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Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Mr. Robert DeV. Frierson
Secretary
Board of Governors of the Federal Reserve
System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Mr. Gary K. Van Meter
Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Re: Margin and Capital Requirements for Covered Swap Entities – Reopening of
Comment Period for Proposed Rulemaking (RIN 2590-AA45; Docket No. R-1415;
RIN 7100 AD74; RIN 3064-AD79; RIN 3052-AC69; Docket No. OCC-2011-0008,
RIN 1557-AD43)

Ladies and Gentlemen:

Better Markets, Inc.¹ appreciates the opportunity to submit additional comment on matters identified in the above-captioned notice of proposed rulemaking (“NOPR”) relating to certain proposed rules (“Proposed Rules”) of the Office of the Comptroller of the Currency, the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, “Agencies”), promulgated pursuant to or in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

INTRODUCTION

The Dodd-Frank Act establishes a comprehensive new regulatory structure governing derivatives transactions and the market participants involved in those transactions, including “swap dealers,” “major swap participants,” “security-based swap dealers,” and “security-based major swap participants” (collectively, “Swap Entities”).² At the core of this regulatory framework is the requirement that all swaps and security-based swaps be subject to strong capital and margin requirements.

As the financial crisis of 2008 clearly demonstrated, uncollateralized derivatives exposures generate risk on multiple levels. They create an atmosphere of uncertainty in which market participants lack confidence in the ability of their counterparties to cover their exposures; they pose a threat to the safety and soundness of individual market participants; and, most important, they contribute to systemic risk by increasing the likelihood that the failure of a single firm with large uncollateralized derivatives exposure will trigger a chain reaction of failures by other large firms.

The sudden liquidity crunch arising from panicked collateral calls at a time of stress in an opaque market can cause firms to fail even when the exposures themselves are not out of the ordinary and, indeed, can be comfortably covered. The problem is compounded by the fact that a failure to require adequate posting of collateral incentivizes reckless risk-taking, meaning that the opaque exposures themselves are likely to be larger in a non-collateralized marketplace than in one with proper margining practices.

The Dodd-Frank Act seeks to protect the financial and economic system from such panics and runs in part by mandating the use of **central counterparty clearing** for many types of derivatives. Central counterparty clearing involves prudent management of risk through the imposition of margin requirements by regulated entities (primarily, derivatives clearing organizations). This clearing framework is intended to help prevent an episode of cascading defaults in derivatives transactions that could threaten the viability of major financial institutions and the interconnected financial markets.

Recognizing that not all derivatives will be cleared, the Dodd-Frank Act charged the Agencies with implementing strong margin and capital requirements for all derivatives exempted from the clearing requirement, whether via the end-user exception or in cases where clearing is not available. Accordingly, the Dodd-Frank Act requires the Agencies to adopt rules imposing capital requirements and requirements for initial and variation margin with respect to the **un-cleared** swaps and security-based swaps (“Covered Swaps”) of Swap Entities subject to prudential regulation by the Agencies (“Covered Swap Entities”).³ In addition, the Dodd-Frank Act requires the Commodity

² Dodd-Frank Act, Sections 731 and 764.

³ *Id.*

Futures Trading Commission and the Securities and Exchange Commission to impose capital and margin requirements for the swaps and security-based swaps transactions entered into by Swap Entities subject to their respective jurisdictions.

As part of the effort to fulfill this statutory mandate, the Agencies issued the Proposed Rules in April 2011. On July 11, 2011, Better Markets submitted a comment letter arguing that the Proposed Rules included “many prudent and well-structured concepts that will undoubtedly reduce the risk posed to the system by un-cleared derivatives.”⁴ However, Better Markets also argued that some key improvements were necessary to ensure that the Proposed Rules would adequately fulfill the statutory mandate to set margin requirements for un-cleared swaps.⁵ Chief among the necessary improvements highlighted by Better Markets is a provision requiring all Covered Swap Entities to post, as well as collect, margin.⁶

In a Federal Register release dated October 2, 2012, the Agencies announced that they were reopening the comment period for the Proposed Rules to give interested persons additional time to analyze them in light of the Consultative Document recently released by the Basel Committee on Banking Supervision (“BCBS”) and the Board of the International Organization of Securities Commissions (“IOSCO”) on the subject of margin requirements for non-centrally-cleared derivatives (“Consultative Document”).⁷ The Consultative Document provides strong support for requiring Covered Swap Entities to post as well as collect margin in un-cleared derivatives transactions.

SUMMARY OF COMMENTS

As discussed in our previous comment letter on the Proposed Rules,⁸ the Agencies must close a large and unwarranted gap by requiring all swap entities not only to **collect** margin from their counterparties in un-cleared swaps transactions, but to **post** it as well. Unless this gap is closed, the Proposed Rules will establish in effect only half of the new margining regime that is truly necessary to establish transparency and limit risk in the derivatives markets.

In this supplemental comment letter, we emphasize the critical importance of ensuring that margin is required on a bi-lateral basis, in all swap transactions, including those involving Covered Swap Entities. In addition, we highlight the strong support for this approach found in the Consultative Document.

⁴ Better Markets Comment Letter “Margin and Capital Requirements for Covered Swap Entities – Notice of Proposed Rulemaking,” July 11, 2011, incorporated by reference as if fully set forth herein, at 2.

⁵ *Id.*

⁶ *Id.*

⁷ Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions, Consultative Document, “Margin Requirements for Non-Centrally-Cleared Derivatives” (July 2012).

⁸ Better Markets Comment Letter “Margin and Capital Requirements for Covered Swap Entities – Notice of Proposed Rulemaking,” July 11, 2011.

COMMENTS

The Proposed Rules deal only with the **collection** of margin by Covered Swap Entities, not the **posting** of margin by them. This omission cannot be reconciled with the statutory language in the Dodd-Frank Act or the rationale for imposing margin requirements. Moreover, the Consultative Document provides direct and strong support for requiring Covered Swap Entities to post as well as collect margin. The Proposed Rules must be amended to close this gap and to impose bi-lateral margin requirements on all Covered Swap Entities.

The Dodd-Frank Act clearly provides that Covered Swap Entities must “meet” margin obligations, without any language suggesting that they should be exempt from this duty.

There is no statutory or other basis for concluding that Congress intended to exempt Covered Swap Entities from the obligation to post margin in un-cleared swaps transactions. On the contrary, the Dodd-Frank Act expressly provides that—

Each registered swap dealer and major swap participant for which there is a prudential regulator **shall meet** such minimum capital requirements **and** minimum initial and variation margin requirements as the prudential regulator **shall** by rule or regulation prescribe.⁹

This language plainly envisions that Covered Swap Entities “shall meet” margin obligations themselves, not simply ensure that other parties comply with margin requirements. The Dodd-Frank Act further requires the prudential regulators to adopt rules “imposing both initial and variation margin requirements on **all** swaps that are not cleared by a registered derivatives clearing organization.”¹⁰ This broad language encompasses all un-cleared swaps without qualification and regardless of the nature of the parties to the swap.

⁹ Dodd-Frank Act § 731, adding 7 U.S.C. § 4s(e)(1)(A) (emphasis added).

¹⁰ Dodd-Frank Act § 731, adding 7 U.S.C. § 4s(e)(2)(A)(ii) (emphasis added).

The Dodd-Frank Act also imposes additional, explicit requirements for the establishment of margin requirements. It states that—

To offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared, the requirements imposed under paragraph (2) [including initial and variation margin requirements] **shall**—

- (i) help ensure the safety and soundness of the swap dealer or major swap participant; and
- (ii) be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.¹¹

The Proposed Rules fail to comply with these statutory requirements. A Covered Swap Entity that does not post margin simply has not adequately capitalized the risks it has taken. The failure to post margin thus undermines the safety and soundness of the Covered Swap Entity itself, not only its counterparty. In short, the risks to Covered Swap Entities **and** the entire financial system are elevated when the Covered Swap Entities fail to post margin.

The provisions of the Dodd-Frank Act relating to margin requirements make very clear that Covered Swap Entities must be required to post as well as collect margin. To do anything less would violate the express and clear provisions of the law.

Baselessly relieving Covered Swap Entities from the legal requirement to post margin would undermine transparency, threaten the safety and soundness of market participants, and increase the threat of systemic risk.

Disregarding the clear legal requirement for bilateral posting of margin by Covered Swap Entities would seriously undermine the core objectives underlying swaps regulation: enhancing transparency, protecting the safety and soundness of market participants, and reducing systemic risk. The reasons for this are obvious: if no more than unilateral posting of margin is required, only half of the concealed credit risk embedded in derivatives will be addressed. Counterparties will continue to extend unseen credit in uncertain amounts to Covered Swap Entities. Market participants will remain in the dark as to the extent of the exposures of Covered Swap Entities. In a stressed market condition, this could be sufficient to trigger a run on these market participants similar to or worse than the one we witnessed in 2008.¹²

¹¹ Dodd-Frank Act § 731, adding 7 U.S.C. § 4s(e)(3)(A)(i) and (ii) (emphasis added).

¹² The importance of limiting such systemic risks through the imposition of bi-lateral margin requirements and related reforms governing the derivatives markets cannot be overstated. Better Markets estimates that the 2008 near collapse of the financial system and the economic crisis it caused

If the Proposed Rules are finalized without the changes required by the law, the true cost and risk of derivatives will remain substantially in the shadows. Incentives will be distorted. An opportunity to achieve a transparent system in which risks can no longer accumulate unseen to dangerous levels—one of the goals stated by the Agencies—will have been lost.¹³

On the other hand, bilateral posting of margin would ensure that any counterparties dealing with a Covered Swap Entity would be aware that the entity's swap exposures were adequately collateralized. Therefore, even if prices were to move sharply against the Covered Swap Entity, it would need only to cover the additional losses accrued since the last posting of margin, rather than the entire loss measured from the inception of the swap. Without bilateral posting, counterparties would lack this important reason to trust the creditworthiness of Covered Swap Entities in a stressed market.¹⁴ Thus, market participants would lack the critical information required to avoid panics and runs.

The NOPR only addresses the advantages of requiring Covered Swap Entities to collect margin, and it fails to address the need for these market participants to post margin as well. It explains why the **collection** of margin by Covered Swap Entities is important, with these observations:

This approach, which emphasizes the collection rather than the posting of margin, is based primarily on the Agencies' preliminary view that imposing requirements with respect to the minimum amount of margin to be collected (but not posted) is a critical aspect of offsetting the greater risk to the covered swap entity and the financial system arising from the covered swap entity's holdings of swaps and security-based swaps that are not cleared and helps ensure the safety and soundness of the covered swap entity.

will cost at least \$12.8 trillion in lost or avoided-lost GDP through 2018. Any failure to maximize risk controls through fully bi-lateral margin requirements not only ignores Congress's mandate, it also courts financial and economic disaster all over again. See Better Markets, *The Cost of The Wall Street-Caused Financial Collapse And Ongoing Economic Crisis is More Than \$12.8 Trillion* (Sept. 15, 2012), available at http://bettermarkets.com/sites/default/files/Cost%20of%20The%20Crisis_0.pdf.

¹³ "During the financial crisis, the opacity of derivatives transactions among dealer banks and between dealer banks and their counterparties created uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty." NOPR, 76 FR at page 27567.

¹⁴ There is clearly no practical impediment or obstacle to requiring Covered Swap Entities to post margin, as evidenced by the Proposed Rules. The Proposed Rules clearly provide that Covered Swap Entities **will** be required to post margin, but only when they enter un-cleared swap transactions with other Covered Swap Entities. *Id.*

However, the NOPR completely fails to explain or justify the unstated decision that the **posting** of margin by Covered Swap Entities is not “critical” to protecting the safety and soundness of Covered Swap Entities and limiting risk to the entire financial system.

The only way to adequately achieve the transparency and risk mitigation objectives of the Dodd-Frank Act is to require Covered Swap Entities to post margin in un-cleared swap transactions. That is why the Dodd-Frank Act itself requires it and why the Proposed Rules must be changed to require it as well.

Requiring Covered Swap Entities to collect but not post margin would discourage central clearing.

As suggested in the NOPR, if Covered Swap Entities are not required to post margin for un-cleared swaps, they will have an incentive to continue to use un-cleared swaps and to structure their transactions so that they can avoid central clearing whenever possible. To the extent central clearing entails the posting of margin while un-cleared transactions do not, market participants will seek to avoid the former in favor of the latter.

Question 31 in the NOPR frames the point well:

Would requiring a covered swap entity to post initial margin to end-user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging initial margin?¹⁵

The answer to this question is emphatically “yes.” One of the central goals of the Dodd-Frank Act is to maximize central clearing of derivatives transactions to enhance transparency, competition, risk mitigation, and standards of business conduct. Instituting a unilateral approach to margin by Covered Swap Entities will discourage central clearing and undermine all of these Congressional objectives.

The Consultative Document strongly supports imposition of bi-lateral margin requirements on Covered Swap Entities.

The Consultative Document clearly supports the institution of a bi-lateral system of margin for Covered Swap Entities. In the “Key Principle” relating to “Scope of Coverage,” the Consultative Document states that “All [covered entities] that engage in non-centrally-cleared derivatives must **exchange** initial and variation margin as appropriate to the risks posed by such transactions.”¹⁶ The “Proposed Requirement”

¹⁵ NOPR, 76 Fed. Reg. at 27575.

¹⁶ Consultative Document at 14 (emphasis added).

similarly provides that “All covered entities that engage in non-centrally-cleared derivatives must **exchange, on a bilateral basis**, initial and variation margin in mandatory minimum amounts.”¹⁷

The document makes clear that this approach was widely endorsed by the members of BCBS and IOSCO: “There was **broad consensus** within the BCBS and IOSCO that all covered entities engaging in non-centrally-cleared derivatives must exchange initial and variation margin.”¹⁸ Elsewhere, the Consultative Document states that “[A] **majority of the BCBS and IOSCO members** supported margin requirements that, in principle, would involve the mandatory exchange of both initial and variation margins among parties to non-centrally-cleared derivatives (“universal two-way margin”).”¹⁹

The Consultative Document also supports the underlying rationale for a bi-lateral margin system, recognizing that it would help reduce systemic risk and also promote central clearing. For example, in explaining the overarching objectives of margin requirements, the Consultative Document states:

These non-centrally-cleared derivatives, which total hundreds of trillions of dollars of notional amounts, will pose the same type of systemic contagion and spillover risks that materialised in the recent financial crisis. Margin requirements for non-centrally-cleared derivatives would be expected to reduce contagion and spillover effects by ensuring that collateral are available to offset losses caused by the default of a derivatives counterparty...²⁰

Margin requirements on non-centrally-cleared derivatives, by reflecting the generally higher risk associated with these derivatives, will promote central clearing.

The Consultative Document makes an especially strong case for uniformity in the approach to margin as between centrally-cleared and non-centrally-cleared derivatives, explaining that such consistency is necessary to prevent market distortions and regulatory arbitrage—

The central clearing mandate generally applies to all financial entities and systemically important non-financial entities. Ensuring consistency between entities that are subject to the central clearing obligation for standardised derivatives and those entities that are subject to margin requirements for non-centrally-cleared derivatives is desirable because any

¹⁷ *Id.* (emphasis added).

¹⁸ *Id.* at 14 (emphasis added).

¹⁹ *Id.* at 9 (emphasis added).

²⁰ *Id.* at p. 2.

inconsistency may create various market distortions (e.g. by creating preferred counterparties) and could permit regulatory arbitrage.²¹

With respect to requiring the exchange of margin in all transactions, the Consultative Document suggests that such an approach might entail higher “liquidity costs,” but it also reflects a determination that “the policy goals of reducing systemic risk and promoting central clearing” would outweigh any such costs, especially if reasonable thresholds are established.²² Thus, in the carefully considered view of BCBS and IOSCO, the uniform, bi-lateral imposition of margin requirements offers multiple and significant advantages that would outweigh any associated liquidity costs.²³

The Consultative Document thus provides further strong support for imposing bi-lateral margin obligations on all market participants, including Covered Swap Entities.

CONCLUSION

Transparent and orderly rules governing margin and capital in non-cleared derivatives are essential to address the flawed markets that led to the financial crisis. The Agencies have created a reasonable framework to achieve this goal, but the Proposed Rules must be strengthened to comply with the Dodd-Frank Act and to achieve the objectives underlying the law. The BCBS/IOSCO Consultative Document lends further support to the argument that Covered Swap Entities must be required to post, as well as collect, margin on un-cleared swaps.

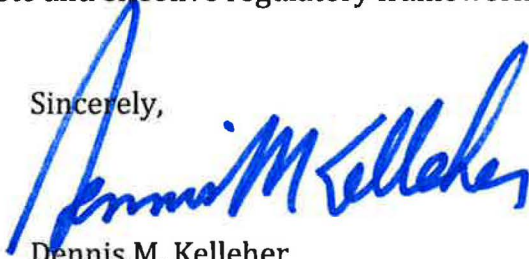
²¹ *Id.* at 9, n. 7.

²² Consultative Report at 14.

²³ Of course, the Agencies are not required to conduct cost-benefit analysis or any comparative weighing of the advantages and disadvantages of the Proposed Rules. In any case, it must be remembered that there would be almost certainly no new net costs arising from bi-lateral margining: the only issues are who pays the costs and when? Does the industry bear the costs prior to a financial crisis or does society pay the costs after the crisis to end it and repair the damage done to the financial and economic system? In short, if any “liquidity costs” were to arise from bi-lateral margining, imposing any such costs on industry is a matter of reallocating them where they belong: on industry to **prevent a crisis**, rather than on taxpayers who invariably bear the cost of cleaning up **after a crisis** has occurred. *See* BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 39-44 (July 30, 2012), *available at* <http://bettermarkets.com/sites/default/files/CBA%20Report.pdf>, incorporated by reference as if fully set forth herein; *see also* Better Markets, The Cost of The Wall Street-Caused Financial Collapse And Ongoing Economic Crisis is More Than \$12.8 Trillion, at 7-8 (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20of%20The%20Crisis_0.pdf.

We hope that our comments are helpful as the Agencies strive to achieve a more complete and effective regulatory framework.

Sincerely,



Dennis M. Kelleher
President & CEO

David Frenk
Research Director

Stephen Hall
Securities Specialist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
dfrenk@bettermarkets.com
shall@bettermarkets.com

www.bettermarkets.com