BETTER MARKETS
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September 21, 2012

Mr. David A. Stawick
Secretary Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington DC 20581

Re: Proposed Clearing Exemption for Swaps Between Certain Affiliated Entities (RIN 3038–AD47)

Dear Mr. Stawick:

Better Markets Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules regarding inter-affiliate Swaps ("Proposed Rules"), issued by the Commodity Futures Trading Commission ("CFTC", "Commission") as part of their rulemaking under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

INTRODUCTION AND SUMMARY OF COMMENTS

In Title VII of the Dodd-Frank Act, Congress recognized that a robust clearing regime is an essential component of a safe and sound, economically productive derivatives market. The Proposed Rules involve an exemption from this regime that is not specifically countenanced in the Dodd-Frank Act. Nevertheless, the Notice of Proposed Rulemaking ("Release", "NOPR") explains that the CFTC believes it has the authority to grant the exemption under §4(c)(1) of the Commodity Exchange Act ("CEA"), which empowers the CFTC to exempt certain transactions or classes of transactions from any provisions of the CEA in order to "promote responsible economic or financial innovation and fair competition." Congress' explicit reason for this provision is "to give the Commission a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner."

While it may be open to debate whether exempting inter-affiliate swaps does in any way "promote responsible economic or financial innovation and fair competition", it is clear that anything beyond a very narrow and strictly implemented exemption for inter-affiliate swaps **does not meet this criterion**. Thus, the CFTC must be careful not to overstep its statutory authority by implementing an excessively broad exemption. The

[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.

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Proposed Rules are a good start in this regard, but they must be tightened in several key respects, and must on no account be loosened to permit a wider exemption or weaker set of restrictions than those proposed.

Specifically, the Proposed Rules must be strengthened in the following respects:

- Majority ownership is too weak a standard. Only true subsidiaries – 100% owned affiliates – should be eligible for the clearing exemption.
- In addition to variation margin, the exchange of initial margin must also be required.
- The requirement to post margin must be extended to non-financial entities.
- Rehypothecation of posted collateral must be banned.

ANALYSIS

As the CFTC has recognized, there is no specific exemption for inter-affiliate swaps in the CEA as amended by the Dodd-Frank Act:

> CEA section 2(h) does not provide any specific exception to swaps entered into by affiliates that are subject to a clearing requirement ("inter-affiliate swaps").[2]

Moreover, the CFTC has also recognized that uncleared inter-affiliate swaps can pose a real and serious threat to the financial system:

> Inter-affiliate swaps that are hedged by back-to-back or matching book swaps entered into with third parties may pose risks to the financial system if the inter-affiliate swaps are not properly risk managed thereby raising the likelihood of default on the outward facing swaps. Furthermore, there could be systemic risk implications if an affiliate used by the corporate group to trade outward facing swaps (commonly referred as centralized treasury or conduit affiliates) has large positions and defaulted on obligations arising from inter-affiliate swaps if such swaps are hedged with third-party swaps.[3]

An explicitly stated goal of the Dodd-Frank Act is to "promote the financial stability of the United States by improving accountability and transparency in the financial system".[4] The central clearing mandate for swaps is a core component of achieving this goal.

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[2] Release at 50426.
[3] *Id.*
[4] Dodd-Frank Act, Preamble.

Therefore, the onus is on the CFTC to demonstrate that there is a sound statutory basis for exempting (a limited number of) inter-affiliate swaps from the legal requirement for clearing. To this end, the CFTC has invoked its CEA §4(c)(1) exemptive authority, which empowers the CFTC to exempt certain transactions or classes of transactions from any provisions of the CEA in order to "promote responsible economic or financial innovation and fair competition."[5]

Importantly, Congress placed a restriction on the CFTC's authority to grant such exemptions:

> 2) The Commission shall not grant any exemption under paragraph (1) from any of the requirements of subsection (a) of this section unless the Commission determines that—
>
> > (A) the requirement should not be applied to the agreement, contract, or transaction for which the exemption is sought and that **the exemption would be consistent with the public interest and the purposes of this chapter**;[6]

Congress thus clearly stipulated that the CFTC must consider the public interest first and foremost. Any exemption for inter-affiliate swaps made under CEA §4(c)(1) that is not consistent with the public interest is illegal.

Therefore, to be legally viable, any exemption for inter-affiliate swaps must meet three criteria:

1. It must be consistent with the purpose of "promot[ing] the financial stability of the United States by improving accountability and transparency in the financial system," or else it violates the explicitly stated purpose of the Dodd-Frank Act.[7]

2. It must "promote responsible economic or financial innovation and fair competition," or else it violates the conditions of the CEA §4(c)(1) exemptive authority.[8]

3. It must be "consistent with the public interest," for the same reason as point 2.[9]

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5 7 U.S.C. § 6(c)(1).
6 *Id.* (emphasis added)
7 *See* Note 4 *Supra.*
8 *See* Note 5 Supra.
9 *Id.*

Affiliates can Cause Huge Losses to their Parent Company and Destabilize the Financial System

The potential for affiliates to cause massive losses to their parent companies cannot be denied. In the run-up to the financial crisis, Asset-Backed Commercial Paper ("ABCP") conduits accounted for $1.2 trillion, an amount that was more than sufficient to do fatal damage to the balance sheets of the largest banks when significant losses occurred within those SIVs and conduits.[10]

Of course, there have been more recent examples of foreign affiliates of United States firms creating problems for their parent companies. The ongoing JP Morgan Chase "London Whale" scandal underscores the risks that affiliates can generate for U.S.-based companies, even those ostensibly well run and allegedly with superior internal and financial controls. In this case, the London-based Chief Investment Office placed a proprietary bet of more than $100 billion, which has generated losses so far of nearly $6 billion for its U.S. parent bank.[11]

This evidence clearly shows that any exemption for inter-affiliate swaps from the clearing mandate, if it is going to pass the three part test above, must be subject to risk management controls that are as strict, if not stricter, than those that would be in place were the swaps to be cleared.

The Commission's conditions on the exemption clearly do not meet this standard as proposed. Several elements of the proposed approach are wholly appropriate:

- The exemption only applies to majority-owned affiliates (or between affiliates both majority owned by a common parent).
- All swaps traded under the exemption must meet appropriate trade documentation standards, and be reported to an SDR.
- Any such swaps must also be subject to a "reasonably designed" centralized risk management program.
- If both parties to a swap are "financial entities," they must both collect and post variation margin.
- Furthermore, this margin must be adequately documented, exchanged in a timely manner, and held only in transparently disclosed accounts.
- The exemption is limited to transactions between entities located either in the United States, or else in a jurisdiction with a "comparable and comprehensive" clearing regime.

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10 V. Acharya *et al.* (2011), p. 3.

11 *See* http://articles.chicagotribune.com/2012-08-23/business/sns-rt-us-jpmorgan-loss-whalebre87m0wg-20120823_1_bruno-iksil-javier-martin-artajo-ina-drew.

However, these conditions must also be strengthened in several key respects:

- Majority ownership is too weak a standard. Only true subsidiaries – 100% owned affiliates – should be eligible for the clearing exemption.
- In addition to variation margin, the exchange of initial margin must also be required.
- The requirement to post margin must be extended to non-financial entities.
- Rehypothecation of posted collateral must be banned.

Majority ownership is too weak a standard. Only true subsidiaries – 100% owned affiliates – should be eligible for the clearing exemption.

The rationale given by the CFTC for propagating an inter-affiliate swap exemption from the clearing requirement is that the "significant" cost savings and "considerable benefits" for eligible affiliates outweigh the increased risk to the financial system and general public, due to a requirement placed on affiliates invoking the exemption that their risk be managed centrally.[12] However, this misses a crucial element of the clearing mandate: its role in ensuring a fair, transparent, and publicly accountable derivatives marketplace.

Using majority ownership as the criterion for exemption allows a majority owner to completely disregard the views of its minority partner when it comes to electing clearing. Perhaps more worryingly, it also creates an incentive for evasive strategies that allow two firms to avoid clearing a swap by creatively structuring a subsidiary partnership. Far from the "responsible economic or financial innovation" required by the statute, a majority ownership standard therefore incentivizes exactly the sort of irresponsible innovation that had such a disastrous effect in the derivatives market during the financial crisis of 2008.

A central part of the reasoning behind the CFTC's decision to countenance an inter-affiliate exemption to clearing swaps is that it may be useful for enabling firms to manage their swaps risk centrally. However, this rationale is only valid in the case of 100% owned subsidiaries. In any other situation, it actually muddies the water. Since counterparty credit risk can only be passed on to a central affiliate through novation or an explicit credit guarantee, allowing an exemption for affiliates that are majority owned but not wholly owned will inevitably generate situations in which price risk is stored at one location and credit risk at another. This will reduce transparency and soundness, and will undermine the clear goals of the Dodd-Frank Act.

The CFTC must therefore raise the threshold for an exemption to 100% ownership.

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[12] Release 50436.

In addition to variation margin, the exchange of initial margin must also be required.

As noted in the recent BCBS/IOSCO consultation document on margining of uncleared swaps, "The legal capacity in which initial margin is held or exchanged can have a significant influence on how effective that margin is in protecting a firm from loss in the event of the default of a derivatives counterparty."[13] Indeed, this is an understatement. **The manner in which initial (and variation) margin is segregated and invested can be the determining factor behind whether a firm is able to survive in stressed market conditions.**

Initial margin is a statistical estimate of the potential consequences of a default, based on a defined methodology. Derivatives counterparty risk is defined by these potential consequences. Variation margin is best viewed as a daily recalibration of the risk estimation device which calculates initial margin: as losses accrue, the impact of a potential default increases commensurably, so variation margin is accrued and collected to offset this increased potential impact. The initial margin and variation margin thus work together to provide an (relatively) up-to-date safety barrier to guard against default. A robust risk-management system for inter-affiliate swaps must therefore include the exchange of initial margin.

LCH Clearnet has clearly articulated this joint role of initial and variation margin in risk-mitigation:

> To ensure that LCH.Clearnet Ltd only faces market risk in the event of the default of one of its clearing members, it needs to ensure that market risk ahead of that default event is fully covered (i.e to keep LCH.Clearnet's risk current). Variation margin, which is a daily collect/pay in cash or collateral, covers this risk by accounting for the change in price since the previous day. Variation margin cannot take account of price moves after a default event since the defaulting member is, by definition, not in a position to pay variation margin. Instead initial margin – previously deposited by the defaulting member – covers that risk.[14]

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[13] Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions Consultative Document, Margin requirements for non-centrally-cleared derivatives (2012), *available at* www.bis.org/publ/bcbs226.pdf. p. 24.

[14] LCH Clearnet, "Variation Margin", *available at* http://www.lchclearnet.com/images/lch%20clearnet%20ltd%20-%20variation%20margin_tcm6-44528.pdf.

The requirement to post margin must be extended to non-financial entities.

The CFTC has acknowledged that the existence of the **end-user exception** renders an inter-affiliate swap exception unneccessary for non-financial firms:

> The Commission believes that the rule proposed in this rulemaking may not be necessary for the vast majority of inter-affiliate swaps involving a non-financial entity or a small financial institution because the end-user exception can be elected for those swaps. Accordingly, it is likely the proposed rule will be used for inter-affiliate swaps between two financial entities that do not qualify for the end-user exception or for swaps involving a non-financial entity that do not qualify for the end-user exception because the swaps do not hedge or mitigate commercial risk. [15]

The question then becomes, why is the CFTC considering granting an exclusion the sole impact of which is to remove the clearing requirement from non-commercial risk mitigating swaps between commercial affiliates? Clearly, eliminating a clearing requirement here does not promote the financial stability of the United States, since Congress determined that clearing such swaps is a crucial component of achieving financial stability (or else they would have been included in the end-user exception). Nor does it "promote responsible economic or financial innovation and fair competition," unless proliferating derivatives transactions with no commercial purpose within the commercial sector is considered "responsible...innovation," which clearly it cannot be. Nor is such an exception "consistent with the public interest," as the public has a clear interest in commercial firms being held to strict standards of transparency, accountability, and risk-management when transacting derivatives.

Therefore, there should be no inter-affiliate exemption for non-financial firms, since such an exemption would simply encourage less safe and transparent financial management of commercial enterprises than would otherwise be the case.

Rehypothecation of posted collateral must be banned.

In a stressed situation, losses accrue on multiple fronts in short time periods. The capacity of the system to survive such an event depends on the absolute level of collateral present in the system relative to the magnitude of the losses, as well as the speed with which this collateral can move to where it is required. **This is no less true when the collateral in question is held against inter-affiliate swaps**. As the CFTC has noted, uncollateralized losses between affiliates can directly lead to defaults against third parties. Inter-affiliate defaults in a stressed market can therefore be highly dangerous and contagious.

Allowing re-hypothecation of margin (whether initial or variation) for inter-affilaite swaps is therefore a radically imprudent move, in clear violation of the stated purpose of

[15] Release at 50426.

the Dodd-Frank Act, and of the conditions of the CEA §4(c)(1) exemption authority. Naturally, each individual firm engaged in inter-affiliate swaps prefers the ability to re-hypothecate collateral, as this constitutes the "cheapest" way to perform these trades. It is also "cheaper" to build a house entirely out of drywall, but the ultimate cost of a structure that is highly vulnerable to collapse is far higher than the initial savings warrant.

Re-hypothecation must not be allowed for either initial or variation margin. To do so would contradict the clear directions of Congress as set down in the Dodd-Frank Act in restricting the authority of the CFTC to exempt transactions from the clearing requirement to cases where the three part test pertaining to CEA §4(c)(1) is met.

The BCBS/IOSCO consultative document lends further support for this view:

> Given the potential for the net treatment of provided margin to undermine the general benefits of the proposed margin requirements, there was broad consensus among the BCBS and IOSCO that the proposed requirements should address these risks by requiring the gross exchange and the segregation or other effective protection of provided initial margin, so as to preserve its capacity to fully offset the risk of loss in the event of the default of a derivatives counterparty...
>
> **...Proposed requirement**
> Initial margin should be exchanged on a gross basis and held in a manner consistent with the key principle above. Cash and non-cash collateral collected as initial margin should not be re-hypothecated or re-used.[16]

As argued above, initial margin cannot be viewed independently from variation margin: the two work together as a holistic risk mitigation tool. Therefore, the reasoning presented in the BCBS/IOSCO document applies to all kinds of margin. Rehypothecation of either aspect of margin must be banned for inter-affiliate swaps.

Analysis of Costs and Benefits

The Release makes clear that the Commission has satisfied its duty under Section 15(a) of the CEA to consider the costs and benefits of the Proposed Rules. In fact, the Commission has exceeded its statutory obligation by weighing the costs and benefits associated with the Proposed Rules at great length.[17] Although the Commission need not engage in such netting or weighing of costs and benefits under Section 15(a), it has elected to do so in the Release.

Nevertheless, notwithstanding the Commission's clear fulfillment of its duty under Section 15(a), representatives from industry still challenge proposed rules claiming that

[16] Op. Cit. p. 25.
[17] Release 50433-8.

the Commission fails to conduct an adequate "cost-benefit analysis." Such claims have already been made twice in the last year: industry lobby organizations have filed lawsuits in federal district court seeking to invalidate two Commission rules claiming insufficient cost-benefit analysis, one establishing position limits and the other requiring investment companies to register as commodity pool operators if they trade commodity interests.[18]

These attacks rest on a series of fundamentally flawed claims that:

(1) exaggerate the actual duty imposed on the agency by the governing statute, Section 15(a) of the CEA;
(2) disregard the paramount role of the public interest in the rulemaking process as required by the governing statute; and
(3) ignore the enormous costs of the financial crisis and the benefit of the rules designed to help prevent a recurrence of that crisis or something far worse.[19]

These three critically important principles governing the application of Section 15(a) of the CEA and the implementation of the Dodd-Frank Act are discussed below, which makes clear that the Commission has fully satisfied its obligations under Section 15(a).

1. The limited duty under Section 15(a) is simply to consider costs and benefits, not conduct a cost-benefit analysis.

Most importantly, Section 15(a) of the CEA imposes a limited obligation on the CFTC simply to "consider" the costs and benefits of its rules in light of five specified public interest factors. [20] Congress's careful choice of words in Section 15(a), and the case law construing similar provisions, make clear that the CFTC has broad discretion in discharging this duty. In fact, the Supreme Court has long recognized that when statutorily mandated

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18 *See* note 24 *infra,* discussing the *amicus* briefs submitted by Better Markets in those rule challenges.

19 *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.

20 Better Markets has set forth a comprehensive analysis regarding the scope of Section 15(a) in the *amicus curiae* brief it filed in support of the Commission in *ISDA v. CFTC,* Civil Action No. 11-cv-2146 (RLW) ("*Amicus* Brief") (*available at* http://bettermarkets.com/sites/default/files/Corrected%20Brief%20of%20Better%20Markets%20as%20Amicus%20Curiae%20in%20Support%20of%20Defendant%20CFTC%20Apr.%2030,%202012.pdf). In that case, representatives of industry are challenging, *inter alia*, the Commission's consideration of costs and benefits in connection with the position limits rule. (*See also* http://bettermarkets.com/sites/default/files/ICI%20v.%20CFTC%20-%20Amicus%20Brief%20of%20Better%20Markets%20June%2025,%202012.pdf). In addition, Better Markets has written to the Office of Management and Budget ("OMB") opposing Commissioner Scott O'Malia's request that OMB review the cost-benefit analysis performed by the Commission in connection with several recently finalized rules. Letter from Better Markets to Jeffrey Zients, Acting Director of OMB (Feb. 29, 2012) ("Letter to OMB") (*available at* http://bettermarkets.com/sites/default/files/O'Malia%20CBA%20letter%20to%20OMB.pdf). In the Letter to OMB, Better Markets makes clear that various executive orders and OMB guidelines requiring cost-benefit analysis are inapplicable to the Commission's rulemaking. Both *Amicus* Briefs and the Letter to OMB are incorporated by reference as if fully set forth herein.

considerations are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty.[21]

In fact, the CFTC has no obligation to quantify costs or benefits, weigh them against each other, or find that a rule will confer a net benefit before promulgating it. The rationale for this flexible obligation in the law is clear: requiring the CFTC to conduct a resource intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives.

2. The Commission must be guided by the public interest as it considers the economic impact of its rules, not by concerns over the costs of regulation imposed on industry.

The five factors that the CFTC must consider under Section 15(a) reflect Congress's primary concern with the need to fashion regulations that serve the public interest and accomplish the agency's mission, not with a need to spare industry the costs of regulation. Without exception, each factor relates to a public benefit that arises from a robustly regulated marketplace, including preventing abuse, promoting competition, enhancing transparency, and limiting systemic risk.[22]

Tellingly, none of the listed factors mentions any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements. Removing any doubt, the fifth and final factor in Section 15(a) requires the CFTC to consider generally "any **other public interest** considerations."[23]

3. For any rule promulgated in accordance with the Dodd-Frank Act, the ultimate "public interest consideration" is implementing the reforms that Congress enacted to prevent another financial crisis.

As the CFTC considers the costs and benefits of rules implementing the Dodd-Frank Act, it must give proper weight to Congress's overriding objective: to institute a comprehensive set of reforms, including a regime for regulating swaps, to prevent another financial collapse and economic crisis, including trillions of dollars in financial losses and incalculable human suffering. By Better Markets' calculation, the dollar cost alone of the financial collapse and still-unfolding economic crisis comes to at least $12.8 trillion.[24] Therefore, as the CFTC assesses the costs and benefits of the Proposed Rules under Section 15(a), it must continue to consider, above all, the benefits of the entire collection of reforms embodied in Title VII and the Dodd-Frank Act, of which a proposed rule is but one, integral part.

Congress's resolve to prevent another financial crisis clearly overrides cost concerns under the Dodd-Frank Act. Congress passed the Dodd-Frank Act knowing full well that it would impose significant costs on industry, yet it determined those costs were

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21 *Sec'y of Agric. v. Cent. Roig Ref. Co.*, 338 U.S. 604, 611 (1950).
22 7 U.S.C. § 19(a)(2).
23 7 U.S.C. § 19(a)(2)(E) (emphasis added).
24 *See* Report, cited *supra* at note 23.

not only justified but necessary to stabilize our financial system and avoid another financial crisis. Those costs include the elimination of extremely profitable lines of business as well as significant and ongoing compliance costs. A leading example is the establishment of the new, comprehensive regulatory regime for swaps. It will require the financial industry to incur significant costs arising from new personnel and technology, ongoing compliance, margin and collateral, and reduced revenues and profits.

Congress fully understood these costs and consequences. It knew that regulatory reform would impose costs, in some cases totaling billions of dollars. The Dodd-Frank Act reflects Congress's unflinching determination to increase the financial industry's costs across the board and very substantially—or, more accurately, to shift those costs back to industry from a society that has paid the bill for industry's unregulated excesses. In short, Congress conducted its own cost-benefit analysis and concluded that the enormous collective benefits of the law far exceeded the costs and lost profits that industry would have to absorb.

Indeed, against the backdrop of the worst financial and economic crisis since the Great Depression, it is inconceivable that Congress would enact sweeping reforms and then allow the implementation of those reforms to hinge on the outcome of a rule-by-rule cost-benefit analysis that ignored the overriding purpose of the new regulatory framework—and that gave controlling weight to cost concerns from the very industry that precipitated the crisis and inflicted trillions of dollars in financial damage and human suffering across the country.

In short, the following analytical framework for the consideration of all relevant costs and benefits must guide the application of Section 15(a) to the Proposed Rules.

- Congress's ultimate objective in the Dodd-Frank Act was to prevent another crisis and the massive costs it would inflict;

- Prudent margining of uncleared swaps is an integral component of the reforms that Congress decided were necessary to achieve this objective; and

- The costs of compliance and reduced profit margins that industry may have to absorb by virtue of these margin requirements pale in comparison with the benefits of preventing another crisis—a benefit that can be valued at over $12.8 trillion.

CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Guidance.

Sincerely,

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