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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
baselcommittee@bis.org

Secretariat of the International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain
wgmr@iosco.org

Submitted via electronic mail

Re: Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions Consultative Document Regarding Margin Requirements for Non-Centrally-Cleared Derivatives

The undersigned group of companies\(^1\) is pleased to provide comments to the Basel Committee on Banking Supervision (“Basel Committee”) and the International Organization of Securities Commissions (“IOSCO”) joint Working Group on Margining Requirements (“Working Group”) regarding its Consultative Document (“Consultative Document”) entitled, “Margin Requirements for Non-Centrally-Cleared Derivatives.”\(^2\) The Consultative Document represents the initial policy proposals of the Working Group, and would establish minimum standards for margin requirements for non-centrally-cleared derivatives.\(^3\)

We applaud the Working Group’s efforts to reduce systemic risk in the worldwide financial system through the reduction of certain derivatives exposures in order to help prevent another economic and financial crisis. In addition, we also recognize the significant benefit of internationally harmonizing derivatives regulation. Efforts to apply a uniform set of derivatives rules across borders will serve to create a transparent and consistent mechanism for the reduction of systemic risk.


\(^3\) Ibid, p. 1.
We are therefore pleased to provide comments to the Working Group regarding its Consultative Document.

**Introduction**

In the Consultative Document, the Working Group recognizes that regulations need to distinguish between entities that present risk to the worldwide financial system and those entities that do not present such risk, and reduce the regulatory burden on lower risk entities. We fully agree with this position, and we appreciate its recognition by the Working Group.

In accordance with this consensus position, we encourage the Working Group to adopt principles to ensure that captive finance companies are treated as non-financial entities. Since such entities do not pose a systemic risk to the global financial system, the United States, for example, has determined that captive finance companies should be treated as non-financial, commercial end-users with respect to swaps they enter into, even though such entities do engage in financial activity. Given the importance of international harmonization with respect to derivatives regulation, we maintain that captive finance companies should receive the same treatment as non-financial, commercial end-users, including with respect to the imposition of margin and mandatory clearing requirements.

**Basel and IOSCO Consultative Document**

We agree with the statement in the Consultative Document that:

> “There was broad consensus within the BCBS and IOSCO that the margin requirements need not apply to non-centrally-cleared derivatives to which non-financial entities that are not systemically-important are a party, given that (i) such transactions are viewed as posing little or no systemic risk and (ii) such transactions are exempt from central clearing mandates under most national regimes.”

We are pleased the Consultative Document recognizes that transactions involving non-financial entities (i.e., commercial end-users) should not be subject to margin requirements because such transactions do not pose systemic risk and are generally not required to be centrally-cleared, which is the case in the United States as well.

Neither the Consultative Document nor the current European Market Infrastructure Regulation (“EMIR”) framework specifically address captive finance companies or explicitly categorize captive finance companies as “non-financial entities” as the U.S.

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4 See page 9 of Consultative Document.
Congress did in the Dodd-Frank Act. This may be attributable to the fact that captive finance companies appear to be more common in the U.S. than in other jurisdictions. Nevertheless, it is important that all international regulators recognize that captive finance companies’ use of swaps to hedge their interest rate and foreign currency exposures does not pose a systemic risk. Additionally, international regulators’ treatment of captive finance companies should mirror that of other non-financial, commercial end-users, and subsequently, should exempt them from margin and mandatory clearing requirements.

Some manufacturing companies with captive finance operations in other jurisdictions, particularly those in Europe, structure those entities as regulated banks. However, given that the purpose and function of these entities remains the same as their captive finance company counterparts in other jurisdictions, it remains critical that these entities be exempt from mandatory clearing as well as margin. A contrary result would effectively nullify the clearing exemption and reduce the ability of non-financial, commercial end-users, like captive finance companies, to efficiently hedge their commercial risks.

**Description of Captive Finance Companies**

*Overview*

To understand why captive finance companies should not be subject to mandatory clearing or margin requirements, it is first necessary to understand what a captive finance company is. Captive finance companies refer to a very small set of entities whose primary mission is to provide financial products that promote and facilitate the sale or lease of products manufactured by their parent companies. Captive finance companies often serve as the primary source of financing for the customers of these products. They are an important source of liquidity for thousands of small, medium, and large businesses seeking to acquire capital equipment to help operate and grow their businesses, as well as consumers seeking to finance the purchase or lease of cars, trucks, equipment, and other products. Captive finance companies also frequently provide financing to dealers or distributors in order to help ensure the health of those networks. Through these activities, captive finance companies play an essential role in the success of their manufacturing parents and directly contribute to thousands of manufacturing jobs throughout the world.

Unlike traditional financial entities, captive finance companies use derivatives for the purpose of hedging and mitigating underlying commercial risk related to interest rate or foreign currency exposures associated with financing their parent companies’ businesses. In almost all respects, the funding and hedging activities of a captive finance company is analogous to – and for purposes of imposing a margin requirement should be considered as an extension of – the treasury division or department of a manufacturing company that is a non-financial, commercial end-user.

*Business Practices and Structures of Captive Finance Companies*

Currently, most captive finance companies do not post margin on swaps they enter into as posting margin is not a universal practice followed by all market participants today. This fact demonstrates that captives and their counterparties are comfortable with their counterparty exposure risk and the recognition that their transactions neither pose nor are
susceptible to systemic risk. Moreover, the debt indentures of a number of the undersigned companies include negative pledge covenants that limit the ability to pledge assets as collateral. Although indentures may be modified for new debt issued by a company, these companies may not be able to pledge assets as margin or otherwise without obtaining the consent of existing debt holders. Consent solicitations are, at best, time-consuming and expensive, and there are no guarantees of success, potentially creating an illegality issue as posting requirements conflict with obligations under the indenture.

The structures of captive finance companies may vary from country to country. However, while such finance operations may have different structures in international jurisdictions (e.g., a regulated bank), their function and fundamental purpose are the same. They primarily provide financial products that support the sale or lease of products manufactured by their parent companies, and as such, their funding and hedging activities are analogous to the parent company’s treasury division or department. This is true irrespective of corporate structure. Therefore, captive finance companies should be considered akin to non-financial, commercial end-users for the purposes of mandatory clearing and margin requirements.

Concerns with Imposing Mandatory Clearing and Margin Requirements on Captive Finance Companies

The imposition of mandatory clearing and margin requirements would significantly increase costs and liquidity requirements for manufacturer end-users and their captive finance companies, as well as divert capital that otherwise could be reinvested in business and job creation. Additionally, margin requirements could necessitate new and costly incremental funding requirements on commercial end-users, who unlike some firms that engage in non-centrally-cleared derivatives, do not have expedient and low-cost access to liquidity sources like the discount window or consumer deposits. Further, the imposition of margin requirements could also create a disincentive for captives and their end-user parents to hedge business risks. Such an outcome would contradict the regulatory imperative for businesses to prudently manage their risks to hopefully avert another economic and financial crisis through the reduction of systemic risk in the global financial system.

As described in more detail below, another key concern related to imposing margin requirements on captive finance companies is the potential disruption in the asset-backed securitization markets. Several of the undersigned companies use the securitization markets to fund loans and leases to our dealers and consumers at competitive rates. Certain securitization transactions require the use of derivatives to protect investors from market risks and support high credit ratings required to access these markets. We are concerned that margin requirements on these derivatives will force major structural changes which would add cost and complexity to securitization transactions and directly impact the amount of financing made available to our dealers and customers. This would happen at a time when credit markets are recovering but remain fragile.
Overview of U.S. Legislative Activity with Respect to Derivatives Regulation and Captive Finance Companies

We believe it would be helpful for the Working Group to understand how the United States has chosen to regulate derivatives, and why U.S. legislators and regulators provided an exception for captive finance companies.

Overall Approach to Derivatives Regulation
In 2010, the United States Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act\(^6\) ("Dodd-Frank Act" or "Act"), which President Barack Obama signed into law on July 21, 2010. A critical component of the Dodd-Frank Act was Title VII,\(^7\) which imposed regulations on the “over the counter” swaps and derivatives markets. Similar to the Consultative Document, Title VII of the Dodd-Frank Act recognized the importance of transparency, centralized clearing and imposition of margin requirements as means to reduce worldwide systemic risk. Among other things, Title VII created new designations for firms engaged in over-the-counter derivatives, including “swap dealers” and “major swap participants,” that would become subject to a host of new regulations, including mandatory clearing and margin requirements.

As with the Consultative Document, Title VII of the Dodd-Frank Act recognized that a distinction existed between financial entities, who frequently engage in swaps for speculative purposes that may present higher risk, and non-financial, commercial end-users, who enter into swaps, not for speculative purposes, but rather to hedge and mitigate commercial risks associated with their businesses. The Dodd-Frank Act rightly determined that unlike financial entities, non-financial, commercial end-users should not be subject to the Act’s mandatory clearing requirements because these entities did not cause the financial crisis and do not pose systemic financial risk. Further, the legislative history and recent Congressional action strongly support the proposition that the Dodd-Frank Act does not impose margin requirements on non-financial, commercial end-users. These points are also recognized in the Consultative Document.\(^8\)

Exempting Captive Finance Companies from Certain Derivatives Regulations in Accordance with Unique Roles and Lower Risk Profiles
Although the Dodd-Frank Act generally subjects entities engaged in financial activities to mandatory clearing and margin requirements, the Act contains a very specific, very narrow exception for “captive finance companies.”\(^9\) Again, captive finance companies are subsidiaries of manufacturing companies (that themselves are considered non-financial, commercial end-users) whose primary purpose is to provide financial products that facilitate the sale or lease of products manufactured by their parent companies. The Act therefore recognizes that a finance subsidiary of a manufacturer, whose financing is

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\(^6\) U.S. Pub.L. 111-203, H.R. 4173
\(^7\) Title VII of the Dodd-Frank Act was called the Wall Street Transparency and Accountability Act of 2010.
\(^8\) See page 9 of the Consultative Document.
\(^9\) The stringent test for an entity to qualify as a captive finance company and be exempt from mandatory clearing and the “major swap participant” definition – the so-called “90/90 test” – is described in detail on page 6 and in Attachment 1.
dedicated to promoting the sale or lease of the parent company’s products, is an essential part of the manufacturer, and should be treated as such. The funding and hedging activities of a captive finance company can be viewed as an extension of the treasury division or department of a commercial end-user.

After careful consideration of the unique role of captive finance companies, the U.S. Congress exempted these companies from the definition of a “financial entity” for purposes of (i) the mandatory clearing requirement and (ii) from the definition of a “major swap participant” in the Dodd-Frank Act. This reflects significant legislative history showing Congress’ belief that swap activity by captive finance companies, like non-financial, commercial end-users, does not pose systemic risk, did not cause the financial crisis, and should not be subject to mandatory clearing and margin requirements.

The 90/90 Test
Congress made conscious and concerted efforts to ensure that the narrow and limited exemptions for captive finance companies could not be exploited by entities to which the exemption should not apply. As a result, Congress adopted a very stringent test, referred to as the 90/90 test, for companies to qualify for the captive finance company exemptions. As defined in the Dodd-Frank Act, the 90/90 test only provides an exemption from mandatory clearing and the definition of a “major swap participant” for a company defined as:

“[A]n entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.” 10

Congress designed this test to ensure that the exemptions identified above apply only to companies that are true captive finance companies, regardless of their corporate structures. Financings that do not facilitate the purchase or lease of actual, physical products and financings of products that are not manufactured by the parent company do not count towards meeting these very high thresholds. Congress specifically adopted this test to ensure entities that provide financing relating to mortgages, speculative ventures, investments or products not manufactured by the parent company do not qualify as captive finance entities or for these exemptions from the mandatory clearing and margin requirements.

There are many different approaches the Working Group could take to narrowly craft an exemption for captive finance companies from the mandatory clearing and margin requirements. The 90/90 test in the Dodd-Frank Act is but one example.

Post Dodd-Frank Act Activities

Since passage of the Dodd-Frank Act, a broad range of U.S. regulatory agencies – several of whom are represented on the Working Group – have issued final and proposed rules interpreting various aspects of the Act. While bound by the text of the statute, the rulemakings completed thus far have interpreted the statutory language fairly and confirmed the unique role of captive finance entities, reflecting an understanding of the critical role they play in the U.S. and global economy.

At the same time, the U.S. Congress, in a bipartisan fashion, has advanced legislation this year that would more clearly state that captive finance companies should not be subject to initial or variation margin requirements, even for swaps where their counterparty is a financial entity that itself is subject to such requirements. We have included a detailed description of the U.S. legislative history related to captive finance companies on Attachment 1. This legislative history makes clear that the U.S. Congress did not intend for captive finance companies to be subject to mandatory margin requirements.

We ask that any principles ultimately endorsed by the Working Group treat captive finance companies as non-financial, commercial end-users and not subject them to mandatory clearing or margin requirements. We support the recognition in the Consultative Document that, with regard to non-financial entities, an exemption from clearing and margin goes hand-in-hand. We request that all regulatory bodies reflect this determination for non-financial, commercial end-users, including captive finance companies.

Impact of Margin Requirements on Securitization for Captive Finance Companies

As we did with U.S. regulators, we would like to highlight the dramatic impact the imposition of margin requirements would have on the securitization process for captive finance companies. Captive finance companies commonly use securitization to fund their own operations and support their parent manufacturing companies. These securitizations are an extension of the financing process and play an important role in their ability to support their parent companies as well as consumers and dealers of their parents’ products. As such, it is imperative that securitization trusts – special purpose entities affiliated with captive finance companies – be treated as captives for purposes of both mandatory clearing and margin requirements. These trusts, when relevant, use derivatives to hedge interest rate risk and ensure investors receive timely payment of interest. These derivatives are crucial to achieving a high credit rating on the asset-backed securities given the protection they provide investors.

Applying the margin requirements to securitization trusts would have serious negative consequences for the asset-backed securities (ABS) market. Securitization trusts would not be able to comply with margin posting requirements as they are not currently structured to have access to cash and liquid securities. The source of repayment for securitization trusts is generally the cash flows from the securitized assets or receivables which are generated over time. Subjecting securitizations to margin posting would, at a minimum, make securitization transactions significantly less efficient, resulting in dramatically higher funding costs. Given potential difficulties associated with developing a
methodology and attempting to quantify potential peak margin requirements over the life of a securitization, there are questions regarding whether ratings on the asset-backed securities needed to access the ABS market are even achievable.

The application of a margin requirement will restrict a securitization trust’s ability to use derivatives and therefore will render many securitizations uneconomic. Captive finance companies may limit or forgo securitizations altogether, causing adverse effects on the functioning of this market and increasing their financing costs. This would, in turn, ultimately translate to higher financing costs for consumers and dealers on the purchase or lease of parent company products, impacting a parent’s ability to reinvest in business and job creation.

We note that it is the current industry view that securitization entities are considered non-financial counterparties and exempt from EMIR clearing and margin requirements. We therefore request that the Working Group adopt a similar approach. Such a position will both preserve the functioning of a market critical to the broader global economy as it allows captive finance companies to continue to support retail customers and dealers throughout the world and harmonize international regulations.

**Conclusion**

Captive finance companies are a small, narrowly-defined group of companies that provide vital financing to support the sales and leasing activities of their parent manufacturers. In many respects, the funding and hedging activities of a captive finance company can be viewed as an extension of the treasury division or department of a commercial end-user manufacturing company. Captives play a vital role in supporting the manufacturing sector and thereby, in creating jobs.

We share the Working Group’s commitment to efforts that reduce worldwide systemic risk in order to avoid another economic and financial crisis. With the 2010 passage of the Dodd-Frank Act, the U.S. Congress recognized the unique role that captive finance companies play in the economy and decided to exempt captive finance companies from the definition of a “financial entity” for purposes of the mandatory clearing requirement and the definition of a “major swap participant” because of their similarities to non-financial, commercial end-users and the lack of systemic risk their financing activities, including the use of derivatives, present.

We urge the Working Group to adopt a similar approach and treat captive finance companies as other non-financial, commercial end-users by exempting them from mandatory clearing and margin requirements. We believe it is possible for the Working Group to craft a policy proposal that provides a narrowly-tailored exception from mandatory clearing and margin requirements for captive finance companies in a manner that prevents abuse, but also protects the unique role played by such entities in supporting manufacturing activities worldwide. Our companies would be happy to assist the Working Group in any appropriate manner to develop such a proposal.
We thank you again for the opportunity to provide you with comments.

Sincerely,

/s/ Michael J. Cave  
President  
Boeing Capital Corporation  
(425) 965-4000

/s/ David A. Kacynski  
Treasurer  
Caterpillar Financial Services Corporation  
(615) 341-3200  
David.Kacynski@cat.com

/s/ Marie Ziegler  
Vice President & Treasurer  
Deere & Company  
(309) 765-9840  
ZieglerMarieZ@JohnDeere.com

/s/ Bernard Silverstone  
Chief Operating Officer  
Ford Motor Credit Company  
(313) 845-9148  
bsilver1@ford.com

/s/ Scott C. Davis  
Treasurer  
American Honda Finance Corporation  
(310) 972-2246  
Scott_C_Davis@ahm.honda.com

/s/ Alan R. Hunn  
Director & Assistant General Counsel  
Nissan North America General Counsel  
Nissan Motor Acceptance Corporation  
(214) 596-5154  
alan.hunn@nissan-usa.com

/s/ Raymond Specht  
Industry & Legislative Affairs  
Toyota Financial Services  
(702) 477-2105  
ray_specht@toyota.com
Attachment 1 – Legislative History of Captive Finance Companies

We thought it would be helpful to provide you with an overview of the legislative history surrounding the Dodd-Frank Act and, specifically, Congress’ express desire to exempt captive finance companies from clearing and margining requirements.

The Dodd-Frank Act

Legislative History

Throughout the deliberations regarding the Dodd-Frank Act, Congress repeatedly recognized that captive finance companies use derivatives to hedge the legitimate business risks of their parent manufacturing companies, and therefore, pose little risk to major financial institutions or to the financial system as a whole. In several instances, key members of Congress engaged in a public colloquy to express this view and ensure that captive finance companies were treated as commercial end-users rather than financial entities.

Legislative History - Exemption from Margin Requirements

The best illustration of Congress’ express desire to not require captive finance companies to be subject to margin requirements came in a colloquy on the Senate Floor between Senators Debbie Stabenow (MI) and Blanche Lincoln (AR) – two of the key Senators responsible for drafting the derivatives provisions in the Dodd-Frank Act. Relevant portions of the colloquy state:

Senator STABENOW. Mr. President, I would like to discuss the derivatives title of the Wall Street reform legislation with chairman of the Senate Agriculture, Nutrition, and Forestry Committee, Senator Lincoln. . . . I particularly want to thank the Senator for her efforts to protect manufacturers that use derivatives to manage risks associated with their operations. Whether it is hedging the risks related to fluctuating oil prices or foreign currency revenues, the ability to provide financial certainty to companies’ balance sheets is critical to their viability and global competitiveness.

I am glad that the conference recognizes the distinction between entities that are using the derivatives market to engage in speculative trading and our manufacturers and businesses that are not speculating. Instead, they use this market responsibly to hedge legitimate business risk in order to reduce volatility and protect their plans to make investments and create jobs.

11 While end-users in general account for no more than one-seventh of total derivatives’ notional value, captives comprise just a fraction of this. According to 2011 estimates, combined captive finance companies’ notional derivative amount is less than $300 billion in the overall $600 trillion derivatives market. That is just 0.05 percent of the overall market and far less than the amount of many large derivative users.

12 See 156 Congressional Record (July 15, 2010), pg. S5905-S5906.
Is it the Senator's understanding that manufacturers and companies that are using derivatives to hedge legitimate business risk and do not engage in speculative behavior will not be subjected to the capital or margin requirements in the bill?

Chairwoman LINCOLN. I thank the Senator for her efforts to protect manufacturers. I share the Senator's concerns, which is why our language preserves the ability of manufacturers and businesses to use derivatives to hedge legitimate business risk. Working closely with the Senator, I believe the legislation reflects our intent by providing a clear and narrow end-user exemption from clearing and margin requirements for derivatives held by companies that are not major swap participants and do not engage in speculation but use these products solely as a risk-management tool to hedge or mitigate commercial risks.

Senator STABENOW. . . . As you know, large manufacturers of high-cost products often establish wholly owned captive finance affiliates to support the sales of its products by providing financing to customers and dealers. . . . If captive finance affiliates of manufacturing companies are forced to post margin to a clearinghouse it will divert a significant amount of capital out of the U.S. manufacturing sector and could endanger the recovery of credit markets on which manufacturers and their captive finance affiliates depend.

Is it the Senator's understanding this legislation recognizes the unique role that captive finance companies play in supporting manufacturers by exempting transactions entered into by such companies and their affiliate entities from clearing and margin so long as they are engaged in financing that facilitates the purchase or lease of their commercial end-user parents products and these swaps contracts are used for non-speculative hedging?

Chairwoman LINCOLN. Yes, this legislation recognizes that captive finance companies support the jobs and investments of their parent company. It would ensure that clearing and margin requirements would not be applied to captive finance or affiliate company transactions that are used for legitimate, nonspeculative hedging of commercial risk arising from supporting their parent company's operations. All swap trades, even those which are not cleared, would still be reported to regulators, a swap data repository, and subject to the public reporting requirements under the legislation.

This bill also ensures that these exemptions are tailored and narrow to ensure that financial institutions do not alter behavior to exploit these legitimate exemptions. . . . The second captive finance provision . . . is a permanent exclusion from the definition of "financial entity" for those captive finance entities who use derivatives to hedge commercial risks 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90
percent or more of which are manufactured by the parent company or another subsidiary of the parent company. It is also limited to the captive finance entity's use of interest rate swaps and foreign exchange swaps.

Senator STABENOW….. Would you please explain the safeguards included in this bill to prevent abuse?

Chairwoman LINCOLN. It is also critical to ensure that we only exempt those transactions that are used to hedge by manufacturers, commercial entities and a limited number of financial entities. We were surgical in our approach to a clearing exemption, making it as narrow as possible and excluding speculators.

In fact, the legislative history shows that the Dodd-Frank Act did not provide U.S. regulators with the authority to impose margin requirements on commercial end-users. Congressional intent is clear on this point. See 156 Cong. Rec. S 6192 (July 22, 2010)(Letter of Senators Dodd and Lincoln)(the statute “does not authorize the regulators to impose margin on end-users, those exempt entities that use swaps to hedge or mitigate commercial risk”) See also statement of 156 Cong. Rec. H5248 (June 30, 2010)(colloquy of Representatives Frank and Peterson)(Mr. Peterson.“[W]e have given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant. Mr. Frank. … [T]he gentleman is absolutely right. We do differentiate between end-users and others. The marginal requirements are not on end-users."

Legislative History - Exemption From Designation As Systemically Risky

The legislative history also confirms Congress' view that captive finance companies do not pose systemic risk and therefore should not be eligible for enhanced prudential supervision by the then-newly created Financial Stability Oversight Council:

Representative KILROY. Thank you, Mr. Chairman. I would like to address the provisions of section 1103, which specifies the criteria to be considered in determining whether a financial company might be subject to stricter standards. It is my understanding that nondepository captive finance companies do not pose the types of risks that warrant such treatment. ... It is my understanding that it is the intent of the committee that nondepository captive finance companies are not the types of finance companies that should be subjected to stricter standards under section 1103 of this legislation; is that correct?

Chairman FRANK of Massachusetts. The gentlewoman is correct. ... Financing companies are not depository institutions. They provide financing for the sale of that particular product in that company. It is again inconceivable to me that somehow they would rise to the level of risk that would justify the Systemic Risk Council stepping in. 13

13 See 155 Congressional Record (December 9, 2009), pg. H14431.
Exemption from Clearing Requirement and Definition of “Major Swap Participant”

Because of the unique role played by captive finance companies, Congress expressly treated them as other commercial end-users in the Act in two very important ways. First, Congress excluded captive finance companies from the definition of a “financial entity” for the purposes of the mandatory clearing requirement of Section 2(h)(7)(C) of the Commodity Exchange Act (“CEA”). This meant that, like other commercial end-users, captive finance companies were exempt from the mandatory clearing and exchange trading requirements contained in Title VII. Second, the Act excluded captive finance companies from the definition of “major swap participant,” regardless of the size of their hedge position, thereby exempting them from a number of regulatory requirements, including margin, in accordance with their lower risk profiles.

The 90/90 Test

Congress was very concerned that a broad range of financing companies might seek to take advantage of the exceptions afforded to captive finance companies. Therefore, Congress adopted a very stringent test for companies to qualify as a captive finance company, regardless of their corporate structure: the so-called “90/90 test.” A captive finance company is defined as:

“[A]n entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.”

Congress designed this test to ensure that the exemptions apply only to companies that are true captive finance companies. Financings that do not facilitate the purchase or lease of actual, physical products and financings of products that are not manufactured by the parent company do not count towards meeting these very high thresholds. This test was adopted specifically to ensure entities that provide financing relating to mortgages, speculative ventures, investments or products not manufactured by the corporate parent do not qualify as captive finance entities.

Although Congress included the 90/90 test in the Dodd-Frank Act in order to exempt captive finance companies from the mandatory clearing requirements and from the definition of a “major swap participant,” the Act did not expressly include the definition of “financial entity” and its exemptions in the margin requirements. Despite this omission, Congress clearly distinguished between financial entities and non-financial entities with respect to margin requirements, as evidenced by the Congressional statements referenced above as well as by advancing legislation this year that would provide even greater

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14 See 7 U.S.C. 2(h)(7)(C)(iii) and 7 U.S.C. 1a(33)(D), respectively.
15 Ibid.
certainty to make sure that non-financial commercial end-users, including captive finance companies, need not post margin. We remain hopeful that regulators will finalize regulations in accordance with that Congressional intent.

**Post-Dodd-Frank Rulemakings by U.S. Federal Agencies**

With the enactment of the Dodd-Frank Act, numerous U.S. regulators – several of whom are represented on the Working Group – were tasked with promulgating rules to implement the new laws.

**CFTC Rulemakings on Definitions and End-user Exception**

Earlier this year the U.S. Commodity Futures Trading Commission (“CFTC”) and the U.S. Securities and Exchange Commission (“SEC”) released a joint Final Rule on “entity definitions” which, among other things, defined and interpreted “major swap participant” and the CFTC issued a Final Rule on the End-User Exception to the Clearing Requirement for Swaps. Both of these rules provide helpful guidance in interpreting the 90/90 test and reaffirm the importance of the captive finance company exemptions. We believe both rules interpret the 90/90 test in a reasonable and fair manner that reflects the actual business practices of captive finance companies and is consistent with Congressional intent. These rulemakings demonstrate that it is possible to create a workable yet limited exception for captive finance companies.

The guidance will help ensure that only true captive finance companies meet the stringent 90/90 test standards, while at the same time, limiting the risk of unintended negative consequences from an overly-rigid interpretation.

**CFTC and Prudential Regulators Proposed Rules on Margin Requirements**

On April 28, 2011, the CFTC issued its proposed rule entitled “Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants” (“CFTC Proposed Margin Rule”). In this proposed rule, the CFTC acknowledges that their definition of a “financial entity” “tracks the definition in Section 2(h)(7)(C) of the Dodd-Frank Act that is used in connection with an exception from any applicable clearing mandate.” However, even though the definition of “financial entity” is expressly based on the CEA Section 2(h)(7)(C) clearing mandate, which clearly exempts captive finance companies, the CFTC Proposed Margin Rule does not also adopt the statutory exemptions to the “financial entity” definition, including the 90/90 test for captive finance companies.

On May 11, 2011, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (the “Prudential Regulators”) issued their proposed rule in connection with the clearing requirements of the Dodd-Frank Act.
issued a proposed rule entitled “Margin and Capital Requirements for Covered Swap Entities (“Prudential Regulators Proposed Margin Rule”). As with other rulemakings, the Prudential Regulators Proposed Margin Rule stated that commercial end-users should not be required to post margin. Footnote 35 of the Proposed Rule states:

“Although the term ‘commercial end-user’ is not defined in the Dodd-Frank Act, it is generally understood to mean a company that is eligible for the exception to the mandatory clearing requirement for swaps...under section 2(h)(7) of the Commodity Exchange Act...”

Unfortunately, however, both the CFTC Proposed Margin Rule and the Prudential Regulators Proposed Margin Rule fail to exclude captive finance companies from the definition of “financial entity” in the manner they are excluded from the mandatory clearing provisions of the Dodd-Frank Act. As a result, the proposed rules require swap dealers to adopt counterparty exposure thresholds above which the swap dealer will be required to collect initial or variation margin from a non-financial end-user counterparty. In essence, both notices of proposed rulemaking categorize captive finance companies as high-risk entities subject to significant margin requirements. We believe this may have resulted from the fact that the proposed rules did not incorporate the full definition of “financial entity” (including its exemptions), and we have asked for this point to be clarified in order to better reflect Congressional intent.

We have submitted comments to, and held meetings with, both the Prudential Regulators and CFTC asking them to review the statutory language in the Dodd-Frank Act and make the definition of "financial end-users" and “financial entity” in their respective proposed rules consistent with the authorizing statute itself and exclude captive finance companies from those definitions as they are from the mandatory clearing requirement. We believe these meetings have been productive and that we have reinforced the Congressional intent that the clearing and margin exemption go hand in hand.

Recent Legislative Activity

We are particularly pleased that over the past several months, the U.S. Congress has taken several steps to reaffirm its original intent to treat captive finance companies as non-financial entities and exempt them from all margin requirements. Earlier this year, the House of Representatives overwhelmingly passed H.R. 2682 by a 370-24 vote. This legislation removes any ambiguity in the Dodd-Frank Act and confirms that margin requirements should not apply to a swap where one of the counterparties qualifies for an exception to the central clearing requirement of CEA Section 2(h)(7)(C). A bipartisan group of Senators introduced similar legislation, S.3480, just last month. While not yet law,

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19 See 76 Federal Register 27564.
20 See 76 Federal Register 27569. Footnote 41 of the Proposed Rule (see 76 Federal Register 27571) also confirms that the “definition of ‘financial end-user’ is based upon, and substantially similar to, the definition of a ‘financial entity’ that is ineligible to use the end-user exemption from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act.”
21 CEA section 2(h)(7)(C), as amended by section 723 of the Dodd-Frank Act
we maintain that this legislation further demonstrates Congress’ intent not to impose margin requirements on commercial end-users, including captive finance companies.