



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

June 30, 2011

The Honorable Gary Gensler
Chairman
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Dear Gary:

I am writing to follow-up on our recent conversations and those of our staffs concerning implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The OCC has appreciated the open dialogue that we have had with you and Commission staff concerning proposed CFTC Title VII rules, however, as you and I have discussed, the OCC continues to have a number of important concerns with certain proposed Commission rules. These concerns are set forth in more detail in the attached OCC staff memorandum.

We would welcome the opportunity to work with the Commission and its staff to further develop a resolution to these issues. OCC points of contact are: Ellen Broadman, Director, or Ted Dowd, Special Counsel, Securities and Corporate Practices Division, (202) 874-5210.

Sincerely,

John Walsh
Acting Comptroller of the Currency



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OCC Staff Comments on CFTC Dodd-Frank Act Proposed Rules

I. Proposed Rule 23.600 – Risk Management Program for swap dealers and major swap participants.

The Commission's proposed risk management rule for swap dealers and major swap participants ("MSP") seems to be written for a universe of swap dealers and MSPs that specialize in those activities, without contemplation of the application of those rules to banks or recognition of the existing, extensive system of regulation and prudential supervision to which banks are subject. As a result, the proposed rule would impose risk management requirements for bank operations that are already subject to comprehensive prudential supervision, including areas of operation that are wholly unrelated to swaps, and create uncertainty and opportunities for regulatory conflict and control failures.

The Commission's proposed risk management rule requires "swap dealers and [MSPs] to establish a risk management program for monitoring and managing the risks associated with their business activities" and further requires that such program address, among other risks: (i) credit risk; (ii) market risk; (iii) liquidity risk; and (iv) foreign currency risk. These rules appear to be designed for specialized entities that, unlike banks, do not engage in a wide range of activities. When applied to a bank that is a swap dealer or MSP, the proposed rule creates conflict with existing prudential supervision since the scope of the rule applies to all bank "business activities," which, by definition, would include activities such as commercial and consumer lending, deposit taking, interest rate management, fiduciary activities, correspondent services, payment services and securities activities. Prudential regulators closely supervise these activities; continuously evaluating banks' risk management procedures and abilities to operate in a safe and sound manner. At the largest banks, prudential regulators have examiners on-site on a full time basis to evaluate the credit, market, operation, reputation and compliance risks of bank activities.

A consideration of credit risk management is illustrative. CFTC proposed rule 23.600(c)(4)(ii) provides that a swap dealer or MSP's credit risk policies and procedures shall take into account the "daily measurement of *overall* credit exposure..." (emphasis supplied). A rule that extends to "overall credit exposure" of a bank swap dealer or MSP would, by its terms cover a wide range of bank operations, including both commercial and retail customer lending operations, as well as bank management of its own credit risk exposures across multiple business lines, not just swaps activities. Credit risk may arise in a broad range of banking activities, including: (i) traditional lending; (ii) selection of investment portfolio products or counterparties for money market transactions; (iii) exposure to sovereign governments; and (iv) guarantor performance. In

sum, credit risk is the most recognizable risk associated with banking. Prudential regulators monitor and supervise banks' management of this risk comprehensively.

Under the CFTC's proposed risk management rules, the potential for conflicting regulation in the area of credit risk management is profound. Banks manage credit exposure across business and product lines, *i.e.* credit risk management is not isolated to discrete bank activities, but is managed on an institution wide basis.¹ Accordingly, any CFTC mandated credit risk management requirement that applies to "overall credit exposure" will potentially reverberate across the bank and will conflict with comprehensive prudential regulation. At a minimum, CFTC credit risk management rules will create uncertainty at bank swap dealers and MSPs with respect to the relationship of such rules to supervision of credit risk by their prudential regulator. This conflict and uncertainty may result in the unintended consequence of reducing or hindering effective enterprise-wide credit risk management.

II. Proposed Rule 23.504 -- Swap Valuation, Conflict with Prudential Regulators' Margin Rule for Uncleared Swaps

Proposed Commission rule 23.504(b)(4) seeks to impose swap documentation standards on swap dealers and MSPs with respect to uncleared swaps. These documentation standards, if adopted, will require counterparties to a transaction to agree on methods, procedures, rules and inputs for determining the value of each swap and will require the parties to disclose this information with sufficient detail to allow the counterparty to "determine the value of the swap independently in a substantially comparable manner." On its face, this seems like an appropriate requirement. However, we are concerned that, in practice, this requirement will incent market participants, who will be understandably reluctant to disclose their proprietary valuation methodologies, to adopt least common denominator valuation methods, *i.e.* *vanilla* models that are substantially less accurate than their proprietary counterparts. We believe that the use of these *vanilla* models will introduce risk to the financial system. For that reason, the OCC did not support inclusion of any similar requirement in the prudential regulators' margin rule for uncleared swaps, and no such requirement is included.² However, the CFTC's proposed documentation rule effectively usurps that result, and the prudential regulators' margin rule, by dictating the valuation methods under which exchange of variation margin will occur.³

¹ Congress recognized this practice in section 610 of Dodd-Frank. Section 610 amended the lending limits of the National Bank Act (12 U.S.C. § 84) to include credit exposures from derivative transactions.

² Notably, the prudential regulators' proposed margin rule for uncleared swaps does not impose a replicability requirement; counterparties to a transaction can continue to use proprietary valuation methods and exchange variation margin based on those calculations. A portion of the text of the documentation provisions in the prudential regulators' margin rule is similar to the Commission's text. However, taken as a whole, the Commission's text clearly contemplates a different approach, including a requirement for counterparties or third parties to be able to replicate values, that is not contemplated by the prudential regulators' margin rule. Under the prudential regulators' margin rule, either party can be designated as the calculation agent for a contract, and both parties can continue to use their proprietary valuation methodologies.

³ The overlay of the Commission's documentation rule on the prudential regulators' margin rule effectively eliminates the proprietary model and calculation agent option provided for in the prudential regulators' rule by requiring that all uncleared swaps be valued under a replicable model.

The use of *vanilla* models for valuation methodology creates a very undesirable situation: the price marks for a dealer's books and records may be different than the price marks that same dealer uses to determine variation margin requirements. This will lead to unsecured credit exposure, as the party that benefits from the difference between the price marks avoids a margin posting requirement. Requiring margin based upon artificial, rather than real world, prices compromises the efficiency of financial markets.

The Commission's proposed rule, with its replicability requirement, seems to be motivated by a desire to eliminate margin call disputes. Eliminating disputes by locking in valuation methods that may become outdated, and therefore produce valuations that don't reflect real world prices, is counterproductive.⁴ We believe that the better approach to the valuation issues that the Commission's rule seeks to address is to focus on robust dispute resolution procedures.

We are also concerned that the replicability requirement will add unnecessary burden to dealing in uncleared swaps.⁵ We expect that banks will maintain two sets of books: one with price marks for a dealer's books and records and another with price marks used to determine variation margin. In addition, the Commission's rule will likely impose substantial cost upon both swap dealers/MSPs and end-users alike given the resources required to negotiate and reach agreement on acceptable valuation models.

III. Proposed Rules 23.500 through 23.502 – Swap Confirmation and Portfolio Reconciliation

Proposed CFTC rules 23.500 through 23.502 establish swap confirmation and portfolio reconciliation requirements for swap dealers and MSPs. The proposed requirements are highly prescriptive, are potentially unachievable in the short term, and may ultimately discourage market participants from legitimate use of the statutory exceptions to general exchange trading and clearing requirements provided by the Dodd-Frank Act. Ultimately, this may increase risk by discouraging appropriate bank risk hedging activities.

A. Swap Confirmation

Under proposed Commission Rule 23.501, swap dealers and MSPs are required to confirm swap transactions with other swap dealers or MSPs that cannot be processed electronically within the same calendar day as execution. For transactions with non-dealer/non-MSP entities, swap dealers and MSPs will be required to have policies and procedures in place to ensure confirmation of swap transactions: (i) within the same calendar day of execution if the counterparty is a financial entity; and (ii) not later than the next business day after execution where the counterparty is not a financial entity.

⁴ Disputes provide important early warning indicators of potential problems, either with a counterparty or with a product. The OCC has found that counterparty disputes on margin calls are often an excellent indicator of liquidity and/or other problems at the party disputing the valuations.

⁵ The documentation rule does not apply to transactions with a derivatives clearing organization. 76 FR 6715, 6725 (February 8, 2011).

The same calendar day trade confirmation requirements would likely significantly dampen, if not eliminate, customized, or bespoke, transactions that, for some specific exposures, can represent the most effective way for both swap dealers/MSPs and end users to manage their risks. Under current market convention, the post-trade detail work of these transactions is negotiated by the parties after execution and typically requires legal representation. In order to meet a same calendar day confirmation requirement, today's post-trade detail work will need to occur prior to execution. The practical implication of this requirement is that market participants will expend significant resources, including legal expenses, negotiating the details of contemplated transactions that are never executed. This increased cost and operational burden may ultimately dissuade market participants from using tools that can help to shape a desired risk profile. Moreover, the Commission's proposed confirmation requirements may increase risk even for those market participants that continue to engage in customized swaps. Same calendar day confirmation will unquestionably delay trade execution as the parties, and their lawyers, negotiate the details necessary to satisfy this requirement. In fast moving markets, execution delay itself can create risks.

B. Portfolio Reconciliation

Proposed Commission Rule 23.502 requires swap dealers and MSPs to engage in portfolio reconciliation as frequently as once each business day for each swap portfolio that includes 300 or more swaps (the rule includes a safe harbor for cleared swaps). The frequency of portfolio reconciliation required under the proposed rule may not be immediately achievable for some market participants, particularly those swap dealers outside of the largest 14 derivatives dealers (the "G-14" banks). As the Commission is aware, the Over-the-Counter Derivatives Supervisory Group ("ODSG")⁶ has been working to establish portfolio reconciliation standards for several years. The current ODSG commitment for the G-14 is daily reconciliation for portfolios with 500 or more trades. However, the gradation to this standard began in 2008 with a goal of weekly reconciliation for portfolios of 5,000 or more trades.⁷ Given the incremental progression that was necessary for the G-14 to develop the infrastructure necessary to approach the standards the Commission has proposed, swap dealers outside the G-14 need to be provided sufficient time to develop required infrastructure.

IV. Proposed Rule 23.105 – Capital Requirements for Bank Swap Dealers and MSPs

In proposed Commission Rule 23.105, the CFTC proposes to require bank swap dealers and MSPs to provide the Commission with capital information upon request. On its face, this seems to insert the CFTC into an area of bank regulation that Congress has unquestionably reserved for

⁶ The ODSG includes the G-14, certain buy-side firms and U.S. and international financial regulators.

⁷ See July 31, 2008 ODSG Commitment Letter, available at <http://www.newyorkfed.org/newsevents/news/markets/2008/an080731.html>

prudential regulators.⁸ The Dodd-Frank Act does not provide the Commission with jurisdiction to exercise supervisory authority over the capital levels of bank swap dealers or MSPs.⁹

As presented, the proposed rule is not a benign data collection. Staff have indicated that OCC stands ready to work in cooperation with CFTC staff with respect to capital issues that may arise with respect to bank swap dealers. Notwithstanding this, the proposed rule was issued, creating the unfortunate inference that the Commission's decision to proceed signals an intent to unilaterally seek more granular capital information from banks and use such information to make qualitative judgments concerning the adequacy of such capital.

The expertise to evaluate and judge the adequacy of bank capital, as Congress recognized, resides with prudential regulators.¹⁰ And, unlike non-bank swap dealers, the business of bank swap dealers is not limited to its swaps activity, but includes a wide range of banking activities, e.g. commercial and retail lending and provision of a wide range of other financial products and services. Bank swap dealers' capital requirements reflect this wide range of activities and prudential regulators are in the best position to evaluate their capital adequacy. Cooperation between the CFTC and prudential regulators represents a far more effective approach to issues concerning capital levels of bank swap dealers and MSPs than the separate reporting regime that the CFTC has proposed.

V. Proposed Rule 1.3 – Swap Dealer Definition

The Commission's proposed implementation of the loan exclusion to the *swap dealer* definition,¹¹ if adopted, will increase risk for certain banks by interfering with their ability to manage commercial lending profiles. The CFTC proposes to limit the loan exclusion to swaps that are connected to the financial terms of a loan and seeks comment on whether the loan exclusion should be further limited to swaps that are entered into contemporaneously with a loan.

The Dodd-Frank Act swap dealer definition includes an exclusion for certain bank activities, providing that "in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." (the "loan exclusion") The statutory language does not limit the loan exclusion to swaps that are connected to the

⁸ Dodd-Frank Act sections 731 and 741 provide prudential regulators with exclusive authority to both establish capital requirements for bank swap dealers and MSPs and to enforce these requirements.

⁹ In addition to the provisions of sections 731 and 741 noted above, section 731(d) explicitly provides that prudential regulation is to be left to the prudential regulator: "The Commission may not prescribe rules imposing prudential requirements on swap dealers or major swap participants for which there is a prudential regulator." Regulation of bank capital is fundamental to prudential regulation.

¹⁰ At the largest banks, prudential regulators have national bank examiners assessing capital adequacy of the bank on a full time basis.

¹¹ Section 721 of the Dodd-Frank Act defines the term "swap dealer" and amends the Commodity Exchange Act ("CEA") to include this definition.

financial terms of a loan, nor does it require that the swap be entered into contemporaneously with loan origination.

The CFTC's proposed implementation of the loan exclusion effectively prevents community and mid-size banks from offering commodity-based swaps to loan customers.¹² We are concerned that this interferes with banks' risk management and believe that it was precisely this type of risk management that Congress intended to preserve through the loan exclusion.¹³ Loan underwriting criteria for community and mid-size banks that offer loans to commercial customers engaged in a commodity driven business may require, as a condition of the loan, that the borrower be hedged against the commodity price risks incidental to its business. This hedging activity reduces the bank's credit risk on the loan since the borrower is situated to withstand potentially volatile commodity price fluctuations. For example, if an agricultural borrower is dependent on income from the sales of crops to repay a loan, the bank may require that the borrower enter into a swap that offsets potential declines in the price of those crops. When a borrower chooses to enter into such a swap with its lender bank to hedge its commodity price risk, that swap is unquestionably offered in connection with origination of a loan and should be recognized as such in the Commission's implementation of the swap dealer loan exclusion.

The loan exclusion should also be implemented in a manner that recognizes the practical reality of bank and end user risk management practices. To that end, the loan exclusion should be tailored to allow for ongoing hedging throughout the life of a loan, provided such hedging is connected to the origination of a loan as discussed above. Limiting the exclusion to swaps that are contemporaneous with loan origination or close thereto, as is contemplated in the proposed rule, would preclude ongoing risk management connected to bank lending and increase credit risk for banks. While a loan to a bank customer may span several years, swaps that hedge the customer's commodity price risk may be much shorter in duration, *e.g.* a growing season. Hence, effective credit risk management dictates that borrowers re hedge commodity price risks as appropriate. In addition, after extending a loan, a bank may determine that a swap is needed to manage lending risks arising from the diminished creditworthiness of a borrower. For example, an interest rate swap may be desirable to protect a borrower from interest rate increases on a loan. In order to preserve this important credit risk management tool for banks, the loan exclusion should allow for ongoing hedging that is connected to an extension of credit.

We understand from the proposed release that the CFTC is concerned that a broader implementation of the loan exclusion than what the Commission has proposed may create a "loophole" to the swap dealer definition.¹⁴ Obviously, the loan exclusion should not be a tool for evasion of swap dealer status, but the provision still may be implemented in a manner that is more consistent with Congressional intent and the plain language of the statute without creating

¹² This loan exclusion will likely be inapplicable to large money center banks since such banks are expected to be swap dealers by virtue of their large volume of swap business with counterparties who are not loan customers.

¹³ The statutory text does not limit the loan exclusion to *financial swaps* (as the Commission has proposed), but applies to *swaps*, a term that Congress defined to include both commodity swaps and agricultural swaps. 7 U.S.C. § 1a (47).

¹⁴ 75 FR 80174, 80181-82 (December 21, 2010)

the loophole that concerns the Commission. For example, the loan exclusion can be narrowly tailored, but still allow banks to continue to manage credit risk through swaps that are connected to customer loans, *e.g.*, risk mitigating swaps that a customer enters into or commits to enter into at the time of loan origination, that are contemplated in the loan underwriting process, as well as swaps that are necessary to manage the credit risks associated with the loan throughout its life.

VI. Proposed Rules 49.17 and 45.2 – Swap Information Access

Proposed Commission rules 49.17 and 45.2 establish recordkeeping requirements for swap data repositories (“SDR”) and swap dealers and MSPs, among other participants. Each of these proposed rules includes provisions that impede prudential regulator access to information that Congress has unambiguously authorized to prudential regulators.

A. Swap Data Repository Information Access – Rule 49.17

Proposed CFTC Rule 49.17 obstructs prudential regulators’ supervision of financial institutions and financial markets and directly contravenes the plain language of the Dodd-Frank Act. This proposed rule provides procedures by which prudential regulators may obtain access to data that registered SDRs maintain. In order to obtain this information, prudential regulators must: “(i) [f]ile a request for access with the registered [SDR] setting forth in sufficient detail the basis of its request; and (ii) [c]ertify the statutory authority for its request and that it is acting within the scope of its jurisdiction.” Proposed Rule 49.17 also requires that an SDR must be “satisfied that the [prudential regulator] is acting within the scope of its authority” prior to providing access to the requested data.

This certification process and the authority provided to SDRs to determine the scope of prudential regulator authority obstructs prudential regulators’ duty to supervise and regulate financial institutions and financial markets.¹⁵ Specifically, the requirement of a detailed statement that sets forth the basis for a prudential regulator request appears to require the prudential regulator to reveal to the SDR non-public surveillance and investigative information. Moreover, even if a prudential regulator were able to reveal non-public information to an SDR to satisfy this requirement, the SDR could still deny the request if it determines, in its judgment, that the prudential regulator is not acting within the scope of its authority. In short, the CFTC’s proposed rule provides SDRs with significant means to deny or substantially delay a prudential regulator’s data request. Such delay or denial will impede real time market supervision and could negatively effect financial market integrity.

¹⁵ Prudential Regulators currently have direct access to swap data at several data repositories per voluntary OTC Derivatives Regulatory Forum agreements (*See e.g.*, http://www.dtcc.com/downloads/products/derivserv/ODRF_guidelines.pdf).

This proposed approach goes beyond what the Dodd-Frank Act requires.¹⁶ The statute contains no language making the provision of data contingent upon the conditions set forth in the Commission's proposed rule.

B. Swap Data Recordkeeping and Reporting, Information Access – Rule 45.2

Proposed Commission rule 45.2 requires that all registered swap dealers and MSPs, as well as other market participants that are under the CFTC's jurisdiction, "shall keep full, complete, and systematic records... of all activity relating to the business of such entities or persons with respect to swaps, as prescribed by the Commission." The Commission explains in its proposing release that these records are "essential to carrying out the regulatory functions of not only the Commission but all other financial regulators..."¹⁷ Despite the Commission's recognition of the importance of these records to other financial regulators, the draft rule restricts prudential regulator access to this information in a manner that is inconsistent with the statute.¹⁸ Specifically, the proposed rule provides that "[a]ll records required to be kept pursuant to this Section... shall be open to inspection upon request by any representative of the Commission... or by any representative of a prudential regulator as authorized by the Commission. (emphasis supplied). The statute does not condition prudential regulator access to this information upon CFTC authorization; it simply provides that prudential regulators shall have access.¹⁹

The Commission's proposed rule also creates conflict with prudential supervision. Registered bank swap dealers and MSPs, in addition to any relevant rules the Commission adopts, are subject, and will continue to be subject to, the recordkeeping and examination requirements of their prudential regulator. Read literally, the Commission's proposed rule would require a registered bank swap dealer to obtain CFTC authorization before responding to a prudential regulator examination request or other informational request related to its swap business. Congress recognized the primary supervisory role of the prudential regulators with banks and did not condition prudential regulator access to swap information on CFTC authorization.

¹⁶ CEA section 21(c)(7) (added to the CEA by Dodd-Frank) provides as follows:

"Duties – A swap data repository shall...

(7) on a confidential basis pursuant to section 8, upon request, and after notifying the Commission of the request, make available all data obtained by the swap data repository, including individual counterparty trade and position data, to—

(A) each appropriate prudential regulator..."

¹⁷ 75 FR 76574, 76579 (December 8, 2010).

¹⁸ See CEA § 4r(c)(2) (Requiring individuals or entities that enter in a swap transaction that is neither cleared nor reported to an SDR to make required books and records open to inspection by an appropriate prudential regulator).

¹⁹ *Id.*