December 2, 2014

Mr. Christopher Kirkpatrick
Secretary of the Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (RIN 3038-AC97)

Dear Mr. Kirkpatrick:

Better Markets Inc.[1] appreciates the opportunity to comment on the above-captioned request for comment on the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants ("Proposed Rule"), as well as the Advanced Notice of Proposed Rulemaking on the cross-border application of such requirements ("ANPR"), issued by the Commodity Futures Trading Commission ("CFTC" or "Commission").

INTRODUCTION

The absence of prudent margining of derivatives transactions led directly to the financial crisis of 2008, requiring the infusion of enormous sums of taxpayer money into the financial markets to avoid total collapse. The cost of the crisis has been in the trillions of dollars, and the economic wreckage has hurt tens of millions of Americans.[2] At the center of the reforms mandated by the Dodd-Frank Act is the direction to the CFTC and other agencies to create a strong and broad margining system for the derivatives markets to help avoid a repeat of this disaster.

The CFTC properly concluded that the Dodd-Frank Act reflects a Congressional recognition that uncleared swaps pose greater risks than cleared swaps and that margining is an essential risk-management tool.[3] As a result, the Proposed Rule generally establishes a system in which margin of the type used by derivatives clearing organizations ("DCOs") is required in connection with certain swaps entered into by Swap Dealers and Major Swap Participants for which the CFTC is the primary regulator ("Covered Swap Entities" or "CSEs"), but in which the standards are more conservative to reflect the heightened risk.

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

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

3 NOPR, 79 FR at page 59901.

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This approach is a necessary and appropriate response to the requirements imposed on the CFTC by the Dodd-Frank Act.

In a previous letter submitted during the first open comment period for this rule, Better Markets argued that the CFTC's original proposal was a good start but needed to be strengthened in important ways.[4] We are relieved that several of the most critical weaknesses in the previous proposal have been substantially corrected in the Proposed Rule, and we commend the Commission for taking meaningful steps to provide a more sound and sensible regime for the margining of uncleared swaps.

As three notable examples, the Proposed Rule requires that margin be exchanged bilaterally; it prohibits the rehypothecation of initial margin assets; and it lowers the material swaps exposure threshold. The Proposed Rule thus corrects previous flaws in the initial proposal so significant that any one of them would have rendered the rule largely ineffective. We appreciate the enormous external pressure on the Commission to maintain such gaps and loopholes during the rulemaking process, and we are encouraged that the Commission elected to prioritize the public interest and the stability of the financial system by now proposing these substantial fixes.

Despite these critical improvements, however, the Proposed Rule must be further strengthened in several respects to fully implement the statutory mandate that uncleared swaps be appropriately margined. Specifically, we provide the following comments:

1. The proposal's treatment of non-financial end-users presents significant improvements over the Prudential Regulators' Proposal that must remain intact.

2. The provisions regarding proprietary margin models must be enhanced.

3. The proposed list of acceptable collateral for initial margin must remove inappropriately risky assets such as equities and securities issued by systemically important firms, and the list of acceptable assets must be regularly reviewed.

4. Variation margin should be subject to the same custodial requirements as initial margin.

Additionally, we provide comment on the appropriate degree to which the Commission should consider the costs and benefits of the Proposed Rule, as well as comments on the ANPR addressing the cross-border treatment of margin for uncleared swaps.

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[4] Better Markets Comment Letter "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," July 11, 2011, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47763&SearchText=better%20markets (incorporated by reference as if fully set forth herein).

Margin is quite literally the front line of defense against the potential contagion and catastrophe posed by our increasingly large and interconnected over-the-counter derivatives market. While it serves as a critical buffer against losses on leveraged bets, it also performs a crucial oversight function by ensuring that derivatives counterparties are constantly evaluating and managing the risks posed by their often complex transactions. The Proposed Rule indicates that the Commission recognizes this important dual functionality, and we hope the following comments assist in crafting a truly comprehensive final rule.

SUMMARY OF COMMENTS

1. The proposal's treatment of non-financial end-users presents significant improvements over the Prudential Regulators' Proposal, and must remain intact.

With respect to the treatment of non-financial entities, the Proposed Rule contains two substantial improvements over the capital and margin rule recently proposed by the prudential regulators.[5] First, the Proposed Rule addresses a flawed provision in the prudential rule that subjects non-financial end-users to arbitrary margin calls by CSEs. Second, the Proposed Rule highlights the dual function of margin as both a risk mitigation tool and an oversight mechanism by requiring the calculation of margin by non-financial entities with material swaps exposure, regardless of whether the margin is actually exchanged. The Commission must resist attempts to weaken this approach.

2. The procedures surrounding approved margin models must be enhanced.

The proposed model-based method of determining the amount of initial margin relies on a Value-at-Risk (VaR) calculation. With respect to the analysis and approval of proprietary margin models, it is important to highlight that VaR-based models are notoriously flawed and unreliable. Any such models should be subject to rigorous stress-testing as part of the approval process, and made available for public scrutiny as soon as commercially practicable. Further, the provisional approval of proprietary models upon the filing of an application pending review **should not** be permitted under any circumstances. Allowing the application of potentially flawed models – even for a limited time – poses risks that are simply too high. Additionally, the rules should be crafted to incentivize industry stakeholders to provide the Commission with the information it needs to perform timely review and approval of margin models.

3. The proposed list of accepted collateral for initial margin must remove inappropriate assets such as equities and securities issued by systemically important firms, and the remaining non-cash assets must be subject to an annual review to ensure they continue to meet the requirements of high-quality collateral.

The expanded list of acceptable non-cash collateral inappropriately includes risky securities that fail to satisfy the requirements of "high quality assets" as described in the

[5] Margin and Capital Requirements for Covered Swap Entities, Proposed Rule, *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf, ("Banking Proposal").

2013 Final Report on Margin Requirements for Non-Centrally Cleared Derivatives ("International Framework"), issued by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO"). Specifically, all equities and securities issued by a systemically important institution must be excluded from the list of acceptable collateral. Furthermore, the list of non-cash assets that are acceptable as initial margin must be reviewed on a regular basis to ensure it continues to meet the requirements of high quality collateral.

4. Variation margin should be subject to the same custodial requirements as initial margin.

We applaud the Commission for requiring that initial margin be segregated and for prohibiting rehypothecation of initial margin assets, but the Commission must set the same high custodial standards for the treatment of variation margin as well.

5. The Commission faces limited responsibilities when considering the costs and benefits of its rules.

For the benefit of the new members of the Commission, and in light of recent court decisions, we include an analysis of the Commission's obligations under the CEA to consider economic factors when promulgating rules. We address the actual requirements regarding the consideration of costs and benefits in CFTC rulemakings, and contrast them with the claims made by certain industry groups seeking to frustrate the regulatory process. Specifically we address the following four crucial points:

(1) Under the CEA, the CFTC has no statutory duty to conduct cost-benefit analysis; in fact, its far more narrow obligation is simply to consider certain factors related to the public interest.

(2) The CFTC need not consider the costs and benefits associated with mandatory rulemakings.

(3) The CFTC must be guided by the public interest as it considers the economic impact of its discretionary rules, not by concerns over the costs of regulation imposed on industry.

(4) Congress's resolve to prevent another massively costly financial crisis clearly overrides any industry-claimed cost concerns under the Dodd-Frank Act.

6. With respect to cross-border transactions, the Commission should follow a combined approach that incorporates the strengths of the previous Guidance and the "Entity-Level" option.

We urge the Commission to consider a fourth approach for the treatment of margin in cross-border transactions, which builds upon the strengths of the Cross-Border Guidance and includes the additional protections addressed in the Entity-Level approach. Regardless of which approach is ultimately selected, however, any cross-border regime

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must define "guarantee" so that it covers **all** transactions that may transmit risk back to the United States.

DISCUSSION

1. **The proposal's treatment of non-financial end-users presents significant improvements over the Prudential Regulators' Proposal.**

The Proposed Rule correctly addresses the Congressional intent to provide relief to non-financial end-users by exempting them from the requirement to exchange margin on uncleared swaps. At the same time, and in contrast with the prudential approach, the Proposed Rule protects those non-financial end-users against the risk of unpredictable margin calls from CSEs.

Under the proposed prudential regime, Covered Swap Entities are not required to exchange margin with non-financial entities, but "shall collect initial margin at such times and in such forms (if any) that the covered swap entity determines appropriately address the credit risk posed by the counterparty and the risks of such non-cleared swaps."[6] Effectively, the prudential regime subjects non-financial end-users to arbitrary one-way margin calls by SDs and MSPs, at the sole discretion of those SDs and MSPs. Not only does such an approach cause non-financial entities tremendous uncertainty, it subjugates the interests of the non-financial entity to that of the Covered Swap Entity. The effect of this provision is to defeat the intent of the law: to provide relief to end-users.[7]

In an attempt to balance the prudent risk-management obligations of CSEs with the need to provide non-financial end-users with relief, the Commission has proposed a regime that is both simple and consistent with the spirit of the law:

> "[T]he rules would require CSEs to enter into certain documentation with all counterparties, including non-financial entities, to provide clarity about the parties' respective rights and obligations. CSEs and non-financial entities would be free to set initial margin and variation margin requirements, if any, in their discretion and any thresholds agreed upon by the parties would be permitted."[8]

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6 Banking Proposal, 79 FR at page 57368.

7 In its comment letter on the prudential regulators' proposed rule on margin for uncleared swaps, Better Markets advocates for the CFTC's proposed approach in place of the existing counterproductive proposal. Better Markets Comment Letter "Margin and Capital Requirements for Covered Swap Entities" (Nov. 24, 2014), *available at* http://bettermarkets.com/sites/default/files/FCA%2C%20FDIC%2C%20FHFA%2C%20FRS%2C%20OCC%20-%20CL%20-%20Margin%20and%20Capital%20Requirements%20for%20Covered%20Swap%20Entities%20-%2011-24-2014.pdf.

8 NOPR, 79 FR at page 59906.

This approach accomplishes multiple objectives: It continues to relieve end-users of the obligation of post margin and it maintains the ability of CSEs to manage their swap risk, all without subjugating an end-user's interests or creating an environment of uncertainty.

The additional requirement by the CFTC – that non-financial entities with material swaps exposure must calculate the hypothetical margin for each trade as if they were a CSE, even if not required to exchange such margin, or if subject to separate margin agreements with their counterparty – is also commendable, as it clearly implements the dual function of margin as both a risk-mitigation tool and an oversight mechanism.[9]

2. The procedures surrounding approved margin models must be enhanced.

A. *Models based on Value-at-Risk are inherently unreliable, especially when they are based on proprietary industry approaches, and the Commission should specify standardized models.*

The proposed type of model, which relies on a Value-at-Risk (VaR) style of calculation, can lead to widely divergent estimates of risk.[10] Variance/Covariance, Historical Simulation, and Tail-Index Based methods applied to the same data set can produce dramatically different results, potentially characterizing the very same portfolio as either risk free or possibly fatal.[11]

The potential for such unreliable results is especially acute when market participants are allowed to use their own proprietary models to assess VaR, in this case during the calculation of initial margin. That is a dangerous approach that has failed in the past. Large derivatives users, of course, have a financial incentive to keep their risk estimates low, as this will reduce the amount of collateral they are required to post.

History proves the point. Even models that have been subjected to a rigorous approval process may obscure fatal flaws until it is too late. For example, in the run up to the financial crisis, when the five United States stand-alone investment banks were rapidly increasing their leverage, their Unit VaR measures did not reflect increasing risk to the

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9 "The proposal would require each CSE to calculate hypothetical initial and variation margin amounts each day for positions held by non-financial entities that have material swaps exposure to the covered counterparty. That is, the CSE must calculate what the margin amounts would be if the counterparty were another SD or MSP and compare them to any actual margin requirements for the positions. These calculations would serve as risk management tools to assist the CSE in measuring its exposure and to assist the Commission in conducting oversight of the CSE." NOPR, 79 FR at page 59907.

10 "The model-based approach calculates an amount of IM that is equal to the potential future exposure (''PFE'') of a swap or a netting set of swaps. PFE is an estimate of the one-tailed 99% confidence interval for an increase in the value of the swap over a 10 day period (i.e., VaR model for a 10 day period)." NOPR, 79 FR at page 59921.

11 This is especially the case for derivatives portfolios with embedded convexity. The famous "12 sigma events" of 2008 are a case in point. *See* Nassim N. Taleb, Distinguished Professor of Risk Engineering, NYU-Polytechnic Institute, Testimony before the House Financial Services Committee, July 14, 2011, *available at* http://financialservices.house.gov/uploadedfiles/071411nassim.pdf.

banks or to the financial system.[12] Similarly, AIG reported a very low "capital markets trading" VaR immediately prior to the financial crisis.[13] Even commentators from within the derivatives world have made it clear they consider VaR to be an inadequate tool. For example, David Einhorn, founder of Greenlight Capital, has stated that VaR is "relatively useless as a risk-management tool and potentially catastrophic when its use creates a false sense of security among senior managers and watchdogs. This is like an air bag that works all the time, except when you have a car accident."[14]

That is precisely the fault with internal models: JPMorgan Chase's infamous multi-billion dollar loss from the so-called "London Whale" trade happened while many claim to have been managing and watching VaR very closely.[15] Additionally, the complexity of JPMorgan's VaR model allowed several spreadsheet errors to go unnoticed.[16] These errors also contributed to underestimating the actual risks of the London Whale positions. A fully vetted standardized model would be substantially less vulnerable to such mistakes.

The 2012 post-mortem report by the United States Senate Permanent Subcommittee on Investigations concluded, "In contrast to JPMorgan Chase's reputation for best-in-class risk management, the whale trades exposed a bank culture in which risk limit breaches were routinely disregarded, risk metrics were frequently criticized or downplayed, and risk evaluation models were targeted by bank personnel seeking to produce artificially lower capital requirements."[17] The fact that a bank considered to be among the industry leaders in risk management was susceptible to such improper, if not illegal, treatment of un-cleared derivatives risks is a damning indictment of the practice of allowing financial firms to use their own internal risk models.

Instead of relying on similar inadequate risk modeling techniques to account for the risks posed by un-cleared OTC derivatives, the CFTC should require the use of standardized requirements across the board and ensure that they are sufficiently calibrated to reflect the demonstrated dangers of un-cleared OTC derivatives markets.

B. <u>Provisional approval of proprietary models is unacceptable.</u>

Despite the optimistic pledge that primary regulators will approve and monitor these models, the fact is they are unlikely to have the resources to rigorously evaluate them

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[12] Tobias Adrian & Hyun Song Shin, *Procyclical Leverage and Value-at-Risk*, Federal Reserve Bank of New York Staff Report, No. 338 (2012), *available at* http://www.newyorkfed.org/research/staff_reports/sr338.pdf.

[13] Michael G. Wacek, *Derivatives AIG and the Future of Enterprise Risk Management*, Society of Actuaries (2008), *available at* www.soa.org/library/essays/rm-essay-2008-wacek.pdf.

[14] Joe Nocera, *Risk Mismanagement*, NY TIMES, (Jan. 4, 2009), *available at* http://www.nytimes.com/2009/01/04/magazine/04risk-t.html?pagewanted=all&_r=0.

[15] Matt Levine, *JPMorgan Dissects A Whale Carcass*, Dealbreaker (Jan. 16, 2013), *available at* http://dealbreaker.com/2013/01/jpmorgan-dissects-a-whale-carcass/.

[16] *See Report of JPMorgan Chase & Co. Management Task Force Regarding 2012 CIO Losses*, at 128, *available at* *http://files.shareholder.com/downloads/ONE/2272984969x0x628656/4cb574a0-0bf5-4728-9582-625e4519b5ab/Task_Force_Report.pdf.*

[17] *JP Morgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses*, Majority and Minority Staff Report Permanent Subcommittee on Investigations United States Senate ("PSI Report"), at 7.

in a timely manner. This point is underscored by the request for comment in the release on whether the CFTC may provide provisional approval of proprietary models until they are able to complete a formal review.[18]

This is unacceptable. It means that deeply flawed models may be in place for extended periods, as the Commission's ability to evaluate those models on a timely basis is uncertain, given its limited resources and the potential for further budgetary constraints. Indeed, this gift to the industry would only further incentivize the continued assault against proper funding of the agency, as a lack of resources would extend the horizon under which such unexamined and potentially flawed models are allowed to stand. The Commission must not allow the use of any proprietary margin models until they have been rigorously analyzed and approved by the Commission.

C. All approved proprietary models must be open to full public scrutiny

If proprietary models are permitted, then they should be publicly disclosed and the banks' application of those models should also be publicly disclosed, after some appropriate but limited time as necessary to prevent the premature disclosure of specific, genuinely confidential information. Only by subjecting the models and the application of the models to independent public scrutiny, analysis, and debate, will regulators ever have a complete basis for believing that the models are in fact robust and working to properly identify and test for the right risks under the right circumstances.

3. The proposed list of accepted collateral for initial margin must remove inappropriate assets such as equities and securities issued by systemically important firms, and the remaining non-cash assets must be subject to an annual review to ensure they continue to meet the requirements of high-quality collateral.

A. The list of acceptable non-cash collateral has been inappropriately widened to include risky and unstable assets.

The expanded list of acceptable collateral for initial margin assets raises a number of serious concerns. As a threshold point, the industry-driven claim that regulatory policies are driving a global collateral shortage, which is the basis for the decision to expand the list of collateral,[19] has been questioned by both by industry-supported academic studies[20] and the Bank for International Settlements ("BIS").[21]

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18 "The Commission is also considering whether it would be appropriate to provide for provisional approval upon the filing of an application pending review. The Commission requests comment on the appropriateness of such an approach." NOPR, 79 FR at page 59909.

19 "This list includes a number of assets that were not included in the 2011 proposal. This is responsive to a number of commenters who expressed concern about the narrowness of that list and the potential that there would be insufficient available collateral." NOPR, 79 FR at page 59912.

20 *See, e.g.*, The Economics of Collateral A Study by Ronald W. Anderson and Karin Jõeveer, The London School of Economics, *available at*

In a stressed market situation, mismatches in both the liquidity and the price-stability of assets are often fatal. As was widely documented during the financial crisis, long-term assets funded by short-term liabilities led to huge losses and fire sales.[22] An analogous problem can easily arise in OTC derivatives. Sharp price moves that trigger default by one party can leave the counterparty facing severe replacement risk, especially when prices are moving sufficiently quickly that daily marks are soon outdated.

In such a scenario, not only is there a gap created by the delay between the most recent mark and the default; if the collateral received as insurance against default is not sufficiently stable or liquid in the stressed market conditions precipitating the default, it will be useless. This, in turn, may trigger the additional default of the counterparty holding inadequate collateral, and thus may ignite a chain reaction.[23] Consequently, acceptable forms of non-cash collateral must be severely restricted to only highly liquid assets, and the rules should be strengthened to stipulate that these assets should be legitimately stress-tested to ensure they would continue to remain liquid in scenarios likely to trigger default.

As noted in the Release, the International Framework determined price stability to be a fundamental requirement when determining the collateral eligibility of an asset:

> "To ensure that assets collected as collateral can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect covered entities from losses in the event of a counterparty default, these assets should be highly liquid **and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress."**[24]

Equities, as an asset class, are precisely the instruments with which investors most easily gain exposure to the health of the financial system, and of course, they performed spectacularly poorly in the most recent episode of extreme financial stress. They are perhaps the class of assets that is most unsuitable to meet the criteria outlined above.[25] Equity securities present the idiosyncratic risks of a particular company, and their value and price resiliency depend on a host of variable factors, including the business activities of the company, its management, prevailing and changeable market conditions, and others.

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http://www.dtcc.com/~/media/Files/Downloads/WhitePapers/LSE%20Report.pdf

21 *See, e.g.*, Risk Magazine BIS finds 'no evidence' of persistent collateral scarcity May 29, 2013, *available at* http://www.risk.net/risk-magazine/news/2271074/bis-finds-no-evidence-of-persistent-collateral-scarcity.

22 *See, e.g.*, http://www.federalreserve.gov/newsevents/testimony/eichner20120802a.htm.

23 *See, e.g.*, Bank for International Settlements, "The Basel Committee's Response to the Financial Crisis: Report to the G-20," *available at* http://www.bis.org/publ/bcbs179.pdf.

24 NOPR, 79 FR at page 59900.

25 Further, the ubiquity of high-frequency trading in equity securities, and the significant risk of algorithm-driven calamities as witnessed in the Flash Crash, present an additional risk factor that compound the potential instability of equity prices even outside of periods of market stress. While previous market disruptions attributable to HFT trading were intense but short-lived, there is no doubt that more lasting upheaval in the equities markets could very well result from HFT activity, leading to persistent degradation in equity prices. Unfortunately, with many high-frequency trading firms, hedge funds, and trading desks running trading algorithms which link securities together into baskets, a wholesale equity panic could be precipitated in that scenario.

Consequently, their quality is not sufficiently reliable and predictable to warrant their treatment as permitted initial margin collateral. No equity security should be eligible for initial margin.[26]

Similarly, the assets of non-bank systemically important financial firms – or, more broadly, all systemically important firms - by definition present heightened sensitivity to weaknesses in the financial system and would be poor candidates to maintain value during periods when that system is under stress. This is, after all, the nature of their designation as systemically important. Like equities, the assets of all systemically important institutions do not meet the requirements of acceptable collateral and must not be added to the list of acceptable assets under any circumstances.

B. <u>All non-cash collateral assets must be subject to a mandatory annual review.</u>

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

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

Only such an annual review will provide information on the liquidity risk of those instruments and attempt to ensure that the proposed acceptable collateral provides sufficient protection to ensure the financial stability of the U.S. under actual market conditions. However, even a robust Collateral Annual Review will have its limitations, given that the evaluated collateral performance will likely be during periods of more-or-less normal range market fluctuations rather than extreme, broad-based market stress similar to an emerging or actual financial crisis or crash. Therefore, a Collateral Annual Review of the type proposed herein is all the more important, including in particular a vigorous analysis of the sufficiency of the haircuts.

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

4. Variation margin should be subject to the same custodial requirements as initial margin.

A. *Variation margin, as well as initial margin, must be subjected to segregation and rehypothecation rules.*

The Proposed Rule now requires that initial margin assets be segregated at an unaffiliated third party, with a strict prohibition against rehypothecation. We applaud this common-sense correction to the previous proposal, which represented an enormous gap. Indeed, for the reasons set forth in the release, only custodial arrangements meeting these basic requirements can adequately achieve the dual purposes of protecting the safety and soundness of the CSEs and preserving the stability of the U.S. financial system as a whole.

It is for this reason that the absence of these provisions in the treatment of variation margin is so troubling and inconsistent. The manner in which *both* initial and variation margin is segregated and invested can be the determining factor behind whether a firm is able to survive in stressed market conditions.

This point is crucial: the two types of margin work in tandem to mitigate risk. Initial margin is a statistical estimate of the potential consequences of a default, based on a defined methodology. Derivatives counterparty risk is defined by these potential consequences. Variation margin is best viewed as a daily recalibration of the risk estimation device which calculates initial margin: as losses accrue, the impact of a potential default increases commensurably (and may in fact accelerate), so variation margin is accrued and collected to offset this increased potential impact. The initial margin and variation margin thus work together to provide a (relatively) up-to-date safety barrier to guard against default. They must therefore be treated together with respect to segregation and rehypothecation rules.

LCH.Clearnet has clearly articulated this joint role of initial and variation margin in risk-mitigation:

> "To ensure that LCH.Clearnet Ltd only faces market risk in the event of the default of one of its clearing members, it needs to ensure that market risk ahead of that default event is fully covered (i.e. to keep LCH.Clearnet's risk current). Variation margin, which is a daily collect/pay in cash or collateral, covers this risk by accounting for the change in price since the previous day. Variation margin cannot take account of price moves after a default event since the defaulting member is, by definition, not in a position to pay variation margin. Instead initial margin - previously deposited by the defaulting member - covers that risk."[27]

[27] LCH.Clearnet, *Variation Margin*, http://www.lchclearnet.com/images/lch%20clearnet%20ltd%20-%20variation%20margin_tcm6-44528.pdf.

In a stressed situation, losses accrue on multiple fronts in short time periods. The capacity of the system to survive such an event depends on the absolute level of collateral present in the system relative to the magnitude of the losses, as well as the speed with which this collateral can move to where it is required. After all, a dealer or large swap trader who is ultimately "flat" market risk may still find himself unable to pay out on his obligations if he has collected insufficient collateral on his positions (even if they are net positive) and a counterparty on those positions defaults. In this way, defaults can become contagious.

Allowing re-hypothecation of margin (whether initial or variation) is a suicidal move from the perspective of the system as a whole. Naturally, each individual dealer and trader prefers the ability to re-hypothecate collateral, as this constitutes a supremely cheap form of financing for their own derivatives trades. However, to ensure proper risk management of uncleared derivatives, both initial and variation margin must be fully segregated, and never rehypothecated.

5. **The Commission faces limited responsibilities when considering the costs and benefits of its rules.**

A. *The industry has launched persistent and unfounded criticisms regarding agency economic analysis.*

Even when the CFTC has clearly fulfilled its duty to consider the economic impact of its rules, representatives from industry have challenged proposed rules claiming – without merit – that the CFTC failed to appropriately conduct what the industry calls "cost-benefit analysis."

These attacks rest on a series of fundamentally flawed claims. For example, in challenging rules promulgated by the CFTC, the industry has:

(1) greatly exaggerated the actual duty imposed on the CFTC by its governing statute, Section 15(a) of the CEA, in effect seeking to transform that limited duty into an "industry cost-only analysis;"

(2) entirely disregarded the paramount statutorily required role of the public interest in the rulemaking process; and

(3) indefensibly ignored the enormous cost of the financial crisis and the larger collective benefit of all rules designed to help prevent a recurrence of that crisis or something far worse.[28]

In light of these attacks, the CFTC should adhere to several core principles whenever it conducts economic analysis. These principles accurately reflect the true nature and scope of the obligation that the CFTC has when considering the economic impact of its rules.

(1) *Under the CEA, the CFTC has no statutory duty to conduct cost-benefit analysis; in fact, its far more narrow obligation is simply to consider certain factors related to the public interest.*

Section 15(a) of the CEA imposes a limited obligation on the CFTC simply to "consider" the costs and benefits of its rules in light of five specified public interest factors.[29] It contains no language requiring a cost-benefit analysis and there is no basis for imposing any such requirement. Indeed, the United States Court of Appeals for the District of Columbia Circuit has recently assessed the CFTC's economic analysis duty under Section 15(a) and confirmed that "[w]here Congress has required 'rigorous, quantitative economic analysis,' it has made that requirement clear in the agency's statute, but it imposed no such requirement here."[30]

The CFTC is not even required to obtain empirical evidence for its consideration of costs and benefits. Courts have held that the agency must merely "'acknowledge [the] factual uncertainties and identify the considerations it found persuasive' in reaching its conclusions."[31] In these situations, the agency's duty is to "acknowledge the lack of data or identify concomitant uncertainties."[32]

Furthermore, the D.C. Circuit has held that an agency may consider unquantifiable benefits without attempting to monetize them.[33] The court recognized that requiring

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[29] Better Markets has set forth a comprehensive analysis regarding the scope of Section 15(a) in the *amicus curiae* brief it filed in support of the CFTC in *ISDA v. CFTC*, Civil Action No. 11-cv-2146 (RLW) ("*Amicus* Brief") (*available at* http://bettermarkets.com/sites/default/files/Corrected%20Brief%20of%20Better%20Markets%20as%20Amicus%20Curiae%20in%20Support%20of%20Defendant%20CFTC%20Apr.%2030,%202012.pdf). In that case, representatives of industry challenged, *inter alia*, the CFTC's consideration of costs and benefits in connection with the position limits rule. *See also* Better Markets *amicus* Brief filed in another case challenging a different rule, *available at* http://bettermarkets.com/sites/default/files/ICI%20v.%20CFTC%20-%20Amicus%20Brief%20of%20Better%20Markets%20June%2025,%202012.pdf. In addition, Better Markets has written to the Office of Management and Budget ("OMB") opposing then-CFTC Commissioner Scott O'Malia's request that OMB review the cost-benefit analysis performed by the CFTC in connection with several recently finalized rules. Letter from Better Markets to Jeffrey Zients, Acting Director of OMB (Feb. 29, 2012) ("Letter to OMB"), *available at* http://bettermarkets.com/sites/default/files/O'Malia%20CBA%20letter%20to%20OMB.pdf. In the Letter to OMB, Better Markets makes clear that various executive orders and OMB guidelines requiring cost-benefit analysis are inapplicable to the CFTC's rulemaking. Both *amicus* Briefs and the OMB Letter are incorporated by reference as if fully set forth herein.

[30] *Inv. Co. Inst. v. CFTC*, 720 F.3d 370, 379 (D.C. Cir. 2013) (*citing American Financial Services Ass'n v. FTC*, 767 F.2d 957, 986 (D.C. Cir. 1985)); *cf., e.g.*, 2 U.S.C. § 1532(a).

[31] *Sec. Indus. & Fin. Mkts. Ass'n v. CFTC*, 2014 U.S. Dist. LEXIS 130871 (D.D.C. Sept. 16, 2014), *quoting Rural Cellular Ass'n v. FCC*, 588 F.3d 1095, 1105 (D.C. Cir. 2009).

[32] *Id.*

[33] *See Nat'l Ass'n of Mfrs. v. SEC*, at 369 (D.C. Cir. 2014) ("The Commission determined that Congress intended the rule to achieve compelling social benefits, but it was unable to readily quantify those benefits because it lacked data about the rule's effects. That determination was reasonable.") (internal quotations omitted.)

otherwise would force agencies and reviewing courts to make a pointless "apples-to-bricks" comparison whenever benefits cannot be framed in terms of dollars and cents.[34]

Moreover, Congress's careful choice of words in Section 15(a) and the case law construing similar provisions, make clear that the CFTC has broad discretion in discharging its duty. The Supreme Court has long recognized that when statutorily mandated considerations are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty.[35]

The fact is that the CFTC has no statutory or other obligation to quantify costs or benefits,[36] weigh them against each other,[37] or find that a rule will confer a net benefit before promulgating it. The rationale for this flexible obligation in the law is clear: requiring the CFTC to conduct a resource intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives.

(2) The CFTC need not consider the costs and benefits associated with mandatory rulemakings.

It is also clear from the statute that the CFTC's obligation to consider costs and benefits applies only to the discretionary components of a rulemaking. Not only is it unnecessary under the statute for the CFTC to consider the costs and benefits of actions mandated by Congress, it would also be fruitless for the agency to do so, since the agency has no authority to second-guess, ignore, or countermand the directives of Congress on cost-benefit or any other grounds.

Indeed, by mandating a rulemaking, Congress necessarily has already weighed the costs and benefits and the agency's role is simply to implement Congress's directive. To construe a statute otherwise would make it impossible for Congress to mandate a rulemaking because all such rules would nonetheless be subject to some form of economic or cost-benefit analysis by an agency and then, almost assuredly, by a court. That would

34 *Nat'l Ass'n of Mfrs. v. SEC*, at 369 (D.C. Cir. 2014).

35 *Sec'y of Agric. v. Cent. Roig Ref. Co.*, 338 U.S. 604, 611 (1950).

36 *Cf.* 42 U.S.C. § 300g-1(b)(3) (imposing a duty on the Environmental Protection Agency to use analysis of specific factors including the "[q]uantifiable and nonquantifiable health risk reduction benefits," the "[q]uantifiable and nonquantifiable costs," and "[t]he incremental costs and benefits associated with each alternative."). Courts have repeatedly held that an agency need not quantify the costs and benefits of a rule when a statute does not require it. *See, e.g., FMC Corp. v. Train*, 539 F.2d 973, 978-979 (4th Cir. 1976) (finding that 33 U.S.C. §§ 1314(b)(1)(B), (b)(2)(B) and § 1316 do not require quantification of the benefits in monetary terms). In fact, the D.C. Circuit has explicitly recognized that an agency's "predictions or conclusions" do not necessarily need to be "based on a rigorous, quantitative economic analysis." *Am. Fin. Services Ass'n. v. FTC*, 767 F.2d 957, 986 (D.C. Cir. 1985); *see also Pennsylvania Funeral Directors Ass'n v. FTC*, 41 F.3d 81, 91 (3d Cir. 1994) (recognizing that "much of a cost-benefit analysis requires predictions and speculation, in any context," and holding that the "absence of quantitative data is not fatal").

37 Courts distinguish statutes which include language of comparison, requiring a cost-benefit analysis, and statutes which do not. *See Am. Textile Mfrs. Inst. v. Donovan*, 452 U.S. 490, 512 n.30 (1981); *Reynolds Metal Co. v. EPA*, 760 F.2d 549, 565 (4th Cir. 1985); *Weyerhaeuser Co. v. Costle*, 590 F.2d 1011, 1045 (D.C. Cir. 1978).

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violate the constitutional principles of separation of powers, subordinating Congress's legal powers to both the agencies – which are the very creatures created by Congress to carry out its directives – and the courts.

The D.C. Circuit recently applied this principle when it upheld the SEC's conflicts minerals rule. In *NAM*, the Circuit Court found that Congress had already determined that the costs of the rule were necessary to further the goals of "peace and security in the Congo."[38] Any attempt by the SEC to revisit or second-guess this judgment, explained the Court, would have put the agency in an "impossible position."[39] Similarly, the district court in *SIFMA* found that the CFTC's requirement to consider costs and benefits applied only to "its own discretionary choices regarding the substantive requirements of the Rule," and that the agency "could not have . . . second-guessed Congress's decision that the Rule apply" in a specific manner.[40]

(3) The CFTC must be guided by the public interest as it considers the economic impact of its discretionary rules, not by concerns over the costs of regulation imposed on industry. For any rule promulgated in accordance with and in furtherance of the Dodd-Frank Act, the ultimate "public interest consideration" is implementing the reforms that Congress passed to provide for a safer and sounder financial system and to prevent another financial crisis.

The five factors that the CFTC must consider as specified in Section 15(a) reflect Congress's primary concern with the need for regulations that serve the public interest and accomplish the agency's mission, not with a need to spare industry the costs of regulation. Without exception, each factor relates to a public benefit that arises from a robustly regulated marketplace, including preventing abuse, promoting competition, enhancing transparency, and limiting systemic risk.[41]

Tellingly, none of the factors listed in the statute mentions any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements.[42] Removing any doubt, the fifth and final factor in Section 15(a) requires the CFTC to consider generally "any **other public interest** considerations."[43]

The overarching public interest goal that the CFTC must pursue derives from the statute mandating or authorizing a rule, in this case the Dodd-Frank Act. The CFTC must therefore consider the costs and benefits of the rulemaking in light of the goals of that statute, giving proper weight to Congress's overriding objective. That objective is to

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38 *Nat'l Ass'n of Mfrs. v. SEC*, 748 F.3d 359, 369 (D.C. Cir. 2014).

39 *Id.*, at 370.

40 *Sec. Indus. & Fin. Mkts. Ass'n v. CFTC*, 2014 U.S. Dist. LEXIS 130871 (D.D.C. Sept. 16, 2014),

41 7 U.S.C. § 19(a)(2).

42 *Cf.* 42 U.S.C. § 300g-1(b)(3)(C) (requiring analysis of certain costs of safe drinking water regulations including costs that "are likely to occur solely as a result of compliance with the maximum contaminant level, including monitoring, treatment, and other costs"); 42 U.S.C. § 6295(d) (1976 ed., Supp. II) (requiring a weighing of the economic impact on manufacturers and the savings in operating costs as "compared to any increase in the price of, or in the initial charges for, or maintenance expenses of, the covered products which are likely to result").

43 7 U.S.C. § 19(a)(2)(E) (emphasis added).

institute a comprehensive set of reforms, including a regime for regulating swaps, to prevent another financial collapse and economic crisis, including trillions of dollars in financial losses and incalculable human suffering.

The dollar cost alone of the financial collapse and economic crisis is conservatively estimated to be in the trillions. A study by Better Markets estimates that those costs will exceed $12.8 trillion.[44] In addition, the Government Accountability Office has issued the results of a study on the costs of the crisis, finding that "the present value of cumulative output losses [from the crisis] could exceed $13 trillion."[45] Therefore, as the CFTC assesses the costs and benefits of proposed rules under Section 15(a), it must continue to consider, above all, the benefits of the entire collection of reforms embodied in the Dodd-Frank Act, of which any specific rule is but a single, integral part.

(4) Congress's resolve to prevent another massively costly financial crisis clearly overrides any industry-claimed cost concerns under the Dodd-Frank Act, a desire the CFTC may not second-guess.

Congress passed the Dodd-Frank Act knowing full well that it would impose significant costs on industry, yet it determined those costs were not only justified but necessary to stabilize our financial system, avoid another financial crisis, and prevent the human suffering which came with it. Those costs include the elimination of extremely profitable lines of business as well as significant and ongoing compliance costs. Here, the new, comprehensive regulatory regime for swaps will require the financial industry to incur significant costs arising from new personnel and technology, ongoing compliance, margin and collateral, and reduced revenues and profits.

However, the financial reform law and the rules implementing it do not, in fact, add any incremental costs (or, if they do, those costs are *de minimis*). Rather, they reallocate costs so that industry bears them in a regulated environment that **prevents** financial failure and bailouts. As a result, the public and society are spared the massive costs of responding to economic crises after the fact.[46]

Congress fully understood this. It knew that re-regulation would impose costs on the industry, in some cases totaling billions of dollars. The Dodd-Frank Act reflects Congress's unflinching determination to shift the costs of de-regulation and non-regulation of the financial industry back to the industry from a society that has paid and continues to pay the bill for industry's unregulated excesses. In substance, Congress conducted its own

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[44] *See* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf.

[45] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013) (released Feb. 14, 2013), *available at* http://gao.gov/assets/660/651322.pdf.

[46] *See* BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 39-44 (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf.

cost-benefit analysis and concluded that the enormous collective benefits of the law far exceeded the costs and lost profits that industry would have to absorb.[47]

Against the backdrop of the worst financial and economic crises since the Great Depression, it is inconceivable that Congress would enact sweeping reforms and then allow the implementation of those reforms to hinge on the outcome of a biased cost-benefit analysis that ignored the overriding purpose of the new regulatory framework—and that gave controlling weight to cost concerns from the very industry that precipitated the crisis and inflicted trillions of dollars in financial damage and human suffering across the country. The industry's desire to have its costs prioritized over all other costs does not change the law, the reasoned basis for the law, or the underlying policy.

In short, the following analytical framework must guide any consideration of the economic impact of rules implementing the Dodd-Frank Act, or any rules that are promulgated within the broader Dodd-Frank Act context:

- Congress's ultimate objective in the Dodd-Frank Act was to prevent another crisis and the massive costs it would inflict to our financial system, taxpayers, investors, economy, and country;

- The rule is an integral component of the overall body of reforms that Congress envisaged to achieve this objective; and

- The costs of compliance and reduced profits that industry may have to absorb by virtue of the rule, as well as the entire Dodd-Frank Act, were considered by Congress in passing the law and determined to pale in comparison with the benefits of preventing another crisis—a benefit that can be valued at over $12.8 trillion.

6. <u>With respect to cross-border transactions, the Commission should follow a combined approach that incorporates the strengths of the previous Guidance and the "Entity-Level" option.</u>

A. *The Commission should adopt a cross-border approach that combines the Guidance with certain enhancements found in the Entity-Level Approach.*

The ANPR presents three potential approaches for dictating how margin requirements may apply to cross-border transactions:

(1) A "Transaction Level Approach" that is applied according to the CFTC's Cross-Border Guidance;

(2) A "Prudential Approach" that follows the treatemtent of transactions as outlined in the prudential regulators' proposed rule on margin for uncleared swaps; and

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[47] *Id.* at 43.

(3) An "Entity Level Approach" that expands on the Prudential Approach to include margin requirements on certain additional non-U.S. entities.

Better Markets has generally supported the Commission's Cross-Border Guidance, and continues to believe that the approach articulated in the Guidance is appropriate and thorough with respect to the application of margin for uncleared swaps.[48] Nevertheless, the Guidance has certain gaps that should be addressed, and the Commission should seize the opportunity to do so now as it finalizes its final rule on margin.

Generally, Better Markets has advocated a broad application of the CFTC's cross-border authority – one that minimizes potential loopholes and opportunities for evasion, and limits the availability of substituted compliance to only those circumstances where a foreign regulatory regime is in fact equivalent in form, substance, enforcement, and over time.

With this framework in mind, the proposed Entity-Level Approach presents some material benefits over the Transaction-Level Approach embodied in the Guidance, and those benefits should be incorporated with respect to cross-border transactions. As noted in the Release,

> "This approach would be intended to address the concern that the source of the risk to a firm...is not confined to its uncleared swaps with U.S. counterparties or to its uncleared swaps executed within the United States. A firm's losses in uncleared swaps with non-U.S. counterparties, for example, could have a direct and significant impact on the firm's financial integrity and on the U.S. financial system."[49]

This is an important point and highlights a significant weakness in the Guidance approach, which generally permits substituted compliance for trades between non-U.S. counterparties (or excludes them from the regime entirely). The Entity-Level Approach would correctly subject certain Non-U.S. SDs and MSPs to U.S. regulations – at least with respect to variation margin and the collection of initial margin – where the Guidance approach would permit substituted compliance to both parties in all respects. The Entity-Level treatment, in this case, is a meaningful and substantive improvement.

However, the Entity-Level Approach also contains provisions that are significantly weaker than the Guidance approach, such as making substituted compliance available to certain non-U.S. counterparties of U.S. SDs or MSPs. The Guidance approach rightfully

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[48] "Proposed Interpretive Guidance and Policy Statement: Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act (RIN 3038-AD57)" (August 16, 2012) *available at* http://bettermarkets.com/sites/default/files/CFTC-CL- Cross Border Delay- 8-16-12.pdf; "Proposed Interpretive Guidance and Policy Statement: Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act (RIN 3038-AD57)" (August 27, 2012) *available at* http://www.bettermarkets.com/sites/default/files/CFTC- CL- Cross Border Application of swaps provisions 8-27-12.pdf; and "Proposed Further Interpretive Guidance and Policy Statement: Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act (RIN 3038-AD85)" (February 15, 2013) *available at* http://bettermarkets.com/sites/default/files/CFTC- CL- Cross-Border further guidance- 2-15-13.pdf, incorporated here as if fully set forth.

[49] NOPR, 79 FR at page 59917.

requires that both counterparties fully comply with U.S. rules in all transactions involving a U.S. SD or MSP.

Therefore, we encourage the Commission to consider a fourth regime that builds upon the existing Guidance to address the potential risk of non-U.S. counterparties as outlined above, without simultaneously weakening its necessary and appropriate application to U.S. firms.

B. *In all circumstances, the definition of Guarantee must be expanded to cover all structures and arrangements where the risk of a swap transaction my transfer back to the U.S.*

Regardless of which approach is ultimately taken by the Commission regarding cross-border transactions, the issue of regulatory evasion through the de-guaranteeing of affiliates and transactions must be substantively addressed by the CFTC. The lack of clarity regarding the Commission's use of its authority to regulate transactions that pose risk to the U.S. threatens to compromise not only the Proposed Rules, but the entire Title VII regime.

Even when a subsidiary lacks an explicit guarantee, it almost certainly possesses an implicit or "de facto" guarantee – not necessarily on a transaction-by-transaction basis (hence why counterparties rightly regard a guaranteed subsidiary as a safer bet) – but certainly on a portfolio level. This is because reputationally, a dealer or large trader in the swaps market simply cannot afford to allow a supposedly non-guaranteed subsidiary to fail, except in the most marginal cases.

As all swap market participants can confirm, a parent's or sponsoring company's "choice" to let a subsidiary fail will inevitably be interpreted as a sign of balance sheet weakness or as a breach of a claimed prior understanding, practice, or expectation. As a result, any substantial market participant making such a decision will inevitably see a decline in business and order flow, likely a large and precipitous decline. In the most extreme case, a failure to bail out a subsidiary can trigger a crisis of market and counterparty confidence, causing a sudden liquidity squeeze, precisely the conditions that caused the near collapse of the financial system post-Lehman bankruptcy.

Indeed, the last financial crisis proved definitively that non-guaranteed subsidiaries are routinely bailed out when under stress, bringing the risks and liabilities back to the U.S. financial system and proving that cross-border regulation must be applied to them.

Citigroup's structured investment vehicles ("SIVs") were just one high profile example of non-guaranteed subsidiaries that were eventually bailed out by the parent.[50] As documented in Better Markets' Volcker Rule comment letter, Citigroup engaged in extensive proprietary trading in the run-up to the crisis, which ultimately precipitated its near downfall. Much of this proprietary trading took place through either guaranteed conduits or non-guaranteed SIVs. In 2007, to avoid failure of its guaranteed conduits,

[50] Better Markets comment letter to FSOC on Supervision of Large Nonbank Financial Companies, on 7, *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2011-0001-0082.

Citigroup bought $25 billion of commercial paper that had been issued by its Super Senior conduits and placed those Super Senior securities on the books of the Citigroup commercial bank.[51] Citigroup also "chose" to bring $49 billion of SIV assets onto its balance sheet, even though it had no legal obligation to do so, since no guarantee was in place.[52] No distinction was made between the guaranteed subsidiaries and the non-guaranteed subsidiaries: Citigroup knew that to allow either to fail would have been corporate suicide.

Beginning in November 2007, Citigroup was forced to recognize huge losses on the Super Senior securities and other positions.[53] By the end of 2008 Citigroup had written off $38.8 billion related to these positions and to asset-backed securities and CDO securities it held in anticipation of constructing additional CDOs, as well as extensive losses on the positions it absorbed from SIVs.[54]

These losses dramatically reduced Citigroup's capital, helped to bring the company to the brink of failure, and required hundreds of billions of dollars in bailouts. The amount of federal help required to prevent Citigroup from failing was breathtaking, including capital injections, debt guarantees, and asset guarantees.[55] Other transnational banks – including Barclays, HSBC, Dresdner, and Bank of Montreal – also moved SIV assets onto their balance sheets to avoid reputational damage.[56]

This clearly illustrates why there should be no distinction drawn in applying swaps regulations cross-border between guaranteed and non-guaranteed subsidiaries of a U.S. person: both types of subsidiary have a proven track record of causing life-threatening losses to the parent company, so both must be regulated as U.S. persons due to the immediate threat they can pose to U.S. commerce in stressed situations. Both must be bailed out to avoid a complete loss of market and counterparty confidence, and both are therefore capable of generating huge, systemically significant losses for the parent company.

The CFTC must ensure that the term guaranteed affiliate is appropriately defined to include those affiliates that are de facto guaranteed, even when not explicitly subject to a guarantee agreement. Both pose a significant risk of contagion to the U.S. guarantor in times of market stress. Because of this connection to the U.S. "guarantor," the de facto

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[51] Better Markets comment letter to CFTC on Volcker Rule, at 15, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=57403&SearchText=.

[52] Citigroup Inc. 2007 10-K, 163. *See* www.marketwatch.com/story/citigroup-to-take-49-bln-of-siv-assets-onto-balance-sheet.

[53] Citigroup, Inc. (2007). Press release, November 4 (announcing losses of approximately $8 billion to $10 billion), *available at* http://www.sec.gov/Archives/edgar/data/831001/000110465907079495/a07-28417_1ex99d1.htm.

[54] *See* Citigroup, Inc., Form 10K for the period ending December 31, 2007, 48; Form 10K for the period ending December 31, 2008, 68.

[55] *See* Special Inspector General for the Troubled Asset Relief Program (2011). Extraordinary Financial Assistance Provided to Citigroup, Inc., January 13.

[56] W. Bratton and A. Levitin (2012). A Transactional Genealogy of Scandal: From Michael Miliken to Enron to Goldman Sachs, University of Pennsylvania Law School Research Paper No. 12-26, 55-56, *available at* http://ssrn.com/abstract=2126778.

guaranteed entity should be classified as a "U.S. person" under the CFTC regime – or at least regulated to the same extent as explicitly guaranteed entities.

We applaud the Commission for including the thoughtful and comprehensive question regarding how guarantees should be treated or defined in the context of these margin rules. Consistent with the concerns illustrated above, the Commission must ensure that the definition of "guarantee":

1. covers all agreements, arrangements, and structures that transfer risk directly or indirectly back to the U.S. with respect to financial obligations arsing out of a swap;

2. covers such agreements, arrangements, and structures even if they do not specifically reference any relevant swap or even if they affirmatively state that they do not apply to such swap; and

3. covers agreements, arrangements, and structures even if the other party to the swap terminates, waives, or revokes the benefits of such agreements, arrangements, or structures.

Only those foreign affiliates that categorically cannot and do not potentially transmit swaps risk back to the U.S. should be allowed to remain outside the important protections mandated by the Proposed Rule.

CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Rule.

Sincerely,

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