Testimony of Kenneth E. Bentsen, Jr.
Executive Vice President for Public Policy and Advocacy
Securities Industry and Financial Markets Association

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Committee on Financial Services, U.S. House of Representatives

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Chairman Garrett, Ranking Member Waters, members of the Subcommittee, my name is Ken Bentsen and I am the executive vice president for public policy and advocacy at the Securities Industry and Financial Markets Association (Sifma)[1]. Thank you for the opportunity to share our views regarding the Dodd-Frank Act today.

The Dodd-Frank Act is the most expansive financial regulatory law in more than seventy years. In addition to amending the multitude of prior statutes, the Act contains a tremendous amount of new law, resulting in at least 150 rulemakings affecting every aspect of financial services. There is much in the Act that SIFMA's members supported such as the establishment of a systemic risk regulator, the Financial Stability Oversight Counsel (FSOC), the new Orderly Liquidation Authority designed to resolve failing systemically identified firms, and the authorization of a uniform standard of care for brokers and advisors providing personalized investment advice. We believe that properly crafted through the rule making process, these provisions as well as others can appropriately increase supervision to mitigate systemic risk, improve coordination among regulators, eliminate too big to fail, and improve protections and confidence for individual investors. However, other provisions, if not properly crafted both domestically and in coordination with regulators around the world, could have far reaching negative consequences to the detriment of the businesses, governments, non-profits, and individual and institutional investors who rely upon deep and liquid U.S. capital markets.

In response to the Committee's request I will limit my written remarks to implementation of the Volcker Rule, Credit Risk Retention, Title VII, and Section 165(e) Single Counterparty Credit Limits.

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org

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1. The Volcker Rule

We believe that Congress' goal in adopting the statutory Volcker Rule was to focus banking entities on providing liquidity to customers and to prohibit excessive risk taking beyond that required for customer activity. The rule (the "Proposal"), as proposed by the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) (the "Agencies") however, defines Congressionally permitted activities far too narrowly and subjects banking entities to a conceptually difficult and operationally expensive set of requirements, the costs of which cannot be justified based on their benefits. Specifically, these requirements may paralyze effective market making, which is far from the statute's intent. In addition, as an unintended and deleterious side effect, the Proposal will severely limit banking entities' abilities to hedge their own risk, thereby increasing rather than decreasing the risk to banking entities and the financial system.

Our Key Conceptual Concerns with the Proposal's Approach:

Artificial Distinction Between Permitted Activities and Proprietary Trading. The Proposal attempts to draw a bright dividing line between the permitted activities and prohibited short-term proprietary trading. We believe that drawing such a line is not only unnecessary and impractical, but also is inconsistent with the structure of the statutory Volcker Rule. Congress allowed the permitted activities ***regardless*** of the fact that they are short-term proprietary trading. Therefore, the Agencies' attempt to define the permitted activities as distinct from proprietary activities is inconsistent with congressional intent and doomed to failure. It results in an overly narrow interpretation of the permitted activities that constrains the beneficial effects those activities have for corporate issuers and investors that rely on the capital markets.

Negative Presumptions and Reliance on Hard-Coded Criteria. The Agencies' focus on prohibited behavior, at the cost of overly restricting permitted activities, is expressed in the negative presumptions that permeate the Proposal. Throughout the Proposal, the Agencies assume that activities are prohibited unless proven otherwise. We believe that this negative presumption is inconsistent with explicit congressional intent to allow useful principal activity. We believe it is also inconsistent with the historical approach that the Agencies have taken in supervising banking entities, which would have formed Congress' expectation of how the Volcker Rule would be implemented. We believe that the numerous letters to the Agencies from members of Congress and from the Financial Services Committee hearing on the Proposal both indicate Congress' surprise and concern at the path the Agencies have taken.

The negative presumption manifests itself most clearly in the Agencies' reliance on hard-coded criteria to define the permitted activities, under which the failure to meet any single criterion

disqualifies the trading unit from engaging in the permitted activity. Such an approach shoehorns all permitted activity into one or a few archetypes, rather than reflecting the numerous ways market participants engage in beneficial activities that Congress meant to protect. Even more unfortunately, the archetype chosen by the regulators does not represent the majority of the markets, but rather is reflective of a small portion of transactions in one type of liquid market.

For example, the heavy reliance on bid-ask spreads, and the presumption that revenues that deviate from bid-ask spreads are indicative of prohibited proprietary trading, are at odds with the fact that few markets have a readily determinable bid-ask spread that is quantifiable or that could sustain a market-making business. As a result, in order to rebalance the proprietary trading proscription with the permitted activities, we believe that the hard-coded criteria should be removed from the rule and, subject to our specific recommendations and, to the extent relevant, incorporated into the final Volcker Rule regulations as guidance.

In addition, revenue sources differ significantly by asset class. In markets where trades are large and less frequent, such as the market for customized securitized products, appreciation of the price of a covered financial position may be a major (or the predominant) contributor to revenues, since one position moving up or down significantly may have a marked impact on the profit and loss of the trading unit. Requiring that the activity generate revenues primarily from fees, commission, bid-ask spread, etc. places a limit on the extent to which the sources of income can differ by asset class.

Transaction-by-Transaction Approach. We believe that the Proposal's transaction-by-transaction approach to principal trading is symptomatic of the focus on proscribing proprietary trading and is inconsistent with the intent of a statute that broadly speaks of permitted "activities." We believe that an analysis that seeks to characterize specific transactions as either market making, hedging, underwriting or another type of permitted or prohibited activity does not accord with the way in which modern trading units operate, which generally view individual positions as a bundle of characteristics that contribute to their complete portfolio. We believe that analyzing permitted activities on a transaction-by-transaction basis will not only be unsuccessful but will also, in the process, harm legitimate activity in financial markets.

Overly Specific and Prescriptive Compliance Regime. Finally, we believe that the Proposal's compliance regime is overly specific, prescriptive and impractical. We believe this arises from trying to develop a scheme that identifies each and every possible instance of prohibited proprietary trading in an otherwise permitted activity. We believe the effect, instead, will be to make some activities so impractical for banking entities that they can no longer be cost-justified. For example, the strict dichotomy in the Proposal between customer trades and non-customer trades would seem to require banking entities to tag each and every trade as to whether the counterparty qualifies as a customer at that particular time for that particular trade. We believe

that, instead, the Agencies should institute a principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the actual structure and activities of their organizations. The Agencies should permit banking entities to leverage existing compliance regimes, including the use of existing board-level governance protocols.

Potential Costs of the Proposal. The potential costs to the financial markets, investors and corporate issuers from incorrectly implementing the Volcker Rule, in a manner consistent with the Proposal, are enormous. For example, in a study commissioned by SIFMA, the Oliver Wyman financial consulting firm estimated the impact on issuers and investors of a loss of liquidity possibly resulting from the Proposal.

Oliver Wyman found that liquidity losses could cost investors between $90 billion and $315 billion in mark-to-market losses on the value of their existing holdings; cost corporate issuers between $12 billion and $43 billion per year in borrowing costs; and cost investors between $1 billion and $4 billion per year in transaction costs as the level and depth of liquidity decreases.[2] Further, Stanford University professor Darrell Duffie noted in a paper commissioned by SIFMA that the "direct and indirect effects" of the Proposal "would increase trading costs for investors, reduce the resiliency of markets, reduce the quality of information revealed through security prices, and increase the interest expense and capital raising costs of corporations, individuals, and others," explaining that "[t]hese outcomes would lead to somewhat lower expected economic growth" that would have "potential adverse consequences for systemic risk"[3]

Many commenters, including customers, buy-side market participants, industrial and manufacturing businesses, treasurers of public companies and foreign regulators, central banks and sovereign issuers—constituencies with different goals and interests—have agreed that the Proposal would significantly harm financial markets. They point to the negative impacts of decreased liquidity, higher costs for issuers, reduced returns on investments, and increased risk to corporations wishing to hedge their commercial activities. Commenters from each of these groups have made the case that other market participants are unlikely to be able to fill the critical role played by the customer-oriented principal activities of banking entities.

We agree with AllianceBernstein that "the inability to confidently engage in market making activities on a principal basis under the Proposal, along with the onerous recordkeeping and compliance burdens required will have a material and detrimental impact on the ability of covered banking entities to engage in market making activity [and] will dramatically reduce

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[2] Oliver Wyman, *The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity* (Feb. 2012) ("Oliver Wyman 2012 Study").
[3] Darrell Duffie, Stanford University, *Market Making Under the Proposed Volcker Rule* (Jan. 16, 2012) ("Duffie Analysis")

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market liquidity, increase costs and in some cases impact the ability of market participants to meet their legally required obligations to investors and other stakeholders."[4]

We do not think these consequences were the Agencies' intention. We believe that the Agencies, like Congress, wish to allow banking entities to provide corporations and investors liquidity in financial instruments by intermediating between market participants over time and in size—the essential function of market makers.

Our Suggestion for Reorienting the Proposal

We believe that the Proposal can be reoriented to avoid much of this negative impact and bring it closer to congressional intent regarding the statutory Volcker Rule. Rather than seeking to scrutinize every transaction in search of possible prohibited proprietary trading, the Proposal should protect the ability of banking entities to engage in the critical financial intermediation explicitly permitted by Congress. We agree that Congress intended, and the Agencies should require, banking entities to eliminate pure proprietary trading businesses. However, banking entities should be allowed to engage in customer-focused principal trading under the statutorily permitted activities.

To foster customer-oriented business, the Agencies' hard-coded criteria should be recast as guidance that helps banking entities to differentiate client-focused business from other business. We believe a business should be viewed as customer-focused, and therefore engaged in market making, if it is oriented to meeting customer demand throughout market cycles. The Agencies' guidance should explicitly recognize that maintaining a customer focus not only requires a commitment to buy from and sell to customers, but also requires obtaining positions in anticipation of customer flow and trading in the interdealer market in order to validate liquidity, volatility, pricing, and other market trends.

This guidance would be incorporated in policies and procedures by the banking entities with risk limits and controls monitored by the Agencies through examinations. Certain quantitative metrics, measured at a level within the organization that permits activities to be viewed as a whole, may help highlight certain activities that could be discussed with examiners and in the context of horizontal reviews. As suggested in the Proposal, however, metrics should not be used as a bright-line trigger for remedial action. Some metrics may be more relevant than others, depending upon the particular asset class, activity, particular market, and unique characteristics of each banking entity. Over time, based on discussions with examiners, the banking entities and

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[4] Letter from AllianceBernstein L.P. to the Agencies (Nov. 16, 2011). *See also* Duffie Analysis at 3 (noting that "the Agencies' proposed implementation of the Volcker Rule would reduce the quality and capacity of market making services that banks provide to U.S. investors" and that "investors and issuers of securities would find it more costly to borrow, raise capital, invest, hedge risks, and obtain liquidity for their existing positions"); Oliver Wyman 2012 Study at 2 (concluding that the Proposal "could significantly impair liquidity provided by market makers").

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examiners would determine the usefulness and relevance of individual metrics. We believe this reorientation would ensure that covered banking entities avoid prohibited speculative activity while preserving deep and liquid financial markets.

2. Credit Risk Retention – Premium Capture Provisions

In the securitization markets, SIFMA has long held a view that any one proposal should not be viewed on its own. Mortgage lending, for example, is a sequence of many connected and interdependent events – from appraisals and loan origination, to secondary market funding, to servicing, securitization, and trading. Many parties are involved, from consumers to lenders, lawyers to rating agencies, appraisers and accountants, and in many ways most importantly, mortgage investors. It all must work together, and it all exists in a world where multiple regulations impact various aspects of each step. Retention is but one issue; one must also consider how retention interacts with accounting standards (consolidation standards), capital rules (e.g., Basel 2.5 and Basel III) and lending laws (e.g., the definition of the "Qualified Mortgage," which is intimately connected to the Qualified Residential Mortgage (QRM)), among others. Our testimony will focus on retention, and in particular, one aspect of the Agencies' Proposing Release.

On April 29, 2011, the Department of the Treasury, OCC, Federal Reserve, FDIC, SEC, Federal Housing Finance Agency (FHFA), and the Department of Housing and Urban Development (HUD) jointly proposed rules ("the "Proposing Release") to implement the requirements of section 941(b) of the Dodd-Frank Act regarding credit risk retention.[5] SIFMA has been on the record in support of the general principles that underlie risk retention since before the rule became the law. The proposed rules would implement a risk retention regime, define the contours of a so-called Qualified Residential Mortgage, and implement other qualified asset tests. My comments here will focus on one aspect of the proposal that we believe must be amended due to its destructive nature – the so-called Premium Capture Cash Reserve Account provisions (PCCRA).

This premium capture requirement likely will deter sponsors from structuring securitizations with premium or interest-only tranches, or other structures that monetize excess spread up-front. Both our buy- and sell-side members are strongly concerned that the requirement for a premium capture cash reserve account as presently configured presents a serious obstacle to structuring securitizations, including residential mortgage securitizations, by taking away a legitimate source

[5] SIFMA has submitted four comment letters on the Proposing Release. See: April 21, 2011 letter on Par Value (http://www.sifma.org/issues/item.aspx?id=24954), June 10, 2011 letter on behalf of sponsor and issuer members (http://www.sifma.org/issues/item.aspx?id=25925), June 10, 2011 letter on behalf of investor members (http://www.sifma.org/issues/item.aspx?id=25926), and a January 20, 2012 letter on PCCRA (http://www.sifma.org/issues/item.aspx?id=8589937126).

of funds to enable sponsors to recoup costs and generate a reasonable return. We believe that the reserve account as proposed will undermine any hopes of reviving the private market for those securities.

Moreover, this premium capture cash reserve account is not required by the Act. This concern was expressed in an August 1, 2011 letter from House Financial Services Chairman Spencer Bachus and Representative Scott Garrett to the heads of the federal regulatory agencies implementing the PCCRA that stated: "Specifically, the proposal contains a requirement never discussed during the deliberations on what became the Dodd-Frank Act that securitizers set aside the premium from sales of securities in so-called premium capture cash reserve accounts (PCCRAs)….Cutting off or greatly reducing this vital source of capital through the operation of a provision that Congress never considered (or even contemplated) is bad policy and an inappropriate exercise of regulatory authority."

Operation of the PCCRA Provision

The PCCRA provisions are likely to significantly impair the ability of private capital to assist in reducing the role of the government sponsored enterprises (GSEs) in mortgage finance. The effect of these provisions could negatively impact the economics of many securitizations to the extent that they would not be possible. As it is structured, PCCRA would eliminate or materially eliminate all profitability from a transaction. It would also drive the amount of risk retained by the sponsor to levels well beyond those envisioned by the law. This is bad for lenders and issuers, as it removes securitization as a funding option. This is bad for investors, who need new mortgage products to invest in. And most importantly, it is bad for consumers, as the PCCRA provisions stand to reduce the ability of private funds to finance mortgage lending and will likely reduce the features that customers are able to obtain with their mortgages, such as rolling closing costs into the loan amount.

Here is how PCCRA is defined: The proposed rules provide that *in addition to the amount of credit risk that a sponsor is already required to retain under the other provisions of the proposed rules (e.g., 5 percent)*, a sponsor must establish and fund a premium capture cash reserve account in an amount equal to any amount by which (1) the gross proceeds, net of closing costs paid by the sponsor(s) or issuing entity to unaffiliated parties, received from the sale of asset-backed securities (ABS) interests in the issuing entity to persons other than the retaining sponsor exceed; (2) 95 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction or 100 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction (depending on the specific form of retention chosen).

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In a simplified example[6]: A pool of loans has a par value of $100 and the proceeds from the securitization of those loans is $104. Under premium capture, the $4 above the par value of the loans is held back. This is *in addition to* the $5 of required risk retention, meaning that the overall level of risk retained is 8.7 percent (9/104) rather than the prescribed 5 percent (5/100). If the profit motive is taken off the table, what is the incentive to issue securitizations?

This requirement is so onerous that, as stated in the Proposing Release, "few, if any, securitizations would be structured to monetize excess spread at closing and, thus, require the establishment of a premium capture cash reserve account."[7] We agree. Left unstated in the Proposing Release, however, is what a securitization sponsor that holds premium assets is to do, other than to "structure their securitization transactions in a manner that does not monetize excess spread at closing"[8] – or find an alternative to securitization.

Based upon communications with certain of the Agencies and our review of the Proposing Release, we believe that the Agencies intend that in a securitization of a premium pool, the sponsor would artificially increase the par value of the residual interest by the amount of the premium - thus avoiding the funding of a cash reserve account equal to the amount of the premium, but forcing the sponsor to retain (or try to find a buyer for) a residual interest having a par value representing the premium. It is also possible that in some cases the sponsor could increase the value of other ABS interests in addition to the residual, although it is not clear how this would work in practice. We fail to see why the credit risk retention rules should force a sponsor to artificially adjust the values of securitization interest, or compel sponsors to structure transactions in certain ways. The law requires the retention of 5 percent of the risk of a transaction, and that is what the implementation rules should use as a target. Regulations should not add completely new and unconsidered structures to the law when all market participants have expressed concern over the viability of the market under such a structure. Once again, the sponsor would be economically disadvantaged for purposes that appear to be outside the scope of congressional intent.

The economic result of this approach would be so severe that, if it were implemented through the risk retention rules, many sponsors would avoid securitization. The premium capture provisions appear to be based on a view that all excess spread belongs in the residual interest, and that to allocate any excess interest cash flows in another way inappropriately devalues the residual interest. We believe that this is a misconception.

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[6] Please note that the exact meaning of the term "par value", as used in the Proposing Release is unclear. This complicates the analysis of PCCRA and many other provisions of the rulemaking. See SIFMA June 10, 2011 letter on behalf of sponsor and issuer members at 15, and SIFMA April 21, 2011 letter on this specific issue of the definition of par value.

[7] Proposing Release, 76 Fed. Reg. 24090 at 24113.

[8] *Id.*

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Accounting and Capital Implications of PCCRA will Further Weaken the Ability of Private Capital to Fund Mortgage Lending

We also note, as mentioned in the first paragraph of this section, that the PCCRA provisions will interact with other regulations and rules – most importantly accounting rules. We believe that the requirement for a fully subordinated premium capture cash reserve account in addition to the amount of credit risk required to be retained under the proposed rules could prevent sponsors from achieving sale treatment for assets transferred to securitization vehicles in transactions that otherwise would qualify for sale treatment under U.S. accounting rules. This would drive increases in capital requirements and would further weaken the incentive to securitize as well as further weaken the ability of securitization to fund mortgage credit origination.

A securitizer's determination of the financial accounting and reporting to accord a securitization transaction can be a complex exercise, requiring an analysis of the application of both consolidation and sales accounting standards, in that order. A securitizer must determine whether it is required to consolidate the special purpose (securitization) entity to which the assets were transferred, by applying the relevant guidance in the FASB's Accounting Standards Codification ("ASC") Topic 810, *Consolidation*. If the securitizer must consolidate the securitization entity, the transferred assets will continue to be reported in the securitizer's financial statements and continue to attract capital requirements for that institution.

In those cases in which a sponsor retains 5 percent of the ABS interests and is obligated to fund a subordinated cash reserve account in the amount of any premium capture, the effect of the premium reserve account is akin to imposing an incremental, *de facto* horizontal risk retention on the securitizer. Thus, the securitizer's obligation to fund losses under the premium capture arrangement, alone or in combination with other retained interests, would likely require the securitizer to consolidate the securitization entity.

An extended discussion of the potential consequences stemming from a securitizer's consolidation of a securitization entity – in contrast to the transaction achieving off-balance sheet/sales accounting treatment with respect to the transferred assets – is beyond the scope of this testimony. However, suffice it to say that ongoing "on-balance sheet" reporting of securitized assets may, importantly for a regulated financial institution, require the entity to maintain more regulatory capital to support the on-balance sheet assets. This will further limit the ability of private capital to fund mortgage lending and reduce the availability of credit to consumers.

Consequences of PCCRA for Consumers

Unless withdrawn, the premium capture provisions would likely discourage many securitization transactions, unnecessarily change some lenders' origination practices, and increase the cost of some consumer loans.

The premium capture provisions would have the harshest impact on residential and commercial mortgage securitization markets. The commercial market has recently begun to recover, but the residential mortgage securitization market, outside of the GSEs, has yet to show much life. The premium capture provisions could severely damage the recovery of commercial markets and inhibit any recovery in residential securitization markets.

The premium capture rules do not appear to consider the costs of origination or otherwise account for a securitizer's cost basis in the pool assets. All that matters under the premium capture provisions as proposed is whether gross proceeds, or deemed gross proceeds, exceed the requisite percentage of par value. The fact that a securitizer may have paid a premium for the pool assets does not appear to excuse the securitizer from being obligated to subordinate the premium, either in a cash reserve account or in the residual interest. In such circumstances, there may be very little market for premium loans.

Lenders could react to the premium capture provisions by changing origination practices to avoid above-market rates and instead charge borrowers higher points and fees. Mortgage lenders could be reluctant to grant rate locks to prospective borrowers due to the risk that market rates move lower and the lender is left with a premium loan that is expensive to securitize.

It is not clear to us whether the premium capture provisions are intended, in whole or in part, to indirectly limit certain lending practices. If such is the case, we suggest that these matters are more appropriately handled directly in regulation of consumer lending.

The Agencies should Withdraw PCCRA and Re-propose the Risk Retention Rules

We note that our PCCRA concerns were echoed in a Special Report[9] authored by Mark Zandi and Christian deRitis of Moody's Analytics that stated: "As a result of the way the premium capture rule is stated, the mortgage rate impact to borrowers would be significant— on the order of an increase of 1 to 4 percentage points depending on the parameters of the mortgages being originated and the discount rates applied…Yet the consequences of the rule as written could significantly impede the return of private securitization markets and permanently cement the government's role in housing finance."

We urge the Agencies to take the time needed to carefully reevaluate the proposed rules, perform a risk/benefit analysis of the rules and their potential effects, and republish the rules in proposed form in order to provide a fair and reasonable opportunity for public comment. In doing so, the premium capture provisions should be withdrawn; they appear to be related more to limiting profitability and indirectly regulating lending practices than to risk retention. The provisions

[9] Moody's Analytics, Special Report – A Clarification on Risk Retention, September 22, 2010, pages 2-3.

would also impose an undue economic burden on securitizations, potentially further limiting access to credit for many borrowers.

3. Title VII – Derivatives Regulation

We are supportive of the goals of Title VII derivatives regulation, namely improving oversight of over-the-counter (OTC) derivatives markets and reducing systemic risk. In fact many aspects of swap market regulation, such as greater transaction reporting and central clearing were well underway before the Dodd-Frank Act was passed into law. As with all regulation, our concerns focus on making sure that requirements are workable, and that the benefits – as measured by how well such rules accomplish their stated purposes – outweigh the costs. Those costs, after all, are borne by market participants (financial and commercial entities) who may find it more difficult and expensive to access credit or other financial resources, such as hedging, that are vital to risk management functions.

We have outlined our concerns through written comments on rules pertaining to many aspects of Title VII rulemaking.[10] In particular, we believe rigorous cost benefit analysis is not only necessary in determining whether a particular rule is on balance beneficial; it is also crucial in evaluating alternative approaches to accomplishing regulatory goals. We have also urged regulators to take care to avoid unintended costs and market impacts by carefully sequencing and phasing in the implementation of rules by category, type of participant, asset class and products within asset classes. The idea that such fundamental building blocks of a new market structure, such as, but not limited to: the establishment of, and reporting to, swap data repositories; the establishment of central counterparties and determinations of mandatory clearing requirements; the establishment of swap execution facilities (SEFs) and mandatory trading requirements; the registration of swap dealers and major swap participants; real time reporting; internal and external business conduct requirements; and capital and margin requirements can all be implemented at virtually the same time, and without benefit of gaining crucial insights as each block is put into place, is highly unrealistic at best and reckless at worst.

But that is not the end of the story; regulators have spoken of cooperation both at home and globally in OTC derivatives rulemaking, but we see very little real evidence of actual coordination. Except for the two definition rule sets, where there exists a statutory requirement to conduct joint rulemaking, there is scant evidence that there will be harmonized rules for swaps and securities-based swaps, even though there are business lines in which the line between the two products is an arbitrary distinction such as "narrow-based" vs. "broad-based" indexes. These products only differ because one is based on nine or fewer underlying reference assets and the other ten or more; they are traded by the same person or group whose counterparties are also the

[10] http://www.sifma.org/issues/regulatory-reform/otc-derivatives/activity/

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same, and yet they will likely have to comply with different business conduct requirements and execute on different types of SEFs. For example, the SEC states in its proposed rules for SEF core principles that the regulatory approaches taken by the SEC and CFTC may differ due to "differences between the markets and products that the [SEC] and CFTC currently regulate." As noted above, many market participants will engage in both swaps and security-based swaps and thereby will be subject to both regulatory regimes. Requiring such market participants to execute similar types of transactions in dissimilar ways on separate trading platforms will add significant administrative and compliance costs and risks, generating unnecessary confusion to no one's benefit.[11] Both agencies should be particularly careful in their approach towards SEF rules, and rules related to central trading and clearing, such as block trade size thresholds, as a robust and flexible environment is crucial to developing liquid swap markets.

The CFTC and SEC should also continue to evaluate the impact of amendments to Rules 4.5/4.13 and how Registered Investment Companies that must now register as Commodity Pools will be subject to redundant, and in some areas conflicting, SEC and CFTC requirements. The lack of consistency between the two regimes will have a number of adverse consequences, including increased costs for investors and unnecessary, and potentially confusing, forms of disclosure and reporting to investors.

Another area where lack of coordination is likely to have costly consequences is the cross border application of Title VII rulemaking. If improperly drawn, as the initial reading of the recently proposed CFTC guidance appears to be, extraterritorial application of U.S. regulations could create two sets of rules for swap regulation and could isolate the U.S. swap market from the global market, of which it is currently a major part. If transacting with a U.S. entity (financial intermediary, financial end user and commercial end user alike) puts non-U.S. entities at risk of becoming subject to U.S. regulation globally, it is clear that such non-U.S. entities will not transact with U.S. entities, denying U.S. firms access to those global markets. This will raise the cost of hedging, for example, and if the cost is prohibitive, will lead U.S. firms to decide not to hedge.

The recently proposed CFTC cross border guidance is complex, expansive in scope, and highly prescriptive. At this time we are not at all sure that the terms of so-called substituted compliance –which theoretically should allow market participants in other well regulated markets to rely on their home market regulation – actually would work in practice.

This "substituted compliance" process will be different than the "mutual recognition" model and would require the CFTC individually review the rules of foreign nations. We are concerned generally by determinations of cross border equivalence that are not outcomes based, and are

[11] SIFMA AMG letter to SEC on registration and regulation of security-based swap execution facilities, April 4, 2011.

used instead as a tool to export regulations from one jurisdiction to another. As we have noted in previous comment letters, if a host country regulator were to extend certain regulations to the global entity, the entity would be subject to overlapping and potentially inconsistent regulation. In such an event, the non-U.S. entity may decide that the easiest way to comply with each jurisdiction's requirements is to register separate entities in many more jurisdictions than it otherwise would. This fragmentation of global firms could lead to inefficient results. With respect to capital, for example, it would remove the benefits of netting, collateral management and centralized risk management, which are key components of systemic risk mitigation.[12]

Further, we believe the CFTC's cross border application approach is flawed in that the Commission chose to do so in the form of guidance as opposed to a rule, and apparently, without sufficient coordination with the SEC. By failing to put forth a rule, the CFTC avoided conducting any cost benefit analysis and formal comment by affected parties. We believe a more holistic, rules-based approach, as we understand the SEC is likely to do after all of the Title VII rules have been proposed, is a more prudent approach.

We have long supported a more genuinely cooperative and harmonized approach to cross border rulemaking, such as mutual recognition or global standard setting. We believe these are more appropriate tools for developing a coherent regulatory structure, providing regulators and the regulated with substantial efficiencies while avoiding placing unnecessary burdens on markets, creating barriers to market entry, distorting competition or encouraging regulatory arbitrage.

4. Section 165(e) Single Counterparty Credit Limits

SIFMA supported the inclusion of a single counterparty credit limit in Section 165 of the Dodd-Frank Act because our members have been using internal models for many years to measure and control such exposures. SIFMA, however, does not support the Federal Reserve Board's proposal (the "FRB proposal") in its current form because the proposal would needlessly reduce liquidity in the financial system and dampen economic activity. The FRB proposal would result in the need for extraordinary adjustments of relationships among market participants that are unnecessary, unwise, potentially destabilizing and, in certain instances, unsupported by the statute or congressional intent.

Dodd-Frank instructed the Federal Reserve to promulgate regulations prohibiting covered companies from having a credit exposure to any unaffiliated company in excess of 25 percent of the covered company's capital stock and surplus. "Capital stock and surplus" is calculated by adding the covered company's total regulatory capital to its excess loan loss reserves. The Act defines credit exposure to an unaffiliated company as:

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[12] SIFMA letter to the Agencies on the extraterritorial application of Title VII regulations, February 3, 2011.

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- All repos, reverse repos, securities borrowing, and lending transactions with the company;
- All guarantees, acceptances, or letters of credit issued on behalf of the company;
- All purchases of or investments in securities issued by the company;
- Counterparty credit exposure to the company in connection with a derivative transaction; and
- Other similar transactions that the Federal Reserve designates by regulation.

The Federal Reserve has proposed a two tiered rule to implement Section 165(e):

- **Tier 1:** No covered company may have an aggregate net credit exposure to any single unaffiliated counterparty in excess of 25 percent of the covered company's capital stock and surplus.
- **Tier 2:** No covered company with $500 billion or more in assets (major covered company) may have an aggregate net credit exposure in excess of 10 percent to any other major covered company or to any foreign banking organization with $500 billion or more in assets. SIFMA believes the Federal Reserve did not make a case for this part of the FRB proposal.

This proposal requires large banking organizations to use new methodologies for measuring credit exposures that ignore their current approved internal methodologies. The new method is a crude measure that overstates exposures under any reasonable calculation methodology by a significant multiple. *The effect of the new methodology for measuring credit exposure will be a reduction in market liquidity that may have a significant effect on markets more broadly.*

In particular, it would:

- force banking organizations away from CCPs;
- discriminate against foreign government debt;
- deny the benefits of double default protection;
- limit the use of collateral posted against certain credit transactions; and
- not allow firms to fully net some exposures.

Central Counter-Parties (CCPs)
The Dodd-Frank Act contains numerous provisions that encourage firms to use CCPs, to improve transparency and increase the oversight of the swaps market. The FRB proposal, however, requires firms to limit their exposures to CCPs like all other counterparties to the same

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25 percent cap. Because of the limited number of CCPs and the high barriers to establishing a CCP that would meet regulatory requirements, a firm might hit the cap with respect to all available CCPs. This may lead firms to create more customized swaps that may be cleared bilaterally, avoiding CCPs altogether. This creates a perverse incentive for banking organizations not to use CCPs for their derivative transactions. This runs against the policy in Title VII to improve transparency and the use of CCPs.

Non-US Government Bonds
When a firm holds foreign sovereign debt, including as collateral, the firm must count it as an exposure to the foreign government. This discriminates against other government debt in favor of US Treasury bonds as collateral. This will certainly impact the liquidity of foreign debt markets. Additionally, these limits will most affect US firms doing business overseas, where they must frequently use the local non-US government debt as collateral for transactions.

Double Default (Substitution)
If a firm purchases credit protection from a third-party with a direct counterparty, the firm must count these as credit exposures to the third-party protection provider, and not the direct counterparty. This ignores the double default protection that such protection provides. "Double default protection" simply means that's it is less likely that both the third-party and the covered firm or the direct counterparty would default at the same time. The FRB proposal ignores the widely recognized benefits of double default protection and results in a significant overstatement of exposure that is concentrated in the protection providers. Because there are relatively few providers with the infrastructure and capital that market participants expect, the effect of this requirement may be to limit the availability of these important credit risk management products. *The rule should give banks credit for the double default protections that third-party credit protection provides.*

Collateral
The rule does not give a firm credit for the full value of all collateral posted against a derivative transaction. This is an inaccurate measurement of a firm's real credit exposure, and *the rule should give greater credit for the vital risk-managing function that collateral provides.*

Netting
The FRB proposal does not allow firms to fully net, or off-set, their derivative positions with counterparties. This results in an inaccurate measurement of a firm's real credit exposure, and *the rule should provide for a fuller recognition of netting.*

Alternatives
SIFMA, along with The Clearing House, the American Bankers Association, The Financial Services Roundtable and the Financial Services Forum suggested several alternative ways the

Federal Reserve could implement the single counterparty credit limit required in the Dodd-Frank Act. First, the Federal Reserve could amend its proposal to fix the problems as noted above: exempting high quality non-U.S. sovereigns, individuals, CCPs, and allowing netting, the use of the full value of collateral and double default protection. A second alternative would be to allow firms to use a "stressed" version of the internal models they currently use to measure such risk. Thirdly, the Federal Reserve could use a supervisory stress approach which would require a covered company to use a replacement cost, calculate in accordance with regulatory capital rules for derivative transactions under specific stress scenarios specified by the Federal Reserve.

The full potential combined impact of financial services regulatory reforms, including the FRB proposal, Basel III (both capital and liquidity), Title II of Dodd-Frank, proposed margin requirements for swaps (Section 731 of Dodd-Frank) and the Volcker Rule (and related regulations currently under consideration by U.S. regulators has not yet been comprehensively analyzed and, to our knowledge, no one in the regulatory or academic communities has asserted that it has. The reality is that the cumulative effects of the FRB proposal and other rulemakings and reforms, which are often individually complex and when considered together amount to an incredibly complex mosaic, are almost certain to have unintended consequences and potential economic costs, and are likely in some cases to create the potential for actually increasing instead of decreasing systemic risks.

Conclusion

The United States has taken a more comprehensive approach than any other country to address regulatory reform. Although some countries have taken steps to address components of topics covered by Dodd-Frank, no country has adopted restrictions comparable to the Volcker Rule or adopted legislation or regulations having the scope of Dodd-Frank. There can be no question but that substantive regulation has competitive consequences. It is essential that U.S. regulatory agencies, in proposing regulations, consider and analyze both the individual aspects and combined impact of proposed rules that may place U.S. financial markets at an unwarranted competitive disadvantage compared to those countries that have not implemented a comparable approach. We urge U.S. regulators to consider and address the interplay among reforms in the context of considering individual reforms. Further, regulators should undertake substantial cost-benefit analysis to determine what affect such rules may have on the competitiveness of U.S. financial markets and the impact on the users of those markets.