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How the Dodd-Frank Act Will Bring Back Stagflation

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Those of us lucky enough now to be approaching our fifties or older might fondly remember a decade that featured not only our national Bicentennial, the racehorse Secretariat, and chessmaster Bobby Fischer's defeat of Boris Spassky, but also the Vietnam War, wage and price controls, an oil price shock, gas lines, a Vice President resigning after pleading to felony charges, a President resigning under threat of impeachment for burglary (as opposed to speaking a little too precisely about an affair), diplomatic staff held hostage in Iran, and a Soviet invasion of Afghanistan. Other events contributing to the feeling of a nation spun completely out of control included the kidnapping of heiress Patty Hearst by the Symbionese Liberation Army, a deadly riot at Attica State Prison, the Son of Sam serial killings, and large-scale looting during a blackout in New York. If you're fifty or older, your blood is boiling from this list; if you're under fifty and want a feel for the time, watch "Taxi Driver" and "Apocalypse Now."

Stagflation

But perhaps nothing contributed more to the sense of a nation fearing it was collapsing in on itself than the economy of the 1970s: stagnant with runaway inflation. Unemployment broke a 34 year record when it hit 9.2% in 1975. Inflation exceeded 13.3% a year by the end of the decade. President Ford's solution of telling people to wear buttons that said "WIN," for "Whip Inflation Now," failed, but Fed Chairman Paul Volcker's tight interest rates pushed the prime rate above 20% by 1981 and tamed inflation. The country climbed out of the resulting recession (which had even higher unemployment) within a couple of years, and with a few notable hiccups, we did not look back until the credit crisis in 2008.

Inflation coupled with lack of economic growth is known as "stagflation." It was previously unencountered at such scale and persistence. Normally, inflation is a problem of a growing economy, and the Federal Reserve Bank will raise interest rates when it thinks that economic growth will create inflation through "overheating." Inflation isn't so bad if you have a job and can get a raise. It's pretty awful if you don't have

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a job and are watching what savings you have (which will be none if you are a real American) evaporate before you can spend it. Times like that should be escaped, not sought out.

Dodd-Frank

Unfortunately, we have condemned ourselves to repeat a little history. On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] Title VII of that law targets "Wall Street"[2] because Congress and the President found it politically far more palatable to blame the credit crisis on the derivative instruments by which too-easy home loans were packaged for resale than on the too-easy home loans themselves. "Wall Street" is a far richer demagogic opportunity than Fannie Mae. When lawmakers misplace blame, a law passed in "response" has many adverse consequences. Such is the case here.

The Dodd-Frank Act requires that derivatives transactions, also known as "swaps," to the maximum extent possible, be removed from over-the-counter ("OTC") swap markets to highly regulated exchanges, and also adds extensive new regulation to OTC swap markets, which were previously largely unregulated. Supposedly, this will lead to greater marketplace "transparency" and reduce impacts of the economic failures of large counterparties. Practically, it will mean inflation and economic stagnation, or, in a word, "stagflation." Here's why.

Margin Requirements

After two parties enter into a trade in a commodity, whether they are corporate counterparties to an OTC trade, or a trader and an exchange, the market price of the commodity will change.

If the market price moves opposite the trade, losses accrue to the trader and gains accrue to its counterparty, subject to the ability of the trader to make good on his losses when it comes time to settle the trade. The risk that a trader will be unable to make good on his losses is addressed through distinctly different mechanisms by exchanges and OTC markets. In each case, however, traders can provide collateral or "margin" as assurance that they will be able to make good when settlement is due.

Exchanges seek to eliminate this settlement risk through "variation margin" and "initial margin." "Variation margin" is daily settlement of gains and losses intended to reduce the time in which losses can accrue before a trader must make good on them. Initial margin seeks to ensure there are sufficient funds to cover liquidating the trader's positions if the trader does not settle a string of daily losses every day.

OTC markets operate very differently from exchanges. In OTC markets, market participants generally seek to rationalize, rather than eliminate, settlement risk through prudent extension of unsecured credit and passing back and forth margin when accrued losses exceed a previously agreed collateral threshold. Participants in OTC markets typically value their trades against observed market prices[3] on a daily basis and estimate gains and losses that have accrued relative to the price for each trade; i.e., they mark their trades to market.

OTC market participants that are engaging in hedging transactions often agree privately either that neither will post any margin to the other,[4] or to extend each other specified amounts of unsecured credit, represented by a "collateral threshold"[5] and require less than 100% of the value of the market movement be margined. If creditworthiness is an especial concern, a party may require from the other that a fixed amount known as an "Independent Amount," be added to the mark to market calculation, which can be analogized to initial margin.

In an exchange transaction, the initial margin, which is required to enter the trade, and the full amount of any market movement, i.e., the variation margin, combine to add up to more than 100% of the value of the difference between the trade price and the market price. When two private companies trade with each other in the OTC markets, there is no "initial margin" (except, to the extent analogous, an Independent Amount, if applicable) or "variation margin," and usually less than 100% of the difference between the trade price and the market price is posted as margin.

In OTC markets, the collateral threshold amount is effectively a free, unsecured line of credit provided by the exposed party to its counterparty. Most participants in OTC swap markets have multiple counterparties, so these unsecured lines of credit add up very fast. The typical U.S. corporate counterparty likely has, and uses, hundreds of millions of dollars in unsecured credit available to it in OTC swap markets.

Costs of Hedging

An airline typically hedges its fuel supply through OTC swaps with a number of counterparties. Smart management of positions across multiple counterparties might allow the airline aggregate collateral thresholds — and therefore unsecured trading lines — of, for example, half a billion dollars of collective spread between contract prices and market prices over a number of separate transactions. As discussed below, the Dodd-Frank Act is not clear respecting the margin requirements on end-users such as airlines, but were those OTC swaps moved onto an exchange or cleared by a clearinghouse, which provide no collateral threshold leeway and in fact also require initial margin, for a total of more than 100% of the difference between the contract prices and the market prices, the airline, deprived of the half a billion dollars in unsecured credit that it had with its counterparties in OTC markets, will need to decide whether to borrow, or divert from other uses, such as salaries, acquisitions or other investments and capital expenditures,[6] that half a billion dollars in order to hedge its fuel costs. The costs of this extra capital will be passed on to consumers. If the airline decides it cannot spare the capital, its fuel exposure will be unhedged, and the volatility of this exposure — which could easily exceed what would have been the cost of the capital to hedge — will be passed on to its customers, too. This increase in prices, repeated with every company in every production industry, is inflationary. As the costs of operating in the U.S. with these additional collateral costs drive businesses out of the United States, they cause domestic unemployment. Inflation plus unemployment is stagflation.

Commodity pricing is just one cost of doing business that is normally hedged. Many lenders require hedging as part of large loan facilities. If such hedging is inhibited by the Dodd-Frank Act, either the increased cost of such hedging will be incurred by the borrower, or the increased risk to the lender of such hedging not being undertaken will be passed on by the lender to its borrower as a cost, in either case to be passed on by the borrower to its customers. As lenders reject the additional risk, or as the additional capital costs render a potential financing uneconomic, there will be lost liquidity and fewer financings, leading to scarcity or, in plain English, fewer jobs created plus inflation, i.e. stagflation.

Although Volcker's ruinous short-term interest rates are largely credited with ending the high inflation of the 1970s, it might not be a coincidence that OTC derivative markets started to play a much larger role in commerce around the same time. By providing these hedging tools, OTC markets enabled a reduction of the ultimate cost to customers by reducing producer risk. Your airplane ride can be cheaper if booked far in advance only if the airline can lock in its fuel cost. End-user exemptions in OTC swap hedging requirements do not address the risks and costs discussed here if the entities with whom end-users engage in hedging transactions must incur these costs, or if the instruments are not available to end users because they are no longer practical for dealers.

Dodd-Lincoln Letter

There is an exemption in the Dodd-Frank Act that allows "end users" to use OTC swaps to hedge their exposures without being subject to the clearing requirement.[7] However, the Dodd-Frank Act also states that margin requirements "shall" be set against "all" uncleared swaps, and the end user exemption to these margin requirements was mysteriously deleted, allegedly due to perceived redundancy, during the final hours prior to passage. Senators Dodd and Lincoln sought to quell the resulting outcry through a letter apparently contradicting the words they wrote in their statute: "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 . . . [i]f regulators raise the costs of end user transactions, they may create more risk."[8]

On December 16, 2010, Senators Bachus and Lucas wrote a letter referring to the Dodd-Lincoln letter stating "[W]e have serious concerns that Dodd-Frank will force American companies, which did not cause or contribute to the financial crisis, to move billions of dollars in capital onto the sidelines … . Requiring end-users to post margin will delay or prevent businesses from expanding and will limit the creation of badly needed jobs. … End-users must be able to rely upon their exemption from the clearing and exchange trading requirements without having to overcome unnecessary bureaucratic obstacles."[9]

End users will probably be exempted from margin requirements pursuant to the rulemakings under the Dodd-Frank Act.[10] However, even if margin requirements are not imposed directly on the end user, the end user will bear the cost of OTC margin requirements that are placed on its OTC dealer counterparties in their offsetting trades. The Dodd-Lincoln and Bacchus-Lucas letters may be fine as far as they go, but they do not actually go very far. They address margining by end users. But, speeches on the floor of Congress to the contrary, there's no lumpy green sauce bubbling in a cauldron behind the plate glass walls of a swap dealer that magically creates interest-free money. If the swap dealer has additional capital costs because it has to margin, it will pass those costs on to the end user, and the end user will pass those costs on to the consumer. The stagflation that the Dodd-Frank Act will cause will not be avoided by providing that end-users do not have to post margin in OTC swaps.

Rehypothecation

When the hypothetical airline enters into an OTC fuel hedge with its bank dealer counterparty, the bank, which does not make jet fuel, but earns its living on the price spread between that at which it buys and sells, enters into an offsetting position with a New York bank, which enters into an offsetting position with a Chicago hedge fund, which enters into an offsetting position with a Tulsa jet fuel maker. These offsetting positions will not necessarily mirror each other, but will be sliced and diced to be specifically tailored for the needs of each member of the chain. But let's assume they are similar enough.

Counterparties with investment grade ratings typically allow each other[11] to use cash collateral posted to them by their counterparties for any purpose; they are not required to segregate the cash. Accordingly, a party holding cash margin can post it to other counterparties to whom they are required to post margin. In the case of government securities given as collateral, this is called "rehypothecation," which term I will use here to include repledging cash. This has until quite recently been a central feature of the U.S. financial system.

When the airline must post cash above its collateral threshold to its investment bank, the investment bank uses that cash to fund its collateral requirement to the New York bank, which uses the same cash to fund its collateral requirement to the Chicago hedge fund, which uses the money to fund the amount above its collateral threshold to the Tulsa jet fuel maker. The same dollars have funded the above market positions for a number of counterparties.

Section 724(c) of Dodd-Frank

The ability of its counterparty to rehypothecation is critical to economical hedging by commercial and industrial enterprises, but several provisions of the Dodd-Frank Act throw this ability and its functioning into doubt. One such provision is Section 724(c), which added Section 4s(1) to the Commodity Exchange Act:

(l) Segregation Requirements.—

(1) SEGREGATION OF ASSETS HELD AS COLLATERAL IN UNCLEARED SWAP TRANSACTIONS.—

(A) NOTIFICATION.—A swap dealer or major swap participant shall be required to notify the counterparty of the swap dealer or major swap participant at the beginning of a swap transaction that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty.

* * *

(2) APPLICABILITY.—The requirements described in paragraph (1) shall—

(A) apply only to a swap between a counterparty and a swap dealer or major swap participant that is not submitted for clearing to a derivatives clearing organization; and

(B)(i) not apply to variation margin payments; or

(ii) not preclude any commercial arrangement regarding—

(I) the investment of segregated funds or other property that may only be invested in such investments as the Commission may permit by rule or regulation; and

(II) the related allocation of gains and losses resulting from any investment of the segregated funds or other property.

* * *

(4) REPORTING REQUIREMENT.—If the counterparty does not choose to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty, the swap dealer or major swap participant shall report to the counterparty of the swap dealer or major swap participant on a quarterly basis that the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements are in compliance with the agreement of the counterparties.

Scarcity of Capital

It costs a dealer a lot less to use rehypothecated collateral to fund the collateral requirements of the offsetting side of its trade with an end-user than it does for the dealer to separately raise the capital if there is segregation. A dealer cannot transact if it doesn't know its cost for the deal, and it cannot know the cost of its deal without knowing the liquidity requirements, which change if a party that had allowed rehypothecation suddenly changes its mind. Admittedly, in arrangements that permit letters of credit, the dealer has always been exposed to receipt of collateral that it cannot rehypothecate, such as posted letters of credit. The dealer may also be subject to the risk of the loss of the right to rehypothecate if it loses an investment grade credit rating if this term was negotiated in the agreement between the parties. However, if my investment bank has to, or has to risk having to, borrow money to provide collateral to its New York bank counterparty to hedge the other side of its trade with me because its right to rehypothecate my cash is limited, it is going to pass that cost on to me in pricing.

This negative is replicated on a much larger scale in the course of requiring the clearing of all the swaps that otherwise would have been margined bilaterally and through rehypothecated cash and collateral. This is because the cash collateral will now be required by the clearinghouses and their clearing members, and all of that cash must be separately funded or borrowed by each company participating in the market, and, instead of flowing through the financial system when rehypothecated, will now most likely be invested in government paper held by clearinghouse or clearing members. Instead of cash working its way through the financial system in a network of OTC trades providing great liquidity to its participants, the Dodd-Frank Act and rulemakings that either directly require swaps to be cleared, or indirectly corral swaps into clearing with OTC rules that are too confusing or burdensome to follow, causing the cash collateral supporting those positions to be removed from the financial system and invested in government debt and whatever clearinghouses and clearing members are allowed to do with their cash.[13] This forced diversion of trillions of dollars away from the economy at large into government hands reduces investment and economic activity.

CFTC Rulemaking

The Commodity Futures Trading Commission (the "CFTC") has been tasked with dozens of rulemakings that are required under the Dodd-Frank Act, to fill in the gaps and conflicts in the statute created by the legislators. The staff people at the CFTC are clearly working very hard, and sincerely seek to understand the markets they seek to regulate while scrupulously maintaining an open process. Nevertheless, the CFTC's Notice of Proposed Rulemaking ("NOPR") relating to Section 724(c)[14] is hilariously unrelated to how OTC markets function.

Under Proposed Rule §23.600: "'*Initial Margin*' means money, securities, or property posted by a party to a swap as performance bond to cover potential future exposures arising from changes in the market value of the position." and "'*Variation Margin*' means a payment made by a party to a swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market." (emphasis supplied). In contrast to the Proposed Rule itself, the introductory matter in the NOPR states: "The distinction between 'initial margin' and 'variation margin' … is temporally-based: … 'Initial margin' is defined as an amount calculated based on anticipated exposure to future changes in the value of a swap. … 'Variation margin' is defined as an amount calculated to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market." (emphasis supplied)

Although "margin" is a term used in OTC markets, "initial margin" and "variation margin" are exchange concepts, not OTC concepts. The CFTC is following the lead of the statute and applying to OTC markets terms used for exchanges that lack meaning in OTC markets. Neither "initial margin" or "variation margin" is used in OTC markets, although the terms might be analogized to "Independent Amount" and "collateral securing mark-to-market exposure," respectively, in OTC parlance. If it is that simple, there would be far less risk and far fewer resources consumed if the regulation used the terms the marketplace uses. The disconnect between what the regulation purports to call what occurs in the market, and what the market itself calls what occurs in it, creates ambiguity and uncertainty, and hence risk and cost, without any identifiable benefit.

Section 23.601(b) of the proposed rule says "The right referred to in [§23.601(a)] does not extend to Variation Margin." Is it fair to say that the CFTC "meant" Independent Amount when it said "Initial Marin"? Maybe, but if they did, why didn't it say so? If your job depended on your employer not getting a letter from a regulator eager to make a high-profile example, would you take that chance? The term "performance bond" is not used in the OTC market. Independent Amounts are often posted not to secure "changes in market position," or market risk, but rather to protect settlement risk, which is the risk of the counterparty not paying its bill when due, and are designed to ensure that derivatives positions remain fully collateralized between margin calls. OTC margining is an exchange of collateral, based on market movements, and is not a "payment" in the sense of "paying" for something; or in the exchange-traded sense of settling the prior days' market movements. OTC margining generally represents an estimate of the exposure from a current market movement on an amount that will become due in the future.

Section 23.601 of the proposed rule says:

> "(a) At the beginning of each swap transaction that is not submitted for clearing,[15] a swap dealer or major swap participant shall notify each counterparty to such transaction that the counterparty has the right to require that any Initial Margin the counterparty provides in connection with such transaction be segregated… (c) The notification … shall be made to the Chief Risk Officer, or, if there is no such Officer, the Chief Executive Officer, or if none, the highest-level decisionmaker for the counterparty. (d) Prior to confirming the terms of any such swap, the swap dealer or major swap participant shall obtain from the counterparty confirmation of receipt by the person specified in [§23.601(c)] of the notification specified in [§23.601(a)], and an election to require such segregation or not. (emphasis supplied)

Proposed §23.601(e) states "Notification pursuant to [§23.601(a)] to a particular counterparty by a particular swap dealer or major swap participant need only be made once in any calendar year." However, as the counterparty must actually respond to the notification "at the beginning" of each swap "prior to confirming," this implies that the notification must be made both before and after the trade.[16]

In OTC markets, parties hang multiple trades on the framework of a single master agreement that they usually negotiate before trading starts. Generally, parties address rules concerning rehypothecation, as well as the setting of collateral threshold, margin, and Independent Amount matters,[17] in the master agreement, rather than on a trade by trade basis. If a counterparty stopped liking the terms it had negotiated for the master agreement, it would ask for an amendment, and if it did not obtain it, would simply cease trading with the particular counterparty and move on to a counterparty willing to trade on terms acceptable to it. This rulemaking therefore should have addressed whether a right to require segregation, and the right to receive the notice could be waived when the parties negotiated their master agreement, or afterwards, and if so, whether irrevocably so.[18]

Rather than one notice, and one decision, per master agreement, there are potentially thousands. In fast moving markets, which is all of them, counterparties will be seriously disadvantaged by market movements while awaiting "confirmation" of receipt of an election respecting each of these notices from extremely busy and otherwise occupied CEOs. Very few swap trades go before CEOs or CROs, but under the CFTC proposed rules, the notice about the right to prohibit rehypothecation goes straight to the top. Even if the rule only required one notice per counterparty per year, if a CEO spent only two hours a year dealing with this paperwork this rule alone, without reference to the rest of the Dodd-Frank Act,[19] sucks 0.1% of all CEO annual productivity right out of the economy, to no discernable social or economic benefit.[20] This time requirement may be much greater if indeed each swap requires a notice and response, rather than once per counterparty per year. Further, if this indeed is the case, the delay from notice to permitted execution creates price opacity, and not transparency, since before it can consummate the transaction that precipitated the notice and the need for a response, the counterparty must go back to the dealer to find out the price movement between the trader's receipt of the price quote and the dealer's receipt of confirmation that the CEO received the notice. The notice and "confirmation" mechanism[21] may also conflict with corporate resolutions, and agreement representations, regarding who is authorized to trade for the counterparty.

The requirement that the notice go with each trade might lead one to suspect that "initial margin" does not mean "Independent Amount," since the Independent Amount is typically set at the outset of the trading relationship in the master agreement, although it can sometimes also be set for a particular swap. Does the rule require that notice be given only if there is initial margin required? If an Independent Amount has been posted to a master trading contract relationship, does it apply to all swaps, whether or not the swap calls for its own Independent Amount? If there is no Independent Amount in the master agreement or the swap, is the notice required for each swap in order to tell the "highest-level decision maker," over and over again, that if an Independent Amount (if that is in fact what "initial margin" means) is ever required, the counterparty has the right to require its segregation? These are examples of the performance and legal risks that counterparties will see in these rules, which will impair trading in OTC markets, thus pushing trades to capital-consuming, exchange-traded transactions, driving up costs, and ultimately prices.

Further adding to unpredictability, and therefore risk and therefore cost, is proposed §23.601(f): "A counterparty's election to require segregation of initial margin, or not to require such segregation, may be changed at the discretion of the counterparty upon written notice delivered to the swap dealer or major swap participant, which changed election shall be applicable to all swaps entered into between the parties after such delivery." This means that on a given day a counterparty can say that all swaps going forward will not permit rehypothecation, but all those before will continue to permit rehypothecation, which means two calculations of margining by the swap dealer — the rehypothecated and the not — or possibly four, with the "initial margin" and the "variation margin" (whatever those terms mean), within rehypothecated and not rehypothecated individually broken out, all of which presumably need to be disclosed on a high frequency basis. If a counterparty has this valuable option to demand collateral sequestration at any time, and cannot waive it, all counterparties will be charged for this option, whether or not they use it or want it. A dealer might instead seek to segregate the posted collateral from the start, incurring a capital cost, rather than deal with the mechanics of change, even if that does not enable an escape from the mechanics of notice. Each approach is inflationary.

Conclusion

Section 724(c) and the NOPR are just a few paragraphs and pages of a massive statute and rulemaking effort, and just one example among hundreds. Contradictions, confusion, and contraindicated provisions live a thousand-fold in the statute's hundreds of pages and potentially thousands more pages of rulemakings. Personally, I feel sad that we have passed a law that will deprive a younger generation of the predominately relentless economic expansion that I have been fortunate enough to experience most of my professional life. Title VII of the Dodd-Frank Act should be immediately repealed, and any replacement legislation enacted only after study of the very extensive materials that have been developed by the CFTC and SEC in the current rulemakings. The Dodd-Frank Act as it is now is a disaster. It attacks the derivatives that were just a tool of mortgage and many other markets rather than the actual factors that caused the credit crisis; analogously, it addresses mail fraud by shooting the mailman. Thanks to it you will be able to watch unemployment continue to escalate and the economy continue to stagnate. For those who remember the 1970s, it won't bring back polyester leisure suits, but it will bring back the feeling.

NOTES

* Jeremy D. Weinstein is an attorney in Walnut Creek, California. His particulars are available at http://jweinsteinlaw.com. He gratefully acknowledges the review, comments and encouragement of Patricia Dondanville, Eric Freedman, Lauren Teigland-Hunt, Christian Yoder, and several who requested anonymity, but takes sole responsibility for all casuistry expressed herein.

1 Dodd-Frank Act, Public Law. 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at *http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.*

2 Pursuant to Section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

3 In OTC markets there is no established mechanism for daily settlement of gains and losses against a universally accepted clearing price for any particular swap. Since participants in OTC markets mark their trades to market independently, minor differences of opinion with respect to the value of any given trade are relatively common. To the extent that a particular trade involves a commodity that is traded infrequently or contains unique structural aspects, such differences of opinion can become more significant. Unsecured credit and collateral thresholds accommodate this lack of precision in valuing trades prior to settlement.

4 Which is rational, e.g., if one party is a utility that has been assured by regulators that it can recover its costs from customers. In contrast, current market practice is for major dealers to require parties like hedge funds and asset managers to post 100% of exposure plus an independent amount as collateral; in other words, as shown ISDA's 2010 Margin Survey, available at http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf, the major financial institutions engaging in these markets currently protect themselves quite effectively.

5 Collateral thresholds are usually set at levels tied to respective credit ratings. For example, a party with a rating of AA might be required to post collateral only to the extent that the value of the position to its counterparty exceeded a $50,000,000 collateral threshold against it, with that threshold declining to $15,000,000 for a party with an S&P rating of BBB+. Most market participants set the collateral threshold to zero for a counterparty at or below BBB-, or Baa3 from Moody's, both of which are the lowest "investment grade" ratings. Provisions in the Dodd-Frank Act, not addressed here, that substantially increase the potential liability of

publishers of ratings, put at risk the viability of published credit ratings as a tool for this purpose.

6 According to Keybridge Research, An Analysis of the Business Roundtable's Survey on Over-the-Counter Derivatives, April 10, 2010, available at http://businessroundtable.org/uploads/studies-reports/downloads/An_Analysis_of_the_Business_Roundtables_Survey_on_Over-the-Counter_Derivatives.pdf, a 3% margin requirement across the S&P 500 companies would reduce capital spending by $5 to $6 billion per year and lead to a loss of 100,000 to 120,000 jobs. This article posits a different, and much more systemically damaging, path of economic disruption than that analyzed by the Business Roundtable.

7 Commodity Exchange Act §2(h)(7).

8 156 Cong. Rec. H5248 (daily ed. Jun. 30, 2010); available at http://online.wsj.com/public/resources/documents/dodd-lincoln-letter070110.pdf.

9 156 Cong. Rec. H____ (daily ed. Dec. 16, 2010); available at http://online.wsj.com/public/resources/documents/bachus.pdf.

10 There are a number of pending rulemakings not discussed here that will further establish and regulate prospective and retroactive margin requirements by end users.

11 Paragraph 6(c) of the ISDA Master Agreement Credit Support Annex.

12 In contrast, this right is considered quite valuable to many in the hedge fund and asset management community given the money many such entities lost in Independent Amounts posted to Lehman Brothers. Such entities typically post only cash to their dealers, and it is not market practice for them to post letters of credit because letters of credit cannot be easily adjusted on a daily basis.

13 I admit I bought stock in CME the day the Dodd-Frank Act passed.

14 Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, Federal Register 75432, Vol. 75, No. 232, Friday, December 3, 2010.

15 Remember, as stated above, "not submitted for clearing" is a key consideration, since "cleared" swaps require 100%+ margining, while parties to uncleared OTC swaps can continue to provide each other unsecured credit through collateral thresholds.

16 Although §23.601(e) requires that notice under §23.601(a) "need only be made once in any calendar year," it does not mitigate the paperwork blizzard by requiring only one correspondence per relationship per year, because §23.601(e) does not cover the receipt of an election prior to confirmation <u>of each trade</u> required in §23.601(d). Rather, §23.601(e) only refers to notice once a year, not receipt of election once a year. Additionally, if the rule really did mean that each counterparty was to be told of its right once per year, the rule would simply say "At least once a year, a swap dealer or major swap participant will notify all of its counterparties of the right to require segregation."

17 It is not unusual for parties that have not granted each other collateral thresholds above $0 to also agree that they could require an Independent Amount for a particular transaction, with levels to be determined on a trade by trade basis or at the master agreement level.

18 "Yes" is the correct answer to both.

19 And there is much to which reference could be made. According to the Congressional Budget Office:

> Another approach to regulating the OTC market … would be to increase the cost of OTC transactions in the hope that participants would shift them to exchanges or clearinghouses. The Dodd-Frank law does this by raising capital requirements … and by increasing margin requirements for institutions that trade in OTC contracts. Specifically, the law requires the CFTC to impose higher capital and margin requirements … . The resulting increase in compliance costs for OTC transactions is designed to serve as an incentive to standardize contracts and move them onto exchanges or clearing houses [sic]. … Historical evidence suggests that higher capital requirements cause banks to shift toward riskier investments … [and] sometimes reduce[] their lending to small businesses and individuals … .

Congressional Budget Office, Evaluating Limits on Participation and Transactions in Markets for Emissions Allowances, Dec. 2010, available at http://www.cbo.gov/ftpdocs/120xx/doc12006/12-10-LimitsAllowanceMarkets.pdf

20 The CFTC completely omits the cost of swap dealer customer staff and CEO/CRO time in reviewing and responding to these notices in

its Paperwork Reduction Act discussion in its NOPR, referring only to the staff time at the swap dealers and major swap participants. See, contra, Executive Order 13563, Improving Regulation and Regulatory Review, signed January 18, 2011, 76 FR 3821, January 21, 2011, and President Barak Obama, "Toward a 21st Century Regulatory System," Wall Street Journal, p. A17, January 18, 2011.

21 This creates further confusion; since swap trades are documented on "confirmations," now two different things called "confirmations" are necessary for swap trades.