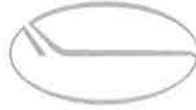

AIR TRANSPORT ASSOCIATION

July 11, 2011

FILED ELECTRONICALLY

David A. Stawick
Secretary, Commodity Futures Trading Commission
3 Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: **Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants**, *76 Fed. Reg. 23732* (April 28, 2011), RIN No. 3038-AC97

Capital Requirements of Swap Dealers and Major Swap Participants, *76 Fed. Reg. 27802* (May 12, 2011), RIN No. 3038–AD54

Dear Mr. Stawick:

The Air Transport Association of America, Inc. ("ATA") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or "Commission") proposed rules: "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," *76 Fed. Reg. 23732* (April 28, 2011) ("Proposed Margin Rules"); and "Capital Requirements of Swap Dealers and Major Swap Participants," *76 Fed. Reg. 27802* (May 12, 2011) ("Proposed Capital Rules"). Under Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[1] which added new Section 4s to the Commodity Exchange Act ("CEA"), the Commission is required to issue margin and capital rules for covered swap entities ("covered swap entities") which are all swap dealers ("SD") and major swap participants ("MSP") that are not banks, including nonbank subsidiaries of bank holding companies.[2]

ATA supports the Proposed Margin Rules, as they are consistent with Congressional intent to exempt non-financial end users from clearing and its associated costs and to allow non-financial end users to use various forms of assets as collateral to meet margin requirements. ATA recommends, however, that the Commission modify its Proposed Capital Rules to ensure that, consistent with Congressional intent and the reduced risk of swaps entered into by non-financial end users for hedging or commercial risk mitigation purposes, capital charges will not be applied to transactions for swaps entered into by nonfinancial end users.

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[1] Public Law No. 111–203, 124 Stat. 1376 (2010).
[2] Section 4s(e) of the CEA requires each SD and MSP for which there is no "prudential regulator" (Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Farm Credit Administration, and Federal Housing Finance Agency) to comply with the Commission's capital and margin regulations.

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ATA

ATA is the principal trade and service organization of the U.S. scheduled airline industry.[3] It is the nation's oldest and largest airline trade association, and its members account for more than 90 percent of the passenger and cargo traffic carried by U.S. airlines. Since its founding in 1936, ATA has encouraged governmental policy decisions that foster a financially stable U.S. airline industry capable of meeting the nation's travel and shipping needs while withstanding the inherently cyclical nature of the airline industry.

ATA members are major consumers of jet fuel, the price of which is tied to the price of crude oil. Fluctuations in crude oil prices significantly affect market volatility and consequently the profitability and financial health of member airlines. Many members of ATA thus actively participate in the over-the-counter swaps markets in order to hedge their price exposure to jet fuel, typically with counterparties that will be either SDs or MSPs subject to margin and capital rules under Section 731 of Dodd-Frank. Requiring capital charges for uncleared swaps transactions with non-financial end users, such as ATA's members, will impose substantial new costs and burdens on ATA's members, significantly harming their businesses.

ATA Supports the Proposed Margin Rules

Proposed Commission Rules 23.154(a)(1)-(6) and 23.154(b)(1)-(4) require that a covered swap entity collect initial and variation margin, respectively, "as may be required pursuant to the credit support agreement" between itself and a nonfinancial end user counterparty, and permit the agreement to establish a threshold below which the covered swap entity need not collect initial or variation margin. Proposed Commission Rules 23.154(a)(7) and (b)(6), respectively, require each covered swap entity to "calculate each day a hypothetical [initial and variation] margin requirement for each such uncleared swap as if the counterparty were a [SD] and compare that amount to any [initial and variation] margin required pursuant to the credit support arrangements." And finally, Proposed Commission Rules 23.157(a)(3) and 23.157(b)(3), respectively, state that covered swap entities shall accept as initial or variation margin from non-financial entities "only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements."

ATA strongly supports the Proposed Margin Rules as they relate to non-financial end users. Because non-financial end users pose minimal risks to the safety and soundness of covered swap entities, the exemption of non-financial end users from mandatory margin is consistent with the mandate of section 4s(e)(3)(A) of the CEA to adopt margin rules for covered swap entities that are "appropriate for the risk associated with the uncleared swaps they hold."[4]

ATA also believes that the exemption of non-financial end users from mandatory margin, as the Commission has proposed, is consistent with Congressional intent. In a letter to the CFTC

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[3] The members of the association are: ABX Air, Inc.; AirTran Airways; Alaska Airlines, Inc.; American Airlines, Inc.; ASTAR Air Cargo, Inc.; Atlas Air, Inc.; Continental Airlines, Inc.; Delta Air Lines, Inc.; Evergreen International Airlines, Inc.; Federal Express Corporation.; Hawaiian Airlines; JetBlue Airways Corp.; Southwest Airlines Co.; United Airlines, Inc.; UPS Airlines; and US Airways, Inc. Associate members are: Air Canada; and Air Jamaica.

[4] Proposed Margin Rules, 76 *Fed. Reg.* at 23733.

Commissioners, Senator Stabenow, and other Senators, urged the Commission, in designing its capital and margin rules, to avoid impeding the access of non-financial end users to the derivatives markets. The letter notes that such access can enable them to "increase certainty in their businesses" and to engage in "prudent risk management activities" through swaps hedging. Also, the base text used by the Dodd-Frank Conference Committee ("Conference") stated that margin requirements would not apply to swaps where one of the parties was a non-financial end user.[5] Numerous colloquies indicate that the conferees believed that the text adopted in Conference (which ultimately became Dodd-Frank) fully exempted non-financial end users from margin and that an explicit amendment was unnecessary.[6] Leadership within both the House and Senate Committees responsible for the legislation that was enacted as the Dodd-Frank Act also repeatedly stated that imposing margins on non-financial end users that hedge legitimate business risks through swaps would defeat the purpose of the end user exemption and contravene Congressional intent.[7]

Calculation of Hypothetical Margin Requirement for Uncleared Swap

In order to address the issue of possible risk of its positions to the covered swap entities, the Proposed Margin Rules mandate that covered swap entities calculate hypothetical initial and variation margin amounts daily for positions held by non-financial end users as if those entities were SDs. These daily hypothetical calculations are effective "risk management tools that w[ill] assist the [covered swap entities] in measuring its exposure."[8] This is a sensible alternative to requiring the collection of margin in connection with nonfinancial end user transactions.

Use of Noncash Collateral by Non-financial End Users for Margin

The Proposed Margin Rules also permit the use of noncash collateral by non-financial end users for initial and variation margin. The preamble to the Proposed Margin Rules notes that:

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[5] House-Senate Conference Committee Holds a Meeting on The Wall Street Reform and Consumer Protection Act, Unofficial Transcript, CQ Transcriptions, LLC Copyright 2010 at 17 (June 29, 2010) (Senator Chambliss: "Mr. Chairman, last Thursday, the House stripped, and the Senate accepted, stripping a provision on the margin Section of Title VII. This stated, 'Any transaction involving an end user would be exempt from the margin requirement.'"). This provision was omitted, however, from the base conference text, presumably because it was considered redundant. *See* Dodd-Lincoln Letter.

[6] *See, e.g.,* 156 Cong. Rec. H5248 (June 30, 2010) (Rep. Barney Frank, responding to Rep. Colin Peterson: "[T]he gentleman is absolutely right. We do differentiate between end users and others. The marginal [*sic*] requirements are not on end users."); House-Senate Conference Committee Holds a Meeting on The Wall Street Reform and Consumer Protection Act, Unofficial Transcript, CQ Transcriptions, LLC Copyright 2010 at 17, 18 (June 29, 2010) (Senator Dodd: "There is a difference of opinion on how clear the language [on end user margin] is. Our consideration, based on conversations we've had, is that the language is clear.... But I've suggested that a colloquy on the floor of the United States Senate, and it might have had a similar colloquy in the floor of the House. So it's up to the members of the House to decide to clarify what we believe is the clarity of the language." . . . "It was not decided to subject literally all of these individual's organizations to have to – to make margin requirements.").

[7] *See* Letter from Chairmen Christopher Dodd and Blanche Lincoln to Chairmen Barney Frank and Colin Peterson ("Dodd-Lincoln Letter") (June 30, 2010); Letter from Chairman Debbie Stabenow *et al.* to Treasury Secretary Timothy Geithner *et al.* ("Stabenow Letter") (Apr. 6, 2011); Letter from Ranking Member Spencer Bachus, Comm. on Fin. Services, and Ranking Member Frank Lucas, Comm. on Agriculture, to Treasury Secretary Timothy Geithner, *et al.* (Dec. 16, 2010).

[8] Proposed Margin Rules, 76 *Fed. Reg.* at 23737.

> To the extent a non-financial entity and a covered swap entities have agreed that the non-financial entity will post [initial and/or variation] margin, [the proposed rule] provides flexibility for [initial and variation] margin posted by non-financial entities with covered swap entities as to what assets are permissible. The standard is simply that the value of the asset is reasonably ascertainable on a periodic basis.[9]

Permitting the use of noncash collateral by end users that use swap deals to hedge or mitigate commercial risk for initial and variation margin is consistent with both the language of new section 4s(e)(3)(C) of the CEA and with Congressional intent. Section 4s(e)(3)(C) states that regulators "shall permit the use of noncash collateral" when prescribing margin requirements as consistent with protecting the swaps markets and the U.S. financial system.

Proposed Commission Rules 23.157(a)(3) and 23.157(b)(3) permitting non-cash collateral are clearly supported by Congressional intent. During the Senate Debate on Dodd-Frank, Senator Hutchison noted:

> [W]e must also protect end users such as airlines, utilities, manufacturers, and oil and gas companies. These companies use derivatives as a cost effective strategy to control price and risk. Many structure derivatives contracts [that] are unique to their business, making it difficult to clear and trade on a market. I share concerns from derivatives end users that this mandate to post margins with cash, rather than collateral, will remove capital from investment and job creation.[10]

ATA strongly supports the Proposed Margin Rules which provide for an exemption of non-financial end users from mandatory margin and permit nonfinancial end users to use noncash collateral for initial and variation margin.

The Proposed Capital Rules are Contrary to the End User Exemption of the Dodd-Frank Act

The Commission also proposed rules regarding capital requirements for covered swap entities. Specifically, Proposed Commission Rules 23.101(a)(1) and 23.101(b)(1), respectively, provide that each covered swap entity (except for SDs that are a subsidiary of a U.S. bank holding company)[11] "must meet or exceed the greatest of the following regulatory capital requirements: (i) Tangible net equity ... in an amount equal to $20,000,000 plus the amounts calculated under this part for [the covered entity's] market risk exposure requirement and its over-the-counter derivatives credit risk requirement associated with swap positions and related hedge positions that are part of the [covered entity's] swap activities...."

Under Proposed Rule 23.101(a)(1), a covered swap entity will be required to take a charge to capital associated with its uncleared swap transactions regardless of whether the transaction is with a nonfinancial end user under the end user exemption. This charge consists of

[9] *Id.* at 23739.
[10] Cong. Rec. S.5881 (July 15, 2010).
[11] The Commission's proposed rules apply to all covered swap entities except for Swap Dealers that are a subsidiary of a bank holding company. The Commission proposed that the capital rules of the prudential regulators shall apply to such entities. *See* Proposed Capital Rules, 76 *Fed. Reg.* at 27805-6.

two components, the "over-the-counter derivatives credit risk requirement" relating to the "potential counterparty credit exposures for receivables arising from OTC swap positions" and the "additional market risk exposure requirement" relating to the total potential market risk associated with such swaps and any product used to hedge that exposure. It is reasonable to assume that the covered swap entity would shift the cost of its capital charges back to the nonfinancial end user.

Moreover, Proposed Rule 23.104(e) provides that the over-the-counter derivatives credit risk requirement is partly determined by a "counterparty exposure charge" which includes "the credit equivalent amount of the [SD] or [MSP's] exposure to the counterparty, *minus collateral values* …." Thus, under Proposed Rule 23.104(j), a covered swap entity "may reduce its credit risk equivalent [of its counterparty exposure charge] … to the extent of the market value of *collateral* pledged to and held by the [SD] or [MSP] to secure an over-the-counter position." Accordingly, a covered entity will incur a higher capital charge if it does not collect margin from its counterparty regardless of whether the counterparty is a nonfinancial end user entering into the transaction to reduce its commercial risk.

ATA is very concerned with the effect that the Proposed Capital Rules will have on nonfinancial end users choosing to avail themselves of the end user exemption from the mandatory clearing requirement. Most, if not all, of the hedging transactions by ATA's members are effected through over-the-counter transactions. As nonfinancial end users, ATA members, without doubt, will continue to effect their risk management transactions through uncleared transactions under the end user exemption. The proposed capital charges, however, will result in increased capital charges to the covered swap entities in connection with nonfinancial end user transactions, particularly transactions that are not subject to the collection of margin. Assuming that the covered swap entities pass on this increased cost to the end user, the proposed capital requirements effectively will punish nonfinancial end users for exercising the exemption which Congress provided, and will negate the benefits of uncleared transactions to end users and of the end user exemption itself.

Placing capital charges on nonfinancial end user transactions is contrary to the Dodd-Frank Act and Congressional Intent

The legislative record clearly evidences that the drafters of the Dodd-Frank Act recognized the significance and critical importance of allowing nonfinancial end users, which played no role in the financial crisis and pose minimal, if any, risk to U.S. financial stability, to continue to hedge their commercial risk without having to bear the added costs of capital.

<u>Swap activities of nonfinancial end users did not play a role in the financial crisis.</u>

Exempting nonfinancial end user transactions from mandatory capital-related costs is consistent with the central goal of Dodd-Frank to mitigate systemic risk. As noted above, Congress has recognized that nonfinancial end users need access to derivatives to enable them to "increase certainty in their businesses," and to engage in "prudent risk management activities" by

using swaps to hedge.[12] Also, as noted above, the CFTC has recognized the minimal risks that nonfinancial end users pose to the safety and soundness of covered swap entities and U.S. financial stability. Imposing additional costs on nonfinancial end users is not necessary (nor even directly related) to the mitigation of risk either to counterparties or to the financial system as a whole.

To the extent that regulators need to assess the relative exposures of covered swap entities and their ability to meet their obligations, the Commission's risk-based proposed approach of requiring that covered swap entities calculate their hypothetical margin including end user transactions would be a sound approach to regulatory capital as well.[13] Specifically, the Commission has proposed to require each covered swap entity to calculate hypothetical initial and variation margin amounts daily for positions held by nonfinancial end users as if those entities were covered swap entities. We believe this approach appropriately addresses the mitigation of systemic risk. The daily hypothetical calculations will "serve as risk management tools that w[ill] assist the [covered swap entity] in measuring its exposure."[14] A similar approach could be used for capital as well. Such an approach, rather than imposing capital charges on end user transactions, would be more in keeping with the statute and Congressional intent.

Congress Intended to Protect Nonfinancial End Users from Additional Costs

Congress understood that capital requirements in connection with such end user transactions were within the end user exemption and that capital charges should not be assessed in connection with such end user transactions. As noted above, the base text on which the Dodd-Frank Conference Committee worked had explicitly provided that margin requirements would not apply to swaps where one of the parties was a nonfinancial end user.[15] This provision, however, was inadvertently omitted from the base conference text, presumably because it was considered redundant.[16] Numerous colloquies during the conference indicate that the conferees believed that the text adopted in conference (which ultimately became Dodd-Frank) fully exempted nonfinancial end users from margin and that an explicit amendment was not necessary.[17] Congress's intent in this regard is again highlighted in the Dodd-Lincoln Letter, which points out that the revisions made during conference that removed the explicit exemption for end users from margin requirements were expressly made "to eliminate redundancy" and "to streamline the regulatory framework," and not to affect the "consistent Congressional directive

[12] Stabenow Letter.
[13] Proposed Rule 123.154.
[14] Proposed Margin Rules, 76 *Fed. Reg.* at 23737.
[15] *See supra* note 5.
[16] *See* Dodd-Lincoln Letter.
[17] *See, e.g.*, 156 Cong. Rec. H5248 (June 30, 2010) (Rep. Barney Frank, responding to Rep. Colin Peterson: "[T]he gentleman is absolutely right. We do differentiate between end users and others. The marginal [sic] requirements are not on end users."); House-Senate Conference Committee Holds a Meeting on The Wall Street Reform and Consumer Protection Act, Unofficial Transcript, CQ Transcriptions, LLC Copyright 2010 (June 29, 2010) (Senator Dodd: "There is a difference of opinion on how clear the language [on end user margin] is. Our consideration, based on conversations we've had, is that the language is clear.... But I've suggested that a colloquy on the floor of the United States Senate, and it might have had a similar colloquy in the floor of the House. So it's up to the members of the House to decide to clarify what we believe is the clarity of the language." . . . "It was not decided to subject literally all of these individual's organizations to have to – to make margin requirements.").

throughout all the drafts of this legislation, and in Congressional debate, … to protect end users from burdensome costs associated with margin requirements and mandatory clearing." For the same reasons that Congress has directed the regulators not to impose margin on nonfinancial end users, it has also made clear that capital requirements are not to be imposed on end users.

As stated in the Dodd-Lincoln letter, "Congress clearly stated in this bill that the margin *and capital* requirements are not to be imposed on end users[.]" Moreover, "changes made in Conference to the section of the bill regulating capital and margin requirements for Swap Dealers and [MSPs] should not be construed as changing this important Congressional interest in protecting end users." Indeed, "[c]apital and margin standards should be set to mitigate risk in our financial system, not punish those who are trying to hedge their own commercial risk." The Dodd-Lincoln letter also reaffirms Congress' view that there is "substantial public interest in keeping [end user derivatives] costs low."[18]

What is perfectly clear is that Congress intended to protect nonfinancial end users from the additional costs attendant to increased capital on SDs and MSPs. Allowing such charges to be imposed on nonfinancial end user transactions will remove the very benefits intended by Dodd-Frank's exemption for nonfinancial end users from mandatory clearing. Indeed, to the extent that capital charges would be higher for uncleared swaps (as contemplated by the Commission's proposed rules), nonfinancial end users effectively will be penalized each time they elect to use the statutory exemption. This cannot have been what Congress intended.

For all these reasons, we respectfully request that the Commission modify its capital rules to exempt transactions that qualify for the end user exemption from associated capital charges.

Exemption for End User Transactions Should Apply to Swap Dealers that are Subsidiaries of a Bank Holding Company

Further, we request that the Commission work with the prudential regulators to recognize that Congress did not intend for capital charges to apply to transactions under the end user exemption. The Commission has proposed to "defer to the Federal Reserve Board's existing capital requirements for swap dealers and major swap participants that are nonbank subsidiaries of a U.S. bank holding company." The Commission reasoned that "existing capital requirements encompass the scope of the swaps activity and related hedging activity contemplated under the Dodd-Frank Act."[19] The end user exemption, however, does not become effective until the effective date of the Dodd-Frank Act and therefore cannot be included within the current capital requirements. Accordingly, both the prudential regulators and the CFTC should reconsider the capital treatment afforded to transactions under the end user exemption.

The Dodd-Frank Act requires the prudential regulators, the CFTC and the SEC consult with respect to capital and margin rules and to establish and maintain "to the maximum extent practicable" "comparable" requirements. The CFTC, rightly, has differed from the prudential regulators with respect to its proposed margin requirements. The CFTC's proposed capital rules,

[18] Dodd-Lincoln Letter.
[19] Proposed Capital Rules, 76 *Fed. Reg.* at 27806.

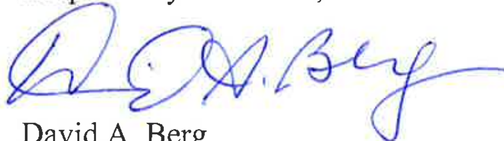
however, including its deferral to the prudential regulators with respect to the capital charges applicable to nonbank subsidiaries of a bank holding company, do not follow Congressional intent. Accordingly, we urge all of the regulators to rethink the proposed capital rules as they apply to end user transactions and to modify their proposals to conform to the legislative intent. We believe that the CFTC's proposal in connection with the proposed margin rules to require a hypothetical risk management calculation with respect to such transactions offers a sound alternative to imposing capital charges on such end user transactions, consistent with Congress's intent.

Conclusion

ATA appreciates the opportunity to comment on the Proposed Rules and commends the Commission on its efforts to implement the provisions of Dodd-Frank. We urge the CFTC, together with its sister regulators, to exempt transactions under the end user exemption from the imposition of capital charges.

We would be happy to discuss our comments above at greater length with the staff. Please feel free to contact David Berg, Senior Vice President and General Counsel, Air Transport Association of America, Inc., at (202) 626-4234 or Paul M. Architzel of Wilmer Cutler Pickering Hale and Dorr LLP, outside counsel to ATA, at (202) 663-6240, if you have any questions regarding our comments.

Respectfully submitted,



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