COMMITTEE ON CAPITAL MARKETS REGULATION

November 24, 2014

Department of the Treasury
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218, Mail Stop 9W-11
Washington, DC 20219
Docket ID OCC-2011-0008

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Attn: Robert deV. Frierson, Secretary
Docket No. R-1415

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attn: Comments / Legal ESS
Robert E. Feldman, Executive Secretary
RIN 3074-AE21

Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581
Attn: Christopher Kirkpatrick, Secretary of the Commission
RIN 3038-AC97

VIA ELECTRONIC MAIL: regs.comments@federalreserve.gov; comments@fdic.gov; regs.comments@occ.treas.gov; http://comments.cftc.gov

Re: Margin Requirements for Covered Swaps Entities (RIN 3074-AE21); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swaps Participants (RIN 3038-AC97) (the "**Proposed Rules**")

Dear Sir or Madam:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the margin requirements for covered swaps entities proposal, released jointly by the Board of Governors of the Federal Reserve System (the "**Board**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), and the Office of the Comptroller of the Currency (the "**OCC**," and together with the Board and the FDIC, the "**Prudential Regulators**").[1] The Committee is also grateful for the opportunity to comment on the requirements for non-cleared swaps proposal, released by the Commodity Futures Trading Commission (the "**CFTC**").[2] The proposals are referred to herein as the Proposed Rules.

[1] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348 (proposed September 24, 2014).
[2] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg.
[2] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg.
59898 (proposed October 3, 2014).

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-five leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Proposed Rules would implement margin requirements for the non-cleared swaps activities of swap dealers and major swaps participants ("**covered swaps entities**").[3] Generally speaking, the CFTC has defined swap dealers as market makers in swaps with over $8 billion in aggregate gross notional derivatives exposures with, or on behalf of, its customers.[4] There are currently 106 registered swaps dealers.[5] The CFTC has generally defined major swaps participants as non-market makers that have uncollateralized exposures in swaps exceeding $5 billion, excluding positions held for hedging or mitigating risk.[6] There are two registered major swaps participants.[7]

There will be three separate rules implementing margin requirements for non-cleared swaps. The Prudential Regulators' Proposed Rule establishes margin requirements for the covered swaps entities for which they are the prudential regulators.[8] The CFTC's Proposed Rule establishes margin requirements for the non-cleared swap activities of covered swaps entities for which there is no prudential regulator, including non-bank entities registered as swaps dealers.[9] These are the two already issued and are addressed by this letter. The Securities Exchange Commission has yet to issue its proposed rules, which will apply only to non-cleared "securities-based" swaps. According to the OCC, approximately 80% of non-cleared swaps would be subject to the Prudential Regulators' Proposed Rule.[10]

The Committee notes that this fragmented approach to setting rules for initial margin requirements will complicate the implementation of *consistent* initial margin requirements. For example, the Prudential Regulators' Proposed Rule and CFTC Proposed Rule potentially differ in their cross-border application. This brings to light the continuing problem of the fragmented U.S.

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[3] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348 (proposed September 24, 2014); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898 (proposed October 3, 2014).

[4] U.S. Commodity Futures Trading Commission, *Final Rules Regarding Further Defining "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant"* 1, 3 (2012).

[5] U.S. Commodity Futures Trading Commission, *Provisionally Registered Swap Dealers* (2014), *available at* http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer.

[6] U.S. Commodity Futures Trading Commission, *Final Rules Regarding Further Defining "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant"* 1, 5 (2012).

[7] U.S. Commodity Futures Trading Commission, *Provisionally Registered Major Swap Participants* (2014), *available at http://www.cftc.gov/LawRegulation/DoddFrankAct/registermajorswappart*.

[8] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348 (proposed September 24, 2014)

[9] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898 (proposed October 3, 2014).

[10] The U.S. Office of the Comptroller of the Currency supervises nine national banks and six federally chartered branches of foreign banks that represent almost 80% of the non-cleared swaps market. U.S. Office of the Comptroller of the Currency, *Economic Impact Analysis for Swaps Margin Proposed Rule* 1, 5 (August 28, 2014).

regulatory structure. In *The Global Financial Crisis: A Plan for Regulatory Reform*, the Committee recommended a reorganization and consolidation of the U.S. regulatory structure whereby only one agency would implement margin requirements.[11]

The Committee believes that non-cleared swaps serve a vital purpose for insurance companies, pension funds, asset managers, non-financial corporates, and others, because they include customized terms that allow these entities to better hedge their particular risk exposures. It is because of these customized terms that these non-cleared swaps lack sufficient liquidity for central clearing.[12] The Committee supports margin requirements for non-cleared swaps, as margin requirements will limit the build up of uncollateralized exposures in the financial system. Moreover, the Committee agrees that margin requirements for non-cleared swaps should exceed the margin requirements for cleared swaps, as this will incentivize derivatives users to standardize swaps contracts when possible, thereby promoting central clearing. However, the Committee believes that margin requirements for non-cleared swaps should not be so onerous that they prevent financial and non-financial end-users from using non-cleared swaps to manage financial risk.

The Committee has three major concerns with the Proposed Rules. First, the proposed initial margin requirements are not appropriately risk-adjusted, as they require ten days of initial margin for all types of non-cleared swaps, regardless of their liquidity.[13] For example, there are $135 trillion in outstanding non-cleared interest rate swaps, and only $10 trillion in non-cleared credit swaps; however, both types of non-cleared swaps would require sufficient initial margin to cover a liquidation horizon of ten days. As a result, derivatives users may forego hedging financial risk with non-cleared swaps due to the cost of posting unnecessarily high amounts of liquid assets as initial margin. Second, the Proposed Rules are more stringent than the Basel Committee's *Margin Requirements for Non-Centrally Cleared Derivatives* and the recently proposed European standards.[14] Differences between U.S. and European rules for non-cleared swaps threaten to put U.S. market participants at a competitive disadvantage by increasing their relative cost of hedging financial risk. Third, although the Prudential Regulators' and the CFTC's Proposed Rules are virtually identical, they differ in their cross-border application. For example, the Prudential Regulators' Proposed Rule does not clarify a standard for determining whether a counterparty is a U.S. or foreign entity, whereas the CFTC Proposed Rules include a "U.S. person" standard for making such a determination.[15]

The Committee recommends that the Prudential Regulators and the CFTC consider the liquidity of different types of non-cleared swaps when determining the appropriate minimum amount of initial margin. The Committee also recommends that the Prudential Regulators and the

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[11] Comm. on Capital Mkts. Reg., *The Global Financial Crisis: A Plan for Regulatory Reform* 1, 51 (May 2009), *available at* http://capmktsreg.org/2009/05/the-global-financial-crisis-a-plan-for-regulatory-reform/.
[12] ISDA, *Sizes and uses of the Non-Cleared Derivatives Market* 1, 20 (April 2014).
[13] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59909 (proposed October 3, 2014).
[14]European Banking Authority, *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012* 1 (April 14, 2014), *available at* http://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+(CP+on+risk+mitigation+for+OTC+derivatives).pdf.
[15] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59916 (proposed October 3, 2014).

CFTC revise their Proposed Rules to align with the Basel international standards and European proposal. Finally, the Committee recommends that the Prudential Regulators and the CFTC implement a consistent approach to the cross-border application of the Proposed Rules.

Summary of the Proposed Rules

A. Initial Margin

According to the Proposed Rules, initial margin is intended to protect the transacting parties from the potential exposure that could arise from *future* changes in the mark to market value of a non-cleared swap after a counterparty defaults, during the time it takes to value and close out the position.[16]

The Proposed Rules would require the exchange of initial margin between a covered swap entity entering into a non-cleared swap with another covered swap entity or a financial end user with "material swaps exposure."[17] Initial margin must be exchanged between these counterparties immediately after entering into a non-cleared swap.[18] Covered swaps entities would not be required to collect or post initial margin for non-cleared swaps with non-financial end-users and financial end-users *without* material swaps exposure.[19] Financial end-users are defined to include banks, broker-dealers, investment companies, insurance companies, pension funds, commodity pools and others, that are *not* registered as swaps dealers or major swaps participants.[20] Material swaps exposure is defined as an average daily aggregate notional amount of non-cleared swaps in excess of $3 billion across all counterparties.[21]

While certain non-dealers post initial margin to their dealer counterparties, initial margin is currently not exchanged for non-cleared swaps between dealers.[22] Thus, the Proposed Rules would mark a substantial change in current market practice. In an effort to mitigate the effect on covered swaps entities, the Proposed Rules do not require initial margin to be exchanged until the total non-cleared swaps exposures between two counterparties would necessitate $65 million in initial margin.[23] This is referred to as the "minimum collection amount."[24] For example, if two covered swaps entities have $2 billion in non-cleared swaps with one another and their initial

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[16] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348 (proposed September 24, 2014); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898 (proposed October 3, 2014).
[17] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57353 (proposed September 24, 2014); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898, 59904 (proposed October 3, 2014).
[18] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898, 59904 (proposed October 3, 2014).
[19] *Id.*
[20] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57360-57363 (proposed September 24, 2014).
[21] *Id.* at 57357.
[22] *See* Daniel Tarullo, *Draft Notice of Proposed Rulemaking – Margin and Capital Requirements for Covered Swap Entities* 1, 18 (August 29, 2014). "Although large dealers currently exchange variation margin, they generally do not exchange initial margin."
[23] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57354 (proposed September 24, 2014).
[24] *Id.*

margin models determined that they would each only be require to collect $50 million in initial margin, they would not have to exchange that amount because it falls below the "minimum collection amount."[25]

The Proposed Rules require covered swaps entities to collect and post enough initial margin to account for 99% of potential price moves of a swap for 10 days following the default of a counterparty.[26] Covered swaps entities may calculate initial margin using initial margin models that have been approved by the Prudential Regulators and the CFTC.[27] According to the Proposed Rules, eligible initial margin collateral includes cash, gold, certain government bonds, corporate bonds, and equities, subject to certain minimum haircuts.[28] Finally, the Proposed Rules require that collateral posted as initial margin be segregated at a third-party custodian and prohibit counterparties from re-pledging (re-hypothecating) initial margin collateral.[29]

B. Variation Margin

The Proposed Rules also require covered swaps entities to exchange variation margin for certain non-cleared swaps.[30] Variation margin is intended to recognize any *present* changes in the value of a non-cleared swap and reduce unrealized losses to zero. The exchange of variation margin is already a widely adopted best practice for non-cleared swaps.[31]

The Proposed Rules would require a covered swap entity to collect and post minimum amounts of *variation* margin to a counterparty that is also a covered swap entity or a financial end user.[32] According to the Proposed Rules, variation margin exchanged between these entities need not be segregated with a third-party custodian and may be re-pledged (re-hypothecated) to other counterparties.[33] However, the Proposed Rules restrict the type of collateral that can be posted as variation margin to cash only.[34] Covered swap entities would not be required to collect or post variation margin for non-cleared swaps with non-financial end-users.[35]

Analysis of the Proposed Rules

A. Risk-Adjustment of Margin Requirements for Non-cleared Swaps

The Committee is concerned that the margin requirements for non-cleared swaps are not adequately adjusted to reflect the risk posed by different types of non-cleared swaps. Given that estimates of the increase in total initial margin required by the Proposed Rules range from $280

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[25] Prudential Regulators Proposal, Page 70
[26] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57352 (proposed September 24, 2014).
[27] *Id.* at 57374.
[28] *Id.* at 57371-57372.
[29] *Id.* at 57355.
[30] *Id.* at 57356.
[31] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898, 59924 (proposed October 3, 2014).
[32] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57354 (proposed September 24, 2014).
[33] *Id*. at 57354.
[34] *Id*. at 57355.
[35] *Id.* at 57366.

billion to $3.6 trillion, the Proposed Rules could impose a sizeable liquidity burden on the financial system unless appropriately calibrated.[36] This burden is exacerbated by the fact that any assets exchanged as initial or variation margin would not count towards a bank's liquid asset buffer under the Liquidity Coverage Ratio. If the margin requirements are too burdensome then financial entities seeking to hedge risk may no longer hedge these risks or may switch to products that do not match their risk exposures as directly. The Committee therefore stresses that the Prudential Regulators and the CFTC revise their initial margin requirements in three crucial respects.

First, the Proposed Rules would require covered swaps entities to post sufficient initial margin to cover a ten-day liquidation period for *all* types of non-cleared swaps.[37] In other words, the Proposed Rules assume that it would take ten days to value and close out any non-cleared swaps after a counterparty defaults. However, the Proposed Rules do not offer any empirical support or explanation for why a ten-day liquidation period is appropriate for *all* non-cleared swaps generally. While the Committee agrees that margin requirements should be higher for non-cleared swaps than for cleared swaps, the CFTC only requires a five day liquidation period for cleared interest rate and credit default swaps and one day of initial margin for cleared commodity swaps. It is not evident that non-cleared interest rate and credit swaps warrant double the liquidation period and commodity swaps warrant ten times the liquidation period as their cleared counterparts.[38] Moreover, the across-the-board ten-day liquidation period in the Proposed Rule fails to take into account the role of liquidity in determining appropriate amounts of initial margin: the higher the liquidity the lower the delay in closing out the position, thus minimizing the losses that the initial margin must absorb. The same problem is already reflected in the CFTC rule requiring the same five-day liquidation period for *cleared* interest rate and credit default swaps[39]—two wrongs do not make a right.

The Committee recommends that the Prudential Regulators and the CFTC risk adjust their initial margin requirements by considering the liquidity characteristics of different types of non-cleared swaps.[40]

Second, portfolio margining would allow covered swaps entities and financial end-users to calculate their non-cleared margin requirements based on their total exposures to a counterparty, accounting for any offsetting positions in other related transactions with that counterparty. Although the Proposed Rules permit portfolio margining for non-cleared swaps within narrow and well-defined asset classes, such as credit, interest rate, and certain commodity swaps with a particular counterparty,[41] they do not address whether portfolio margining is permissible across product types, such as non-cleared swaps, cleared swaps, and futures on the same asset class with the same counterparty. Different products within the same asset class are likely hedging highly similar types of risk and thus may reduce the total risk of a customer's portfolio. The Committee therefore recommends that the Proposed Rules clarify that in

[36] U.S. Office of the Comptroller of the Currency, *Economic Impact Analysis for Swaps Margin Proposed Rule* 1 (August 28, 2014).
[37] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898, 59924 (proposed October 3, 2014).
[38] *Id.*
[39] *Id.*
[40] U.S. Office of the Comptroller of the Currency, *Economic Impact Analysis for Swaps Margin Proposed Rule* 1, 5 (August 28, 2014).
[41] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898, 59900 (proposed October 3, 2014).

determining the minimum amount of initial margin that must be posted for non-cleared swaps, counterparties may consider any offsetting exposures from different product types on the same asset class.

Third, the Proposed Rules require the Prudential Regulators and the CFTC to review and approve any models used by covered swaps entities for determining the minimum amount of initial margin.[42] It is expected that all swaps dealers will use the same standard initial margin model for inter-dealer non-cleared swaps and that the Prudential Regulators and the CFTC will review and approve this standard initial margin model once a year. As a result, the recalibration of the internal margin models during a market downturn would lead to higher initial margin requirements across the financial industry and the resulting scramble for eligible collateral may exacerbate any market stresses. The Committee therefore recommends that the Prudential Regulators and the CFTC allow covered swaps entities a phase-in period to raise the increased amount of initial margin if an increase is mandated.

B. Divergence from Basel and European standards

1. Material Swaps Exposures Threshold

The Basel and European standards only apply the initial margin rules to non-cleared swaps between covered swaps entities and financial end-users that have total "material swaps exposure" exceeding $11 billion.[43] As noted earlier, the Proposed Rules instead define "material swaps exposures" as total swaps exposure exceeding only $3 billion,[44] thereby expanding the class of U.S. financial end-users that are subject to the initial margin rules. However, the Basel standards, European standards, as well as the Proposed Rules do not require these entities to actually exchange initial margin collateral until their non-cleared swaps exposures to one another would necessitate $65 million in initial margin.[45] As noted earlier, this is referred to as the "minimum collection amount."

The Proposed Rules diverge from international standards, because an analysis by the Prudential Regulators and the CFTC found that financial end-users with total "material swaps exposures" exceeding $3 billion and less than $11 billion would, on average, be required to post more than the $65 million "minimum collection amount."[46] The Prudential Regulators and CFTC reasoned that the Basel Committee intended the "material swaps exposure" threshold to be

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[42] *Id.*

[43] European Banking Authority, *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012* 1, 12 (April 14, 2014), *available at* http://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+(CP+on+risk+mitigation+for+OTC+derivatives).pdf.

[44] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57357 (proposed September 24, 2014).

[45] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57354 (proposed September 24, 2014); European Banking Authority, *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012* 1, 8 (April 14, 2014), *available at* http://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+(CP+on+risk+mitigation+for+OTC+derivatives).pdf.

[46] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57366 (proposed September 24, 2014).

aligned with the "minimum collection amount" threshold, so they lowered the $11 billion "material swaps exposures" threshold to $3 billion.[47] However, the Prudential Regulators and CFTC have in fact adopted an approach inconsistent with the Basel Committee's standards, which do not reflect the intent to align these thresholds.

The "material swaps exposure" threshold ensures that financial end-users with minimal *total* swaps exposures do not bear the incremental costs associated with posting initial margin. For example, a financial end-user, like an investment company or insurance company, that uses only $6 billion in non-cleared interest rate swaps to hedge interest rate risk does not comprise a meaningful proportion of the total non-cleared swaps market and thus its hedging costs should not be increased by a minimum initial margin requirement. Thus, the Basel Committee thought that the $11 billion threshold (not the proposed U.S $3 billion threshold) was the right threshold for imposing initial margin requirements.

As a separate matter, the "minimum collection amount" threshold ensures that initial margin is only exchanged for large exposures between counterparties. For example, two large swaps dealers are not required to exchange initial margin until their exposures to one another exceed the level where the failure of one entity could deplete the capital of the other entity by this specified amount. Thus, given the materially different motivation behind each threshold, the Basel standards reflect no need to align them; one exempts financial end-users with minimal *total* swaps exposure and the other exempts small exposures between two covered swaps entities.

The Committee recommends that the Prudential Regulators and CFTC revise the "material swaps exposures" threshold of $3 billion, so that it is consistent with the Basel and European requirements of $11 billion. Otherwise, U.S. financial entities that seek to use non-cleared swaps to hedge financial risks will have increased hedging costs and be at a competitive disadvantage to foreign financial entities. Furthermore, the Committee recommends that the Prudential Regulators and the CFTC clarify that the "minimum collection amount" threshold applies separately to each distinct investment fund, instead of aggregating exposures across multiple funds managed by the same investment adviser. This would be consistent with the Basel Committee standards.

2. Collateral Requirements

According to the Basel standards, initial margin collateral that has been posted to a covered swaps entity may be re-pledged if applicable insolvency law gives a financial end-user protection from risk of loss of initial margin in the case that the covered third party becomes insolvent.[48] If such protections exist, and a financial end-user consents to having its initial margin reused, then a covered swap entity may re-hypothecate, re-pledge, or reuse initial margin provided by a financial end-user one time to hedge the covered swap entities exposure to the financial end user.[49] On the contrary, the Proposed Rules do not permit initial margin to be re-hypothecated, re-pledged, or reused.[50]

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[47] *Id.*

[48] Basel Committee on Banking Supervision, *Margin Requirements for Non-centrally cleared derivatives* 1 (September 2013).

[49] *Id.* at 18.

[50] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57355 (proposed September 24, 2014).

The reuse of initial margin collateral can efficiently reduce the cost of non-cleared swaps for U.S. financial end-users, because it allows covered swaps entities to hedge their exposures. For example, a covered swap entity *selling* non-cleared credit swap protection to a financial counterparty could re-use the initial margin that it receives from that transaction to *buy* non-cleared credit swap protection from another counterparty. Thus, allowing for the reposting of initial margin can reduce the liquidity burden on covered swaps entities of entering into offsetting positions, thereby reducing transaction costs for derivatives users. Moreover, because U.S. bankruptcy laws protect U.S. financial entities in the case of an insolvency of the covered swaps entity, and the collateral may only be re-pledged *once* for hedging purposes, the Basel standards would not expose U.S. financial entities to any undue risk. Therefore, the Committee recommends that the Prudential Regulators and the CFTC revise the Proposed Rules to be consistent with the Basel standards.

The Proposed Rules also diverge in the acceptable types of collateral for variation margin. In defining "eligible assets" for margin purposes, the Basel and European standards do not distinguish between initial and variation margin, thus allowing various types of liquid assets, including government securities, to be posted as variation margin.[51] Instead, the Proposed Rules only permit cash to be posted as variation margin.[52] Similarly, the Basel and European standards would not impose a haircut on cash collateral posted in a different currency,[53] whereas the Proposed Rules implement an 8% haircut on cash collateral in non-U.S. dollars.[54]

The Committee recommends that the Proposed Rules also be aligned with the Basel and European standards in these respects, as the Prudential Regulators and the CFTC have not established a need for more stringent collateral standards on U.S. covered swaps entities and financial entities. These more stringent requirements would further increase the cost of hedging for U.S. financial entities, like insurance companies and pension funds, which would be required to hold investments in cash with no return, putting them at a competitive disadvantage to their foreign counterparts.

C. Cross-Border Application

In applying its derivatives rules extra-territorially, the Prudential Regulators' Proposed Rule substantially differs from the CFTC's guidance on extra-territoriality ("CFTC Guidance").[55] In general, the Prudential Regulators' Proposed Rule imposes an approach that lacks clarity as to the non-cleared swaps transactions that are subject to U.S. laws.

For example, the Prudential Regulators would require foreign swaps dealers that are "controlled" by a U.S. parent to comply with its Proposed Rule without the possibility for

[51] Basel Committee on Banking Supervision, *Margin Requirements for Non-centrally cleared derivatives* 1, 14-15 (September 2013).
[52] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57366 (proposed September 24, 2014).
[53] Basel Committee on Banking Supervision, *Margin Requirements for Non-centrally cleared derivatives* 1, 14-15 (September 2013).
[54] Margin Requirements for Covered Swaps Entities, 79 Fed. Reg. 57348, 57396 (proposed September 24, 2014).
[55] Notice of Interpretive Guidance and Policy Statement, 78 Fed. Reg. 45292, (finalized July 26, 2013)

substituted compliance,[56] however the Prudential Regulators' Proposed Rule provides limited clarity on how this "control" test should be applied. The CFTC Guidance would instead apply a similar approach only if a U.S. parent "guarantees" a foreign subsidiary and sets forth a clear explanation of possible guarantees.[57] The lack of clarity of the Prudential Regulators' Proposed Rule is relevant to foreign bank subsidiaries of U.S. banks, because they cannot be sure whether they are subject to U.S. rules or foreign rules.

Additionally, the Prudential Regulators' Proposed Rule provides limited guidance as to how foreign covered swaps entities can determine whether a counterparty that is a financial end-user is a U.S. entity or a foreign entity—the rules would only apply to swaps with a U.S. entity. On the contrary, the CFTC Guidance uses the clear "U.S. person" standard, which precisely defines which financial end-user counterparties are U.S. entities and which entities are foreign.[58] Due to the lack of clarity of the Prudential Regulators' Proposed Rules, foreign covered swaps entities cannot be sure which non-cleared swaps transactions are subject to U.S. laws and neither could their counterparties. For example, an investment company based in the Cayman Islands with U.S. investors that enters into a non-cleared swap with a foreign covered swap entity cannot be sure whether it would be subject to U.S. laws.

These divergences between the Prudential Regulators' Proposed Rule and the CFTC Guidance, regarding the cross-border application of margin for non-cleared swaps, are inconsistent with the Dodd-Frank requirement that the Prudential Regulators and the CFTC align their margin rules as much as possible. The Committee therefore recommends that the Prudential Regulators revise their Proposed Rule to be consistent with the CFTC Guidance in the abovementioned respects.

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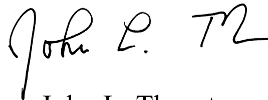
Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Prof. Hal S. Scott (hscott@law.harvard.edu); its Executive Director of Research, Brian Johnson (bjohnson@capmktsreg.org); or John Gulliver, Senior Fellow (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,



R. Glenn Hubbard
CO-CHAIR

John L. Thornton
CO-CHAIR

Hal S. Scott
DIRECTOR

[56] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 57363 (proposed October 3, 2014).
[57] *Id.* at 57371.
[58] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59916 (proposed October 3, 2014).