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Financing America's Economy

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By Electronic Mail

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Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581
RIN 3038—AC97

RE: Margin Requirements for Covered Swap Entities

Ladies and Gentlemen:

The Financial Services Roundtable[1] (the "Roundtable") respectfully submits these comments in response to the proposal (the "Proposal")[2] by the Commodity Futures Trading Commission (the "Commission") to establish margin and capital requirements for certain swap dealers and major swap participants under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] We appreciate the opportunity to comment.

Title VII requires that the Commission establish margin requirements for swap dealers and major swap participants for which there is no prudential regulator ("covered swap entities") in connection with uncleared swaps. Mandating the collection or posting of margin is expected to add new costs and risks for many market participants. It is critical to evaluate those costs and risks to determine whether they are justified in light of the potential benefits to the system they are intended to create. In particular, costs that reduce the availability of hedging to end-users or make swaps too expensive or too risky may increase systemic risk rather than reducing it. As with many other aspects of the

[1] The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $ 92.7 trillion in managed assets, $ 1.2 trillion in revenue, and 2.3 million jobs.

[2] 76 Fed. Reg. 23732 (April 28, 2011).

[3] Pub. Law No. 111-203, § 939A, 124 Stat. 1887 (July 21, 2010).

Dodd-Frank Act, the margin provisions will affect different market participants in different ways, and a tailored approach is essential to minimize undue adverse effects and to protect vulnerable market participants. We appreciate the efforts the Commission has made to adopt a graduated approach based on the perceived risk of the applicable swaps transactions, and many of our comments are intended to further refine elements that are already included in the proposal.

I. Swaps between covered swap entities and financial entities

A. We support less stringent requirements for transactions with low-risk financial entities as opposed to high-risk financial entities, and believe that the criteria for low-risk financial entities should be modified.

The Commission has proposed a three-part test to identify entities that should be considered low-risk financial entities. These entities must:

(a) not have significant swaps exposure,

(b) predominantly use swaps to hedge, and

(c) be subject to capital requirements established by a prudential regulator or a state insurance regulator.

The central condition in this analysis is whether the swaps are being used predominantly to hedge. The regulatory system established under Title VII generally acknowledges that swaps used for hedging purposes are inherently less risky than other swaps,[4] and we agree that the use of a swap for hedging should be a core aspect to determining whether a financial entity may be classified as low risk. We believe that the other two criteria should act as alternative, rather than joint, conditions. An entity that is subject to capital requirements established by a prudential regulator or a state insurance regulator and that is using swaps predominantly to hedge should not present the type of risk that would justify requiring margin in all circumstances. Moreover, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "Agencies") have proposed a limit on the threshold that would be available even to low-risk financial end-users, so that even if such an entity had significant swaps exposure it should not have such exposure to any single covered swap entity. Similarly, an entity that uses swaps predominantly to hedge and that does not have significant swaps exposure, even if not subject to regulatory capital requirements, should be considered low-risk, especially given the proposed limitation on the threshold for low-risk financial entities. Accordingly, we believe the proposed definition should be revised to allow thresholds greater than zero for financial entities that satisfy either conditions (a) and (b), or conditions (b) and (c), but not all three conditions.

B. The threshold permitted for transactions with low-risk end financial users should

[4] See, e.g., Dodd-Frank Act, Section 723, which conditions the commercial end-user exemption from mandatory clearing on the use of the swap for hedging purposes.

not be limited by dollar amount and should be tied to Tier 1 capital as of the date of the agreement.

The Commission has proposed thresholds for margin that would be the lesser of a specified dollar amount (between $15 million and $45 million) and a percentage of the regulatory capital of the covered swap entity. Although we appreciate the approach of limiting the thresholds to a percentage of regulatory capital—effectively ensuring that no one counterparty relationship places a significant portion of the covered swap entity's capital at risk—our members have expressed concern that the threshold must be set at the time the agreement is executed, rather than fluctuating with the covered swap entity's regulatory capital. We request that the Commission clarify that the proposed restrictions are intended to be used to determine a dollar-amount for the threshold, but are not intended to mandate that the threshold refer to a formula based on regulatory capital.

In addition, the specified dollar amount component of the threshold seems arbitrary at best. The proposed numbers seem to be grounded neither in a determination of the ability to create systemic risk nor in the attributes of either the covered swap entity or the low-risk financial entity. We therefore recommend that this prong of the threshold limitation be dropped.

C. Preservation of ability to negotiate two-way posting of margin

The Commission's proposal does not require the posting of margin by covered swap entities to their financial end-user counterparties. However, under current market practice, two-way posting of variation margin between covered swap entities and financial end-users can be negotiated between the parties as a matter of contract. We interpret the Commission's proposal to have no impact on this market practice. If the current proposal is adopted, we would expect this market practice to continue.

D. Sovereign governments should be treated as commercial end-users rather than as financial entities, with no set limits.

We do not believe sovereign governments are appropriately correlated with financial entities in terms of risk and exposures. They are a separate category, with their own unique attributes related to their tax base, natural resources, political structure, demographics and a myriad of other factors unrelated to financial systems generally. Moreover, they have a wide range of options in terms of swap counterparties, and will likely eliminate from consideration any U.S. entities that offer adverse financial terms relative to other market participants. Finally, we believe it is likely that the European Union will specifically exempt its member sovereigns from complying with the margin requirements, which would create a further competitive disadvantage for U.S. covered swap entities. We therefore believe that the proposed treatment of such entities is inappropriate and will cause significant competitive harm to covered swap entities. We urge the Commission to reconsider this position.

II. The allowable forms and processes for segregation of margin should be expanded.

The forms in which margin can be held for transactions between covered swap entities, or between covered swap entities and financial entities, are too restrictive and should also include, at a minimum, high-quality corporate debt and money market funds with an appropriate haircut.[5] We recognize that the restrictions imposed by the Dodd-Frank Act on the use of credit ratings in federal regulations may be constraining the ability to rely on what has been the traditional method of determining whether an investment was high quality. We do not believe, however, this constraint justifies restricting the options available to covered swap entities and their counterparties to such a narrow range of choices. Other means to determine the quality of an obligation can include a board determination, similar to that used by Rule 2a-7 funds under the Investment Company Act (including a board determination that includes consideration of credit ratings), or an analysis of trading characteristics such as spread to US treasury bonds or volatility. In addition, the permitted forms of margin should be the same for initial margin and variation margin, and so should include Fannie Mae, Freddie Mac and other agency residential mortgage backed securities even for variation margin.[6]

We also believe that other accommodations should be considered to avoid the decline in efficiency involved in having to post collateral separately for back-to-back swaps. It is typical for a small swap dealer to hedge its exposure to a customer swap by entering into a back-to-back swap with another swap dealer. If the customer posts margin to a small dealer, for instance, and elects to have that margin segregated, under the Proposal the small dealer would have to post a similar amount of margin to a covered swap entity that was the swap dealer for its hedging swap. As a result, the total margin is likely to be twice as high for the swap exposure as it would be if the margin were not segregated. One possible way to address this would be to permit the intermediate small swap dealer to post its swap agreement with its customer as collateral for its hedging swap, rather than separately posting margin. If the intermediate entity defaults, the swap dealer for the hedging swap can step into its position with respect to the customer swap. And if the customer defaults, the intermediate entity can use the amount received from the customer, including through use of its margin, to replace the margin for the second swap. All parties are protected, but the margin is only segregated once. We believe this would be a much more efficient approach.

Finally, we believe that covered swap entities should have discretion as to whether and where margin posted by them will be segregated. The decision to require segregation of margin can increase the cost of a transaction and add operational burdens, and covered swap entities should be permitted to analyze these matters in light of potential counterparty risk. Moreover, we do not believe covered swap entities should be restricted to using custodians subject to the same insolvency regime so long as they have evaluated the risks of using a particular custodian. We also believe the reference to the

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[5] See part III below for a discussion of the forms of margin that should be permitted for transactions with commercial end-users.

[6] We also have concerns about supply to the extent that a very narrow range of assets may be permitted not only under this regulation but under others, such as those addressing liquidity reserves as part of enhanced regulatory capital requirements. We believe the Agencies should consider the cumulative effect of multiple regulations that require financial institutions to hold the same very limited types of assets for a variety of purposes.

insolvency regime is intended to mean the same national regime. Otherwise this would preclude entities potentially subject to resolution under the Federal Deposit Insurance Act, for instance, from using the same custodian as would be required for an entity subject to the Bankruptcy Code, potentially making some custodial arrangements impossible.

Similar issues would apply to cross-border transactions generally. We believe the most critical issues with respect to the legal framework applicable to the custodian are (i) whether, in the event of the insolvency of the custodian, custodial assets would not become part of the insolvency estate of the custodian and (ii) whether a court located in the jurisdiction of the custodian would respect the parties' choice of law in determining rights with respect to the custodial assets. These issues should be analyzed by a covered swap entity in consultation with its legal counsel, but should not be the subject of a bright-line rule.

III. Swaps between covered swap entities and commercial end-users

A. We support the Commission's proposal to allow covered swap entities to establish very flexible margin arrangements, including not requiring margin and allowing a broad range of forms of collateral, when dealing with commercial end-users.

The Commission has proposed a flexible approach to margin for commercial end-users and we fully support this approach. For many commercial end-users, the cost of posting margin may be prohibitive while providing little meaningful protection to the covered swap entity. Commercial end-users are used to flexible arrangements when posting collateral, especially for commodity swaps, and the Commission's proposal to permit a broad range of assets—"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"—to be used as collateral is appropriate in this context. Finally, for many commercial end-users, the possibility of a margin call would create a significant risk that at best would require changes in liquidity management and at worst would preclude them from hedging entirely. We believe that the Commission has appropriately factored in these issues in allowing covered swap entities to exercise significant discretion in establishing the amount and form of margin requirements for commercial end-users.

B. If no margin is required, no credit support annex or similar documentation should be required.

If the Commission adopts its proposal to allow covered swap entities to enter into transactions with commercial end-users that do not require the collection of margin, we believe that documentation of the credit support arrangements should also not be required. The process of agreeing a credit support annex may be very unfamiliar to many commercial end-users, and is a time-intensive endeavor. We believe that such a requirement would be both confusing and burdensome to end-users. Even where credit support documentation is required because margin required, we ask that the Commission clarify that an ISDA-form credit support annex is not required. Instead, parties should be able to use a more conventional pledge agreement.

C. It is important that the conditions under which margin is held for commercial end-users not differ depending on whether the swap dealer is subject to prudential regulation or Commission oversight, as this will create significant competitive inequalities.

Section 731 of the Dodd-Frank Act, adding Section 4s(e)(2) to the Commodity Exchange Act, specifically requires the Agencies to establish margin regulations for the entities subject to prudential regulation in consultation with the Commission and the SEC. Moreover, these provisions further require that the Agencies, the Commission and the SEC "to the maximum extent practicable, establish and maintain comparable . . . minimum initial and variation margin requirements, including the use of non cash collateral, for—(I) swap dealers; and (II) major swap participants."[7] We do not believe that the margin requirements as currently proposed by the Agencies and the Commission satisfy that statutory directive.[8] As drafted, the Agencies' margin proposals would create significant competitive disadvantages for banks and other prudentially regulated financial institutions, without any safety and soundness considerations that justify such distinctions. We believe the more flexible approach proposed by the Commission is the more appropriate of the two proposals, and we urge the Commission to work with the Agencies so that the treatment of end-user transactions in their final rules conforms to the Commission approach.

IV. Treatment of pre-effective date swap transactions

We strongly support the Commission's decision not to impose margin requirements on pre-effective date swaps. Making such changes on a retroactive basis would significantly change the economics of outstanding transactions and would require extensively negotiated amendments with counterparties. Because the volume of an entity's existing legacy swaps far outstrips the number of any new transactions it may enter, extending margin requirements to pre-effective swaps would also require costly modifications to an entity's internal collateral monitoring system which may be unfeasible. We believe, therefore, that it is neither appropriate nor viable to impose such a requirement on outstanding trades.

To the extent pre-effective date transactions are included in portfolio margining, we believe the margin associated with those trades should be determined based on the terms originally negotiated by the parties, rather than being tied to the requirements of the Proposal (which would require, among other things, a formal amendment and counterparty consent). Such a determination should extend to the form of the margin as well as to the amount. Thus, portfolio-wide margining that included pre-effective date trades would likely include a mix of methodologies to determine the relevant margin requirements and permit a broader range of collateral for use as margin for pre-effective date swaps. We believe this is both the most appropriate and the most efficient result where parties decide to include such pre-effective date swaps in the netting

[7] Commodity Exchange Act, Section 4s(e)(3)(D)(ii).
[8] See, Scott O'Malia, Commissioner, Commodities Futures Trading Commission, Opening Statement, Thirteenth Series of Proposed Rulemakings under the Dodd-Frank Act (April 12, 2011), *available at* http://cftc.gov/PressRoom/Speeches Testimony/omaliastatement041211.html.

determinations.

V. The Proposal should integrate alternative means for the calculation and collection of margin

The Commission has proposed significantly more cumbersome methods for the determination of margin than those proposed by the Agencies. Instead of permitting proprietary models, the Commission has proposed to require that covered swap entities use third-party models, and further proposed significant filing and review requirements that may be difficult to comply with, especially where the model is acquired from a third party and may have intellectual property rights that limit its publication. The Commission also has proposed to allow determination of margin by reference to cleared swaps where comparable cleared swaps exist, and otherwise by reference to comparable futures transactions. This approach is fairly subjective and may lead to disputes as to what products are comparable.

We do not object to either of these approaches being on a menu of available options, but we believe other approaches should also be permitted. In particular, we support the Agencies' proposal to allow parties to establish initial margin either by using a look up table or by using an internal model.[9] If the Commission does not have the resources to evaluate an internal model, we suggest that the Commission allow the covered swap entity to provide either its own testing result or third party validation. Permitting a variety of approaches will allow counterparties who are negotiating margin requirements with covered swap entities to choose the model which is either the most transparent or the one with which they have the greatest level of familiarity. Because the Proposal addresses margin for uncleared swaps, the means by which such margin is calculated may well be a matter of negotiation. The Commission should help facilitate that negotiation.

We are concerned that the provisions for calculating valuation margin would incorporate documentation of valuation methodology as proposed by the Commission,[10] which would require a level of detail that is inconsistent with current practice and is likely to be impossible to implement. Although we have made these comments previously in the response to the Commission's trade documentation proposals, we feel it important to reiterate here that the requirements of the valuation proposal are too prescriptive to be workable, and the Commission should be taking an approach more consistent with current market practice.

We support the proposed safe harbor for covered swap entities that are unable to collect variation margin because a counterparty refuses or fails to provide it as required, which we read to provide protection when there has been a breach, and also under

[9] We believe the proposed minimum transfer amount of $100,000 is reasonable and should not create operational difficulties.

[10] See Commodity Futures Trading Commission, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732, 23734 (April 28, 2011), referencing Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715 (Feb. 8, 2011).

circumstances in which there is a bona fide dispute over the amount of such margin.

Finally, we note that the Commission has reserved the right to require higher levels of margin in some circumstances, based on either on a determination of the risk of the relevant product or a determination that the counterparty presents a heightened risk. We believe it is very important that, once an agreement is reached between a covered swap entity and a counterparty, the terms of that agreement not be changed by the Commission. During the financial crisis, margin calls that were made based on changes in counterparty risk often had the effect of destabilizing those counterparties. We believe that it is more important, in terms of managing systemic risk, that the counterparties have certainty about the degree of exposure they have to margin calls.

VI. Netting arrangements

We note that the Commission has proposed to allow netting with respect to the determination of variation margin. The Commission does not, however, seem to contemplate netting with respect to initial margin. We believe that, as proposed by the Agencies, netting should be permitted in connection with the calculation of initial margin as well as variation margin, and that covered swap entities should have the option of including only transactions executed after the effective date of the regulations.

We are further concerned that, even in the circumstances in which netting is permitted, or models are permitted to consider offsetting exposures, the approach may be too narrow. The following are some of our key concerns on this point:

a) Proposed Section 23.155(c)(2) would provide that, in calculating initial margin, "[r]eductions in margin based on offsetting risk characteristics of products shall not be applied across asset classes except that reductions may be applied between the currency asset class and the interest rate asset class." The process of tracking netting along such category lines would be extremely difficult to manage operationally, and could potentially add settlement risk. Netting across product lines should be permitted as long as it is consistent with legal certainty.

b) To the extent such arrangements can be documented with sufficient legal certainty, netting should be permitted across cleared and uncleared exposures of the same counterparty. For example, if a swap dealer is indemnifying a clearing agency on behalf of a customer, and is also collecting margin in connection with uncleared swaps, netting should be permitted.

c) To the extent such arrangements can be documented with sufficient legal certainty, netting should be permitted across affiliated entities.

d) There are potential legal issues for state-regulated insurance companies that are domiciled in some states with respect to the "well-founded basis" to conclude that netting agreements are enforceable in an insurer insolvency proceeding. Although the market has become comfortable with these issues from a risk perspective, agreements with insurance companies domiciled in these states may not technically be "qualifying master netting agreements" under the Proposal,

which would significantly increase the cost of hedging for insurance companies in affected jurisdictions. The provisions of the Insurance Receivership Model Act with respect to qualified financial contracts are intended to address the legal certainty point, but not all states have adopted this or similar legislation.

e) The proposal should clarify that collateral associated with foreign currency swaps and forwards, even though such agreements are expected to be carved out of the general provisions of Title VII, should nonetheless be permitted to be included in a qualifying master netting agreement.

VII. Extraterritorial application

There must be a limit to the extraterritorial application of Title VII, and we believe that where foreign covered swap entities engage in transactions with other non-U.S. entities, those transactions should not be subject to the margin requirements set forth in the Proposal, regardless of whether the foreign covered swap entity is affiliated with a US company. This would bring the Commission's proposal more in line with the Agencies' proposal, which explicitly exempts swaps conducted between foreign covered swap entities and non-US counterparties from margin requirements subject to certain limitations. (As noted in our response to the Agencies' proposal, we believe the exception proposed by the Agencies is too narrow, because it does not allow foreign swap dealers and MSPs that are subsidiaries of US companies to utilize the exemption.) We believe that it is critical to establish boundaries that do not require margin collection for transactions executed entirely outside the U.S. Failure to create such boundaries will place foreign covered swap entities at a significant competitive disadvantage when entering into swaps with non-US entities. We urge the Commission to work with the Agencies to clarify the extraterritorial reach in a way that avoids such competitive disadvantages.

VIII. Intercompany transactions

We believe intercompany transactions should be exempt from all margin requirements. Corporate groups may find it more efficient to have a single entity engage in swaps activities with external parties, and in such circumstances may use back-to-back intercompany swaps to allocate the swap economics among various affiliates. Little benefit would come from requiring margin to be posted within an affiliated group. We encourage the Commission to provide an express exemption from the requirement for a covered swap entity to collect margin when it is dealing with an affiliate.

IX. Certain entities that may otherwise be characterized as financial entities should instead be treated as commercial end-users for purposes of these provisions.

There are a number of types of special purpose vehicles that potentially could be determined to be financial entities for purposes of the Proposal that we believe should instead be treated as if they were commercial end-users. For example, it is common for securitization vehicles to enter into swaps to hedge the interest rate or currency risk of a pool of assets. For nonrevolving asset pools, all such swaps would be customarily

entered into concurrently with the issuance of the securities, and would amortize as the underlying assets amortize. For revolving master trusts, swaps might be entered into concurrently with a new issuance of securities, but the master trust would not be expected to enter into swaps at other times. In either circumstance, the swap counterparty would be entitled to cash flows from, and would be secured by, the asset pool. The swaps used by these securitization vehicles usually have the following characteristics:

- They are unleveraged interest rate or currency swaps;
- They are structured to match the terms of the securities issued by the vehicle with the terms of the assets held by it;
- They are entered into to hedge risk;
- Their notional amount never exceeds the notional amount of the underlying assets; and
- They are issued by a vehicle that is prohibited from incurring debt other than in connection with the securitization.

It will be difficult for securitization vehicles to respond to margin calls. The cash flows on their assets are usually distributed on a monthly basis, not daily or weekly. Providing either a separate liquidity facility or a funded cash collateral account to facilitate margin calls will increase the cost of meeting those margin calls substantially, and may place additional pressure on the credit ratings of the securitization. Securitization vehicles are already preparing for new and costly risk retention requirements that are intended to improve the quality of securitized assets; adding an additional cost to provide cash margin to protect a swap that is already fully secured will further restrict the utility of this funding source without a commensurate reduction in risk to the covered swap entity. We believe the better approach is to allow covered swap entities to conduct a credit evaluation of these vehicles and their assets at the time of entry into the swap, and then set discretionary initial margin requirements, without requiring any mark-to-market adjustments over time.[11]

X. Interplay with Section 716 swaps push out rule

A number of our members who may have to push all or part of their swaps activity out to an affiliate as a result of Section 716 of the Dodd-Frank Act are particularly concerned about the lack of uniformity between the rules proposed by the Commission and those proposed by the Agencies. It is important that swaps market participants that are moving from prudential regulation to Commission oversight avoid having to first implement the Agencies' proposal and then undergo a second change in regulations and procedures as a result of regulatory differences. In addition, there is a need for regulatory consistency to ensure that swaps activity that is divided between a

[11] Alternatively, we believe these entities should be treated as low-risk financial entities, with a threshold not to exceed a percentage of the covered swap entity's Tier 1 capital, but again with no obligation to post variation margin.

prudentially regulated entity and a separate swaps affiliate can be conducted in comparable ways across both entities. We therefore urge all sets of regulators to work together to bring the proposed requirements into closer alignment.

XI. The timing of final implementation

Although the Commission has not yet proposed timing for implementation of these regulations, we note that the Agencies have proposed that the new margin regulations would become effective 6 months after the date of adoption of the final regulations. We believe 6 months will not allow sufficient time for most covered swap entities to bring their swaps businesses in line with the new requirements. Implementing these changes will include (1) determining the appropriate categorization of counterparties, (2) developing and testing models, (3) making systems changes, (4) updating operations, (5) negotiating custodial arrangements, and (6) modifying standard forms of CSAs. In addition, the new margin regulations will be part of a much more dramatic change in the regulatory landscape related to swaps activity, including a panoply of new registration, clearing, exchange trading, recordkeeping and reporting requirements being concurrently promulgated by the Commission and the SEC. These margin regulations will need to be coordinated across agencies to avoid costly inefficiencies such as having to renegotiate swaps documentation multiple times with the same counterparty. We therefore believe that the 6 month implementation period suggested by the prudential regulators is not only far too short, but also needs to be integrated into the timing of effectiveness of the broader Title VII rulemaking process. We ask that the Commission take an alternative approach to the effective date that better reflects these concerns.

Because implementation of the margin requirements will be particularly time and document-intensive, it may be necessary for the Commission to employ a phased-in approach. For instance, final implementation deadlines for margin requirements rules could first cover agreements between two swap dealers or major swap participants, then agreements including high-risk financial entities, then agreements including low-risk financial entities, and then finally swap agreements including commercial end-users.

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The Roundtable and its members appreciate the opportunity to comment to the Commission on the Proposal with respect to margin regulations for covered swap entities. If it would be helpful to discuss the Roundtable's specific comments or general views on this issue, please contact me at Rich@fsround.org. Please also feel free to contact the Roundtable's Senior Regulatory Counsel, Brad Ipema, at Brad.Ipema@fsround.org.

Sincerely yours,

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The Financial Services Roundtable