



Americans for Financial Reform
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September 20, 2012

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

Re: Notice of Proposed Rulemaking – Clearing Exemption For Swaps Between Certain Affiliated Entities (RIN 3038–AD47)

Dear Mr. Stawick:

Americans for Financial Reform (“AFR”) appreciates this opportunity to comment on the above-referenced notice of proposed rulemaking (the “NOPR”) by the Commodity Futures Trading Commission (the “Commission”) proposing regulations (the “Proposed Rules”) that exempt swaps between certain affiliated entities from clearing requirements enacted under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

AFR is a coalition of over 250 national, state, local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups along with prominent independent experts.

Inter-Affiliate Swaps Generate Systemic Risk

This proposal envisions a wide-ranging exemption from clearing requirements for swaps between commonly owned affiliates of a financial institution (‘inter-affiliate swaps’). Such inter-affiliate swaps have the potential for creating systemic risk and threatening the U.S. financial system. A key positive element of this NOPR is the Commission’s recognition of this fact.¹

Inter-affiliate swaps raise many potential issues related to systemic risk:

¹ See CFR 50427, “the Commission is also taking into account the systemic risk repercussions of inter-affiliate swaps”

- 1) The failure to properly risk manage swaps across the entire holding company may endanger the parent company. Since inter-affiliate swaps are part of this risk management, their proper conduct has implications for financial stability.
- 2) An inter-affiliate swap may be one part of a larger transaction that includes an outward-facing swap.
- 3) An inter-affiliate swap may be executed between two affiliated companies that do not share 100 percent common ownership. In this case, the swap will transfer risk across corporate entities. This is a particular issue in this proposal.
- 4) An inter-affiliate swap may be used to transport swaps to a jurisdiction that has little or no regulatory oversight, at which point outward-facing transactions could be done in that jurisdiction. Such transactions could result in the movement of parts of the U.S. swaps market outside of regulatory oversight.
- 5) An inter-affiliate swap can contribute to financial contagion across different groups within a large complex financial institution, and can make it more difficult to ‘ring-fence’ risks in one part of an organization.
- 6) An inter-affiliate swap could involve an affiliate in a jurisdiction with laws or regulations that would prevent access of U.S. counterparties to the resources of that affiliate in the event of a bankruptcy or resolution of a failing financial firm. Inter-affiliate swaps thus represent an issue for U.S. bank resolution authorities.
- 7) An exemption for inter-affiliate swaps may deprive clearinghouses of swaps volume and liquidity that is necessary for risk management. If volume was reduced sufficiently, this could restrict the type of swaps that can be safely designated for clearing and in general make risk management at clearinghouses more difficult.

The last issues are particularly noteworthy as the Commission does not appear to have considered them in the proposal.

All of these concerns are heightened by the fact that this clearing exemption will apply only to large banks and speculative activity. As the Commission points out, there is already a wide-ranging clearing exemption available for non-financial companies hedging commercial risk, as well as smaller banks and cooperatives that the Commission has specifically exempted from the clearing requirement. The exemption proposed here is thus targeted specifically at large global banks and financial institutions, and at speculative swaps activity by large commercial companies with many affiliates.

The Legal Justification For This Exemption Is Weak

Furthermore, the legal justification for this exemption is also somewhat doubtful. The Dodd-Frank Act devotes considerable attention to the issue of affiliate swaps at commercial companies financing commercial purchases. The legislation also grants a broad exemption from clearing to

commercial hedgers, and specifies that regulators have the option of exempting smaller banks from clearing requirements. However, there is no mention of any exemption to clearing for inter-affiliate swaps at large banks, or at commercial companies using derivatives for speculation.

The Commission cites its generalized exemption authority in 7 USC 6(C(1)) as the legal basis for this exemption. But the exercise of this authority requires an affirmative public interest justification. The major such justification advanced in this rule appears to be the risk management benefits of centralizing swaps in a single treasury or conduit affiliate within a large complex financial organization. Such a centralized treasury affiliate can perform netting and hedging functions across the organization, and economize on risk management resources.

While this benefit may be real in cases where such risk management is performed well, it must be offset against the many issues listed above. In addition, there was a widespread failure of risk management at major banks prior to and during the 2008 financial crisis. This implies that the Commission cannot assume that ‘business as usual’ practices at global banks will result in effective risk management. It must require real confirmation that any potential for improved risk management by treasury affiliates is actually realized.

Finally, the risk management benefits created by such centralized treasury or conduit affiliates still falls well short of the full novation of swaps to a central counterparty, as occurs in a clearinghouse. Any benefits resulting from the centralized management of swaps within a global financial institution must be measured relative to the benefit of clearing such swaps in a clearinghouse. It cannot be measured relative to the costs of poor or uncoordinated swaps management in a laissez-faire regime with no clearing requirement. The Commission correctly states this baseline in the section on cost-benefit analysis (Section III.B, CFR 50433).

It is important that this baseline be held to in all consideration of potential public benefits of this exemption. Holding to this baseline means that this inter-affiliate swaps exemption will likely reduce the effectiveness of risk management, as the mandatory clearing regime required by Congress in the Dodd-Frank Act represents a more comprehensive level of risk management. The benefits of economizing on margin are likely to be small, as the true economic costs of margin are relatively low.² These factors raise serious doubts about the public benefit justification for this exemption.

Existing Restrictions On The Exemption Must Be Fully Retained, And The Exemption Must Be Further Narrowed

The combination of the many systemic risk issues potentially involved in inter-affiliate swaps, and the need for a truly compelling public interest justification for any new clearing exemption, implies that any exemption that is granted should be relatively narrow. The exemption granted here remains too broad.

The Commission’s proposal does place several restrictions on the exemption. These restrictions include:

² See Mello, Antonio and John Parsons, “[Margins, Liquidity, and the Cost of Hedging](#)”, MIT Center for Economic and Policy Research Working Paper 2012-005, Massachusetts Institute of Technology, May, 2012.

- The requirement that variation margin be posted on inter-affiliate swaps.
- The requirement that a centralized risk management regime exist for inter-affiliate swaps.
- The requirement that inter-affiliate swaps be reported to regulators.
- The restriction of the inter-affiliate clearing exemption to jurisdictions in which there exists a clearing requirement comparable to U.S. law.

Should the Commission proceed with this general clearing exemption, it is crucial to maintain all of these protections. Dispensing with or weakening any of these provisions would heighten systemic risk and force the Commission to stretch its already doubtful exemption authority still further. All of these requirements are critical, but the variation margin requirement deserves special mention. It is the only requirement that actual collateral be reserved against possible derivatives losses. It is difficult to imagine that any effective risk management program could operate without the capacity to calculate and reserve margin against losses.

However, these protections do not sufficiently narrow the exemption granted here. It remains overly broad in several key areas. To further narrow the exemption and address the possibility for systemic risk, AFR recommends that the following further steps be taken:

The exemption should be limited to swaps between affiliates that share 100 percent common ownership. The justification for the 50 percent figure in the proposal is unclear, as the systemic impact of swaps is based on ownership and not corporate control. Under this proposal, minority owners of affiliates could control a substantial share of affiliate value, exposing them to significant potential losses on the swap. These losses would create the possibility of systemic contagion. In addition, permitting relatively low levels of joint ownership would open up additional avenues for evasion of the clearing requirement. A class of joint ventures could arise whose major purpose was to enable swap trading between banks without the necessity of central clearing or the reservation of initial margin.³ The low level of joint ownership proposed to qualify for this exemption is a major weakness in this proposal.

The comparability procedure for determining whether to permit the clearing exemption in a foreign jurisdiction should be expanded. In its cross-border guidance the CFTC laid out a fairly detailed comparability procedure that would examine both rules and enforcement in 14 delineated areas of swaps regulation. No such comparability procedure is described here. Such a detailed comparability procedure is needed.

It is also especially important to address two specific areas of weakness in the comparability rules discussed here:

- 1) Clearing requirements are specific to particular types and classes of swaps. Even if a foreign jurisdiction has a comprehensive clearing requirement in a general sense, a particular class of swaps that is required to be cleared in the United States may not be required to be cleared in that jurisdiction. This can occur if the foreign jurisdiction does not have the clearing capacity or the market liquidity to risk manage that type of swap. The rule must state that the foreign

³ In theory such a situation could be addressed through the CFTC's anti-evasion authority, but this would be far more complex and difficult than simply getting the rule right in the first place.

jurisdiction must have a comprehensive and comparable requirement to clear the specific type of swap that is being considered for the exemption.

- 2) No inter-affiliate clearing exemption with a foreign affiliate should be granted until comparable clearing requirements in foreign jurisdictions are actually finalized and implemented. No foreign regime can be comparable until that regime is actually fully in place.

Reservation of initial as well as variation margin should be required: The requirement that only variation and not initial margin be reserved appears to be an awkward compromise between sound risk management practices and what may have been pressures for a wider exemption. Both the Dodd-Frank Act and internationally accepted guidance from the Basel Committee of Banking Supervisors (BCBS) / International Organization of Securities Commissions (IOSCO) mandate that initial and variation margin must be collected for non-cleared swaps between financial entities. For example, the recent BCBS/IOSCO consultative document on margining practices for non-centrally cleared derivatives states as one of its main core principles that⁴:

“All financial firms and systemically-important non-financial entities (“covered entities”) that engage in non-centrally-cleared derivatives must exchange initial and variation margin as appropriate to the risks posed by such transactions.”

The reservation of variation and not initial margin will create a difficult-to-predict variation in the amount of actual protection against default provided by margin, that will vary by the characteristics of the swap and the volatility of the market. An exemption from clearing requirements should follow the emerging state of the art in risk management practices for non-cleared derivatives between financial entities, and require both initial and variation margin.

The CFTC should consult with the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve on the potential issues created for bankruptcy and resolution by this proposal, as well as the issues concerning ‘ring-fencing’ of risk. As mentioned above, the capacity to move swaps risk into jurisdictions that may have widely differing bankruptcy or resolution regimes could create issues in retrieving resources from affiliates in case of a bankruptcy or the resolution of a major financial institution. This will of course be particularly dangerous if adequate margin is not reserved on such swaps. These issues could threaten the capacity of U.S. creditors or taxpayers to retrieve value from foreign affiliates. This is a potentially crucial aspect of the comparability of foreign regulatory regimes. As the major expertise in these areas is held at the banking agencies, particularly the FDIC, the Commission should consult with these agencies regarding issues raised by this rule.

In addition to bankruptcy and resolution issues, U.S. banking law places restrictions on transfer of risk from non-depository to depository subsidiaries. Similar issues arise in insurance law. The implementation of Section 716 of the Dodd-Frank Act will also require the ‘ring-fencing’ and separate capitalization of swaps affiliates. While these issues can in many ways be addressed by

⁴ See BCBS-IOSCO Consultative Document, “[Margin Requirements for Non-Centrally-Cleared Derivatives](#)”, Bank of International Settlements, July, 2012.

the main prudential regulator of the entity, this exemption may create issues for enforcement of these barriers.

Thank you for the opportunity to comment on this proposal. We hope that the comments set forth above are helpful to the CFTC. For any questions, please feel free to contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company

- Home Actions
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS

- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council

- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG

- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin
- UNET

