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July 10, 2013

The Hon. Tim Johnson, Chairman
The Hon. Mike Crapo, Ranking Member
Senate Banking, Housing and Urban Affairs Committee
534 Dirksen Senate Office Building
Washington, DC 20510

RE: Bills Under Consideration by the Committee: H.R. 1062, S. 474 and H.R. 634

Dear Members of the Senate Banking, Housing and Urban Affairs Committee,

Implementation of the Dodd-Frank Act ("Act") is still incomplete. While the Act has had some notable achievements already, episodes such as the risky trading and evasion of regulations by JPMorgan's Chief Investment Office (also known as the "London Whale" fiasco) show that the Act needs to be implemented fully in order to limit unaccountable risk-taking by large financial institutions.

In spite of (or perhaps because of) this need, efforts are underway to undo much of the regulatory framework built to prevent future financial meltdowns. A number of bills currently in the Senate pipeline would roll back Dodd-Frank provisions and impede regulatory rule-making. Three of the most worrisome bills have been referred to the Banking Committee:

- H.R. 1062 has passed the House in a partisan vote. It would impose additional cost-benefit requirements on rulemaking by the Securities Exchange Commission ("SEC"). While that sounds reasonable, in fact the SEC already performs cost-benefit analysis. In practice, this bill would impose cumbersome requirements that would hamstring the SEC and make it even more subject to second-guessing by the courts than it already is.

- S. 474 is identical to H.R. 992 which has passed the House Financial Services Committee. It would effectively repeal an important provision of the Dodd-Frank Act designed to prevent bailouts of Systemically Important Financial Institutions (SIFIs). Not

only should this provision remain law, even more is needed to address the "Too Big To Fail" problem as the Senate unanimously resolved this spring.[1]

- H.R. 634 has also passed the House. It would also roll back important provisions of the Dodd Frank Act and undermine some of its effectiveness at improving financial stability.

We oppose these bills for the reasons given below.

I. H.R. 1062: Impediments to Regulatory Operations

H.R.1062 calls for the SEC to perform cost benefit analysis before promulgating rules and to craft a rule that "imposes the least burden on society."[2] On its face, this seems to be a reasonable requirement, but it is clear to us that H.R. 1062 was actually designed to impede the Commission's ability to institute rules that the financial industry opposes.

We would note that the SEC is already required to perform cost-benefit analyses on proposed regulations, which leads us to wonder why this bill is necessary or even desirable. The bill's cost-benefit provisions are a superfluous bureaucratic requirement that will only hamper the rulemaking process. Proposed Section 23(e)(2)(A) of the Securities Exchange Act of 1934 requires the Commission to evaluate whether the regulation is "tailored to impose the least burden on society". While the proposal requires consideration of both costs and benefits, its wording is oriented towards heightened recognition of the costs of regulation and largely overlooks the prospect of societal benefits from proposed regulations. Thus, the bill sends a signal to the Commission that the agency should regulate as little as possible.

Moreover, the requirement that the Commission only adopt the "least" burdensome regulation possible will subject the agency to a flood of industry lawsuits challenging inconvenient regulations on purely technical grounds: was the adopted regulation "the least" burdensome among the universe of possible regulations? The Commission would waste millions of dollars in litigating the existential question of whether a proposed rule placed the "least burden on society." Thus, practically speaking, H.R. 1062 would create an insurmountable obstacle to the promulgation of meaningful rules by the Commission.

Further evidence of the de-regulatory intent of the bill can be found in proposed Section 23(e)(3), which requires the SEC to explain itself if it has the temerity to reject proposals put forth by industry or consumer groups. No mention is made of comments by individuals, non-consumer/public advocacy organizations or investor groups. In any case, even if this language were more balanced in its listing of pre-endorsed commenters, the bill would still make the SEC beholden to industry. As an active participant in the rulemaking process, Occupy the SEC is all too aware that the preponderance of comment letters on financial regulation are indeed from industry sources. Thus, requiring the SEC to craft regulation tailored to the whims of commenters would all but ensure that final rules of any significance would invariably bow to the interests of the regulated.

In addition, industry groups are likely the only groups with sufficient resources to bring litigation over cost-benefit analyses. We have already seen cost-benefit analysis used as a pretext to block

the SEC's and the CFTC's efforts to regulate in favor of investors' voices and the broader public interest.[3] This bill would be an open invitation for additional litigation and judicial interference in the rulemaking process. H.R. 1062 would have a profoundly negative effect on SEC rulemaking. This bill imposes very substantial burdens on crucial regulatory agencies. Congress should apply a "cost-benefit analysis" to its own actions and reject this bill as severely harmful to society.

II. S. 474 – Increasing the Possibility of Government Bailouts Due to Swaps

A. The Sweeping Impact that S. 474 Would Have on Section 716 of Dodd-Frank

S. 474 (and the identical bill H.R. 992) propose to roll back a key provision of the Dodd-Frank Act: the Lincoln Amendment, or Section 716. In its current form, Section 716 prohibits federal assistance to "swap entities."[4] Shortly after Section716 was passed, certain members of the Senate, including that section's primary author Senator Blanche Lincoln, conceded that there were certain mistakes made in the amendment. She stated the following:

> It is my understanding that a number of [...] U.S. branches and agencies of foreign banks will be swap entities under section 716 and title VII of Dodd- Frank. Due to the fact that the section 716 safe harbor [exempting interest rate, foreign currency and certain other swaps] only applies to ''insured depository institutions,'' it means that U.S. branches and agencies of foreign banks will be forced to push out all their swaps activities. This result was not intended. U.S. branches and agencies of foreign banks should be subject to the same swap desk push out requirements as insured depository institutions under section 716.[5]

We would like to point out that S. 474 actually goes beyond fixing the supposed oversight that Senator Lincoln identified in the drafting of Section 716. According to Sen. Lincoln, that section's intent was to make "U.S. branches and agencies of foreign banks [...] subject to the same swap desk push out requirements [and exemptions] as insured depository institutions." S. 474, however, greatly expands the scope of permissible swaps dealings in which government backstopped institutions (domestic and foreign) can participate. The following table summarizes what swaps would be required to be pushed out from the public safety net under Section 716, under current law and how that would change under S. 474.

Swaps NOT Required to be Pushed Out Under § 716	**Swaps Required to be Pushed Out Under § 716**
All interest rate swaps All foreign exchange (FX) swaps and forwards Gold and silver swaps Swaps on US government securities Swaps on investment grade corporate debt securities Swaps on general state obligations Cleared CDS	Commodity and agricultural swaps Equity swaps Energy swaps Metal swaps (excluding gold and silver) Agricultural swaps Non-cleared, non-investment-grade CDS and CDS on asset-backed securities (ABS)
Swaps NOT Required to be Pushed Out Under S. 474	**Swaps Required to be Pushed Out Under S. 474**
All interest rate swaps All foreign exchange (FX) swaps and forwards Gold and silver swaps Swaps on US government securities Swaps on investment grade corporate debt securities Swaps on general state obligations Cleared CDS Commodity and agricultural swaps Energy swaps Metal swaps (excluding gold and silver)	Non-cleared, non-investment-grade swaps based on asset-backed securities (ABS); *subject to jointly adopted rules relating to credit quality of assets*

The net result of S. 474 would be to allow almost all swaps activities to be conducted within government backstopped institutions, and to potentially subsidize such activities with public funds.

In a letter to the House Agriculture Committee, the American Bankers Association ("ABA") made the outrageous claim that H.R. 992's (S. 474's) vast expansion of the scope of permissible swaps activities was necessary. The ABA claimed that, without that expansion, bank "customers would lose the ability to do 'one-stop shopping' with a bank for loans and swaps to offset their credit risk, even if they prefer to do 'one-stop shopping' with a bank and may prefer to have a bank as a counterparty because of credit risk."[6]

This claim is outrageous for two reasons. First, in a classic tale of the tail wagging the dog, this reasoning assumes that a bank should take on a customer's counterparty risk simply because that company *prefers* that the bank do so. In reality, a customer's *preference* should not play a determinative role in defining how risk is controlled at banks. Rather, limitations on bank exposure should be defined by taking into account broader considerations like systemic risk and

bank solvency. Secondly, the fact that the ABA prioritizes the ability of customers to do "one-stop shopping" with banks is troublesome because that reasoning exhibits the same myopic view of customer risk that contributed to the 2008 financial crisis. The ABA's view is hauntingly analogous to the reasoning employed by proponents of sub-prime lending before 2008: that major banks should be unhampered in their ability to buy subprime debt because that would allow customers with poor credit to have easier, "one-stop shopping" access to liquidity.

This "one-stop shopping" line of reasoning is a commonly used, and thoroughly debunked, argument for maintaining the Too Big to Fail ("TBTF") status quo.

B. The Cost of Section 716 is Mischaracterized by Proponents of S. 474

Proponents of the S. 474 rollback argue that this bill is needed because Section 716 will make derivatives trading activity too costly for hedging purposes, and hence will disrupt the financial markets. That is, without the benefit of S. 474, Section 716 will make "derivatives so expensive that businesses will be forced to stop using them to hedge against risks."[7] Admittedly, the push-out rule under Section 716 will result in increased cost to derivatives dealers, but that is the very purpose of that section's restriction. Section 716 was written with the objectives of the broader public benefit in mind, and not just the interests of derivatives dealers and users.

At its core, S. 474 is short-sighted because it rewards banks with public subsidies for engaging in risky derivatives trading. Publicly subsidizing banks to engage in such activity, under the guise that failing to do so is "too costly for businesses," is analogous to giving someone who has been in repeated automobile accidents a reduced premium on auto insurance so that she can afford to buy a faster car.

Moreover, the rhetoric of "cost" that is employed by proponents of S. 474 is self-serving and highly conjectural, as it fails to account for the holistic costs of derivatives activity. In our view, the cost analysis needs to adequately incorporate the broader costs that derivatives activity imposes on society, in the form of expensive government guarantees. The proposed bill fails to take these larger, more significant costs into account, focusing instead on the fat wallets of derivative dealers.

Proponents of S. 474 further argue that maintaining swaps activities within banks is key to controlling systemic risk because banks are subject to prudential regulations.[8] However, this is but a thinly veiled argument for maintaining the TBTF status quo. One lesson learned from the financial collapse of 2008 is that effective financial regulation is undermined by the centralization and concentration of risk in entities that are subject to prudential oversight. Regulators frequently fail to catch malignant activity before it becomes a problem because balance sheets in TBTF entities have become bloated and opaque. The pushout rule would bring much needed clarity as to the true risk profiles of entities subject to prudential regulations (and their affiliates).

The proponents' argument boils down to the following tautology: markets will fall apart if banks cannot continue using the same derivatives that previously caused the markets to fall apart. We

do not accept this argument. Any revision to Section 716 should be drawn narrowly to address Senator Lincoln's concerns specifically.

III. H.R. 634: Misleading Representation of "Risk Mitigation"

H.R. 634 would eliminate margin requirements for certain businesses that use swaps to hedge their risks. This produces a contradiction. Margin requirements are intended to mitigate loss. Eliminating margin-requirements only increases the risk profile of companies. Risk is a function of two variables: likelihood of losses multiplied by the impact of losses in the event of losses, or the conditional expected losses. If this bill passes and margin requirements are eliminated for certain businesses then the upper limit on their conditional expected losses increases. This increase in conditional expected losses goes in the opposite direction of any benefit that a business may achieve by hedging its exposures through swaps. Thus, H.R. 634 could actually render hedging activity by affected businesses *more* risky.

Futures contracts have margin requirements for all parties, hedgers and speculators alike. There is an argument for lower requirements for hedge transactions than purely speculative ones. Futures exchanges recognize this and set lower requirements. Wisely, they do not waive them entirely. This has worked well for decades and has not impeded hedging. It would be foolish to eliminate margin requirements for swaps, which are not traded on exchanges.

IV. Interaction Between Bills and Implementation of the Volcker Rule

A. S. 474 and the Volcker Rule

While the Volcker Rule is meant to limit proprietary trading at government-backstopped banks, its mandate is significantly diluted by numerous exemptions, including one permitting market-making activities. One key aspect of section 716 is that it "pushes out" market-making in certain swaps at insured depository institutions. In this way, section 716 has the potential to make up for a controversial shortcoming in the Volcker Rule (the market-making exemption).

In practice, it is often difficult to tell the difference between market making and proprietary trading. Section 716 reduces the risks associated with such ambiguities by pushing out swaps activities that present significant risks or deviate from "traditional bank activities." If S. 474 were to pass, then the scope of swaps activities that would be permitted would be greatly expanded, and Congress would forfeit a valuable opportunity to circumvent complications relating to the scope of the market-making exemption in the Volcker Rule.

B. H.R. 634 and the Volcker Rule

As we argue above, H.R. 634's elimination of margin-requirements of end-users creates the potential for excessive risk taking and the possibility of localized business failures. To the extent that such end-users are truly isolated from the larger economic system, the global impact of their failures can be mitigated and global contagion can be avoided.

Unfortunately, certain exemptions in the Volcker Rule make such isolation less likely, and consequently, make global contagion from isolated end-user losses more likely. The Volcker Rule permits banks to engage in market making and certain hedging, particularly on behalf of customers. Thus, risk from end-users of swaps can easily be transferred to interconnected banks. If the Volcker Rule had not carved out exemptions for market-making and hedging, then it might have been possible to avoid the system-wide distribution of risks accruing from end-user engagement in swaps. Unfortunately, it is difficult to isolate the failure of end-users when such users are imbricated in and dependent upon a banking system that is permitted to make markets in swaps. Thus, H.R. 634 is especially dangerous because its elimination of margin requirements for bank customers could result in even greater concentration of risk at banks by virtue of the Volcker Rule's allowances for customer dealings.

Moreover, as we explained in our comment letter regarding the implementation of the Volcker Rule, the proposed version of the Rule is riddled with loopholes and exemptions that make it difficult for banks and regulators to distinguish legitimate market making and hedging activities from prohibited proprietary trading activities. Indeed, the Volcker regulations actually enable banks to actively conceal proprietary trading activity under the guise of the customer-facing hedging or market making. Eliminating margin requirements for swap end-users would compound these complications, as it would allow banks to imperil their balance sheets by purchasing highly toxic swap holdings from their customers.

With this consideration in mind, we encourage Congress to wait until the Volcker Rule is finalized and fully implemented before passing any legislation easing margin requirements on swap end-users. The hasty passage of H.R. 634 could ensconce into the law structural failures that themselves would need legislative fixes in the future.

IV. Conclusion

All three of these bills would impede efforts to improve financial stability and the functioning of the financial markets. They should be rejected.

Thank you for your attention to these important matters of public concern.

Sincerely,
/s/
Occupy the SEC

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Joshua Reynolds
Josh Snodgrass
Akshat Tewary
Kristine Ekman
et al

Endnotes:

[1] Ramsey Cox, *Senate Votes to End Advantages to "Too Big to Fail" Banks*, The Hill, Mar. 22, 2013, *at* http://thehill.com/blogs/floor-action/senate/289987-senate-votes-to-end-advantages-for-too-big-to-fail-banks.

[2] H.R. 1062 proposed revision to Section 2(e)(2)(A)(ii) of the Securities and Exchange Act of 1934.

[3] *See, e.g.*, *Business Roundtable, et al. v. SEC*, No. 10-1305 slip op. (D.C. Cir., July 22, 2011) *available at* http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FBBBE/$file/10-1305-1320103.pdf; *see also* Barbara Roper, *Will Cost-Benefit Analysis Seal the SEC's Fate as an Industry Lap Dog?*, Huffington Post, Sep. 17, 2012, http://http://www.huffingtonpost.com/barbara-roper/sec-cost-benefit_b_1878949.html.

[4] Under Section 716 a swap entity is defined as a swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant that is registered under the Commodity Exchange Act or the Securities Exchange Act of 1934. 15 U.S.C. § 8305 (2012).

[5] 156 Cong. Rec. S5903-04 (daily ed. July 15, 2010) (statement of Sen. Lincoln).

[6] Comment Letter of American Bankers Association re: ABA's Views on H.R. 634, the Business Risk Mitigation and Price Stabilization Act of 2013; HR. 677, the Inter-Affiliate Swap Clarification Act; H.R. 992, the Swaps Regulatory Improvement Act; H.R. 1003, to improve consideration by the Commodity Futures Trading Commission of the costs and benefits of its regulations and orders; and H.R. ___, discussion draft of the Swap Jurisdiction Certainty Act (Mar. 19, 2013), *available at* http://www.aba.com/Issues/LetterstoCongress/Documents/House%20Ag%20Memo%20re%20DFA%20Title%20VII%20031913.pdf.

[7] Frank D. Lucas, Opening Statement Before Committee on Agriculture Public Hearing Examining Legislative Improvements to Title VII of the Dodd-Frank Act (Mar. 14, 2013), *at* http://agriculture.house.gov/statements/opening-statement-chairman-frank-d-lucas-committee-agriculture-public-hearing-examining.

[8] Daniel Wilson, *Reps. Look To Soften Dodd-Frank Swaps 'Pushout' Rule*, Law360, Mar. 7, 2013.

[9] 12 U.S.C. § 1851 (2012).