By Electronic Mail

December 2, 2014

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street NW,
Washington, DC 20581
RIN 3038 AC97

RE: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants

Dear Mr. Kirkpatrick:

The Financial Services Roundtable[1] ("FSR") respectfully submits these comments in response to the proposal (the "Proposal")[2] by the U.S. Commodity Futures Trading Commission (the "Commission") to establish margin requirements for uncleared swaps for swap dealers and major swap participants under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] We appreciate the opportunity to comment.

Title VII requires that the Commission establish margin requirements for "covered swap entities"—swap dealers and major swap participants—in connection with non-cleared swaps. In setting new standards for the collection or posting of margin, FSR believes it is critical to carefully evaluate the new costs and risks that these rules will impose on market participants in comparison to the potential benefits they are intended to create. In particular, costs that reduce the availability of hedging to financial and corporate end-users or make swaps too expensive or too risky may increase systemic risk rather than reducing it. As with many other aspects of the Dodd-Frank Act, the margin provisions will affect different market participants in different ways, and a tailored approach is essential to minimize undue adverse effects and to protect

1 As advocates for a strong financial future™, FSR represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. FSR member companies provide fuel for America's economic engine, accounting directly for $ 78.3 trillion in managed assets, $ 980 billion in revenue, and 2.1 million jobs.

2 79 FR 59898 (October 3, 2014).

3 Pub. Law No. 111-203, § 939A, 124 Stat. 1887 (July 21, 2010).

market participants. We appreciate that the Proposal is a re-proposal of the original proposal[4] to establish margin requirements for swap dealers and major swap participants regulated by the Commission, in light of the international policy framework establishing minimum standards for margin requirements for non-centrally cleared derivatives that was released by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.[5] We also appreciate the efforts the Commission has made to adopt a graduated approach based on the perceived risk of the applicable swaps transactions, and many of our comments are intended to further refine elements that are already included in the Proposal.

We recognize that the Commission has made significant changes to prior proposals that reflect comments we have previously made, including with respect to the treatment of commercial end-users under the rule and the expansion of available forms of collateral for initial margin, and we appreciate and support these changes. However, we continue to have serious concerns about the liquidity implications of the proposed rules for market participants, including with respect to inter-affiliate swaps; the competitive disadvantage at which U.S. market participants will be placed to the extent the rules deviate from those adopted in other jurisdictions; and the practicalities of the netting proposals included in the Proposal.

I. Treatment of Financial End Users

a. The threshold for an entity to have a "material swaps exposure" should be higher and should not aggregate registered swap dealer affiliates.

The Proposal would require covered swap entities to collect initial margin from financial end users with a material swaps exposure.[6] An entity will have a "material swaps exposure" if such entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds $3 billion.[7] We support a higher material swaps exposure (i.e., a gross notional exposure) in line with the standards set forth in the 2013 International Framework. Under such international framework, initial margin requirements would only apply to a financial end user with a material swaps exposure of at least €8 billion (approximately $11 billion). Moreover, the European Market Infrastructure Regulation ("EMIR") draft regulatory technical standards issued by European Securities and Markets Authority ("ESMA") have set the threshold for posting of initial margin for financial entities with a gross notional exposure of €8 billion, in line with the 2013 International

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4 76 FR 23732 (April 28, 2011).

5 *See* BCBS and IOSCO published a paper entitled *Margin requirements for non-centrally cleared derivatives* in September 2013 in consultation with the Committee on Payment and Settlement Systems and the Committee on the Global Financial System (the "2013 International Framework").

6 *See* Proposal at § 23.152(a).

7 *See* Proposal, definition of "material swaps exposure" at § 23.151.

Framework.[8] We recognize that perfect alignment of these thresholds may not be achievable given the differences in currencies used to set the thresholds, but urge the Commission to bring the US threshold as close as possible to that which is adopted in Europe.[9] The cost difference for margined or unmargined swaps may be significant, and accordingly we would expect that entities that exceed the US threshold but fall below the European threshold will be incentivized to transact with non-US counterparties. Such an outcome will place U.S. firms at a competitive disadvantage while having little or no impact on systemic risk.

Further, FSR is concerned that the definition of "material swaps exposure" casts a wider net than necessary. Because the definition requires a determination of the aggregate daily notional amount within a corporate group, affiliates of registered swap dealers (including affiliates with limited activity in non-cleared swaps) would most likely exceed the exposure calculation. We urge the Commission to exclude registered swap dealers from the word affiliate in the "material swaps exposure" calculation.

b. Securitization Vehicles

Many securitizations only have access to cash once a month, when they make their scheduled distribution to investors. Moreover, the rating agencies that rate their securities, for instance with respect to timely payment of interest, generally do so on the basis of cash flows they can model. The unpredictability of daily variation margin payments thus may make it difficult or impossible to obtain ratings, which would mean that securitizations that need to include swaps would likely not be issued. The Commission has not addressed earlier comments regarding the burden on securitizations of posting daily margin, but that burden nonetheless creates a very real concern. Moreover, securitizations by definition hold a pool of financial assets that by their terms convert into cash in a finite period of time, thus providing a significant source of financial collateral to secure the securitization's performance with respect to its swaps. We recognize that the Commission has not yet been persuaded that securitizations should be subject to special rules. At the same time, however, we believe that the challenges presented to securitizations by the requirement to post variation margin on a daily basis will significantly curtail the use of swaps in securitizations, leaving unhedged exposures in such vehicles or making the securitization impossible. Market participants continue to actively discuss whether there are workable conditions that minimize risk to covered swap entities without imposing a daily variation margin requirement. We encourage the Commission to explore such alternative approaches.

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8 Article 1 FP – Final Provisions, as contained in the draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012, as published in a consultation paper dated 14 April 2014.

9 We note that the use of outstanding notional amount is an extremely imprecise means of measuring risk. The risk profiles of swaps can vary significantly based on the asset class, tenor and other terms and factors of the transaction. Given that the Commission (and the international community) have chosen a unit of measurement that is at best poorly correlated to risk, we see little reason to compound that difficulty by then using it as a basis to codify opportunities for cross-border arbitrage.

II. Treatment of Inter-Affiliate Transactions

a. Inter-affiliate swaps should be excluded from the margin requirements.

Under the Proposal, covered swap entities and their affiliates would be required to (i) post and collect initial margin for swaps they enter into with each other ("inter-affiliate swaps") and (ii) post and collect variation margin. We believe that there are important reasons not to require initial margin on any inter-affiliate swaps, which will reduce liquidity within a financial institution without providing protection against systemic risk. Inter-affiliate swaps are used by financial groups to effectively manage and reduce rate, currency, credit and other risks as part of an integrated risk-management strategy across the enterprise as a whole. Inter-affiliate swaps allow financial groups to allocate, manage and transfer risks within a financial group by maximizing netting and offsetting of exposure with a single customer and by bringing together a diversified portfolio into a single risk-managing entity. This risk management tool increases efficiency by capitalizing on an affiliate's industry expertise and reduces cost, while improving financial services available to customers and promoting financial innovation and fair competition. Inter-affiliate swaps that are entered into in compliance with the affiliate transaction rules discussed above generally do not raise the systemic risk concerns that Title VII of the Dodd-Frank Act was intended to address because such transactions do not create additional counterparty risk and do not increase interconnectedness with third parties. In fact, such central risk management strategies intend to centralize risk in an entity that is best equipped to hedge such risk. Moreover, corporate groups have more information on the financial health of other members of the corporate group, which means they are in a better position to anticipate issues before they arise, and are also likely to have more effective means available to address potential payment and performance failures than they would when dealing with third parties. Imposing initial and variation margin requirements would disincentivize corporate groups to utilize central risk management strategies and risk being procyclical.

The Commission has already examined the issues presented by inter-affiliate swaps in connection with its clearing rules and promulgated a rule under which it agreed to exempt such swaps subject to certain conditions (the "Inter-Affiliate Clearing Exemption").[10] In the adopting release for the Inter-Affiliate Clearing Exemption, the Commission stated that "there is less counterparty risk associated with inter-affiliate swaps than swaps with third parties to the extent that affiliated counterparties internalize each other's counterparty risk because they are members of the same corporate group" and that "exempting inter-affiliate swaps would enable corporations to structure their groups so that corporate risk is concentrated in one entity".[11] We believe the same reasoning supports a similar exclusion in the context of margin for uncleared swaps.

Moreover, the proposed approach deviates from the approach taken in Europe. EMIR exempts inter-affiliate transactions from being subject to any such margin requirements,

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10 *See* CFTC Final Rule, *Clearing Exemption for Swaps Between Certain Affiliated Entities*, 77 FR 50425 (August 21, 2012).

11 77 FR at 50427.

provided that certain requirements are met.[12] Given the global nature of the swaps market, we continue to oppose inconsistencies that create the opportunity for regulatory arbitrage.

b. If the Commission chooses to impose margin requirements on inter-affiliate swaps that would not be subject to collateral requirements under the affiliate transaction rules, FSR requests an impact study prior to the imposition of such requirement.

While we strongly believe that the Commission should exempt inter-affiliate swaps from the Proposal's margin requirements, if the Commission chooses not to exempt inter-affiliate swaps from the margin requirements, we ask that the Commission conduct a study to consider the full impact of such margin requirements on inter-affiliate swaps before imposing such requirements. We do not believe such an impact study has been previously conducted by the Commission.

III. Initial and Variation Margin Calculations

a. Calculation of initial margin threshold amount

The Proposal would permit an initial margin threshold of $65 million of aggregate credit exposure from all non-cleared swaps between a covered swap entity and its affiliates and a counterparty and its affiliates.[13] The Proposal defines "affiliate" to mean any company that controls, is controlled by, or is under common control with another company. We are concerned that the definition of affiliate could in certain instances capture employee benefit plans under ERISA ("ERISA Plans"). The inclusion of such plans in the aggregated initial margin threshold calculation could potentially run afoul of and/or conflict with the fiduciary obligation rules for such ERISA Plans. For example, to the extent a covered swap entity must allocate to its affiliate ERISA Plans a portion of the initial margin threshold amount, it would need to do so in such a way that does not violate its fiduciary duty to such ERISA Plans. Moreover, we do not believe that inclusion of ERISA Plans in the definition of affiliate would serve to mitigate systemic risk nor that their exclusion from that definition would increase systemic risk, as these entities are already highly regulated in a way that restricts their ability to assume risk from their sponsors or advisors.[14] Given the robust regulatory regime to which such plans are already subject, we believe the Commission should exempt ERISA Plans from the definition of affiliate for purposes of the initial margin threshold amount calculation. Barring clarity from the Department of Labor on how to apply the initial margin threshold calculation without running afoul of the ERISA

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12 Article 11(5) to (11) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

13 *See* Proposal at § 23.151.

14 For example, ERISA regulation would prohibit sponsors or advisors that might technically be considered to "control" related ERISA Plans under the proposed definition from being able to evade the initial margin requirements by housing their hedging activities in the ERISA Plan.

rules, the inclusion of such plans under the definition of "affiliate" would create legal uncertainty with little to no benefit.

b. Netting of initial and variation margin should be permitted across products (including exposures under products that are not swaps) if such netting is legally enforceable.

Under the Proposal, initial and variation margin would be determined on an aggregate net basis with respect to all non-cleared swaps governed by an eligible master netting agreement.[15] We support a more expanded view of netting. Covered swap entities should be permitted to net swaps against any other exposures (including exposures under products that are not swaps) if such netting is legally enforceable. The Commission has acknowledged the significant liquidity costs that will be imposed by their margin requirements. To the extent the Commission can mitigate those costs through a more inclusive recognition of the effects of netting, we encourage them to do so.

c. Definition of Eligible master netting agreement

The proposed definition of "eligible master netting agreement" prohibits any such agreement from containing "a walkaway clause that…permits a non-defaulting counterparty to make a lower payment…or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is or otherwise would be, a net creditor under the agreement".[16] Under Section 2(a)(iii) of the ISDA Master Agreement, a non-defaulting party may suspend payment to a counterparty if such counterparty is defaulting but would still be required to fulfill its payment obligations upon termination of the swap. The right to suspend payment to a defaulting party under Section 2(a)(iii) may be seen as running afoul of the definition of eligible master netting agreement in the Proposal. Without these rights, a non-defaulting party would be obligated to make payments after a counterparty defaults. The market impact of such a one-sided payment obligation is exacerbated if such covered swap entity is an adhering party to a resolution protocol such as the ISDA 2014 Resolution Stay Protocol, which prevents the non-defaulting party from closing out trades upon a counterparty's default.[17] FSR requests that the Commission clarify that Section 2(a)(iii) of the ISDA Master Agreement and other agreements between parties which allow for a non-defaulting party to suspend a payment obligation owing to a defaulting party would not be captured by the definition of "walkaway clause" under the definition of "eligible master netting agreement". We further request that the Commission explicitly permit parties to enter into a limited contractual stay upon default of one of the parties of the type set out in the ISDA 2014 Resolution Stay Protocol.

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15 *See* Proposal at § 23.153(c).

16 *See* Proposal at § 23.151 (clause (3) of the proviso to the definition of "Eligible master netting agreement").

17 Prudential regulators have been supportive of such resolution protocols. *See* Joint Press Release, Federal Reserve Board and FDIC Welcome ISDA Announcement *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20141011a.htm.

d. Treatment of pre-effective date trades

i. Portfolio margining

Under the Proposal, covered swap entities would be required to include both pre-and post-effective date swaps in their margin calculations to take advantage of an eligible master netting agreement. Requiring pre-effective date swaps to be included for purposes of post-effective date margin calculations has the potential to impose significant retroactive costs. Alternatively, entering into a separate eligible master netting agreement solely for post-effective date swaps may otherwise constrain a covered swap entity's ability to make appropriate use of netting arrangements, including under the regulatory capital rules relating to a qualifying master netting agreement The new rules may have significant retroactive effect that will materially change the cost of those swaps to counterparties, or alternatively, may adversely affect the cost of entering into new swap transactions with existing counterparties. To avoid these costs, we believe that counterparties should be allowed to consider or exclude pre-effective date swaps in determining their margin requirements under existing eligible master netting agreements. Notwithstanding the foregoing, covered swap entities should still be able to legally restructure trades and trading arrangements, including by entering into a separate eligible master netting agreement for post-effective date swaps.

ii. Novated pre-effective date trades

The Commission should not treat legacy swaps that have been novated to an affiliate, as part of a corporate reorganization or other restructuring, as new swaps that are subject to the margin requirements. Especially in light of the potential application of swaps push-out rules and the resolution planning efforts in which covered swaps entities are actively engaged, the ability to transfer swaps between affiliates may be critically important. However, covered swap entities will be restricted in their ability to make such transfers if the transfer would change their counterparties' economics by requiring margin posting or collection. The imposition of margin requirements on the novated trades with a third party counterparty will likely inhibit and interrupt necessary corporate actions with little to no benefit.

IV. Collateral

a. Eligible collateral for variation margin should be expanded.

The Proposal would only allow for variation margin to be posted and collected in cash denominated in US dollars or the currency in which payment obligations under the swap are required to be settled.[18] We support a broader group of eligible collateral in respect of variation margin and urge the Commission to reconsider this proposal. FSR is deeply concerned that the liquidity constraints for financial institutions generally imposed by the already stringent margin requirements for non-cleared derivatives will be further impacted by only allowing the posting of cash to satisfy variation margin requirements. Such a requirement places a substantial cost on long term investors that are required to hedge their portfolios, such as pension funds and insurance companies. The requirement to post cash for variation margin is costly for such

[18] *See* Proposal at § 23.156(a)(1).

entities as it would require the liquidation of high quality assets on a daily basis. The daily posting of cash collateral essentially imposes a daily settlement requirement for such institutions.

Further, the limitation placed on eligible collateral for variation margin under the Proposal is a deviation from the 2013 International Framework which supports a more diverse set of eligible collateral for variation margin. The 2013 International Framework looks to collateral that can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect secured parties in the event of a counterparty default. In addition to cash, the 2013 International Framework would permit variation margin to be exchanged in the form of: high-quality government and central bank securities; high-quality corporate bonds; high-quality covered bonds; equities included in major stock indices; and gold, in each case subject to appropriate haircuts that would address potential volatility and would provide additional transparency.[19] The draft EMIR regulatory technical standards issued by ESMA related to margin requirements contemplate this broader range of collateral[20]. Allowing additional forms of eligible collateral to satisfy variation margin requirements under the Proposal would have the effect of (i) reducing the potential liquidity impact of the margin requirements by permitting entities to use noncash collateral, (ii) improving symmetry with central clearing practices, as clearinghouses frequently accept a broader array of collateral, and (iii) maintaining US competitiveness abroad.

Moreover, we believe that the Commission has a statutory obligation to allow for a diverse set of eligible collateral for variation margin that includes noncash collateral. Section 4s(e)(3)(C) of the Commodity Exchange Act provides, in pertinent part, that in prescribing margin requirements the Commission shall permit the use of noncash collateral the Commission determine to be consistent with (i) preserving the financial integrity of markets trading swaps and (ii) preserving the stability of the United States financial system. Under a "plain meaning" interpretation of statutory construction, to give meaning to the verb "shall", the Commission is obligated to provide noncash alternatives in respect of the variation margin requirements unless the use of noncash collateral would not preserve the financial integrity of the markets trading swaps or the stability of the United States financial system. We strongly believe that the use of noncash collateral would not have either of these effects and in fact can improve the accessibility and stability of the swaps markets in many instances.

We urge the Commission to reconsider and support a more diverse set of eligible collateral for variation margin. Additionally, we urge the Commission to allow for more flexibility in the structuring of transactions and risk. For instance, allowing counterparties to take into account excess initial margin and calculate any exposure net of any excess initial margin would assist certain transactions that have more readily available cash at the onset of the transaction and that would otherwise face a liquidity crunch under the Proposal.

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19 2013 International Framework, Key Principle #4.

20 Article 1 LEC – Eligible collateral for initial and variation margin, as contained in the draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012, as published in a consultation paper dated 14 April 2014.

b. Rehypothecation

The Proposal would prohibit custodians from rehypothecating, repledging, reusing or otherwise transferring (through securities lending, repurchase agreement, reverse repurchase agreement or other means) initial margin that such custodian holds under the Proposal.[21] Although these provisions focus on the restrictions placed on the custodian, the effect of the provisions—as acknowledged in the preamble—is also to prevent rehypothecation, repledging and reuse of the collateral by all parties to the transaction, including the collecting counterparty. Requiring initial margin to be segregated and held in this way effectively pulls large amounts of liquid assets out of the flow of commerce and increases the cost of these transactions significantly. For example, a covered swap entity that enters into back-to-back transactions for an unclearable swap will need to post and collect initial margin on both sides of that transaction, effectively doubling the amount of initial margin that will need to be posted. We believe the Commission should allow rehypothecation of margin so long as the party to which it is rehypothecated segregates such margin from its proprietary assets.

V. Cross-Border Application of the Margin Rules

We support a substituted compliance framework that will address instances where covered swap entities would be subject to multiple regulatory frameworks. We encourage the Commission to evaluate the foreign regulations based on the 2013 International Framework when making substituted compliance determinations. Failure to use the 2013 International Framework will risk subjecting foreign entities to multiple and at times conflicting regulations.

VI. Treatment of Commercial End Users

a. Covered swap entities should not be required to calculate a hypothetical initial margin for swaps entered into with commercial end users that have a material swaps exposure.

The Commission has proposed that covered swap entities would be required to, for each business day, calculate a hypothetical initial margin requirement for each swap for which the counterparty is a non-financial end user that has a material swaps exposure to the covered swap entity as if the counterparty were a financial end user or a swap dealer or major swap participant and compare that amount to any initial margin required pursuant to the margin documentation between the parties.[22] This requirement adds unnecessary burden to an already robust risk management process under which covered swap entities currently operate and we urge the Commission not to take such an approach and allow covered swap entities to determine the applicable margin requirements in accordance with their own internal risk management policies and procedures.

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21 *See* Proposal at § 23.157(c)(1).

22 *See* Proposal at §23.154(a)(ii)(6) and §23.155(a)(3).

b. Treatment of sovereign governments

We support the treatment of sovereign governments as non-financial end users. Sovereign governments are not similarly situated with financial end users in terms of risk and exposure. Similarly, EMIR has specifically exempted sovereigns from margin requirements. Maintaining a harmonized approach to regulation, as here, will help protect US covered swap entities from any competitive disadvantage resulting from disparate rules.

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FSR appreciates the opportunity to comment on the Proposal. As the Commission progresses in its on-going effort to refine and finalize the Proposal and harmonize the approach with foreign and domestic regulators, we would welcome the opportunity to assist in the process. Please feel free to contact me at Richard.Foster@FSRoundtable.org or (202) 589-2424.

Sincerely yours,

Rich Foster

Vice President & Senior Counsel for
Regulatory and Legal Affairs