July 11, 2011

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

Via agency website

Re: "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" / File Number RIN 3038-AC97

I. Introduction and Summary of Comments

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comments by the Commodity Futures Trading Commission ("CFTC" or the "Commission") entitled "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants." The Coalition represents companies that use derivatives predominantly to manage risks. Hundreds of companies have been active in the Coalition throughout the legislative and regulatory process, and our message is straightforward: Financial regulatory reform measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users, who did not contribute to the financial crisis, would create more economic instability, restrict job growth, decrease productive investment, and hamper U.S. competitiveness in the global economy.

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

Our comment letter is structured as follows:

- In Section II we discuss policy and economic reasons why financial end-users should not be treated differently under the new regulatory structure and should not be subjected to margin requirements.
- Section III explains why parts of the proposed rule would unnecessarily burden end-users and offers alternative formulations that comport with the statute while imposing less financial hardship on the business community. Specifically, we believe that
  - high margin requirements for uncleared swaps create unnecessary incentives to use cleared swaps;
  - requiring the negotiation of new credit support arrangements would create substantial new legal and administrative costs;

  - margin lending facilities are not an effective solution to issues raised by the proposed rule;
  - the proposed rule overly-restricts the use of non-cash collateral;
  - the proposed rule may not adequately account for the benefits of credit hedging; and
  - end-users will face unnecessary micromanagement of their counterparty relationships.

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

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

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

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

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

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

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

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

The Coalition represents both financial and non-financial end-users. While we appreciate that the Commission's proposed rule largely exempts non-financial end-users from margin requirements, we believe that financial end-users should be granted the same exemption. Financial end-users include entities such as, pension plans, captive finance affiliates, mutual life insurance companies, and commercial companies with non-captive finance arms. These entities do not pose systemic risk to the financial system and use derivatives predominantly to hedge risks associated with their businesses. In short, they use derivatives the same way non-financial end-users do. We thus believe that margin should not be required for all end-users, whether financial or non-financial.

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

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

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

We believe that modifying the margin requirements for financial end-users without meaningfully increasing systemic risks is possible. A recent economic analysis performed by the economics department of the Office of the Comptroller of the Currency ("OCC") on the

corresponding rule for bank SDs and MSPs supports our position.[1] The OCC analysis looked at the 74 OCC regulated banks that had more than $100 million in swaps as of December 31, 2010. The notional amount of swaps held by these 74 institutions totaled $179.49 trillion. The OCC then considered the impact of increasing the $100 million threshold to see the swap notional that would be outstanding when considering a smaller group of banks in the sample. Although raising the threshold from $100 million to $10 billion reduced the number of banks in the sample from 74 to 22, the outstanding notional for the remaining 22 banks remained virtually unchanged. The aggregate notional amount for the 22 largest institutions amounted to $179.44 trillion.

The OCC explains this phenomenon as follows: "Because total swap amounts are concentrated in a relatively small number of institutions, varying this threshold has little impact on the dollar amount of swaps affected by the proposed rule. Varying the threshold does, however, affect the number of institutions that would be subject to the proposed rule." Because of the concentration of swaps exposures within a small number of market participants, addressing systemic risk concerns is substantially a function of subjecting only those institutions to the salient aspects of regulation.

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

During the debate over the margin provisions of the Dodd-Frank Act, the bill's managers did not distinguish between financial and non-financial end-users. For example, House Agriculture Committee Chairman Peterson stated that Congress had "given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant." In response, House Financial Services Chairmen Frank agreed, saying that "the gentleman is absolutely right. We do differentiate between end-users and others."[2] This colloquy was carefully crafted to emphasize that Congress wanted margin requirements to apply to SDs and MSPs, not financial or non-financial end-users. The text of the Dodd-Frank Act underscores the fact that no distinction between financial and non-financial end-users was intended with respect to margin requirements. There simply is no textual support for such a distinction in the statute.

---

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

[2] 156 CONG. REC. H5248 (June 30, 2010) (colloquy of Representatives Frank and Peterson).

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

The Coalition appreciates the Commission's acknowledgement that not all financial entities pose a high risk to the financial system as demonstrated by the Commission's providing for margin thresholds higher than zero for low risk financial end-users.[3] However, we believe the criteria used by the Commission to determine which entities are low risk do not account for important factors that we believe the Commission should employ to distinguish the relevant risk characteristics of a particular entity. For example, the Treasury Department explained in a whitepaper that "[a]ny financial firm whose combination of the size of a derivatives portfolio, leverage, and interconnectedness could pose a threat to financial stability if it failed…should be subject to robust consolidated supervision and regulation, regardless of whether the firm owns an insured depository institution."[4] The Treasury Department's analysis establishes that size,[5] leverage, and interconnectedness must be considered *together* to determine whether an entity could pose a threat to the financial system. In other words, no single factor alone is sufficient to determine whether an entity should be classified as "high risk."

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

- The quantity of the entity's uncollateralized credit exposure to SDs and MSPs;
- Whether the derivative is used for hedging or speculative purposes;
- The entity's degree of leverage;

---

3 76 Fed. Reg. 23736 (Apr. 28, 2011). We use the terms "high risk" and "low risk" in this letter to refer to financial entities that must have a zero margin threshold and those that are permitted to have a margin threshold above zero, respectively, as classified in the proposed rule.

4 Department of the Treasury, Whitepaper on Financial Regulatory Reform, *available at*: http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf.

5 For the purpose of derivatives legislation, the size in question relates not to the size of the firm, but rather to the size of its derivatives portfolio.

- The entity's dependence on substantial quantities of uncollateralized short-term funding; and
- The quantity of an entity's derivative counterparties or derivative transactions.

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

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

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

As Section VIII below confirms, the Dodd-Frank Act does not give regulators the authority to impose margin on any swaps to which an end-user is a party.[6] If, however, the CFTC disregards the text of the Dodd-Frank Act and Congressional intent by imposing margin requirements on swaps that involve financial end-users, the Commission should exempt specific classes of swaps from margin requirements that do not increase systemic risk.[7]

There are many classes of swaps that should rightly be exempt from the Dodd-Frank Act's margin requirements because they are used to hedge or mitigate commercial risk and do not contribute to systemic risk. We urge the Commission to exempt from margin requirements all swaps entered into by end-users for these purposes. Further, we appreciate that the Securities and Exchange Commission ("SEC") and CFTC, in their proposed definition of those positions,

---

[6] *See* Section VIII *infra*. *See also*, 7 U.S.C. § 4s(a)–(e); Dodd-Frank Act § 731.

[7] We acknowledge that the Dodd-Frank Act directs the Commission to impose margin requirements on swaps between SDs and MSPs. Thus, if the Commission exempted a specific class of swaps from margin requirements, we acknowledge that swaps within that class that are between SDs and MSPs would still be subject to margin requirements.

"established to hedge or mitigate commercial risk," have relied upon a standard of "economic appropriateness" rather than a hedge accounting standard.

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

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

Further, for derivatives positions held by financial end-users that may not meet the requirements of FAS 133, but that do meet the final definition of "positions established to hedge or mitigate commercial risk," the Coalition urges the Commission to, at a minimum, allow for lower margin requirements than would be applied to speculative trades.[8] Such an approach

---

[8] The CME Group's margin requirements on futures contracts allow for a lower margin requirement for hedges, *available at*: http://www.cmegroup.com/clearing/risk-

[Footnote continued on next page]

matches current market practice in the futures market and would acknowledge the lower risks posed by derivatives used to mitigate commercial risk.

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

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

In particular, it is not clear whether the Commission intended to classify captive finance units as financial end-users or as non-financial end-users. We note that the term "commercial end user" is "generally understood to mean a company that is eligible for the exception to the mandatory clearing requirement. . . ."[9] Because captive finance units are eligible for the exception to mandatory clearing, it could be concluded that the Commission intended that they be classified as commercial end-users. However, we urge the Commission to clarify that this is their intent.

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

Recommendations:

In addition to the aforementioned recommendation concerning swaps that comply with hedge accounting standards, if the Commission applies margin requirements to financial end-users, the Coalition recommends the following:

- The Commission should clarify that captive finance units are not intended to be classified as financial end-users.
- The Commission should exempt small banks, farm credit system institutions, and credit unions from margin requirements in the final rule.
- The definition of low risk financial end-user should remove the criterion referring to regulatory capital requirements.
- Classification as a high risk financial entity should be predicated on a combination of factors including the following:
  - The quantity of the entity's uncollateralized credit exposure to SDs and MSPs;

[Footnote continued from previous page]
management/historical-margins.html and http://www.cmegroup.com/clearing/risk-management/files/26_2008_to_december_2010.pdf.

[9] 15 U.S.C. § 78c-3(g).

  - Whether its derivatives are used for hedging or speculative purposes;
  - The entity's degree of leverage;
  - The entity's dependence on substantial quantities of uncollateralized short-term funding; and
  - The quantity of an entity's derivatives counterparties or derivatives transactions.
- The maximum threshold available to low risk financial end-users should be higher, be risk-based and be commensurate with the amount of uncollateralized exposure that has systemic significance. Thresholds that would trigger classification as a MSP are a useful proxy for systemically significant exposures.
- At a minimum, financial end-users that use derivatives that qualify as hedges under Accounting Standards Codification Topic 815, *Derivatives and Hedging*, previously known as Statement of Financial Accounting Standards No. 133, should qualify for the same margin treatment as non-financial end-users.

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

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

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

In particular, the Coalition believes that the proposed margin rule creates an economic incentive for end-users to abandon customized hedges in favor of standardized hedges because standardized hedges will have lower margin costs overall. This cost difference has at least two sources. First, the proposed rule requires more stringent margin calculations for uncleared swaps when used by financial end-users. For example, margin for cleared swaps is typically calculated by accounting for all price variations over a three to five day period. The proposed margin rule for uncleared swaps, however, requires margin calculation models to account for all price changes over a ten-day period.[10] Second, both financial and non-financial end-users will face higher margin costs for uncleared swaps because the proposed margin rules will lead to increased bilateral transactions costs. For example, the requirement to execute credit support arrangements for every counterparty relationship and the initial margin requirements imposed on SDs for trades with end-users will each impact end-user costs.

---

[10] 76 Fed. Reg. 23746 (Apr. 28, 2011).

Recommendations:

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

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

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

1. The proposed margin rule leaves open the possibility that all market participants would be required to enter into new credit support arrangements. The Commission should clarify that existing documentation practices satisfy the requirements to have credit support arrangements.

The Coalition appreciates the intent of the Commission to codify market practice, but vague provisions in the proposed rule could be interpreted to require negotiation of new credit support documentation for all end-user transactions. Today's marketplace does involve bilateral margin agreements, but to a limit. According to a survey of Coalition members, only 61% of all end-users employ bilateral margin agreements. The proposed margin rule could be interpreted as forcing the other 39% to adopt new documentation, which would impose significant administrative and legal costs on end-users.[11] Of the end users that have not entered into margin posting agreements (e.g., such as those documented under a Credit Support Annex), the vast majority have entered into ISDA documentation[12] that specifies that they do not have a specific

---

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

[12] The existence of credit support documentation, including but not limited to the requirement to post margin under a Credit Support Annex, is typically specified in Part 4 of the Schedule to the International Swaps and Derivatives Association's Master Agreement (both the 1992 and 2002 versions). For end-user transactions for which there is no margin posting requirement, the participants typically would specify that there is no such Credit Support Annex in Part 4, or would specify other agreements that serve as credit support for the

[Footnote continued on next page]

margin posting requirement. The Coalition requests that the Commission specify that that such language in previously negotiated agreements is sufficient, and that the term "credit support arrangement" is not limited to include only margin posting agreements, such as the Credit Support Annex.

Even the 61% that already transact with bilateral margin agreements currently have wide latitude in negotiating the terms of those agreements. If the Commission were to require market participants to negotiate new credit support arrangements, the proposed margin rule would create substantial new legal costs, especially for those that hedge infrequently but would still have to incur the requisite negotiation costs. By using the CFTC's estimate for the number of end-users affected, the Coalition estimates that these legal costs could be substantial. As shown in Figure A, making assumptions about the time it takes to negotiate a credit support arrangements and any third party account agreements, the number of counterparty relationships per end-user, and the legal cost to negotiate, one could easily estimate costs rising to hundreds of millions of dollars.

	Assumptions[13]
End-Users	**30,000**
% End-Users with No CSAs	**39%**
Adjusted End-users	**11,700**
Attorney Hours Per CSA	**5**
CSA's per end-user	**11**
Cost per Attorney Hour	**$300**
Total Cost for End-Users	**$193,050,000**

Figure A. Estimated legal costs associated with mandatory CSAs.

[Footnote continued from previous page]
transactions between the two parties to the ISDA in Part 4 (e.g., a "cross-collateralization" arrangement that specifies that other collateral backs the swaps under the ISDA).

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

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

For many market participants, and especially for end-users, an initial margin requirement such as that proposed for financial end-users would be a new economic cost that is not normally applicable to the bilateral over-the-counter ("OTC") market. A recent Coalition survey found that 3% initial margin requirement on the S&P 500 companies could be expected to reduce capital spending by $5.1 billion to $6.7 billion.[14] The United States would lose 100,000 to 130,000 jobs from both direct and indirect effects.[15] The analysis illustrates that the strength of the economy and people's livelihoods are at stake.

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

Because all market participants will bear the cost of increased system-wide margin requirements, the Coalition believes that the margin requirements must be set at levels consistent with historical loss experience. Since inception of the financial crisis, U.S. financial institutions have reported $1.262 trillion[16] in losses in their financial statements. Of this amount, only $49 billion resulted from derivatives. More than half was attributable to AIG and was made up of mortgage-related credit default swaps, which financial end-users typically do not use. The remaining losses from the $1.262 trillion came from non-derivatives products, including loans.

This derivatives loss data offers a useful point of comparison to evaluate whether setting aside the substantial cash resources required by the proposed rule is appropriate. In its economic analysis of the Prudential Regulators' comparable rule for bank SDs and MSPs, the OCC estimated the cash resources that would be required to satisfy the initial margin requirements of the Act on 74 OCC regulated banks. It concluded that $2.05 trillion would be required to be set

---

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

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

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

aside to satisfy the initial margin requirements of the rule. Although the proposed rule did not calculate the impact of such requirements on non-OCC regulated banks, the conclusions presented therein are useful for the CFTC as it determines its own margin framework. Specifically, the analysis counsels that (1) a quantitative analysis of the proposed rule is feasible, (2) that the results of such an analysis suggest the margin requirements are quite significant and (3) that the results, if accurate, are presently disconnected from the historical loss experience in the derivatives market.

It is worth noting that there is a simple and compelling reason that explains why initial margins have historically been applied universally for central clearing, but often inapplicable to bilateral end-user hedges. In central clearing, the central clearing party must guarantee a contract's performance even if one of the two counterparties defaults. This guarantee requires the central clearing party to perform a close-out process with the defaulting party and replace the defaulting contract with a new one. The new contract's cost should theoretically equal the variation margin already collected. If the close-out occurs over a longer time period, however, any adverse movement in the replacement contract's cost can be covered by the initial margin. In contrast, a non-defaulting SD counterparty in a bilateral situation has no obligation to replace the defaulted contract with a new one. In fact, dealers may only need to terminate offsetting hedges that are more liquid than the customer OTC transactions

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

Furthermore, the proposed rule's requirement that portfolio margining may not be offset across asset classes under the alternative calculation method, that variation margin payments from end-users meet specific minimum transfer amounts and that they be transferred within certain periods of time, undermine the ability of end-users and their counterparties to negotiate the best terms for a given transaction. Offsetting of positions across asset categories can allow counterparties trading under master netting agreements to calculate their true exposure to each other, while limiting this practice could unnecessarily increase the margin requirements on end-users. Current practice also allows counterparties to determine minimum transfer amounts

and the timing of both initial and variation margin payments for their transactions. However, the proposed rules would require a minimum transfer amount of no greater than $100,000 and that SDs and MSPs must collect these payments at least once a day from financial end-users. Such new requirements will reduce the ability of counterparties to customize the terms of their transactions, which will generally advantage the covered swap counterparties and drive up the administrative and margin costs for end-users.

The end-user will also be disadvantaged if, in circumstances when portfolio margining is appropriate, SDs and MSPs are enabled to include in margin calculations an end-user's swap positions entered into prior to the effective date of the new rules. By allowing an SD or MSP to choose to include pre-effective date swaps in their margin calculations without the consent of their end-user counterparty, the proposed rule may provide SDs and MSPs with an incentive to maximize the margin collected from end-users, regardless of the original documents in place between counterparties and without regard to the true risk of the counterparty.

3. The eligibility of initial models is unnecessary restrictive.

Proposed § 23.155(b)(1)(i) to (iii) sets forth eligibility requirements for initial margin models that would forbid the use of internally developed models at the present time. As the Commission has noted, this aspect of the proposal differs from the Prudential Regulators' approach. Although the Commission provides for three alternatives to license and use third party initial margin models,[17] these alternatives present at least two challenging issues for the SDs and MSPs.

The first issue is that many factors limit the availability of third party models.

- First, DCOs and prudentially regulated SDs and MSPs may not have an incentive to stray from their core businesses and offer their proprietary models for licensing.
- Second, DCOs are traditionally equipped to value standardized derivatives rather than the customized derivatives typical of bilateral transactions.

---

[17] § 23.155(b)(1) To be eligible for use by a covered swap entity, a model shall meet the standards set forth in paragraph (b)(2) of this section, be filed with the Commission by a covered swap entity pursuant to paragraph (b)(3), be approved by the Commission pursuant to paragraph (b)(4) of this section and either be:

(i) Currently used by a derivatives clearing organization for margining cleared swaps;

(ii) Currently used by an entity subject to regular assessment by a prudential regulator for margining uncleared swaps; or

(iii) Made available for licensing to any market participant by a vendor.

- Third, DCOs and prudentially regulated SDs and MSPs may be reluctant to share their proprietary valuation models with external customers in order to protect their intellectual property and competitive advantages.
- Forth, the derivatives industry has evolved over the years with a predisposition towards developing internal valuation models. As such, the availability of independent vendors offering robust risk management models is limited, and no vendors exist for some product types.
- Fifth, the availability of flexible and extendable third party models that can be easily and quickly adapted to the changing product offerings of customized derivatives is inherently limited.

The second issue is whether third party models are appropriately robust for risk management by an SD or MSP. Without a deep understanding of the internal assumptions, workings, and short-comings of risk management models, an SD or MSP would be dependent on the quality of the third party's models and in essence cede part of its risk management responsibilities to the third party.

These challenges may force SDs and MSPs to use the Alternative Method proposed in § 23.155(c) whereby, the initial margins of uncleared swaps are approximated with cleared swaps or futures contracts, subject to regulatory multipliers of 2.0x or 4.4x. The use of approximations and multipliers would likely impute punitive initial margins on uncleared swaps, and increase the costs of hedging for end-users.

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

Margin lending facilities would not provide a potential solution to financial end-user concerns with margin requirements.[18] Instead, they would simply force more complexity and regulatory burden onto financial end-users without reducing systemic risk by increasing costs both directly and through exposure to new types of risk. First, financial end-users need certainty and liquidity to manage their balance sheets. But the amount of margin borrowed and costs associated with a margin lending facility cannot be known upfront. The amount cannot be known because it depends on market fluctuations. The costs cannot be known because lenders typically base credit fees on a floating interest rate, plus credit spread. Thus, the total costs of a margin lending facility vary based on the unpredictable amount needed to be borrowed and the unpredictable interest costs of that borrowing.

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

---

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

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

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

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

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

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

While we appreciate that the proposed rule allows non-financial end-users to use non-cash collateral, for financial end-users, the proposed rule radically narrows the universe of eligible collateral to cash, obligations guaranteed by the U.S. government, or GSE senior debt obligations.[19] This is a major change from current market practice, which allows parties to use many other types of liquid collateral. For example, parties can currently negotiate and agree to use any of the following types of securities to satisfy margin requirements today:

- Agency pass-through securities;
- Callable and non-callable agency debt;

---

[19] 76 Fed. Reg. 23747 (Apr. 28, 2011).

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

Existing market practice further allows for non-cash collateral as negotiated by the parties, which could include physical real estate, physical plants, or physical commodities. This is particularly important for end-users that carry limited cash or liquid securities on their balance sheets. Such collateral may be pledged in connection with a commercial or real estate loan and may secure both the loan and the swap.

Congress recognized the inherent benefits of these loan and swap arrangements in crafting the insured depository institution carve-out to the SD definition.[20] This carve-out exempts banks from the SD definition when they offer swaps in connection with originating a loan and acknowledges the important role swaps play in reducing risks inherent in commercial borrowing and lending. Further, such swaps are offered generally by one member of a lender's group and the lack of these hedges could reduce the ability of banks to offer asset-backed loans, as the commercial price risk exposed by the borrower impacts the future revenue predictability.

The carve-out provision also confirms that depository institutions' practice of offering swaps in connection with loan originations and using non-cash collateral does not carry the risks that the Dodd-Frank Act is intended to address. Indeed, the market currently manages the lower liquidity inherent in non-cash collateral by applying haircuts instead of banning its use.[21] This practice accounts for relative liquidity differences. Parties customize and agree to haircuts as

---

[20] Dodd-Frank Act § 716(b)(2)(B).

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

part of their credit support arrangements based on credit health and the liquidity of the collateral being posted.

Some have suggested that end-users that traditionally pledge non-cash collateral could continue their operations by using a secured financing facility. Like the margin lending facility discussed earlier in Section III.B.4, a secured financing facility does little or nothing to remove risks from the system. Instead, it simply changes the name of the risk from derivatives exposure to financing facility exposure. Additionally, in the case of financial end-users that typically pledge real property as collateral for a swap, these entities may be limited in their ability to pledge their property as collateral to a margin lending facility because of the terms of the property's financing. While many lenders are willing to allow a borrower to pledge the same property as collateral on a swap used to hedge the interest rate risk of a loan secured by that property, pledging that property as collateral for a margin lending facility may violate the loan's restrictions against additional indebtedness.

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

The Dodd-Frank Act requires that regulators "*shall* permit the use of noncash collateral" so long as doing so is consistent with preserving the financial integrity of swap markets and the stability of the U.S. financial system.[22] Congress thus directs regulators to promulgate non-cash collateral requirements according to systemic risk and according to not other factors. We understand the Commission's proposed rule as differing from the companion rule proposed by the Prudential Regulators in that it allows for non-cash collateral to be posted in certain circumstances and ask that the CFTC clarify that such forms of collateral are acceptable. We also agree that limiting the use of non-cash collateral for SDs and MSPs is worthy of consideration. However, prohibiting the use of most forms of non-cash collateral for all financial end-users as well ignores both the text of the Dodd-Frank Act and economic reality, leaving financial end-users to pay an unnecessary price.

Recommendations:

The Coalition urges the Commission not to impose margin on uncleared trades entered into by financial or non-financial end-users. If, however, the Commission does impose margin on any end-users, we recommend the following:

- As stated previously, for all end-users, the final rule should clarify that it did not intend to require the negotiation of new credit support arrangements. Instead, we urge the Commission to simply allow existing trade documentation, such as, transaction confirmations) to reflect any collateral arrangements that the parties have bilaterally agreed to, even if such arrangements do not require collateral. This approach would provide

---

[22] 7 U.S.C. § 4r(e)(3)(C); Dodd-Frank Act § 731.

regulators comfort that SDs are not extending credit to an excessive degree to a given end-user, while eliminating the need for new documentation that would impose unnecessary costs and burdens.

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

- The Commission should allow the use of internally developed initial margin models that meet the requirements set forth in § 23.155(b)(2). One of the requirements specified by the Commissions requires models to be "validated by an independent third party before being used and annually thereafter." Such a requirement should provide the Commission with sufficient assurance that appropriate risk management practices are used whether the Commission does or does not develop internal capacity to validate models.

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

- SDs and MSPs should be allowed to establish minimum transfer amounts of up to $250,000.

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

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

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

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

- Commonly accepted forms of collateral subject to appropriate haircuts should be allowed for trades involving end-users, including the following:
    - Agency pass-through securities;
    - Callable and non-callable agency debt;

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

- Assets that are not securities should be allowed for use as collateral by end-users, including the following:
    - Physical real estate;
    - Plants; and
    - Physical commodities.

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

The proposed rule imposes a broadly applicable requirement that "each covered swap entity shall execute with each counterparty swap trading relationship documentation regarding credit support arrangements" [23] While the proposed rule currently allows SDs and MSPs some latitude to set the thresholds in agreements with certain financial end-users, the Coalition is concerned that the proposed rule grants the Commission substantial authority over models used to calculate initial margin. For example, the proposed rule states that "[t]he Commission may at any time require a covered swap entity to modify a model to address potential vulnerabilities."[24] Such broad authority puts financial end-users in a needlessly uncertain position: Faced with the constant threat that their margin costs and requirements could suddenly increase at any time, financial end-users may become more hesitant to grow their businesses or hire new workers.

Recommendations:

The Coalition appreciates the Commission's efforts to acknowledge the lower risk posed by non-financial end-users by allowing for negotiated margin agreements. We believe, however, that the supervisory authority over financial end-user margin levels reserved by the Commission was not intended by Congress and is unnecessary for the mitigation of systemic risk. We thus

[23] 76 Fed. Reg. 23744 (Apr. 28, 2011).

[24] 76 Fed. Reg. 23746 (Apr. 28, 2011).

urge the Commission to clarify that they do not have a supervisory role over thresholds mutually agreed to by an SD or MSP and a financial end-user.

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

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

The Dodd-Frank Act's margin provisions[25] rightly focus on regulating systemic risk related to SDs and MSPs. The structure of the Dodd-Frank Act's margin provisions and the "Standards for Capital and Margin" indicate that Congress intended regulators to focus on systemic risk as a primary criterion for establishing margin requirements. By their terms, these sections apply only to entities that pose systemic risk to the financial system: "swap dealers" and "major swap participants."[26]

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

As Congress correctly recognized,[27] end-users' use of derivatives to hedge or mitigate their commercial risks did not cause the financial crisis. Chairman Bernanke agrees: "The [Federal Reserve] Board does not believe that end-users other than major swap participants pose the systemic risk that [the Dodd-Frank Act] is intended to address."[28] Any argument to the contrary—that the simultaneous failure of many end-users, each posing a small amount of risk,

---

[25] Dodd-Frank Act § 731, 764.

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

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

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

could cause the failure of an SD or MSP—stretches the bounds of reason. Historical evidence and available data simply do not support such an argument. The latest market activity report from the Bank for International Settlements ("BIS") confirms that non-financial end-users[29] represent only 8.4% of the OTC derivatives market.[30] This small portion of the market is spread across tens of thousands of end-users, making any individual end-users' exposure quite small relative to the overall market and making it extremely unlikely that an end-user could cause an SD or a MSP to fail.

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

Recommendations:

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

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

Capital requirements play a major role in offsetting the risk posed by uncleared swaps to SDs and MSPs and the financial system. Existing capital requirements for banks already require those entities to set aside high quality and liquid capital to offset both market risks and counterparty credit risks from their derivative positions.

Margin requirements provide overlapping regulation to solve a problem that capital requirements already adequately address. Both capital and margin requirements are suitable alternatives for addressing counterparty credit risk in the derivatives market and for increasing the safety and soundness of large institutions. But applying both of these requirements concurrently is unnecessary. Although margin requirements reduce the amount of capital a large institution must hold, end-users strongly prefer to address counterparty credit risk through capital requirements. It is true that capital requirements often do increase transaction cost for end-users, but they also avoid burdening end-users with unpredictable liquidity constraints. End-users

---

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

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

hedge primarily to avoid these constraints. Thus, any hedging transaction that removes unpredictable exposures to interest rates or currency exchange rates, but simultaneously adds unpredictable liquidity burdens, diminishes a financial end-user's incentive to hedge and may cause some end-users to avoid hedging altogether.

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

In response to the financial crisis, recent recommendations by the Basel Committee on Banking Supervision, known as the Basel III capital adequacy standards, will introduce significantly higher capital requirements for banks and, in particular, higher capital requirements for counterparty credit risks related to derivatives. These newly-heightened capital requirements will mitigate systemic risk and serve as potent insurance against a future financial crisis. Treasury Secretary Tim Geithner recently confirmed that the new Basel III capital requirements have been set "at a level designed to allow institutions to absorb a level of losses comparable to what we faced at the peak of this crisis."[31] Basel III would introduce a requirement to cover paper losses for the first time. Uncleared derivatives could require many more times the capital than required by pre-crisis regulations. According to one analysis, the expected U.S. adoption of Basel III's heightened capital requirements would require an additional $870 billion in Tier 1 capital, $800 billion in short-term liquidity, and $3.2 trillion in long-term funding.[32] In this regulatory environment, imposing margin requirements, especially on those that pose no meaningful threat to financial stability, is unnecessary given the robust new capital framework applicable to derivatives.

Further, banks are able to reduce credit exposure to financial end-users through credit hedging. If a bank's exposure to financial end-user grows beyond acceptable internal limits—which could, for example, occur when those limits are lowered—banks are often able to enter into credit default swaps that compensate them in the event of a financial end-user's default. In such situations, whether or not its positions with the financial end-user are collateralized, the banks' hedged losses are offset. Such offsets can thus reduce negative outcomes associated with counterparty credit losses. The benefits to bank safety and soundness are contemplated also in capital requirements recommended by the Basel III. Specifically, hedged credit risk reduces a

---

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

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

bank's derivatives-related capital requirements. Similarly, margin rules should account for the lower risk posed to the system when credit risks are hedged. The Commission should clarify that the benefits associated with credit hedging may be contemplated by SDs and MSPs when those entities establish and subsequently modify thresholds above which collateral must be posted by financial end-users.

Recommendations:

The Coalition recommends that the Commission consider the impact of the Basel capital requirements and take these capital requirements into account during the finalization of the proposed margin rule. Exposures that are subject to Basel capital requirements should not be subject to margin requirements or should be subject to substantively less onerous margin requirements than have been proposed by the Commission, especially those margin requirements applicable to financial or non-financial end-users.

V. Extraterritorial Scope of the Proposed Margin Rule

We believe that more information is needed about the uncertain statutory authority and applicability of the margin rule in foreign jurisdictions. The Coalition suggests that the Commission provide clarifying information about the following considerations:

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

We urge the Commission not to adopt the same, overly-broad extraterritorial application of its margin rules that the Prudential Regulators proposed.[33] Under the Prudential Regulator's proposed extraterritorial application, their proposed margin rule could touch almost every transaction, including transactions between entities with extremely tenuous ties or potential to affect the United States. Applying the proposed margin rule in this broad manner to foreign jurisdictions is unnecessary. Foreign covered swap entities will already have foreign capital, regulatory, and governance requirements. Overlapping and potentially conflicting regulations from multiple jurisdictions applying to the same swap may result. The compliance issues could also have a deleterious effect on the ability of end-users to administer effective and efficient risk management programs. U.S. companies that compete globally may have foreign branches, or foreign incorporated subsidiaries that hedge commercial risks. Historically, these foreign branches or subsidiaries have enough dealer counterparties to transact with, including foreign SDs and foreign branches or subsidiaries of U.S. SDs. Having access to a range of dealer counterparties provides multiple benefits—including more liquidity and more competition—which improves the cost of hedging. An overly-broad extraterritorial application of the CFTC's proposed margin rule could diminish access to a robust pool of pricing sources and market

[33] 76 Fed. Reg. 27580 (May 11, 2011).

participants, including U.S. SDs operating a foreign branch or U.S. SDs operating a foreign incorporated subsidiary. This could reduce liquidity and market competition, leading to a potential decrease in price transparency and worse pricing than available today.

Recommendations:

We recommend that the Commission look to where the locus of an entity's capital and regulatory requirements is located to determine whether the extraterritorial application of the proposed margin rule is appropriate and allowed by Title VII. If an entity's locus of capital and regulatory requirements is in a foreign jurisdiction, then the foreign regulator and foreign central bank should regulate that entity. U.S. regulators do not have statutory authority to ensure the safety and soundness of a foreign swap entity. Even if a foreign swap entity trades with a U.S. end-user, the transaction should not automatically be subject to the proposed margin rule.

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

We applaud the CFTC and the SEC for articulating in the recently-proposed products definition rule their commitment to "considering whether inter-affiliate swaps and security-based swaps should be treated differently from other swaps or security-based swaps in the context of the Commissions' other Title VII rulemakings."[34] But the Coalition urges the CFTC to go beyond mere consideration and confirm that certain requirements, applicable to street-facing swap transactions, including but not limited to margin requirements, do not apply to inter-affiliate swaps. Without confirmation from the Commission, swaps between commonly-controlled affiliates could be required to be executed on a swap execution facility and centrally cleared, and margin could be required to be posted. This requirement would cause artificial and inefficient capital allocations for end-users, increase consumer costs, and undermine efficiencies that end-users currently realize through centralized hedging affiliates.

A. Definition of "Affiliate"

The Dodd-Frank Act relies on the Federal Deposit Insurance Act's ("FDI Act") definition of control.[35] The Dodd-Frank Act cautions, however, that if "context otherwise requires," then

---

[34] 76 Fed. Reg. 25274 n. 22 (May 23, 2011).

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

the term "control" should be interpreted differently than in the FDI Act.[36] The Coalition agrees that determining what constitutes control in any given situation should take into account that situation's context. Specifically, we believe that any interpretation of the term "control" should reflect the economic reality of a given situation. This flexible approach would be preferable to instituting a single definition of "control," which may function well in many situations, but be inappropriate in others.

For the purposes of the SD and MSP definitions, the Coalition believes that the definition of control described in our comment letter regarding entity definitions is appropriate and matches the economic reality of that situation.[37] In the context of inter-affiliate swap transactions, entities should be considered to be affiliates of a parent entity not only when those entities are wholly-owned, but also when the parent entity manages and has day-to-day control over the entity. In other words, if a parent and subordinate entity are treated as a single entity for all or almost all other purposes, the group should be treated as a single entity for purposes of swap transactions as well.

B. The Economic Reality of Inter-Affiliate Swaps

Regulation of inter-affiliate swaps should square with a simple economic reality: They do not increase systemic risk. Instead, inter-affiliate swaps merely allocate risk within a corporate group. The CFTC explicitly agreed with this fact in its proposed entity definitions rule, stating its preliminary belief that it would "be appropriate . . . to consider the economic reality of any swaps . . . it enters into with affiliates . . . including whether those swaps . . . simply represent an allocation of risk within a corporate group.[38] Yet, in the same section of that proposal, the Commission simultaneously asserted that inter-affiliate swaps "would continue to be subject to all laws and requirements applicable to such swaps."[39]

Maintaining this inconsistent position would create legal uncertainty for market participants. It would be arbitrary for the CFTC to agree that inter-affiliate swaps do no more than allocate risk in one context, but then subject inter-affiliate swaps to the same regulatory burden imposed on street-facing swaps in other contexts. Instead of increasing risk, inter-

---

[36] Dodd-Frank Act § 2.

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

[38] 75 Fed. Reg. 80183 (Dec. 21, 2010).

[39] 75 Fed. Reg. 80183 (Dec. 21, 2010).

affiliate swaps promote practices that serve to reduce risk. For example, many end-users execute a significant portion of their swap transactions through wholly-owned central hedging centers. In this common organizational model, the hedging center may structure transactions to offset commercial risk for the parent company and its affiliates or follow specific hedging instructions from affiliated entities within the corporate group. Although variation in the structure of trades exists, the hedging center typically serves as the primary street-facing entity for the entire corporate group, entering both into transactions with affiliated entities and into corresponding hedge positions with unaffiliated SDs.

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

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

The centralized model has the added benefit of being able to net positions across an entire corporate group, which lowers the overall credit risk a corporate group poses to the market generally. It also provides a broader base for the netting of counterparty-facing transactions. Without the centralized model, costs would increase for all entities across the board. For example, affiliates could lose the benefit of their parent's corporate credit rating if they hedged as stand-alone entities. There would also be increased duplication of functions in in execution, accounting, settlement, compliance, risk management, and reporting, including mandatory filings.

The Commission should chart a consistent course in its treatment of inter-affiliate swaps that comports with economic reality and exempt them from the Dodd-Frank Act's execution, clearing, margin, and real-time reporting requirements. Imposing margin and clearing requirements is unnecessary because inter-affiliate swaps do not increase risk. Imposing execution and real-time reporting requirements is unnecessary because doing so would not enhance price discover or market transparency.

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

Many of the benefits and opportunities for risk reduction provided by the centralized hedging model would disappear, however, if regulators imposed the same requirements on both external and inter-affiliate swaps. The increased costs associated with full regulation of inter-affiliate swaps would push firms away from centralized hedging and back to a decentralized

model. Full inter-affiliate swap regulation would substitute corporate business judgment with a government mandate and could put economic pressure on companies to stop using a successful business model that has many benefits.

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

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

Congress established margin requirements to offset the systemic risk posed by uncleared swaps to the "swap dealer or major swap participant and the financial system."[40] To this end, the Dodd-Frank Act requires the Commission to adopt margin regulations that meet two, specific criteria: Any margin regulations must both "help ensure the safety and soundness of the swap dealer or major swap participant" and "be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."[41] In other words, Congress requires regulators to use systemic risk as a gauge for calibrating the appropriate level of margin.

The Coalition believes that imposing margin requirements on inter-affiliate trades would cut against these explicit, systemic risk-based standards set forth in the Dodd-Frank Act for promulgating margin rules. As a unique class, inter-affiliate swaps do not increase systemic risk, and, as described above, instead help lower risk by allowing end-users to adopt centralized hedging practices. Imposing margin requirements on inter-affiliate trades would merely cause margin to be transferred between affiliates that operate and are treated as a single entity. Inter-affiliate trades also could not somehow be used to transfer risk without adequate margin because all affiliates within a corporate group are consolidated for financial accounting and reporting purposes. Margin requirements would thus ignore both economic reality and the Dodd-Frank Act's requirement that margin be set according to systemic risk. Because inter-affiliate swaps pose no systemic risk, they should not be subject to margin.

The Dodd-Frank Act's margin provisions give the Commission broad discretionary authority for how it promulgates margin rules. Nothing in the Dodd-Frank Act explicitly or implicitly directs the Commission to impose margin requirements on inter-affiliate swaps specifically. For inter-affiliate swaps that involve end-users, the argument is simple: As Section VIII below confirms, the Commission does not have the authority to impose margin on any end-user swaps, which includes end-user inter-affiliate swaps. In all other situations, including one

---

40 Dodd-Frank Act § 731(e)(3).

41 Dodd-Frank Act § 731(e)(3).

in which the Commission does not follow the text and Congressional intent of the Dodd-Frank Act and imposes margin requirements on end-users, regulators still have authority to prevent margin from being paid or collected for inter-affiliate swaps.

First, the Dodd-Frank Act states only that regulators must impose margin "requirements" on all swaps between SDs and MSPs. The Commission could thus impose "requirements" that allow unlimited margin thresholds for calculating margin for inter-affiliate swaps. This approach would satisfy the statute because there would be a margin requirement, but still allow the parties to inter-affiliate trades to escape actually having to pay margin in practice. Second, as already explained, Congress requires regulators to set their margin requirements to ensure "the safety and soundness of the swap dealer or major swap participant," and to "be appropriate for the risk associated with the uncleared swaps held as a swap dealer or major swap participant."[42] Because inter-affiliate swaps, by nature, do not pose systemic risk, excepting them from margin requirements easily satisfies these two criteria.

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

Legislative history confirms that Congress did not want clearing and execution requirements to apply to inter-affiliate swaps. Senator Lincoln, Chairman of the Senate Agriculture Committee and one of the Dodd-Frank Act's chief architects, explained during debate that "[w]hile most large financial entities are not eligible to use the end-user clearing exemption for standardized swaps entered into with third parties, it would be appropriate for regulators to exempt from mandatory clearing and trading inter-affiliate swap transactions which are between wholly-owned affiliates of a financial entity."[43]

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

---

[42] Dodd-Frank Act § 731(e)(3).

[43] 156 CONG. REC. S5921 (July 15, 2010).

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

The Dodd-Frank Act's real-time reporting requirements aim to increase market liquidity and enhance price discovery.[44] Reporting real-time transaction data for inter-affiliate swaps, however, would accomplish neither goal. It could instead misrepresent market liquidity by double-counting transactions and flood the market with irrelevant pricing data. In a public swaps market, a swap's price reflects costs associated with trading of the swap such as hedging costs, administrative costs, and possible credit costs. Real-time reporting data of prices that do not include these costs does not provide market participants with better information about the market than they could otherwise obtain. Because inter-affiliate swaps occur between entities that are commonly controlled, the prices and other transaction details of these swaps do not reflect the prices, trading volume, or other characteristics that the swap would have were it traded in a public market. Thus, the real-time reporting of inter-affiliate trades will not enhance price discovery for market participants. In fact, it is feasible that such information could distort public perception about market prices, by double counting that arises through examination of both the marketing facing and inter-affiliate trades.

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

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

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

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

---

[44] Dodd-Frank Act § 727.

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

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

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

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

The drafters of the Dodd-Frank Act did not intend for end-users to be classified and regulated as MSPs.[45] Thus, subjecting entities that would otherwise be classified as end-users to enhanced regulation simply because of the corporate structure in which the entity resides would be contrary to the Dodd-Frank Act.

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

A credit support provider's entity classification should not affect the classification of the entity receiving credit support. When entering into a swap to hedge or mitigate commercial risk, an affiliate or subsidiary that would otherwise qualify as an end-user may rely on credit support from an MSP parent entity. In such a situation, the affiliate or subsidiary should still be classified as an end-user, regardless of its reliance on the parent entity for credit support. The

---

[45] "Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simple because they use swaps to hedge risk in their ordinary course of business. Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business." 156 CONG. REC. S6192 (July 22, 2010).

issuance of such guarantees does not increase or alter the risk profile of the parent guarantor because the underlying commodity or other position of the subsidiary provides offsetting collateral.

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

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

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

Similarly, a non-consolidated joint venture, regardless of who the joint venture partners are, should be treated as an end-user if a swap is entered into by the joint venture and not by one of the partners, and the joint venture uses derivatives to hedge risks associated with its business activities. Smaller companies may receive less capital from larger companies if a larger company's status as a SD, MSP, or financial entity, requires a joint venture to post margin.

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

VIII. The Commission does not have authority to impose margin requirements on any end-users.

A. The Commission's Proposed Margin Rules Do Not Give Effect to the Unambiguous Intent of Congress, as Required under *Chevron*

The Dodd-Frank Act does not authorize regulators to impose margin on end-users. Hence, the proposed margin regulations go beyond the authority granted by the Dodd-Frank Act. In crafting the margin framework for uncleared swaps, the Commission is required to give effect to the clear intent of Congress that end-users not be subject to the margin framework mandated by the Dodd-Frank Act.[46] The proposed margin regulations do not give effect to the plain intent of Congress and, as such, are an impermissible interpretation of the Dodd-Frank Act.

To determine whether an agency's interpretation of a statute is permissible, courts utilize the *Chevron* two-step analysis. Under *Chevron*, the courts will determine first whether Congress has directly spoken to the precise question at issue. "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[47] If the court determines that Congress has not directly addressed the precise question at issue, the court will determine whether the agency's interpretation is based on a reasonable reading of the statute.[48]

Here, the precise question at issue is whether Congress intended for end-users to be subject to margin requirements. The intent of Congress is clear on this question—Congress intended that end-users should be exempted from the margin framework mandated by the Dodd-Frank Act. Under step one of the *Chevron* analysis, to determine whether Congress has

---

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

[47] Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842–43 (1984); *See also*, Catawba County, N.C. v. E.P.A., 571 F.3d 20, 35 (D.C. Cir. 2009) ("[A] statute may foreclose an agency's preferred interpretation despite such textual ambiguities if its structure, legislative history, or purpose makes clear what its text leaves opaque."); Bell Atlantic Tel. Cos. v. F.C.C., 131 F.3d 1044, 1047 (D.C. Cir. 1997) ("Under the first step of Chevron, the reviewing court must first exhaust the 'traditional tools of statutory construction' to determine whether Congress has spoken to the precise question at issue. The traditional tools include examination of the statute's text, legislative history, and structure, as well as its purpose. . . . If this search yields a clear result, then Congress has expressed its intention as to the question, and deference [to the agency's interpretation] is not appropriate").

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

addressed the issue, courts use "traditional tools of statutory construction," which include "examination of the statute's text, legislative history, and structure, as well as its purpose."[49] As demonstrated in greater detail in the subsections below, using the tools of statutory construction it is evident not only that Congress addressed the issue at hand, but that its intent was unambiguous. The structure, legislative history, and purpose of the Dodd-Frank Act all evidence that Congress did not intend for end-users to be subject to margin requirements and the Commission's implementation of the margin regulations to the contrary is beyond the authority granted to them.

The Commission's proposed margin regulations do not "give effect to the unambiguously expressed intent of Congress."[50] As Section VIII.B discusses, the structure of Title VII of the Dodd-Frank Act, particularly Section 731, authorizes the Commission to impose margin only on SDs and MSPs. This limited scope of authority does not permit regulators to fashion the margin framework that they have proposed and, in so doing, they have exceeded their statutory authority.

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

The Dodd-Frank Act was enacted to address systemic risk and to ensure the safety and soundness of SDs and MSPs, as discussed in VIII.D. These goals do not mandate that regulators impose margin on end-users. In fact, by imposing margin on end-users, regulators are increasing systemic risk by limiting the liquidity of end-users and subjecting them to burdensome requirements. The proposed margin requirements hinder the purpose of the Dodd-Frank Act and, as such, are contrary to the clear intent of Congress. Under the *Chevron* analysis, therefore, the Commission's proposed regulations are not "based on a permissible construction of the statute"[51] as they "contravene the unambiguously expressed intent of Congress."[52] As such, the Dodd-Frank Act "foreclose[s] [the regulators'] preferred interpretation despite such textual

---

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

[50] F.D.A. v. Brown & Williams Tobacco, 529 U.S. 120, 125–26 (2000).

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

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

ambiguities [as] its structure, legislative history, or purpose makes clear what its text leaves opaque."[53]

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

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

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

Section 731 of the Dodd-Frank Act grants the Commission the authority to impose margin on an important, but limited class of regulated swap entities—MSPs and SDs. The NPRM reads as follows: "[I]t is noteworthy that [Section 731] requires both variation margin and initial margin for SDs and MSPs on *all non-cleared swaps*."[54] From this, the NPRM claims authority to impose margin on the uncleared swaps of MSPs and SDs, including swaps that are with financial end-user counterparties. But this interpretation of authority is supported neither by a close reading of the text of the statute nor its legislative history.

Subsection 731(e)(2)(B) requires that the Commission "adopt rules *for* swap dealers and major swap participants, *with respect to their activities as a swap dealer and a major swap participant*."[55] The NPRM interprets this language as granting the CFTC authority to deputize swap entities *to collect* margin from their counterparties, including financial end-users. But the statute does not say that the Commission is authorized to adopt rules "for" swap entities to "collect" margin from financial end-users and others; it says that the rules are to impose margin on the swap entities themselves. Indeed, referencing subsection 731(e)(2)(B), the immediately preceding text, subsection 731(e)(1)(B), requires that each swap entity "*shall meet* . . . such minimum initial and variation margin requirements as the prudential regulator shall by rule or

---

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

[54] 76 Fed. Reg. 23733 (Apr. 28, 2011) (emphasis in original).

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

regulation prescribe under paragraph (2)(B)."[56] If subsection 731(e)(2)(B) were intended to authorize the Commission to deputize swap entities to *collect* margin from end-users and others, subsection 731(e)(1)(B) would not have framed the authority solely in terms of swap entities "meeting" margin requirements. Instead, the statute would have referred also to swap entities' responsibilities to "collect" margin or "execute" margin collection requirements. But the statute includes no such text. This absence of explicit authority to impose margin collection requirements on SDs and MSPs is entirely consistent with the Dodd-Frank Act's legislative history, which makes clear that Congress never intended for margin to be imposed on end-users.

The plain text of the Dodd-Frank Act also makes clear that end-users are not within the regulatory framework governing margin. First, Section 731 by its title, "Registration and Regulation of *Swap Dealers and Major Swap Participants*,"[57] limits its applicability only to MSPs and SDs. The focus of Section 731 is on MSPs and SDs and all requirements therein apply to MSPs and SDs and their activities as MSPs and SDs. Similar to the margin requirements subsection, the other subsections of Section 731 on recordkeeping and reporting, real-time reporting, and business conduct standards all deal with the regulation of MSPs and SDs and specify, when applicable, other entities to which the rules apply.[58] Consequently, if Congress wanted to grant the Commission authority to impose margin requirements on other entities it would have identified these entities in the margin requirements subsection, as it did in other subsections of Section 731.

Section 731 does not *include* end-users among the regulated entities for which the Commission may set margin requirements. The Dodd-Frank Act does not authorize the Commission to impose margin, directly or indirectly, on end-user counterparties. It is thus not necessary for end-users to be explicitly excluded from the margin requirements: Section 731 consistently and exclusively identifies MSPs and SDs as the entities subject to margin, and end-users do not fall within the statutory definition of MSPs or SDs.[59] Section 723, which prescribes clearing obligations, applies to "any person [who] engage[s] in a swap," whereas Section 731 specifically applies to "swap dealers and major swap participants." Because of this,

---

[56] Dodd-Frank Act § 731(e)(1)(B) (emphasis added).

[57] Emphasis added.

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

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

Section 723 includes an exemption for certain end-users from the mandatory clearing requirement; however, Section 731 does not have a similar exemption as its scope is restricted to MSPs and SDs already.

Because the text and history behind Section 731 together produce a plain meaning contrary to that assumed in the NPRM, we do not believe the proposed rule can stand because it imposes margin requirements on financial end-users.[60] We thus urge the Commission to interpret Section 731 as authorizing the imposition of margin only on trades in which an SD or MSP is a counterparty and an end-user is not.

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

The legislative history also confirms, leaving no doubt, that the Dodd-Frank Act's drafters did not mean for Section 731 to apply to end-users. One of the main topics during the discussions and debates surrounding the Dodd-Frank Act was exemption of end-users from certain provisions. Throughout the drafting process in the House and Senate, the question was not *whether* to exempt end-users but rather how *broad* the exemption for end-users would be. Before consideration of the Dodd-Frank Act in conference, the margin provisions in the bill initially passed by the Senate included a broad transaction-based exemption.[61] This exemption was not limited to the end-user side of a swap, but instead applied to both sides of all "swaps in which 1 of the counterparties is" an end-user. Although conferees deleted this transaction-based exemption, they preserved the carve-out for end-users in the definitions of MSP and SD.

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

> Now, that has been of some concern and, frankly, a misinterpretation of the conference report's language regarding capital and margin requirements by some who want to portray these requirements as applying to end users of derivatives. This is patently false.

---

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

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

> The section in question governs the regulation of major swap participants and swap dealers, and its provisions apply only to major swap participants and swap dealers. Nowhere in this section do we give regulators any authority to impose capital and margin requirements on end users. . . . One of the sources of financial instability in 2008 was that derivative traders like AIG did not have the resources to back up their transactions. If we don't require these major swap participants and swap dealers to put more backing behind their swap deals, we will only perpetuate this instability. That is not good for these markets, and it is certainly not good for end users.[62]

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

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

> Mr. PETERSON. [W]e have given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant. While the regulators do have authority over the dealer or MSP side of a transaction, we expect the level of margin required will be minimal. . . . That margin will be important, however, to ensure that the dealer or major stock [sic] participant will be capable of meeting their obligations to the end-user. . . . I would ask Chairman Frank whether he concurs with my view of the bill.
>
> Mr. FRANK of Massachusetts. . . . [T]he gentleman is absolutely right. We do differentiate between end users and others. The marginal requirements are not on end users. They are only on the financial and major swap participants.[63]

Statements by other members of Congress regarding the Dodd-Frank Act leave no doubt that Congress did not draft the margin requirements with the intention that end-users would be

---

[62] 156 CONG. REC. H5245 (June 30, 2010) (colloquy of Representative Peterson).

[63] 156 CONG. REC. H5248 (June 30, 2010) (colloquy of Representatives Frank and Peterson).

subject to margin. For example, Representative Peters stated: "… because commercial end users, who are those who use derivatives to hedge legitimate business risks, do not pose systemic risk and because they solely use these contracts as a way to provide consumers with lower cost goods, they are exempted from clearing and margin requirements."[64] Similarly, Representative Perlmutter stated: "[The Dodd-Frank Act] also recognizes the important role that derivatives play in actually reducing systemic risk for our end user companies and in increasing the flow of credit throughout our economy. . . . These end-user companies pose little or no systemic risk to our economy, and this bill protects them from unnecessary and burdensome margin and clearing requirements."[65] These statements help demonstrate that it was not Congress's intent for margin to be imposed on end-users. Members of Congress reiterated repeatedly that under the Dodd-Frank Act, end-users are exempt from margin requirements.

We believe that the Commission has accurately reflected the statutory text and legislative intent by not imposing margin on either side of a non-financial end-user trade. However, a false distinction between different categories of end-users – one not contemplated by the Act's drafters – still permeates the proposed rule.

Senators Dodd and Lincoln submitted a June 30, 2010 letter to the House sponsors of the Dodd-Frank Act, which addressed the treatment of end-users under the Act. As Senators Dodd and Lincoln explained in this letter, the Act "does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk."[66] The Senators go on to state:

> Congress clearly stated in [the Dodd-Frank Act] that the margin and capital requirements are not to be imposed on end users, nor can the regulators require clearing for end user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, *but rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction*.[67]

The June 30, 2010 letter addresses directly the margin regime in which margin is imposed on end-user counterparties. It states unequivocally that the Commission does not have the authority to create this type of regime.

---

[64] 156 CONG. REC. H5244 (June 30, 2010) (colloquy of Representative Peters).

[65] 156 CONG. REC. H5230 (June 30, 2010) (colloquy of Representative Perlmutter).

[66] 156 CONG. REC. S6192 (July 22, 2010).

[67] 156 CONG. REC. S6192 (July 22, 2010) (emphasis added).

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

> In harmonizing the different approaches taken by the House and Senate in their respective derivatives titles, a number of provisions were deleted by the Conference Committee to avoid redundancy. . . . However, a consistent Congressional directive throughout all drafts of [the Dodd-Frank Act], and in Congressional debate, has been to protect end users from burdensome costs associated with margin requirements and mandatory clearing. Accordingly, changes made in Conference to the section of the [Dodd-Frank Act] regulating capital and margin requirements for Swap Dealers and Major Swap Participants should not be construed as changing this important Congressional interest in protecting end users. *In fact, the House offer amending the capital and margin provisions of Sections 731 and 764 expressly stated that the strike to the base text was made "to eliminate redundancy*."[68]

As the Senators noted, revisions to margin provisions in conference were *not* intended to authorize the application of margin rules to end-users. These statements by the Senate sponsors of the Dodd-Frank Act confirm what the text makes clear: The Commission is not authorized to impose margin on non-MSPs and non-SDs. And the fact that the margin section of title VII does not include a specific exemption for end-users reflects the fact that a specific exemption would be a "redundancy." Indeed, the Commission acknowledges that end-users are to be exempt from margin requirements, but limits the exemption to non-financial end-users.[69] Moreover, instead of adhering to the expressed intent of all four of the bill's managers, the Commission has constructed a regulatory framework that not only allows for margin to be imposed on financial end-users, but provides regulators with authority to require, on a case-by-case basis, that SDs and MSPs collect margin from financial end-user counterparties.

To be sure, the great majority of end-user trades are entered into with SDs. It is also not disputed that Section 731 permits, but does not require, the Commission to require SDs or MSPs

---

[68] 156 CONG. REC. S6192 (July 22, 2010) (emphasis added).

[69] 76 Fed. Reg. 23736 (Apr. 28, 2011). *See also*, Section VIII.E *infra* discussing that there should be no distinction between financial and non-financial end-users.

to post margin.[70] But nothing in the Dodd-Frank Act permits the Commission to require the collection of margin from end-user counterparties in swaps with MSPs and SDs. Such an extension of margin rules would eviscerate the exemption for end-users in the MSP and SD definition, because virtually all end-user swaps are linked to a MSP or SD counterparty. Senators Dodd and Lincoln made precisely this point in their June 30, 2010 letter:

> This is . . . why we narrowed the scope of Swap Dealer and Major Swap Participant definitions. . . . In implementing Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in the ordinary course of their business. Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business.[71]

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

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

Against the plain text of the Dodd-Frank Act and these clear expressions of congressional intent, the Commission has asserted that the stated goals of the margin provision require regulating financial end-users.[72] Section 731(e)(3) provides in part:

> To offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared, the [margin and capital] requirements imposed under paragraph (2) shall—
>
> (i) help ensure the safety and soundness of the swap dealer or major swap participant; and

---

[70] The Coalition notes, approvingly, that the Commission has not imposed margin on the SD or MSP side of a non-financial end-user trade. Such a requirement would do little to mitigate systemic risk while imposing substantial and unwarranted, indirect burdens on end-users.

[71] 156 CONG. REC. S6192 (July 22, 2010) (emphasis added).

[72] 76 Fed. Reg. 23735–36 (Apr. 28, 2011). The Commission states that under Section 731(e)(3) it is necessary to establish "margin requirements for uncleared swaps that are at least as stringent as those for cleared swaps. . . to fulfill its statutory mandate." *Id.* at 23734.

> (ii) be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.[73]

Contrary to the Commission's interpretation, this language does not constitute license to "offset the greater risk to the swap dealer or major swap participant and the financial system" and "help ensure the safety and soundness of the swap dealer or major swap participant" by authorizing (and possibly requiring) SDs and MSPs to collect margin on financial end-users. Rather, Section 732(e)(3) articulates statutory goals that *do not* expand the scope of the Commission's authority to impose margin requirements on end-users, but apply (by the terms of Section 731(e)) only to "swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant."[74] Section 731(e)(3) limits the *means* that the Commission can use to achieve these broad ends; it does not obliquely expand the terms of the margin section to authorize the collection of margin from any end-users. And if there is any doubt as to meaning of the statutory language, the clear legislative history of that language puts such doubt to rest. There is simply no indication, either in the statute or its legislative history that Congress meant to authorize regulators to deputize SDs or MSPs to collect margin from any end-user counterparties, including financial end-users.

But the proposed rule takes the argument a step further into unintended territory. The Commission posits that Section 731 "requires both initial and variation margin for… *all* uncleared swaps,"[75] including swaps in which a financial end-user is a counterparty. This interpretation cannot be squared with the unambiguous legislative history of the statute. But there is another interpretation that is entirely consistent with the managers' intent. If the requirement to adopt rules imposing margin on "all swaps that are not cleared" is not read in isolation and, instead, is interpreted in the context of the subparagraph in which it resides,[76] as well as the legislative history surrounding the language, then it becomes clear that the statute is meant to apply to swaps between swap entities, and not to swaps in which an end-user is a counterparty.

Moreover, this interpretation is consistent with one of the central purposes of derivatives reform, which is to reduce systemic risk. The margin provision of the Dodd-Frank Act states that margin standards should guard against risks to "the financial system."[77] Congress

---

[73] Dodd-Frank Act § 731(e)(3)(A)(i).

[74] Dodd-Frank Act § 731(e)(2).

[75] 76 Fed. Reg. 23733 (Apr. 28, 2011).

[76] Dodd-Frank Act § 731(e)(2)(A).

[77] Dodd-Frank Act § 731(e)(3)(A).

recognized that application of new margin rules to end-users would not serve that purpose. As Senators Dodd and Lincoln wrote in their June 30, 2010 letter, "If regulators raise the costs of end user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth."[78] End-users do not pose the same gravity of risk introduced into our financial system by derivatives speculation. To the contrary, derivatives use by end-users actually reduces risk within companies and redistributes it more efficiently through the financial system. The economic concerns that motivated the end-user exemption were well-founded. Studies have shown that margin requirements could tie up billions of dollars of funds that could otherwise be put to productive use. According to a Coalition survey conducted earlier this year,[79] without an end-user exemption, a 3% initial margin requirement on the S&P 500 companies could be expected to reduce capital spending by $5.1 billion to $6.7 billion, causing a loss of 100,000 to 130,000 jobs. This survey's assumptions were conservative—they did not contemplate the effects of a requirement to post variation margin, which would significantly increase the amount of funds required to be set aside to meet margin calls, likely resulting in even greater job losses. Indeed, the Natural Gas Supply Association and the National Corn Growers Association estimated that the liquidity costs of mandating central clearing and margining across the entire OTC derivatives market, including end-users, could reach as high as $700 billion.[80]

Furthermore, the OCC's impact analysis estimates that, assuming no clearing, under the proposed margin rules, initial margin may total $2.56 trillion in the first year alone.[81] The study estimates that $2.05 trillion will be collected in initial margin and that the opportunity cost of the initial margin requirement would be $25.6 billion.[82] Although the calculations in the OCC's

---

[78] 156 CONG. REC. S6192 (July 22, 2010).

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

[80] See Press Release, Natural Gas Supply Association and the National Corn Growers Association (May 24, 2010), *available at*: http://www.ngsa.org/Assets/docs/2010%20press%20 releases/21-ngsa%20urges%20fix%20for%20derivs%20title%20in%20conference.pdf.

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

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

analysis are focused on OCC regulated banks, the impact of these requirements on banks will impact end-users, which will bear the cost of higher requirements imposed on banks. These costs are staggering and significantly disproportionate to the impact that end-users have on the financial system.

Margin requirements can "help ensure safety and soundness of the swap dealer or major swap participant and the financial system" without imposing margin on end-users. First, 90% of swaps held by MSPs and SDs have as their counterparty another MSP, dealer, or other regulated entity.[83] Even with a robust exemption for end-users, Section 731 gives the Commission broad authority to apply margin rules to both sides of the vast majority of swaps held by MSPs and swap dealers, thereby "help[ing] ensure the safety and soundness" of those entities. Second, the application of margin to financial end-users could increase systemic risk and destabilize companies that use derivatives to manage risks in connection with their day-to-day businesses.

The drafters of the Dodd-Frank Act defined the key regulated entities and took care to exclude from those definitions entities that use swaps to hedge risks associated with their businesses. The margin provision of the Dodd-Frank Act, Section 731, repeatedly uses those defined terms—"major swap participants" and "swap dealer"—to limit the scope of the regulators' authority and to identify those parties subject to the mandatory margin regime. Statements by the key sponsors of the Act confirm what the text and structure of the Act make clear: Congress did not intend to authorize regulators to impose margin on financial end-users. Furthermore, the goals of Section 731, to offset the greater risk to SDs or MSPs and the financial system arising from the use of uncleared swaps, do not require or necessitate the imposition of margin requirements on financial end-users.

E. Any Margin Requirements on End-Users Should Not Distinguish Between Financial and Non-Financial End-Users

The proposed rule distinguishes between four different types of swap counterparties: (1) covered swap entities, (2) high risk financial end-users, (3) low risk financial end-users and (4) non-financial end-users. In establishing margin requirements, however, Section 731 of the Dodd-Frank Act does not draw any distinction between financial and non-financial end-users. If the Commission imposes margin requirements on any end-users, the rule should follow the Dodd-Frank Act and congressional intent, and not impose different margin requirements on financial and non-financial end-users. The Coalition believes that financial end-users and non-financial end-users should be treated identically under the Commission's margin requirements,

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

as both groups use swaps to hedge commercial risks and pose minimal risks to the financial system.

The legislative history of the Dodd-Frank Act does not distinguish between financial and non-financial end-users with respect to margin requirements. In the debates and discussions surrounding the Dodd-Frank Act, members of Congress referred to "commercial end-users," defining them, generally, as companies who use swaps to hedge or mitigate commercial risk.[84] This definition invariably includes financial entities that use swaps to mitigate risks associated with their business. These financial entities that are end-users of swaps are not MSPs and SDs. It is thus not necessary to treat them differently from other end-users. In the June 30, 2010, letter from Senators Dodd and Lincoln, the Senators state: "[End-users] could be anything ranging from car companies to airlines or energy companies who produce and distribute power to farm machinery manufacturers. They also include captive finance affiliates, finance arms that are hedging in support of manufacturing or other commercial companies."[85] Here, Senators Dodd and Lincoln draw no distinction between financial and non-financial end-users. Instead, they refer to both groups simply as "end-users." The Commission should do the same and not differentiate between financial and non-financial end-users for setting margin requirements, as this distinction is not statutorily mandated and has no basis in the margin section of the Dodd-Frank Act or its legislative history.

Furthermore, other sections of the Dodd-Frank Act demonstrate that Congress had the necessary vocabulary to distinguish between financial and non-financial entities, but chose not to make that distinction in Section 731. Specifically, in Section 723, regarding clearing requirements for swaps, the Dodd-Frank Act exempts non-financial end-users from the provisions, while subjecting financial end-users to these requirements.[86] This distinction, between financial and non-financial end-users in Section 723, indicates that if Congress wanted to treat financial and non-financial end-users differently with respect to margin requirements, it could have made the same distinction in Section 731. The silence of Congress on the distinction between financial and non-financial end-users in Section 731, cannot be interpreted as granting the Commission the authority to impose different margin requirements on different end-users. To do so would be to extend authority to the Commission that was not intended by Congress.[87]

---

[84] 156 CONG. REC. S6192 (July 22, 2010). *See also* 156 CONG. REC. H5244 (June 30, 2010); 156 CONG. REC. H5248 (June 30, 2010).

[85] 156 CONG. REC. S6192 (July 22, 2010).

[86] Dodd-Frank Act § 723(h)(7).

[87] "The best evidence of the scope of authority is found… in the language establishing the authority. Where, as here, that language unambiguously uses a statutorily defined term, that

[Footnote continued on next page]

The Coalition urges the Commission to eliminate the distinction between groups of end-users and exempt from margin requirements both financial and non-financial end-users alike.

IX. Required Analysis of Costs and Benefits

A. Cost-Benefit Analysis

Section 15(a) of the CEA[88] requires the Commission to evaluate the costs and benefits of any new rule promulgated under the CEA. Specifically, that provision states that the Commission "*shall consider* the costs and benefits" and further directs that "[t]he costs and benefits of the proposed Commission action shall be *evaluated* in light of (A) considerations of protection of market participants and the public; (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets; (C) considerations of price discovery; (D) considerations of sound risk management practices; and (E) other public interest considerations."[89]

The Commission's cost-benefit analysis consists of a recitation of the new rule's requirements and an announcement that "to the extent [market participants] currently do not post initial margin or have high variation margin thresholds the proposal will impose costs on them."[90] But the Commission has made no attempt to estimate or objectively value the costs imposed by this and other rulemakings under the Dodd-Frank Act.

We believe that the Commission's current approach does not satisfy the requirements of Section 15(a). Section 15(a) does not simply "require[] the Commission to 'consider the costs and benefits' of its action," as the Commission asserts .[91] That section goes on to direct that

[Footnote continued from previous page]
definition controls the scope of authority." Wolverine Power Co. v. F.E.R.C., 963 F.2d 446, 451 (D.C. Cir. 1992)

88 7 U.S.C. § 19(a).

89 7 U.S.C. § 19(a) (emphasis added).

90 76 Fed. Reg. 23743 (Apr. 28, 2011)

91 76 Fed. Reg. 23742 (Apr. 28, 2011); *see also,* Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3698 (Mar. 24, 2011); End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80754 (Dec. 23, 2010); Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg. 80638 (Dec. 22, 2010).

"[t]he costs and benefits of the proposed Commission action shall be *evaluated* . . . ."[92] The plain and ordinary meaning of the term "evaluate" connotes a determination of value or worth.[93] This meaning becomes more clear in context, because the object of "evaluate[]" is "costs"—a monetary figure. Section 15(a) is best understood to require the Commission to formulate an estimate, particularly when (as here) compliance costs are susceptible to empirical measurement.

To be sure, agencies have discretion in choosing a method of cost-benefit analysis. But judicial deference "does not authorize [the reviewing court] to gloss over the critical steps of [the agency's] reasoning process."[94] Courts have not hesitated to vacate or remand agency rules founded on irrational or incomplete cost-benefit analyses.[95] And it is well-established that a reviewing court can "set aside agency action under the Administrative Procedure Act because of failure to adduce empirical data that can readily be obtained."[96] Here, the Commission concluded that "the benefits to the overall financial system, and to the individual participants in the swaps market outweigh the costs to those participants."[97] But the path of reasoning the

---

[92] 7 U.S.C. § 19(a)(1).

[93] This is the primary dictionary definition. *See, e.g.,* Webster's Third New International Dictionary 786 (1986) (defining evaluate as "1. a. to set down or express the mathematical value of: express numerically. b. to estimate or ascertain the monetary worth of: value."); The American Heritage Dictionary (2d ed.) (defining evaluate as "1. To ascertain or fix the value or worth of."); see also Hoppe v. Great Western Business Services, LLC, 536 F.Supp.2d 888, 894 (N.D. Ill. 2008) ("Evaluation means 'to determine the significance, worth or condition of, usually by careful appraisal and study.'") (quoting Merriam Webster's Collegiate Dictionary (11th ed. 2003)).

[94] Gas Appliance Mfrs. Ass'n, Inc. v. Dep't of Energy, 998 F.2d 1041, 1046 (D.C. Cir. 1993).

[95] *See, e.g.,* Public Citizen v. Fed. Motor Carrier Safety Admin., 374 F.3d 1209, 1218-19 (D.C. Cir. 2004) (vacating agency rule based in part on faulty cost-benefit analysis conducted by the agency); Advocates for Highway and Auto Safety v. Fed. Motor Carrier Safety Admin., 429 F.3d 1136, 1146 (D.C. Cir. 2005) (remanding agency rule based in part on the agency's irrational application of cost-benefit analysis); Gas Appliance Mfrs. Ass'n, Inc., 998 F.2d at 1046 (remanding agency rule based in part on the agency's flawed and irrational to cost-benefit model).

[96] F.C.C. v. Fox Television Stations, Inc., 129 S. Ct. 1800, 1813 (2009) (citing Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 46-56 (1983)).

[97] 76 Fed. Reg. 23743 (Apr. 28, 2011).

Commission followed to reach that conclusion is not discernable, because it has made no attempt to calculate either the costs or the benefits.

The Commission's approach to cost-benefit analysis also stands in contrast to the SEC's approach in its parallel rulemaking for security-based swaps.[98] In evaluating the cost of clearing notification, for example, the SEC calculated the aggregate annual cost per end-user based on its estimates of the number of security-based swap transactions, the percentage of those transaction in which parties will be eligible to invoke the end-user exception, and the annual "burden hours" for that class of regulated entities.[99] The Commission should adopt a cost-benefit model at least as thorough as that employed by the SEC.

Even if a cursory approach to Section 15(a) cost-benefit analysis were sufficient in other contexts, it fall shorts of the evaluation that the Commission should undertake in the implementation of the Dodd-Frank Act. This series of rulemakings will impose unprecedented new compliance costs on participants in the OTC derivatives market, and those costs should be thoroughly evaluated as the Commission moves forward.[100]

Recommendations

The Coalition urges the Commission to conduct a cost-benefit analysis, as it is required to do under the CEA, to evaluate the costs that the proposed rule will impose on market participants.

---

[98] *See* SEC, End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. 79992 (2010).

[99] *See* SEC, End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. 80007 (2010).

[100] In addition, we note that Executive Order 13563 states that an agency should "propose or adopt regulation only upon a reasoned determination that its benefits justify its costs." 76 Fed. Reg. 3821 (Jan. 21, 2011). While we recognize that the Executive Order is not binding on the CFTC, just today President Obama asked independent agencies "to follow the key cost-saving, burden-reducing principles outlined in" Executive Order 13563. The White House, Office of the Press Secretary, Memorandum for the Heads of Independent Regulatory Agencies (Jul. 11, 2011). We join the President in urging the CFTC to conduct a cost-benefit analysis of the proposed margin rules and to ensure that any final rule issued carries with it benefits that outweigh the costs to end-users and to the U.S. economy. As the OCC analysis and the Coalition survey demonstrate, the costs of the proposed margin rule are enormous, but these costs have not been examined in a comprehensive manner that accounts for the costs all market participants may face.

X. Conclusion

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

Sincerely,

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