust exemption for end-users, Section 731 gives the Prudential Regulators broad authority to apply margin rules to both sides of the vast majority of swaps held by SDs and MSPs, thereby "help[ing] ensure the safety and soundness" of those entities. Second, 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.

The drafters of the Dodd-Frank Act defined the key regulated entities and took care to exclude from those definitions entities that use swaps to hedge risks associated with their businesses. The margin provision of the Dodd-Frank 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 those parties subject to the 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. Furthermore, the goals of Section 731, to offset the greater risk to SDs or MSPs and the financial system arising from the use of uncleared swaps, do not require or necessitate the imposition of margin requirements on end-users.

[Footnote continued from previous page]
http://www.ngsa.org/Assets/docs/2010%20press%20 releases/21-ngsa%20urges%20fix%20for%20derivs%20title%20in%20conference.pdf.

97 Office of the Comptroller of the Currency, Economics Department, Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule, 5–6 (April 15, 2011).

98 Office of the Comptroller of the Currency, Economics Department, Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule, 5–7 (April 15, 2011).

99 An analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives (Feb. 11, 2011), *available at*: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Coalition-for-Derivatives-End-Users-OTC-Derivatives-Survey_Final-Version-2-11-11.pdf.

The Coalition agrees with the Prudential Regulators that "the statute requires the Agencies to take a risk-based approach to establishing margin requirements."[100] The Coalition believes also that this mandated risk-based approach proves further that the Prudential Regulators are not required to impose margin on all uncleared swaps. A risk-based approach involves assessment of the swap, the parties involved, and the potential risk of the swap to the financial system. Thus, under a risk-based approach, margining would not be appropriate in all instances, but only for those swaps that have a risk profile that requires margining.

The Prudential Regulators recognize this, and propose a limited exception for certain swaps with end-user counterparties. Specifically, under the proposed rule, MSPs and SDs would not be required to collect margin from an end-user counterparty if the MSPs' or SDs' exposures to the end-user were below the credit exposure limits that the MSP or SD has established under credit processes and standards.[101] The Coalition believes that this exemption should be expanded to exempt all end-user counterparty swaps because end-user counterparties have a low risk profile and, under a risk-based approach, will not require margining generally. Such an expansion is consistent with legislative intent, whereas the proposed regime, which contemplates the imposition of margin on end-users, does not.

E. Any Margin Requirements On End-Users Should Not Distinguish Between Financial And Non-Financial End-Users.

The proposed rule distinguishes between four different types of swap counterparties: (1) SDs and MSPs (covered swap entities), (2) high risk financial end-users, (3) low risk financial end-users and (4) non-financial end-users. In establishing margin requirements, however, Section 731 of the Dodd-Frank Act does not draw any distinction between financial and non-financial end-users. If the Prudential Regulators impose margin requirements on end-users, the rule should follow the Dodd-Frank Act and congressional intent, and not impose different margin requirements on financial and non-financial end-users. The Coalition believes that financial end-users and non-financial end-users should be treated identically under the Prudential Regulators' margin requirements, as both groups use swaps to hedge commercial risks and pose minimal risks to the financial system.

The legislative history of the Dodd-Frank Act does not distinguish between financial and non-financial end-users with respect to margin requirements. In the debates and discussions surrounding the Dodd-Frank Act, members of Congress referred to "commercial end-users,"

---

100 76 Fed. Reg. 27569 (May 11, 2011).

101 76 Fed. Reg. 27570 (May 11, 2011).

defining them, generally, as companies who use swaps to hedge or mitigate commercial risk.[102] This definition invariably includes financial entities that use swaps to mitigate risks associated with their business. These financial entities that are end-users of swaps are not MSPs and SDs. It is thus not necessary to treat them differently from other end-users. In the June 30, 2010, letter from Senators Dodd and Lincoln, the Senators state: "[End-users] could be anything ranging from car companies to airlines or energy companies who produce and distribute power to farm machinery manufacturers. They also include captive finance affiliates, finance arms that are hedging in support of manufacturing or other commercial companies."[103] Here, Senators Dodd and Lincoln draw no distinction between financial and non-financial end-users. Instead, they refer to both groups simply as "end-users." The Prudential Regulators should do the same and not differentiate between financial and non-financial end-users for setting margin requirements, as this distinction is not statutorily mandated and has no basis in the margin section of the Dodd-Frank Act or its legislative history.

Furthermore, other sections of the Dodd-Frank Act demonstrate that Congress had the necessary vocabulary to distinguish between financial and non-financial entities, but chose not to make that distinction in Section 731. Specifically, in Section 723, regarding clearing requirements for swaps, the Dodd-Frank Act exempts non-financial end-users from the provisions, while subjecting financial end-users to these requirements.[104] This distinction, between financial and non-financial end-users in Section 723, indicates that if Congress wanted to treat financial and non-financial end-users differently with respect to margin requirements, it could have made the same distinction in Section 731. The silence of Congress on the distinction between financial and non-financial end-users in Section 731 cannot be interpreted as granting the Prudential Regulators the authority to impose different margin requirements on different end-users. To do so would be to extend authority to the Prudential Regulators that was not intended by Congress.[105] The Coalition urges the Prudential Regulators to eliminate the distinction between groups of end-users and exempt from margin requirements both financial and non-financial end-users alike.

---

102 156 CONG. REC. S6192 (July 22, 2010). *See also* 156 CONG. REC. H5244 (June 30, 2010); 156 CONG. REC. H5248 (June 30, 2010).

103 156 CONG. REC. S6192 (July 22, 2010).

104 Dodd-Frank Act § 723(h)(7).

105 "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).

X. Required Analysis

A. The Prudential Regulator's Initial Regulatory Flexibility Analysis Does Not Satisfy the Regulatory Flexibility Act

Under the Regulatory Flexibility Act ("RFA"), a federal agency issuing a notice of proposed rulemaking must prepare and make available for public comment initial and final regulatory flexibility analyses.[106] Such analyses must describe the impact of the proposed and final rules on small entities,[107] and must be published concurrently with the proposed and final rules.[108] Section 603 of the RFA requires the Prudential Regulators to describe the economic impact of the proposed margin and capital regulations on small entities and propose alternatives that may minimize the economic burdens of the proposed regulations on small entities.[109] Specifically, the RFA requires that the Prudential Regulators include in their initial regulatory flexibility analysis: the impact of the proposed regulations on small entities; the number of small entities to which the rules will apply; the projected reporting, recordkeeping, and other compliance requirements of the proposed rule; and all relevant Federal rules that may duplicate, overlap or conflict with the proposed rule.[110]

The Prudential Regulators' current approach does not satisfy the requirements of the RFA. To comply with the RFA, the Prudential Regulators are required to make a "reasonable, good faith effort to carry out the mandate of [the RFA]."[111] In this case, they have not done so. The Prudential Regulators identify two categories of small entities that may be affected by the proposed regulations: swap entities and derivatives counterparties. The Prudential Regulators, however, fail to describe meaningfully the impact of the proposed regulations on these

---

106 5 U.S.C. § 603.

107 The Small Business Administration is responsible for administering the RFA and has defined small entities for bank purposes as an entity with assets of $175 million or less. 13 C.F.R. 121.201.

108 5 U.S.C. § 603.

109 5 U.S.C. § 603.

110 5 U.S.C. § 603

111 Associated Fisheries of Maine, Inc. v. Daley, 127 F.3d 104, 114 (1st Cir. 1997).

entities.[112] With regard to swap entities that may be small entities, the Prudential Regulators state that there will be no such swap entities and do not explain the basis for their reasoning. Similarly, regarding counterparties, the Prudential Regulators merely assert: "the Agencies expect any economic impact on counterparties that are small entities to be negative to the extent that swap entities that currently do not collect initial margin or variation margin from those counterparties but would be required to do so under the proposed rule."[113]

Such a conclusory statement is not a reasonable, good faith effort to comply with the RFA as it includes no meaningful analysis whatsoever. The Prudential Regulators must more fully and cogently describe the impact that the proposed regulations will have on small entities in order to satisfy the statutory mandate.[114] We therefore urge the Prudential Regulators first to determine and then to describe the impact that these regulations will have on small entities in a meaningful manner.

In addition, Section 603 of the RFA requires that the initial regulatory flexibility analysis include "a description of projected reporting, recordkeeping and other compliance requirements of the proposed rule, including an estimate of the classes of small entities which will be subject to the requirement and the type of professional skills necessary for preparation of the report or record."[115] This description is not included in the initial regulatory flexibility analysis. Under the subheading "Compliance," the Prudential Regulators do not describe the compliance burdens that small entities may face as Section 603 requires; rather, they state simply: "the margin requirements may affect the amount of margin that counterparties that are required to post to

---

112 "An Agency can satisfy [the RFA] as long as it compiles a meaningful, easily understood analysis that covers each requisite component dictated by the statute. . . ." Associated Fisheries of Maine, Inc. v. Daley, 127 F.3d 104, 115 (1st Cir. 1997).

113 76 Fed. Reg. 27586 (May 11, 2011).

114 Indeed, courts will consider an "agency's compliance with the RFA. . . in determining whether [the agency] complied with the overall requirement that an agency's decision making be neither arbitrary nor capricious." Allied Local and Regional Mfrs. Caucus v. U.S. E.P.A., 215 F.3d 61, 79 (D.C. Cir. 2000). Further, courts have vacated or remanded agency rules founded on irrational or incomplete analyses. *See, e.g.,* See, e.g., Public Citizen v. Fed. Motor Carrier Safety Admin., 374 F.3d 1209, 1218-19 (D.C. Cir. 2004) (vacating agency rule based in part on faulty cost-benefit analysis conducted by the agency); Advocates for Highway and Auto Safety v. Fed. Motor Carrier Safety Admin., 429 F.3d 1136, 1146 (D.C. Cir. 2005) (remanding agency rule based in part on the agency's irrational application of cost-benefit analysis); Gas Appliance Mfrs. Ass'n, Inc., 998 F.2d at 1046 (remanding agency rule based in part on the agency's flawed and irrational to cost-benefit model).

115 5 U.S.C. § 603.

dealer counterparties."[116] Again, the Prudential Regulators have not provided the required description that the RFA mandates and small entities remain unaware of the burdens of reporting, recordkeeping and compliance that may accompany these proposed rules. The Coalition urges the Prudential Regulators to comply with the RFA by describing these projected requirements that small entities may face.

The Prudential Regulators assert that they are unable to ascertain the impact of the rules on small entities.[117] However, the OCC was able to conduct an analysis of the impact of the proposed regulations on the institutions regulated by the OCC, including smaller banks. The mandate of the RFA is not as far-reaching as that of the Unfunded Mandates Reform Act of 1995 (the statute under which the OCC conducted its analysis), as the RFA requires the Prudential Regulators to describe the impact of the regulations only insofar as it affects small entities regulated by the Prudential Regulators. Because they have provided no reason for why information on the impact of the proposed regulation on small entities is not available either directly or through imputation from a broader set of data, the Prudential Regulators have failed to satisfy the statutory mandate under the RFA.[118]

Recommendations:

The Prudential Regulators must describe meaningfully the impact of the proposed margin and capital regulations on small entities, including the projected reporting, recordkeeping, and compliance requirements that small entities may face.

B. Cost-Benefit Analysis

Under the Unfunded Mandates Reform Act of 1995, the OCC is required to prepare a budgetary impact statement before promulgating any proposed rule that is likely to result in the expenditure of $100 million or more (adjusted for inflation)[119] by State, local, and tribal governments or by the private sector in any one year.[120] The impact statement is required to

---

116 76 Fed. Reg. 27586 (May 11, 2011).

117 76 Fed. Reg. 27586 (May 11, 2011).

118 It is well established that a reviewing court can set aside agency action under the Administrative Procedure Act because of a failure to adduce empirical data that can readily be obtained." F.C.C. v. Fox Television Stations, Inc., 129 S. Ct. 1800, 1813 (2009) (citing Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 46-56 (1983)).

119 The current inflation-adjusted expenditure threshold is $126.4 million. *See* 76 Fed. Reg. 27586 (May 11, 2011).

120 2 U.S.C. § 1532.

include a qualitative and quantitative assessment of the anticipated costs and benefits of the proposed rule, estimates of the future compliance costs of the proposed rule, the anticipated impact of the proposed rule on the national economy, and a summary of concerns raised about the proposed rule and the OCC's evaluation of these concerns.[121] The OCC is also required to identify and consider a reasonable number of regulatory alternatives and select the alternative that is the least costly, most cost-efficient or least burdensome alternative that achieves the objectives of the proposed rule.[122]

The OCC issued an impact analysis of the Prudential Regulators' proposed margin and capital rules on OCC regulated banks.[123] The analysis estimates that approximately 74 OCC regulated banks have $100 million or more outstanding in swaps each, which, under the proposed SD and MSP definitions, would subject them to the proposed margin requirements. The OCC estimates initial margin in one year, for new swaps entered into after the effective date of the proposed rule, could total $2.56 trillion—assuming no clearing.[124] If some swaps are cleared, the impact analysis estimates that initial margin collected under the proposed rule could be $2.05 trillion.[125] The impact analysis goes on to estimate that the proposed rule will result in administrative costs totaling $10.8 million and opportunity costs of approximately $25.6 billion.[126]

Since the financial crisis, U.S. financial institutions have reported approximately $1.262 trillion in losses in their financial statements.[127] Of this estimate, only $49 billion resulted from derivatives, most of which was attributable to AIG. The amount of margin that will be collected under the proposed rule will far surpass the derivatives-related losses that were incurred during

---

121 5 U.S.C. § 1532.

122 2 U.S.C. § 1535.

123 Office of the Comptroller of the Currency, Economics Department, Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule, 3 (April 15, 2011).

124 Office of the Comptroller of the Currency, Economics Department, Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule, 5 (April 15, 2011).

125 Office of the Comptroller of the Currency, Economics Department, Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule, 5 (April 15, 2011).

126 Office of the Comptroller of the Currency, Economics Department, Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule, 7 (April 15, 2011).

127 Writedowns and credit-market losses, as determined through the Bloomberg WDCI function as of 6/3/2011.

the financial crisis. Indeed, the amount of initial margin to be collected only from OCC regulated banks will exceed all the losses of all financial institutions since the financial crisis. Further, the opportunity costs the analysis estimates is predicated on a very conservative estimate of lost yield, thereby suggesting that the actual opportunity costs will likely be much more.

The OCC's very conservative cost benefit analysis demonstrates aptly the high cost that the margin rules will have, especially given its narrow scope solely on OCC regulated banks, that are unjustified by the benefits that the proposed rule. Pursuant to the Unfunded Mandates Act, the OCC must identify and consider alternative margin regimes that are less costly, more cost-efficient, or less burdensome than the proposed rule. The OCC, however, identifies two alternatives but the consideration of these alternatives is minimal. Indeed, the OCC states that, for its first alternative, if the swap entity threshold is changed, this will have no impact on its calculation and for the second alternative, that they are unable to assess its impact. These alternatives, therefore, are not an improvement on the proposed margin rule. The Coalition urges the OCC to propose and consider alternatives that are in keeping with its statutory mandate and ultimately adopt a margin rule that appropriately balances costs and benefits.

A Coalition survey conducted in February 2011 estimates that a 3% margin requirement on OTC derivatives could reduce capital spending by $5.1 to $6.7 billion per year for S&P 500 companies, leading to a loss of approximately 130,000 jobs. The survey further estimates that the margin requirements will result in a $100.5 billion decline in cash flow among S&P 500 companies, which represents approximately 7.4% of the combined cash flow of these companies in 2010.[128] The proposed margin rules, therefore, would have a significant impact on the level of working capital companies require to operate their business. Margin requirements also would increase transaction and administrative costs of hedging that will be passed on to customers.

By any measure, weighing the costs against the benefits, the proposed rule would fail. Executive Order 13563 states that an agency should "propose or adopt regulation only upon a reasoned determination that its benefits justify its costs."[129] While we recognize that the Executive Order is binding only on the OCC, just today President Obama asked independent agencies "to follow the key cost-saving, burden-reducing principles outlined in" Executive Order 13563.[130] We join the President in urging the Prudential Regulators to conduct a cost-benefit analysis of the proposed margin rule and to ensure that any final rule issued carries with it

---

128 An analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives (Feb. 11, 2011), *available at*: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Coalition-for-Derivatives-End-Users-OTC-Derivatives-Survey_Final-Version-2-11-11.pdf.

129 76 Fed. Reg. 3821 (Jan. 21, 2011).

130 The White House, Office of the Press Secretary, Memorandum for the Heads of Independent Regulatory Agencies (July 11, 2011).

benefits that outweigh the costs to end-users and to the U.S. economy. As the OCC analysis and the Coalition survey demonstrate, the costs of the proposed margin rule are enormous, but these costs have not been examined in a comprehensive manner that accounts for the costs all market participants may face.

Recommendations:

The Prudential Regulators should engage in their own cost-benefit analysis, to understand fully the economic burdens that the proposed rule will inflict on market participants. This analysis should be made available for public comment and the Prudential Regulators should take this analysis into account in establishing the final margin regulatory framework.

XI. Conclusion

We thank the Prudential Regulators for the opportunity to comment on these important issues. The Coalition looks forward to working with regulators to help implement margin requirements that serve to strengthen the derivatives market without unduly burdening end-users and the economy at large. We are available to meet with the Prudential Regulators to discuss these issues in more detail.

Sincerely,

Association for Financial Professionals
Business Roundtable
Commodity Markets Council
Financial Executives International
National Association of Corporate Treasurers
National Association of Manufacturers
National Association of Real Estate Investment Trusts
The Real Estate Roundtable
U.S. Chamber of Commerce