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Mr. Alfred M. Pollard, General Counsel
Attention Comments/ RIN-AA45
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Mr. Barry F. Mardock, Acting Director
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1501 Farm Credit Drive
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November 24, 2014

Re: Margin and Capital Requirements for Covered Swap Entities: "Reproposed Rule" [RIN 2590-AD43][1]

The American Council of Life Insurers ("ACLI") is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry in the United States. Many of our members also provide life insurance, annuity and employee benefit programs on a global basis. We greatly appreciate the opportunity to offer our commentary on the Reproposed Rule jointly issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Farm Credit Administration (collectively, the "Prudential Regulators").

Life insurers have actively participated in the dialogue concerning the regulation of domestic and international derivatives markets and have provided constructive input on proposed rulemaking implementing Title VII of the Dodd Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act") in general, and on standards for margining non-cleared swap transactions in particular.[2] We strongly encourage coordinated domestic and international approaches to

[1] 79 Fed. Reg. Vol. 79, No. 185 (Sept 24, 2014), at page 57348.

[2] ACLI submitted detailed comments on the following parallel regulatory proposals developed by the Prudential Regulators, the U.S. Commodity Futures Trading Commission ("CFTC"), and the U.S. Securities and Exchange Commission ("SEC"):

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derivatives regulation that will achieve desired stability of the global financial system while enabling cost-effective compliance and discouraging regulatory arbitrage.

Summary of ACLI's Positions

Several aspects of the Reproposed Rule constructively improve the Prudential Regulators' initial 2011 rule proposal, and productively track global regulatory approaches to margin in uncleared swaps. Other elements of the Reproposed Rule, however, would thwart life insurers in responsibly managing asset and liability risks, contrary to statutory mandates and global regulatory standards.

Life insurers are highly regulated entities that invest their assets to support their liabilities to policyholders, and they use derivatives to manage risks associated with this business. Life insurers unequivocally supported the collateralization of non-cleared swap exposures, and have been doing so even prior to the implementation of the Dodd Frank Act. We believe, however, the Reproposed Rule is deficient in a number of fundamental ways, particularly in its deviation from both the governing statutory mandate and the BCBS-IOSCO Margin Requirements for Non-Centrally Cleared Derivatives[3] (the "Final Framework").

For these reasons and others, ACLI opposes the Reproposed Rule's cash-only limitation for variation margin ("VM"). In addition, ACLI believes that the Prudential Regulators have mischaracterized VM for non-cleared swaps as settlement or payment rather than collateral, and also advocates that VM amounts be determined by mid-market pricing.

- Supplemental Request for Comments on Proposed Margin and Capital Requirements for Covered Swap Entities; [http://www.fhfa.gov/webfiles/24691/95_American%20Council%20of%20Life%20Insurers%20ACLI.pdf] [Prudential Regulators];
- Supplemental Request for Comments on Proposed Margin Requirements Governing Uncleared Swap Transactions for Swap Dealers and Major Swap Participants [http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58806&SearchText=wilkerson] [CFTC];
- CFTC Proposal on Protection of Cleared Swaps Customer Contracts and Collateral [http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48045&SearchText=wilkerson] [CFTC]; and,
- SEC proposal on margin, capital and segregation for security-based swap dealers and major security-based swap participants [http://www.sec.gov/comments/s7-08-12/s70812-25.pdf].

ACLI also submitted comments on the initial BCBS-IOSCO Consultative Document for Non-Centrally Cleared Derivatives, published by the Basel Committee on Bank Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) (May 2012) ("BCBS-IOSCO Consultative Paper") [http://www.bis.org/publ/bcbs226/acoli.pdf] [BCBS-IOSCO], and the BCBS-IOSCO Second Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives (Feb. 2013) ("Second BCBS-IOSCO Consultative Paper") [http://www.bis.org/publ/bcbs242.pdf].

[3] BCBS-IOSCO Margin Requirements for Non-Centrally Cleared Derivatives, September 2013 [http://www.bis.org/publ/bcbs261.pdf].

We also identify a number of functional and operational issues under the Reproposed Rule. Specifically, the Prudential Regulators should reassess the impacts of new documentation on existing legacy trades as well as trades executed after the VM requirements become applicable but before the initial margin ("IM")[4] requirements are implemented. In addition, the definitions of Eligible Master Netting Agreement and Affiliate should be clarified to address issues that are unique to insurers, as well as issues that relate to the treatment of collective investment vehicles. The Prudential Regulators must also consider unintended macro-economic impacts that the Reproposed Rule may have on the capital markets generally and the ability to raise capital. Finally, in order to address the multitude of operational impacts of the Reproposed Rule, ACLI strongly advocates requiring VM effective December 1, 2015 consistent with current market practices while extending the implementation date for other VM requirements to coincide with the implementation of the IM requirements.

I. Life Insurers Prudently Use Derivatives to Manage Asset and Liability Risks Associated With the Products They Provide to Millions of Americans

Life insurers provide essential retirement and financial security to millions of customers through products such as life, long-term care and disability insurance and annuities. These obligations often have durations that last one or more decades. Accordingly, in order to meet their commitments to policyholders, life insurers invest in a broad spectrum of assets, many of which are long-dated, including government and corporate bonds, mortgage backed securities, public and private equities, commercial real estate mortgages and alternative assets. Cash and cash equivalents represent a relatively small portion of life insurers' portfolios because they provide no return to support the insurers' long-dated liabilities.

Because of the lengthy duration of their liabilities and the accompanying asset portfolios that support them, insurers are exposed to significant risks posed by changes in interest rates, currency exchange rates, equity market performance, and credit defaults, among others. Life insurers hedge the risks inherent in their assets and liabilities through the prudent use of exchange-traded and both cleared and non-cleared over-the-counter ("OTC") swaps.[5] Insurers have generally preferred to use OTC swaps because their terms can be structured to most closely offset risks in the asset or liability. While many OTC swaps used by insurers have become clearable, insurers will continue to demand and use non-cleared OTC swaps to hedge complex risks that are unique to specific combinations of assets and liabilities. Therefore, cost-effective access to, and participation in, the non-cleared swap markets is fundamental to life insurers' ability to responsibly manage risks and deliver affordable products to policyholders.

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[4] Under existing over-the-counter swap practices and documentation, IM is generally referred to as "Independent Amounts" ("IA").

[5] A 2014 NAIC Capital Markets Special Report on the Insurance Industry's Derivatives Exposure at Year-End 2012 (the "NAIC Special Report") indicated that the notional amount of insurers' derivatives holdings was almost $1.7 trillion. There were 264 insurance companies using derivatives of which 147 were life insurance companies. Life insurance companies are the primary users of derivatives, with $1.58 trillion notional amount or 95.4% of the outstanding notional at year-end 2012.

State insurance laws and regulations govern life insurers' use of derivatives and restrict their use to hedging, asset replication, and limited income generation transactions.[6] State laws contain limitations on an insurer's derivatives exposure generally and combine counterparty swap exposure limits with other exposures to the same counterparty in order to manage concentration risk. Furthermore, many state laws require a comprehensive derivatives use plan which may be reviewed by the applicable regulator. Finally, all derivatives transactions (including terminated transactions) are reported on a quarterly and annual basis. Like Title VII of the Dodd Frank Act, these long-standing regulatory mandates are designed to prevent financial and economic instability attributable to derivatives transactions.[7]

For years, life insurers have utilized collateral support arrangements to mitigate counterparty risk in OTC transactions. Under the terms of most insurers' agreements, no independent amount is required and collateral is exchanged on a daily basis. Furthermore, in response to the financial crisis, many life insurers renegotiated their OTC agreements to reduce or eliminate thresholds for posting collateral. As a result, their non-cleared swap exposures are generally fully collateralized with the exception of one day market movements.

A critical element of life insurers' current OTC agreements is the broad range of collateral that is permissible as VM. Essentially, life insurers have been able to use the assets that are ordinarily on their balance sheets to collateralize their non-cleared swap obligations. By allowing the use of collateral other than cash, insurers have been able to remain invested in assets that support their liabilities instead of having to maintain excess cash. This has enabled life insurers to hedge their risks without a meaningful give-up in yield. If cash becomes the sole means of posting variation margin, insurers will confront significantly increased hedging costs which may diminish the range of products that they can offer to support their customers' financial stability and security.

II. Life Insurers Oppose the Cash-Only Limitation for VM in the Reproposed Rule

The Reproposed Rule limits the eligible collateral for the posting of VM to cash only. We submit that this limitation to a single class of eligible collateral is a significant departure from the Final Framework and the text and intent of the Dodd Frank Act, and a major deviation from current market practice. At the same time, this marked shift is not accompanied by strong policy arguments or thorough cost-benefit analysis. Moreover, we think that the Prudential Regulators have based some of their justifications on a narrow and unrepresentative view of market practice. For the

[6] The NAIC Special Report indicated that 95.7%of insurers' derivatives exposure at year-end 2012 was for hedging followed by 3.2% for asset replication.

[7] State insurance departments heavily regulate the operations, products, solvency, market conduct and financial condition of life insurance companies. Uniformity of regulation is promoted throughout the states by means of model statutes and regulations developed by the National Association of Insurance Commissioners (the "NAIC"). The broad scope and comprehensiveness of these state insurance statutes and regulations achieves functional harmonization and prevents regulatory arbitrage. Each jurisdiction regularly examines its domestic life insurers' financial condition and market conduct, and ensures that laws and regulations are properly followed. To provide further context about the state regulation of insurers' derivatives activities, we attach as **Appendix A** an outline describing the provisions in the NAIC's Investments of Insurers Model Act as well as a list of applicable state laws.

reasons described below, we believe that the categories of eligible collateral for VM should be expanded to be more in line with current market practice and international regulation.

A. By Requiring the Use of Cash as VM for Non-cleared Swap Transactions, the Reproposed Rule Unacceptably Departs from the Consensus Reflected in the Final Framework

In September 2013, BCBS-IOSCO issued its Final Framework following two exhaustively detailed consultative proposals with extensive global commentary. Although the Prudential Regulators actively participated in this deliberative process, the Reproposed Rule inexplicably deviates in important ways from the global consensus that the Prudential Regulators helped develop.

Perhaps the most significant departure is the Reproposed Rule's requirement that cash, and cash alone, must be used to support VM requirements in non-cleared swaps transactions. The unexplained failure to follow the unequivocal recommendation of BCBS-IOSCO on the use of non-cash assets, including high-quality corporate debt, for VM in non-cleared swap transactions constitutes a material difference between the U.S. regulatory regime and the consensus international approach to eligible collateral. It is noteworthy that the proposed requirements for eligible VM collateral set forth by the European Securities Market Authority follow the international consensus and expressly permit non-cash collateral to be posted as VM.[8]

BCBS-IOSCO explicitly considered, and ultimately rejected, narrowly constraining the range of assets eligible as collateral for non-cleared swaps:

> BCBS and IOSCO have considered the types of collateral that should be deemed eligible for use in meeting margin requirements. . . . One approach would be to restrict eligible collateral to the most liquid top-quality assets, such as cash and high-quality sovereign debt. . . . Another approach would be to permit a broader set of eligible collateral . . .and address the potential volatility of such assets through the application of appropriate haircuts to their valuation for margin purposes. . . . After evaluating each of these alternatives, the BCBS and IOSCO have opted for the second approach (broader eligible collateral).[9]

Accordingly, the Final Framework provided the following examples of recommended eligible collateral:

- Cash;
- High quality government and central bank securities;

[8] *See* European Securities Market Authority, Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP under Article 11 (15 of Regulation (EU) No. 648/2012, Consultation Paper 32 (April 14, 2014), available at: http://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf.
[9] Final Framework at 16.

- High quality corporate bonds;
- High quality covered bonds;
- Equities included in major stock indices; and
- Gold.

In adopting this more expansive approach, BCBS-IOSCO recognized that permitting the use of a wide range of assets as collateral, subject to appropriate haircuts, would reduce the potential liquidity impact of margin requirements, while still providing adequate protection against systemic risk in times of financial stress. ACLI has consistently supported this view. In fact, the Final Framework is largely consistent with a parallel suggestion that ACLI presented to U.S. regulators on eligible collateral for margin.[10]

[10] On July 11, 2011, ACLI submitted a proposal to the CFTC and U.S. Prudential Regulators based on an analytic framework utilizing basic diversification techniques on a portfolio of corporate bonds. ACLI also met with staff in the Office of General Counsel of the Board of Governors of the Federal Reserve to explain our concerns about the proposed rule's exclusion of certain classes of highly liquid collateral from the list of variation margin and our proposed solution to defining high-quality corporate debt on May 23, 2012 (summary of meeting) and again on June 16, 2014. This analysis demonstrates, almost to the level of statistical certainty, that high-quality corporate collateral would provide sufficient cushion even against some of the most severe economic downturns. A brief summary of this proposal provides support for the position advanced in this letter.

In light of the Dodd Frank Act's prohibition against reliance on credit ratings provided by nationally recognized statistical rating organizations (NRSROs), ACLI's proposal uses the Barclays U.S. Credit Index, a broad-based index containing 4,430 issues/CUSIPs representing an outstanding amount of $3.4 trillion. The Barclays U.S. Credit Index (together with its predecessor, the "Barclays Index") has many advantages, including clearly defined eligibility rules, a defined list of eligible CUSIPs limited to large liquid issues, and a ready source of daily pricing and historical data. The Barclays Index is also widely benchmarked by money managers evidencing wide acceptability by other financial end users. In addition, the Barclays Index is one of many indices that are available to reference high-quality, U.S. corporate bonds and we believe our analysis could be applied to other indices as well.

Following the Prudential Regulators' determination that close out of uncleared derivatives and liquidation of collateral could take ten days in a stress scenario, we analyzed individual CUSIPs from the Barclays Index during 2008 and found that nearly 20% of CUSIPs experienced a ten-day price decline in excess of 20% with a maximum decline in excess of 90% in 0.2% of the CUSIPs, leading to the conclusion that tail events, though rare, do occur. Thus, a collateral pool consisting of one or a very small number of CUSIPs is not advisable.

In expanding the analysis to look at the impact of adding additional CUSIPs to the collateral pool, ACLI chose a single month (September 2008) to ensure a continuous set of CUSIPs and selected a random portfolio as of September 1, 2008, subject to diversification rules limiting each issuer to a specified percentage and each broad sector (Financial Institutions, Industrials, Utilities, Transportation, Agencies, Local Authorities, Sovereign and Supranational) to no more than 45% of the portfolio. The market value of the equally weighted portfolio was calculated as it evolved through the month, including the largest 10-day (rolling) price drop that occurred during the month.

The analysis shows that corporate bond tail risk can be controlled with basic diversification rules (e.g., minimum of 20 CUSIPs and 45% concentration limit per broad sector) and that collateral haircuts of 15-20% provide a high degree of protection upon the occurrence of a covered swap entity default. The maximum decline at the 99th percentile was 10.25% in our portfolio simulation. We also learned that further diversification beyond these rules provided little incremental benefit while substantially increasing operational burdens.

Moreover, the balance reflected in the Final Framework also avoids significant unintended consequences attributable to a narrower formulation.[11] In sum, the Final Framework strikes an appropriate balance between security and liquidity considerations and advances two of the Key Principles in the Final Framework: Element 4, discussed above, regarding the range of eligible margin, and Element 7, that "[r]egulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives across jurisdictions."[12] Accordingly, we strongly recommend that the Prudential Regulators follow the consensus enunciated in the Final Framework by allowing broader categories of eligible collateral, such as high-quality corporate debt.[13]

Our analysis shows that high-quality corporate bonds, appropriately haircut and diversified, can be prudently included as eligible collateral for cleared and non-cleared swap exposure. We also suggest that other high-quality collateral types such as Agency Debentures and Agency RMBS should also be included as eligible collateral. Our proposal recommended prudent haircuts, portfolio diversification and concentration limits to further support an expanded list of eligible collateral.

[11] ACLI's July 11, 2011, submission to the CFTC and the Prudential Regulators also noted that limiting eligible collateral to cash and government securities could impose unintended negative consequences on the market for these securities, and could create liquidity log jams. *See* ACLI submission at 6. In the submission, ACLI emphasized that limiting non-cash eligible collateral to U.S. Treasury and guaranteed agency securities may also alter the markets for these securities -- artificially increasing prices due to rising demand and suppressing yields for investors in these securities. There could be new sensitivity in the markets for these securities which could lead, in times of market stress, to increased volatility. This volatility could ripple across the financial markets. Increased demand for U.S. Treasuries as eligible collateral would be exacerbated by the "flight to quality" in times of market turmoil or distress. Otherwise sound firms could potentially be thrust into a scenario where they are forced to liquidate other high-quality assets to fulfill increasing margin requirements with a narrowly defined collateral universe. Being able to avoid this type of scenario is arguably a primary reason behind the wide range of eligible collateral types available at the Federal Reserve Discount Window. In addition, by limiting variation margin to cash only (and further restricting that category to either U.S. dollars or the currency in which payment obligations under the swap are required to be settled) and excluding other major currencies, the U.S. may be seen as favoring U.S. assets in a way that could have the unintended consequence of discouraging other G-20 regulators implementing the IOSCO Framework from accepting U.S. dollars and securities as margin, contributing to liquidity stress in U.S. dollar-based assets without gaining protections in terms of collateral quality. This same concern applies to exclusion from VM of low risk-weight sovereign debt and other high-quality non-U.S. dollar assets – it will cut against the goal of harmonizing global regulation and reducing liquidity stress without adding meaningful counterparty protection.

[12] Final Framework Key Principles 4 and 7.

[13] The Final Framework observed that its list of eligible collateral should not be considered exhaustive. *See* Final Framework at 17. We therefore recommend that additional assets and instruments, such as residential mortgage-backed securities and commercial mortgage-backed securities should also be evaluated by regulators for inclusion as eligible collateral. A broad range of eligible, high-quality collateral - with appropriate haircuts - would prudently assure satisfaction of counterparty obligations while also enhancing liquidity in the market and reducing systemic risk. We also note that the haircuts provided in Appendix B of the Proposed Rule (at 57396) suggest an additional haircut of 8% for the value of assets denominated in a currency that differs from the currency of the swap obligation. We believe that parties should have the option of using a model-based haircut to account for currency risk, an approach that is consistent with the Final Framework's suggestion that haircuts could be based on either quantitative models or a standardized schedule. *See* Final Framework at 17. We believe that an 8% adjustment will result in over-collateralization and place additional stress on margin requirements applicable to financial end-users such as life insurers. We

B. The Reproposed Rule is Inconsistent with the Statutory Mandate to the Prudential Regulators to Permit Non-cash Margin Unless Doing So Would Negatively Affect the Financial Integrity of the Swaps Trading Market or Threaten the Stability of the U.S. Financial System

Section 4s(e)(3)(C) of the Commodity Exchange Act ("CEA") states that the Prudential Regulators "***shall*** permit the use of non-cash collateral, as the regulator…determines to be consistent with ***(i) preserving the financial integrity of markets trading swaps; and (ii) preserving the stability of the United States financial system.***"[14] In the Reproposed Rule, the Prudential Regulators permit only cash collateral for VM and do not provide an analysis that would support a determination that permitting non-cash collateral for VM would negatively affect the financial integrity of the swaps market or the stability of the U.S. financial system.[15] Accordingly, as described below, the rules of statutory construction strongly support the conclusion that the words "shall permit" in Section 4s(e)(3)(C) should be read as mandating the Prudential Regulators to allow non-cash collateral for VM.[16]

Not surprisingly, the CEA does not define the word "shall." Various canons of construction are therefore necessary to ascertain its meaning, and this section will discuss three relevant canons to determine the probable meaning of "shall": the "Plain Meaning Rule," the "Meaningful Variation Rule" and the "Rule against Surplusage." Finally, we note that the proposed prohibition for non-cash VM is inconsistent with the legislative history of the new margin provisions of the CEA.

1. Plain Meaning Rule

An often-used canon of statutory construction is the "Plain Meaning Rule" in which courts apply the plain meaning of the text without further judicial inquiry or interpretation.[17] Words that are not terms of art and that are not statutorily defined are customarily given their ordinary meanings, often derived from the dictionary.[18] Since "shall" is not statutorily defined in the CEA, the correct meaning

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note that ISDA has persuasively argued that this risk is more accurately addressed by incorporating FX risk into an initial margin model (*See* ISDA letter to the European Securities and Markets Authority, the European Banking Authority and the European Insurance and the Occupational Pensions Authority re: Proposed Margin Requirements: Analysis of Currency Mismatch Haircut, dated 17 August 2014 and available at http://www2.isda.org/functional-areas/wgmr-implementation/) and we would be supportive of that approach as an alternative to the less precise 8% haircut.

[14] 7 U.S.C. § 6s(e)(3)(C) (2012) (emphasis added).

[15] *See* Reproposed Rule at 57371. The only reference to the two-prong statutory provision is a background reference in footnote 10 of the Prudential Regulators' Proposal.

[16] *See also* Memorandum of Sutherland Asbill & Brennan LLP Regarding "Statutory Analysis of Section 4s(e)(3)(C) of the Commodity Exchange Act" attached hereto as **Appendix B**.

[17] *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992).

[18] *Asgrow Seed Co. v. Winterboer*, 513 U.S. 179, 187 (1995).

must rely on the dictionary and ordinary meaning of "shall." The word "shall" has been defined traditionally as a mandatory verb.[19]

2. Meaningful Variation Rule

The "Meaningful Variation Rule" states that if both mandatory and permissive verbs are used in the same statute or in the same section, courts should make a fair inference that the legislature realized the difference in meaning and intended that the verbs should carry with them their ordinary meanings.[20] "Shall" and "may" are used in Section 4s of the CEA repeatedly and in close proximity. The "Meaningful Variation Rule" thus dictates that there is a fair inference that Congress appreciated the difference in meaning. Congress likely intended for the verbs "shall" and "may" to carry their traditionally distinct meanings. Accordingly, "shall" should reasonably be read as a mandatory verb, as "may is a permissive one.

3. Rule Against Surplusage

Finally, the "Rule against Surplusage" states that "effect must be given, if possible, to every word, clause and sentence of a statute."[21] In this case, the word "shall" in Section 4s(e)(3)(C) is followed by the phrase "as the regulator or the [Commodity Futures Trading] Commission determines to be consistent with (i) preserving the financial integrity of markets trading swaps and (ii) preserving the stability of the United States financial system."[22] Since the "Rule Against Surplusage" dictates that every phrase must be given effect, the phrase following "shall" must also be given effect. Stated simply, if the Prudential Regulators make the determination that allowing non-cash collateral for VM would negatively affect the financial integrity of the swaps trading market or threaten the stability of the U.S. financial system then such a determination would likely negate the affirmative obligation to allow non-cash collateral. However, as previously noted, there is scant evidence that the Prudential Regulators did, in fact, make such a determination.

4. The Reproposed Rule Ignores the Legislative History of the New Margin Rules

Statutes are found to be mandatory or permissive on the basis of legislative history establishing legislative intent.[23] Courts normally refer to relevant legislative history if the statutory text and the canons of construction leave uncertain the Congressional intent underlying the specific issue or

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[19] WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2085-86 (3rd ed. 1993); *Lexecon, Inc. v. Milberg Weiss Bershad Hynes & Lerach*, 523 U.S. 26, 35 (1998) (The word "shall" "creates an obligation impervious to judicial discretion."); *Anderson v. Yungkau*, 329 US 482, 485 (1947) ("The word 'shall' is ordinarily the language of command.").

[20] *United States v. Thoman*, 156 U.S. 353, 360 (1895) ("In the first [provision] the word 'shall' [is used] and in the latter provision the word 'may' is used, indicating command in the one and permission in the other."); 3 SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 57:11 (Norman J. Singer ed., 7th ed. 2014 rev.).

[21] 2A SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 46:6 (Norman J. Singer ed., 7th ed. 2014 rev.); *Corley v. United States*, 129 S. Ct. 1558, 1567 (2009); *Hibbs v. Winn*, 542 U.S. 88, 101 (2004).

[22] 7 U.S.C. § 6s(e)(3)(C) (2012).

[23] 3 SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 57:5 (Norman J. Singer ed., 7th ed. 2014 rev.).

provision, *i.e.,* the statute is ambiguous with respect to a specific provision or issue.[24] Were a court to find that the meaning of "shall" in Section 4s(e)(3)(C) is ambiguous, the court would look at the legislative history of Section 4s which seems to indicate that Congressional intent was for "shall" to be a mandatory verb.

The House Committee Report provides an illuminating view to the meaning of the word "shall" as used in Section 4s(e)(3)(C) of the CEA. Senator Chris Dodd, a co-sponsor of the Dodd Frank Act, wrote a letter intended to be an explanatory floor statement. This letter was incorporated into the House Committee Report.[25] By "specifically mandat[ing]" that the Prudential Regulators permit the use of non-cash collateral, Senator Dodd made clear the drafters' intention that "shall" in Section 4s(e)(3)(C) be read as a mandatory verb.[26]

Moreover, reading "shall" as a mandatory verb supports the legislative purpose of Section 4s. After all, the main objective of statutory construction is to effectuate statutory purpose.[27] In this case, the purpose of Section 4s(e)(3)(C) of the CEA is clearly stated in its legislative history. The Prudential Regulators were tasked with ensuring that the margin rules would not be prohibitively expensive for end users to manage their risk. Senator Dodd stated:

> ....[T]he [P]rudential [R]egulators ***must not make hedging so costly it becomes prohibitively expensive for end users to manage their risk***....It is imperative that the regulators do not ...***discourage hedging by end users or impair economic growth***....
>
> ...a consistent Congressional directive...and in Congressional debate, has been ***to protect end users from burdensome costs associated with margin requirements***.... [28]

Thus, "shall" in Section 4s(e)(3)(C) of the CEA was written with the intent to specifically mandate that the Prudential Regulators allow non-cash collateral as VM because Congress was concerned with protecting end users from burdensome costs.

In sum, "shall" was intended as a mandatory verb in Section 4s(e)(3)(C) of the CEA. Absent a clear determination by the Prudential Regulators that allowing non-cash collateral would negatively affect the financial integrity of the swaps trading market or threaten the stability of the U.S. financial

[24] *See, e.g.*, *Muscarello v. United States*, 524 U.S. 125, 132 (1998) (analyzing evidence of congressional intent because ambiguous statutory language was identified).

[25] 156 CONG. REC. H5233-61 (daily ed. June 30, 2010) (letter of Sen. Chris Dodd) (emphasis added).

[26] Senator Dodd stated: "....Congress ***specifically mandates that regulators permit the use of non-cash collateral*** for counterparty arrangements with Swap Dealers and Major Swap Participants to permit flexibility. Mitigating risk is one of the most important reasons for passing this legislation." *Id.*

[27] *SEC v. Joiner*, 320 U.S. 344, 350-51(1943) ("[h]owever well these [statutory construction] rules may serve at times to decipher legislative intent, they long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the general expressed legislative policy.").

[28] 156 CONG. REC. H5233-61 (daily ed. June 30, 2010) (letter of Sen. Chris Dodd) (emphasis added).

system, it would be reasonable to conclude that Congress mandated the Prudential Regulators to permit the use of non-cash collateral for counterparty arrangements with swap dealers and major swap participants.

A more detailed analysis of the statutory mandate appears in **Appendix B**.

C. The Proposed Cash-Only Limitation for Collateral for VM is not Consistent with Market Practice

1. Restricting VM to Cash is Not Standard Market Practice

The Prudential Regulators make several observations in support of their contention that limiting VM to cash is consistent with market practice. The Prudential Regulators cite, for example, the recent 2013 Standard Credit Support Annex published by ISDA ("SCSA") which calls for all VM to consist of cash. However, the SCSA has not gained any significant market acceptance among end-users and to our knowledge no life insurer uses this document. The SCSA is primarily directed to dealers who enter into swaps where payments are to be made in multiple foreign currencies.[29] Indeed, a draft ISDA publication summarizing the history and explaining the operation of the SCSA specifically acknowledges why it may not be an attractive alternative for many end-users:

> It is important to note that the [SCSA] offers a new alternative to the existing [Credit Support Annex], but does not replace it in any sense. In fact, because the [SCSA] necessarily standardizes many terms that are variable under the [Credit Support Annex], it is anticipated that some market participants will continue to use the classic [Credit Support Annex] because it affords useful flexibility. ***For example, market participants who are natural holders of long security positions that can be cost-effectively deployed as collateral may find problematic the [SCSA]'s restriction of variation margin collateral to cash only***.[30]

Instead, the overwhelming majority of Credit Support Annexes ('CSAs") currently in use allow for non-cash assets, subject to agreed haircuts, to satisfy margin requirements.[31] In addition to

[29] ISDA, "The Annotated ISDA 2013 Standard Credit Support Annex for New York law and English law forms" at p. 4 (Draft 6/10/13 available at: http://www.fpml.org/wgroup/scsawg/First-Draft-Annotated-SCSA.pdf). We note that even the SCSA allows parties to select collateral from among seven major currencies, and does not limit collateral to U.S. dollars or the currency in which payment obligations under the swap are required to be settled (*see* footnote 9 infra). The SCSA defines "*Eligible Transport Currency"* as "any of AUD, CHF, CAD, EUR, GBP, JPY and USD" at p. 14.

[30] *Id.* (emphasis added).

[31] The CSAs that are currently in use, excluding the SCSA are: the 1994 ISDA Credit Support Annex New York Law (referred to herein as the "CSA"); the 1995 ISDA Credit Support Annex English Law (the "English CSA"); the 1995 ISDA Credit Support Deed English Law; the 1995 ISDA Credit Support Annex Japanese Law; the 2001 ISDA Margin Provisions and other agreements (including those of central counterparties). *See* ISDA Margin Survey 2014 (April 2014) ("ISDA Margin Survey") at 17, available at: http://www2.isda.org/functional-areas/research/surveys/margin-surveys/. In reporting on the composition of active agreements, the ISDA Margin Survey notes that slightly more than 75% of bilateral agreements are documented on either the CSA or the English CSA forms. *See Id.* at 9. The CSA is the most widely used

Treasury securities, insurers' CSAs generally allow for various high-quality, liquid assets to be eligible collateral including agency and high quality corporate bonds.[32] Recognizing that assets pledged as collateral must be liquidated in a reasonable amount of time to generate proceeds that protect secured parties from losses and that the value of such assets may fluctuate – especially in a time of market stress - the traditional CSA widely used by life insurers includes prudent haircuts. This approach is consistent with the Final Framework, which observed that the assets posted as collateral should be liquid and, after accounting for an appropriate haircut, maintain their value in time of financial stress.[33] The Final Framework concluded that securities issued by the counterparty or its related entities should not be accepted as collateral and that accepted collateral should be reasonably diversified. ACLI endorses these constraints on non-cash collateral and would support appropriate haircuts on non-cash assets in order to maintain their viability as VM, as well as IM.[34]

2. Restricting VM to Cash Represents a Major Change for How Life Insurers Manage Their Assets and May Have Unintended Consequences for the Bond Markets

Life insurers as a class are the single largest investor in U.S. corporate debt.[35] As previously noted, life insurers' asset portfolios are designed to match their liabilities. While insurers maintain prudent liquidity with cash and cash equivalents, they prefer to hold assets that provide yield. The Reproposed Rule's restriction of VM to cash would require life insurers to partially liquidate higher yielding assets to meet cash VM requirements. This could unnecessarily impair the U.S. bond market and small issuers in raising capital. For these reasons, we maintain that the Reproposed

ISDA credit support document. All of the ISDA CSAs excluding the SCSA allow for transfer of non-cash assets, subject to agreed haircuts, to satisfy margin requirements.

[32] CSA Para. 13(b)(ii) Eligible Collateral.

[33] Element 4 of the Final Framework, pages 16-18.

[34] In this regard, ACLI questions the Reproposed Rule's classification of government-sponsored-entity ("GSE") securities (other than those guaranteed by the U.S. or supported by direct financial assistance) together with corporate debt securities for purposes of collateral haircuts. *See* Proposed Rule, Appendix B to Part [ ]—Margin Values for Cash and Noncash Initial Margin. This seems inconsistent with the recent decision of certain Prudential Regulators to "recognize U.S. GSE securities as highly liquid instruments that trade in deep and active markets by including them as a level **2A** liquid asset" in the final rule implementing the liquidity coverage ratio ("LCR") standard established by the Basel Committee on Banking Supervision. *See* Liquidity Coverage Ratio: Liquidity Risk Measurement Standards ("LCR Rule"), 79 Fed. Reg. at 69440. Corporate bonds, on the other hand, were determined to be less liquid and were classified as level **2B** liquid assets. Utilizing the same analytical framework employed in finalizing the LCR Rule, there appear to be good reasons to create a new category of eligible GSE securities that would reside between government guaranteed debt and corporate debt. This would be consistent with the current market practice of life insurers, where the haircuts assigned to GSE securities are typically lower than the haircuts assigned to corporate bonds in negotiated Credit Support Annexes.

[35] Life insurers provide the largest U.S. source of corporate bond financing, holding 20% of total U.S. corporate debt outstanding ($2.3 trillion at the end of 2013). In 2013, approximately 51% of life insurers' $6.2 trillion of total assets were held in bonds, divided between corporate bonds (38%) and government bonds (13%). Over 37% of bonds purchased by life insurers for their general accounts have maturities in excess of twenty years at the time of purchase. *Sources*: ACLI tabulations of NAIC data (year-end 2013), used by permission; Federal Reserve Board, Z.1 *Financial Accounts of the United States, Second Quarter 2014.*

Rule represents a significant shift from current market practices and one which may have deleterious consequences for the economy.

D. Any Suggestion that Cash-Only Collateral Will Reduce Valuation Disputes Is Highly Questionable

In further support of the cash-only VM requirement, the Prudential Regulators state that "[l]imiting variation margin to cash should sharply reduce the potential for disputes over the value of variation margin collateral."[36] While it is certainly true that there would be scant reason to dispute the value of cash collateral, the valuation of non-cash collateral has not been a significant source of disputes in the non-cleared swap markets. There were numerous disputes between swap counterparties during the financial crisis (some of which remained unresolved over significant periods of time), but these disputes centered on the changing value of underlying trades, not on the value of collateral that had been delivered or offered. We are not aware of any disputes involving the value of non-cash collateral (e.g., Treasury securities and corporate bonds) posted to swap dealers by insurance companies during the financial crisis that were not expeditiously resolved using the dispute resolution procedure set out in the CSA.[37]

E. Cost-Benefit Analysis is Missing in the Reproposed Rule

The Prudential Regulators' limitation of VM to cash would impose significant, unnecessary costs and burdens on life insurers. Moreover, any suggestion that the economic impact of limiting VM payments to cash will be "low" is not accurate regarding life insurers and others that traditionally rely on high-quality, long dated securities to satisfy their VM requirements. Congress, the Executive Branch and the Judicial Branch have issued unequivocal guidance advising Federal agencies to execute cost-benefit analysis in rulemakings. The Reproposed Rule fails to include any cost-benefit analysis of the cash-only requirement for VM collateral.

A consistent line of Executive Orders mandate careful cost-benefit analysis in federal agency rulemaking.[38] The Administrative Procedure Act (APA), 5 U.S. Code chapter 552, provides

[36] Reproposed Rule at 57371.
[37] See CSA Para. 5 and Para. 13.
[38] Executive Branch mandates for cost-benefit analysis began with Executive Order 12,291 (1981) that created a new procedure for the Office of Management and Budget (OMB) to review proposed agency regulations, and ensured the President greater control over agencies and improve the quality and consistency of agency rulemaking. The order unequivocally stated that "regulatory action shall not be undertaken unless the potential benefits to society for the regulation outweigh the potential costs to society." 46 Fed. Reg. 13193, 13193 (Feb. 17, 1981). In 1993, Executive Order 12,866 superseded the 1981 order, but retained cost-benefit analysis as a fundamental requirement in rulemaking. Executive Order 12,866 instructs that "in deciding whether and how to regulate, agencies should assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating." President Obama has reaffirmed the importance of cost-benefit analysis in 2011 through Executive Order 13,563, and reinforced the core principles in Executive Order 12,866 by emphasizing that "each agency must . . . propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs (recognizing that some benefits and costs are difficult to quantify). Exec. Order 13,563, § 1(b), 76 Fed. Reg. 3821 (Jan. 18, 2011). *See also*, Helen G. Boutrous,

comprehensive standards governing federal agency rulemaking, and includes guideposts for judicial review of agency rulemaking under an arbitrary and capricious threshold.[39] In a trilogy of significant cases involving recent SEC rulemaking, the U.S. Court of Appeals for the D.C. Circuit overturned major initiatives due to that agency's failure to conduct adequate cost-benefit analysis, which the court viewed as arbitrary and capricious action contrary to the mandate of the APA.[40] The three rulings provide a template for measuring appropriate cost-benefit analysis in federal agency rulemaking, and provide a roadmap to avoiding litigation.[41]

In sum, the guidance established by Congress, Executive Orders, and seminal court cases strongly warrants a carefully balanced and detailed cost-benefit analysis, particularly regarding the requirement for cash exclusively as VM. This is almost wholly lacking in the Reproposed Rule.

III. The Prudential Regulators Have Mischaracterized the Transfer of VM as a "Settlement" or "Payment"

The Prudential Regulators state that they use the terms "pay" and "paid" when referring to VM based on their preliminary understanding that market participants "view the economic substance of variation margin as settling the daily exposure of non-cleared swaps between the counterparties."[42] The Prudential Regulators also make certain comparisons between the markets for cleared and non-cleared swaps that omit significant differences between the two markets. The Prudential Regulators seek comment on the appropriateness of the proposed terminology. As we explain in more detail below, characterizing the transfer of VM as a "settlement" or "payment" is not an accurate or helpful characterization of how participants in the non-cleared swap markets regard these transfers.

A. The Market Does Not View Transfers of VM as "Settlement" Or "Payment"

1. Contractual and Accounting Treatment

The Prudential Regulators note that, the "market perception that VM essentially *settles* the current exposure may not always align with the underlying legal requirement or with contracts that

Regulatory Review in the Obama Administration: Cost-Benefit Analysis for Everyone, 62 ADMIN. L. REV. 243, 260 (2010).

[39] As one tool in this process, the OMB provided federal agencies with extensive guidance to perform cost-benefit analysis in its Circular A-4.21 C, which identifies three fundamental elements to federal agency rulemaking: (i) a statement of the need for the proposed regulation; (ii) discussion of alternative regulatory approaches; and, (iii) an analysis of both qualitative and quantitative costs and benefits of the proposed action and the leading alternatives.

[40] *See* Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005), Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010), and Bus. Roundtable & U.S. Chamber of Commerce v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

[41] *See generally* Peter M. Shane, *Political Accountability in a System of Checks and Balances: The Case of Presidential Review of Rulemaking*, 48 ARK. L. REV. 161, 176-78 (1994).

[42] Reproposed Rule at 57369. Elsewhere, the prudential regulators state that "[v]ariation margin payments reflect gains and losses on a swap transaction, and payment or receipt of variation margin generally represents a transfer of ownership in the collateral." (Reproposed Rule at 57371).

document the parties' rights and obligations with respect to swaps." It is certainly the case that the legal requirements expressed in the counterparties' contracts do *not* reflect the "payment" of VM but rather, refer to VM transfers as collateral postings.[43] Further to the point, not only do the documents fail to support the characterization of VM as "paid", VM is not accounted for as a payment under standard accounting principles and practices. Rather, VM is treated as collateral for accounting purposes – even when it is cash.[44]

To be more specific, when non-cash VM is posted by the out-of-the-money party, the asset transferred (e.g., a Treasury or corporate bond) stays on the balance sheet of the transferor subject to the in-the-money counterparty's security interest and there is no change to the transferee's balance sheet. When cash is transferred as VM, in a non-cleared swap, the transferee's accounting may or may not reflect the cash as a reduction of its derivative assets on its balance sheet depending on its contractual rights and GAAP accounting election (i.e., whether the transferee uses a net presentation or a gross presentation). If the derivative assets shown on the balance sheet have been reduced by the cash VM received (a net presentation), the gross amount is required to be disclosed in a footnote. In either a gross or a net presentation, the transferee will not treat the VM cash received as a settlement payment of the swap. Similarly, the transferor of cash VM may or may not treat the cash paid as a reduction of its derivatives liabilities on its balance sheet, but it will not treat the cash paid as settlement of its swap transaction.

2. VM Pays Interest in the Non-cleared Swap Markets

Because VM for non-cleared swaps has never been regarded as "settlement payments," it has long been industry practice for the secured party receiving the VM to pay interest to the pledgor on cash collateral and to remit to the pledgor any interest received by the secured party holding the pledgor's securities.[45] This practice has continued with regard to cleared swaps in the form of "price alignment interest." By contrast, it has never been the practice for clearinghouses to pay interest (or its equivalent) to futures customers with respect to VM exchanged through the clearinghouse. If VM for swaps truly represented "settlement" there would be no reason to require the party receiving VM to pay interest (or to return interest earned on pledged securities).

3. The Pricing of VM for Non-cleared Swaps Reflects Its Status as Collateral

The idea that it is appropriate to think of transfers of VM for non-cleared swaps as "settling daily exposures" also ignores the reality of pricing non-cleared swaps. Swaps that are liquid and actively traded may well be eligible for clearing (on a mandatory or optional basis) and daily pricing by a clearinghouse, but this is not the case with respect to most non-cleared swaps that are not suitable for clearing. Such swaps must be priced based on various pricing inputs and models

[43] We note that Reproposed Rule at §___.6(a) correctly directs a "covered swap entity" to collect and "post" IM and VM.

[44] Furthermore, it is difficult to reconcile the concept of minimum transfer amounts with the concept of settlement. Settlement should be an all-or-nothing concept of full payment, whereas minimum transfer amount is consistent with transferring only significant amounts of collateral.

[45] The practice of paying and receiving price alignment interest is paralleled by the transferor's receipt of coupon interest if it has posted a noncash asset such as corporate bond.

and/or by obtaining quotes from market participants that trade comparable instruments. The absence of publicly accessible prices for comparable transactions also explains why VM in non-cleared swaps has historically been based on estimates of mid-market prices rather than actual transaction prices and why the procedure for resolving disputes regarding VM determinations has entailed seeking market quotes from multiple dealers. The bid-ask spread for non-cleared swaps can, and in most cases will, be materially larger than for cleared swaps.

The significance of the bid-ask spread in non-cleared swaps is apparent in a close-out situation. The cost of replacing a defaulted non-cleared swap will differ (often by a material amount) depending on which side of the transaction defaults. The documentation for master agreements and the collateral arrangement for non-cleared swaps underscore this point. First, the distinction between the value of swaps for purposes of VM transfers is specified as estimates of mid-market prices whereas the value of swaps for close-out purposes is determined for replacement transactions at the side of the market of the non-defaulting party.[46] Second, upon a default, a defaulting party holding VM is obligated to immediately return the VM to the non-defaulting party.[47] This is completely inconsistent with the idea that the VM it holds should be viewed as a "settlement."

B. There are Significant Differences Between the Cleared and Non-cleared Swap Markets That Should be Reflected in the Characterization of VM

The suggestion that VM for non-cleared swaps can be viewed similarly to VM for cleared swaps fails to recognize how inserting a clearinghouse into the relationship between the original parties to a swap fundamentally changes the nature of VM transfers.[48] In the case of cleared swaps, the clearinghouse becomes the party to each of the two equal and opposite transactions with the original parties to the swap that arise from the clearing function. With respect to VM, the clearinghouse acts solely as an intermediary between the two original parties to the swap, receiving VM from the out-of-the money party and delivering it to the in-the-money party. The clearinghouse never retains VM and has no ongoing security or other interest in the VM. Likewise, because the original parties are no longer counterparties with each other, the party posting the VM to the clearinghouse has no claim against the party receiving VM from the clearinghouse. In the case of non-cleared swaps – where the relationship between the original parties to the swap is unaltered - the party receiving the VM is entitled to retain it as security for future performance of the swap by the out-of-the money party. The VM remains an asset of the posting party, unless and until the secured party realizes on the security in connection with a termination.

[46] *Compare* CSA at Para 12 (definition of "Exposure") with 1992 ISDA Master Agreement at Sec. 6 and 14 (definitions of "Market Quotation" and "Loss) and the 2002 ISDA Master Agreement at Sec. 6(e) and 14 (definition of "Close-out Amount").

[47] *See* CSA at Para. 8(b)(iii) (Upon default by the Secured Party [the "Secured Party"] will be obligated immediately to transfer all posted Collateral and the Interest Amount to the Pledgor.") Any posted collateral not so returned may be set off by the non-defaulting party against any amounts owed to the Secured Party. *Id.* at Para. 8(b)(iv).

[48] The Prudential Regulators note as support for the requirement that VM be paid only with cash that "central counterparties generally require variation margin to be paid in cash." Reproposed Rule at 57371.

Because the clearinghouse is always obligated to re-deliver the VM it receives, the clearinghouse needs VM to be delivered to it in the form of cash. It would not be feasible for a clearinghouse to convert non-cash VM to cash in the timely manner required for it to redeliver that cash to the in-the-money party. This explains why clearinghouses generally require VM to be cash, but there is no such necessity in the case of non-cleared swaps.

Another fundamental distinction between VM for cleared swaps and VM for non-cleared swaps relates to the manner in which VM is determined. In the case of cleared swaps, the amount of VM to be transferred is always determined by the clearinghouse, which is a neutral body that has the ability to perform this function in a non-biased and objective manner. The clearinghouse generally has extensive pricing data for executed arm's length transactions, either identical or highly comparable to the trades being valued, on which to base its VM determinations. The situation for non-cleared swaps is entirely different. Valuations are not made by an unbiased, independent third party, nor is there any established market entity in a position to provide this service. Because non-cleared swaps are generally bespoke and not actively traded, there is often no pool of pricing information comparable to the data that forms the basis for VM valuations by clearinghouses. This explains why in most collateral agreements for non-cleared swaps (1) there is no designation of a single party to make VM determinations and (2) there is a robust procedure for resolving disputes regarding VM transfers.[49] The counterparties to the clearinghouse in respect of a cleared swap have no dispute rights with respect to VM.

C. There Are Significant Accounting, Tax and Other Unintended Consequences to Re-Characterizing VM

The Prudential Regulators recognize that legal, tax and accounting conventions may not align with treating VM as a "payment" and they specifically state that they "do not intend to alter the characterization of such transfer of variation margin funds for accounting, tax or other purposes."[50] Nonetheless, notwithstanding the Prudential Regulators' lack of intent, characterizing VM as "paid" and "settled" may have a significant effect on accounting and tax treatment. We are informed by accounting and finance experts at our member insurers that they base their analysis of the correct accounting treatment on many factors – including the economic elements surrounding asset transfers. The characterization of VM as "paid" and "settled" could, we are informed, alter the accountants' view of the matter and support a conclusion that VM should not be treated as collateral but as settlement – fundamentally altering VM's treatment on insurers' balance sheets. The characterization of VM as "paid" and "settled" could potentially support a conclusion that VM should not be treated as collateral but as settlement. The Prudential Regulators' characterization of VM as a settlement might reopen well settled tax treatment of VM.

The re-characterization of VM could trigger unnecessarily the loss of grandfathered status under the U.S. Foreign Account Tax Compliance Act ("FATCA"). Characterizing VM as a "settlement" could unnecessarily trigger additional collateral tax consequences. To the extent the Reproposed Rule requires derivatives contracts to be amended concerning acceptable collateral for VM, it could give

[49] The fallback for resolving disputes regarding the value of a transaction or of collateral held is based on dealer quotes. *See* CSA at Para. 5(i)(B).

[50] Reproposed Rule at 57369.

rise to payments subject to withholding tax under FATCA. The proposed amendments regarding both acceptable collateral and settlement may be deemed a material modification of those contracts for FATCA purposes. FATCA generally grandfathers payment obligations issued prior to July 1, 2014, meaning those obligations do not give rise to withholding or reporting requirements. However, those obligations lose their grandfathered status to the extent they are materially modified after July 1, 2014. The proposed amendments, therefore, could create significant uncertainty or administrative burdens under FATCA as market participants will have to determine which modified agreements might create additional FATCA compliance requirements.

The Prudential Regulators' re-characterization of VM transfers as "payment" may also have unintended secondary consequences for life insurers. If regulators re-characterize transfers of VM as "payments" rather than the posting of collateral, market participants are likely to follow suit. Lenders or institutional policy holders often have contractual rights to take remedial measures or to declare a default if a life insurer should miss a "payment" with respect to a derivative obligation. If a life insurer disputes a VM demand and makes partial "payment," believing in good faith that its counterparty miscalculated the requested amount of VM, would its failure to make full "payment" on the demand be a failure to pay (rather than a failure to transfer or post collateral)? If so, the effect will be to undercut the life insurer's leverage against any counterparty demanding a "payment" of VM based on that counterparty's sole calculation.

For all these reasons, we suggest in response to the Prudential Regulators' solicitation of comment, that the final rules abandon the concept of VM being "paid" in a "settlement."

IV. The Definition of "Variation Margin Amount" Should be Clarified to Require that VM be Determined with Reference to Mid-market Pricing

The Reproposed Rule defines "Variation Margin Amount" to mean "the cumulative mark-to-market change in value to a covered swap entity of a non-cleared swap or non-cleared security based swap …"[51] A "covered swap entity" is a swap dealer or major swap participant. A plain reading of this definition is that VM is to be determined with reference to the value of the swap to the swap dealer, a dramatic departure from industry practice which has long determined VM on the basis of an estimate of mid-market swap values.[52] Both the CSA and the more recent SCSA clearly contemplate that VM will be determined at mid-market prices.

The determination of VM based on a valuation at the swap dealer's side of the market is fundamentally flawed and highly biased to the disadvantage of the end-user party. The VM paid to an end-user that is in-the-money will more likely be insufficient to cover its replacement cost should the swap dealer default than would be the case under existing mid-market pricing. For an end-user that is out-of-the-money, the VM payment will be excessive (again as compared to mid-market pricing) in that it will likely be greater than the amount owed upon a swap dealer default, thus

[51] Proposed Rule §__.2 (definition of *Variation Margin Amount*).

[52] The CFTC proposed margin rule for non-cleared swaps does not contain a similar definition and presumably leaves undisturbed the existing market practice with respect to determining VM. *See* CFTC Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898 (Oct. 9, 2014) (the "CFTC Reproposed Rule"), at 59928 (definition of "Variation Margin").

leaving the end-user with a general creditor's claim against the defaulting swap dealer. The Prudential Regulators have provided no rationale for mandating such a material departure from existing industry practice with respect to the determination of VM.

V. The Prudential Regulators Should Reexamine the Potential for Retroactive Margin Treatment of Legacy Trades; Netting and Related Documentation Issues Should be Addressed to Permit All Counterparty Trades to be Executed Under a Single Master Agreement and CSA

In order to benefit from portfolio netting, the Reproposed Rule would require counterparties to apply IM and VM requirements to all swap transactions entered into after the effective date of the new margin requirements plus all other swaps documented under the same master agreement.[53] As portfolio netting is critical to achieving the appropriate level of IM, this would result in retroactive margin treatment for all pre-effective swap transactions. This is a highly undesirable result because it would effectively re-write the economic terms of such legacy swaps even though the Reproposed Rule purports to apply only prospectively. Apparently, the only way to achieve portfolio netting and also avoid such retroactive treatment is to have post-effective swaps documented under a new, separate master agreement. It appears, therefore, that in order for life insurance companies to avoid retroactive treatment for their legacy swaps, they will be required to enter into at least three master agreements with each of their counterparties:

(1) a master agreement for swaps entered into prior to the effective date of the new VM requirements;
(2) a master agreement for trades entered into after the VM requirements become effective and before the IM requirements take effect (presumably in 2019); and
(3) a master agreement for all swaps entered into after the IM requirements become effective.

The margining of swaps significantly affects their pricing. Margin terms are also critical to how insurance companies manage their liquidity risk and counterparty credit risk. Thus, imposing new margin terms retroactively can essentially be the same as changing the basic economic terms of a swap (e.g., modifying fixed rate payments or the maturity of the swap). We do not believe that, in adopting the Dodd Frank Act, Congress intended to rewrite the terms of existing swaps. The Prudential Regulators have recognized this, but the solution offered (separate master agreements for legacy trades) is not a workable solution.

Requiring multiple master agreements with each counterparty in order to avoid retroactive application of the margin rules is unnecessary and could well result in heightened counterparty credit risk and systemic risk. Master agreements are a critical tool utilized by insurance companies and other market participants to manage counterparty credit risk because they provide for close-out netting of all outstanding positions with a counterparty upon a default or other early termination. If insurers must enter into multiple master agreements with each counterparty, they will have to forego netting across trades with each of their counterparties in the event of an early termination. It

[53] Reproposed Rule at §§__.4(d); __.8(b)(2) & __.8(d)(5).

is unclear that an enforceable umbrella netting agreement between the parties (a so-called master-master agreement) would remedy the situation because the margin rules may then consider all the trades with that counterparty to be entered into under a "single" master agreement.

There is no compelling reason to force market participants to enter into multiple master agreements with a counterparty in order to avoid retroactive application of the new margin requirements. Besides potentially increasing counterparty risk, such a result will clearly entail significant additional costs and complexity. We would encourage the Prudential Regulators to allow both legacy trades and trades subject to new margin requirements to be documented under a single master agreement and credit support arrangement. The concept here is that the credit support terms could apply to separate "buckets" of trades entered into under the single master agreement.

VI. Definition of Eligible Master Netting Agreement Needs Clarification

Three elements of the proposed definition of Eligible Master Netting Agreement ("EMNA") should be revised or clarified to ensure that insurance company financial end users are not unintentionally harmed. First, the definition must be expanded to clarify that a limited stay under State insurance insolvency and receivership laws is a permissible exception to the second criterion, which requires "any exercise of rights under the agreement will not be stayed or avoided." Second, the definition must be amended to allow standard provisions regarding suspension of payment obligations in the event of a default by the counterparty. Third, the fourth criterion should clarify that the phrase "conduct sufficient legal review…to conclude with a well-founded basis" should not be interpreted as requiring the collection by a covered swap entity of a formal legal opinion from a financial end user. These points are further described below.

As discussed above, in the United States an insurance company is regulated primarily by the insurance regulator in the State where it was incorporated (often referred to as its "domiciliary state"). Such regulation extends to the insolvency and receivership of the insurance company. Shortly following the recent financial crisis, numerous swap dealers approached insurance company counterparties expressing concerns about the absence of certainty under state insurance codes as to the treatment of qualified financial contracts (QFCs), including non-cleared swaps, in an insurance company's insolvency. In response, a number of insurance companies worked with their legislatures to adopt laws based on Section 711 ("Section 711") of the National Association of Insurance Commissioners (NAIC) Insurer Model Receivership Act (IRMA).[54] Section 711 was designed to mirror concepts in the U.S. Bankruptcy Code and provides clarity that a receiver may not stay or avoid the exercise of rights of counterparties under QFCs. Among numerous arguments made to both legislatures and insurance departments to support the adoption of the new legislation was that it would enable insurance companies to be on a level playing field with banking institutions and other entities covered by the U.S. Bankruptcy Code.

Recently, a committee of the NAIC has urged states that have not adopted Section 711-like legislation to consider the inclusion of a 24-hour stay in future legislation. Pressure is increasing from the Financial Stability Board, the Prudential Regulators and ISDA to incorporate limited stays

[54] Currently, 22 states have adopted such legislation.

through legislation or contract for the benefit of systemically significant financial institutions.[55] These financial institutions represent affiliates of the primary swap dealers with which insurance companies conduct their swap business. Accordingly, it is reasonable to expect that insurance regulators may wish to encourage legislatures to incorporate similar limited stays in an insurance company receivership. However, if they did so, insurance companies would no longer have an EMNA because the limited stay would be imposed by a regulator which is not recognized in the proposed definition.[56]

EMNAs are necessary to net VM across swaps and net IM within broad risk categories. The absence of netting would significantly increase the cost of hedging and would diminish the ability of insurers to hedge their assets and liabilities. Meanwhile, it seems unfair that state insurance regulators (and the insurance companies they regulate) would be penalized for seeking to implement essentially the same limited stay that federal and international regulators acknowledge is prudent. Accordingly, we encourage the Prudential Regulators to revise the definition to clearly address state insurance regulation which includes a limited stay to facilitate the orderly resolution of an insurance company.

Our second concern relates to the definitional requirements of an EMNA,[57] which forbid any clauses that "suspend or condition payment, to a defaulter." This provision should be clarified to confirm that it does not intend to override standard conditions precedent in master netting agreements that permit a party to suspend payments if an event of default or potential event of default has occurred and is continuing with respect to the other party. It is unreasonable to require a party to continue to make payments and deliveries to a defaulting or potentially defaulting counterparty. The inability to suspend performance in the event of a default or potential event of default constitutes a vast departure from current industry practice and the basic tenets of the ISDA Master Agreement structure, and could result in virtually all pre-existing ISDA Master Agreements failing to qualify as an EMNA. This requirement in the definition also creates risk of more frequent closeouts in the market, as parties will be incentivized to move quickly to close out trades (to avoid a requirement to continue making payments), rather than allowing time for the defaulting party to cure or negotiate a resolution. Such a requirement could have negative consequences in the event of a market disruption, operational errors, or temporary factors unrelated to the financial condition or outside the control of the defaulting counterparty, where a temporary suspension would otherwise allow the parties to resolve the issue without proceeding to a close out.

[55] *See* ISDA 2014 Resolution Stay Protocol, located at: http://assets.isda.org/media/f253b540-25/958e4aed.pdf/.

[56] The Prudential Regulators acknowledge state insurance regulators in the definition of financial end user. *See* Reproposed Rule at §__.2 (definition of "*Financial End User*"), clause 1(x).

[57] Reproposed Rule at §__.2 (definition of "*Eligible Master Netting Agreement*"), clause (3). To the extent this language is designed to prohibit the use of the "first method" or so-called "walkaway clauses" following an Early Termination Event under a 1992 ISDA Master Agreement, we would not find it objectionable, but we believe the provision in its current form has potentially broader and undesirable consequences.

Our third concern relates to ensuring that covered swap entities do not transfer their responsibility for "legal review…to conclude with a well-founded basis"[58] to insurance company end users by requiring legal opinions from end users' counsel. Such opinions can be expensive and requiring them would unduly shift the risk and responsibility that the statute clearly places on the covered swap entity.

VII. The Definition of "Control" for Purposes of Calculating Aggregate Counterparty Exposure, IM Threshold Amount and the Effective Date for IM Requirements Should Follow the Current Market Practice Reflected in Standard Swap Documentation.

We appreciate the request for comment on the proposal's definition of the terms "affiliate" and "control". These terms play an important role in at least three key areas of the Reproposed Rule: (1) the calculation of material swaps exposure; (2) the allocation of the $65 million threshold for posting IM; and (3) the phase-in of compliance dates for the IM requirements.

The Prudential Regulators have defined the terms "affiliate" and "control" in accordance with the definition of those terms under the Bank Holding Company Act (the "BHCA"). Under the BHCA, ownership, control or power to vote 25% or more of a class of voting securities or ownership or control of 25% or more of the equity in a company is enough to establish control (the "25%-Ownership Test"). This represents a dramatic departure from the use of these terms in standard derivatives documentation. It is also at odds with the use of similar terms in other key rulemaking areas under the Dodd Frank Act, where the inclusion of affiliates was also intended to deter the proliferation of affiliates as a way to circumvent the relevant regulation. Moreover, the 25%-Ownership Test is at odds with the Final Framework and would have the effect of further exacerbating the differences between jurisdictions in the calculation of material swaps exposure, introducing a significant difference across jurisdictions in the level of the threshold for IM and creating a shorter phase-in period for entities falling under the regulatory authority of the Prudential Regulators than established under the Final Framework.

The Prudential Regulators provide no policy justification for this significant departure from established practice in the industry, previous regulation under the Dodd Frank Act, and the Final Framework. In addition, the 25% threshold poses serious informational challenges for entities seeking to monitor their relationship with the material swaps exposure threshold and it poses operational and fiduciary difficulties for entities allocating the $65 million threshold across "affiliates." Finally, our members with affiliated asset managers believe that the Reproposed Rule must be clarified as it applies to advised and sponsored funds.

A. The Definition of Control is a Significant Departure from Current Market Practice and with Previous Regulations under Dodd Frank

Standard swap documentation, including both the 1992 and 2002 ISDA Master Agreements, defines "control" as "ownership of a majority of the voting power of the entity or person" (the "Majority-Ownership Test"). Given the important ways that "affiliate" (and, as a consequence,

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[58] Reproposed Rule at §__.2 (definition of "*Eligible Master Netting Agreement*"), clause (4)(i).

"control") is used throughout standard derivatives documentation, swaps market participants have already developed systems for monitoring the activities of entities defined as "affiliates" under standard swap documentation. In describing their choice of the 25%-Ownership Test, the Prudential Regulators do not make any affirmative arguments for adopting this more inclusive standard. Instead, the Prudential Regulators explain that their proposed definition is similar to the definition under the BHCA and therefore "familiar to many market participants."[59] We do not think that the Prudential Regulators have given sufficient consideration to the additional costs that would be required to establish systems to monitor "affiliates" under the 25%-Ownership Test.

B. The Definition of Control is a Significant Departure from the Definition Used in Other Dodd Frank Act Regulations

While the Prudential Regulators do not include a policy argument for adopting a 25%-Ownership Test for establishing "control," they provide a policy argument for including affiliates in the calculation of material swaps exposure and the $65 million threshold for posting IM: that application of the rule on a consolidated basis "precludes the possibility that covered swap entities and their counterparties would create legal entities and netting sets that have no economic basis" and whose existence aims to circumvent the regulation.[60] This same policy argument was made to justify the inclusion of affiliates in the calculation of the *de minimis* exception to classification as a swap dealer under Regulation § 1.3(ggg) adopted by the CFTC. However, the concept of control embedded in the definition of "affiliate" for purposes of that rule looked to the definition of "control" and "affiliate" under the Exchange Act, which is more consistent with the Majority-Ownership Test than with a 25%-Ownership Test. The Prudential Regulators have not articulated a policy concern that would require a more expansive definition of "affiliate" and "control" here to meet the same goal of deterring the proliferation of affiliates.

C. The 25% Ownership Test is a Departure from the Final Framework.

While the BCBS/IOSCO Framework does not explicitly define a concept of "control" for the purposes of describing how certain measures should be calculated on a consolidated entity basis, we note that the Basel III legislation[61] incorporates a definition of "control" that is more consistent with standard swap documentation than the 25%-Ownership test.[62] We think this difference places entities regulated by the Prudential Regulators at a possible disadvantage.

[59] Reproposed Rule at 57363.
[60] Proposed Rule at 57366.
[61] Regulation (EU) no 575/2013 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment firms and Amending Regulation (EU) No 648/2012.
[62] Article 1 of Directive 83/349/EEC. Article 1 of Directive 83/349/EEC, in broad terms, requires each European member state to require consolidated accounts/a consolidated annual report where a parent undertaking subject to the laws of that member state has, in respect of a subsidiary undertaking: (a) a majority of the shareholders/members' voting rights; (b) a shareholding, and the right to appoint/remove a majority of the members of the subsidiary's administrative, management or supervisory body; (c) a shareholding, and the right to exercise a dominant influence over the subsidiary; or (d) a shareholding and (i) a majority of the members of the administrative, management or supervisory bodies of the subsidiary who held office at the relevant time were appointed solely as a result of the exercise of its voting rights (except where a different

Further, we believe that this distinction exacerbates the already significant discrepancy between the Final Framework's suggested €8 billion material swaps exposure threshold and the Prudential Regulators' $3 billion material swaps exposure threshold. By adopting a more expansive definition of the affiliates that must be aggregated for the purposes of calculating material swaps exposure, the Prudential Regulators are sweeping up a broader array of affiliated entities under the already lower threshold of material swaps exposure.

Likewise, by using a more expansive definition of affiliates that must be considered for purposes of applying the $65 million IM threshold, the Prudential Regulators are introducing a new departure from the Final Framework by requiring prudentially regulated entities to spread the IM threshold across a broader array of affiliated entities than the Final Framework does.

D. Challenges for Allocating the $65 Million IM Threshold Across Entities Not Controlled in the Traditional Sense of the Word

The 25%-Ownership Test also poses significant challenges for entities seeking to coordinate and monitor the allocation of the $65 million IM threshold on a consolidated basis, particularly where the trading in each account may be managed by separate entities. Information about swap activities would not generally be shared across entities that meet the BHCA definition of control but that do not meet the Majority Ownership Test, especially where trading activities were separately managed. These difficulties are compounded, as described below, in the case of sponsored funds.

E. The Prudential Regulators Should Clarify How the Reproposed Rule Will Apply to Sponsored Funds and Investment Vehicles and Pension Plans

The Prudential Regulators clearly state that they intend to follow the Final Framework's approach of excluding advised and sponsored funds from treatment as a party's affiliates, unless they are guaranteed or otherwise supported by the party in the event of the fund's insolvency.[63] However, they also state that such entities would be considered affiliates if the sponsor or adviser of the fund or securitization vehicle meets the definition of control.[64] We are concerned that the language in the definition of "control" leaves some room for confusion on this issue. The definition refers to "voting securities of the company", ownership of "the total equity of the company", or control of "a majority of the directors or trustees of the company."

Advised and sponsored funds, including mutual funds, as well as pension plans, may be established as many different types of legal entities, including limited liability companies, limited partnerships, and trusts. These entities may not have voting securities or directors. It may be important for the validity or tax status of these entities that the sponsor or its affiliate makes the decisions for, and thus in some way controls, the entity, as managing member or general partner,

undertaking has "control" as identified at (a), (b) or (c) above); or (ii) controls (alone or under an agreement with other shareholders / members) a majority of shareholders/members' voting rights in that undertaking.

[63] Reproposed Rule at 57363-64.
[64] *Id.* at 57363.

for example. The sponsor may begin the entity with seed money, to establish it and give it a track record before outside investors join. These elements of control should not cause the sponsored fund to be an "affiliate" for purposes of the Reproposed Rule.

Having a sponsored fund be treated as an affiliate would be particularly detrimental in the context of the calculation of the $65 million of credit exposure for purposes of the IM threshold amount. The Prudential Regulators explain that allocating the $65 million threshold among a counterparty and its affiliates would be "subject to agreement between the firm and its counterparties."[65] If the threshold must be allocated among a sponsor and its managed funds, the sponsor is put in the difficult position of allocating a scarce resource (exposure for which IM need not be posted) among itself and managed entities funded by investors to whom it owes some duty of care and good faith.[66] There is no clearly fair way that the exposure could be allocated between an entity and its sponsored funds, or among an entity's sponsored funds.

Accordingly, we propose that a fourth numbered paragraph be added to the definition of "control", to the effect that an entity's control of the decisions, including the investment decisions, of another entity does not constitute "control" of such other entity, if a majority of the beneficial or economic interest in such other entity is held by other entities.

VIII. Documentation Requirements, Including Dispute Resolution, with Respect to Both VM and IM Should be Clarified

The Reproposed Rule contains requirements for "documentation of margin matters."[67] Specifically, swap dealers would be required to execute trading documentation with other swap dealers or financial end-users regarding credit support arrangements that:

1. Provide contractual rights to collect and post IM and VM as required by the new margin rules;
2. Specify "the methods, procedures, rules, and inputs for determining the value of each non-cleared swap ... for purposes of calculating <u>variation</u> margin requirements."; and

[65] *Id.* at 57366.
[66] The operation of prohibited transaction rules under the Employee Retirement Income Security Act of 1974 ("ERISA") (Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 5 U.S.C., 18 U.S.C., 26 U.S.C., 29 U.S.C., and 42 U.S.C.)) might further complicate the allocation of the IM threshold amount across affiliated entities, where an end-user is deemed to have an affiliate whose assets were subject to ERISA. For example, to the extent an end-user (or a dealer, for that matter) sponsors or controls an ERISA pension plan that uses swaps, the end-user would potentially have to allocate to that ERISA plan a portion of any IM threshold amount available to the consolidated group in a manner that does not discriminate or disadvantage the ERISA plan under applicable ERISA prohibited transaction rules (i.e., it must avoid preferring accounts not subject to ERISA at the expense of accounts subject to ERISA). Many life insurers manage ERISA plan assets in "separate account" structures and would have to contend with this added challenge when allocating the IM threshold amount across "affiliates".
[67] Reproposed Rule §__.10 at p. 57395-57396.

3. Specify procedures by which disputes "concerning the valuation of non-cleared swaps" or the "valuation of assets collected or posted as initial margin or variation margin, may be resolved."[68]

These proposed requirements seem both overly prescriptive in some respects and deficient in others. The requirement that the documentation specify "inputs" seems particularly onerous as the inputs may vary from swap to swap and will change over the life of the swap. As a practical matter, this requirement will lead to documentation containing a very generic description of the inputs to be utilized in any dispute resolution procedure. Instead, we believe the focus should be on requiring parties to share the actual "inputs" being used to determine IM and VM at any particular point in time upon request (and particularly in the event of a dispute).

At the same time, the Reproposed Rule seems materially deficient in its failure to address either inputs or dispute resolution procedures related to IM. The inputs for determining IM are completely different from those required to value non-cleared swaps.[69] They relate more to the volatility of pricing for non-cleared swaps than to determining the value of a swap at any particular point in time.

The Prudential Regulators should promote consistency and transparency in approving and updating Initial Margin Models, which will limit disputes between financial end-users and Covered Swap Entities ("CSEs"). Initial Margin Model calculations should apply equally to both CSEs and financial end-users. Financial end-users ordinarily transact with a number of CSEs across multiple asset types. Having a single, transparent model in place across all market participants would significantly reduce operational risk and complexity. A lack of transparency in Initial Margin Models would force life Insurers to rely upon the CSE for the calculation of Initial Margin.

For example, the Reproposed Rule gives the CSE discretion in choosing certain calculation methods (subject to regulatory approval). Where discretion is granted to the CSE, we believe the financial end user must be involved in the valuation process in the same manner as in the CSA to existing ISDA Master Agreements for uncleared OTC derivatives, which provides for two-way valuations and a robust dispute resolution mechanism.

The Prudential Regulators ask whether they should defer to the documentation requirements previously adopted by the CFTC set out in CFTC Reg. §23.504(b) for the purposes of complying with this segment of the Reproposed Rule.[70] In general, life insurers strongly support regulatory harmonization allowing market participants to comply with a uniform set of documentation requirements. However, in this instance, deference to CFTC Reg. §23.504(b) is not a good solution

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[68] *Id.*

[69] The Standardized Minimum Gross Initial Margin Requirements for Non-Cleared Swaps and Non-Cleared Security-Based Swaps in Table A of the Proposed Rules reflects this fact. *See* Reproposed Rule at 57396. The table is based on percentages of the notional amount of outstanding swaps, not their values. *See also* the discussion of various risk factors that must be taken into account in developing an initial margin model, Reproposed Rules at §__.8(d)(3).

[70] Reproposed Rule at 57387. The Prudential Regulators also ask whether compliance with the applicable SEC documentation requirements should be deemed compliance with the Reproposed Rules. *Id.* Because the SEC has not yet proposed rules in this area, we submit that deemed compliance would be premature.

because that regulation – in its current form – is deficient for purposes of resolving disputes relating to IM.

CFTC Reg. §23.504(b)'s description of dispute resolution procedures focuses on "methods, procedures, rules, and inputs, for determining the value of each swap at any time from execution to the termination, maturity, or expiration of such swap for the purpose of complying with the margin requirements under section 4s(e) of the [CEA]."[71] It goes on to specify that such documentation shall include either "[a]lternative methods for determining the value of a swap" or "[a] valuation dispute resolution process by which the value of the swap shall be determined…"[72] Given that the determination of IM is not directly tied to the value of a swap, CFTC Reg. §23.504(b)'s dispute resolution requirements would be a poor vehicle addressing disputes regarding the value of collateral posted or collected.[73]

In summary, we believe that the Prudential Regulators should coordinate with the CFTC and the SEC to adopt a single revised set of margin documentation requirements that clearly provide for resolution of disputes regarding:

(1) IM
(2) VM, and
(3) the value of collateral collected or posted.

Each involves different procedures and inputs. The final rule should not be overly prescriptive. It should require the parties to document the methodology and data sources to be used to determine IM and VM and to resolve disputes.[74] The rule should not, however, require specification of the "inputs" that will be required, but instead should require the parties to share the inputs that they may use over the life of the swap to determine VM, IM and the value of collateral posted and collected. With respect to swap valuations for purposes of determining VM and the valuation of posted or collected collateral, the rule should encourage the parties to seek prices based on recently-executed transactions, executable valuations provided by independent third parties, or other objective criteria.[75] With respect to determinations of IM, swap dealers should be required to share or provide access to any approved models used to determine IM as well as all inputs utilized by the swap dealer in determining IM and end-users should be entitled to reasonably dispute all such inputs. ACLI intends to comment on the CFTC Reproposed Rule to discuss the shortcomings identified here.

[71] CFTC Reg. §23.504(b)(4)(i).
[72] CFTC Reg. §23.504(b)(4)(ii).
[73] IM is not determined on the basis of the value of a swap or portfolio of swaps. Rather, it is an amount designed to absorb losses that may be realized in liquidating a swap or portfolio of swaps, in this case a ten-day close-out period. *See* Reproposed Rules at 57375.
[74] *See* CFTC Reproposed Margin Rule, §23.158(b), at 59898, 59932.
[75] *See* CFTC Reg. §23.504(b)(4).

IX. Potential Unintended Macro Consequences of the Reproposed Rule

We have described above certain particularized unintended consequences of the Reproposed Rule (e.g., in the realms of accounting, taxation and contract.) But without minimizing these potential problems, we respectfully suggest that the Reproposed Rule could have even broader unintended consequences for insurers and their customers.

As stated above, the proposed cash-only rule for VM marks a sharp departure from international standards expressed in the Final Framework. It must be assumed that regulators and markets outside the U.S. will permit financial counterparties such as insurers to deploy the full assortment of assets for VM. Therefore, these foreign swap market participants will be relieved of the burdens of collateral transformation for VM. But beyond the near term costs of converting bonds or other non-cash assets into cash (and converting them back again when VM comes back), the proposed cash-only rule is likely to have negative longer term consequences for U.S. life insurers competing in a global market:

- Portfolio returns will suffer because of the drag created by the cash-only rule that requires a larger than customary part of every portfolio to be reserved in uninvested, non-interest paying cash to meet VM demands;
- The non-cleared swaps market in the U.S. will be priced differently than any market that continues to allow non-cash VM;
- Fractured markets, divided over collateral rules, will diminish overall liquidity because participants will not be able to move freely between markets where critical margin rules are materially different; and
- Ultimately, to the detriment of their customers seeking the long term benefits of life insurance products, insurers will be required to re-price their products in light of these new cost factors.

We respectfully submit that the Prudential Regulators can avoid these short and longer term negative consequences by continuing to allow non-cash assets to qualify as VM.

X. The Compliance Timeline for Implementing VM Requirements Should be Extended to Coincide with Implementation of IM Requirements

The Reproposed Rule would require numerous and complex changes to existing agreements. We identify below a number of ways in which the Proposed Rule departs from current industry practice, as reflected in the widely utilized traditional CSA, each of which will need to be reflected in new documentation between counterparties. In addition to points made earlier in this letter:

- The Reproposed Rule mandates zero thresholds.[76] There has been a trend towards CSAs with zero thresholds for VM; however, many CSAs continue to provide for fixed or laddered thresholds.[77]

- The Reproposed Rule requires VM to be exchanged every business day, subject to the minimum transfer amount.[78] Current market practice is generally to allow, <u>but not require</u>, either party to request the transfer of VM on any business day (either to increase collateral to cover its in-the-money position or to request the return of collateral to correct an over-collateralized position).[79]

- The Reproposed Rule allows for no exceptions to the requirement that VM be exchanged every business day. Current market practice recognizes various events that would excuse a party to a swap from the obligation to transfer VM. These "conditions precedent" include situations where an Event of Default, Potential Event of Default or Specified Condition has occurred and is continuing with respect to the other party.[80]

- The Reproposed Rule requires documentation that provides contractual rights for both the covered swap entity and its counterparty to pay or collect VM as required by the rules.[81] The documentation must specify: "[t]he methods, procedures, rules and inputs for determining the value of each non-cleared swap or non-cleared security based swap for purposes of calculating variation margin requirements" and the procedures by which any disputes concerning the valuation of such swaps may be resolved.[82] The CSA and the SCSA provide a method for resolving collateral disputes, and arguably address the methods and procedures for determining the value of each non-cleared swap, but do not specify the "inputs" to be used.[83]

- The Reproposed Rule requires that parties to non-cleared swaps post and receive IM without regard to the VM that has been exchanged.[84] Under the CSA, The independent amount and VM calculations are generally integrated so that the independent amount paid to counterparty is reduced by the amount of VM due from the counterparty.[85]

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[76] Reproposed Rule at §__.2 Definitions ("*Variation Margin Amount*").
[77] CSA, para. 13(b)(iv)(B).
[78] Reproposed Rule at §__.4(b) & §__.5(a).
[79] CSA Para. 3, 4 & 13(c).
[80] CSA Para. 4(a) and 13(d). Specified Conditions can include various tax events involving taxes, illegality, credit events upon merger and other agreed upon early termination events.
[81] Reproposed Rule at §__.10(a)(1).
[82] Reproposed Rule at §__.10(a)(2)(i) & (ii).
[83] CSA, para. 5 Dispute Resolution and para. 12 Definition of "Exposure; SCSA, para. 5 and para. 12 Definition of "Exposure."
[84] Reproposed Rule at §__.8 Initial models and standardized amounts.
[85] CSA Para. 3(b) Definition of "Credit Support Amount." In some instances the parties modify the CSA and agree that Independent Amounts will be posted without regard to exchanges of VM.

- The Reproposed Rule sets a maximum for the minimum transfer amount (to include both VM and IM) of $650,000.[86] Under the CSA, minimum transfer amounts have been negotiated between the parties and may exceed this limit.

As noted above, these new requirements, particularly the requirement that VM must be comprised of cash, are substantial deviations from existing practice. They will require major changes in financial end users' operational, technological and compliance areas. In addition, many insurance companies have swap documentation in place with fifteen or more counterparties and their affiliates often have a similar number of agreements in place. Given the number of agreements that will need to be revised to comply with the Reproposed Rule, life insurers are concerned that they will be forced by their counterparties to agree to unfavorable terms in order to meet the proposed deadlines. The numerous changes required to implement the Reproposed Rule are so extensive that the projected timeline for making the new VM rules effective is not plausible and should be extended to coincide with implementation of the IM requirements.

XI. Conclusion

ACLI supports harmonized international standards for IM and VM in non-cleared swaps transactions. We strongly support the key concepts in the Final Framework, including enlarging the scope of eligible collateral for IM and VM and focusing on the impact of margin requirements on liquidity. All of these matters will lower the risk of financial entities, promote consistent global regulation, and prevent regulatory arbitrage. We support alignment of margin requirements for non-cleared swaps globally, especially between major market jurisdictions.

We greatly appreciate your attention to our views. If any questions develop, please let me know.

Sincerely,

/S/

Carl B. Wilkerson

CC:

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[86] Reproposed Rule at §__.5(a).

Appendix A

The Use of Derivative Financial Instruments by Life Insurers Under State Insurance Law

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American Council of Life Insurance

I. The National Association of Insurance Commissioners (NAIC) Investments of Insurers Model Acts Serves as the Basis for Many State Laws Governing Derivatives Use by Life insurers

A. Purpose of Investment Law Provisions, as noted in the NAIC Investments of Insurers Model Act (*Defined Limits Version*) (1996):

1. The development of regulation of the investments of insurers requires an analysis of the complexities, uncertainties, competitive forces and frequent changes in the investment markets and in the insurance business, the diversity among insurers, and the need for a balance among risk, reward and liquidity of an insurer's investments. NAIC Model Reporting Service, Vol. II, Section 1, at 280-1.

2. It also requires an analysis of how to safeguard the financial condition of domestic insurers and at the same time to permit domestic insurers to be competitive with insurer's domiciled in other states and with other financial industries that operate under different regulatory regimes. *Id.*

3. The NAIC advises each state to determine through independent study which methods are best suited to its needs and whether its existing regulatory structure may be improved by using provisions of model laws recommended by the National Association of Insurance Commissioners (NAIC) or existing regulatory structures in other states or industries. *Id.*

4. This model law is not considered by the NAIC to exhaust regulatory methods to address the regulation of investments of insurers. Nor is this model law recommended by the NAIC to be used as a standard for the examination of insurers unless *substantially similar* provisions are found in the statutes and regulations of the state of domicile of the insurer. *Id.* (emphasis added).

B. The NAIC has addressed these goals with two different approaches:

1. The NAIC Investments of Insurers Model Act (*Defined Limits Version*) sets forth specific limits on insurers investments, including derivatives, and is discussed below.

2. A second alternate choice exists in the NAIC Investments of Insurers Model Act (*Defined Standards Version*) which implements modern portfolio management practices.

   a. The Defined Standards version serves as an alternative to the Defined Limits version of the Investments of Insurers Model Act which requires that investments be made only in assets that are specifically identified and with quantitative limits for assets invested in each category.

b. The Defined Standards version provides a “prudent person” approach to investments that implements modern portfolio theory, and establishes the following type of investment authority:

(1) An insurer is obligated to fulfill the “minimum asset requirement” as that term is defined in the model act.

(a) The minimum asset requirement is made up of an insurer’s liabilities and what is called the “financial security benchmark.”

(b) This benchmark equals either the company’s minimum capital surplus as required by statute or the authorized control level risk-based capital which applies to the insurer as set forth in the risk-based capital law of the state, whichever is greater; and,

(2) An insurer invests its assets after fulfilling the minimum asset requirement according to a prudence standard. The Defined Standards version establishes factors that must be evaluated and considered by the insurer in determining whether its investment portfolio is prudent.

C. **Overview of the Investments of Insurers Model Act (Defined Limits Version) and its application to derivatives**

1. **Scope**

a. The Act applies only to investments and investment practices of domestic insurers and United States branches of alien insurers entered through the individual states.

b. The Act does not apply to investments for separate accounts of an insurer except to the extent the provisions of the NAIC Model Holding Compact so provide.

2. **Purpose to the defined limits version**

a. The purpose of this Act is to protect the interests of insureds by promoting insurer solvency and financial strength. This will be accomplished through the application of investment standards that facilitate a reasonable balance of the following objectives:

(1) To preserve principal;

(2) To assure reasonable diversification as to type of

investment, issuer and credit quality; and

(3) To allow insurers to allocate investments in a manner consistent with principles of prudent investment management to achieve an adequate return so that obligations to insureds are adequately met and financial strength is sufficient to cover reasonably foreseeable contingencies.

3. **Treatment of Derivatives**

a. Article II Section 18 governs derivative transactions

b. The NAIC Commentary indicates that derivatives by insurers should be limited to hedging and, to a limited extent, income generation transactions.

4. **Definitions**

a. "Derivative instrument" [Article I, Section 2 (V)] means an agreement, option, instrument or a series or combination thereof:

(1) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or

(2) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

b. "Derivative instruments" include options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof and any agreements, options or instruments permitted under regulations adopted under Section 8. *Id.*

c. "Derivative transaction" means a transaction involving the use of one or more derivative instruments. [Article I, Section 2 (W)].

5. Substantive provisions permitting life insurers to engage in derivative transactions.

a. **General conditions**

(1) Limitations on Hedging Transactions

(a) An insurer may use derivative instruments under

Section 18 of the Model Act to engage in hedging transactions and certain income generation transactions, as these terms may be further defined in regulations promulgated by the commissioner.

(b) An insurer shall be able to demonstrate to the commissioner the intended hedging characteristics and the ongoing effectiveness of the derivative transaction or combination of the transactions through cash flow testing or other appropriate analyses.

(2) An insurer may enter into hedging transactions under Section 18 of the Model Act if, as a result of and after giving effect to the transaction :

(a) The aggregate statement value of options, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one half percent (7.5%) of its admitted assets;

(b) The aggregate statement value of options, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and

(c) The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets.

(3) **Limitations on Income Generation Transactions**

(a) An insurer may only enter into the following types of income generation transactions if as a result of and after giving effect to the transactions, the aggregate statement value of the fixed income assets that are subject to call or that generate the cash flows for payments under the caps or floors, plus the face value of fixed income securities underlying a derivative instrument subject to call, plus the amount of the purchase obligations under the puts, does not exceed ten percent (10%) of its admitted assets:

i) Sales of covered call options on non-callable fixed income securities, callable fixed income securities if the option expires by its terms prior to the end of the noncallable period or derivative instruments based on fixed income securities;

ii) Sales of covered call options on equity securities, if the insurer holds in its portfolio, or can immediately acquire through the exercise of options, warrants or conversion rights already owned, the equity securities subject to call during the complete term of the call option sold;

iii) Sales of covered puts on investments that the insurer is permitted to acquire under this Act, if the insurer has escrowed, or entered into a custodian agreement segregating, cash or cash equivalents with a market value equal to the amount of its purchase obligations under the put during the complete term of the put option sold; or

iv) Sales of covered caps or floors, if the insurer holds in its portfolio the investments generating the cash flow to make the required payments under the caps or floors during the complete term that the cap or floor is outstanding.

(4) **Counterparty Exposure**

(a) An insurer shall include all counterparty exposure amounts in determining compliance with the limitations of Section 10 of the Model Act, which governs diversification standards and certain foreign investments.

(b) Additional Transactions

i) Pursuant to regulations to implement the Model Act which may promulgated under the authority of Section 8, the insurance commissioner may approve additional transactions involving the use of derivative instruments in excess of the limits imposed by Section 8(B) or for other risk management purposes under regulations promulgated by the commissioner, but replication transactions shall not be permitted for other than *risk management* purposes.

(c) Definition: "Counterparty Exposure Amount" means:

i) The net amount of credit risk attributable to a derivative instrument entered into with a business entity other than through a qualified exchange, qualified foreign exchange, or cleared through a qualified clearinghouse ("over-the-counter derivative instrument")

ii) The amount of credit risk equals:

a) The market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurer; or

b) Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer.

iii) If over-the-counter derivative instruments are entered into under a written master agreement which provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or if not within the United States, within a foreign jurisdiction listed in the Purposes and Procedures of the Securities Valuation Office as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of:

a) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment to the insurer; and

b) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity.

a. **Written Agreement and Conditions Required Under the Act**

(1) The insurer shall enter into a written agreement for all transactions authorized in this section other than dollar roll transactions.

(a) "Dollar roll transaction" means two (2) simultaneous transactions with different settlement dates no more than ninety-six (96) days apart, so that in the transaction with the earlier settlement date, an insurer sells to a business entity, and in the other transaction the insurer is obligated to purchase from the same business entity, substantially similar securities of the following types:

i) Asset-backed securities issued, assumed or guaranteed by the Government National Mortgage Association, the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation or their respective successors; and

ii) Other asset-backed securities referred to in Section 106 of Title I of the Secondary Mortgage Market Enhancement Act of 1984 (15 U.S.C. s 77r- 1), as amended.

(2) The written agreement shall require that each transaction terminate no more than one year from its inception or upon the earlier demand of the insurer.

(3) The agreement shall be with the business entity counterparty.

D. NAIC Derivative Instruments Model Regulation, NAIC Model Reporting Service, Volume III at 282-1(1996).

1. This model regulation was adopted together with the NAIC Investments of Insurers Model Act (Defined *Limits* Version).

2. It provides additional guidance and clarification for application of the model law.

3. **Selected provisions**

a. Guidelines and Internal Control Procedures are set forth at Section 4

(1) Before engaging in a derivative transaction, an insurer shall establish written guidelines that shall be used for effecting and maintaining the transactions. The guidelines shall:

(a) Address investment or, if applicable, underwriting objectives, and risk constraints, such as credit risk limits;

(b) Address permissible transactions and the relationship of those transactions to its operations, such as a precise identification of the risks being hedged by a derivative transaction; and

(c) Require compliance with internal control procedures.

(2) An insurer shall have a system for determining whether a derivative instrument used for hedging has been effective.

(3) An insurer shall have a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount.

b. Documentation Requirements are set forth at Section 5

(1) An insurer shall maintain documentation and records relating to each derivative transaction, such as:

(a) The purpose or purposes of the transaction;

(b) The assets or liabilities to which the transaction relates;

(c) The specific derivative instrument used in the transaction;

(d) For over-the-counter derivative instrument transactions, the name of the counterparty and the counterparty exposure amount; and

(e) For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade.

(2) **Trading Requirements** are set forth at Section 6, which mandates that each derivative instrument shall be:

(a) Traded on a qualified exchange;

(b) Entered into with, or guaranteed by, a business entity;

(c) Issued or written by or entered into with the issuer of the underlying interest on which the derivative instrument is based; or

(d) Entered into with a qualified foreign exchange.

4. **Overview of the Defined Standards Version of the NAIC Investments of Insurers Model Act**

a. This Model Act is premised on specific capital standards, and provides a framework in which these standards relate to the investment laws, and established consequences for failure to meet capital standards. To the extent an insurer's investment program is imprudent, the insurer is deemed unsound.

b. The minimum financial security benchmark and the minimum asset requirement jointly form the foundation for regulating life insurer investments according to a modern portfolio or prudence standard.

(1) These twin tools allow a high level of investment discretion above the minimum asset requirement while still providing meaningful regulatory protections for policyholders and claimants from adverse investment management.

(2) Section 3 of the Defined Standards Proposal creates limitations and restrictions on investments counted toward the minimum asset requirement; Assets in excess of the minimum asset requirement would not be subject to these limitations and restrictions and may be invested according to the insurer's individual written investment policy.

c. Three philosophies to capital requirements are central to the Act's approach to regulating investments according to a prudence standard.

(1) The Act's "minimum capital" (for stock insurance companies) and "minimum surplus" (for mutual insurance companies) ensure financial stability at the inception of a new insurance enterprise. The amount of capital or surplus needed depends on what types of business the insurer intends to conduct, and are established based on the information the insurer gives the insurance commissioner at the time of formation. See, Annotations to Section 3 of NAIC Investments of Insurers Model Act

(Defined Standards Version) at 17 (1997).

(2) The "minimum financial security benchmark" measures the minimum capital requirements of an established enterprise, and expand as the financial needs to the enterprise expand, but may also contract with them. *Id.*

(3) The "proper surplus" appropriate for a particular company's operation is determined by the insurer's board of directors in consultation with management. *Id.*

d. The fundamental enforcement mechanism under the defined standards proposal appears in Section 11 which provides that if an insurer does not meet the minimum asset requirement, them under Section 11D, the insurer may be deemed to be in financially hazardous condition, and the commissioner may initiate liquidation and rehabilitation proceedings against the insurer. *Id.* at 21.

(5) Status of Investments of Insurers Model Acts in the States

(A) A state by state chart follows this section.

STATE	LAWS AND REGULATIONS
Alabama	ALA. CODE §§ 27-41-1 to 27-41-41 (1977/1993) (Life).
Alaska	ALASKA ADMIN. CODE tit. 3, §§ 21.201 to 21.399 (2001/2005). ALASKA STAT. §§ 21.21.010 to 21.21.420 (1966/2001) (Includes authority to adopt regulations consistent with defined limits version).
Arizona	ARIZ. REV. STAT. ANN. §§ 20-531 to 20-561 (1954/2000).
Arkansas	ARK. CODE ANN. §§ 23-63-801 TO 23-63-841 (1959/2009).
California	CAL. INS. CODE §§ 1170 to 1212 (1935/2009). CAL. CODE REGS. Tit. 10, §§ 2690.90 to 2690.94 (2007); BULLETIN 95-5A (1995).
Colorado	COLO. REV. STAT. §§ 10-3-213 to 10-3-242 (1969/2000).
Connecticut	CONN. GEN. STAT. §§ 38a-102 to 38a-102*i* (1991/2009); BULLETIN FS-14c-00 (2000).
Delaware	DEL. CODE ANN. Tit. 18, §§ 1301 to 1332 (1953/2002).
District of Columbia	D.C. CODE §§ 31-1371.01 to 31-1375.01 (2002).
Florida	FLA. STAT. §§ 625.301 to 625.340 (1959/1993).
Georgia	GA. CODE ANN. §§ 33-11-50 to 33-11-67 (2000).
Guam	GUAM GOV'T. CODE § 43166 (1951).
Hawaii	HAW. REV. STAT. §§ 431:6-101 to 431:6-501 (1987/2009); §§431:6-601 to 431:6-602 (1987/2008).
Idaho	IDAHO CODE ANN. §§ 41-701 to 41-736 (1961/2006).
Illinois	215 ILL. COMP. STAT. 5/126.1 to 5/126.32 (1997). ILL. ADMIN. CODE tit. 50, §§ 806.10 to 806.60 (1998/2001). Company Bulletin 92-2 (1992).
Indiana	IND. CODE §§ 27-1-12-2 to 27-1-12-3.5 (1935/2004) (Life); §§ 27-1-13-3 to 27-1-13-3.5 (1935/2004) (P/C).
Iowa	IOWA CODE §§ 511.8 to 511.8A (1868/2000) (Life); § 515.35 (1868/1997) (P/C). IOWA ADMIN. CODE r. 191-93.6; BULLETIN 2008-18 (2008).

STATE	LAWS AND REGULATIONS
Kansas	KAN. STAT. ANN. §§ 40-2a01 to 40-2a28 (1972/2005) (P/C); §§ 40-2b01 to 40-2b29 (1972/2005) (Life).
Kentucky	KY. REV. STAT. ANN. §§ 304.7-010 to 304.7-473 (2000).
Louisiana	LA. REV. STAT. ANN. §§ 22:581 to 22:601 (2007/2010).
Maine	ME. REV. STAT. ANN. Tit. 24-A, §§ 1101 to 1137 (1969/2000) (P/C); §§ 1151 to 1161 (1987/2000) (Life).
Maryland	MD. CODE ANN., INS §§ 5-501 to 5-512 (1922/2003) (Life); §§ 5-601 to 5-609 (1943/1997) (P/C); MD. ADMIN. CODE CH. 650 §§ 1 to 011 (1998/2008).
Massachusetts	MASS. GEN. LAWS. Ch. 175 §§ 63 to 68 (1817/1996).
Mississippi	MISS. CODE ANN. §§83-19-51 to 83-19-55 (1892/2010).
Missouri	MO. REV. STAT. §§ 375.325 TO 375.355 (1939/2002); §§ 375.532 TO 375.534 (1991/2005) (All insurers); §§ 376.300 to 376.311 (1939/2002) (Life) §§ 376.311, 379.083 (1997/2002); § 375.345 (2002); MO. CODE REGS. ANN. Tit. 20, § 200-12.020 (2009).
Montana	MONT. CODE ANN. §§ 33-12-101 to 33-12-312 (1999/2001).
Nebraska	NEB. REV. STAT. §§ 44-5101 to 44-5154 (1991/2009).
Nevada	NEV. REV. STAT. §§682A.010 to 682A.290 (1971/2003).
New Hampshire	N. H. REV. STAT. ANN. §§ 402:27 to 402:29-d (1917/1991) (All insurers); §§ 411-A:37 (1978/1990) (Life).
New Jersey	N.J. STAT. ANN. §§ 17:24-1 to 17:24-16 (1902/1995) (P/C); §§ 17B:20-1 to 17B:20-8 (1971/2005) (Life).
New Mexico	N.M. STAT. ANN. §§ 59A-9-1 to 59A-9-27 (1984/1988).
New York	N.Y. INS. LAW §§ 1401 to 1413 (1984/2008). N.Y. COMP. CODES R. & REGS. Tit. 11, §§ 178.0 to 178.10 (Regulation 168) (2001).
North Carolina	N.C. GEN. STAT. §§ 58-7-165 to 58-7-205 (1991/2005).
North Dakota	N.D. CENT. CODE §§ 26.1-05-18 to 26.1-05-22 (1983/2001).

STATE	LAWS AND REGULATIONS
Ohio	OHIO REV. CODE ANN. §§ 3907.14 to 3907.141; §§ 3925.20 to 3925.21 (1953/2001) (Life); §§ 3925.05 to 3925.06 (1953) (P/C).
Oklahoma	OKLA. STAT. tit. 36, §§ 1601 to 1629 (1957/2005).
Oregon	OR. REV. STAT. §§ 733.510 to 733.780 (1959/2006).
Pennsylvania	40 PA. STAT. ANN. §§ 504.1 to 506.1 (1986/2004) (Life).
Puerto Rico	P. R. LAWS ANN. tit. 26, §§ 648-662 (2003).
Rhode Island	R.I. GEN. LAWS §§ 27-11-1 to 27-11-3 (1947/1956); §§ 27-11.1 to 27-11.1-8 (1984/2002).
South Carolina	S.C. CODE ANN. §§ 38-12-10 to 38-12-510 (2002).
South Dakota	S.D. CODIFIED LAWS §§ 58-27-1 to 58-27-111 (1966/2005); S.D. ADMIN. R. 20:06:26:01 (2005/2008). S.D. ADMIN. R. 20:06:26:01 (1995/2008).
Tennessee	TENN. CODE ANN. §§ 56-3-301 to 56-3-409 (1907/1998) (Life); §§ 56-3-401 to 56-3-409 (1979/1984) (P/C).
Texas	TEX. INS. CODE ANN. §§ 424.001 to 424.218 (2005/2007).
Utah	UTAH CODE ANN. §§ 31A-18-101 to 31A-18-110 (1985/2006).
Vermont	VT. STAT. ANN. tit. 8, §§ 3461 to 3472 (1967/2000).
Virginia	VA. CODE ANN. §§ 38.2-1400 to 38.2.1447 (1986/2002).
Washington	WASH. REV. CODE ANN. §§ 48.13.010 to 48.13.360 (1947/2004).
West Virginia	W. VA. CODE §§ 33-8-1 to 33-8-32 (1957/2004).
Wisconsin	WIS. STAT. §§ 620.01 to 620.25 (1971/1992).
Wyoming	WYO. STAT. ANN. §§ 26-7-101 to 26-7-116 (1967/2001).

SUTHERLAND

MEMORANDUM

November 7, 2014

RE: **Statutory Construction Analysis of Section 4s of the Commodity Exchange Act**

On September 3, 2014, the Board of Governors of the Federal Reserve System (the "Board") jointly adopted, with certain federal banking regulators,[1] re-proposed rules (the "PR Proposal") that will require swap entities[2] to collect margin from, and post margin to, certain of their counterparties in connection with over-the-counter swaps.[3] Notably, the PR Proposal only allows for cash as "eligible collateral" for variation margin, even though many market participants include in their trading documentation the ability to post other types of assets, *e.g.*, U.S. Treasuries and corporate bonds, for variation margin purposes.

This memorandum is intended to assist in the development of legal and policy arguments that may be raised in substantive comments in response to the PR Proposal or, potentially, as part of a legal challenge to the PR Proposal. Specifically, this memorandum addresses whether Congress mandated that the Prudential Regulators permit the use of noncash collateral for variation margin purposes in rules adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") imposing margin requirements for certain non-cleared swaps and security-based swaps.

I. Introduction

A. Section 4s(e)(3)(C) of the Commodity Exchange Act

The authorizing statute[4] for the proposed margin requirements imposed on swap dealers and major swap participants is Section 4s[5] of the Commodity Exchange Act ("CEA"), as amended by

[1] The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively with the Board, the "Prudential Regulators").
[2] "Swap entities" refers to swap dealers, security-based swap dealers, major swap participants and major security-based swap participants. "Covered swap entities" refers to swap entities and any other entity that the Prudential Regulators deem appropriate to be subject to its rules.
[3] The PR Proposal was published in the Federal Register on September 24, 2014 and is open for public comment through November 24, 2014. Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57,348 (proposed Sept. 24, 2014).
[4] 15 U.S.C. § 78o-10(e)(3)(C) parallels Section 4s(e)(3)(C) and similarly authorizes the Prudential Regulators to adopt margin requirements for transactions by security-based swap dealers and major security-based swap participants. The Senate Committee Report regarding Title VII of the Dodd-Frank Act stated that the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") may (instead of

the Dodd-Frank Act. Section 4s(e)(1) of the CEA mandates that swap entities must meet minimum initial and variation margin requirements to be set forth by the Prudential Regulators. Section 4s(e)(3)(C) of the CEA gives guidance on how the margin requirements are to be implemented. Specifically, Section 4s(e)(3)(C) states that:

> [i]n prescribing margin requirements under this subsection, the prudential regulator with respect to swap dealers and major swap participants for which it is the prudential regulator and the [Commodity Futures Trading] Commission with respect to swap dealers and major swap participants for which there is no prudential regulator ***shall permit the use of noncash collateral, as the regulator or the [Commodity Futures Trading] Commission determines to be consistent with—***
>
> ***(i) preserving the financial integrity of markets trading swaps; and***
>
> ***(ii) preserving the stability of the United States financial system.***[6]

B. Analysis of CEA Section 4s(e)(3)(C)

The relevant phrase in CEA Section 4s(e)(3)(C) is "shall permit the use of noncash collateral, as the regulator…determines to be consistent with (i) preserving the financial integrity of markets trading swaps; and (ii) preserving the stability of the United States financial system"[7] Since the Prudential Regulators required only cash collateral for variation margin, one would have anticipated an analysis on the part of the Prudential Regulators as to whether permitting noncash collateral for variation margin would negatively affect the financial integrity of the swaps market or the stability of the U.S. financial system. However, the Prudential Regulators did not specifically address the two prongs when making the decision regarding the variation margin.[8] Rather, the rationale offered by the Prudential Regulators for the cash-only requirement is that it would reduce the potential for disputes over the value of variation margin and that it is consistent with "regulatory and industry initiatives to improve standardization and efficiency in the OTC swaps market."[9]

"shall") permit the use of noncash collateral by security-based swap dealers and major security-based swap participants. However, this memorandum will focus only on Section 4s(e)(3)(C) which applies to swap dealers and major swap participants. Moreover, this memorandum will focus on the Prudential Regulators, instead of the CFTC and the SEC. See Appendix C for the relevant section of the Senate Report.

[5] 7 U.S.C. § 6s(e)(3)(C) (2012).

[6] *Id.* (Emphasis added).

[7] *Id.*

[8] *See* Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,351. The only reference to the two-prong statutory provision is a background reference in footnote 10 of the PR Proposal.

[9] *Id.* (citing the 2013 Standard Credit Support Annex published by ISDA). This memorandum does not seek to address whether there is, in fact, a case to be made that allowing noncash variation margin would negatively affect the integrity of the swaps market or the stability of the U.S. financial system.

This memorandum analyzes the meaning of the word "shall" in the context of its use in the phrase "shall permit the use of noncash collateral" and, in particular, whether the word "shall" was used as a mandatory or permissive verb. Section II of this memorandum briefly describes the process and theory of statutory construction. Section III analyzes the meaning of the word "shall" by using canons of construction. Section IV summarizes the legislative history and purpose behind Section 4s.

II. Statutory Construction

Statutory construction analysis involves ascertaining (1) a statute's meaning and (2) its legislative intent. Ascertaining the meaning of a statute is an objective way of analyzing the words of the statute. Such analysis asks how the public, to whom the statute is addressed, understands the act.[10] This is also known as looking at "intrinsic evidence," which is looking at the statute within itself to determine its meaning. On the other hand, ascertaining legislative intent is more of a subjective way of reading the statute, because it involves looking at the intent of the legislature that passed such statute.[11] This is also known as looking at "extrinsic evidence" to determine the meaning of the statute.[12]

Courts will not go through the process of interpreting the words of a statute if the statute is facially clear and unambiguous.[13] Ambiguity exists when a statute is capable of being understood by a reasonably well-informed person in two or more different ways.[14]

Based on the foregoing principles, if Section 4s(e)(3)(C) of the CEA is challenged in court, such court will first decide whether or not the statute is facially clear and unambiguous. If the court decides that the statute is unambiguous, the court will not look at any extrinsic evidence and will just apply the ordinary meaning of the word "shall" as used in the statute. On the other hand, if such court decides that the word "shall" was used in an ambiguous manner, the court will engage in a statutory construction analysis. "Shall" has to be capable of being understood by a reasonable person in two or more different ways before a court will engage in statutory construction.

III. The Meaning of CEA Section 4s(e)(3)(C)

If Section 4s(e)(3)(C) of the CEA is challenged in court, such court will likely engage in a statutory construction analysis if it finds that the words of the statute are ambiguous. A statute's definition of an ambiguous word will be determinative. If such ambiguous word is not defined by the statute, a court will ascertain the meaning of the ambiguous word through various canons of construction.[15]

[10] *Malat v. Riddell*, 383 U.S. 569, 572 (1966) ("the words of statutes...should be interpreted where possible in their ordinary, everyday senses.").
[11] 2A SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 45:8 (Norman J. Singer ed., 7th ed. 2014 rev.).
[12] *Id.*
[13] *Caminetti v. United States*, 242 U.S. 470, 485 (1917).
[14] 2A SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 45:2 (Norman J. Singer ed., 7th ed. 2014 rev.).
[15] Canons of construction are guiding principles that help determine the meaning of legislation.

In this case, the CEA does not define the word "shall." Various canons of construction are therefore necessary to ascertain its meaning and this memorandum will discuss three relevant canons to determine the probable meaning of "shall": the "Rule Against Surplusage," the "Plain Meaning Rule" and the "Meaningful Variation Rule."

The following analysis will discuss the meaning of the word "shall" as modified by the noncash collateral phrase and the meaning of the word "shall" on its own.

A. The Rule Against Surplusage

The meaning of a word or phrase in a statute must take into account the rest of the sentence and the statute. This canon is called the "Rule Against Surplusage." The "Rule Against Surplusage" states that "effect must be given, if possible, to every word, clause and sentence of a statute."[16] No part is superfluous to the statute. Courts assume that every word, phrase, and clause in a legislative enactment is intended and has some meaning and that none was inserted accidentally.[17]

In this case, the words "shall permit the use of noncash collateral" in Section 4s(e)(3)(C) is followed by the phrase "as the regulator or the [Commodity Futures Trading] Commission determines to be consistent with (i) preserving the financial integrity of markets trading swaps and (ii) preserving the stability of the United States financial system."[18] Since the "Rule Against Surplusage" dictates that every phrase was intended and must be given effect, the above two-prong requirement must be recognized because it acts as a modifier to the phrase "shall permit the use of noncash collateral." Stated simply, if the Prudential Regulators make the determination that allowing noncash collateral for variation margin would negatively affect the financial integrity of the swaps trading market or threaten the stability of the U.S. financial system then such a determination would likely negate the affirmative obligation to allow noncash collateral. However, as previously noted, there is scant evidence that the Prudential Regulators did, in fact, make such a determination.[19] Absent that determination, the question remains whether the Prudential Regulators are obligated by the use of the word "shall" to permit the use of noncash collateral.

B. Plain and Ordinary Meaning of "Shall" as a Mandatory Verb

"Shall" is plainly and ordinarily used as a mandatory verb. An often-used canon of construction is the "Plain Meaning Rule," wherein courts will look at the statutory text and presume that a "legislature says in a statute what it means and means in a statute what it says there."[20] If the text of a statute is unambiguous, then courts will apply the plain meaning of the text without

[16] 2A SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 46:6 (Norman J. Singer ed., 7th ed. 2014 rev.).
[17] *Id.*
[18] 7 U.S.C. § 6s(e)(3)(C) (2012).
[19] *See* Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,351.
[20] *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992).

further judicial inquiry or interpretation.[21] Thus, the duty of interpretation does not arise and the rules of statutory interpretation do not apply.[22]

Words that are not terms of art and that are not statutorily defined are customarily given their ordinary meanings, often derived from the dictionary.[23] Thus, courts rely on regular dictionary definitions to interpret the words of a statute.[24]

Because "shall" is not statutorily defined in the CEA, a court will have to rely on the dictionary and ordinary meaning of "shall." Relying on its dictionary meaning, the word "shall" is a mandatory verb. "Shall" is defined in the Merriam-Webster dictionary in similar and unambiguous ways. It is a word: (1) used to express a ***command or exhortation***; (2) used in laws, regulations or directives to express what is ***mandatory***; (3) used to express what is ***inevitable***; and (4) used to express ***determination***.[25] Similarly, Black's Law Dictionary defines "shall" as: (1) having a ***duty*** to or is ***required*** to; and (2) a ***mandatory*** word that drafters typically intend and that courts typically uphold.[26] Moreover, historically, courts have interpreted "shall" as a mandatory verb.[27] Thus, "shall" is ordinarily used as a mandatory verb.

However, in recent times, there has been confusion over the use of the word "shall." For example, the 2007 Edition of Black's Law Dictionary defines "shall" as "may."[28] In 1999, the Eighth Circuit stated that "shall" can be sometimes substituted for "may" in the right context.[29] Similarly, the D.C. Circuit in 2003 noted that while "shall" is presumptively mandatory, the legislative context may require the word "shall" to be deemed permissive.[30] Therefore, even though "shall" has been historically used as a mandatory verb, it has also recently been used as a permissive verb.

Were Section 4s(e)(3)(C) of the CEA to be challenged in court, such court may find that the plain meaning of the word "shall" applies and interpret the word as a mandatory verb. However, a court may also find the word "shall" ambiguous if it relies on its recent dictionary meaning and ordinary use. It would then have to look into the legislative intent to ascertain its intended use. We will address the issue of legislative intent in Section IV below.

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[21] *Id.*
[22] *Caminetti*, 242 U.S. at 485.
[23] In the absence of a statutory definition, "we construe a statutory term in accordance with its ordinary or natural meaning." *FDIC v. Meyer*, 510 U.S. 471, 476 (1994).
[24] *Asgrow Seed Co. v. Winterboer*, 513 U.S. 179, 187 (1995).
[25] WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2085-86 (3rd ed. 1993) (emphasis added).
[26] BLACK'S LAW DICTIONARY 1407 (8th ed. 2007) (emphasis added).
[27] *Lexecon, Inc. v. Milberg Weiss Bershad Hynes & Lerach*, 523 U.S. 26, 35 (1998); *Forest Guardians v. Babbitt*, 174 F.3d 1178, 1187 (10th Cir. 1999); *see Rastelli v. Warden, Metro Correctional Center*, 782 F.2d 17, 23 (2d Cir. 1986).
[28] BLACK'S LAW DICTIONARY 1407 (8th ed. 2007).
[29] "Should" sometimes is substituted for "may" as a permissive word. *Union Elec. Co. v. Consolidation Coal Co.*, 188 F.3d 998, 1001 (8th Cir. 1999).
[30] Shall is presumptively mandatory unless there is something in the context or character of legislation which requires it to be looked at differently. *Verplanck v. England*, 257 F.Supp. 2d 182, 188 (D.C. Cir. 2003).

C. Meaningful Variation of "Shall" and "May" in CEA Section 4s(e)(3)(C)

The use of both "shall" and "may" in Section 4s of the CEA likely signals that Congress probably intended "shall" and "may" to have different meanings. An often-used canon of construction is the "Meaningful Variation Rule" wherein different words used in the same statute are assigned different meanings whenever possible.[31] Thus, if both mandatory and permissive verbs are used in the same statute or in the same section, courts make a fair inference that the legislature realized the difference in meaning and intended that the verbs should carry with them their ordinary meanings. This is especially true where "shall" and "may" are used in close juxtaposition.[32]

Section 4s of the CEA uses both "shall" and "may." "Shall" appears 66 times and "may" appears 18 times in Section 4s of the CEA. Moreover, "shall" and "may" are closely juxtaposed in some sentences. Specifically, Section 4s(b)(2)(B) states that:

> A person that is registered as a swap dealer or major swap participant ***shall*** continue to submit to the [Commodity Futures Trading] Commission reports that contain such information pertaining to the business of the person as the [Commodity Futures Trading] Commission ***may*** require.

Because "shall" and "may" are used in Section 4s repeatedly and in close proximity, the "Meaningful Variation Rule" dictates that courts should make a fair inference that Congress realized the difference in meaning. Thus, Congress likely intended for the verbs "shall" and "may" to carry their traditionally opposite meanings in Section 4s of the CEA. Accordingly, "shall" could reasonably be read as a mandatory verb.

IV. Legislative History of CEA Section 4s(e)(3)(C)

A. Reading "Shall" as a Mandatory Verb Supports Legislative Intent

Statutes are found to be mandatory or permissive on the basis of legislative history establishing legislative intent.[33] Courts normally refer to relevant legislative history if the statutory text and the canons of construction leave uncertain the Congressional intent underlying the specific issue or provision, *i.e.*, the statute is ambiguous with respect to a specific provision or issue.[34] Were a court to find that the meaning of "shall" in Section 4s(e)(3)(C) is ambiguous, the court would look at the legislative history of Section 4s. The legislative history of Section 4s seems to indicate that the legislature's intent was for "shall" to be a mandatory verb.

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[31] 2A SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 46:6 (Norman J. Singer ed., 7th ed. 2014 rev.).
[32] 3 SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 57:11 (Norman J. Singer ed., 7th ed. 2014 rev.).
[33] *Id.* at § 57:5.
[34] *See, e.g.*, *Muscarello v. United States*, 524 U.S. 125, 132 (1998) (analyzing evidence of congressional intent because ambiguous statutory language was identified).

There are significant differences in the willingness of judges to use legislative history to interpret statutory construction. Some courts disfavor relying on legislative intent for statutory analysis because some judges are not convinced about the propriety of using "extrinsic evidence" to interpret statutes.[35] Some judges assume the "existence of a determinate plain meaning of a statute's text" and will adopt a plain meaning interpretation even if such interpretation does not comport with how such term was interpreted in case law.[36] Nonetheless, legislative intent has been the most common criterion of statutory interpretation.[37] If the legislative history is considered by a court, then the relevant House or Senate committee reports[38] should be accorded the most interpretive weight followed, in descending order, by:

- bill sponsors' explanatory floor statements;
- floor or hearing colloquies, particularly those by supporters of the enacted provision;
- statements about the bill from non-legislative drafters; and
- any subsequent legislative history.[39]

In this case, the House Committee Report provides an illuminating view to the meaning of the word "shall" as used in Section 4s(e)(3)(C) of the CEA. Senator Chris Dodd, the cosponsor of the Dodd-Frank Act, wrote a letter intended to be an explanatory floor statement. This letter was incorporated into the House Committee Report.[40] By specifically mandating that the Prudential Regulators permit the use of noncash collateral, Senator Dodd appears to have intended "shall" in Section 4s(e)(3)(C) to be used as a mandatory verb. Senator Dodd stated:

> .... Congress ***specifically mandates that regulators permit the use of non-cash collateral*** for counterparty arrangements with Swap Dealers and Major Swap Participants to permit flexibility. Mitigating risk is one of the most important reasons for passing this legislation.[41]

The explanatory floor statements of Representative Barney Frank, the other cosponsor of the Dodd-Frank Act, also support a reading of "shall" as mandatory. While not as direct as Senator Dodd's quote above, Representative Frank alluded to the permitted use of noncash collateral by

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[35] *See* Katherine Clark & Matthew Connolly, *A Guide to Reading, Interpreting and Applying Statutes*, at 5, The Writing Center at GULC (2006), *available at* http://www.law.georgetown.edu/academics/academic-programs/legal-writing-scholarship/writing-center/upload/statutoryinterpretation.pdf.
[36] *Id.*
[37] 2A SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 45:5 (Norman J. Singer ed., 7th ed. 2014 rev.).
[38] *See Church of the Holy Trinity v. United States*, 143 U.S. 457, 464 (1892) (referencing that a committee report helps determine Congress's intent or reasons for enacting a bill: "the evil which was sought to be remedied interprets the statute").
[39] *See* CLARK ET AL., *supra* note 26.
[40] 156 CONG. REC. H5233-61 (daily ed. June 30, 2010) (letter of Sen. Chris Dodd).
[41] Appendix A contains the House Congressional Record that includes Senator Dodd's statements. (Emphasis added.)

stating that marginal requirements should be "done with an appropriate touch." Such appropriate touch should be applied in order to keep margin at a minimal level:

> ....We expect the level of margin required will be ***minimal*** in keeping with the greater capital that such dealers and MSPs will be required to hold... The marginal requirements are not on end-users. They are on the financial and major swap participants. And they are permissive. They are not mandatory, and ***they are going to be done***, I think, ***with an appropriate touch***.[42]

B. <u>Reading "Shall" as a Mandatory Verb Supports Legislative Purpose</u>

Reading "shall" as a mandatory verb will support the legislative purpose of Section 4s. The main objective of statutory construction is to effectuate statutory purpose.[43] In this case, the purpose of Section 4s(e)(3)(C) of the CEA is clearly stated in its legislative history. An overarching concern in Senator Dodd's letter is the protection of end users from burdensome costs—the Prudential Regulators were tasked with ensuring that it would not be prohibitively expensive for end users to manage their risk. Senator Dodd stated:

> ....[T]he [P]rudential [R]egulators ***must not make hedging so costly it becomes prohibitively expensive for end users to manage their risk***....It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would ***discourage hedging by end users or impair economic growth***....
>
> ...a consistent Congressional directive throughout all drafts of this legislation, and in Congressional debate, has been ***to protect end users from burdensome costs associated with margin requirements*** and mandatory clearing. Accordingly, changes made in Conference to the section of the bill regulating capital and margin requirements for Swap Dealers and Major Swap Participants should not be construed as changing ***this important Congressional interest in protecting end users***....
>
> ....Congress strongly encourages regulators to establish margin requirements for such swaps or security-based swaps in a manner

[42] Appendix B contains the House Congressional Record that includes Representative Frank's statements. (Emphasis added.)
[43] *SEC v. Joiner*, 320 U.S. 344, 350-51(1943) ("[h]owever well these [statutory construction] rules may serve at times to decipher legislative intent, they long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the general expressed legislative policy.").

> that is consistent with the ***Congressional intent to protect end users from burdensome costs***.[44]

Thus, "shall" in Section 4s(e)(3)(C) of the CEA was written with the intent to specifically mandate that the Prudential Regulators allow noncash collateral as variation margin because Congress was concerned with protecting end users from burdensome costs. To read "shall" as a permissive verb and allow Prudential Regulators to require cash-only collateral would contradict the Congressional purpose of protecting end users from prohibitive costs, since permitting only cash collateral would be economically burdensome for certain end users.

The legislative history noted above does not explicitly address the additional statutory directive to the Prudential Regulators regarding the preservation of the financial integrity of the swaps markets and the stability of the United States financial system.

V. Conclusion

Based on the foregoing analysis of Section 4s(e)(3)(C) of the CEA, absent a clear determination by the Prudential Regulators that allowing noncash collateral would negatively affect the financial integrity of the swaps trading market or threaten the stability of the U.S. financial system, it would be reasonable to conclude that Congress mandated the Prudential Regulators to permit the use of noncash collateral for counterparty arrangements with swap dealers and major swap participants to allow flexibility. In this situation, "shall" in Section 4s(e)(3)(C) appears to have been intended as a mandatory verb.

[44] Appendix A contains the House Congressional Record that includes Senator Dodd's statements. (Emphasis added.)

Appendix A

families. And they want those opportunities without pushing our country into greater debt. Unfortunately, this bill fails on all accounts.

□ 1720

Mr. FRANK of Massachusetts. I yield 1 minute to my colleague, the gentleman from Minnesota (Mr. PETERSON), the chairman of the Agriculture Committee.

Mr. PETERSON. Mr. Speaker, I would like to enter into the RECORD a letter that Chairman FRANK and I received from Chairmen LINCOLN and DODD on the treatment of end users under the derivatives title of the bill. As the letter makes clear, we have given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant.

While the regulators do have authority over the dealer or MSP side of a transaction, we expect the level of margin required will be minimal, in keeping with the greater capital that such dealers and MSPs will be required to hold. That margin will be important, however, to ensure that the dealer or major stock participant will be capable of meeting their obligations to the end users. We need to make sure that they have that backing.

I would also note that few, if any, end users will be major swap participants, as we have excluded "positions held for hedging or mitigating commercial risk" from being considered as a "substantial position" under that definition.

I would ask Chairman FRANK whether he concurs with my view of the bill.

The SPEAKER pro tempore. The time of the gentleman has expired.

Mr. FRANK of Massachusetts. I yield the gentleman 15 additional seconds.

And the gentleman is absolutely right. We do differentiate between end users and others. The marginal requirements are not on end users. They are only on the financial and major swap participants. And they are permissive. They are not mandatory, and they are going to be done, I think, with an appropriate touch.

U.S. SENATE,
Washington, DC, June 30, 2010.

Hon. Chairman BARNEY FRANK,
Financial Services Committee, House of Representatives, Rayburn House Office Building, Washington, DC.

Hon. Chairman COLLIN PETERSON,
Committee on Agriculture, House of Representatives, Longworth House Office Building, Washington, DC.

DEAR CHAIRMEN FRANK AND PETERSON: Whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool. Regulators, namely the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the prudential regulators, must not make hedging so costly it becomes prohibitively expensive for end users to manage their risk. This letter seeks to provide some additional background on legislative intent on some, but not all, of the various sections of Title VII of H.R. 4173, the Dodd-Frank Act.

The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs of end user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.

Again, Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end users, nor can the regulators require clearing for end user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, but rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction. In cases where a Swap Dealer enters into an uncleared swap with an end user, margin on the dealer side of the transaction should reflect the counterparty risk of the transaction. Congress strongly encourages regulators to establish margin requirements for such swaps or security-based swaps in a manner that is consistent with the Congressional intent to protect end users from burdensome costs.

In harmonizing the different approaches taken by the House and Senate in their respective derivatives titles, a number of provisions were deleted by the Conference Committee to avoid redundancy and to streamline the regulatory framework. However, a consistent Congressional directive throughout all drafts of this legislation, and in Congressional debate, has been to protect end users from burdensome costs associated with margin requirements and mandatory clearing. Accordingly, changes made in Conference to the section of the bill regulating capital and margin requirements for Swap Dealers and Major Swap Participants should not be construed as changing this important Congressional interest in protecting end users. In fact, the House offer amending the capital and margin provisions of Sections 731 and 764 expressly stated that the strike to the base text was made "to eliminate redundancy." Capital and margin standards should be set to mitigate risk in our financial system, not punish those who are trying to hedge their own commercial risk.

Congress recognized that the individualized credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management. That is why Congress specifically mandates that regulators permit the use of non-cash collateral for counterparty arrangements with Swap Dealers and Major Swap Participants to permit flexibility. Mitigating risk is one of the most important reasons for passing this legislation.

Congress determined that clearing is at the heart of reform—bringing transactions and counterparties into a robust, conservative and transparent risk management framework. Congress also acknowledged that clearing may not be suitable for every transaction or every counterparty. End users who hedge their risks may find it challenging to use a standard derivative contracts to exactly match up their risks with counterparties willing to purchase their specific exposures. Standardized derivative contracts may not be suitable for every transaction. Congress recognized that imposing the clearing and exchange trading requirement on commercial end-users could raise transaction costs where there is a substantial public interest in keeping such costs low (i.e., to provide consumers with stable, low prices, promote investment, and create jobs.)

Congress recognized this concern and created a robust end user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk. These entities could be anything ranging from car companies to airlines or energy companies who produce and distribute power to farm machinery manufacturers. They also include captive finance affiliates, finance arms that are hedging in support of manufacturing or other commercial companies. The end user exemption also may apply to our smaller financial entities—credit unions, community banks, and farm credit institutions. These entities did not get us into this crisis and should not be punished for Wall Street's excesses. They help to finance jobs and provide lending for communities all across this nation. That is why Congress provided regulators the authority to exempt these institutions.

This is also why we narrowed the scope of the Swap Dealer and Major Swap Participant definitions. We should not inadvertently pull in entities that are appropriately managing their risk. In implementing the Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in their ordinary course of business. Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business. For example, the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business. Congress incorporated a de minimis exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.

Just as Congress has heard the end user community, regulators must carefully take into consideration the impact of regulation and capital and margin on these entities.

It is also imperative that regulators do not assume that all over-the-counter transactions share the same risk profile. While uncleared swaps should be looked at closely, regulators must carefully analyze the risk associated with cleared and uncleared swaps and apply that analysis when setting capital standards for Swap Dealers and Major Swap Participants. As regulators set capital and margin standards on Swap Dealers or Major Swap Participants, they must set the appropriate standards relative to the risks associated with trading. Regulators must carefully consider the potential burdens that Swap Dealers and Major Swap Participants may impose on end user counterparties—especially if those requirements will discourage the use of swaps by end users or harm economic growth. Regulators should seek to impose margins to the extent they are necessary to ensure the safety and soundness of the Swap Dealers and Major Swap Participants.

Congress determined that end users must be empowered in their counterparty relationships, especially relationships with swap dealers. This is why Congress explicitly gave to end users the option to clear swaps contracts, the option to choose their clearinghouse or clearing agency, and the option to segregate margin with an independent 3rd party custodian.

In implementing the derivatives title, Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to "book-out" their physical delivery obligations under a forward contract.

Congress recognized that the capital and margin requirements in this bill could have an impact on swaps contracts currently in existence. For this reason, we provided legal certainty to those contracts currently in existence, providing that no contract could be terminated, renegotiated, modified, amended, or supplemented (unless otherwise specified in the contract) based on the implementation of any requirement in this Act, including requirements on Swap Dealers and Major Swap Participants. It is imperative that we provide certainty to these existing contracts for the sake of our economy and financial system.

Regulators must carefully follow Congressional intent in implementing this bill. While Congress may not have the expertise to set specific standards, we have laid out our criteria and guidelines for implementing reform. It is imperative that these standards are not punitive to the end users, that we encourage the management of commercial risk, and that we build a strong but responsive framework for regulating the derivatives market.

Sincerely,

Chairman CHRISTOPHER DODD,
Senate Committee on Banking, Housing, and Urban Affairs, U.S. Senate.

Chairman BLANCHE LINCOLN,
Senate Committee on Agriculture, Nutrition, and Forestry, U.S. Senate.

Appendix B

H5248 CONGRESSIONAL RECORD — HOUSE *June 30, 2010*

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Appendix C

Calendar No. 349

111TH CONGRESS *2d Session*	SENATE	REPORT 111–176

THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010

APRIL 30, 2010.—Ordered to be printed

Mr. DODD, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

MINORITY VIEWS

[To accompany S. 3217]

The Committee on Banking, Housing, and Urban Affairs, having considered the original bill (S. 3217) to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

CONTENTS

89–010

Subsection

terrence of abuses, trading procedures, and financial integrity of transactions. This subsection also establishes core regulatory principles for ASEFs relating to enforcement, anti-manipulation, monitoring, information collection and disclosure, position limits, emergency powers, recordkeeping and reporting, antitrust considerations, and conflicts of interest. This subsection directs the SEC and CFTC to jointly prescribe rules governing the regulation of alternative swap execution facilities, and authorizes the SEC to exempt from registration under this subsection an alternative swap execution facility that is subject to comparable, comprehensive supervision and regulation by another regulator.

Subsection (c). Trading in security-based swap agreements

This subsection prohibits parties who are not eligible contract participants (as defined in the Commodity Exchange Act) from effecting security-based swap transactions off of a registered national securities exchange.

Subsection (d). Registration and regulation of swap dealers and major swap participants

This subsection requires security-based swap dealers and major security-based swap participants to register with the SEC, and directs the SEC and CFTC to jointly prescribe uniform rules for entities that register with the SEC as security-based swap dealers or major security-based swap participants and entities that register with the CFTC as swap dealers or major swap participants. This subsection also requires security-based swap dealers and major security-based swap participants to (1) meet such minimum capital and margin requirements as the primary financial regulatory agency (for banks) or CFTC and SEC (for nonbanks) shall jointly prescribe; (2) meet reporting and recordkeeping requirements; (3) conform with business conduct standards; (4) conform with documentation and back office standards; and (5) comply with requirements relating to position limits, disclosure, conflicts of interest, and antitrust considerations. The Commission may exempt security-based swap dealers and major swap participants from the margin requirement according to certain criteria and pursuant consultation with the Financial Stability Oversight Council. If a party requests margin for an exempt swap, the exemption shall not apply. Regulators may permit the use of non-cash collateral to meet margin requirements.

Subsection (e). Additions of security-based swaps to certain enforcement provisions

This subsection adds security-based swaps to the Exchange Act's list of financial instruments that a person may not use to manipulate security prices.

Subsection (f). Rulemaking authority to prevent fraud, manipulation, and deceptive conduct in security-based swaps

This subsection prohibits fraudulent, manipulative, and deceptive acts involving security-based swaps and security-based swap agreements, and directs the SEC to prescribe rules and regulations to define and prevent such conduct.