December 9, 2019

By Electronic Submission

Board of Governors of the Federal Reserve System
Ann E. Misback, Secretary
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket No. R-1682, RIN: 7100-AF62

Federal Deposit Insurance Corporation
Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
550 17th Street, N.W.
Washington, D.C. 20429
RIN: 3064-AF08 — Margin Amendments

Office of the Comptroller of the Currency
Chief Counsel's Office
Attention: Comment Processing
400 7th Street, S.W.
Suite 3E-218
Washington, D.C. 20219
Docket ID No. OCC-2019-0023, RIN: 1557-AE69

Farm Credit Administration
Office of Regulatory Policy
Barry F. Mardock, Deputy Director
1501 Farm Credit Drive
Mclean, VA 22102-5090
RIN: 3052-AD38

Federal Housing Finance Agency
Alfred M. Pollard, General Counsel
Attention: Comments/ RIN: 2590-AB03
Constitution Center (OGC Eighth Floor)
400 7th Street, S.W.
Washington, D.C. 20219
RIN 2590-AB03

Re: Margin and Capital Requirements for Covered Swap Entities, 84 Fed. Reg. 59970 (November 7, 2019)

Ladies and gentlemen,

Better Markets, Inc. ("Better Markets")[1] appreciates the opportunity to comment on the above notice of proposed rulemaking ("Interaffiliate Margin Proposal")[2] issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (together, "the Agencies").

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] Margin and Capital Requirements for Covered Swap Entities, 84 Fed. Reg. 59970 (November 7, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-11-07/pdf/2019-23541.pdf.

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Although elements of the proposal are reasonable, the proposed provisions eliminating initial margin ("IM") requirements on interaffiliate derivatives transactions between derivatives dealing banks and their affiliates would do each of the following:

1) Facilitate avoidance or evasion of U.S. statutory requirements in violation of a critical Congressional mandate;

2) Reverse the Agencies' own longstanding legal and policy views; and

3) Implement unsupported regulatory changes with significant implications for the safety and soundness of U.S. financial institutions and the U.S. financial system.

For these reasons, explained at length below, the Agencies must withdraw or not finalize that element of the proposal (or at least re-propose it with sufficient information to permit meaningful public comment).

It is noteworthy that **this element of the proposal was instigated by eight of the most prominent trade associations and lobbying organizations for the financial industry**,[3] which collectively requested repeal of interaffiliate IM requirements for self-interested, profit-maximizing, and shortsighted commercial reasons. That, of course, should not be an unexpected course of action for organizations whose sole purpose is to advance the commercial interests of their members. However, it is not a valid basis for administrative action by Agencies charged with the responsibility to ensure the safety and soundness of the legal entities under their oversight.

## I. The proposal to eliminate interaffiliate IM requirements, if adopted, would be a violation of the statutory mandate that all swaps and security-based swaps be subject to the Dodd-Frank Act's IM requirements and would deviate from the Agencies' own regulations and longstanding policy views.

The 2008 financial crisis revealed systematic risk management failures at Wall Street's largest financial institutions, especially failures to manage counterparty credit risks in the over-the-counter derivatives markets. The consequence was exemplified by the near-failure of American International Group, Inc. ("AIG"), where the spillover effects on other financial institutions—including every systemically important investment bank—essentially extorted the Agencies, other U.S. policymakers, and U.S. taxpayers to directly and indirectly spend, lend, commit, guarantee, pledge, assume, or otherwise put at risk tens of trillions of dollars in bailouts, facilities, and other extraordinary programs to benefit the very institutions that precipitated the worst economic downturn in generations.[4] Counterparty credit risk

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[3] See Letter to the Agencies from the American Bankers Association ("ABA"), the ABA Securities Association, the Bank Policy Institute, the Financial Services Forum, the Institute of International Bankers, the International Swaps and Derivatives Association, the Securities Industry and Financial Markets Association, and the Center for Capital Markets Competitiveness (May 13, 2019), available at https://www.sifma.org/wp-content/uploads/2019/05/Joint-Trades-Letter-to-Prudential-Regulators-on-IA-IM-Requirements-dated-May-13-2019.pdf.

[4] For a high-level overview of these interventions, see, e.g., Dennis M. Kelleher, Testimony to Senate Committee on Agriculture, Nutrition, and Forestry on "The State of the Derivatives Market and Perspectives for CFTC Reauthorization (June 25, 2019), available at https://www.agriculture.senate.gov/imo/media/doc/Testimony_Kelleher%2006.25.19.pdf. See also J. Felkerson, A Detailed Look at the Fed's Crisis Response by Funding Facility and Recipient, Public Policy Brief, Levy Economics Institute of Bard College, No. 123 (2012), available at https://www.econstor.eu/bitstream/10419/121982/1/689983247.pdf (calculating "the total amount of loans and asset purchases made . . . from January 2007 to March 2012" and determining that the Federal Reserve's cumulative 2008 financial crisis interventions were "over $29 trillion"). For another discussion of the beneficiaries of the Troubled Asset Relief Program, total crisis outlays, and endless industry disagreements on the precise final numbers, see also Better Markets, Wall Street's

management has since become one of the most critical concerns of global regulators, motivating the 2009 G20 commitments to encourage and mandate central clearing of standardized derivatives and impose higher capital requirements on non-cleared derivatives.[5]

In 2011, the G20 added margin requirements for non-centrally cleared derivatives as a third pillar for managing counterparty credit risk.[6] By then, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[7] already had implemented that commitment by requiring the Agencies to jointly adopt variation and initial margin requirements for all swaps[8] and security-based swaps[9] booked into prudentially regulated[10] swap dealers and security-based swap dealers (and other less relevant

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Six Biggest Bailed-Out Banks: Their RAP Sheets & Their Ongoing Crime Spree, Special Report (April 9, 2019), available at https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Wall%20Street%27s%20Six%20Biggest%20Bailed-Out%20Banks%20FINAL.pdf. As we emphasize in that report, the $29 trillion figure is based on a reasonable methodology for calculating the cumulative Federal Reserve and U.S. government interventions, but "the precise amount isn't as relevant as its magnitude and long-term impact: It was inconceivably high and will be costing the U.S. and its people for a generation or more." Id. at 33. With respect to the long-term effects of the crisis, see, e.g., R. Barnichon, C. Matthes, A. Ziegenbein, Federal Reserve Bank of San Francisco, Economic Letter 2018-19, The Financial Crisis at 10: Will We Ever Recover?, available at https://www.frbsf.org/economic-research/files/el2018-19.pdf (finding "a large fraction of the gap between current GDP and its pre-crisis trend level is associated with the 2007–08 financial crisis" and concluding that "GDP is unlikely to revert to the level implied by its trend before the crisis"). For another study of the devastating effects of the 2008 financial crisis, see T. Atkinson, D. Luttrell, and H. Rosenblum, Federal Reserve Bank of Dallas, Staff Paper No. 20, How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis (July 2013), available at https://www.dallasfed.org/~/media/documents/research/staff/staff1301.pdf. Better Markets previously estimated that the total cost of the financial crisis may exceed more than $11 trillion in lost gross domestic product alone.

[5] See G20 Declaration of the Summit on Financial Markets and the World Economy, The White House President George W. Bush, (November 15, 2008), available at http://www.fsb.org/wp-content/uploads/pr_151108.pdf (stating that prudential regulators must "[s]trengthen[] the resilience and transparency of credit derivatives markets and reducing their systemic risks"); See also G20 Leaders' Statement, the Pittsburgh Summit (September 24-25, 2009), available at http://www.fsb.org/wp-content/uploads/g20_leaders_declaration_pittsburgh_2009.pdf (stating that "[a]ll standardized OTC derivative contracts should be . . . cleared through central counterparties" and that "[n]on-centrally cleared contracts should be subject to higher capital requirements").

[6] See G20 Cannes Summit Final Declaration—Building Our Common Future: Renewed Collective Action for the Benefit of All (Nov. 4, 2011), available at http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html ("We call on the Basel Committee on Banking Supervision (BCBS), the International Organization for Securities Commission (IOSCO) together with other relevant organizations to develop . . . consultation standards on margining for non-centrally cleared OTC derivatives . . . ."). The Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") issued an international framework for margin requirements on Non-Cleared Derivatives ("International Margin Framework") in 2013. See BCBS and IOSCO Margin requirements for non-centrally cleared derivatives (March 2015), available at https://www.bis.org/bcbs/publ/d317.pdf. See also BCBS and IOSCO Margin requirements for non-centrally cleared derivatives (September 2013), available at https://bis.org/publ/bcbs261.pdf. Element 6 of the International Margin Framework related to the "[t]reatment of transactions with affiliates." Id at 21. Key Principle 6 of that Element provided that "[t]ransactions between a firm and its affiliates should be subject to appropriate regulation." Id. Although the framework did not specifically require initial margin on all interaffiliate derivatives transactions, it did require supervisors to "***put in place initial and variation margin requirements as appropriate***" to the local legal and regulatory systems and market conditions. Id (emphasis added).

[7] Pub. L. 111-203, 124 Stat. 1376 (2010).

[8] 7 U.S.C. § 1a(47) (providing the statutory definition of "swap").

[9] 15 U.S.C. § 78c(a)(68) (providing the statutory definition of "security-based swap").

[10] 7 U.S.C. § 1a(39) (defining the term "prudential regulator" for purposes of the margin requirements applicable to certain regulated entities).

registrants) (collectively, "Covered Swap Entities"),[11] if they are not cleared by a derivatives clearing organization or a clearing agency ("Non-Cleared Derivatives").

Importantly, the Dodd-Frank Act did ***not*** provide the Agencies discretionary authority to determine whether to impose, or not to impose, such variation and initial margin requirements. It amended the Commodity Exchange Act ("CEA")[12] and the Securities and Exchange Act of 1934 ("Exchange Act")[13] to mandate that the Agencies impose variation and initial margin requirements on all Non-Cleared Derivatives:

> The prudential regulators, in consultation with the [CFTC] and the [SEC], **shall** jointly **adopt rules** for swap dealers and major swap participants . . . for which there is a prudential regulator **imposing** . . . **both initial and variation margin requirements on all swaps that are not cleared** by a registered derivatives clearing organization.[14]
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> The prudential regulators, in consultation with the [SEC] and the [CFTC], **shall adopt rules** for security-based swap dealers and major security-based swap participants . . . for which there is a prudential regulator **imposing** . . . **both initial and variation margin requirements on all security-based swaps that are not cleared** by a registered clearing agency.[15]

This statutory language is prescriptive, deliberate, and unequivocal. Congress adopted a statutory ***mandate*** ("shall") and used the word "both" to statutorily direct the Agencies to "**impose**" IM requirements, in addition to variation margin ("VM") requirements. The ordinary and dictionary meanings of the word, "impose," are instructive: "[T]o establish or bring about as if by force,"[16] "to establish something as a rule to be obeyed,"[17] or "to officially force a rule, tax, punishment, etc. to be obeyed or received."[18] Congress' use of this statutory language yields the following inescapable conclusions:

1) The Agencies are required to impose IM requirements "as a rule" on "all" Non-Cleared Derivatives; and

2) The Agencies in no way have been conferred discretionary authority to do otherwise.

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[11] CEA section 4s requires registration of swap dealers and major swap participants with the Commodity Futures Trading Commission ("CFTC"). See 7 U.S.C. 6s. Section 15F of Securities Exchange Act similarly requires registration of security-based swap dealers and major security-based swap participants with the Securities and Exchange Commission ("SEC"). See 15 U.S.C. 78o-10. These CFTC and SEC registrants are subject to the Dodd-Frank Act's mandatory margin requirements, as explained below.

[12] 7 U.S.C. § 1 et seq.

[13] 15 U.S.C. § 78a et seq.

[14] 7 U.S.C. § 6s(e)(2)(A)(ii) (emphasis added).

[15] 15 U.S.C. § 78o–10(e)(2)(A)(ii) (emphasis added).

[16] Merriam-Webster.com Dictionary, "impose (vb.)," accessed Dec. 9, 2019, available at https://www.merriam-webster.com/dictionary/impose.

[17] Cambridge Dictionary.com, "impose (vb.)," accessed Dec. 9, 2019, available at https://dictionary.cambridge.org/us/dictionary/english/impose.

[18] Id.

Indeed, the common sense meaning of "all" precludes any interpretive acrobatics that would apply mandatory VM and IM requirements to only "some" Non-Cleared Derivatives.[19]

Other provisions affirm the Agencies' directive to prescribe or establish VM and IM on all Non-Cleared Derivatives. In CEA section 4s(e)(3)(C)[20] and Exchange Act section 15F(e)(3)(C),[21] for example, Congress provided that "[i]n ***prescribing*** margin requirements," the Agencies "shall permit the use of noncash collateral" as "determine[d] consistent with preserving the financial integrity of markets trading" Non-Cleared Derivatives[22] and "preserving the stability of the United States financial system."[23] In this closely related statutory context, Congress again used language that can be reasonably read only as a mandate to ***prescribe*** margin ***requirements***. Indeed, like the word "impose" in the related provisions above, the word "prescribe" has ordinary and dictionary meanings that compel the Agencies "to lay down a rule"[24] or "to tell someone what they must have or do, or to make a rule of something,"[25] in this case collect VM and IM as a Covered Swap Entity.

In addition, Congress tellingly coupled the statutory mandate to impose or prescribe VM and IM requirements with discretionary authority to "permit the use of noncash collateral" to satisfy them "as . . . ***determined*** to be consistent with" additional statutory standards.[26] Congress could have provided similar discretionary authority for the Agencies to "determine" whether to "impose" or "prescribe" of VM and IM requirements in the first instance. It did not. It instead set forth a clear statutory mandate and still elsewhere, required the Agencies, the SEC, and the CFTC "to the maximum extent practicable, [to] ***establish*** and ***maintain*** comparable . . . minimum initial and variation margin requirements"[27] for Covered Swap Entities. The iteration of mandatory language (e.g., "shall," "impose," "prescribe," and "establish") in a series of closely related statutory margin provisions cannot be reasonably construed as mere coincidence, especially as contrasted with deliberate discretionary language used to effect other provisions within the statutory framework.

Finally, CEA section 4s(e)(3)(A)(i)-(ii)[28] and Exchange Act 15F(e)(3)(A)(i)-(ii)[29] set forth "standards for capital and margin" not only for establishing statutorily required IM but also for determining the *extent* of the IM required. Congress explicitly noted that VM and IM requirements were intended to

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[19] In any event, the Agencies have not cited to any valid general exemptive authority in proposing to effect an acknowledged "exemption" from CEA section 4s(e) and Exchange Act section 15F(e). They merely conclude that such an exemption would be warranted.

[20] 7 U.S.C. § 6s(e)(3)(C).

[21] 15 U.S.C. § 78o-10(e)(3)(C).

[22] 7 U.S.C. § 6s(e)(3)(C)(i) (emphasis added). 15 U.S.C. § 78o-10(e)(3)(C)(i) (emphasis added).

[23] 7 U.S.C. § 6s(e)(3)(C)(ii) (emphasis added). 15 U.S.C. § 78o-10(e)(3)(C)(ii) (emphasis added).

[24] Merriam-Webster.com Dictionary, "prescribe (vb.)," accessed Dec. 9, 2019, available at https://www.merriam-webster.com/dictionary/prescribe.

[25] Cambridge Dictionary.com, "prescribe (vb.)," accessed Dec. 9, 2019, available at https://dictionary.cambridge.org/dictionary/english/prescribe.

[26] 7 U.S.C. § 6s(e)(3)(C). 15 U.S.C. § 78o-10(e)(3)(C).

[27] 7 U.S.C. § 6s(e)(3)(D)(ii). 15 U.S.C. § 78o-10(e)(3)(D)(ii).

[28] 7 U.S.C. § 6s(e)(3)(A)(i)-(ii).

[29] 15 U.S.C. § 78o-10(e)(3)(A)(i)-(ii).

"offset the greater risk" to Covered Swap Entities and the financial system "from the use of" Non-Cleared Derivatives[30] and further emphasized that VM and IM "***requirements imposed***" under the CEA and Exchange Act shall (1) "help ensure the safety and soundness" of ***the*** Covered Swap Entity;[31] and (2) "be appropriate for the risk associated with" the Non-Cleared Derivatives "held" by ***the*** Covered Swap Entity.[32] This statutory iteration—yet again—that CEA section 4s(e)(2) and Exchange Act section 15F(e)(2) ***impose*** VM and IM ***requirements***, and for a statutorily specified policy reason (i.e., to "offset the greater risk" of Non-Cleared Derivatives to Covered Swap Entities and the financial system"), confirms Congress' intent to ensure that the Agencies institute mandatory VM and IM requirements at a level that serves safety and soundness objectives.[33]

Interaffiliate Non-Cleared Derivatives executed between Covered Swap Entities and their affiliates are merely specific types of Non-Cleared Derivatives and therefore must be subject to the statutory requirements applicable to "all" Non-Cleared Derivatives. For all of the above statutory reasons, the Agencies simply do not have authority to ignore the CEA and Exchange Act's clear statutory commands and to instead finalize an exemption that eliminates existing IM requirements on interaffiliate Non-Cleared Derivatives.[34] Furthermore, unlike other Dodd-Frank Act provisions that explicitly contemplate "special" treatment for interaffiliate transactions (see, e.g., the six Dodd-Frank Act subsections providing special clearing provisions for affiliates),[35] neither CEA section 4s(e) nor Exchange Act section 15F(e) even mention affiliates or distinguish interaffiliate derivatives transactions from other Non-Cleared Derivatives transactions. To the contrary, both provisions effect clear, sweeping, and deliberate statutory mandates to "impose" variation and initial margin requirements on "all" Non-Cleared Derivatives executed by Covered Swap Entities.

These statutory realities informed the Agencies' final regulations implementing a general IM mandate on Non-Cleared Derivatives, including interaffiliate derivatives between Covered Swap Entities and their affiliates.[36] In relevant part, and only a few short years ago, the Agencies rightly reasoned as follows:

> The requirement for covered swap entities to collect initial margin from, but not to post initial margin to, affiliates should **help to protect the safety and soundness of covered swap entities in the event of an affiliated counterparty default**. At the same time, the

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[30] 7 U.S.C. § 6s(e)(3)(A). 15 U.S.C. § 78o-10(e)(3(A).

[31] 7 U.S.C. § 6s(e)(3)(A)(i). 15 U.S.C. § 78o-10(e)(3)(A)(i).

[32] 7 U.S.C. § 6s(e)(3)(A)(ii). 15 U.S.C. § 78o-10(e)(3)(A)(ii).

[33] The statutory emphasis on the safety and soundness of the specific legal entity regulated as a Covered Swap Entity has a critical policy implication, as the statute rightly demands that the Agencies focus not solely on overall Non-Cleared Derivatives risks throughout the consolidated group but on the specific allocation of risks to Covered Swap Entities within that consolidated group. We discuss this issue in section II below.

[34] Margin and Capital Requirements for Covered Swap Entities, 84 Fed. Reg. 59970, 59975 (November 7, 2019) ("The proposal would amend the treatment of affiliate transactions in the Swap Margin Rule by creating an exemption from the initial margin requirements for non-cleared swaps between affiliates.").

[35] 7 U.S.C. § 2(h)(7)(D)(i)-(vi).

[36] Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840, 74845-74846 (November 30, 2015), available at https://www.govinfo.gov/content/pkg/FR-2015-11-30/pdf/2015-28671.pdf (explaining that "a covered swap entity is required to collect initial margin from its affiliate pursuant to § __.3(a) under the final rule" and noting that "[w]here a covered swap entity transacts with another covered swap entity that is an affiliate, this will result in a collect and post regime for initial margin among affiliates"). See also § __.3(a), which generally requires Covered Swap Entities to collect IM in connection with interaffiliate derivatives transactions.

> final rule **does not permit such inter-affiliate swaps, which may be significant in number and notional amount, to remain unmargined and thus to pose a risk to systemic stability** . . .
>
> The Agencies believe that the final rule's provisions for inter-affiliate swaps balance the concerns raised by commenters about the impact of full two-way margin on inter-affiliate swaps **while at the same time, consistent with the statute, taking into account the risk of these swaps and protecting the safety and soundness of covered swap entities**.[37]

There is little change in regulatory or market circumstances that we are aware—and none cited by the Agencies—that would change this rationale for requiring IM on interaffiliate Non-Cleared Derivatives. Indeed, the Agencies have not explained in any non-conclusory manner the rationale for dramatically reversing course on such a consequential safety and soundness measure, much less disclosed data and supervisory information informing this policy change. That, in itself, is a violation of the Administrative Procedures Act ("APA").[38]

Before we turn to the reasons that an interaffiliate initial margin exemption is unwarranted, likely to increase systemic risk, and likely to facilitate avoidance or evasion of critical financial reforms, consider the context in which the Dodd-Frank Act's statutory margin requirements were enacted. CEA section 4s(e) and Exchange Act section 15F(e) were adopted less than two years after the darkest months of the 2008 financial crisis. The failure of Wall Street's largest, systemically important investment banks to collect sufficient margin on AIG credit derivatives had recently contributed to the panic that led the financial system to the brink of meltdown, requiring hundreds of billions of dollars in direct and indirect bailouts, facilities, and other extraordinary programs to benefit AIG's counterparties.[39]

It is inconceivable that Congress would have contemplated a broad margin exemption for interaffiliate derivatives in this context. If it did, it would be especially non-sensical to give such an exemption effect through a non-discretionary directive that the Agencies "***shall*** adopt rules ***imposing*** margin requirements."[40] Congress could have provided a statutory exception[41] or merely authorized the

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37 Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840, 74889 (November 30, 2015).

38 See 5 U.S.C. § 551 et seq. Case law interpreting the APA clearly provides that when an agency departs from a prior policy position, it must "display awareness that it *is* changing position" and "must show that there are good reasons for the new policy." F.C.C. v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009) (emphasis in original). In addition, when a "new policy rests upon factual findings that contradict those which underlay [an agency's] prior policy," the agency must "provide a more detailed justification than what would suffice for a new policy created on a blank slate." Id. This is because, when changing policies, "a reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy." Id. This requirement is all the more important where, as here, the Agencies seek to change a policy that was adopted very recently and only after a lengthy and exceptional rulemaking process, involving years of interagency discussions and international coordination and consideration of a mountain of supervisory and other information. See also fn. 56 infra.

39 For a useful summary of AIG-related events in 2008 and early 2009, including the circumstances of AIG's major credit default swap counterparties, see Office of the Inspector General for the Troubled Asset Relief Program, Factors Affecting Efforts to Limit Payments to AIG Counterparties, SIGTARP-10-003 (Nov. 17, 2009), available at http://www.denninger.net/pdf/sigtarp-aig.pdf.

40 7 U.S.C. § 6s(e)(2)(A)(ii) (emphasis added). 15 U.S.C. § 78o–10(e)(2)(A)(ii) (emphasis added).

41 See, e.g., 7 U.S.C. § 1a(49)(D) (providing that the CFTC "shall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing" and that the CFTC "shall promulgate regulations to establish factors with respect to the making of this determination to exempt").

Agencies to adopt special rules for interaffiliate derivatives "as determined appropriate," as it did in many other derivatives-related provisions within the Dodd-Frank Act.[42] **Again, it did not.**

It is important to emphasize that the primary beneficiaries of the Interaffiliate Margin Proposal would be the very dealers whose poor derivatives risk management, trading, and other practices exacerbated the 2008 financial crisis. Recall that the five largest U.S. derivatives dealers are now also the five largest taxpayer-backed U.S. banks, which conduct approximately 90% of gross notional dealing among domestic banks.[43] These systemically important U.S. banks also dominate global markets through foreign affiliates, which facilitated much of the roughly $542 trillion in derivatives notional outstanding as of 2017.[44] **The Interaffiliate Margin Proposal undeniably would import more of the risks of this foreign dealing activity to the U.S.**, as we discuss below, in the process facilitating the avoidance or evasion of U.S. regulatory reforms.

## II. The proposal would implement unsupported changes to interaffiliate IM requirements with significant implications for the financial stability of U.S. financial institutions and the U.S. financial system.

The Dodd-Frank Act's VM and IM requirements address fundamentally different risks in Covered Swap Entities' derivatives portfolios. VM is a risk management tool designed to reduce market risks by requiring collateralization of a counterparty's daily change in mark-to-market or mark-to-model exposures within an eligible derivatives portfolio. IM, on the other hand, is a risk management tool designed to reduce credit risks in the event of a counterparty's default by requiring collateralization of defaulting counterparty's potential future exposure ("PFE"), which is based, in part, on a derivatives portfolio's assumed liquidation and hedging time horizon.[45] These counterparty-specific requirements supplement capital requirements based on market and credit risk measures across all of a Covered Swap Entity's derivatives counterparties. Understanding the specific risks addressed by IM, as opposed to other types of margin and prudential protections, is key to understanding the risks of unmargined interaffiliate derivatives transactions.

### A. PFE arising from interaffiliate Non-Cleared Derivatives can be transferred to Covered Swap Entities with custody of U.S. deposits and customer funds and critical responsibilities in the U.S. financial markets.

For a Covered Swap Entity, the credit risk of an interaffiliate Non-Cleared Derivatives portfolio is a function of the period of time that it needs to effectively hedge risks or to novate or liquidate the affiliate's portfolio upon default. The longer that process takes—and the more likely a precipitous decline in the value

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42 See, e.g., 7 U.S.C. § 6s(h) (providing that "[e]ach swap dealer or major swap participant shall conform with such business conduct standards as prescribed in [7 U.S.C. § 6s(h)(3)] and as may be prescribed by the [CFTC] by rule or regulation that relate to" specific substantive areas, including "such other matter as the [CFTC] determines appropriate"). See, also 7 U.S.C. § 6s(h)(3)(D) (providing that the business conduct requirements adopted by the [CFTC] shall "establish such other standards and requirements as the [CFTC] may determine are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [7 U.S.C. § 1 et seq.]").

43 See Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities (First Quarter 2019), available at https://www.occ.gov/publications-and-resources/publications/quarterly-report-on-bank-trading-and-derivatives-activities/files/pub-derivatives-quarterly-qtr1-2019.pdf.

44 See Bank for International Settlements, Statistical Release: OTC Derivatives statistics at end-December 2017 (May 3, 2018), available at https://www.bis.org/publ/otc_hy1805.pdf.

45 See Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840, 74845-74846 (November 30, 2015).

of the elements of the portfolio that cannot be easily hedged and liquidated—the more credit risk is assumed by the Covered Swap Entity.

Interaffiliate IM mitigates this credit risk and helps to ensure the non-defaulting Covered Swap Entity can, in extreme but plausible market conditions, contain and orderly manage losses from a Non-Cleared Derivatives portfolio with an affiliate. Because Covered Swap Entities cannot know ex ante the actual exposure of a Non-Cleared Derivatives portfolio upon default, however, they frequently estimate PFE for IM purposes[46] using a standard industry margin model,[47] which assumes a hedging and liquidation time horizon (i.e., a standard margin period of risk)[48] and takes as inputs data on the behaviors of risk components within the affiliated derivatives portfolio. If the modeled risk relationships remain reasonably predictive in default, and other expectations remain valid,[49] the Covered Swap Entity's portfolio with the affiliate in default should be sufficiently collateralized to permit orderly hedging and liquidation and therefore should pose limited risk.[50]

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46 For the technical articulation of PFE, see § __.8 ("Potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the non-cleared swap, non-cleared security-based swap or netting portfolio of non-cleared swaps or non-cleared security-based swaps due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates, and spreads, over a holding period equal to the shorter of ten business days or the maturity of the non-cleared swap, non-cleared security- based swap or netting portfolio.").

47 The standard industry margin model ("SIMM") is a sensitivities-based model implemented by the International Swaps and Derivatives Association, Inc. ("ISDA"). For technical specifications, see ISDA, ISDA SIMM Methodology, version 2.2 (Effective Dec. 1, 2019), available at https://www.isda.org/a/osMTE/ISDA-SIMM-v2.2-PUBLIC.pdf. ISDA has strong commercial incentives to act in the interests of its members and influence the SIMM's IM outputs within the broad margin model and model risk management framework adopted by the Agencies. This is one reason that the Agencies should be sensitive to the potential for systematic underestimation of PFE and required IM in SIMM calculations.

48 The Agencies currently permit a five-day margin period of risk for interaffiliate derivatives transactions that are "subject to an exemption from mandatory clearing." See Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840, 74846 (November 30, 2015) ("[A] covered swap entity may use a holding period in its margin model equal to the shorter of five business days or the maturity of the portfolio for any swaps with an affiliate that are subject to an exemption from mandatory clearing, provided that the initial margin amount for these swaps are calculated separately from other swaps."). Any uniform margin period of risk inevitably will at once overestimate and underestimate required IM for different counterparty pairs and portfolios. For the Agencies, however, the key financial stability consideration must be potential ***underestimation*** affecting the interaffiliate Non-Cleared Derivatives portfolios of the largest, systemically important, too-big-to-fail Covered Swap Entities. Key considerations in this regard would be the size and complexity of portfolios relative to the shallowest regular market depth of markets for liquidating positions, and the liquidity and diversity of hedging markets, with significant adjustments to reflect the likely market realities in distressed market conditions. But regardless of the IM parameters, before eliminating required interaffiliate IM, the Agencies should have at least attempted to measure the resulting change in PFE between the primary dealing affiliates of the most systemically important financial institutions in the U.S., an exercise it has not suggested, considered, or attempted.

49 For example, the collateral posted as IM must be sufficiently stable in stressed in market conditions and not correlated with the financial condition of the affiliate. That is why the Agencies limit the eligible collateral and provide haircutting of eligible collateral used to satisfy the IM requirement. See, e.g., § __.6.

50 That is the theory. In practice, the assumptions and relationships driving IM outputs from the industry's margin model very well may breakdown, especially in the most likely extreme but plausible market conditions leading to an affiliate's default. Consider the realistic circumstances of a Covered Swap Entity having a complex, hard-to-hedge, challenging-to-liquidate, and concentrated Non-Cleared Derivatives portfolio with a defaulted affiliate. Unwinding and hedging large, complex portfolios in stressed market conditions may prove exceedingly difficult. The liquidity in the over-the-counter derivatives markets is episodic, with substantial variation in liquidity measures at different times and on different trading days. Moreover, the margin period of risk for many interaffiliate Non-Cleared Derivatives is equal to that used in certain cleared derivatives markets, which is not a valid basis for comparison. If a clearinghouse hedges, liquidates, and/or auctions a defaulted clearing member's positions, the process is amenable to relatively speedy resolution, mainly because the clearing member has a single counterparty exposure in relevant respects—the clearinghouse—and that exposure may be a fully netted position, with fully netted payments. Cleared derivatives also are less susceptible to valuation disputes. In addition to these and other factors,

***In the absence of IM to collateralize PFE and mitigate credit risk, Covered Swap Entities—very often U.S. banks with depositor funds—can transfer significant risks to the U.S. from foreign jurisdictions using interaffiliate Non-Cleared Derivatives.*** The derivatives dealers, in fact, openly acknowledge that they use interaffiliate Non-Cleared Derivatives to pass along risks from one legal entity to another within their global corporate families. For example, a London affiliate to a U.S. Covered Swap Entity might execute derivatives transactions with European counterparties; and its Hong Kong affiliate might execute derivatives transactions with Asian counterparties. When such trades are booked into the London and Hong Kong affiliates, however, such affiliates then each execute other Non-Cleared Derivatives transactions that transfer the risks of the initial transactions to the affiliated U.S. Covered Swap Entity.

There are legitimate business reasons to structure derivatives transactions in this manner. For example, a U.S. bank may manage some or all of its corporate group's risks relating to a particular set of derivatives and/or may have specific risk management expertise and/or systems in its U.S. risk function. In addition, non-U.S. counterparties may prefer to enter into a derivatives transaction with a local dealing entity for legal, regulatory, and other reasons. This, in turn, allows the foreign affiliate to facilitate the transaction without needing separate capital or to build out its own risk management and control frameworks.

The dealers, unsurprisingly, justify their request to eliminate interaffiliate IM in less commercial terms, claiming that interaffiliate transactions promote responsible risk management and reduce risks across consolidated entities. ***That is demonstrably untrue in certain respects, and incomplete in others***.

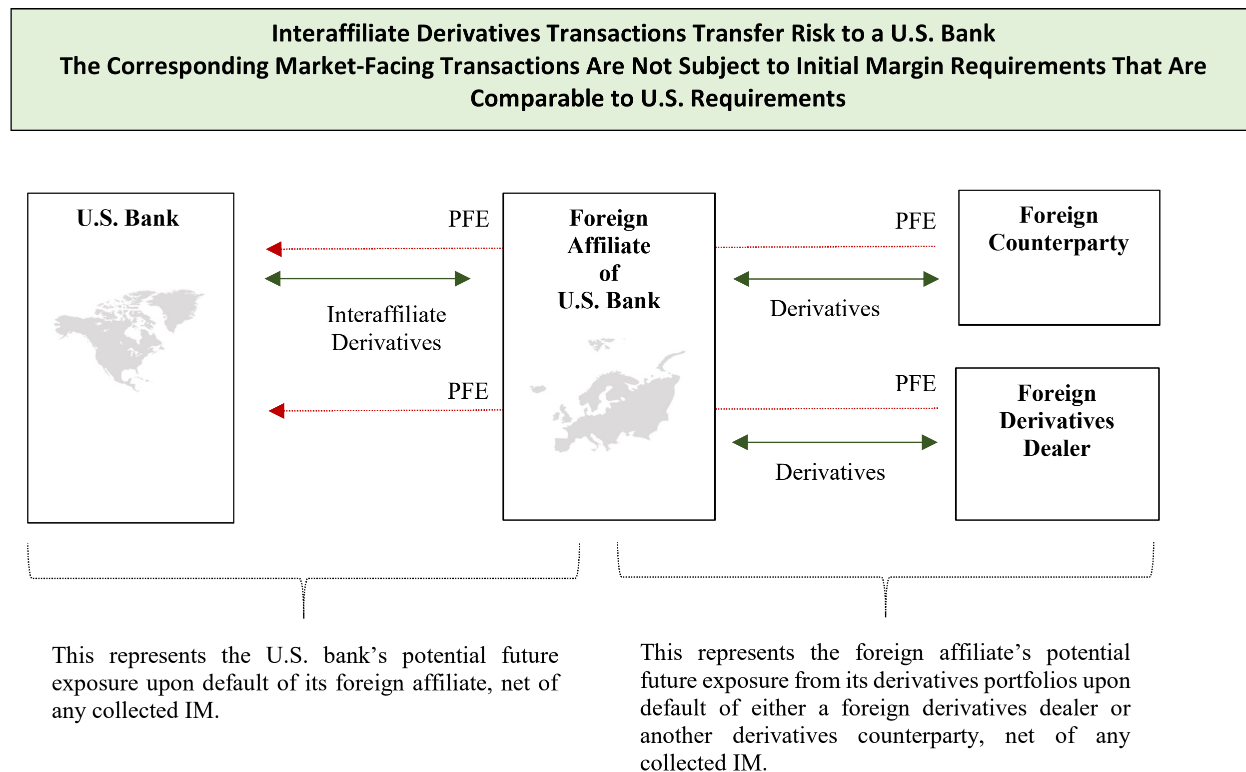
**The sole purpose of interaffiliate Non-Cleared Derivatives is to transfer risks between legal entities and very often, to move risks *into* U.S. banks that have control or custody of deposits and customer funds.** If the U.S. Covered Swap Entity's foreign affiliate is not sufficiently and independently capitalized or does not properly impose IM on all Non-Cleared Derivatives with its third-parties, the default of one or more foreign counterparties would require the affiliate to realize losses equal to some amount of the PFE in the foreign-facing derivatives portfolio. For virtually all large, complex portfolios, the derivatives in the affiliate's external portfolio that cannot be effectively and promptly hedged or liquidated would impose risks and losses on the foreign affiliate itself.

Such losses, if significant, could in turn precipitate the foreign affiliate's default on its interaffiliate Non-Cleared Derivatives with the U.S. Covered Swap Entity, which then could realize losses equal to some amount of the PFE in the interaffiliate derivatives portfolio. Derivatives in the interaffiliate portfolio that cannot be effectively and promptly hedged or liquidated, as above, would impose risks and losses on that U.S. bank, which means, in turn, losses may affect other counterparties, U.S. customers and depositors, the U.S. deposit insurance fund, and/or U.S. taxpayers.[51]

losses in the portfolios of multiple bilateral derivatives counterparties and affiliates may be correlated, so the affiliate's default and resulting losses could come at the precise time that the Covered Swap Entity and similarly situated entities face other losses and defaults and therefore seek to reduce their trading activities and risk appetites. The performance of those portfolios may not be independent, because each may be impacted by others depending on the market presence of the defaulting affiliate, the concentration of positions in specific markets, and the nature of the hedging and unwind activities.

[51] Conversely, if the foreign affiliate of the U.S. bank is both (1) sufficiently and independently capitalized; and (2) properly imposes initial margin (with high quality, stable collateral) on all derivatives transactions with third-parties, it is conceivable that there would be little potential exposure to transfer. In the absence of both conditions (neither of which are contemplated by the proposal), the risk transfer and increase in systemic risk is not just an inescapable reality but the deliberate, sole purpose of the exemption.

In other words, interaffiliate derivatives can be risk ***enhancing***, and although the consolidated entity may merely pass along risks (losses) from one legal entity to another, those risks (losses) are ***re-allocated*** **within the banking organization** in manner that directly affects U.S. interests and financial stability. Consider the following graphic depiction of the risk transfer to the United States, and U.S.-based IDIs:




The <u>above</u> illustration demonstrates in a simple, straightforward fashion that the ultimate risks to a U.S. bank depend on the likelihood that the foreign affiliate of the U.S. bank can meet its obligations in connection with its interaffiliate derivatives portfolio. That, in turn, depends largely on the capital and margin frameworks applicable to the market-facing derivatives transactions giving rise to risks transferred the U.S. bank. And that, again in turn, is a function of the regulatory framework in place in the multiple foreign jurisdictions in which the foreign affiliate deals.[52]

This risk transfer has been acknowledged by Wall Street's largest derivatives dealers and even in the Memorandum to the Board of Governors of the Federal Reserve System recommending adoption of the final margin regulations:

> The draft final rule does not exempt inter-affiliate transactions from the initial margin requirements as advocated by many commenters. Inter-affiliate swaps pose risk to the covered swap entity, which the Dodd-Frank Act directs the Agencies to protect. <u>**However, the covered swap entity, which for the prudential regulators is generally an insured**</u>

[52] These policy concerns do not relate solely to derivatives losses that arise from a directional trading strategy gone wrong, as might be the primary consideration with respect to the Volcker Rule and market risk regulations. PFE may be actualized, and perhaps is most relevant, when a Covered Swap Entity is on the <u>right</u> side of the transaction and therefore accrues a material unsecured claim that the affiliate cannot pay (because, like cascading defaults threatened by AIG, the affiliate's counterparty cannot pay).

> **depository institution ("IDI"), is protected from the risks of a swap with an affiliate if the IDI collects margin from the affiliate** . . . .[53]

We are inclined to agree with the Federal Reserve staff's assessment and Governor Tarullo. ***Eliminating interaffiliate IM would not eliminate U.S. risks from derivatives transactions; it would amplify them.*** And it would facilitate the transfer of the amplified risk from unregulated, less regulated, or differently regulated foreign affiliates[54] to U.S. banks that do each of the following:

1) Maintain control or custody of U.S. deposits and customer funds; and

2) Facilitate liquidity and financial transactions through market-making, underwriting, credit, and payments functions critical to U.S. economic activities.

**B. The proposal lacks a balanced discussion (really, any discussion) of financial stability issues involved in the elimination of interaffiliate initial margin for Non-Cleared Derivatives.**

The APA does not authorize the Agencies to propose regulations that are understandable only by a handful of cognoscente. They must explain and provide at least some assessment of the potential risk transfers, collateral costs, and other financial stability factors presented by eliminating interaffiliate IM. Yet, not one sentence addresses in a balanced manner the potential systemic risk implications of a proposed regulation that would release, by some estimates, as much as $39.4 billion in collateral for the U.S.'s too-big-to-fail financial institutions, increasing U.S. risk exposures rather significantly, if not commensurately.[55]

**That is neither responsible policymaking nor lawful rulemaking under the APA, which demands that the public have an opportunity to provide meaningful comment on the substance and merits of a proposal.[56]**

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[53] Memorandum from Daniel Tarullo to the Board of Governors of the Federal Reserve System, Draft Final Rule and Draft Interim Final Rule—Margin and Capital Requirements for Covered Swap Entities (October 21, 2015), available at https://www.federalreserve.gov/aboutthefed/boardmeetings/swap-margin-board-memo-20151030.pdf.

[54] Because interaffiliate risks may arise in connection with market-facing transactions in a foreign jurisdiction and because those risks may arise (1) in the absence of comparable, comprehensive regulations and (2) in cases where regulations exist but institute material differences in haircutting, collateral eligibility, margin modeling, model risk management, risk sensitivities, etc., those risks can directly contribute to additional risks in the U.S. affiliate.

[55] ISDA Research Study, ISDA Margin Survey Year-End 2018 (Apr. 2019), available at https://www.isda.org/a/nIeME/ISDA-Margin-Survey-Year-End-2018.pdf.

[56] 5 U.S.C. § 551 et seq. The APA requires federal agencies to provide to the public notice and an opportunity to comment on regulatory proposals. 5 U.S.C. § 553(b). More specifically, the APA directs federal agencies to give interested persons an opportunity to participate in rulemakings through the submission of written data, views, or arguments to be considered in the agency's deliberative process. 5 U.S.C. § 553(c). Rulemakings must provide sufficient factual detail on the legal basis, rationale, and supporting evidence for regulatory provisions such that interested parties are "fairly apprised" of content, the reasoning of the agency implementing them, and the manner in which such regulations foreseeably may affect their interests. See, e.g., Mid Continent Nail Corporation v. United States, 846 F.3d 1364, 1373-1374 (Jan. 27, 2017); U.S. Telecom Ass'n v. F.C.C., 825 F.3d 674, 700 (June 14, 2016), citing Honeywell Int'l, Inc. v. E.P.A., 372 F.3d 441, 445 (June 29, 2004); Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin., 407 F.3d 1250, 1259-1260 (May 24, 2005); Am. Medical Ass'n v. Reno, 57 F.3d 1129, 1132-1133 (June 27, 1995); Florida Power & Light Co. v. U.S., 846 F.2d 765, 771 (May 13, 1988). Better Markets notes that three public interest organizations requested an extension of the proposal's minimal 30-day public comment period, which would have provided a comment period commensurate with the complexity and significance of the Interaffiliate Margin Proposal. The Agencies, however, have failed to act upon that request, denying the

Better Markets notes, moreover, that existing interaffiliate IM requirements already likely systematically underestimate the PFE of Non-Cleared Derivatives portfolios between Covered Swap Entities and affiliates. Margin period of risk and other flawed IM model specifications have left plenty of risk in interaffiliate portfolios, though comprehensive consideration of these risk issues is beyond the scope of the current proposal. In this regard, the Agencies also permit a $20 million unsecured threshold that each Covered Swap Entity is permitted to have with each affiliate involved in derivatives dealing.[57] To compound such existing risks, and others, by simply abolishing interaffiliate IM altogether is shortsighted and unnecessary, and by its nature, will permit large banking entities to import risks directly to the U.S., U.S. taxpayers, and U.S. customers.

## III. Sections 23A and 23B of the Federal Reserve Act, as well as Regulation W, do not fully address PFE arising from the proposed elimination of interaffiliate IM.

In a single cursory paragraph, the Agencies suggest that much of the potential exposure that would increase from the proposed elimination of initial margin requirements would be mitigated by the interaffiliate restrictions and requirements in sections 23A and 23B of the Federal Reserve Act ("FRA").[58] In addition to being largely and admittedly incorrect, this passing reference is grossly inadequate pursuant to the requirements of the APA. The Agencies acknowledge, for example, that "***certain*** affiliate transactions ***are subject to*** the requirements of section 23A and 23B of the Federal Reserve Act as implemented by the Federal Reserve's Regulation W, as ***these requirements*** continue to apply to affiliate transactions with an insured depository institution."[59] The Agencies' analysis confirms the following two limitations:

> 1) That FRA sections 23A and 23B are not applicable to <u>all</u> interaffiliate derivatives transactions; and
>
> 2) That the interaffiliate transactions that are subject to FRA sections 23A and 23B may not be margined in a manner that is comparable to the margin required under the prudential regulators' margin regulations.

Differently stated, the critical missing observation is that the PFE from interaffiliate Non-Cleared Derivatives is not addressed by Regulation W and related statutory provisions, because affiliate restrictions and requirements either (1) <u>do</u> <u>not</u> apply, as is the case, for example, with respect to certain transactions between IDIs and subsidiaries (so-called "bank-chain" entities); or (2) <u>do</u> apply but do not necessarily limit, much less require collateral to fully offset, PFE in the same manner and to the same extent as Title VII prudential margin requirements.[60] Thus, when the Agencies' state that "[c]urrently, almost all U.S. covered

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public at large an opportunity to provide meaningful comment on numerous financial stability issues, including interactions between different prudential regulations.

[57] <u>See</u> <u>Margin and Capital Requirements for Covered Swap Entities</u>, 80 Fed. Reg. 74840, 74889 (November 30, 2015) ("The final rule provides that a covered swap entity may apply a $20 million initial margin threshold to each of its affiliates. For example, if a covered swap entity engages in three inter-affiliate swaps with an initial margin amount of $100 million each with three separate affiliates, the total amount of initial margin that the covered swap entity would be required to collect would be (($100m-20m) + ($100m-$20m) + ($100m-$20m)) = $240m.").

[58] 12 U.S.C. § 371c and 12 U.S.C. § 371c-1.

[59] <u>Margin and Capital Requirements for Covered Swap Entities</u>, 84 Fed. Reg. 59970, 59976 (November 7, 2019).

[60] FRA section 23B protects a member bank by requiring that certain derivatives transactions between the bank and its affiliates occur under market terms that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies. <u>See, e.g.,</u> 12 U.S.C. § 371c–1(a)(1)(A).

swap entities are [IDIs] that would be subject to Sections 23A, 23B, and Regulation W,"[61] that again may be technically correct but materially incomplete: it neglects to address the relevant issue of whether comparable IM requirements adhere to all subject interaffiliate derivatives transactions. The answer to that question is simply "no."

These regulatory deficiencies can and should be remedied, in part, through amendments to Regulation W, which may require amendments to the enabling provisions of FRA sections 23A and 23B. No such compensating amendments have been proposed, much less finalized, however, and any such amendments would merely complement, and in no way abrogate, the statutory margin requirements imposed on Covered Swap Entities.

## IV. Conclusion

The Agencies conclude that regulations imposing IM on interaffiliate Non-Cleared Derivatives have had "limited systemic risk benefits," because "other jurisdictions (as well as the U.S. market regulators) do not consistently apply swap margin rules to interaffiliate swaps."[62] Even assuming that were accurate, the solution to that supposed problem is to consistently apply interaffiliate IM requirements, ***not to consistently not apply them.*** In any event, the Agencies have no such discretion and no such choice: they are bound by their own statutory mandates and policy determinations, not those in other jurisdictions or adopted by U.S. market regulators.

The systemic risk and financial stability benefits of requiring interaffiliate IM are clear and immense. Indeed, according to ISDA, at least $39.4 billion in collateral is required solely for IM on interaffiliate Non-Cleared Derivatives. That cannot be true and yet provide "limited [U.S.] systemic risk benefits."[63] The PFE measure that generates required IM amounts depends, in the first instance, on the existence of risk. Collateralizing that PFE measure with high-quality collateral must reduce that exposure and therefore reduce systemic risk and increase financial stability. Among other reasons, that is why Congress required IM to be collected in the first place and imposed a clear and binding mandate on the Agencies.

Sincerely,

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President and CEO

Joseph R. Cisewski
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[61] Margin and Capital Requirements for Covered Swap Entities, 84 Fed. Reg. 59970, 59976 (November 7, 2019).

[62] Id.

[63] Id. For additional information on the $39.4 billion IM figure, see supra fn. 55.

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