ROPES & GRAY LLP
PRUDENTIAL TOWER
800 BOYLSTON STREET
BOSTON, MA 02199-3600
WWW.ROPESGRAY.COM

September 14, 2012

Christopher A. Klem
T +1 617 951 7410
F +1 617 235 0061
christopher.klem@ropesgray.com

Via Electronic Submission: http://comments.cftc.gov

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (RIN 3038-AC97) (the "Proposing Release")

Dear Mr. Stawick:

We appreciate this opportunity to comment on the rules proposed by the Commodity Futures Trading Commission (the "Commission") under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") relating to margin requirements for uncleared swaps for swap dealers and major swap participants (the "Proposed Rules").[1] We provide our comments from the perspective of "financial entities" on the buy-side of the market. Along with both buy- and sell-side institutions, we support the Commission's efforts to reduce risk and promote stability in the U.S. financial system, while also maintaining a robust market for cleared and uncleared swaps to suit the varying needs of a wide range of market participants.

Our comments primarily focus on the Proposed Rules governing swaps between swap dealers and major swap participants for which there is no prudential regulator ("covered swap entities" or "CSEs"), on the one hand, and "financial entities," on the other hand. As described in more detail below, we respectfully request that the Commission: (i) require bilateral exchange of initial and variation margin; (ii) permit parties to negotiate appropriate thresholds for initial margin; (iii) expressly permit netting of initial margin for uncleared swaps and netting of initial margin across cleared and uncleared swaps; (iv) revise the methodology for calculating initial margin to align it more closely with margin for cleared swaps, where appropriate based on the risk profile of various categories of uncleared swaps; and (v) require that tri-party custodial arrangements include a

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[1] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (Apr. 28, 2011) ; 77 Fed. Reg. 41109 (July 12, 2012) (extending comment period).

provision allowing a counterparty to a CSE to take control of collateral in the tri-party account upon the CSE's bankruptcy or insolvency.

As a general matter, we support the Commission's effort to balance the Act's goals of reducing risk by promoting central clearing (and, where clearing is not available, implementing measures to reduce risks associated with uncleared swaps) with the need to maintain active buy-side participation in our markets. However, we remain concerned that, from the perspective of those large, sophisticated buy-side participants that have implemented their own extensive risk management, some of the requirements suggested by the Commission will unduly increase both the cost and risk of transacting with CSEs. This may have significant adverse effects both on the investment activities of these buy-side investors, and on the stability and depth of the financial markets in general.

As our major institutional investors invest on an international scale, we support the Commission's efforts to harmonize its regulations with those in other jurisdictions, most notably the policy recommendations set forth by the Basel Commission on Banking Supervision and the International Organization of Securities Commissions Working Group on Margin Requirements ("WGMR").[2]

I. Mandatory Bilateral Exchange of Initial and Variation Margin

In proposed § 23.153, the Commission addresses initial and variation margin for uncleared swaps between CSEs and financial entities. Proposed § 23.153 would require CSEs to collect margin from financial entity counterparties, but not to pay initial or variation margin to such counterparties. Bilateral exchange of initial and variation margin is a key principle in the Basel Report, and bilateral exchange of variation margin is a nearly uniform market practice today.

We join the WGMR and other market participants in encouraging the Commission to require bilateral posting of initial and variation margin in swaps between CSEs and financial entities. First, bilateral exchange of margin will have the effect of reducing systemic risk in the financial markets and limiting the amount of unsecured exposure between swap counterparties. Bilateral exchange of variation margin addresses actual current mark-to-market exposures (*i.e.*, losses) between counterparties and its daily exchange helps to avoid accumulation of large, uncollateralized losses that a party may not be able to cover during a time of significant market stress. It is standard market practice for parties to swap transactions to exchange bilateral variation margin. Requiring the bilateral exchange of variation margin would reinforce this sound market practice, causing little disruption to the market. In addition, as the Commission notes in the Proposing Release, because uncleared swaps in many cases will tend to be more customized and therefore less liquid than their cleared counterparts, failing to remove current exposures in connection with such swaps through bilateral exchange of margin could exacerbate losses in the event of a default by the CSE (because

[2] Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, Consultative Document, Margin Requirements for Non-Centrally-Cleared Derivatives (July 2012) (the "Basel Report").

such swaps might be more difficult and/or expensive to liquidate), particularly during a time of significant market stress.

Likewise, we urge the Commission to require bilateral posting of initial margin. We believe that one-way posting of margin will, in addition to the problems discussed previously, distort the swaps market and have the effect of discouraging central clearing of swaps. Under the Proposed Rules, initial margin required from a financial entity in its uncleared swaps with a CSE generally will be higher than initial margin for cleared swaps. (Our concerns with this approach are discussed in more detail in Section IV below.) Furthermore, CSEs will be required to post initial and variation margin for cleared swaps, but will able to avoid legally-imposed margin requirements altogether in connection with uncleared swaps. We share and underscore the concern, reflected in a question in the “Request for Comment” section of the Proposing Release, that allowing dealers not only to collect more initial margin for uncleared swaps than cleared swaps, but also to avoid having to post initial or variation margin to their counterparties could incentivize dealers to try to structure transactions to avoid central clearing, where the CSE will be able to collect less initial margin from its counterparty and will be required to post initial and variation margin.

In the Proposing Release, the Commission discusses the relative amounts of risk that financial entities and non-financial entities pose to CSEs in support of its imposition of initial and variation margin requirements on the former but not the latter. We do not agree that all financial entities necessarily pose greater risk to CSEs than all non-financial entities, or that a financial entity necessarily poses greater risk to a CSE than the CSE poses to the financial entity. To be sure, in many of the cases in which we are involved, the counterparty to the CSE is more creditworthy than the CSE itself, whether measured by credit ratings or other relevant objective criteria. For this and the other reasons noted above, we respectfully request that the Commission require bilateral posting of initial and variation margin in swaps between CSEs and financial entities.

II. Thresholds for Initial Margin

Under proposed § 23.153, CSEs would be required to collect initial and variation margin from financial entity counterparties, subject to a zero threshold and a minimum transfer amount that is less than $100,000. A limited exception to the zero threshold is available for swaps between a CSE and a financial entity that is able to make certain representations. However, the exception will not be available to a significant category of large institutional investors because it requires, among other things, the financial entity to be subject to capital requirements established by a prudential regulator or a state insurance regulator. The Proposed Rules do not adequately identify financial entities that have different levels of risk. Furthermore, we believe that thresholds are appropriate in the context of initial margin, whereas full exchange of variation margin is generally required to protect against the accumulation of large uncollateralized losses. Instead of following a one-size-fits-all approach, we urge the Commission to give parties to uncleared swaps more discretion to determine whether, and to what extent, a threshold will apply to initial margin. As the Commission is aware, even

within the "financial entity" category, there exists a wide variety of size, sophistication, experience, creditworthiness and financial resources. To assume that all financial entities pose the same amount of risk – and therefore should be required to post the same amount of initial and variation margin – ignores this variety, leaving those sophisticated and creditworthy financial entities that have robust risk management practices with disproportionate amounts of capital tied up with their CSE counterparties (while receiving no initial or variation margin in return). It is difficult to understand how this scenario serves to reduce risk or promote stability in the financial system.[3]

The Basel Report states that "it may be desirable to apply different threshold amounts to different types of derivative market participants"[4] but stops short of proposing how such thresholds should be derived. The Commission asks a number of questions in the Proposing Release on this subject, including whether "the definitions adequately identify financial entities that have different levels of risk."[5] We respectfully submit that parties to uncleared swaps where one party is a financial entity[6] should be permitted to use thresholds that are determined by contract and customized by the parties to the swap, and otherwise subject to a maximum threshold amount that would apply across the universe of financial entities. We believe that the parties to the swap – especially where the parties have had a longstanding trading relationship – are in the best position to evaluate each other's creditworthiness and to determine an appropriate threshold amount for initial margin.

III. Netting of Initial Margin

Proposed § 23.153(b)(5) expressly permits parties to net variation margin in a swap between a CSE and a financial entity. This is consistent with current market practice among many market participants (*e.g.*, pursuant to master netting agreements), allowing them to efficiently deploy capital while ensuring that overall exposure to a counterparty is appropriately collateralized.

It is less clear whether netting of initial margin would be permitted under the Proposed Rules. Section 23.155(b)(2)(v) (governing calculation of initial margin based on a model meeting the requirements set forth in the Rule) states that "[a]ny portfolio offsets or reductions shall have a sound theoretical basis and significant empirical support." While this suggests that netting of initial margin may be permitted, we respectfully urge the Commission to clarify in the final rules that parties may net initial margin. Clarifying in the final rules that parties may net initial margin would

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[3] It can, of course, be argued that all large derivatives traders pose more systemic risk and are more likely to impact the market during times of financial stress than other types of investors. However, even within the category of large derivatives traders, there exist many entities that have strong risk management and compliance resources, and long-term experience and sophistication in derivatives trading, and, though large, in practice pose little threat to the overall financial system due to their resources, abilities to absorb losses, objectives and methods.
[4] Basel Report at 10.
[5] Proposing Release at 23740.
[6] We agree with and support the Commission's proposal to allow the parties to swaps between a CSE and a non-financial entity to determine initial and variation margin requirements and applicable thresholds.

be consistent with the Proposed Rules governing variation margin and current industry best practice.

In addition, we respectfully urge the Commission to clarify in the final rules that CSEs and their counterparties may net initial margin between cleared and uncleared swaps. The Proposed Rules are silent on this issue. Many market participants currently have the ability to net initial margin between cleared and over-the-counter transactions through the use of master netting agreements. As mentioned previously, these netting arrangements allow parties to provide an amount of margin that appropriately reflects overall exposure to a counterparty.

IV. Calculation of Initial Margin for Uncleared Swaps

Proposed § 23.155(b) and (c) set forth alternative methods for calculation of initial margin. Proposed § 23.155(b) allows CSEs to use a model meeting the requirements and standards set forth in § 23.155(b)(1) and (2). To the extent that the CSE does not use a model meeting the requirements and standards set forth in § 23.155(b), initial margin must be calculated in accordance with the method set forth in § 23.155(c) (the "Alternative Method"). Very generally, the Alternative Method would calculate initial margin by reference to margin for comparable cleared swaps or futures transactions, subject to a multiplier of 2.0 for cleared swaps and 4.4 for comparable futures transactions. In calculating these multipliers, the Commission made a number of assumptions regarding risk factors for uncleared swaps as compared to their cleared counterparts, including the anticipated liquidation time horizon for transactions and basis risk between cleared and uncleared products.

We are concerned that these multipliers are unnecessarily high and, in some instances, unduly distort the risks associated with uncleared swaps as compared to comparable cleared swaps or futures transactions. Imposing higher initial margin requirements on uncleared swaps provides an incentive for buy-side market participants to favor cleared swaps over uncleared swaps. However, given that mandatory clearing will be phased in beginning soon and other incentives that already exist to promote clearing of new contracts, we doubt that a further incentive that comes in the form of a potentially high cost to transacting and overall market liquidity is necessary. Further, imposing substantially higher initial margin requirements on uncleared swaps unnecessarily burdens all uncleared swaps, including those that may not pose substantially higher risks than their cleared counterparts.

We urge the Commission to revise the rules governing calculation of initial margin for uncleared swaps to more closely correlate to the risks associated with uncleared swaps and, specifically, to reduce the multipliers used for calculating margin for uncleared swaps under the Alternative Method. Based on the experience of our institutional investor clients, we do not necessarily agree with the Commission's conclusion, as reflected by the multipliers, that all uncleared swaps pose significantly (*i.e.*, two or four times) more risk than all cleared swaps – in some cases the additional

risk associated with an uncleared swap as compared to a cleared swap may be incremental at most. Uncleared swaps will remain an important part of financial entities' portfolios, and overly burdening them with substantially higher margin requirements may cause a drag on the financial markets.

V. Custodial Arrangements

Proposed § 23.158 requires CSEs to offer each counterparty the opportunity to select an unaffiliated custodian to hold initial margin. Furthermore, for each uncleared swap between a CSE, on the one hand, and a swap dealer, major swap participant, or financial entity, on the other hand, the CSE is required to offer to enter into a tri-party custodial agreement with the counterparty and the custodian that provides, among other things, that the custodian release the margin to a party that certifies that it is entitled to control of such margin, provided that certain requirements are met.

As currently drafted, the rules do not specify the circumstances under which a party would be entitled to take control of the margin, and instead leave this to negotiation between the parties. We respectfully request that the Commission require in § 23.158 that, at a minimum, a party is entitled to control of the margin subject to the agreement without delay to the extent the CSE becomes bankrupt or insolvent. This is a key principle in the Basel Report, which states that "collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law."[7]

In our experience, this term is frequently negotiated in tri-party arrangements governing initial margin accounts. We believe that adding such a requirement to the Proposed Rules would contribute to stability in the financial system by protecting customer margin in the event of a bankruptcy or insolvency by a CSE, without disrupting current market practice.

We appreciate the Commission's attention to these comments.

Sincerely yours,

/s/ Christopher A. Klem
Christopher A. Klem

/s/ Leigh R. Fraser
Leigh R. Fraser

/s/ Molly Moore
Molly Moore

[7] Basel Report at 25.