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Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

September 14, 2015

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 – Cross-Border Application of the Margin Requirements", RIN 3038-AC97

To Whom It May Concern:

Americans for Financial Reform ("AFR") appreciates this opportunity to comment on the above-referenced proposed rule (the "Proposed Rule") by the Commodity Futures Trading Commission (the "Commission" or "CFTC"). AFR is a coalition of more than 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]

In numerous previous comments, AFR has raised serious concerns about the Commission rules and guidance that exempt foreign subsidiaries of U.S. banks, or U.S. subsidiaries of foreign entities that are highly active on Wall Street, from a wide range of Dodd-Frank derivatives rules.[2] Given the global character of the derivatives market, we believe that such cross-border exemptions create the possibility for large-scale evasion of U.S. rules. Recent reports about 'de-

[1] A list of AFR member organizations is available at http://ourfinancialsecurity.org/about/our-coalition/.
[2] Americans for Financial Reform, "Comment to the CFTC On Proposed Cross Border Guidance", August 27, 2012; Michael Greenberger and Americans for Financial Reform, "Comment Letter to CFTC For Proposed Rule 78 FR 909", February 11, 2013; Americans for Financial Reform, "Letter to the CFTC On Cross-Border Application of Derivatives Rules", July 3, 2013; Americans for Financial Reform, "Letter to CFTC and SEC On Derivatives 'De-Guaranteeing' Ploy", November 25, 2014.

guaranteeing' of derivatives transactions to permit avoidance of CFTC rules indicate that such concerns are well founded.[3]

AFR supports the expansion of the cross-border application of derivatives margin regulation that is proposed in this rule. In our previous comment on the Commission margin proposal, we urged that foreign subsidiaries be covered under U.S. margin requirements.[4] This Proposed Rule does address this issue, and goes some distance toward limiting possibilities for cross-border rules evasion as regards margin requirements in particular. This is progress in the right direction.

However, we believe that properly addressing the issue of cross-border derivatives regulation requires a much more comprehensive re-examination of the approach adapted by the Commission in its 2013 cross-border guidance, and there are serious problems with reforming the cross-border approach for margin rules alone. These issues include the following.

1) **It adds complexity to what is already a highly complex set of cross-border rules.** This Proposed Rule adds the important concept of a 'Foreign Consolidated Subsidiary' (FCS) and also changes the 2013 Guidance approach in numerous ways. But these changes only apply to the margin context, and only for entities that are regulated by the CFTC and not prudential regulators. Market participants and observers must now master another set of cross-border rules which only applies to one set of margin rules and not to other regulatory contexts.

2) **The justification for this rule conflicts with the justification given for previous rules.** The reasons given in this Proposed Rule for expanding the application of U.S. margin rules to foreign subsidiaries of U.S. swaps entities apply equally well to the cross-border application of other derivatives rules. For example, the Proposed Rule states that the swaps activities of a non-guaranteed Foreign Consolidated Subsidiary have a "direct impact on the financial position…of a U.S. parent entity…and a potential spill-over effect on the U.S. financial system".[5] However, this statement would also justify a much more expansive application of other derivatives rules that protect against financial risk, such as for example clearing requirements, than was required in the 2013 Guidance. The 2013 Guidance exempts many activities non-guaranteed FCS from numerous derivatives regulations on the ground that the swaps activities of these entities do not present a risk to the U.S. financial system. If the Commission believes that FCS can have a direct impact on the U.S. financial system statement in the context of these proposed margin rules, then it must re-examine the numerous exemptions offered to FCS for other derivatives rules.

3) **Exemptions granted in the 2013 Guidance undermine the proper application of these margin rules.** The applicability of the proposed margin rules is limited to CFTC-

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[3] Levinson, Charles, "Vanishing Act: How U.S. Banks Moved Billions of Dollars in Trades Beyond Washington's Reach", Reuters Investigates, August 21, 2015.
[4] Americans for Financial Reform, "Comment on Margin Requirements For Uncleared Swaps", December 2, 2014.
[5] CFR 41385

registered swaps entities. However, under the aggregation rules in the 2013 Guidance, transactions between non-guaranteed foreign affiliates of U.S. persons and foreign branches or non-guaranteed foreign affiliates of U.S. persons are not counted toward the de minimis requirement for registering as a swaps entity. Thus, even if an entity is a Foreign Consolidated Subsidiary of a U.S. person, so long as it is not guaranteed it could avoid registration as a swaps entity, and thus the application of margin rules, if it limits swaps counterparties to foreign branches of U.S. banks or non-guaranteed foreign affiliates of U.S. banks (including non-guaranteed affiliates that are themselves FCS). This could seriously undermine the effort in this proposed rule to capture FCS of U.S. banks even where they are not guaranteed.

Thus, if the Commission limits its rethinking of cross-border rules to the area of margin requirements for non-bank swap dealers, and does not reexamine the guidance approach more broadly, the cross-border regulatory regime will be excessively complex and will continue to include unnecessary and damaging loopholes that undermine the intent of the rules. We therefore urge the Commission, as we have previously, to engage in a general reexamination of its cross-border policies, particularly as regards the exclusion of foreign consolidated subsidiaries that lack an explicit guarantee from coverage under a wide range of crucial derivatives rules.

In considering the specific details of this Proposed Rule, we would like to comment in three areas. These are the concept of Foreign Consolidated Subsidiaries (FCS) and the use of the FCS concept to determine the coverage of margin rules, the change in the definition of 'guarantee' as compared to the 2013 guidance definition, and the scope of the proposed rules exclusion and substituted compliance provisions. Our points in these areas can be summarized as follows:

- In general, we strongly support the use of the FCS concept to expand the scope of margin requirements beyond the 2013 Guidance approach, to all non-guaranteed FCS of U.S. parents. However, we believe that the FCS concept could usefully be supplemented by a provision to apply a facts and circumstances analysis of control in those cases where a non-consolidated entity could have a major impact on the financial well-being of the parent, including cases where the parent does not use GAAP accounting.

- We oppose the narrower definition of 'guarantee' in this proposal. While the harm created by the weakening of the 'guarantee' definition as compared to the 2013 Guidance definition may be limited due to the expansion of margin rules coverage to FCS, the introduction of such a weak definition of guarantee into the cross-border rules set creates an extremely poor precedent, especially considering that the majority of key derivatives rules are not extended to non-guaranteed FCS under the 2013 Guidance approach. It is also likely to be confusing to market participants. The apparent intent of the Commission in this proposal could be achieved without actually changing the guarantee definition.

- It is unclear in this proposal whether the Commission plans to certify international CPSS-IOSCO rules as acceptable for substituted compliance with U.S. rules. We do not believe

these international rules should meet the substituted compliance standard, as they differ significantly from U.S. regulatory standards.

- We furthermore believe that the combination of a narrow definition of 'guarantee' in this proposal and the limitation of the FCS concept to subsidiaries of registered swaps entities (as opposed to consolidated subsidiaries of any U.S. person) is likely to lead to an overbroad application of the substituted compliance and regulatory exclusion provisions in this rule. We also question the Commission's decision to grant a full exclusion from any margin requirements to trades between foreign-owned entities that include a U.S. registered swap dealer.

These points are discussed further below.

The FCS Concept: The Proposed Rule diverges from the 2013 Guidance approach by extending U.S. derivatives jurisdiction to Foreign Consolidated Subsidiaries (FCS) of swaps entities, even where such FCS are not U.S. persons and do not have an explicit legal guarantee. In numerous previous comments, AFR has pointed out that the sweeping exemptions the Commission has granted to foreign subsidiaries of U.S. swaps entities are a major weakness in the current regime for derivatives regulation. The use of the FCS concept to expand the reach of U.S. derivatives rule is a logical way to address this weakness in the area of margin for un-cleared swaps, and we support it. The Proposed Rule points out in several places that an FCS by definition has a direct impact on the financial position of the parent entity that consolidates it and that such impact creates incentives for support on the part of the parent entity and expectations for support on the part of market counterparties, even if there is no explicit legal obligation for support. We strongly agree with these points, which are well supported by evidence.[6] They echo arguments made by AFR and others in previous comments and, as discussed above, should also be applied in other areas of derivatives regulation.

The FCS concept is a logical and reasonable approach to determining which subsidiaries of U.S. swaps entities can expect an implicit guarantee from the U.S. parent, and it economizes on Commission resources by tying regulatory coverage to easily available accounting information. However, it may not encompass all subsidiaries which could expect an implicit subsidy. In the margin rule proposed by prudential regulators, a control test as opposed to a consolidation test was used. Under U.S. GAAP, control and accounting consolidation are closely related, but some forms of control may not trigger consolidation in all circumstances.[7] The close relationship between consolidation and control does mean that the FCS concept is likely to capture most cases in which control exists. However, some instances in which a parent and a subsidiary entity are closely related and the parent faces strong reputational incentives to support the subsidiary

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[6] See footnote 61 of the Proposed Rule, as well as extensive discussion in Americans for Financial Reform, "Letter to CFTC and SEC On Derivatives 'De-Guaranteeing' Ploy", November 25, 2014.
[7] Price Waterhouse Coopers, "Point of View: Consoldiation", May, 2013.

may not be captured. This is most obvious in the case of privately held entities that are not required to prepare consolidated financial statements under GAAP. But it may also apply to certain variable interest entities or owned funds. Indeed, there is continuing controversy regarding whether GAAP requirements for consolidation of off-balance-sheet entities are adequate.[8]

Furthermore, placing the emphasis on consolidation alone means that future changes in accounting rules for consolidation will directly impact the coverage of derivatives rules, perhaps in undesirable ways. Prior to the financial crisis and then the passage of FASB 166 and 167, it is clear that U.S. GAAP accounting failed to properly require consolidation of many securitization entities that eventually had a profound impact on the balance sheet of the originating entity. Such gaps in accounting consolidation rules could appear in the future.

We would therefore urge the Commission to preserve its discretion to engage in a facts and circumstances analysis of the relationship between a foreign subsidiary and a U.S. parent entity in order to determine whether sufficient nexus exists to require the subsidiary to comply with margin rules. We also urge the Commission to include within the FCS definition those non-U.S. swaps entities whose U.S. parent is not required to prepare consolidated financial statements, but which would meet standards for consolidation or control were the parent so required. If the Commission failed to include such entities within the FCS definition, entities with a similar nexus to the U.S. financial system would be treated differently depending on e.g. whether the ultimate parent was publicly traded or not. This is an unreasonable outcome that would permit gaps in regulatory coverage to develop.

Finally, we believe that the limitation of the definition of FCS to subsidiaries of swaps entities inappropriately expands the scope of the exclusion created by this rule. Defining an FCS as a consolidated subsidiary of any U.S. parent (including end users and other entities not registered as swap dealers) would address this issue. This objection is discussed further below.

The definition of 'guarantee': The definition of 'guarantee' used in this Proposed Rule is much narrower than the definition of 'guarantee' given in the 2013 Guidance, and includes only a legally enforceable right of recourse for the swap counterparty to a U.S. person. In contrast, the 2013 Guidance definition went well beyond a legally enforceable right of recourse, and included all arrangements by the U.S. parent which, in view of the facts and circumstances, supported the non-U.S. subsidiary's ability to satisfy financial obligations resulting from its swaps obligations.

AFR believes that limiting the guarantee definition to a legally enforceable right of recourse for specific swaps is too narrow, and that the 2013 guidance definition is far preferable. As the

[8] Levinson, Charles, "How Wall Street Captured Washington's Efforts to Rein In Banks", Reuters Investigates, April 9, 2015.

Proposed Rule explicitly states, limiting the definition of guarantee to purely a right of recourse means that even formal arrangements between parent and subsidiary that legally commit the U.S. parent to financial responsibility for the subsidiary's debts would not trigger coverage under U.S. derivatives rules. Such arrangements clearly can create the kind of direct and significant relationship between the U.S. financial system and subsidiary swaps obligations envisioned by Congress when it added Section 2(i) to the CEA in the Dodd-Frank Act. The narrow definition of guarantee proposed in this rule also fails to capture the kind of implicit guarantees that led U.S. parent entities to provide support for failing securitization vehicles and funds during the financial crisis.[9]

It is unclear why the Commission has proposed this narrowing of the definition of 'guarantee'. It may be that, in the context of this rule with its explicit requirement that all FCS (guaranteed or not) of U.S. persons be covered under at least substituted compliance, the Commission feels that the broader definition of 'guarantee' in the 2013 Guidance is unnecessary. The Commission may also feel that the narrower definition of guarantee proposed here is the more appropriate one for determining whether substituted compliance vs. full U.S. coverage will apply. As discussed below, we have some concerns with this decision. But even accepting that the Commission's intent is a legitimate one, we feel that it can be achieved without proposing an entirely new definition of 'guarantee' that narrows the 2013 Guidance definition. By creating a second definition of guarantee, the Commission needlessly complicates the overall set of cross-border rules, and also establishes a precedent which interested parties will likely use to try to narrow the 2013 Guidance definition as well. We urge the Commission to avoid introducing such a weak precedent into the cross-border rules, rules which we believe already do not create sufficient regulatory coverage of foreign subsidiary transactions.

Instead, the Commission could achieve the same result as is created by this proposal by simply specifying that, while the 2013 Guidance definition of 'guarantee' continues to apply, in the case of a FCS of a U.S. parent, only an explicit recourse guarantee triggers full coverage under U.S. rules. A subsidiary which is guaranteed in a manner that falls short of a legally enforceable right of recourse for swaps counterparties may be covered under substituted compliance. So instead of referring to a 'guarantee' or 'guaranteed by a U.S. person' to define when full U.S. coverage applies in this rule, the Commission could instead state 'explicit recourse guarantee' or 'a U.S. person has provided an explicit right of recourse'. This would make clear that the overall

[9] As we have argued in other comments we believe that the 2013 Guidance definition of guarantee, as actually applied by the Commission, also fails to capture such implicit guarantees. But at least conceptually the 2013 Guidance definition offers the possibility that Commission staff could apply a facts and circumstances analysis to capture a greater share of implicit guarantees, and the definition clearly should cover broader contractual guarantees of subsidiary-level debt by the parent. This 'explicit right of recourse' definition in this Proposed Rule would make such coverage impossible.

definition of guarantee used by the Commission for its broader set of cross-border rules has not changed, while still providing clarity on the application of margin rules.

The Scope of Substituted Compliance and Exclusion In This Proposal: The Proposed Rule would permit substituted compliance for transactions involving non-guaranteed FCS. It would completely exclude transactions between non-U.S. swaps entities and non-U.S. persons from coverage under U.S. rules, so long as neither entity has a guarantee from a U.S. person.

We have two issues with the proposal in this area. First, we believe that international margin rules that follow the CPSS-IOSCO agreement should not qualify for substituted compliance treatment, as they differ too significantly from U.S. rules. Second, we feel that the limitation of 'guarantee' to an explicit recourse guarantee and the limitation of the FCS concept to foreign subsidiaries of U.S. swaps entities are likely to create an excessively broad application of the proposed exclusion in the rule, and of substituted compliance if the CPSS-IOSCO qualified for such treatment.

Because both international and U.S. rules have been proposed, it is possible to have a much clearer idea of the contrast between U.S. and likely foreign margin rules then it is for other areas of derivatives rules. While there are many similarities between these rules, there are also a number of important differences. The most important difference appears to be that U.S. rules apply a threshold of $3 billion to the amount of un-margined swaps permitted to any financial counterparty, while the threshold in the international rules is 8 billion Euros, which is approximately $9 billion or more than three times as high as the proposed U.S. exclusion.[10] We believe that this difference alone renders foreign rules non-comparable to U.S. rules. There are also a number of other differences and still further differences are likely to emerge in the oversight of margining models by different regulators.

This Proposed Rule offers substituted compliance to essentially any foreign subsidiary that does not have an explicit recourse guarantee. This creates very significant scope for substituted compliance, particularly when the counterparty is not a swaps entity. If this substituted compliance was limited to foreign rules sets that were very similar to U.S. rules (except perhaps for relatively minor differences in implementation or administration) then the scope for substituted compliance would not be a concern. However, if the Commission plans to certify the internationally agreed margin rules as adequate for substituted compliance purposes, despite the significant differences that exist from U.S. rules, then we feel that this Proposed Rule creates excessive opportunities for substituted compliance. At the least, the Commission should specify that the most significant elements of difference between U.S. and foreign rules, including the

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[10] Basel Committee on Banking Supervision and International Organization of Securities Commissions, "Margin Requirements for Non-Centrally Cleared Derivatives", March 2015.

counterparty threshold and important differences in margin models, should apply to all transactions involving a FCS.

The Proposed Rule also offers a full exemption from margin rules for transactions between 'truly' non-U.S. swaps entities (i.e. swaps entities whose ultimate parent is not a U.S. person and are not U.S. branches of a foreign entity) and non-U.S. persons. We appreciate that the U.S. supervisory interest is lower for 'truly' foreign transactions, e.g. those between foreign banks and foreign companies. However, as laid out in the Proposed Rule Appendix A, this exclusion does not appear limited to such 'truly' foreign transactions, as it would apply to transactions between a foreign swaps entity and a non-guaranteed foreign subsidiary of a U.S. financial end user that is not a swaps entity. Even if consolidated, such a foreign subsidiary of a U.S. person would not be defined as an FCS under the rule. Thus, this exclusion appears to cover a range of transactions between foreign banks and U.S. end users. We believe this is inappropriate.

Furthermore, the fact that even a foreign financial firm is registered as a U.S. swaps entity indicates that the swaps entity does have a nexus with the US financial system, even if it is not ultimately within the U.S. financial safety net. We believe that this makes a complete exclusion from margin rules inappropriate. Instead, we would favor holding 'truly foreign' transactions involving a foreign swaps entity to a standard that at least meets the internationally agreed margin rules. While we feel that these rules do not meet the standard for full substituted compliance, they do represent an internationally agreed 'floor' for derivatives margin.

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.