July 11, 2011

VIA ONLINE SUBMISSION: http://comments.cftc.gov

Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.,
Washington, D.C. 20219
Attention: David A. Stawick, Secretary

Subject: CFTC – RIN 3038 AC97 – Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants

JPMorgan Chase & Co. ("JPMorgan" or "JPM") welcomes the opportunity to provide comments to the Commodity Futures Trading Commission ("CFTC") relating to Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (the "Margin Rulemaking"). The Margin Rulemaking relates to proposed rules under Section 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act"). Any capitalized terms not otherwise defined herein shall have the meaning assigned to such term in Dodd-Frank or the Margin Rulemaking, as applicable.

General

Section 731 of Dodd-Frank sets out the standards that regulators must follow in determining margin requirements for uncleared swaps:

''(3) STANDARDS FOR CAPITAL AND MARGIN.—
(A) IN GENERAL.—To offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared, the requirements imposed under paragraph (2) [the applicable rules] shall—
(i) help ensure the safety and soundness of the swap dealer or major swap participant; **and**
(ii) **be appropriate** for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant. "
(emphasis added)

JPMorgan fully supports efforts to increase transparency in the swap markets, reduce systemic risk in the financial markets, and promote market integrity. Many aspects of the Margin Rulemaking would further those goals. In several areas, however, the Margin Rulemaking would severely reduce liquidity in swap markets and reduce the competitiveness of U.S. swap

entities, without any reduction in systemic risk or increase in market integrity. The Margin Rulemaking in several instances imposes requirements that are not risk based and that would seriously diminish market liquidity. Congress did not intend that regulators adopt a one-size-fits-all approach to setting margin requirements for uncleared swaps; if that were the case, then (ii) above would not have been necessary. Indeed, Congress intended margin requirements under Section 731 to be risk-based and required that those requirements be appropriate to address the associated risks. In the case of Non-financial Entities, those associated risks are low, and Congressional intent manifestly was to exclude non-cleared swaps entered into with Non-financial Entities from the margin requirements. In the case of Financial Entities and other Swap Dealers and Major Swap Participants, the determination of appropriateness must take into account differences between these entities. In all cases, it should be recognized that there is a cost to collateralization as well as a benefit, which cost can extend to the competitiveness of the US financial system. The margin requirements must be made on the basis of that cost-benefit analysis, the calibration between ensuring safety and soundness and setting requirements that are appropriate for the relevant risk. Our detailed comments are as follows.

Initial Margin Requirements

The Margin Rulemaking mandates that (i) all agreements relating to uncleared swaps between Swap Dealers must require each Swap Dealer to post Initial Margin to the other and (ii) all agreements relating to uncleared swaps between Swap Dealers and Financial Entities ("FEs") must require the FEs to post Initial Margin to the Swap Dealer (the amount of such margin depends on whether the FE meets certain criteria set forth in the Margin Rulemaking). These requirements are inconsistent with proven market practice, ignore significant differences in credit quality among Swap Dealers and FEs which justify differential margining treatment and will lead to excessive amounts of collateral being required in comparison to the actual risks of the underlying swap transactions and portfolios.

1. **The Initial Margin Requirements Should Differentiate Based on Credit Quality**. Section 731 explicity requires margin requirements to reflect risk, yet the Margin Rulemaking ignores the credit quality of Swap Dealers and instead imposes a zero threshold on all. Swap Dealers generally are of high credit quality; for example, at JPMorgan the 34 entities that we treat as Swap Dealer counterparties have an average long term debt rating of A+/A1. Swap Dealers already have two way variation margining arrangements in place with zero thresholds with other Swap Dealers, and these arrangements performed quite well during the financial crisis of 2008. The Margin Rulemaking identifies no risk-based justification for layering zero threshold, bilateral Initial Margin requirements for all Swap Dealers above and beyond their existing variation margin arrangements. Initial Margin is appropriate in some circumstances, but it must to take into account the credit quality of counterparties.

Unlike Swap Dealers, which are generally of high credit quality, there is a wide spectrum of credit quality in the broad category of Financial Entities. Many pension plans, sovereigns and supranationals, for example, are of extremely high credit quality, as reflected in their credit ratings and/or their ability to borrow on an unsecured basis. At the other end of the credit spectrum, many hedge funds, for example, are highly leveraged and are of lower credit quality. Many of these types of entities already are required to post Initial Margin to their dealer counterparties. To fulfill the Congressional mandate to set appropriate margin requirements, we believe that there should be a risk based approach to requiring Initial Margin to be posted by FEs, which approach would take into account the credit quality of such entities based upon a Swap Dealer's internal credit analysis of its counterparty, instead of requiring all such entities to post Initial Margin regardless of credit quality.

There are, of course, difficult issues involved in measuring the credit quality of individual entities, and overreliance on rating agency credit ratings should be avoided. This is an issue that banks face in many of their existing businesses, and cannot justify requiring swap dealers to ignore risk in setting Initial Margin requirements.

2. **The Time Horizon required to be used by the Risk-based Initial Margin Model is unjustifiably long**. §23.155(b) of the Margin Rulemaking specifies a time horizon for the risk-based Initial Margin model of 10 business days, compared with a typical 3-5 business day time horizon used by derivatives clearinghouses. It is important to remember, however, that one of the main purposes, if not the sole purpose, of Initial Margin is to serve as a buffer against market movements during the time between variation margin calls. All Swap Dealers have margin agreements allowing for daily variation margin calls on swap portfolios, and many Financial Entities, particularly hedge funds, have similar arrangements. Under the documentation governing the swap portfolios and margining, failure to meet a variation margin call results in an event of default after 1 business day, and the nondefaulting party then has to wait another business day before it can terminate the swap portfolio. Even taking into account delays and time slippage, the termination should take place within 5 business days of the failure to meet the variation margin call. Termination of the swap portfolio entails liquidation of all open positions, and once that liquidation has occurred, there is no need for, and in fact no legal basis to require, Initial Margin. Consequently, the time horizon for Initial Margin should reflect the expected time period to terminate a swap portfolio after a failed margin call, and we believe a conservative approach to that time period would be result in a 5 business day time horizon.

3. **The Eligible Collateral Between Swap Dealers and Financial Entities Is Too Restrictive.** By permitting only the posting of cash or U.S. Treasury or Agency Securities as Initial Margin and cash or Treasuries as Variation Margin, the Margin Rulemaking unnecessarily restricts the types of collateral that can be posted as margin.

Current market practice, as well as sound risk management practices, permits the posting of a much wider variety of securities collateral including additional types of U.S. Dollar denominated collateral and securities collateral denominated in a number of foreign currencies, particularly OECD government securities. Variations in credit quality are taken into account by haircuts, an approach which the Margin Rulemaking already takes with respect to Treasuries and Agencies. The Margin Rulemakings cite no legitimate systemic risk reduction objective for making the definition of Eligible Collateral so restrictive. In fact, the restriction to Treasuries and Agencies is not supported by the relevant statutory provision in Dodd-Frank. Section 731 specifically allows the use of non-cash collateral if such use is determined to be consistent with ''(i) preserving the financial integrity of markets trading swaps; and (ii) preserving the stability of the United States financial system." The pervasive current use of other types of securities as collateral, with no evidence of credit concerns resulting therefrom, evidences that the financial integrity of the markets would be best preserved through an expanded definition of eligible forms of margin in §23.157, and appropriate haircuts would preserve the stability of the U.S. financial system.

4. **Transactions between U.S. Banks and Their Subsidiaries and Affiliates Should Be Excluded From The Margin and Segregation Requirement.** U.S. banks often engage in derivatives transactions with their subsidiaries and affiliates, including entities that will register as Swap Dealers, in order to manage risk effectively among the overall corporate group's legal entities. These transactions do not increase risk; instead they transfer risk within the corporate group to an entity that is better positioned to manage that risk. The initial transaction still would be subject to the full range of provisions in the Margin Rulemaking and Dodd-Frank, and thus the further risk management transactions that transfer risk internally pose no incremental systemic risk issues. We believe transactions between a CFTC-regulated Swap Dealer and its subsidiaries or affiliates should be exempt from the Initial Margin and Variation Margin requirements. Consequently, we believe there is no safety and soundness benefit from having a swap dealer exchange Initial and Variation Margin with its subsidiaries, and there could be a significant cost and competitive disadvantage. If the CFTC-regulated Swap Dealer is an affiliate of a U.S. bank, transactions between a U.S. bank and its affiliates are already covered by Sections 23A and 23B of the Federal Reserve Act and Board Regulation W, as augmented by Section 608 of Dodd-Frank, and we believe that statute and regulation, with their long history of use in the market, provide the appropriate regulatory oversight of these transactions. Lastly, we note that in the latest version of the draft European Market Infrastructure Regulation, it is proposed that there be a broad intra-group exemption from clearing and margining for non-cleared trades that would apply to financial institutions.

5. **Requiring the Independent Custodian be Located in the Same Jurisdiction as the Pledgor is Unclear, Unsupported by Law or Policy and Impractical.** The Margin Rulemaking requires that the "independent custodian shall be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity". This requirement is unclear and, if taken literally, will make compliance impossible; moreover, no justification is given for it. This requirement is unclear because there is no definition of what "same insolvency regime" means. For example, it is unclear whether the FDIC insolvency regime applicable to U.S. banks and the U.S. Bankruptcy Code applicable to non-bank debtors are the same or different insolvency regimes. They are both creatures of U.S. law and both deal with insolvency, but they have important substantive differences. As another example, are the different sets of provisions in the FDIC Insolvency statute applicable to (i) Qualified Financial Contracts and (ii) funds held by a bank as custodian the same or different insolvency regimes? If taken literally, this requirement will be impossible to comply with and is impractical. In the United States, all independent custodians currently operate as banks, which as noted above are subject to an FDIC insolvency regime. Under Section 716 of Dodd-Frank, certain enumerated swap activities will have to be "pushed out" to non-bank holding company affiliates. These non-bank affiliates will be subject to the insolvency regime established by the U.S. Bankruptcy Code. These entities could never comply with the segregation requirement because no independent custodian operating in the U.S. is subject to the Bankruptcy Code.

6. **The Definition of Independent Custodian Should be Clarified to Include Affiliates.** A definition of "independent" which does not include affiliates creates several results which are inconsistent with the intent of the margin requirements. As noted in the previous paragraph, such a limited definition would require U.S. banks and their subsidiaries to deliver Initial Margin to an unaffiliated custodian in connection with their swap transactions. That definition would very likely also create the unintended consequence of directing a substantial amount of the Initial Margin for swap transactions involving entities with an affiliated custodian to a very limited number of other custodians. Entities selecting such other custodians once may be compelled to do so on many (if not all) of their swap transactions in order to create operational efficiencies. As a result, the negative impact on the system could be great, with hundreds of billions, if not trillions, of dollars in Initial Margin being held by a limited number of custodians.

7. **The Timing of the Initial Margin Requirement is Too Restrictive.** The Margin Rulemaking sets forth a requirement for parties to deliver Initial Margin "on or before the date of execution of an uncleared swap." This is inconsistent with current market practice, will require significant and burdensome changes in operational processes and be of little benefit in reducing systemic risk.

Margin calculations are done, by necessity, on a backward looking basis. Participants in the swap market calculate an overall margin requirement, consisting of an aggregate amount of initial margin, if required, and variation margin, across the entire portfolio of transactions between the parties based upon values of the close of business of the immediately preceding business day. The party obligated to deliver an overall margin amount, which may be a mix of initial margin and variation margin, generally has until the close of business on the next business day to deliver the required margin. This timing is dictated by operational realities-it takes time to calculate the required margin amount, and it also takes time for the party receiving the margin demand to double check the calculations before sending the required margin. It is simply not possible to send initial margin on the trade date of a transaction, and requiring this could in fact be risk increasing. For example, it is possible that a party that is required to pay initial margin in respect of a transaction done today could, on an overall basis, be entitled to a return of margin, calculated with respect to the entire portfolio, tomorrow. Requiring that party to deliver initial margin in respect of the transaction done today when he is entitled to an overall return of margin tomorrow is, for that party, risk increasing, not risk reducing. The Margin Regulations should recognize operational realities and mandate timing requirements for delivery of initial margin that accord with current market practice.

Definition of "Financial Entity"

In crafting the definition of "financial entity" in Dodd-Frank, Congress made a determination of which entities should be subject to the clearing regime, and we believe that the CFTC should adopt that determination in deciding which entities are subject to the heightened initial and variation margin requirements for non-cleared swaps. First, there should be an explicit exclusion from the definition of "Financial Entity" in the Margin Rulemaking for so-called "captive finance" subsidiaries and affiliates that meet the standards and requirements set forth in Section 723 of Dodd-Frank. Second, commodity pools and private funds that are organized outside the U.S. and have no nexus to the U.S. should not fall within the definition of "Financial Entity" in the Margin Rulemaking. The CFTC has not provided any basis for extending the reach of the Margin Rulemaking to these entities, and the safety and soundness impact of dealing with these entities can be addressed through existing supervisory mandates. Moreover, such an extension will encroach on other regulatory regimes and could cause inconsistencies in regulatory treatment of the same transactions. Lastly, we believe that prong (6) of the definition, foreign governments and their subdivisions, agencies and instrumentalities, should be deleted. The reason given for including these entities is that their financial condition will be closely linked to the financial condition of their banking system and could pose a systemic risk. Congress made no such determination in crafting the clearing requirement. In fact, Congress specifically excluded "any agreement, contract, or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States" from the definition of "swap" and thus from Title VII altogether, Section 721(a)(47)(B)(ix), evidencing that close linkage to the financial condition of a banking

system is no basis for posing systemic risk. Consequently, there is little safety and soundness basis for including foreign governments and their subdivisions, agencies and instrumentalities within the definition of "Financial Entity", and such an inclusion would cause significant competitive damage to U.S. banks in their dealings with such entities and thus would be inappropriate.

Margin Arrangements with Non-financial Entities

The Margin Rulemaking requires Swap Dealers to enter into "Credit Support Arrangements" with Non-financial Entities. This will be a significant change from current market practice, is contrary to Congressional intent and will serve as a significant disincentive for Non-financial Entities to enter into legitimate risk management transactions.

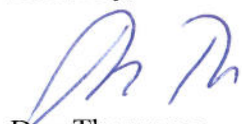
The Margin Rulemaking will require entering into Credit Support Arrangements with those counterparties to document the mechanics of collecting margin. Even if Margin Thresholds are set at levels that would, as a practical matter, mean that no Margin will ever actually be exchanged between a Covered Swap Entity and a Non-financial Entity, the requirement to negotiate Credit Support Arrangements will be burdensome and will restrict legitimate end user hedging activity. Credit Support Arrangements in the OTC markets are typically negotiated using an industry standard "Credit Support Annex' with a customized schedule attached to it which sets forth many important features of the margin relationship between the parties, including who may call for margin, what types of margin are eligible to be posted, how frequently margin may be required and many other matters. From the perspective of Swap Dealers, this will require extensive renegotiation of many existing agreements, even though as the CFTC states, Non-financial Entities will never be required to post margin. As a point of reference, JPMorgan has in place with Non-financial Entities over 4,000 agreements that do not have Credit Support Arrangements. Requiring all of those agreements to be renegotiated will be incredibly burdensome and will do little to further any of the public policy goals of Dodd-Frank implementation timetable of the Margin Rulemaking. From the perspective of Non-financial Entities, the requirement to negotiate Credit Support Arrangements will be burdensome and may restrict their hedging and risk management activities. Many Non-financial Entities enter into agreements with multiple swap dealers so that they can benefit from the transparency and pricing benefits of requiring multiple dealers to compete for their business. These Non-financial Entities will be required to expend time, money and resources on renegotiating multiple agreements to add Credit Support Arrangements with multiple dealers even though the Non-financial Entity will never have to post Margin.

Conclusion

The Margin Rulemaking is an important first step in addressing the Act's requirement to implement margin requirements for non-cleared swaps entered into by swap dealers and major swap participants. As noted, however, we believe that several changes to the Margin Rulemaking are necessary to make the rules appropriate to the risks they are meant to address and to prevent them from impairing the efficiency of U.S. financial markets.

Thank you for the opportunity to comment publicly on these important matters.

Sincerely,



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