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June 3, 2011

Re: RIN 3038-AD00 - 17 CFR Part 39 and 140 Process for Review of Swaps for Mandatory Clearing 75 Fed. Reg. 67277[1]

Re: RIN 3235- AK87 - 17 CFR Parts 240 and 249 Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations 75 FR 82490

Re: RIN 3038-AD06 - 17 CFR Part 1 Securities and Exchange Commission 17 CFR Part 240 Further Definition of "Swap Dealer", "Security-Based Swap Dealer", "Major Swap Participant", "Major Security-Based Swap Participant" and "Eligible Contract Participant" 75 FR 80174.[2]

Re: RIN 3038–AD18 - 17 CFR Part 37 Core Principles and Other Requirements for Swap Execution Facilities 76 FR 1214[3]

RE: RIN: 3235-AK93 - 17 CFR Parts 240, 242 and 249 Registration and Regulation of Security-Based Swap Execution Facilities 76 FR 10948

Subject: Treatment of intra group transactions for purposes of mandatory clearing and requirements to execute on an exchange, a Swap Execution Facility or a Security-Based Swap Execution Facility

We welcome the opportunity to provide comments to the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**") (together the "**Commissions**") with respect to the treatment of intra group transactions under the proposed rules referred to above.

In our view the Commissions should exercise their statutory authority to identify intra group transactions as a class of transactions that is not required to be cleared because these transactions are a crucial part of the risk management programs of global firms and subjecting intra group transactions to these regulations would increase operational risk without offsetting benefits to the system. The Commissions should also clarify that the exchange/swap execution facility trade execution requirement will not apply to intra group risk transfers. We set out our detailed analysis below.

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[1] Comment period re-opened until June 3, 2011 by 17 CFR Chapter 1 Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") 76 FR 25 2741.
[2] Id.
[3] Id.

The Dodd-Frank Act amends both the Commodity Exchange Act and the Securities Exchange Act of 1934 to provide that "it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing" to a qualifying derivatives clearing organization ("**DCO**") or clearing agency (each a "**clearing house**"), provided the swap is required to be cleared.[4] The Commissions each have the authority to determine whether any class of swaps and security-based swaps, as the case may be, is required to be cleared. The Commissions also have the authority to issue regulations governing the registration of swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, as well as regulations governing swap execution facilities and security-based swap execution facilities (together "**SEFs**") and exchanges.

J.P. Morgan supports the regulatory framework requiring clearing as a tool to reduce systemic risk. We have been engaged in clearing dealer to dealer OTC transactions for a decade. Recently, we have made significant investments in our client clearing franchise and we employ several hundred people in support of our client clearing service.

The Dodd-Frank Act grants the Commissions authority to review on an ongoing basis each swap or group, category, type, or class of swaps to make a determination as to whether the swap or group, category, type, or class of swaps should be required to be cleared[5]. We respectfully submit that swaps, security-based swaps (together, "**swaps**") and other transactions between affiliates that are under the direct or indirect common control of one holding company ("**intra group transactions**") should not qualify as a class of swaps that are required to be cleared.

Intra group transactions are a necessary component of a safe and sound global operation for US corporations doing business on a global basis

US based corporations that operate on a global basis are often required under local regulations to use a locally licensed affiliate to face clients in a particular jurisdiction. However the most efficient way to manage risk is often on a portfolio level, meaning that all risks that the group faces on a global basis are then aggregated in one entity through risk transfers between affiliates. This way all the risk for the group resides in one entity and can be managed in a more efficient manner. It reduces market risk at each legal entity and can reduce risk on a group level since offsetting positions in different members of the group can be aggregated to mitigate the overall risk of the portfolio. This also allows regulators to more easily assess the net risk position on a group level rather than piecing together data from separate affiliates in an attempt to reconstruct the actual risk profile of the group.

In our view the policy objectives of Dodd-Frank Act would not be served and in fact would be harmed by the introduction of a requirement to clear intra group swaps.[6] Intra group transactions are internal risk transfers, which reduce market risk at each legal entity while the risk entity managing the overall risk for the group can use offsetting positions to mitigate the overall risk of its portfolio. Introducing a requirement to clear intra group transactions would result in a

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[4] Dodd-Frank Act, Sections 723(a)(3) and 763(a).
[5] Id.
[6] Indeed, Senate Agriculture Committee Chairwoman Blanche Lincoln stated that it would be "appropriate for regulators to exempt from mandatory clearing and trading inter affiliate swap transactions which are between wholly-owned affiliates of a financial entity." (156 Cong. Rec. S5921, July 15, 2010) Similarly, Senate Banking Committee Chairman Christopher Dodd stated that inter affiliate swap transactions should not be considered in determining an entity's status as a Swap Dealer. (156 Cong. Rec. S5907, July 15, 2010).

multiplication of cleared transactions without any obvious reduction in counterparty risk, and would increase exposure of the group to clearing houses.

U.S. and international regulators recognize the importance of assessing exposure on a group level. Introducing a requirement to clear intra group transactions does not present the counterparty risk Dodd-Frank Act mandatory clearing is meant to address.

The CFTC has proposed that DCOs be required to maintain sufficient financial safeguards to cover one or two member defaults, depending on the size of the DCO.[7] The CFTC's aggregation approach in the context of DCO risk management standards is consistent with that adopted by the Committee on Payment and Settlement Systems – Technical Committee of the International Organization of Securities Commissions ("**CPSS-IOSCO**") in its proposed clearing house credit risk management standards. In particular, Principle 4 of CPSS-IOSCO's "Principles for financial market infrastructures" (March 2011) requires clearing houses to maintain excess financial resources sufficient to cover a wide range of potential stress scenarios, including a default at the one or two entities representing the largest aggregate credit exposure of the clearing house. Affiliate exposures would be aggregated for this purpose.[8]

Recognizing intra group swap correlation, the CFTC has proposed to treat affiliated clearing members as a single entity for purposes of determining the largest financial exposure. We are supportive of consolidation in this context. Risk within a corporate group is highly correlated. Group members are able to access intra group funding to manage liquidity.

An affiliated group should be defined as any group of entities that is under common control and that reports information or prepares its financial statements on a consolidated basis

So long as a person engages in dealing activity that is not *de minimis* (based, among other things, on the number of counterparties with whom such person trades swaps), the person will be a swap dealer or security-based swap dealer.[9] For purposes of determining the number of counterparties, the Commissions have proposed that counterparties who are members of an affiliated group would generally count as one counterparty, "given that the purpose of the limit is to measure the scope of a dealer's interaction with separate counterparties." For this purpose, an affiliated group would be defined as any group of entities that is under common control and that reports information or prepares its financial statements on a consolidated basis.[10] We agree with the Commissions' use of the concept of "control" in this context and would support the same basis for determining qualifying affiliates for purposes of intra group transactions not subject to the clearing requirement. A control standard (rather than ownership or other similar standard) would ensure appropriate coverage of common group affiliates structures, such as joint ventures and similar arrangements.

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[7] 17 CFR Parts 39 and 140 Financial Resources Requirements for Derivatives Clearing Organizations 75 FR 63313.

[8] For a more detailed analysis of clearing house risk management issues please refer to our other comment letters regarding this matter, listed by date: (i) November 17, 2010 regarding proposed financial resources requirements of derivatives clearing organizations and proposed limits on the ownership of clearing houses, SEFs and exchanges[8]; and February 11, 2011, regarding risk management requirements for DCOs:
http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26480&SearchText=; and
http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27687&SearchText=zubrow

[9] Dodd-Frank Act, Section 721(a)(21), definition of "swap dealer" and 761(a)(6), definition of "security-based swap dealer".

[10] 75 FR 80180.

Due to the loss mutualization feature of clearing, the introduction of a clearing requirement for intra group transactions would result in increased systemic risk

If the requirement to clear intra group trades were introduced, this would result in increased systemic risk. Every time a transaction is cleared, the clearing member takes on liability for the potential default of every other clearing member facing the clearing house and every client of that clearing member. We are supportive of the introduction of a clearing requirement for swaps that are sufficiently liquid and in cases where the clearing house is prudently managed. However in the case of an intra group transaction, in our view the analysis should focus on the swap between the affiliate facing the customer and that customer or, for dealer to dealer transactions, the swap between the affiliate and the counterparty not part of the same group. If that transaction is subject to a clearing requirement in the local jurisdiction it should be cleared. However, any further risk transfer within the group should not be subject to the clearing requirement. The Dodd-Frank Act contains clear anti-avoidance provisions. This would result in only the actual *bona fide* intra group transactions being allowed, which we believe is consistent with the spirit and the letter of the Dodd-Frank Act.

Failure to clarify that intra group transactions are not subject to the clearing requirement would result in an increase in operational risk

Applying the clearing requirement to intra-group risk transfer would require up to four transactions to be created between the clearing house and the group affiliates involved in the transaction and its hedge: the swap between the client and the first affiliate (this would result in two cleared transactions: one house transaction and one client transaction); and the transaction between the first affiliate and the main risk managing entity within the group (this would result in at least two more house transactions, bringing the total number to four cleared transactions at a minimum). These four swaps would result in a proliferation of operational risk for the group. Intra group clearing would also distort data on market activity and would involve additional trade data reporting which could impede the ability of regulators to understand where the risk ultimately resides.

With respect to transaction reporting, in our view the publication of data relating to intra group transactions does not serve a meaningful price discovery function because the internal transfers are done in connection with transactions with counterparties that are outside of the corporate group. It is those transactions that should be and are subject to reporting for price discovery purposes.

Higher costs resulting from including intra group transactions in mandatory clearing may result in higher transaction costs for all, including end users

Clearing intra group transactions will result in increased cost for the whole system, with a likelihood of additional cost for end-users without a real benefit to systemic stability. Clearing membership and sourcing and posting of collateral on an intra-day basis would increase. These costs would ultimately have to be passed on to the end user. This would discourage hedging and therefore increase market risk.

The effect of clearing of intra group transactions will be to drain liquidity from the system as group entities are forced to borrow cash or liquid securities to post as collateral at clearing houses. Resources used in this process could otherwise be used to invest or to extend credit to clients as part of group financing services.

Moreover, as further addressed below, increased costs are trade barriers. US corporations will no longer be competitive when compared with global competitors.

Proposed anti-avoidance rules should provide sufficient safeguards and should be strictly enforced

To the extent that an entity seeks to use transactions between persons under common control to avoid one of the covered entity definitions, the Commissions have the authority to prohibit practices designed to evade the requirements applicable to swap dealers and security-based swap dealers.[11] For example, the CFTC stated it would not be permissible for an entity that provides liquidity on one side of the market to use affiliated entities to provide liquidity on the other side in an attempt to avoid having to register as a swap or security-based swap dealer.[12] We support such anti-avoidance provisions.

The Commissions should clarify that the exchange/SEF execution requirement will not apply to intra group swaps

We note that the clearing and execution requirements under the Dodd-Frank Act are linked. The reasoning set out above in respect of the clearing requirement is even more clearly applicable with respect to the exchange or SEF execution requirement. SEFs are expected to operate on the basis of anonymous trading. This would mean that if intra group transactions were required to be executed on a SEF, the two affiliates that intend to transfer risk between them may end up facing other counterparties that are not within the same group. This would render impossible portfolio risk management at the group level. It would be helpful if the Commissions could clarify that the exchange trading and SEF execution requirement does not apply to intra group swaps.

International coordination between regulators

Many groups manage cleared and uncleared transactions between affiliates within the US or on a 'global' model reaching across regulatory borders. By way of example, a member of a corporate group that is established in the European Union may manage its risk through a group member that is established in the US, and vice versa. Harmonization on this point would encourage market participant groups to trade in jurisdictions with comparable regulatory safeguards.[13]

A determination that intra group transactions are not suitable for clearing and are not required to be cleared would be consistent with the proposed rules in Europe. Specifically, the proposed regulation of derivative transactions by the European Parliament explicitly carves out intra group transactions from the clearing requirements for financial and non-financial counterparties.[14] Coordination with European regulators would promote global regulatory harmonization and would mitigate any undue imbalance between swap market participant groups hedging significant US swap activity at an offshore affiliate and those hedging with an onshore affiliate.

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[11] See Dodd-Frank Act sections 721(c), 761(b)(3).

[12] 75 FR 80183.

[13] We have expressed our views regarding the extra-territorial application of swap dealer registration (in a letter written on our behalf by Sullivan & Cromwell LLP regarding extraterritorial application of the covered entity definitions, dated February 22, 2011) and the application of the clearing rules to offshore affiliates: http://comments.cftc.gov/PublicComments/ViewExParte.aspx?id=201&SearchText=

[14] Proposal for a Regulation of the European Parliament and the Council on derivative transactions, central counterparties and trade repositories, Title II, Art.3, 2010/0250/COD (April 11, 2011).

Conclusion

Corporate groups that participate in derivatives markets should be encouraged to diversify and manage their risk optimally. Appropriate treatment of intra group transactions would not increase, but rather would reduce systemic risk. Inter-jurisdictional regulatory harmonization would generally mitigate regulatory disadvantages between US entities managing risk with onshore versus offshore affiliates.

Thank you for the opportunity to comment publicly on these important matters. Please contact J.P. Morgan should you wish to discuss these matters in greater detail.

Sincerely,

Alessandro Cocco
Managing Director
J.P. Morgan

cc:
Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner

Honorable Mary L. Schapiro, Chairman
Honorable Elisse B. Walter, Commissioner
Honorable Kathleen L. Casey, Commissioner
Honorable Luis A. Aguilar, Commissioner
Honorable Troy A. Paredes, Commissioner