**Americans for Financial Reform**
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December 2, 2014

The Honorable Tim Massad, Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

RE: "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants", RIN 3038-AC97

To Whom it May Concern:

Americans for Financial Reform ("AFR") appreciates this opportunity to comment on the above-referenced notice of proposed rulemaking (the "Proposed Rule") by the Commodity Futures Trading Commission (the "Commission"). AFR is a coalition of over 200 national, state, and 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.[1]

AFR supports mandatory margin requirements for un-cleared swaps. Mandatory margin requires participants in the swaps market to take full account of the risks of their derivatives transactions and provide some level of advance provisioning for such risks. The availability of properly segregated margin is clearly of enormous value in case of the default of a swaps counterparty. Integrating routine margining into derivatives business also improves risk management in all areas of managing a derivatives book, as it requires modeling and forecasting future risk exposures.

It is true that margining places liquidity demands on derivatives market participants, and these demands will tend to be pro-cyclical. However, the creation of pro-cyclical liquidity demands is a feature of the derivatives market itself and the demands of private counterparties, not regulatory margin requirements. During the financial crisis of 2007-2008, total collateral in the derivatives market almost tripled, growing from $1.3 trillion at the close of 2006 to almost $4

[1] A list of AFR coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/ ,

trillion at the close of 2008.[2] This increase of nearly $2.7 trillion in systemic liquidity demands occurred in the absence of regulatory margin requirements. Instead, it was driven by the growth of market risk in derivatives and by private sector demands that counterparties provide margin to cover this risk. If regulators wish to avoid pro-cyclical spikes in liquidity demands, the answer is not to avoid margin requirements. The contingent liabilities in derivatives contracts do not cease to exist because participants are not required to recognize them.

Instead, regulators should ensure that routine requirements for both margin and capital for derivatives transactions reflect the tail risks that may occur during stressed periods. In this manner, the costs of derivatives transactions will better reflect the liquidity externalities that they can place on the system during financial stress periods, and market participants will adjust their use of derivatives contracts appropriately.

The specific margin requirements in the Proposed Rule have a number of important positive elements that AFR strongly supports. Some of these requirements include:

- Two-way posting between swap dealers and counterparties. This represents a significant advance over the one way posting from end users to dealers required by the previous (2011) margin proposal, as it protects counterparties from the failure of a dealer and requires the dealer to fully incorporate swaps risks.

- The posting of initial margin on a gross basis in both directions, and the holding of this collateral at a custodian with limitations on reuse or rehypothecation.

- The requirement that internal initial margin models capture non-linearities in risks, to include price risks resulting from changes in volatility. As the uncleared swaps addressed by this proposal include large amounts of non-standardized and exotic swaps, it is likely that many will have a significantly non-linear risk profile. It is crucial that such non-linearities be captured in margin models.

- The 10-day closeout period for internal margin models.

- The requirement to calibrate internal margin models to a period of significant stress.

These elements go some distance to address issues around collateral availability in a stressed period, and indeed the fundamental problem of pro-cyclicality in derivatives margin. It is crucial that regulators create a culture of routine planning and pre-provisioning for stressed periods. This should force management of liquidity needs well in advance of an actual period of financial

[2] See Chart 1, International Swaps and Derivatives Association, "ISDA Margin Survey: 2014", April, 2014.

stress and limit the sudden spike in liquidity demands that occurs when market shocks impact market participants who are unprepared for them.

We support the Commission's choice to set the threshold for material swaps exposure in this proposal at a level significantly lower than the 2013 BIS proposal on margin for uncleared swaps, at $3 billion as opposed to $8 billion. This choice is well supported by the Commission's research on total initial margin postings associated with the $3 billion notional threshold as opposed to the higher $11 billion (8 billion euro) level.

AFR also strongly supports the Commission's proposal to require all covered swaps entities to calculate hypothetical initial and variation margin amounts on a daily basis for all non-financial entities for which they have material swaps exposure, even when the end user exemption applies (23.154(a)(6) and 23.155(a)(3) of the Proposed Rule). Particularly given the Commission's resource limitations, it will be very difficult to monitor the total volume of non-margined transactions associated with end users unless swaps entities maintain such records and share them with the Commission. Furthermore, these records would be an important element of the internal risk management program by swaps entities themselves. A failure to at least monitor total un-margined credit exposures to end users would indicate a poor risk management by any financial entity. Finally, as discussed below, we are concerned that the Commission's choice to exempt agent affiliates of end users may result in a significant volume of un-margined swaps by financial entities, particularly given the broad scope of the no-action letters the Commission has released on this issue. Given this, it is especially important to carefully monitor the volume of swaps that are non-margined due to the end user exemption.

AFR also has a number of significant concerns with the rules as written. Our most important concern relates to the proposed cross-border application of the rule. The application of the July, 2013 Commission guidance on cross-border transactions to these margin rules could result in large-scale avoidance of U.S. margin requirements by foreign subsidiaries of U.S. banks. If such subsidiaries are classified as 'non-guaranteed', they would also avoid any requirement to follow comparable foreign rules. As discussed below, we feel this exemption is too broad and leaves dangerous possibilities for evasion. We recommend that the Commission use an approach that applies at least a substituted compliance requirement to margin requirements for U.S. registered swap dealers. This is similar to the 'entity level approach' outlined as the third option in the Proposed Rule, which reclassifies derivatives margin as an entity-level requirement and thus applies at least substituted compliance requirements for margin to all non-U.S. swaps entities. However, the potential ability of U.S. bank subsidiaries to avoid designation as a swaps entity under the terms of the Commission's 2013 guidance also raises concerns for this approach. We would thus favor either changes in the 2013 guidance or the application of substituted compliance requirements to foreign subsidiaries of U.S. banks that are not swaps entities.

Other concerns include:

- The scope of the margin exemption for end users in the proposed rule, particularly the unlimited inclusion of agent affiliates of end users in the exemption.

- Reliance on internal models for derivatives margin calculations.

Below, we briefly discuss each of these concerns and related recommendations.

**Cross-Border Applicability**

The Commission proposes several options concerning the cross-border application of the margin rules laid out in this proposed rule. The first option would be to apply the margin provisions already stated in the Commission's 2013 Guidance concerning cross-border transactions. AFR has recently sent the Commission a detailed analysis of the excessively broad exemption for 'non-guaranteed' foreign affiliates of U.S. banks that is included in the 2013 Guidance.[3] As laid out in that letter, the 2013 Guidance grants such 'non-guaranteed' subsidiaries a complete exemption from all U.S. derivatives rules classified as 'transaction-level' rules, including an exemption from any requirement for substituted compliance with comparable foreign rules. Since margin requirements are classified as such a 'transaction-level' rule, under the 2013 Guidance approach, this exemption would apply to margin requirements.

We believe that it is completely inappropriate to apply such a broad cross-border exemption to a crucial prudential requirement such as derivatives margin. Especially given the vague and weak definition of 'guarantee' that the Commission has apparently been using, such an exemption could pose major risks to the financial system by encouraging a 'race to the bottom' among jurisdictions concerning margin requirements. By undermining basic risk management practices in the global derivatives markets, this would create significant costs related to financial instability.[4]

The second option given by the Commission is to follow the prudential regulators approach to cross-border transactions, by applying margin requirements to all foreign swaps entities controlled by a U.S. parent. We regard this approach as greatly superior to the first option of

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[3] Americans for Financial Reform, "Letter to Financial Regulators Regarding 'De-Guaranteeing'", November 25, 2014.

[4] The risks associated with a general exemption for 'non-guaranteed' affiliates could only be avoided if the Commission applies a definition of 'guarantee' that requires genuine firewalling of foreign subsidiaries. Such a definition would have to classify as a 'guarantee' any case in which the market recognized that the parent was likely to provide funds to prevent subsidiary default, either for contractual or reputational reasons. As discussed in the November 25th AFR letter referenced above, there is no evidence that the Commission is currently applying such a definition to classifying foreign affiliates. Even in such a case, it is difficult to see why the requirement for substituted compliance with equivalent foreign rules should not apply.

using the July, 2013 CFTC guidance, as it would apply margin requirements to foreign affiliates of U.S. banks that are classified as swap dealers or major swap participants, regardless of whether such affiliates are nominally 'guaranteed'.

However, as detailed in our letter to the prudential regulators, we are concerned that this approach too would be affected by the weaknesses in the July 2013 CFTC guidance with regard to the designation of swaps entities. The prudential regulators' approach would exempt controlled foreign subsidiaries of U.S. banks that are not registered with the CFTC as swaps entities. The July 2013 guidance offers potential avenues for major foreign subsidiaries of U.S. banks to avoid registration as a swaps entity, so long as they claim their transactions are 'non-guaranteed' by the U.S. parent, and their counterparties are also 'non-guaranteed'. For example, at CFR 45324 in the final cross-border guidance, the CFTC states that "The Commission notes that under its interpretation of section 2(i), a non-U.S. person that is not a guaranteed or conduit affiliate would not have to count its swap dealing transactions with other non-U.S. persons that are not guaranteed affiliates" toward registration as swap dealer. This implies that transactions between two 'non-guaranteed' foreign affiliates of U.S. banks would not count toward the de minimis requirement for registration as a swap dealer.

The third option offered by the CFTC -- reclassifying margin as an entity-level requirement and thus requiring substituted compliance on an entity-wide basis for all foreign swap dealers or MSPs – would require at least substituted compliance for all transactions involving U.S.-registered swap dealers, including those which are controlled by a foreign bank or financial institution. This approach is also clearly superior to the use of the July, 2013 guidance as written, and also offers greater prudential protections for U.S.-registered swap dealers controlled by foreign entities. However, this approach could still be affected by the weakness in the aggregation rules used in the July, 2013 guidance. Once again, foreign subsidiaries of U.S. banks to potentially avoid classification as a swap dealer and therefore coverage under margin rules, through transacting with foreign affiliates of U.S. companies that are nominally unguaranteed by U.S. persons. The weakness in the aggregation rules under the July 2013 guidance could also permit evasion of margin rules under this approach as well.

To address the problems with the latter two options offered by the CFTC, we would favor either changes in aggregation rules under the 2013 guidance to require all transactions with U.S.-controlled entities to be counted toward the de minimis requirements for swap dealer registration, the strengthening of the 'guarantee' definition being used to implement the July, 2013 guidance, or the expansion of the entity-level margin approach to foreign subsidiaries of U.S. banks that exceed a de minimis level of total swaps exposure, regardless of their registration as swap dealers.

Below, we also offer responses to specific questions posed by the Commission.

*1: Under the Guidance Approach and Prudential Regulators Approach, certain trades involving a non-U.S. SD/MSP would be excluded from the Commission's margin rules. The Commission seeks comment on whether this exclusion is over- or under- inclusive, and if so, please explain why.*

As detailed in our letter of November 25th to the Commission, AFR believes that the Guidance approach is under-inclusive of non-US SD/MSPs whose activities do in fact pose risks to the U.S. economy. This is due to the apparent failure of the Commission to enforce a realistic definition of 'guarantee' and to permit U.S. banks to 'de-guarantee' subsidiaries on a purely nominal basis. For example Fitch Ratings has recently commented regarding such 'de-guaranteeing'[5]:

> "Any removal of the existing guarantees between the U.S.-domiciled global trading and universal bank (GTUB) parents and their overseas subsidiaries that house over the counter (OTC) derivative (or swap) dealers will not immediately affect the ratings of these foreign subsidiaries, according to Fitch Ratings.
>
> Under Fitch's rating criteria, ratings assigned to financial institution subsidiaries deemed to be "core" to parent banks' overall operations are typically equalized with the parents' issuer default ratings (IDRs). In the cases of the five U.S. GTUBs, our assessments that their subsidiaries are core to their respective parents generally hold regardless of the existence of (or reliance on) any parental guarantees, because many factors, such as operational integration, reputation, branding and ownership, among others, support these core designations."

Even as the CFTC appears to be treating the removal of nominal 'guarantees' for core foreign subsidiaries as a real and substantial change in relationships for the purposes of the July 2013 guidance regulations, ratings agencies are rejecting this 'de-guaranteeing' as essentially fictitious and irrelevant for assessing the credit worthiness of the subsidiary. We believe that such ratings agency assessments would reflect the beliefs of market participants.

If banks are permitted to de-guarantee on a nominal basis, without adequate attention to the implicit guarantee recognized by the market, then the July 2013 guidance will result in exempting major and central foreign subsidiaries of U.S. banks from all transaction-level regulation, including substituted compliance requirements. This is clearly an over broad exemption.

As regards the prudential regulators approach, our understanding is that this approach would apply margin requirements to foreign subsidiary SDs and MSPs so long as these entities were controlled by a U.S. parent. We view this control approach as superior to the guarantee concept as it is apparently being implemented by the CFTC currently (although as discussed below, it would not necessarily be superior to a more inclusive approach to defining the concept of 'guarantee').

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[5] Fitch Ratings, "U.S. Banks De-Guaranteeing: No Immediate Ratings Impact", Fitch Wire, September 23, 2014.

However, we believe the prudential regulators' approach may be under-inclusive of foreign subsidiaries of U.S. banks that have large volumes of total swaps transactions but are not registered as SDs or MSPs under the rules of the July 2013 guidance, for example due to transactions with non-U.S. persons. Such derivatives transactions still pose a financial risk to the foreign subsidiary and thus to the U.S. parent, even if they do not trigger registration under current CFTC rules. Furthermore, we are concerned that entities such as separate investment funds and special purpose vehicles/variable interest entities sponsored by dealers may in total have significant aggregate swaps exposure even though they are unlikely to qualify as swap dealers or MSPs on an individual basis.

The prudential regulators' approach also excludes U.S.-registered swap dealers controlled by foreign banks from any requirements to follow margin rules with respect to their transactions with other foreign entities, even substituted compliance with equivalent foreign rules. Since these transactions affect the general solvency of these dealers, and their solvency would clearly also impact their transactions with U.S. counterparties, we believe that there is a U.S. regulatory interest in the proper risk management of these transactions as well. We would thus favor the imposition of a substituted compliance requirement for these transactions as well. As these transactions are between two foreign-controlled entities, however, the direct imposition of U.S. rules may not be appropriate.

*2: Each of the options provides for substituted compliance under certain situations. In light of the equal or greater supervisory interest of the foreign regulator in certain circumstances, the Commission is seeking comment on whether the scope of substituted compliance under each option is appropriate.*

A requirement for substituted compliance with genuinely equivalent foreign rules is much preferable to a complete exemption from all U.S. oversight, as could be granted for many transactions under several of the approaches outlined here. However, AFR also has serious concerns with using a substituted compliance approach for foreign subsidiaries of U.S. banks. It is unlikely that a foreign regulator will truly have equivalent supervisory interest with the U.S. in the well-being of a subsidiary of a U.S. bank. It is the U.S. government, not the host country government, that could bear ultimate responsibility for many liabilities of the parent bank if a significant subsidiary fails and brings down the global bank.

Furthermore, it will be difficult to ensure that substituted compliance is based on genuinely equivalent foreign rules. This is particularly true in the case of margin, for several reasons:

1) Rules that have equivalent aggregate margin levels for a representative set of transactions may have significant differences for particular classes of swaps. This would encourage arbitrage between different jurisdictions regarding margin requirements.

2) Jurisdictions that have equivalent margin levels may accept different types of collateral, or may have different valuation metrics for such collateral.

3) Internal margin models may be held to different standards in different jurisdictions, so that similar rules may be implemented quite differently based on regulators' oversight of margin models. Recent reports by the Basel Regulatory Consistency Assessment Program found substantial differences in risk weightings for capital purposes based on supervisory approaches to the use of internal models.[6]

These complexities in the determination of genuine equivalence argue against an overly broad use of substituted compliance, and for careful policing of substituted compliance when granted.

*3. The Commission is seeking comments on whether, in defining a non-U.S. covered swap entity, it should use the concept of ''control,'' in determining whether a covered swap entity is (or should be treated as) a non-U.S. covered swap entity. If the Commission uses a concept of control, should it be the same as that used by the Prudential Regulators, or should it be different?*

We believe that the Commission should certainly use the concept of 'control' in determining whether non-U.S. entities are subject to margin rules. If an entity is controlled by a U.S. parent, particularly if the entity has significant swaps business, then this should trigger a presumption of coverage by U.S. rules. However, the Commission's analysis should incorporate broader considerations about the flow of risk and should not end with the control concept.

Ultimately, the Commission should exercise its jurisdiction over the full range of swaps which could pose a significant risk to the U.S. economy, as is mandated in the Dodd-Frank Act. Such risks may or may not align with the concept of 'control'. A U.S. entity may be contractually exposed to risks from swaps undertaken by an entity that it does not formally control, for example through contractual guarantees or liquidity puts. This occurred during the financial crisis when major banks were forced to take nominally separate entities back on to their balance sheet for reputational reasons and in some cases due to guarantees provided in the transfer contracts. In general, variable interest entities sponsored by a bank may not be formally controlled by that bank but could easily pose significant risks to the bank.

However, control of an entity would in itself tend to make market participants believe that, absent special circumstances, the parent or controlling entity would stand behind its affiliate. The failure of an affiliated entity exposes the parent to significant reputational and business risks. Thus, a definition of guarantee which permits controlled entities, particularly large affiliates, to be defined as 'non-guaranteed' is deeply problematic. A sufficiently expansive definition of guarantee should incorporate presumptions of an effective guarantee that are based on the control relationship.[7]

*4. In the Commission's view, it is the substance, rather than the form, of an agreement, arrangement or structure that should determine whether it should be considered a ''guarantee.'' The Commission invites comment on how the term ''guarantee'' should be construed or defined in the context of*

[6] http://www.bis.org/publ/bcbs240.htm

[7] These presumptions could be rebutted by demonstrating special circumstances and strong firewalls between the affiliated entity and the rest of the corporate structure.

*these margin rules. For example, should the definition cover the multitude of different agreements, arrangements and structures that transfer risk directly back to the United States with respect to financial obligations arising out of a swap? Should the definition cover such agreements, arrangements and structures even if they do not specifically reference the relevant swap or affirmatively state that it does not apply to such swap? Should the definition cover agreements, arrangements and structures even if the other party to the swap terminates, waives, or revokes the benefit of such agreements, arrangements or structures?*

AFR strongly agrees that the substance, and not simply the form, of a risk sharing arrangement should determine whether it should be considered a 'guarantee'. Any formal or informal arrangement that would result in strong legal or reputational pressures on a parent bank to provide support for a related entity under stressed market conditions should count as a guarantee. The Commission should consult the views and consider the practices of market participants, including ratings agencies, to assist in determining whether there are implicit guarantees by a U.S. entity that are broadly recognized in the market, as reflected in pricing terms of the swap or in assessments of credit ratings for the foreign entity. The guarantee definition should also include contractual arrangements such as cross-default provisions relating to a U.S. entity, keep well agreements or liquidity puts provided by a U.S. entity, or other arrangements in which a U.S. entity is effectively committed to provide resources to the nominally foreign entity. Generally, it is likely that such implicit or explicit guarantee relationships would be reflected in default triggers contained in at least some contracts that recognize the default of the subsidiary as a triggering event for the default of the parent. If such default triggers are present for any commitments made by the parent (e.g. bond indentures), then the subsidiary should also be recognized as effectively guaranteed by the parent.

If the Commission chooses to recognize a counterparty waiver of benefits of risk-sharing structures, then this waiver should be made explicitly, be recognized in all contractual terms (including default triggers in all relevant contracts across the group), and be legally binding in all jurisdictions in which the entity operates.

**Application to Commercial End Users**

Swaps with commercial end users represent real credit risk. As stated by former U.S. Comptroller Walsh in response to a Congressional question, swaps with commercial end users clearly create the risk of loss[8]:

> "…swaps with a commercial end user do expose the dealer to credit risk, similar to an unsecured line of credit. The banking agencies have long required dealers to prudently

[8] Response from John Walsh, Acting Comptroller of the Currency, to questions for the record by Senator Crapo, December 6,2011. Available at http://www.chathamfinancial.com/wp-content/uploads/2012/03/Walsh-Resp-to-Crapo-QFRs-12-6-11.pdf

manage this credit risk…Banks have legal lending limits to ensure that they do not have potentially dangerous concentrations of risk with a single counterparty….Derivatives exposures are simply another use of those limits. While end-user activity has not historically contributed meaningfully to systemic risk, it has led to credit losses. Banks report charge-offs of derivatives exposures nearly every quarter. They are typically related to swaps with commercial borrowers, who have indeed used swaps as a hedge."

We are thus concerned with the scope of the margin exemption provided for transactions with commercial end users in this Proposed Rule. We are also highly supportive of elements of the rule that require swap dealers to measure and monitor total aggregate risk related to end user swaps (e.g. 23.154(a)(6) and 23.155(a)(3) of the Proposed Rule).

Our concern is greatly increased by recent moves by the CFTC permitting affiliated financial entities to take advantage of the end user exemption to clearing. While a narrow exemption for central treasury units is appropriate in some cases, the recent CFTC no-action letter of November 26, 2014 greatly expands previous exemptions in this area.[9] The agent affiliate exemption in this rule would apparently extend a matching exemption from margin requirements to any financial affiliate which qualifies under the CFTC no-action policy, including affiliates within the same corporate group as designated non-bank systemically important financial institutions such as GE Capital.

We urge the Commission to separate the clearing and the margin exemptions in these cases. The Commission should carefully examine the systemic risk implications of a broad margin exemption for agent affiliates that are financial entities and restore margin requirements in cases where the volume of such agent affiliate swaps could present risks to the financial system or to affiliated entities determined to be systemically important. We would also urge the CFTC to quantify and make public an analysis of the volume of financial entity swaps that could qualify for the commercial end user exemption.

## Reliance on Internal Models

The Proposed Rule permits reliance on bank internal models for setting margin requirements, despite the fact that U.S. banking regulators are moving away from in the area of modeling capital requirements due to the numerous weaknesses in internal-model based capital regimes exposed during the financial crisis and afterwards.[10]

[9] Commodity Futures Trading Commission, Division of Clearing And Risk, "Further No-Action Relief For Swaps Entered Into By Eligible Treasury Affiliates", CFTC No-Action Letter 14-44, November 26, 2014.
[10] See e.g. the discussion of the IRB approach to capital in Tarullo, Daniel, "Rethinking the Aims of Prudential Regulation", Speech at the Federal Reserve Bank of Chicago Bank Structure Conference, May 8, 2014.

It is true that the un-cleared swaps affected by this rule are likely to include many exotic and non-standardized swaps for which standardized look-up tables may be inappropriate. It is also true that specific regulatory governance requirements are put forward for internal margining models. AFR certainly supports these governance requirements. However, governance requirements alone are likely to be insufficient protection. This is especially true since even well governed internal models are likely to have major differences between banks, which may lead to valuation controversies between swaps counterparties, particularly in times of financial stress.

We would instead support the development of unified modeling capacity within the regulatory community for derivatives margin estimation. Such modeling capacity would offer greater insight for regulators into derivatives risks and also provide a forum for settling controversies about valuation. They could also prevent the inherent conflict of interest that occurs when banks manage their own regulatory models. The proper performance of comprehensive liquidity stress testing such as the Federal Reserve's Comprehensive Liquidity Analysis and Review (CLAR) should in any case require development of margin models within the regulatory community.

Thank you for the opportunity to comment on these Proposed Rules. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.