17 March 2011

Commodity Futures Trading Commission
Three Lafayette Center
1155 Twenty First Street, N.W.
Washington, D.C. 20581

Attention: David A. Stawick
Secretary of the Commission

Re: RIN number 3038-AC96 and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants

Dear Mr. Stawick,

This letter contains the comments on proposed regulations issued by the Commodity Futures Trading Commission (the "Commission") to implement new statutory provisions established under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 731 of the Dodd-Frank Act added a new section 4s(i) to the Commodity Exchange Act (CEA), which requires the Commission to prescribe standards for swap dealers and major swap participants related to the timely and accurate confirmation, processing, netting, documentation, and valuation of swaps. The proposed rules would establish requirements for swap trading relationship documentation for swap dealers and major swap participants.

The undersigned welcomes the decision of the Commission to proceed promptly with its regulatory initiative in order to reduce systemic risks associated with OTC derivative transactions. Title VII of Dodd-Frank Act provides for a scheme regulating "swaps" including registration of swap dealers, capital and conduct requirements of dealers required to register, mandatory central clearing of certain swaps, reporting requirements and position limits.

The Proposed Documentation Rule

In the rules that CFTC recently proposed (February 8, 2011), it states that the aim is to establish precise requirements for swap trading relationship documentation.[1] The Proposed Swap Trading Relationship Documentation Rule states:

1 A notice of proposed rulemaking was issued 8 February 2011 by CFTC with invitation for comments from the public to be submitted on or before 11 April 2011 See http://edocket.access.gpo.gov/2011/2011-2643.htm accessed on 10 February 2011.

*To promote the ``timely and accurate * * * documentation * * * of all swaps" under Sec. 4s(i)(1) of the CEA, proposed Sec. 23.504(a) would require that swap dealers and major swap participants establish, maintain, and enforce written policies and procedures reasonably designed to ensure that each swap dealer or major swap participant and its counterparties have agreed in writing to all of the terms governing their swap trading relationship and have executed all agreements required by proposed Sec. 23.504.*

Proposed Sec. 23.504(b)(1) would specify that the swap trading relationship documentation include written agreement by the parties on terms relating to payment obligations, netting of payments, events of default or other termination events, netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures. Proposed Sec. 23.504(b)(2) would establish that all confirmations of swap transactions, as required under previously proposed Sec. 23.501, would be considered to be part of the required swap trading relationship documentation.

The Importance of Documentation

The importance of documention could not be more emphasized by CFTC when it noted that it is necessary to promote legal and financial certainty, decrease the number and scope of counterparty disputes and promote timely resolutions of disputes when they occur.[2] The CFTC was unequivocal on the the critical importance of legally binding and enforceable provisions of netting obligations between parties and that collateral may be used to meet the net exposure. Thus, it notes:

One important method of addressing the credit risk that arises from OTC derivatives transactions is the use of bilateral close-out netting. Parties seek to achieve enforceable bilateral netting by documenting all of their transactions under master netting agreements. Following the occurrence of a default by one of the counterparties (such as bankruptcy or insolvency), the exposures from individual transactions between the two parties are netted and consolidated into a single net ``lump sum" obligation. A party's overall exposure is therefore limited to this net sum. That exposure then may be offset by the available collateral previously provided being applied against the net exposure. As such, it is critical that the netting provisions between the parties are legally enforceable and that the collateral may be used to meet the net exposure. In recognition of the risk-reducing benefits of close-out netting, many jurisdictions provide favorable treatment of netting arrangements in bankruptcy, and favorable capital and

2 Ibid 5

accounting treatment to parties that have enforceable netting agreements in place.[3] (Underscoring added)

Discussion on Legal Certainty

Although the CFTC rules make clear that netting provisions between the parties should be legally enforceable and that the collateral may be used to meet the net exposure, the rules fail to state clearly that perfection of the security interests in the collateral should be verified and supported by "robust" legal opinions. Lack of legal certainty is one of the key issues which contributed to many losses for financial institutions in the recent crisis. Firms which believed they had "good collateral" discovered that un-perfected security interests resulted in invalidity or unenforceability of the pledged collateral, i.e. no collateral at all.

Collateral use in privately negotiated derivatives transactions and related margined activities, such as repo and derivatives will grow significantly as a result of the CFTC rules under Dodd-Frank. The amount of collateral in circulation today exceeds $3.2 trillion[4], according to the International Swaps and Derivatives Association ("**ISDA**") 2010 Margin Survey. The tracked results of the ISDA Margin Survey highlight an enormous increase over the $250 billion in collateral in circulation reported back in 2002 to the $4.0 trillion in 2008 and the $3.2 trillion in 2009. The growth in collateral use demonstrates the commitment of financial institutions to manage counterparty credit risk and legal exposure. In the past, the decision whether to secure credit risk associated with a derivatives transaction by collateralisation is a credit risk management decision. Under Dodd-Frank, the collateral use will be mandatory for some players, the result of which will be that derivatives players and hedge funds will scramble to find sorely needed collateral to meet margin requirements.

Lack of legal certainty is a serious impediment to the efficient use of collateral and limits the amount of business that could be done on a collateralised basis. This restricts access to financial services and raises costs, particularly for small and medium-sized businesses ("SMEs"). Some legislative improvements have been made, e.g. in Europe and in the US (UCC Article 8 and 9 reform). While many improvements have been made in the past few years in Europe (e.g. the Settlement Finality Directive, the Collateral Directive, the Insolvency Directive and at the Hague Convention (indirectly held securities) current laws and rules throughout the world relating to collateral are still complex, inconsistent, impractical and out-of-date. Outdated laws create uncertainty and unpredictability regarding the effectiveness of collateral.

Many countries have cumbersome and impractical rules for creating, "perfecting", maintaining and enforcing securities collateral. Legal uncertainty exists as to which rules apply and the impracticality of complying with such requirements in fast-moving securities markets where dematerialised or immobilised securities are held through a chain of custodians. The consequence of failure to comply with these rules, where applicable, is often the invalidity or unenforceability of the pledged collateral, a potentially disastrous result.

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3 Ibid 5

4 The measure of collateral fell 20% during 2009, from US$4.0 trillion at end-2008 to US$3.2 trillion, as a result of the reduction in counterparty exposures that accompanied a marked decline in market volatility and a return to more normal interest rate levels and credit spreads. The reported decline in collateral in circulation is consistent with a 23% decline in gross credit exposure during the first half of 2009, as reported by the Bank for International Settlements. ISDA Margin Survey 2010.

One of the most difficult areas for global financial institutions operating on a cross border basis is determining which jurisdiction's laws apply to which aspect of a collateral arrangement, including creation/perfection, priority relative to adverse claimants and enforceability of the arrangement. Not only are the choice of law rules potentially difficult to apply within a single jurisdiction, but another jurisdiction relative to the arrangement might choose differently.

Not surprisingly, Belgium and Luxembourg, countries where the two International Securities Depositories ("ISD") are located, have dealt with these issues by statute, but the position is still unclear and/or unsatisfactory as a practical matter in many other jurisdictions. Belgium's "modern law" position (in large part due to the Euroclear Bank's presence in Belgium) is important. The modernized laws permit clients to find legal comfort in obtaining perfected pledges over cash and securities collateral. Luxembourg, as a result of the existence of Clearstream Bank has followed suit.

Collateral reform proposals to rationalise and harmonise national laws in each of the Member States with regard to collateral arrangements have been seen as very ambitious. Ideally, fundamental issues of property law and insolvency law, as well as a number of other relevant areas of law, need to be addressed from both a civil law and a common law perspective. Much has been accomplished with the implementation of The Settlement and Finality Directive, the Collateral Directive and the Insolvency Directive, all of which are valuable steps in the right direction but all relevant countries need to modernize their rules relating to securities ownership, transfer and pledging laws. Efforts at the Hague Convention on the conflict of law issues have been applauded by some members of the financial community but national formalities must still be complied with to ensure perfection if the *lex situs* is deemed to be in that local country.

Regulators both in the EU and the US more importantly, under Dodd-Frank, have been reviewing collateralisation rules in light of market developments to seek to ensure that the regulatory environment more closely mirrors prudent market practice, within the current constraints of Basel II Capital Adequacy Framework and the EC Directives. Consistent with Basle II, now US regulators are requiring certain transactions to be supported by collateral. The result is that "robust" legal opinions on collateral enforceability should be obtained and such opinions should be updated regularly (i.e. annually). This could mean that regulated entities will no longer be able to rely on in-house legal opinions if they wish to get the benefit of 0% risk weightings.

The growth in cross-border collateralisation began in part due to the importance of risk management, already a central function to ensure the soundness of the banks and broker dealers which form trading counterparties – but increasingly collateralisation is considered crucial to the soundness of the financial system. Along with an organisation's credit rating, collateral is another layer of insurance. Collateral use will continue to grow under Dodd-Frank – it is the new cost of doing business. The day of unsecured lending and naked exposures is coming to an end.

Conclusion and Recommendations to CFTC

As stated at the outset of this letter, the undersigned welcome the issuance of the proposed Swap Trading Relationship Documentation Rule. However, they believe the proposed rules should be modified in certain respects. More particularly, they recommend that: -

1. CFTC rules should make clear that cross-border collateralisation should be mandatory for all forms of credit exposure: loans, derivatives, repos and securities-lending;
2. The requirement to obtain a "robust" legal opinions on enforceability should come from an external law firm and not be issued by an in-house lawyer;
3. These legal opinions should be renewed at a minimum annually;
4. Zero risk weighting and other benefits should accompany the obtaining of such legal opinions; and
5. Firms having obtained these opinions should conduct regular "collateral audits" to ensure that their staff comply with the registration requirements of other formalities to ensuring that the security interests are perfected.

Having sound collateral agreements in place is only the first part of the solution: getting confirmation of perfected security interests in such collateral is the final solution to the soundness of the financial system.

Very truly yours,

Pamela Gonzales de Cordova

Pamela Gonzales de Cordova
VP and General Counsel
Volvo Financial Services Europe
10 Avenue du Hunderenveldlaan
B-1082 Brussels, Belgium
E-mail: pamela.gonzales.de.cordova@vfsco.com

Rosemarie Uy Griño, Esq.
Consultant, Leverlex Solutions Limited
Room 1206, Eastern Commercial Centre
397 Hennesy Road, Hong Kong
E-mail: rosemarie.grino@leverlex.com