From: Bill Harrington
Sent: Thursday, December 04, 2014 2:59 PM
To: StasnyM@sec.gov; OrolH@sec.gov; SprattM@sec.gov; Stuart Feldstein; Feldman, Robert; mardockb@fca.gov; Robert.Frierson@frb.org; Alfred.Pollard@fhfa.gov; ckirkpatrick@cftc.gov
Cc: Richard.Johns@sfindustry.org; Sairah.Burki@sfindustry.org; Bill Harrington
Subject: SFIG/Flip Clauses/Exempting ABS Issuers from Posting Margin

Dear All:

The structured finance industry continues to paint itself into a corner with respect to unenforceable, walkaway flip clauses. Flip clauses ratchet up systemic risk and make future bail-outs more likely. Flip clauses are indefensible from a legal standpoint, from a risk management standpoint, and from a corporate governance standpoint. A simple solution is to require structured finance issuers to post full margin against uncleared swap contracts.

As example of the industry clinging to flip clauses, please see the attached November 24, 2014 letter to the CFTC and Prudential Regulators from the Structured Finance Industry Group (SFIG). This letter lists a set of rationales to support the SFIG lobbying position that structured finance issuers should not post margin against uncleared swap contracts with unenforceable, walkaway flip clauses.

This SFIG letter may also be accessed from the following link.
http://www.sfindustry.org/images/uploads/pdfs/SFIG_Comment_Letter_Margin_Requirements.pdf

Please note footnote 11, p. 8 on unenforceable, walkaway flip clauses.
"We note that termination payments typically remain no lower in priority than the interest of the senior most class of debt interests so long as the swap provider is not the defaulting party. It is standard market practice to include contractual provisions that provide that should the swap provider be the defaulting party to a swap, such default causes the swap provider to “flip” to a more junior position in the priority of payments. The inclusion of such a flip clause is consistent with requirements imposed by investors and rating agencies, who mandate that a defaulting party should not be permitted to maintain its senior position in the waterfall. We believe that the inclusion of a flip clause should not preclude a financial end user from meeting the requirement set forth in criteria No. 2."

The inaccuracies in this footnote are too many to list here. Instead, I suggest that the SEC Office of Structured Finance set up a meeting with SFIG, the CFTC, the Prudential Regulators, other interested parties, and me to dissect the systemic risks that accumulate under uncleared swap contracts with unenforceable, walkaway flip clauses and no margin posting.

Unenforceable, walkaway flip clauses were a prime focus of my December 2, 2014 discussion with Mike Spratt and Allison Lee (counsels to SEC Commissioner Kara Stein), Harriet Orol of the SEC Office of Credit Ratings, and Michelle Stasny of the SEC Office of Structured Finance. Details of this meeting available are at http://www.sec.gov/comments/s7-08-10/s70810-310.pdf.

Best regards,

Bill Harrington

November 24, 2014

Legislative and Regulatory Activities Division Office of the Comptroller of the Currency 400 7th Street, SW Suite 3E-218 Mail Stop 9W-11 Washington, DC 20219	Robert deV. Frierson, Secretary Board of Governors of the Federal Reserve System 20th Street and Constitution Avenue, NW Washington, DC 20551
Robert E. Feldman Executive Secretary Attention: Comments Federal Deposit Insurance Corporation 550 17th Street, NW Washington, DC 20429	Alfred M. Pollard General Counsel Attention: Comments/RIN 2590-AA45 Federal Housing Finance Agency Constitution Center (OGC Eighth Floor) 400 7th Street, SW Washington, DC 20024
Barry F. Mardock Deputy Director, Office of Regulatory Policy Farm Credit Administration 1501 Farm Credit Drive McLean, VA 22102	Christopher Kirkpatrick Secretary of the Commission Commodity Futures Trading Commission Three Lafayette Centre 1155 21st Street, NW Washington, DC 20581

Re: Proposed Rules re: Margin and Capital Requirements for Covered Swap Entities (OCC Docket ID OCC-2011-0008, Federal Reserve Docket No. R-1415 and RIN 7100 AD74, FDIC RIN 3064-AE21, FHFA RIN 2590-AA45) and Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (CFTC RIN 3038-AC97)

Ladies and Gentlemen:

The Structured Finance Industry Group ("SFIG")[1] submits this letter to the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve

[1] Structured Finance Industry Group, Inc. is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary

System (the "FRB"), the Federal Deposit Insurance Corporation (the "FDIC"), the Farm Credit Administration (the "FCA") and the Federal Housing Finance Agency (the "FHFA" and together with the OCC, the FRB, the FDIC, and the FCA, collectively, the "Prudential Regulators") and the Commission (the "Commission").

On September 3, 2014, the Prudential Regulators proposed margin and capital requirements applicable to covered swap entities subject to their jurisdiction (the "Prudential Regulators' Proposed Rule").[2] On September 23, 2014, the Commission issued a proposed rule to establish minimum initial and variation margin collection requirements for uncleared swaps entered into by swap dealers and major swap participants regulated by the Commission (the "CFTC Proposed Rule" and together with the Prudential Regulators' Proposed Rule, the "Proposed Rules").[3] For purposes of this discussion, all entities regulated by the Prudential Regulators or the Commission and subject to the Proposed Rules will be referred to as "Covered Swap Entities."

We previously submitted a comment letter to the Prudential Regulators and the Commission on the margin requirements for uncleared swaps on June 27, 2014.[4] That letter presented the position that securitization Special Purpose Vehicles (hereafter "SPVs") should have the opportunity to qualify as "low risk financial end users" to the extent that they satisfy a set of reasonable and well-developed criteria appropriately suited to assessing the risk characteristics of such SPV. At this time, we propose, and explain the rationale for, a specific set of such criteria and highlight the significant challenges the securitization industry would face if the Prudential Regulators' and Commission's final rules require securitization SPVs to post variation margin for uncleared swaps.[5] A requirement for securitization SPVs (defined herein)

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changes, be an advocate for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.

2 Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 185, 57348 (September 24, 2014) (to be codified at 12 C.F.R. pts. 45, 237, 349, 1221).

3 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 192, 59898 (October 3, 2014) (to be codified at 17 C.F.R. pts. 23, 140).

4 Comment Letter on Margin Requirements for Uncleared Swaps, Structured Finance Industry Group (June 27, 2014). http://www.sfindustry.org/images/uploads/pdfs/Treatment%20of%20ABS%20Issuers%20as%20Low-Risk%20Financial%20End%20Users.pdf.

5 *See* Margin and Capital Requirements, *supra* note 2 at 57390. *See also* Margin Requirements for Uncleared Swaps, *supra* note 3 at 59926-27.

Financial end user means

(1) A counterparty that is not a swap entity and that is:

(i) A bank holding company or an affiliate thereof; a savings and loan holding company; or a nonbank financial institution supervised by the Board of Governors of the Federal Reserve System under Title I of the Dodd-Frank Act (12 U.S.C. 5323);

(ii) A depository institution; a foreign bank; a Federal credit union or State credit union as

to post cash variation margin on a daily basis is unnecessary because the substantial over-collateralization and priority payment requirements mandated by investors already sufficiently insulate Covered Swap Entities from counterparty credit risk. It is impossible or impracticable for the vast majority of securitization SPVs to exchange margin. Subjecting securitization SPVs to margin requirements would severely restrict the feasibility of securitization transactions to hedge interest rate risk and currency risk. Consequently the proposed margin requirements would increase risk to investors who may have to retain unhedged risk. If investors are unable or unwilling to assume such additional risk, the Proposed Rules would reduce the feasibility of securitizations as a funding option for a variety of asset classes that are critical to the real economy.

BACKGROUND

An asset-backed issuer is generally structured as a bankruptcy remote SPV established solely to finance a specific pool of assets through the issuance of securities. The SPV is a

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defined in section 2 of the Federal Credit Union Act (12 U.S.C. 1752(1) and (6)); an institution that functions solely in a trust or fiduciary capacity as described in section 2(c)(2)(D) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(D)); an industrial loan company, an industrial bank, or other similar institution described in section 2(c)(2)(H) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(H));

(iii) An entity that is state-licensed or registered as:

A) A credit or lending entity, including a finance company; money lender; installment lender; consumer lender or lending company; mortgage lender, broker, or bank; motor vehicle title pledge lender; payday or deferred deposit lender; premium finance company; commercial finance or lending company; or commercial mortgage company; except entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers;

(B) A money services business, including a check casher; money transmitter; currency dealer or exchange; or money order or traveler's check issuer;

(iv) A regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)) and any entity for which the Federal Housing Finance Agency or its successor is the primary federal regulator;

(v) Any institution chartered and regulated by the Farm Credit Administration in accordance with the Farm Credit Act of 1971, as amended, 12 U.S.C. 2001 et seq.;

(vi) A securities holding company; a broker or dealer; an investment adviser as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)); an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.).

(vii) A private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80–b– 2(a)); an entity that would be an investment company under section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3) but for section 3(c)(5)(C); or an entity that is deemed not to be an investment company under section 3 of the Investment Company Act of 1940 pursuant to Investment Company Act Rule 3a–7 of the Securities and Exchange Commission (17 CFR 270.3a–7);

(viii) A commodity pool, a commodity pool operator, a commodity trading advisor, or a futures commission merchant;

(ix) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002);

(x) An entity that is organized as an insurance company, primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies, or is subject to supervision as such by a State insurance regulator or foreign insurance regulator;

(xi) An entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets;

(xii) An entity that would be a financial end user described in paragraph (1) of this section, if it were organized under the laws of the United States or any State thereof; or

(xiii) Notwithstanding paragraph (2) below, any other entity that [Agency] has determined should be treated as a financial end user.

distinct legal entity, legally isolated from the sponsor or originator that created it, and operated in accordance with organizational documents and transaction documents that strictly limit its permitted activities as well as the types of liabilities the SPV may incur.

Assets are transferred from the originator of the securitization in a "true sale" to the SPV, and are no longer property of the originator or available to satisfy creditor claims against the originator, including in an insolvency proceeding of the originator.[6] SPVs commonly undertake contractual covenants designed to maximize the likelihood that they would not be substantively consolidated with the estate of the originator in an insolvency proceeding of the originator. These structural safeguards are intended to legally isolate the assets of the SPV from those of the originator and its creditors, giving investors comfort that they are investing in the assets owned by the SPV and not exposing themselves to the general credit risk of the originator.

The structural safeguards that address concerns about bankruptcy risks of a securitization SPV benefit all of the SPV's secured creditors, including, significantly, swap counterparties. The legal isolation of the assets of the SPV coupled with the security interest granted in those assets to swap counterparties means that a Covered Swap Entity that provides a swap to an SPV is protected by its security interest.

Under the Proposed Rules we understand that the majority of securitization SPVs would be captured in the definition of "financial end user."[7] As a result of that categorization, SPVs would be subject to initial margin requirements, should they have a "Material Swaps Exposure,"

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6 We note that whole business securitizations ("WBS") operate somewhat differently than other forms of securitization discussed in this letter. In such transactions, there is no physical transfer of assets to the SPV. Instead, a secured loan structure is used whereby the proceeds of debt issued by the SPV are loaned to a borrower entity and ultimately to the operating company. Cash flows from the operating company are used to pay off the loan from the SPV and the debt held by investors. In such cases the introduction of an SPV to the structure gives investors comfort that an insolvency of the operating company would not lead to a default on the debt, typically resulting in more favorable funding levels than if the operating company were to issue notes directly. Functionally SPVs in WBS operate as corporate end users not "financial end users." We look forward to meeting with the Prudential Regulators and the Commission to discuss the details of WBS in more detail.

7 *See* Margin and Capital Requirements, *supra* note 2 at 57390. For the analogous Commission regulation *See also* Margin Requirements for Uncleared Swaps, *supra* note 3 at 59926-27. We call your attention to the definition of financial end user noting subparts:

> (vii) A private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80–b–2(a)); an entity that would be an investment company under section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3) but for section 3(c)(5)(C); or an entity that is deemed not to be an investment company under section 3 of the Investment Company Act of 1940 pursuant to Investment Company Act Rule 3a–7 of the Securities and Exchange Commission (17 CFR 270.3a–7);
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> (xi) An entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets; and
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> (xiii) Notwithstanding paragraph (2) below, any other entity that [Agency] has determined should be treated as a financial end user.

and would be subject to variation margin requirements applicable to all financial end users, regardless of whether they have a Material Swaps Exposure.[8]

Typically, SPVs make required payments monthly pursuant to an established priority of payments, using collections received on the underlying assets during the previous month. This monthly payment cycle does not allow for intra-month payments such as those proposed for the posting of variation margin. SPVs are not structured, and cannot reasonably or economically be re-structured, to account for the uncertainty of fluctuating daily margin requirements. Any daily variation margin requirement imposed on securitization SPVs would have serious adverse economic consequences on the use of swaps by securitization SPVs, effectively eliminating swaps as a hedging tool for securitization transactions.

A change from present market practice where Covered Swap Entities are secured parties to a scenario where Covered Swap Entities and securitization SPVs become subject to daily cash margin exchanges as set forth in the Proposed Rules can (a) result in less protection for a Covered Swap Entity than it currently enjoys as a secured party who is significantly over-collateralized (as more specifically set forth in Section II hereto) as well as being entitled to payments at a senior level in the payment waterfall and (b) present a number of significant structural challenges, which our membership believes cannot be reasonably or practically overcome, resulting in a significant reduction of the securitization market and, in certain cases, the unavailability of securitization as a funding source.

Preserving the ability of securitization SPVs to enter into swaps is of significant importance to the securitization industry and by extension the larger consumer economy. A significant proportion of securitization transactions require swaps to make them viable investments that investors will purchase.[9] In securitization transactions that are not rated by any rating agency, lenders and investors frequently utilize protective "hedge covenants" which require the SPV to hedge imbedded market risk for the benefit of the debt interest holder. The inability of the SPV to enter into hedges would result in either no deal being consummated because investors and lenders could not take such risk, or would lead to the imposition of such excessive overcollateralization requirements that the transaction would become economically unworkable for the party seeking funding. In rated securitization transactions, rating agencies frequently require hedges to manage rate and/or currency risk. The absence of these hedges

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8 *See* Margin and Capital Requirements, *supra* note 2 at 57391. Material swaps exposure as defined in § .2 means that an entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds $3 billion, where such amount is calculated only for business days. For the analogous Commission regulation *See also* Margin Requirements for Uncleared Swaps, *supra* note 3 at 59927.

9 The experience of our dealer members suggests that in a typical securitization of fixed rate assets, if the pre-payable interest rate risk could not be hedged with a swap, investor demand would diminish significantly or not exist. Additionally, if the debt issued by the securitization is rated, the absence of a swap to temper the embedded market risk would result in no or significantly reduced ratings, again resulting in significantly diminished or no investor demand.

would likely result in significantly reduced ratings (or the inability to obtain a rating at all), which would lead to weakened or no investor demand for certain securitization debt interests.

Swaps allow a securitization SPV to reduce interest rate and/or currency risk associated with the underlying asset. Securitization as a source of financing is critical to the "real economy" and impediments on the ability of asset-backed issuers to use swaps would inhibit the key role that securitization transactions play in providing needed credit. Regulations which impede the ability of securitization issuers to continue to use swaps can reduce the availability or increase costs of consumer and commercial funding in core segments of the economy, such as mortgage finance, vehicle finance, equipment finance, student loans and credit cards.

I. OBTAINING FUNDING FOR MARGIN CALLS IS NOT PRACTICALLY OR ECONOMICALLY FEASIBLE FOR SECURITIZATION TRANSACTIONS.

The bankruptcy remote nature of SPVs would make complying with requirements for daily posting of cash variation margin impracticable. Securitization SPVs are generally passive entities that are severely restricted in the types of activities in which they can engage under their organizational documents. This passivity is by design, to limit creditors of the SPV and protect the assets owned by the SPV in the case of the bankruptcy of the originator or sponsor of the securitization. The swap provider is protected by restrictions that prohibit the SPV from incurring other debt. This prohibition, however, would make it difficult for SPVs should they need to obtain additional funds to post variation margin on an ongoing basis.

In addition, significant structural changes would be necessary for securitization SPVs to post variation margin, changes that would in many cases make securitization an unattractive source of financing. Presently securitization SPVs do not have the operational capacity to calculate or collect variation margin. Operational models for calculating the SPV's daily margin position would be needed and additional costs would be incurred in calculating, tracking, making and accepting margin payments and ensuring that adequate funds remain in the SPV to make such payments on an ongoing basis. Current securitization market practice does not include the securitization SPV, its trustee, or any other designated transaction participant performing such functions. Any such requirement would involve an increase in the scope of the trustee's role (or alternatively, the need to engage a separate "margin calculation agent") and related increase in transaction costs.

In order to comply with the margin requirements contained in the Proposed Rules, securitization SPVs would need to fund variation margin requirements in one of two ways: either through a committed loan facility or from the SPV's cash reserves. Each of these alternatives presents significant issues.

(i) A committed loan facility would likely require the SPV to incur additional funding costs that would need to be repaid ahead of other SPV creditors, including debtholders. In order to provide for the funding of margin by a bank, additional structuring, costs and significant changes to existing securitization program documentation would need to take place. To the extent margin requirements would be funded by a bank there would be challenges involved in integrating the funding bank into the securitization structure. In the case of a rated

transaction, the funding bank would need to meet rating agency criteria. In the case of an unrated transaction, the funding bank would still need to meet credit criteria required to mitigate counterparty credit risk.

It is significant to note that to the extent the bank or other legal entity providing margin funding is also a Covered Swap Entity, the Proposed Regulations could increase systemic risk rather than reduce it. For example, if one bank acts as swap provider and another bank provides a committed loan facility to the SPV in order for that SPV to meet its mandated margin calls, the economic risk for the payment of variation margin would simply be re-assumed by a different Covered Swap Entity, resulting in more systemic risk rather than less, since the funding bank would be exposed to the credit risk of the SPV and the swap counterparty bank would be exposed to the credit risk of the funding bank.

(ii) The need for an SPV to establish a cash reserve account, funded with an upfront contribution and from monthly cash flows generated by the SPV's assets in order to post variation margin is also an impractical means for securitization SPVs to meet their variation margin requirements. Requiring SPVs to hold large amounts of cash reserves to use as their source for posting variation margin requirements would make securitization an expensive and therefore economically unattractive financing option for many current and would-be asset-backed issuers.

II. SWAP PROVIDERS ARE SENIOR, SECURED PARTIES IN SECURITIZATION STRUCTURES. AS A RESULT, SWAPS WITH SPVS POSE MINIMAL SYSTEMIC RISK AND CAN PROVIDE GREATER PROTECTIONS FOR COVERED SWAP ENTITIES THAN THE PROPOSED RULES.

In most securitization transactions, all of the assets of the SPV are pledged to a third-party trustee that maintains its security interest in those assets on behalf of all secured parties to which the SPV owes an obligation, including swap counterparties. This security interest ranks above (or at least *pari passu* with) the interest of the most senior class of debt interests issued in the securitization transaction. The pool of collateral owned by the SPV includes both the securitized financial assets as well as cash collected on those assets. Consequently, in a typical securitization structure the Covered Swap Entity will be secured by a greater monetary value of collateral than that represented by the cash that the SPV would be required to post to a Covered Swap Entity under the Proposed Rules.

Securitization SPVs that grant a security interest in the entire pool of assets they own to secured parties, including swap providers, already accomplish something substantially similar to the collateral "segregation" requirements that the Prudential Regulators and the Commission are seeking to impose via the use of third party custodians to hold initial margin.[10] SFIG believes

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10 Note that the Proposed Rules do not require segregation of variation margin and permit re-hypothecation of variation margin. *See* Margin and Capital Requirements, *supra* note 2 at 57373. For the analogous Commission regulation *See also* Margin Requirements for Uncleared Swaps, *supra* note 3 at 59914, 59920 (noting that "segregation of initial margin would be mandatory under certain circumstances" and later that "[i]nitial margin is required to be held at third-party custodians with no rehypothecation" without addressing similar requirements for variation margin.)

that existing market practices with respect to swaps with securitization SPVs provide substantial and sufficient protections for Covered Swap Entities and align with the Prudential Regulators' and the Commission's policy objectives of ensuring that swap counterparties are able to meet their obligations under the terms of the swaps they enter into thereby limiting systemic risk.

Structural safeguards under existing market practice for securitization swaps provide substantial and sufficient protections for Covered Swap Entities. In securitization transactions, Covered Swap Entities are secured and over-collateralized by the assets owned by the SPV. In a typical securitization, if the SPV does not have cash available to make a payment owing to the Covered Swap Entity, an event of default occurs and the Covered Swap Entity, as a secured party, would receive the proceeds from the entire pool of collateral owned by the SPV at a senior level of priority up to the full amount of their exposure. As a result, Covered Swap Entities that are secured by the assets of the SPV generally bear a low risk of non-payment.

By way of example, the experience of SFIG's membership informs us that in the case of a sample interest rate transaction with the following characteristics:

- $100,000,000 notional interest rate swap;
- five year bullet maturity;
- the SPV pays a fixed rate of interest semi-annually; and
- the Covered Swap Entity makes a quarterly payment based on 3 month LIBOR.

The mark-to-market exposure, calculated to two standard deviations from the mean (covering 95.45% of outcomes), would result in a maximum exposure for the Covered Swap Entity equivalent to 5% of the notional value, or $5,000,000. This maximum exposure is significantly less than the value of the collateral pledged to the Covered Swap Entity in support of such transaction, the value of which would equal at least $100,000,000, and in most cases significantly more. In this case, assuming the value of the underlying collateral is at least equal to $100,000,000, the Covered Swap Entity would be twenty times over-collateralized by the assets that are owned by and legally isolated to the SPV.

SFIG believes that the following structural protections align with the Prudential Regulators' and the Commission's objective to limit systemic risk, while preserving the ability of securitization SPVs to enter into swaps. SFIG respectfully requests that the Prudential Regulators and the Commission incorporate in their final rules a provision that states that swaps with financial end users that meet the following criteria at the time such swap is executed be exempt from the requirement to post initial margin and daily cash variation margin:

1. The Covered Swap Entity is secured in the collateral owned by the financial end user, or otherwise has a direct ownership interest in such collateral;
2. Swap payments owed to the Covered Swap Entity are at least *pari passu* with the interest of the senior most class of debt issued by the financial end user;[11]

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11 We note that termination payments typically remain no lower in priority than the interest of the senior most class of debt interests so long as the swap provider is not the defaulting party. It is standard market practice to include contractual provisions that provide that should the swap provider be the defaulting party to a

3. The transaction to which the swap relates is secured by collateral the value of which equals or exceeds the principal amount of outstanding debt issued by such financial end user;

4. Contractual covenants and/or default triggers exist to maintain such collateralization levels over the life of the swap transaction; and

5. The notional amount of the swap is less than or equal to 110% of the outstanding principal amount of the debt issued by such financial end user.

III. THERE IS A SIGNIFICANT POTENTIAL FOR U.S. SECURITIZATION TRANSACTIONS TO BE AT A COMPETITIVE DISADVANTAGE DUE TO SUBSTANTIAL DIFFERENCES IN THE PROPOSED RULES AND THE EU APPROACH.

On April 14, 2014 the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority jointly published their first draft regulatory technical standards ("RTS"), on risk-mitigation techniques for over the counter derivatives contracts that are not cleared by a central clearing counterparty under Article 11(15) of the European Market Infrastructure Regulation ("EMIR").[12] Under the proposed RTS, certain counterparties will not have to comply with all of the margin requirements set out in the RTS. Most significantly, securitization vehicles will most often be defined as "NFC-" entities; that is, as non-financial counterparties that fall below the clearing threshold of €3 billion in gross notional value for interest rate derivative contracts and foreign exchange derivative contracts. As a result of their characterization as "NFC-" vehicles, securitization SPVs will not be required to exchange initial or variation margin, but rather the decision whether to exchange margin can be negotiated by the parties to the swap.[13]

Under the proposed RTS, covered swap entities subject to EMIR will have the ability to negotiate and, based on the particular facts and circumstances of a transaction, may utilize discretion to decide whether or not they will require an "NFC- " entity to exchange initial or variation margin. The Proposed Rules do not provide U.S. Covered Swap Entities this type of flexibility when transacting with financial end users, regardless of the amounts and types of collateral that have been pledged in support of the swap payments or the priority of such swap payments in the payment waterfall. This substantial difference in approach between the

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swap, such default causes the swap provider to "flip" to a more junior position in the priority of payments. The inclusion of such a flip clause is consistent with requirements imposed by investors and rating agencies, who mandate that a defaulting party should not be permitted to maintain its senior position in the waterfall. We believe that the inclusion of a flip clause should not preclude a financial end user from meeting the requirement set forth in criteria No. 2.

12 https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf

13 See Note 11, Chapter 1, Article 2, Section 4(b).

proposed RTS and the Proposed Rules would put U.S. securitization SPVs at a competitive disadvantage relative to their European peers.

IV. CONCLUSION

If securitization SPVs, as financial end users, become subject to variation margin requirements of the type proposed by the Prudential Regulators and the Commission, the negative consequences for securitization would be significant. On the other hand, the impact of not requiring margin would not result in any significant increase in systemic risk posed by SPV swaps. A Covered Swap Entity whose swap exposure to a securitization SPV is secured by collateral owned by a bankruptcy remote SPV and benefits from a senior position in the SPV's priority of payments, already enjoys the protection of a greater amount and value of collateral under the vast majority of circumstances than would be the case under the Proposed Rules. Therefore, we respectfully request that the Prudential Regulators and the Commission permit financial end users that meet the criteria outlined in Section II above, to be exempt from the requirements to post initial margin and daily cash variation margin as presently set forth in the Proposed Rules.

Should you wish to discuss any matters addressed in this letter further, please contact me at (202) 524-6301 or richard.johns@sfindustry.org, or Sairah Burki at (202) 524-6302 or sairah.burki@sfindustry.org.

Respectfully submitted,

Richard Johns
Executive Director
Structured Finance Industry Group