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Re: Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (OCC Docket ID OCC-2011-0008, OCC RIN 1557-AD43, Fed Docket No. R-1415, Fed RIN 7100 AD 74, FDIC RIN 3064-AD79, FCA RIN 3052-AC69, FHFA RIN 2590-AA45); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (RIN 3038–AC97)

Dear Mr. Walsh, Ms. Johnson, Mr. Feldman, Mr. Van Meter, Mr. Pollard, and Mr. Stawick:

The Committee on Capital Markets Regulation (Committee) appreciates the opportunity to comment on the proposed rules concerning margin requirements for uncleared swaps under § 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] The Committee is commenting in this letter on proposals from both the prudential regulators (Prudential Proposed Rules)[2] and the CFTC (CFTC Proposed Rules),[3] as it wishes to encourage the agencies to adopt a uniform and consistent approach to margin requirements.

Since 2005, the Committee has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial*

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 731, 124 Stat. 1376 (2010) (hereinafter Dodd-Frank Act).
[2] Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (proposed May 11, 2011) (hereinafter Prudential Proposed Rules).
[3] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (proposed Apr. 28, 2011) (hereinafter CFTC Proposed Rules).

Crisis: A Plan for Regulatory Reform, which contains fifty-seven recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.[4] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

The Dodd-Frank Act calls for the prudential regulators and the CFTC to adopt rules concerning margin requirements for swap dealers and major swap participants.[5] It requires the prudential regulators, collectively, to issue their rules jointly, but does not require them to issue the rules jointly with the CFTC. It does, however, require the prudential regulators to issue the rules "in consultation with" the CFTC and the SEC. Although many areas within the two sets of proposed rules are quite similar, the Committee sees no reason why an identical approach should not be used for both. The CFTC wrote that in developing its proposed rules, "every effort has been made to be as consistent as possible with the rules being considered by the prudential authorities."[6] Similarly, the prudential regulators note that they "have consulted with staff of the CFTC and SEC."[7] Despite this collaboration, there are still many important differences between the two sets of proposed rules. We wish to highlight several key differences that should be reconciled, as well as suggest additional changes to the proposed rules.

1. Nonfinancial End Users

The CFTC Proposed Rules do not require the collection of margin from nonfinancial end users; the Prudential Proposed Rules require the collection of margin, but allow a swap entity to set an internal credit limit, below which no margin is required from nonfinancial end users. In our view, the latter approach is more consistent with the statute and is sounder from a risk-management perspective.

As the prudential regulators explain, there is no express statutory exception for nonfinancial end users to the general requirement that rules for margin collection must be written for all non-cleared swaps.[8] In practice, there may be little difference between the approaches because swap entities may set credit thresholds sufficiently high that they are rarely triggered. Yet having risk-based thresholds is a sound risk management practice because there may be instances in which a swap entity has an abnormally large exposure to a nonfinancial end user.

2. Bilateral Margin Collection

Both sets of proposed rules generally require only unilateral margin: a swap entity must collect initial and variation margin from its counterparties, but is not required to post margin to them.[9] Although not all of our members agree, we think this asymmetry is unwise. It is justified by the view that the rules should minimize the exposure to swap entities from the failure of its

[4] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (May 2009), http://www.capmktsreg.org/research.html.
[5] *See* Dodd-Frank Act § 731.
[6] CFTC Proposed Rules, 76 Fed. Reg. at 23,733.
[7] Prudential Proposed Rules, 76 Fed. Reg. at 27,566 n.7.
[8] *See* Prudential Proposed Rules, 76 Fed. Reg. at 27,569; Dodd-Frank Act § 731.
[9] *See* CFTC Proposed Rules, § 23.150–58, 76 Fed. Reg. at 23,733–49; Prudential Proposed Rules 76 Fed. Reg. at 27,567. Note that in swaps between two covered swap entities, each will have an obligation to collect from the other, resulting in bilateral margin collection in such transactions.

counterparties, but it fails to address the fact that counterparties are likewise exposed to the risk that a swap entity could fail. Furthermore, unilateral margin not only fails to mitigate, but actually magnifies, the problem of too-big-to-fail by increasing the impact of the failure of a dealer. For example, had this proposed rule existed in 2008, it would not have required Lehman Brothers to post collateral.

3. Initial Margin Models

The CFTC and the prudential regulators both acknowledge the usefulness of initial margin models but they propose different means of regulating these models. We recommend that these procedures be harmonized and, specifically, that the CFTC adopt an approval process similar to the one proposed by the prudential regulators.

The CFTC acknowledges that its proposed rules diverge from the prudential regulators', but justifies this difference by asserting that it does not have the resources the prudential regulators have to approve proprietary models. This results in a system in which the CFTC relies on approvals from third party sources, including the prudential regulators.[10] Although we understand that the CFTC is operating under resource constraints, we caution against piggybacking on the approvals of other organizations.

4. Initial Margin (non-models)

Initial margin may also be determined without the use of a model. In the absence of a model, the prudential regulators' proposal does not allow for the reduction of initial margin for offsetting positions. We think it is appropriate to allow for netting in the non-model initial margin calculations.

5. Extraterritorial Effect

An important aspect of the proposed rules is the impact they would have on foreign entities. We encourage the CFTC to expressly address the extraterritorial effect of its proposed rules as the prudential regulators' proposed rules do. The prudential regulators' proposal contains a safe harbor for most swaps between foreign entities, but clearly indicates that the safe harbor does not apply to a foreign branch or office of a U.S. bank or a U.S. branch or subsidiary of a foreign bank.[11] The CFTC, by contrast, does not directly address the extraterritorial effect of its proposed rules. Rather, such effect must be inferred through a reading of the Commodity Exchange Act, as amended by the Dodd-Frank Act, which provides that swaps provisions "shall not apply to activities outside of the United States unless those activities...have a direct and significant connection with activities in, or effect on, commerce of the United States."[12] This should be clarified in the rules.

We also encourage more coordination with the European Union on this issue, or else we risk making U.S. swap dealers and major swap participants uncompetitive with their foreign

[10] *See* CFTC Proposed Rules, § 23.155(b), 76 Fed. Reg. at 23,737.
[11] Prudential Proposed Rules, 76 Fed. Reg. at 27,581.
[12] Dodd-Frank Act § 722 (amending 7 U.S.C. § 2(i)).

competitors. A foreign entity, if given the choice, would likely prefer to transact with a dealer that requires less collateral.

6. Eligible collateral

The prudential regulators proposed the following as acceptable forms of collateral: immediately available cash funds and government securities, as well as certain obligations of federal agencies that qualify for initial margin only and are subject to a haircut.[13] We encourage the prudential regulators to consider broadening the scope of securities, with appropriate haircuts, that can be used as collateral in order to promote optimal functioning of the financial markets.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

Respectfully submitted,

Robert Glenn Hubbard

R. Glenn Hubbard
CO-CHAIR

John L. Thornton
CO-CHAIR

Hal S. Scott
DIRECTOR

[13] Prudential Proposed Rules, 76 Fed. Reg. at 27,578.