Coalition for Derivatives End-Users

February 22, 2013

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

<u>*Via agency website*</u>

Re: "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers" / File Number RIN 3235-AL12

I. Introduction

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comments by the Securities and Exchange Commission ("SEC" or the "Commission") entitled "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers." The Coalition represents companies that use derivatives predominantly to manage risks. Hundreds of companies have been active in the Coalition throughout the legislative and regulatory process, and our message is straightforward: Financial regulatory reform measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users, who did not contribute to the financial crisis, would create more economic instability, restrict job growth, decrease productive investment, and hamper U.S. competitiveness in the global economy.

The Coalition strongly agrees with and applauds the SEC's proposal to exclude non-financial commercial end-users from the margin requirements, but we remain concerned about the margin requirements that financial end-users will have to meet under the rule as proposed. The Coalition believes Congress communicated repeatedly both throughout the legislative process and in the text of the Dodd-Frank Act that all end-users should not be subject to margin requirements. This intent reflects policymakers' collective judgment that end-users do not meaningfully contribute to systemic risk and that imposing margin requirements on end-users would unnecessarily impede their ability to efficiently and effectively manage their risks.

II. Financial End-Users Should Not Be Subject to Margin Requirements

A. <u>Distinctions between Financial and Non-Financial End-Users in the Margin Context are Supported Neither by Logic nor the Statute</u>

The Coalition represents both financial and non-financial end-users. While we appreciate that the Commission's proposed rule exempts non-financial end-users from margin requirements, we believe that financial end-users should be granted the same exemption. Financial end-users include entities such as pension plans, captive finance affiliates, mutual life insurance companies, and commercial companies with non-captive finance arms. These entities do not pose systemic risk to the financial system and use derivatives predominantly to hedge risks associated with their businesses. In short, they use derivatives the same way non-financial end-users do. We thus believe that margin should not be required for all end-users, whether financial or non-financial.

The trade associations represented in the Coalition represent thousands of American businesses, including non-financial end-users, as well as many financial end-users. Many non-financial companies also have subsidiary entities that are financial in nature. For example, some non-financial companies centralize their treasury operations in entities that facilitate financing and hedging activities on behalf of affiliates under the same corporate umbrella. Other companies have captive finance units that provide financing to facilitate selling the parent company's products. The pension funds of non-financial firms will also be designated as financial entities and subject to clearing, trading and margin requirements even though they use derivative to manage risk in ways that do not add risk to the financial system. All of these financial end-users predominately hedge commercial risks, just as their non-financial counterparts do. They all work to preserve liquidity, and they all use customized derivatives to hedge idiosyncratic risks. The Coalition has concerns that the proposed margin rule will disproportionately burden these financial end-users.

We believe that modifying the margin requirements for financial end-users without meaningfully increasing systemic risks is possible. An economic analysis performed by the economics department of the Office of the Comptroller of the Currency ("OCC") on the corresponding rule for bank swap dealers and major swap participants supports our position.[1] The OCC analysis looked at the 74 OCC regulated banks that had more than $100 million in swaps as of December 31, 2010. The notional amount of swaps held by these 74 institutions totaled $179.49 trillion. The OCC then considered the impact of increasing the $100 million threshold to see the swap notional that would be outstanding when considering a smaller group of banks in the sample. Although raising the threshold from $100 million to $10 billion reduced the number of banks in the sample from 74 to 22, the outstanding notional for the remaining 22 banks remained virtually unchanged. The aggregate notional amount for the 22 largest institutions amounted to $179.44 trillion.

The OCC explains this phenomenon as follows: "Because total swap amounts are concentrated in a relatively small number of institutions, varying this threshold has little impact on the dollar amount of swaps affected by the proposed rule. Varying the threshold does, however, affect the number of institutions that would be subject to the proposed rule." Because of the concentration of swaps exposures within a small number of market participants,

1 Office of the Comptroller of the Currency, Economics Department, Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule (Apr. 15, 2011).

addressing systemic risk concerns is substantially a function of subjecting only those institutions to the salient aspects of regulation.

Subjecting end-users to margin requirements when those entities are not systemically risky and when they use derivatives to mitigate business risks makes only a fractional contribution to systemic risk reduction, while subjecting these entities to substantial economic burdens. These burdens may have far-ranging economic consequences. For example, pension funds, which played no role in the financial crisis and make no meaningful contribution to systemic risk, nonetheless would be subject to costly new margin requirements, which could affect risk management practices and, as a result, retirement security generally.

During the debate over the margin provisions of the Dodd-Frank Act, the bill's managers did not distinguish between financial and non-financial end-users. For example, House Agriculture Committee Chairman Peterson stated that Congress had "given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant." In response, House Financial Services Chairmen Frank agreed, saying that "the gentleman is absolutely right. We do differentiate between end-users and others."[2] This colloquy was carefully crafted to emphasize that Congress did not want margin requirements to apply to financial or non-financial end-users. The text of the Dodd-Frank Act underscores the fact that no distinction between financial and non-financial end-users was intended with respect to margin requirements. There simply is no textual support for such a distinction in the statute.

B. At a Minimum, Entities Exempt from Clearing Should be Exempt from Margin

Although we believe that all financial and non-financial end-users should be exempt from margin requirements, we believe also, at a minimum, that any entity that is exempt from clearing should be exempt from margin requirements. As currently drafted, there are two classes of entities that Congress exempted from the clearing requirement that the Commission, at a minimum, should exempt from margin requirements.

In particular, it is not clear whether the Commission intended to classify captive finance units as financial end-users or as non-financial end-users. We note that the term "commercial end user" is "generally understood to mean a company that is eligible for the exception to the mandatory clearing requirement. . . ."[3] Because captive finance units are eligible for the exception to mandatory clearing, it could be concluded that the Commission intended that they be classified as commercial end-users. However, we urge the Commission to clarify that this is their intent.

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2 156 CONG. REC. H5248 (June 30, 2010) (colloquy of Representatives Frank and Peterson).

3 15 U.S.C. § 78c-3(g).

III. The Proposed Margin Framework Places an Unnecessary Burden on Financial End-Users

The initial margin requirement is a new and costly requirement for most financial end-users, while the variation margin requirements may undermine the ability of an end-user to negotiate the best terms for a security-based swap. For many market participants, and especially for end-users, an initial margin requirement such as that proposed for financial end-users would be a new economic cost that is not normally applicable to the bilateral over-the-counter ("OTC") market. A recent Coalition survey found that 3% initial margin requirement on the S&P 500 companies could be expected to reduce capital spending by $5.1 billion to $6.7 billion.[4] The United States would lose 100,000 to 130,000 jobs from both direct and indirect effects.[5] The analysis illustrates that the strength of the economy and people's livelihoods are at stake.

Although much of the liquidity impact of the proposed rule will be focused on financial end-users, swap dealers and major security-based swap participants and all market participants, including non-financial end-users, will be impacted by the significant liquidity burdens placed on these market participants.

Because all market participants will bear the cost of increased system-wide margin requirements, the Coalition believes that the margin requirements must be set at levels consistent with historical loss experience. Since inception of the financial crisis, U.S. financial institutions have reported $1.262 trillion[6] in losses in their financial statements. Of this amount, only $49 billion resulted from derivatives. More than half was attributable to AIG and was made up of mortgage-related credit default swaps, which financial end-users typically do not use. The remaining losses from the $1.262 trillion came from non-derivatives products, including loans.

This derivatives loss data offers a useful point of comparison to evaluate whether setting aside the substantial cash resources required by the proposed rule is appropriate. In its economic analysis of the Prudential Regulators' comparable rule for bank swap dealers and major swap participants, the OCC estimated the cash resources that would be required to satisfy the initial margin requirements of the Act on 74 OCC regulated banks. It concluded that $2.05 trillion would be required to be set aside to satisfy the initial margin requirements of the rule. Although

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4 An analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives (Feb. 11, 2011), *available at*: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Coalition-for-Derivatives-End-Users-OTC-Derivatives-Survey_Final-Version-2-11-11.pdf.

5 Id.

6 Writedowns and credit-market losses, as determined through the Bloomberg WDCI function as of 6/3/2011.

the proposed rule did not calculate the impact of such requirements on non-OCC regulated banks, the conclusions presented therein are useful for the SEC as it determines its own margin framework. Specifically, the analysis counsels that (1) a quantitative analysis of the proposed rule is feasible, (2) that the results of such an analysis suggest the margin requirements are quite significant and (3) that the results, if accurate, are presently disconnected from the historical loss experience in the derivatives market.

IV. Extraterritorial Scope of the Proposed Margin Rule

We believe that more information is needed about the uncertain statutory authority and applicability of the margin rule in foreign jurisdictions. The Coalition suggests that the Commission provide clarifying information about the following considerations:

- The permissible territorial scope of the proposed rule;
- The possibility of subjecting transactions to multiple, potentially conflicting, margin requirements established by U.S. and foreign regulators; and
- The potential distortion of competitive equality among U.S. and foreign covered security-based swap entities.

We urge the Commission not to adopt the same, overly-broad extraterritorial application of its margin rules that the Prudential Regulators proposed.[7] Under the Prudential Regulator's proposed extraterritorial application, their proposed margin rule could touch almost every transaction, including transactions between entities with extremely tenuous ties or potential to affect the United States. Applying the proposed margin rule in this broad manner to foreign jurisdictions is unnecessary. Foreign covered security-based swap entities will already have foreign capital, regulatory, and governance requirements. Overlapping and potentially conflicting regulations from multiple jurisdictions applying to the same security-based swap may result. The compliance issues could also have a deleterious effect on the ability of end-users to administer effective and efficient risk management programs. U.S. companies that compete globally may have foreign branches, or foreign incorporated subsidiaries that hedge commercial risks. Historically, these foreign branches or subsidiaries have enough dealer counterparties to transact with, including foreign security-based swap dealers and foreign branches or subsidiaries of U.S. security-based swap dealers. Having access to a range of dealer counterparties provides multiple benefits—including more liquidity and more competition—which improves the cost of hedging. An overly-broad extraterritorial application of the SEC's proposed margin rule could diminish access to a robust pool of pricing sources and market participants, including U.S. security-based swap dealers operating a foreign branch or U.S. security-based swap dealers operating a foreign incorporated subsidiary. This could reduce liquidity and market competition, leading to a potential decrease in price transparency and worse pricing than available today.

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[7] 76 Fed. Reg. 27580 (May 11, 2011).

V. Inter-Affiliate Security-Based Swaps between Entities in a Single Corporate Group Should Not Be Subject to Margin Requirements

The Coalition urges the SEC to confirm that certain requirements, applicable to street-facing security-based swap transactions, including but not limited to margin requirements, do not apply to inter-affiliate security-based swaps for any end-user, including financial end-users. Without confirmation from the Commission, security-based swaps between commonly-controlled affiliates could be required to be executed on a security-based swap execution facility and centrally cleared, and margin could be required to be posted. This requirement would cause artificial and inefficient capital allocations for end-users, increase consumer costs, and undermine efficiencies that end-users currently realize through centralized treasury units.

A. <u>The Economic Reality of Inter-Affiliate Security-Based Swaps</u>

Regulation of inter-affiliate security-based swaps should square with a simple economic reality: They do not increase systemic risk. Instead, inter-affiliate security-based swaps merely allocate risk within a corporate group. Instead of increasing risk, inter-affiliate security-based swaps promote practices that serve to reduce risk. For example, many end-users execute a significant portion of their security-based swap transactions through wholly-owned centralized treasury units. In this common organizational model, the centralized treasury unit may structure transactions to offset commercial risk for the parent company and its affiliates or follow specific hedging instructions from affiliated entities within the corporate group. Although variation in the structure of trades exists, the centralized treasury unit typically serves as the primary street-facing entity for the entire corporate group, entering both into transactions with affiliated entities and into corresponding hedge positions with unaffiliated security-based swap dealers.

Thus, under this and similar organizational models that use inter-affiliate security-based swaps, the security-based swaps serve largely as an internal allocation of risk—not speculative trades that create risk. In effect, affiliate security-based swaps are largely equivalent to inter-company loans, which merely shift capital and risk among entities in the same corporate group.

Instead of increasing risk, to the contrary, centralized treasury units not only serve to reduce risk, but also benefits both end-users and consumers in other ways. From a risk perspective, the centralized treasury units concentrate trade expertise and execution in a single entity. This concentration of trade execution talent improves a corporate group’s ability to accurately evaluate the credit risk profile of counterparties it faces and allows it to be more discerning about which counterparties it trades with. Centralized treasury units also allow for risk management across the entire corporate group, leading to increased efficiency and more comprehensive risk management.

Centralized treasury units have the added benefit of being able to net positions across an entire corporate group, which lowers the overall credit risk a corporate group poses to the market generally. They also provide a broader base for the netting of counterparty-facing transactions. Without centralized treasury units, costs would increase for all entities across the board. For example, affiliates could lose the benefit of their parent’s corporate credit rating if they hedged as stand-alone entities. There would also be increased duplication of functions in in execution, accounting, settlement, compliance, risk management, and reporting, including mandatory filings.

The Commission should chart a consistent course in its treatment of inter-affiliate security-based swaps that comports with economic reality and exempt them from the Dodd-Frank Act's execution, clearing, margin, and real-time reporting requirements. Imposing margin and clearing requirements is unnecessary because inter-affiliate security-based swaps do not increase risk. Imposing execution and real-time reporting requirements is unnecessary because doing so would not enhance price discover or market transparency.

B. Regulating Inter-Affiliate Security-Based Swaps Interferes with Corporate Business and Risk Decisions

Many of the benefits and opportunities for risk reduction provided by centralized treasury units would disappear, however, if regulators imposed the same requirements on both external and inter-affiliate security-based swaps. The increased costs associated with full regulation of inter-affiliate security-based swaps would push firms away from centralized hedging and back to a decentralized model. Full inter-affiliate security-based swap regulation would substitute corporate business judgment with a government mandate and could put economic pressure on companies to stop using a successful business model that has many benefits.

C. Inter-Affiliate Security-Based Swaps Should Not Be Subject to Margin Requirements

Without clarification from the Commission, the Dodd-Frank Act could be misunderstood to require commonly-controlled affiliates to post margin to other entities in the same corporate group. Such unnecessary requirements would require artificial and inefficient capital allocations for end-users, increase consumer costs, cause negative tax implications, and undermine efficiencies that end-users currently realize through their centralized treasury units.

Congress established margin requirements to offset the systemic risk posed by uncleared security-based swaps to the "swap dealer or major swap participant and the financial system."[8] To this end, the Dodd-Frank Act requires the Commission to adopt margin regulations that meet two, specific criteria: Any margin regulations must both "help ensure the safety and soundness of the security-based swap dealer or major security-based swap participant" and "be appropriate for the risk associated with the non-cleared swaps held as a security-based swap dealer or major security-based swap participant."[9] In other words, Congress requires regulators to use systemic risk as a gauge for calibrating the appropriate level of margin.

8 Dodd-Frank Act § 764(a).

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The Coalition believes that imposing margin requirements on inter-affiliate trades would cut against these explicit, systemic risk-based standards set forth in the Dodd-Frank Act for promulgating margin rules. As a unique class, inter-affiliate security-based swaps do not increase systemic risk, and, as described above, instead help lower risk by allowing end-users to adopt centralized hedging practices. Imposing margin requirements on inter-affiliate trades would merely cause margin to be transferred between affiliates that operate and are treated as a single entity. Inter-affiliate trades also could not somehow be used to transfer risk without adequate margin because all affiliates within a corporate group are consolidated for financial accounting and reporting purposes. Margin requirements would thus ignore both economic reality and the Dodd-Frank Act's requirement that margin be set according to systemic risk. Because inter-affiliate security-based swaps pose no systemic risk, they should not be subject to margin.

D. A Regulatory Exemption for Inter-Affiliate Security-Based Swaps Would Not Lead to Abuse

Because inter-affiliate trades merely allocate risk within a corporate group, they do not mitigate external counterparty credit risk. No matter how many inter-affiliate trades a corporate group executes among its affiliates, the exposure created by external security-based swaps would not change. Similarly, a series of internal trades, no matter how long, would not serve to lay risk off from an entity to the market. Hence, there is no compelling reason to believe that inter-affiliate security-based swaps would be used to avoid requirements imposed on external security-based swaps, as one is not an economic substitute for the other. In any event, the Dodd-Frank Act gives regulators explicit anti-evasion authority to respond to and prevent any possible abuse as needed.

VI. Conclusion

We thank the Commission for the opportunity to comment on these important issues. The Coalition looks forward to working with regulators to help implement margin requirements that serve to strengthen the derivatives market without unduly burdening end-users and the economy at large. We are available to meet with the Commission to discuss these issues in more detail.

Sincerely,

Agricultural Retailers Association
Business Roundtable
National Association of Corporate Treasurers
National Association of Manufacturers
U.S. Chamber of Commerce