September 20, 2012

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Notice of Proposed Rulemaking – Clearing Exemption for Swaps between Certain Affiliated Entities (RIN 3038-AD47)

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] and the Securities Industry and Financial Markets Association ("**SIFMA**")[2] appreciate the opportunity to provide the Commodity Futures Trading Commission (the "**Commission**") with comments and recommendations regarding the proposed rulemaking (the "**Proposed Exemption**")[3] described above.

ISDA and SIFMA are grateful for the Commission's consideration of the views expressed in our letter, dated May 14, 2012, on the desirability of an exemption from the clearing and trading requirements for interaffiliate swaps. In the present letter, we respond to questions posed by the Commission regarding its Proposed Exemption, explain our views regarding why an interaffiliate clearing exemption is an appropriate and necessary exercise of the Commission's exemptive authority and make certain recommendations regarding the Proposed Exemption. Specifically, we recommend that:

- The proposed conditions relating to the collection of variation margin and the extraterritorial clearing of swaps related to interaffiliate swaps should be eliminated.
- In the event that the Commission decides to retain the variation margin condition, it should make certain changes and clarifications to the proposed rule text,

[1] ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.
[2] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.
[3] 77 Fed. Reg. 50425 (August 21, 2012)

including the elimination of the "common guarantor" requirement from its proposed exception to the variation margin condition.

- In the event that the Commission decides to retain the extraterritorial clearing condition, it should provide for an appropriate transition period to allow foreign jurisdictions time to implement their G-20 clearing mandates and should make certain other changes and clarifications.

- The trade execution requirement should not apply to interaffiliate swaps, regardless of whether the conditions for the interaffiliate clearing exemption are met.

- The Commission should adopt a more flexible formulation of the proposed documentation requirement.

I. Appropriate Exercise of Section 4(c) Authority

ISDA and SIFMA believe that an exemption from mandatory clearing for interaffiliate swaps is in the public interest and meets the prerequisites for an exercise of the Commission's authority under Section 4(c) of the Commodity Exchange Act ("**CEA**"). As the Commission notes in the release accompanying the Proposed Exemption (the "**Proposing Release**"), the goals of CEA Section 4(c)(1) are to "promote responsible economic or financial innovation and fair competition" and to "provid[e] certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective manner."[4]

Interaffiliate swaps provide important benefits to the corporate groups that use them by enabling centralized (or, in some cases, appropriately localized) management of market, liquidity, capital and other risks inherent in their businesses and allowing these groups to realize the associated hedging efficiencies. For consolidated financial institutions, interaffiliate swaps are integral to an institution's strategies to meet customer needs in an efficient, competitive and sound manner by allowing customers to transact with a single client-facing entity in the customer's jurisdiction, increasing the scope of risk-reducing netting with individual customers as well as risk-reducing netting of offsetting risks within the financial group, and maximizing hedging efficiencies. These benefits allow a financial group to meet customer needs across jurisdictions and to provide improved pricing or other risk management benefits to customers, thereby promoting innovation and competition. Imposing mandatory clearing on interaffiliate swaps would compromise the ability of affiliated groups to realize these benefits.[5]

Interaffiliate swaps do not introduce risks to a corporate group.[6] They allocate and transfer risks among group members. Because capital, liquidity and risk allocation decisions, as well as the exercise of default remedies between group members are under unified management, group entities do not face default risk of other group entities, so long as the group as a whole is

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[4] Id. at 50427.
[5] See Financial Stability Board, *OTC Derivatives Market Reforms*, October 11, 2011, at page 16 (observing that mandatory clearing of intra-group transactions "could substantially increase the capital and liquidity required by firms that centralize risk management … as well as increase operational complexity").
[6] This paragraph responds to Question 2 in the Proposing Release. 77 Fed. Reg. at 50428.

solvent. Unified management is able to act with comprehensive knowledge of group members' condition. Interaffiliate swaps further centralized risk management by allowing management to align risks within a group with the capacity to absorb or hedge them – a goal that management can pursue less directly and often less efficiently through other means, such as capital contributions and withdrawals among group entities or adjustments to the terms of intercompany transactions and liabilities. Partial regulation of one aspect of group risk management would distort the risk management process.

The Commission asks whether interaffiliate swaps pose risks to third parties that have entered into swaps related to the interaffiliate swaps.[7] The credit risks faced by a third party under an uncleared swap with a group member are a function of the group member's entire portfolio of assets and liabilities, collateral and credit support arrangements and other factors. The presence or absence of an interaffiliate swap that might be related to the external swap is an isolated fact with no conclusive effect on its own. For that reason, imposing clearing on an interaffiliate swap would do nothing to protect the external swap counterparty from risks posed to the creditworthiness of the group entity by the entity's non-swap assets and liabilities. If the group entity is not engaged in sufficient outward facing business to be subject to regulation as a swap intermediary, it poses no greater danger to third parties than any other unregulated market participant. If the group entity's swap activities exceed these thresholds, then the Commission may fulfill its regulatory duties through regulation of the entity as a swap dealer or major swap participant. Whether or not the group entity is a Commission registrant, its outward facing swaps are subject to the clearing requirement of CEA Section 2(h) if the transaction is within territorial scope. If the risks of an outward facing swap are transferred through an interaffiliate swap to a Commission registrant, they become subject to all the provisions of the CEA and Commission regulations applicable to the registrant.

Rather than reducing systemic risks, requiring clearing of interaffiliate transactions exposes the affiliated group to considerable new external risk through intermediary and clearinghouse linkages, and exposes clearinghouses and their members to the group's financial risks. Affiliated groups that do not include a futures commission merchant ("**FCM**"), or that choose not to clear through an affiliated FCM, will be required to establish clearing relationships for each relevant affiliate, resulting in more extensive linkages among financial groups. Initial margin posted to support cleared swap positions, as well as accrued gains on such positions, will be exposed to the credit and operational risks of the FCM and the clearinghouse. For those groups that include and decide to clear through an affiliated FCM, their interaffiliate swaps will generally be treated as proprietary positions of the FCM. As such they would be entitled to lesser protection upon default of the FCM, and their associated margin would be available to offset losses of other FCM proprietary positions and positions of defaulting customers of the FCM (a type of "fellow customer risk"). Moreover, the increased default fund contributions arising from the interaffiliate swaps likely will be subject to loss mutualization under clearinghouse rules. Mandated clearing of interaffiliate swaps will also cause risks to flow from the group to the clearinghouse. Through clearinghouse loss mutualization, the cumulative risks of all cleared interaffiliate swaps of all affiliated groups will potentially be borne, in an ultimate sense, by all other clearing members, rather than being netted and managed within the affiliated group.

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[7] Id.

II. Variation Margin Condition

If both parties to an interaffiliate swap are financial entities, the Proposed Exemption conditions the interaffiliate clearing exemption for the swap on the payment and collection of variation margin. The Commission proposes that an exception to this variation margin requirement would be available in the case of "100% commonly-owned and commonly-guaranteed affiliates where the common guarantor is also 100% commonly-owned".[8] For the same reasons that interaffiliate clearing should not be imposed (i.e., the absence of new risks, the fundamentally different character of default risk among group entities and the lack of a direct relationship between intra-group credit arrangements and the counterparty risks faced by third parties), ISDA and SIFMA believe the imposition of a variation margin requirement as a condition for the interaffiliate clearing exemption is unnecessary and undesirable.

It is not necessary to protect group entities from the credit risk of other group entities. As explained above, group management, through its comprehensive knowledge of the group and its control over the allocation of capital and liquidity and the exercise of remedies among group members, possesses the tools needed to resolve potential defaults within the group. As the Commission acknowledges, majority common ownership among group members, which is a component of the proposed definition of interaffiliate swap, is a sufficient indication of a commonality of economic interest among group members to ensure that such credit risks are internalized within the group.[9] A higher common ownership threshold of 100% (or even 80%, as contemplated in Question 22) is not needed. Under the proposed definition of interaffiliate swap, group management's accountability for the financial soundness of all group entities, even those with minority owners, is reinforced by the requirement of accounting consolidation. To the extent the Commission's distinctions between common ownership percentages are motivated by the protection of minority investors in group entities, we submit that such issues are the province of corporate and securities laws.

Any benefits from the variation margin requirement to a group member's external swap counterparties are tenuous at best because, as explained above, such counterparties are exposed to credit risks arising from the group member's entire balance sheet. Finally, the additional liquidity demands resulting from variation margin will distort the group's risk management choices.

The Commission's regulatory mandate to protect third party swap counterparties can be fully achieved through application of the clearing requirement to those outward facing swaps that are subject to the Commission's jurisdiction as well as regulation of those group entities whose outward-facing swap activities are of sufficient scale to subject them to swap dealer or major swap participant registration. Moreover, this approach is consistent with the scope of the Commission's authority, which does not extend to regulate the overall financial soundness of non-registrants.

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[8] Proposed Rule 39.6(g)(2)(iv). Id. at 50442.
[9] Id. at 50427.

The Proposing Release quotes the ISDA/SIFMA letter's statement that variation margin posting "routinely occurs in financial groups and its imposition on affiliates who transact directly with swap dealers … or major swap participants … should not be unduly disruptive."[10] The statement was made in the context of a discussion that ensuring the financial integrity of swap dealers and major swap participants, not corporate groups generally, should be the extent of the Commission's regulatory concern, and that the regulatory regime applicable to swap dealers contained appropriate safeguards, including variation margin requirements.[11] The fact that variation margin posting "routinely" occurs does not mean that it occurs uniformly in all of the circumstances in which the Proposed Exemption would require it, or that its regulatory imposition would not needlessly increase costs.

The Proposed Common Guarantor Requirement

The Commission has not provided an adequate rationale for requiring a common guarantor as a condition for the proposed variation margin requirement not to apply to group members, nor has the Commission made clear which obligations must be guaranteed.[12] The Commission's first stated rationale – ensuring that risks created by external swaps are "ultimately borne by the enterprise (which is defined by an alignment of economic interests)"[13] – is already met by virtue of common majority ownership. The Commission's second stated rationale – that a guarantee ensures that inter-affiliate swaps do not "create new risks for the enterprise" – is flawed. Either with or without a guarantee, an interaffiliate swap allocates risk between two group entities, but does not create new risk. New risks to the group enterprise arise from transactions with unaffiliated parties. In the example used, affiliate B's external swap with T is a new risk to the enterprise, irrespective of whether Parent X has guaranteed it. With a parent guarantee, the risk may propagate to Parent X and may then propagate, via group contagion effects, to affiliate A (the counterparty to the interaffiliate swap with B that is related to T's swap with B). With no guarantee, the same risks could propagate from B to A directly. In both of these scenarios, the risk is borne by the enterprise.

Changes and Clarifications

If the Commission declines to follow our recommendation to remove the variation margin condition, it should make several changes and clarifications to its proposed rule. First, it

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[10] Id. at 50430.

[11] We note that aspects of the regulatory regime for swap dealers and major swap participants with important implications for interaffiliate swaps, in particular margin and capital rules and cross-border guidance, are still in proposed form and the Commission's Proposing Release does not present an integrated picture of how interaffiliate swaps will be dealt with under other these and other relevant regulations. We urge the Commission to consider appropriate accommodation for interaffiliate swaps in finalizing such other rules. In particular, ISDA and SIFMA suggest that, in order to preserve operational and risk management flexibility for affiliated groups that include a swap dealer or major swap participant, interaffiliate swaps that qualify for the clearing exemption should not be subject to an initial margin requirement under the margin rules applicable to swap dealers and major swap participants. Such an approach would recognize the fungibility of initial margin and swap dealer/major swap participant capital as well as other alternative means of meeting the regulatory goal of ensuring the financial soundness of swap dealers and major swap participants.

[12] We note that intra-group guarantees are not typical (or needed) and may in fact be restricted or forbidden to certain entities or groups. See, e.g., Section 23A of the Federal Reserve Act.

[13] Id.

should eliminate the guarantee requirement, for which it has not provided an adequate rationale. Second, in order to maintain drafting consistency with the *direct or indirect* majority ownership criterion in Rule 39.6(g)(1), the Commission should state in the Rule 39.6(g)(2)(iv) exception that *direct or indirect* 100% common ownership will satisfy the requirements of that exception. Third, the meaning of "commonly-guaranteed" is not clear in proposed Rule 39.6(g)(2)(iv) because the proposed rule text does not state which obligations of the affiliates must be guaranteed. If the guarantee condition is kept, it should state clearly which obligations are relevant. [14] (Presumably, the Commission intended to refer to swap obligations to unaffiliated parties.) Finally, if the guarantee condition is kept, the Commission should address the consequences of this guarantee requirement under its interpretive position (set out in the preamble to its final rule further defining "swap") that guarantees of swaps are swaps. The exception to the variation margin condition will be of limited utility if it subjects the guarantor to a requirement to register as a swap dealer.

III. Extraterritorial Clearing Condition

Proposed Rule 39.6(g)(2)(v) would impose a condition that each party to an inter-affiliate swap either (A) is located in the US or a jurisdiction with a comparable and comprehensive clearing regime, (B) is required to clear swaps with non-affiliated parties in compliance with US law or (C) does not enter into swaps with unaffiliated third parties. ISDA and SIFMA urge the Commission to eliminate this condition for the following reasons.

First, the condition may prove to be largely unnecessary because it is expected that the major financial jurisdictions will implement their own clearing regimes. Nevertheless, questions of timing and criteria for comparability make the proposed condition problematic. Unless these are satisfactorily resolved, the condition could hamper the ability of US-based groups to compete in foreign markets and thereby have a detrimental effect on users of those markets. Second, the Commission's anti-evasion authority can adequately address its stated concerns. Application of anti-evasion authority should be limited to cases where the foreign affiliate engages in a pattern of back-to-back swaps with the US affiliate, neither affiliate is subject to capital regulation, and the foreign affiliate's third party counterparty is not subject to capital regulation. In cases where an affiliate is subject to capital regulation, capital requirements will ensure that the interaffiliate swaps have economic consequences, and therefore they should not be considered evasive, regardless of the capital status of the third party. Finally, the Commission's rationale for the requirement (apart from the evasion concern) is incorrect. The Commission states that "financial markets may be at risk if the foreign affiliate enters into a related third-party swap that would be subject to clearing were it entered into in the United States."[15] As explained above, the presence or absence of a swap related to the external swap has no conclusive effect on systemic risk.

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[14] ISDA and SIFMA also recommend further drafting clarifications to proposed Rule 39.6(g)(2)(iv). Specifically, the Commission should make clear that swaps between the common guarantor and its affiliates are eligible for the exception (notwithstanding that the guarantor could not literally be said to "guarantee" its own swaps with unaffiliated parties) and that a publicly owned holding company and its direct or indirect 100% owned subsidiaries are "100% commonly owned" (with the public shareholders of the holding company constituting the common owners).

[15] Id. at 50431.

Should the Commission decide against following our recommendation to eliminate the extraterritorial clearing condition, it should at a minimum (i) provide for an appropriate transition period before the comparable clearing requirement goes into effect so as to allow foreign jurisdictions time to implement their G-20 clearing mandates and (ii) clarify that comparability does not require the host regulators to have made the same mandatory clearing determinations as the Commission. In addition, the Commission should clarify the intended meaning of the condition in proposed Rule 39.6(g)(2)(v)(C) that a counterparty is "required to clear swaps with non-affiliated parties in compliance with US law." For example, would the requirement be satisfied if the foreign affiliate voluntarily cleared all swaps that would be subject to clearing if entered into by two US persons (i.e., swaps of a type subject to a mandatory clearing determination for which neither party would qualify for an end-user exemption)? The Commission illustrates the application of this clause (C) with the example[16] of a "conduit" as defined in the Commission's proposed cross-border guidance. The "conduit" concept has attracted comment in the cross-border proposal and should not be ensconced in other rulemaking until it has been given its final form in final cross-border guidance.

The Commission should not adopt the alternative clearing requirement set out in Q27 (p. 50431), which would require non-US affiliates to clear all swaps with non-US persons if such transactions are "related to" inter-affiliate swaps that would be subject to clearing if entered into by two US persons. This position fails to accord comity to foreign regulators who have formulated their own clearing requirements, and it competitively disadvantages US-based groups operating in foreign markets. Moreover, the undefined concept of "relatedness" is likely to prove vague and unworkable.

IV. Trade Execution Requirement

Interaffiliate swaps should be exempt from trade execution regardless of whether the conditions for the interaffiliate clearing exemption are met. Imposing a trade execution requirement may preclude interaffiliate risk transfers (resulting in the loss of the benefits described in Section I above) because a participant in a swap execution facility ("SEF") will not necessarily have control over the identity of the counterparty with whom its order is matched. Moreover, mandating SEF execution of inter-affiliate trades would not advance the price discovery goals of the trading requirement. As the Commission recognized in adopting the real-time reporting rules, inter-affiliate swap transactions are often not intended to be arm's length[17] and, even if intended to be arm's length in name, are not intended to realize fully competitive pricing. Such trades are fundamentally inconsistent with the anticipated characteristics of trading platforms. No purpose is served by requiring execution in a venue intended to enhance competitive pricing and provide meaningful and informative pre-trade transparency.

V. Other Conditions

Proposed Rule 39.6(g)(4)(iii)(b)

[16] Id., footnote 44.
[17] 77 Fed. Reg. 1182, 1187 (January 9, 2012).

The proposed rule text refers to approval by the board of directors or equivalent body of "the decision not to clear *the swap* [emphasis added]." The singular term creates ambiguity as it suggests swap-by-swap approval is required. Although ISDA and SIFMA believe that the reference to this requirement in section (g)(5), which permits annual reporting, makes clear that a general approval is permissible, ISDA and SIFMA request confirmation of this conclusion.

Documentation Conditions

ISDA and SIFMA are concerned that the documentation requirements under proposed Rule 39.6(g)(2)(ii) are overly prescriptive and will impose unnecessary costs on affiliated groups. For example, valuation and dispute resolution procedures would appear to serve little purpose among majority-owned affiliates. ISDA and SIMFA suggest that a more flexible standard that the documentation adequately evidences all transaction terms under applicable law would be sufficient to meet Commission's stated goals of certainty and transparency.

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ISDA and SIFMA appreciate the opportunity to comment on the proposed rule. Please feel free to contact the undersigned or our staff at your convenience.

Sincerely,

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