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(RIN 1557-AD43)

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(RIN 2590-AA45)

Re: *Margin and Capital Requirements for Covered Swap Entities*

Ladies and Gentlemen:

Covington & Burling LLP appreciates the opportunity to submit these comments in response to the reopening and extension of the comment period for margin and capital requirements (the "*Proposed Margin Rules*") for registered swap dealers, major swap participants, securities-based swap dealers and major security-based swap participants (collectively, "*covered swap entities*") proposed by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the "*Prudential Regulators*").[1] These comments are in response to the Prudential Regulators' requests for comment on the consultative document issued by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions regarding margin requirements for non-centrally cleared derivatives (the "*Consultative Document*"),[2] and are focused solely on a specific aspect of the Proposed Margin Rules relating to the "insolvency regime" of the custodian.

We fully recognize that appropriate margin requirements for uncleared swaps are an important part of reducing systemic risk associated with over-the-counter derivatives. In this regard, we support many of the principles reflected in both the Consultative Document and the Proposed Margin Rules. With respect to the Consultative Document, we agree that "[i]nitial margin collected should be held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default, and (ii) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law."[3]

Both the Prudential Regulators and the CFTC (together with the Prudential Regulators, the "*Agencies*") have previously requested comment on the proposed requirement that "[t]he independent custodian [be] located in a jurisdiction that applies the

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1 Margin and Capital Requirements for Covered Swap Entities ("*Proposed Prudential Regulator Margin Rules*"), 76 Fed. Reg. 27,564 (May 11, 2011) (to be codified at 12 C.F.R. pts. 45, 237, 324, 624 & 1221). On October 2, 2012, the Prudential Regulators reopened and extended the comment period for the Proposed Prudential Regulator Margin Rules. *See* Margin and Capital Requirements for Covered Swap Entities; Reopening of Comment Period, 77 Fed. Reg. 60,057 (Oct. 2, 2012). The Commodity Futures Trading Commission (the "*CFTC*") has proposed similar margin requirements for swap dealers and major swap participants subject to its regulation. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants ("*Proposed CFTC Margin Rules*"), 76 Fed. Reg. 23,732 (April 28, 2012) (to be codified at 17 C.F.R. pt. 23). On July 12, 2012, the CFTC reopened and extended the comment period until September 14, 2012 for all aspects of the Proposed CFTC Margin Rules and specifically requested comments on the comparative costs and benefits of the Proposed CFTC Margin Rules and the initial proposals set forth in the Consultative Document. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 41,109 (July 12, 2012). We use the phrase "*Proposed Margin Rules*" to refer generally to the rules proposed by both the Prudential Regulators and the CFTC.

2 Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions, Consultative Document, *Margin Requirements for Non-Centrally-Cleared Derivatives* (July 2012) (issued for comment by Sept. 28, 2012), *available at* http://www.bis.org/publ/bcbs226.pdf.

3 Consultative Document, *supra* note 2, at 25.

same insolvency regime to the custodian as would apply to the covered swap entity."[4] We agree with other market participants that this proposal, which would require the custodian and the covered swap entity to be subject to the same insolvency regime, is unclear, unnecessary, and unworkable in practice, and therefore should not be included in the final margin rules.[5] As we discuss in greater detail below, we note that the Consultative Document does not contain a similar requirement.

Before explaining our concerns with this requirement, we note that Dodd-Frank amended the Commodity Exchange Act (the "CEA") to require a swap dealer or major swap participant to notify each of its counterparties that the counterparty has the right to require any collateral it posts to be held in a segregated account maintained with an independent third-party custodian.[6] While the Proposed Prudential Regulator Margin Rules do not purport to apply the "same insolvency regime" requirement to margin posted by the counterparty, as opposed to margin posted by the covered swap entity, the concerns expressed in this letter would apply equally to any such requirement.[7] Similarly, as proposed, the "same insolvency regime" requirement applies only to initial margin, and not to variation margin. We believe having different custody arrangements for initial and variation margin would introduce additional risk and administrative difficulties.

The requirement is ill-suited to accomplish its stated objective. In its proposal, the CFTC explained that the requirement that the independent custodian be located in a jurisdiction that applies the same insolvency regime to the custodian as to the covered swap entity "would facilitate quicker recovery of margin assets."[8] However, the CFTC did not provide any further information regarding this assertion, the Prudential Regulators provided no justification for the proposal, and we do not believe that the requirement would accomplish the objective of facilitating the return of margin assets to covered swap entities.

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4 *See* Proposed Prudential Regulator Margin Rules, 76 Fed. Reg. at 27,590 (proposed § ___.7(d)); Proposed CFTC Margin Rules, 76 Fed. Reg. at 23,748 (proposed 17 C.F.R. § 23.158(a)(5)). The Prudential Regulators requested comment on this requirement in Question 69(a) of its proposal. The CFTC requested comment on this requirement at page 23,742 of its proposal.

5 *See* Letter from BNY Mellon, Northern Trust Corporation, and State Street Corporation (July 11, 2011); Letter from the Financial Services Roundtable (July 11, 2011); Letter from the Institute of International Bankers (July 11, 2011); Letter from the International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association (July 11, 2011); Letter from J.P. Morgan Chase & Co. (July 11, 2011).

6 *See* 7 U.S.C. § 6s(*l*).

7 As discussed further below, the Proposed CFTC Margin Rules would apply to margin received from a counterparty that is a swap dealer or major swap participant, as well as margin posted by the covered swap entity. *See* Proposed CFTC Margin Rules, 76 Fed. Reg. at 23,748 (proposed 17 C.F.R. § 23.158(a)(3)). Neither Proposed Margin Rules would apply the third-party custodian, or same insolvency regime, requirement to margin collected from a counterparty that is an end user.

8 Proposed CFTC Margin Rules, 76 Fed. Reg. at 23,739.

As market participants have commented, in the event that the independent custodian is insolvent, the return of margin assets would be facilitated by the rules of an insolvency regime that provides protection for the posting covered swap entity.[9] Although one insolvency regime may be more protective than another, it does not follow that an insolvency regime applicable to the independent custodian in the same jurisdiction as the covered swap entity would be more protective than the insolvency regime of another jurisdiction. As others have stated, while the location of the custodian may be significant, the location of the posting covered swap entity would seem to have little relevance to the recovery of margin assets in the case of insolvency. To the extent the goal is to require the custodian's jurisdiction to facilitate the return of margin assets to the covered swap entity, that goal would be better accomplished in other ways, such as by permitting the use of custodians subject to insolvency regimes that are determined to be protective of covered swap entities. And it is by no means clear that recovery is necessarily quicker when the covered swap entity and the custodian are in the same jurisdiction.

Nor do we believe that the proposed requirement is justified by potential cross-border risk in facilitating the return of margin assets to the covered swap entity. Setting aside the issue discussed above regarding whether a particular insolvency regime is protective of margin assets, cross-border risk could arise if a particular jurisdiction's insolvency regime favored local creditors over foreign creditors. Although that may be the case for foreign cash deposits in insolvency regimes in certain jurisdictions (including the United States), as a general matter, in our experience, applicable insolvency regimes do not materially differ in their treatment of local and foreign creditors and customers.

The "same insolvency regime" requirement is unclear and will be unworkable in practice. The law of a single jurisdiction may apply different insolvency rules to different entities, and it is therefore unclear what is intended by the proposal's reference to "a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity." For example, in the United States, the Bankruptcy Code does not apply to certain institutions, including banks.[10] Banks are generally subject instead

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[9] *See* Letter from BNY Mellon, Northern Trust Corporation, and State Street Corporation at 3.

[10] The Bankruptcy Code provides as follows:

> A person may be a debtor under chapter 7 [titled "Liquidation"] of this title only if such person is *not* —
>
> (1) a railroad;
>
> (2) a domestic insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, a New Markets Venture Capital company as defined in section 351 of the Small Business Investment Act of 1958, a small business investment company licensed by the Small Business Administration under section 301 of the Small Business Investment Act of 1958, credit union, or industrial bank or similar institution which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance

(continued...)

to the insolvency scheme set forth in the Federal Deposit Insurance Act.[11] Other entities are also subject to special insolvency regimes or rules. For example, the Employee Retirement Income Security Act ("ERISA") sets forth rules governing insolvent pension plans.[12] Certain pension plans regulated by ERISA may be covered swap entities by virtue of being major swap participants regulated as such by the CFTC. And domestic insurance companies are subject to special state insolvency regimes.

These multiple, potentially applicable insolvency regimes will make it difficult, if not impossible, to identify whether the custodian is subject to the same insolvency regime as the covered swap entity.[13] In this regard, the "orderly liquidation authority" provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") are particularly problematic.[14] These provisions set forth a special insolvency regime for any large, interconnected financial company the failure of which poses a significant risk to the financial stability of the United States. The applicability of these provisions depends, however, on a "systemic risk determination" made at the time the

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> Act, except that an uninsured State member bank, or a corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991 may be a debtor if a petition is filed at the direction of the Board of Governors of the Federal Reserve System; or
>
> (3)
>
> (A) a foreign insurance company, engaged in such business in the United States; or
>
> (B) a foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association, or credit union, that has a branch or agency (as defined in section 1(b) of the International Banking Act of 1978) in the United States.

11 U.S.C. § 109(b) (emphasis added). As for reorganization, as opposed to liquidation, "[o]nly a railroad, a person that may be a debtor under chapter 7 of this title (except a stockbroker or a commodity broker), and an uninsured State member bank, or a corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991 may be a debtor under chapter 11 [titled "Reorganization"] of this title." *Id.* § 109(d).

11 *See* 12 U.S.C. §§ 1811 *et seq.*

12 *See* 29 U.S.C. § 1426 (titled "Insolvent Plans").

13 *See, e.g.*, 2 *Collier on Bankruptcy* ¶ 109.03[3][b] (16th ed. updated 2012) (noting that "[t]here has been a legion of cases" regarding whether a corporation was a bank or similar institution excluded from application of the Bankruptcy Code and "[t]here appear to be no clear rules for determining whether a particular corporation falls within the … exclusions").

14 *See* Pub. L. No. 111-203, Title II, 124 Stat. 1376, 1442-1520 (2010).

financial company "is in default or in danger of default."[15] Accordingly, in many cases, counterparties will not be able to know at the time they negotiate where margin should be held, or at the time they post margin, whether in fact the custodian and the covered swap entity will be subject to the same insolvency regime.

Multiple insolvency regimes will also make compliance with the proposed rule difficult, if not impossible, for other reasons. If the covered swap entity and the custodian must be subject to the same insolvency regime, then a CFTC-regulated covered swap entity could not use a custodian that is a bank, as that entity will be subject to a bank insolvency regime. Such a result is especially a concern because, by barring federal assistance (defined to include access to credit from the Federal Reserve and deposit insurance from the Federal Deposit Insurance Corporation) to swap entities, Dodd-Frank essentially requires banks to "push out" their swap dealing activities to non-bank affiliates, which will in turn be subject to the Bankruptcy Code.[16] By contrast, most, if not all, third-party custodians are banks that are excluded from application of the Bankruptcy Code and subject instead to bank insolvency regimes.[17] In these circumstances, not only would it be difficult to find a custodian subject to the Bankruptcy Code, but selecting a custodian not subject to bank safety and soundness regulation could potentially offer reduced protection to counterparties and the collateral they post as initial margin.

Compliance would also be difficult, if not impossible, in the case of a swap between a covered swap entity that is a bank and a covered swap entity that is not a bank. The Proposed Prudential Regulator Margin Rules, which would govern the bank covered swap entity, require that any initial margin *posted* by the bank covered swap entity be held by an independent third-party custodian subject to the same insolvency regime as the bank covered swap entity.[18] In other words, the Proposed Prudential Regulator Margin Rules would require the covered swap entity subject to those Rules to use a custodian subject to the same bank insolvency regime. By contrast, the Proposed CFTC Margin Rules, which would govern the non-bank covered swap entity, require that any initial margin *collected* by the non-bank covered swap entity be subject to the same insolvency regime as the non-bank covered swap entity.[19] Thus, the Proposed CFTC Margin Rules would require the same

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15 *See id.* § 203, 124 Stat. at 1450-54.

16 *See* Dodd-Frank, Pub. L. No. 111-203, § 716, 124 Stat. at 1648-51.

17 *See also* Letter from J.P. Morgan Chase & Co. at 5.

18 *See* Proposed Prudential Regulator Margin Rules, 76 Fed. Reg. at 27,589 (proposed § ___.7).

19 *See* Proposed CFTC Margin Rules, 76 Fed. Reg. at 23,748 (proposed 17 C.F.R. § 23.158(a)). Proposed Section 23.158(a)(3) states that "[e]ach covered swap entity shall hold initial margin *received from a counterparty* that is a swap dealer or major swap participant at a custodian that is independent of the covered swap entity and of the counterparty" (emphasis added). Proposed Section 23.158(a)(5), in turn, requires "the independent custodian" to "be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity." The Proposed CFTC Margin Rules do not distinguish between the custodian used for margin posted by the covered swap entity and margin collected by the covered swap entity.

initial margin to be held by a custodian subject to the Bankruptcy Code, which would govern the non-bank covered swap entity. Because the same margin could not be held at the same time by both a bank custodian and a non-bank custodian, compliance would be impossible. And, even if the CFTC did not extend the requirement to initial margin collected by the covered swap entity, but rather limited it to initial margin posted by the covered swap entity, the counterparties would be forced to use two different custodians for margin posted or collected for the same trade. Such a result would impose unnecessary costs and administrative difficulties.

In addition to the issues posed by the "same insolvency regime" requirement, the meaning of and justification for the associated proposed "located in a jurisdiction" requirement are unclear. Determining where an entity is "located" is often a complex inquiry that requires consideration of its place of incorporation, the places where it does business and how, and its relationship with parent or affiliated entities that may be incorporated or may do business in other locations or jurisdictions. This analysis would require extensive further guidance from regulators. Depending on how this requirement is interpreted, it would greatly restrict the number of third-party custodians with which a covered swap entity may do business, by limiting available custodians to entities located in the same country or state. Indeed, in some jurisdictions, there will be no suitable third-party custodian, making it impossible to comply with the Proposed Margin Rules.[20] In addition, such a restriction raises questions about inhibiting commerce among states.

We recognize that one possible interpretation of the "same insolvency regime" requirement could be that a U.S. covered swap entity may only hold margin assets at a custodian organized under United States federal law, or the law of one of the states or territories of the United States. The multiple U.S. insolvency regimes identified above will, however, present challenges for this interpretation. Given, for example, that insurance companies are generally subject to state rather than federal insolvency regimes, the Agencies should clarify, at a minimum, that a U.S. covered swap entity will be permitted to use a U.S. custodian subject to insolvency proceedings in any U.S. state or federal court or by any U.S. state or federal agency, regardless of the insolvency regime applicable to the covered swap entity.

The requirement is not compelled by statute and has not been endorsed by other regulators. We note that the "same insolvency regime" requirement is not mandated by the terms of the CEA, as amended by Dodd-Frank. The CEA requires the Agencies to promulgate capital and margin requirements for swap dealers and major swap participants that "(i) help ensure the safety and soundness of the swap dealer or major swap participant; and (ii) [are] appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."[21] For the reasons stated above, we do not believe that the

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20 *See also* Letter from the International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association at 24-25.

21 7 U.S.C. § 6s(e)(3)(A).

"same insolvency regime" requirement would help ensure the safety and soundness of swap entities or be appropriate for the risk associated with uncleared swaps.

In this regard, it should be noted that Dodd-Frank requires the Securities and Exchange Commission (the "SEC") to issue capital and margin requirements for uncleared security-based swaps based on a materially identical standard.[22] The SEC recently proposed its capital and margin requirements for uncleared security-based swaps.[23] Although the SEC required margin to be held with an independent third-party custodian in certain circumstances and even addressed specific issues with respect to the custodian's insolvency regime,[24] it did not propose to require that the custodian be located in a jurisdiction applying the same insolvency regime to the custodian as to the security-based swap dealer or major security-based swap participant. Thus, if the rules proposed by both the Agencies and the SEC were finalized, this requirement would apply to all swap dealers, as well as to all security-based swap dealers and security-based major swap participants regulated by the Prudential Regulators, but not to security-based swap dealers or security-based major swap participants regulated by the SEC. Precisely to avoid such inconsistencies, Dodd-Frank directs the Prudential Regulators, the CFTC, and the SEC to coordinate and harmonize their regulations generally, and specifically with respect to margin, when possible.[25] We respectfully request that the Agencies avoid inconsistent margin requirements, and to that end, we believe that the Agencies, like the SEC, should not implement a "same insolvency regime" requirement.

Similarly, in its discussion of the treatment of proposed margin, the Consultative Document addresses bankruptcy and insolvency concerns. It does so, however, on the basis of the substance of the protections afforded by a given regime to a creditor that is entitled to receive margin from an insolvent counterparty, not on the basis of the comparability of protections as between different regimes or as applied to different entities. In particular, the Consultative Document notes that "collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law."[26] That the Consultative Document identifies insolvency-related concerns, but does not propose a "same insolvency regime"

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22 *See* 15 U.S.C. § 78*o*-10(e)(3)(A).

23 *See* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70,214 (proposed Nov. 23, 2012) (to be codified at 17 C.F.R. pt. 240).

24 *See, e.g., id.* at 70,243 (proposing to require that a netting agreement be "legally enforceable in each relevant jurisdiction, including in insolvency proceedings").

25 *See, e.g.*, Dodd-Frank, Pub. L. No. 111-203, § 712(a), 124 Stat. at 1641 (requiring that the CFTC "shall consult and coordinate to the extent possible with the [SEC] and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible"); *see also* 15 U.S.C. § 78*o*-10(e)(3)(D) (requiring the Prudential Regulators, CFTC, and SEC "to the maximum extent practicable, [to] establish and maintain comparable minimum capital requirements and minimum initial and variation margin requirements").

26 Consultative Document, *supra* note 2, at 25.

requirement, suggests that other countries will not implement a similar requirement. We believe it will be unworkable for the Agencies to impose this requirement unilaterally on United States covered swap entities.

In light of the foregoing, we believe that the "same insolvency regime" requirement in the Proposed Margin Rules is unclear, unnecessary, and unworkable in practice.[27] We appreciate the Agencies' concern that insolvency of the custodian could potentially delay or frustrate recovery of margin assets.[28] We believe this concern is better addressed, however, through flexible guidance permitting covered swap entities to deal with the risk of custodian insolvency, as appropriate, through their risk management policies and practices. We further believe that such an approach would be consistent with the Consultative Document.

Finally, we believe that a custodial requirement focusing on whether a similar insolvency regime standard is met will impair the ability of custody banks to participate, and compete, in a market in which they are currently active participants. Custodians are typically banks and thus subject to prudential regulation. They perform an important role in the custodial markets, with extensive experience protecting the custodial assets of market participants. They are also subject to vigorous competition, both domestically and internationally. As noted above, such a requirement, particularly if adopted globally, will preclude U.S. custody banks from competing for certain aspects of the custody market, to the detriment of the U.S. financial markets generally. We respectfully submit that there has been no cost-benefit analysis of this outcome, and we believe that the costs of such a restraint of trade would far outweigh any possible benefits.

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27 As explained earlier, given that some U.S. entities are generally subject to state rather than federal insolvency regimes, we believe that, at a minimum, the Agencies should clarify that a U.S. covered swap entity will be permitted to use a U.S. custodian subject to insolvency proceedings in any U.S. state or federal court or by any U.S. state or federal agency.

28 *See, e.g.*, Proposed CFTC Margin Rules, 76 Fed. Reg. at 23,739 (noting that "same insolvency regime" requirement "would facilitate quicker recovery of margin assets"); Consultative Document, *supra* note 2, at 25 (noting that, notwithstanding "robust protection" offered by third-party custodians, "there have been cases where access to assets held by third party custodians has been limited or practically difficult").

We appreciate the opportunity to comment on the Proposed Margin Rules. If there are questions or we can be of any further assistance regarding these important issues, please feel free to contact the undersigned at (212) 841-1060 or bbennett@cov.com.

Very truly yours,

Bruce C. Bennett

cc: Honorable Gary Gensler, Chairman
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner
Honorable Mark P. Wetjen, Commissioner
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