November 24, 2014

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1155 21st Street, N.W.
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Re: Margin and Capital Requirements for Covered Swap Entities, Docket ID OCC-2011-0008/RIN 1557-AD43, Docket No. R-1415/RIN 7100 AD74, RIN 3064-AE21, RIN 2590-AA45, RIN 3052-AC69;[1]

Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, RIN 3038-AC97.[2]

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("SIFMA")[3] welcomes this opportunity to comment on the captioned rule proposals (the "Proposed Rules") published by the

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1 79 Fed. Reg. 57348 (Sept. 24, 2014) (the "Bank Proposal").

2 79 Fed. Reg. 59898 (Oct. 3, 2014) (the "CFTC Proposal").

3 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

Prudential Regulators[4] and the Commodity Futures Trading Commission (the "CFTC" and, together with the Prudential Regulators, the "Agencies") pursuant to their authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The Proposed Rules would establish minimum initial and variation margin ("OTC margin") requirements applicable to (a) uncleared swaps and security-based swaps ("SBS") entered into by registered swap dealers, SBS dealers, major swap participants and major SBS participants (collectively, "Swap Entities") for which there is a Prudential Regulator ("Bank Swap Entities") and (b) uncleared swaps entered into by swap dealers and major swap participants that do not have a Prudential Regulator ("Non-Bank Swap Entities" and, together with Bank Swap Entities, "Covered Swap Entities").

EXECUTIVE SUMMARY

The Proposed Rules incorporate several modifications to the Agencies' original 2011 margin proposals[5] that further harmonize their OTC margin requirements with the Basel Committee on Banking Supervision ("BCBS") and International Organization of Securities Commissions ("IOSCO") September 2013 final international policy framework[6] (the "Final BCBS-IOSCO Framework") and the OTC margin framework proposed in April 2014 by European supervisory agencies[7] (the "EU Proposal").[8] SIFMA supports these elements of the Proposed Rules and acknowledges the broad, and hard won, consistency that has been achieved by the Agencies and their international counterparts generally in the context of OTC margin requirements. The Agencies have also, however, introduced new proposals that diverge in potentially significant ways from the Final BCBS-IOSCO Framework and the EU Proposal.

The characteristics of the uncleared swap[9] market present key challenges, moreover, that require further analysis by the Agencies and modifications to the Proposed Rules. Because of the market's size, changes in the OTC margin framework that increase the amount of initial

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and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

4 In this letter, "Prudential Regulators" refers to the Board of Governors of the Federal Reserve System (the "Board"), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the Farm Credit Administration.

5 76 Fed. Reg. 27564 (May 11, 2011) (original Prudential Regulator proposal) and 76 Fed. Reg. 23732 (Apr. 28, 2011) (original CFTC proposal).

6 BCBS-IOSCO, Margin requirements for non-centrally cleared derivatives (Sept. 2013).

7 See Consultation Paper regarding draft regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP (Apr. 14, 2014).

8 As examples, the Agencies have proposed a $65 million initial margin threshold, a broad range of eligible collateral for initial margin, and a phase-in schedule for compliance with initial margin requirements.

9 Except where the context requires otherwise, reference to "swaps" in this letter include both swaps and SBS.

margin required to be exchanged can have an outsized incremental liquidity impact, particularly in periods of market stress. Certain proposals, such as initial margining of inter-affiliate swaps and the prohibition of initial margin rehypothecation, would require segregation of very significant amounts of additional collateral assets. The risk mitigation benefits of these proposals must be evaluated in relation to their associated liquidity impact and other costs.

The large percentage of swap activity that is conducted on a cross-border basis accentuates the importance of internationally harmonized requirements. Deviation from other jurisdictions, even in the case of requirements that may appear to be technical details, can differentiate the costs of uncleared swaps in ways that impact competition and lead to otherwise avoidable market fragmentation. A workable framework for the cross-border application of OTC margin requirements, including mutual recognition of comparable regimes, is necessary to preserve a level playing field and cross-border markets.

Finally, the operational and related documentation requirements necessary to implement and comply with the evolving OTC margin framework proposed by the Agencies requires continued attention to the transition periods that will be necessary for market participants to come into compliance with the new margin framework in an orderly manner, without risk of disruption to payment and settlement infrastructure.

As we explain more fully in the discussion section of this letter, we recommend that the Agencies take the following steps to address these challenges:[10]

- **Standardized Models**. The Agencies should facilitate the development, approval and use of standardized initial margin models in order to promote efficiency, transparency and predictability of initial margin requirements.

- **Mitigation of Adverse Procyclical Effects**. The Agencies should require (i) counterparties to establish transparent and predictable procedures for adjusting initial margin requirements in response to changing market conditions and (ii) that these procedures allow a counterparty to post increased initial margin resulting from the recalibration of a model over a period longer than one day. These requirements would avoid destabilizing calls for collateral during periods of extreme market stress.

- **Risk Categories**. The Agencies should (i) permit market participants to categorize risk sensitivities, instead of products, into risk categories and (ii) revert to the single commodity risk category contained in the Final BCBS-IOSCO Framework and EU Proposal (instead of the four commodity risk categories contained in the Proposed Rules). These changes would help to ensure that initial margin requirements do not overstate or understate portfolio risk.

[10] We have also included as Annex A to this letter a list of other issues that we believe the Agencies should consider.

- **Collateral Haircuts**. The Agencies should permit the use of approved models to compute collateral haircuts, which would promote international consistency and reduce liquidity burdens. The Agencies should also permit the recognition of relationships between credit exposure and margin assets, which would encourage beneficial collateral posting and hedging activities.

- **Inter-Affiliate Swaps**. The Agencies should adopt an exception from initial margin requirements for uncleared swaps between affiliates, subject to appropriate risk-mitigating conditions. This exception would promote effective group-wide risk management and prevent destabilizing liquidity burdens.

- **Material Swaps Exposure**. The Agencies should defer the adoption of a final "material swaps exposure" definition that differs from the threshold adopted in the Final BCBS-IOSCO Framework and proposed in other jurisdictions until they have conducted an analysis of additional data regarding the risk mitigation and liquidity impact of the threshold and related costs and benefits.

- **Timing of Margin Collection and Posting**. The Agencies should clarify the timing of margin calls, collection and posting to take into account margin calculation processes, time zone differences and collateral settlement mechanics.

- **Dispute Resolution and Margin Documentation**. The Agencies should clarify the Proposed Rules' dispute resolution and documentation provisions, which would support beneficial dispute resolution practices consistent with industry conventions.

- **Eligible Variation Margin**. The Agencies should permit non-cash variation margin in order to promote international consistency and prevent undue reliance on collateral transformation arrangements that will increase operational and settlement costs and risks, without demonstrable offsetting systemic risk mitigation benefits.

- **Covered Products; Portfolio Margin and Cross-Margin Arrangements**. The Agencies should accommodate portfolio and cross-margining of covered products with risk-correlated products not covered by their OTC margin requirements in order to recognize the full range of legally enforceable netting arrangements and prevent unwarranted competitive disparities between different categories of registrant.

- **Segregation Requirements**. The Agencies should adopt more flexible segregation requirements accommodating a wider range of arrangements that protect parties posting initial margin while avoiding conflicts with other regulators' OTC margin requirements and unnecessary collateral costs.

- **Cross-Border Application**. The Agencies should (i) expand the availability of substituted compliance and (ii) limit the extraterritorial application of U.S. margin rules to circumstances where U.S. regulatory interests are strong and there is no other means for satisfying those interests. These steps would prevent conflicts and inconsistencies with foreign rules that could fragment markets by deterring cross-border trading activity.

- **Variation Margin Netting**. The Board should take steps to clarify legal ambiguities that could foster increased settlement risks and costs by preventing the exchange of variation margin on a net basis.

- **Phase-In of OTC Margin Requirements**. In recognition of the time needed to make adjustments once final OTC margin requirements are published, the Agencies should adopt a phase-in schedule calibrated with reference to the publication of those requirements.

- **Legacy Swaps**. The Agencies should not condition grandfathering of legacy swaps on the documentation of those swaps under separate eligible master netting agreements from new swaps, which would increase credit risk by breaking up netting sets. The Agencies should also permit grandfathering of legacy swap novations, which would permit beneficial risk-reducing novations designed to address other regulatory objectives.

- **Securitization/Structured Finance Vehicles**. It is important that the Agencies fashion appropriate margin relief for a broad range of securitization/structured finance vehicles that ensures cross-border consistency and does not effectively preclude or unnecessarily increase the cost of securitizations and structured finance transactions without clear risk mitigation benefits. We believe that the Proposed Rules currently fall short of this standard, and we support the comments of SIFMA's Securitization Working Group.

DISCUSSION

I. Initial Margin Requirements

The Proposed Rules would establish a margin "exchange" regime under which a Covered Swap Entity would be required to collect and post initial and variation margin with (1) another Swap Entity or (2) a financial end user that has a material swaps exposure.[11] The Proposed Rules would permit a Covered Swap Entity to compute initial margin requirements using either a (1) standardized table specified by the Agencies or (2) measure of potential future exposure estimated through use of a model that has been approved by the relevant Agency for the Covered Swap Entity.[12] The Proposed Rules would also prohibit the rehypothecation of initial margin.[13]

The Agencies and other BCBS-IOSCO participants have recognized the liquidity burden associated with these requirements. The Proposed Rules incorporate several measures intended to mitigate this liquidity burden, such as a $65 million initial margin threshold,[14] a broad range

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[11] Bank Proposed Rule § _.3; CFTC Proposed Rule § 23.152.

[12] Bank Proposed Rule § _.8; CFTC Proposed Rule § 23.154.

[13] Bank Proposed § _.7(c); CFTC Proposed Rule § 23.157(c).

[14] Bank Proposed Rule § _.3(a)(2); CFTC Proposed Rule § 23.154(a)(3).

of eligible collateral for initial margin,[15] and a phase-in schedule for compliance with initial margin requirements.[16] Even accounting for these mitigants, the global liquidity impact of initial margin requirements would be very significant, consuming an estimated $962 billion of high-quality, unencumbered assets (or roughly 8% of all such assets).[17] BCBS-IOSCO indicated that they carefully considered these estimates in their design of the Final BCBS-IOSCO Framework, seeking to balance the potential benefits of initial margin requirements against their liquidity impact.[18]

The Proposed Rules, however, contain requirements that would upset that balance, without achieving significant risk mitigation benefits. As described below, these requirements fall into three categories: (a) requirements pertaining to the design and use of initial margin models; (b) the application of initial margin requirements to inter-affiliate swaps; and (c) the proposal to adopt a lower "material swaps exposure" threshold than the Final BCBS-IOSCO Framework and EU Proposal.

A. Initial Margin Models

The use of models to compute initial margin requirements will be necessary to achieve sustainable liquidity requirements.[19] Promoting the use of initial margin models will, however, require the Agencies to address the key issues summarized below.

1. Standardized Models

The broad use of standardized models is highly desirable because proprietary internal models, while they may incorporate more powerful risk analytics, do not provide counterparties with sufficient transparency or predictability. Transparency and predictability in initial margin requirements are necessary for market participants accurately to price their trades, manage their portfolios, and allocate capital/liquidity to trading activities. These attributes are also necessary to prevent an elevated level of margin disputes. Consistency across modeled margin computations is also highly desirable. The use of standardized models also has the potential, over the medium to long term, to significantly reduce public sector and private sector costs and operational, administrative and resource burdens.

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[15] Bank Proposed Rule § _.6(a)(2); CFTC Proposed Rule § 23.156(a).

[16] Bank Proposed Rule § _.1(d); CFTC Proposed Rule § 23.159.

[17] See BCBS-IOSCO, Second Consultative Document, Margin requirements for non-centrally cleared derivatives (Feb. 2013) (the "Second BCBS-IOSCO Consultation") at p. 26 (total estimated initial margin) and p. 36 (estimated initial margin as a percentage of available, unencumbered assets).

[18] Final BCBS-IOSCO Framework at p. 3.

[19] In contrast, use of standardized tables would produce a liquidity burden estimated by BCBS-IOSCO to be six to eleven times greater than the $962 billion estimate noted above. Second BCBS-IOSCO Consultation at p. 36.

Transparency and predictability in initial margin requirements are particularly important in the context of rules that will require many financial institutions (who are subject to regulatory risk management obligations) and asset managers (who are subject to fiduciary obligations) to post initial margin for the first time. These market participants cannot afford to post initial margin at levels they cannot predict or understand. Even if they were willing to assume the considerable burden and expense of developing their own proprietary models, there is no avenue for many of these market participants to gain approval of such models. And in any event, such a development would likely exacerbate problems of transparency and the occurrence of margin disputes. Standardized models are intended to address these issues by providing a risk-sensitive measurement of portfolio exposures while significantly reducing the disputes (and operational resources) associated with the use of approved proprietary modeling methodologies.

Standardized models would also facilitate macro-prudential supervision by permitting regulators to estimate the effect of changing market conditions or trading patterns on initial margin requirements more accurately. The potential for an increase in financial stress to result in a sharp increase in initial margin requirements, as discussed in greater detail below, makes it essential for regulators to be able to assess the market-wide liquidity burden resulting from initial margin requirements quickly and consistently across supervisors and jurisdictions during rapidly shifting market conditions.

More efficient use of public and private sector resources would be another important benefit of standardized models. In contrast, due to resource constraints faced by market participants and regulators alike, a process of firm-by-firm development and approval of initial margin models is unlikely to be completed before OTC margin requirements come into effect and will present ongoing burdens for supervisors and market participants.[20]

It is therefore important that the Agencies' rules facilitate the development, approval and use of standardized margin models. The adoption and maintenance of model parameters that accommodate the use of standardized models and are consistent across regulators and major jurisdictions will be critical to this result. SIFMA strongly endorses the work that is currently being undertaken by the International Swaps and Derivatives Association ("ISDA") to define a set of parameters for standardized initial margin models (such as the "SBA-Margin" model) and encourages the Agencies to proactively engage with the industry and the Agencies' foreign counterparts in order to achieve this objective.

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[20] The Agencies can also mitigate these burdens by recognizing initial margin models subject to approval and oversight by a foreign regulator whose approval and oversight standards are comparable to U.S. standards. A number of foreign financial holding companies have U.S. Swap Entity subsidiaries that are likely to use initial margin models approved by their parent's home country regulator or an affiliate's home country regulator. The consolidated group-wide use of such an approved model promotes effective and efficient credit risk management across the consolidated group. Where such a model is approved, and updates to it are overseen, by a foreign regulator whose approval and oversight standards are comparable to U.S. standards, requiring separate U.S. approval and oversight of the model would result in unnecessary delay, uncertainty, and an inefficient use of resources.

2. Management of Adverse Procyclical Effects from Model Recalibration

The Proposed Rules would require Covered Swap Entities to review and update an initial margin model's empirical inputs at least monthly, and more frequently as market conditions warrant, to ensure that those inputs incorporate an appropriate period of financial stress.[21] The Proposed Rules would also appear to require a Covered Swap Entity to satisfy increased initial margin requirements resulting from such a model recalibration within a day.[22] In a period of relative market stability, model recalibration mitigates risk by ensuring that initial margin models more accurately reflect prevailing market conditions. However, the simultaneous recalibration of margin models, on a market-wide basis in a period of significant market stress, could give rise to demands for significant amounts of collateral. These demands would need to be satisfied by market participants within a brief window of time. In any such scenario, the risk mitigating benefits of the call for additional initial margin could be outweighed significantly by the destabilizing impact of the demand for liquid collateral. That impact would simultaneously affect (and be affected by) the demand for and availability of liquid assets in other sectors of the financial system and economy, with undesirable and unavoidable contagion effects.

By way of example, a recent paper examining the procyclical impact of several different initial margin models during 2008-2012 found that those models produced one-day increases in initial margin during a period of market stress ranging from 40% to 150%.[23] Based on BCBS-IOSCO's estimates, such an increase in initial margin would result in overnight demand for roughly an additional $385 billion to $1.44 trillion in eligible collateral, a demand for which market participants would have had little opportunity to prepare.

It is highly unlikely that the market could absorb such a significant demand for high-quality, unencumbered assets in such a short period of time. This is particularly so during a period of extreme financial stress, as would be the case if initial margin requirements increased substantially as a result of changing market conditions. Moreover, the efforts of market participants to satisfy these requirements could itself be destabilizing. Counterparties unable to source liquidity sufficient to meet margin calls would need to liquidate their positions (or other assets) into a stressed market, causing possibly avoidable losses. This trading activity would increase market volatility, triggering further increases in initial margin requirements.

We recognize that the Agencies have sought to reduce the likelihood that this sequence of events will occur by requiring Covered Swap Entities to calibrate initial margin models using data that already incorporates a period of significant financial stress.[24] In all but the most

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[21] Bank Proposed Rule § _.8(d)(13); CFTC Proposed Rule § 23.154(b)(3)(xiii).

[22] See Bank Proposed Rule § _.3(c); CFTC Proposed Rule §§ 23.152(a)(2) and (b)(2) (requiring daily collection/posting of initial margin).

[23] See David Murphy, Michalis Vasios and Nick Vause, "An investigation into the pro-cyclicality of risk-based initial margin models," Bank of England Financial Stability Paper No. 29 (May 2014), at p. 14.

[24] Bank Proposed Rule § _.8(d)(2); CFTC Proposed Rule § 23.154(b)(3)(ii).

extraordinary and unexpected market conditions, this requirement will mean that model recalibrations will not produce sharply increased, destabilizing initial margin requirements. Nonetheless, reducing the likelihood of a destabilizing increase in initial margin requirements is not a substitute for establishing a framework to address the situation in which the unlikely event occurs.

The EU Proposal would address this issue by requiring counterparties to establish transparent and predictable procedures for adjusting initial margin requirements in response to changing market conditions.[25] The EU Proposal would also require that these procedures allow each counterparty to post increased initial margin requirements resulting from the recalibration of a model over a period longer than one day.[26] The Agencies should adopt a similar approach.

Adopting these requirements would have many benefits. Covered Swap Entities, with supervision by the Agencies, could adopt schedules for satisfying recalibration-related increases in initial margin requirements that would limit incremental liquidity demands to levels that are realistic based on the time horizons within which they and their counterparties could satisfy increased initial margin requirements. A coordinated, and potentially centralized, governance structure could establish and regularly update a protocol or convention for these schedules, ideally in a manner that is informed by periodic studies of market capacity for increased liquidity demands over defined time horizons (*e.g.*, overnight, weekly, monthly). This protocol or convention could work in conjunction with standardized initial margin models, whose use would make it easier to predict the effect of an increase in financial stress on initial margin requirements across the market. Covered Swap Entities could then factor the liquidity demands associated with initial margin recalibration schedules into their existing liquidity contingency plans and stress tests.

3. Risk Categorization Requirements

The Proposed Rules would require a Covered Swap Entity's initial margin model to include at least the following risk categories: foreign exchange ("FX") or interest rate risk; credit risk; equity risk; agricultural commodity risk; energy commodity risk; metal commodity risk; and other commodity risk.[27] The Proposed Rules would not permit initial margin models to recognize empirical correlations across these categories.[28]

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[25] EU Proposal at Art. 3.8 MRM. The EU Proposal would otherwise require model recalibration at least once every six months, instead of monthly as would be required by the Proposed Rules. Id. at Art. 3.7 MRM.

[26] Id at Art. 3.8 MRM.

[27] Bank Proposed Rule § _.8(d)(3); CFTC Proposed Rule § 23.154(b)(3)(iii).

[28] Bank Proposed Rule § _.8(d)(5); CFTC Proposed Rule § 23.154(b)(3)(v).

a. Categorization of Risk Sensitivities vs. Products

It appears that the Agencies interpret the above provisions to require a Covered Swap Entity to categorize each of its uncleared swaps into one of the seven risk categories described above, and then to perform separate initial margin calculations for each risk category.[29] Where a swap has sensitivity to more than one risk category, the Agencies expect a Covered Swap Entity to make a determination as to which category best represents the swap based on a "holistic view" of the swap.[30]

While the approach outlined by the Agencies is one approach through which a Covered Swap Entity could ensure that its initial margin models do not recognize impermissible empirical correlations across risk categories, it is not the only approach. Another approach, which is reflected in ISDA's SBA-Margin model (as well as the BCBS-developed SBA-Capital model on which it is based),[31] is to (1) isolate and model the risk sensitivities exhibited by the products in a portfolio, (2) model the initial margin requirement associated with the sensitivity of the entire portfolio to the risk factors within each of the risk categories and (3) sum those risk category-specific initial margin requirements together. In other words, rather than assigning each product to a risk category, a Covered Swap Entity would apply separate risk category-specific calculations to the entire portfolio.

This approach would be superior to the product categorization approach because it would avoid the over-/under-estimation risk that results from assigning a product to a single risk category and ignoring the other risk sensitivities exhibited by the product. The Agencies should clarify that this approach would satisfy the rules.

Because the risk category-specific calculations described above do not incorporate correlation parameters for risk sensitivities assigned to different risk categories (*e.g.,* there is no correlation recognized between U.S. dollar rates and U.S. equities), this approach would satisfy the prohibition on recognition of cross-risk category correlations. In addition, relative to an approach based on product categorization, an approach based on categorization by risk sensitivities encourages beneficial hedging activities (*e.g.,* hedging the FX risk embedded in an equity swap through an FX transaction with the same counterparty). Encouraging this activity would reduce counterparty credit risk and liquidity demands (by reducing credit risk and initial margin requirements). In contrast, siloing products within risk categories is likely to increase liquidity demands unnecessarily either by overstating initial margin requirements relative to a portfolio's risk sensitivity or discouraging risk-reducing hedging activities. Such siloing also could result in unpredictable changes in initial margin requirements when a product's predominant risk factor changes due to changing market conditions, leading to a recategorization of that product and associated recalculation of initial margin requirements.

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[29] See Bank Proposal at 57375; CFTC Proposal at 59910.

[30] Id.

[31] BCBS, Fundamental review of the trading book: A revised market risk framework (Oct. 2013) ("BCBS Trading Book Review"), at p. 56-63.

b. Commodity Risk Categories

The Proposed Rules include four commodity risk categories instead of the single category contained in the Final BCBS-IOSCO Framework[32] and the EU Proposal.[33]

The Agencies' proposal would increase initial margin requirements for commodity swaps unnecessarily. Many of the empirical correlations across the proposed commodity risk categories are quite high, in some cases greater than correlations within the proposed categories (*e.g.,* the BCBS-developed SBA-Capital model assigns a 45% correlation parameter for base metals relative to crude oil, which is 20% higher than the correlation parameter for base metals relative to precious metals).[34] In our members' experience, although these correlations may change in magnitude over time, they rarely change in sign. As a result, it should be possible to adjust correlations within a single broad commodity risk category dynamically, rather than imposing a *per se* prohibition against recognition of certain cross-commodity correlations.

Commodity index swaps, incorporating exposures to commodities across the four commodity categories proposed by the Agencies, comprise a significant, if not the largest, category of the industry's commodity swap activity. Adopting the proposed four commodity risk categories would only increase the challenges in appropriate categorization of these products and appropriately capturing the risk sensitivities of these products. Additionally, options on such commodity indices cannot be decomposed into an economically equivalent package of individual options on the index components in each commodity category underlying the relevant index/indices. These challenges would make it difficult to capture the risk sensitivities of a Covered Swap Entity's commodity swap portfolio accurately. The correlation disparities across commodity categories that have concerned the Agencies can be addressed adequately by establishing minimum parameters for correlation recognition.

A single broad commodity risk category would also be consistent with the Final BCBS-IOSCO Framework and EU Proposal. That consistency is important to competitive parity and to avoid fragmentation in the commodity swap market. It would also facilitate use of standardized models because it would not require market participants to use different versions of those models depending on the jurisdiction(s) in which the parties to a swap are located. Accordingly, the Agencies should revert to the single commodity risk category contemplated by the Final BCBS-IOSCO Framework.

4. Collateral Haircuts

The Proposed Rules would require Covered Swap Entities to apply haircuts to eligible collateral based on a standardized table.[35] In contrast, both the Final BCBS-IOSCO Framework and the EU Proposal would permit calculation of collateral haircuts using approved models.[36]

[32] Final BCBS-IOSCO Framework at p. 12.

[33] EU Proposal at Art. 4.2 MRM.

[34] BCBS Trading Book Review at p. 76.

Requiring standardized collateral haircuts in the United States would present the prospect of higher transaction costs vis-à-vis the European Union and other jurisdictions that follow the Final BCBS-IOSCO Framework, with attendant competitive impacts and market fragmentation that conflict with the Agencies' objectives.

Standardized collateral haircuts would also result in initial margin requirements that less accurately reflect the risk of collateral assets. Although the volatility of a collateral asset changes over time, standardized collateral haircuts are static. In addition, standardized collateral haircuts do not take account of the relationship between posted collateral assets and the exposures they collateralize.[37] For example, if a Covered Swap Entity entered into an equity swap with a counterparty that pledged the stock underlying that swap, a decrease (increase) in the value of the stock would always correspond to a decrease (increase) in the amount of the Covered Swap Entity's current exposure. Under the Proposed Rules, however, the Covered Swap Entity would still be required to collect an amount of stock in excess of 15-25% of its potential future exposure under the equity swap.

Model-based haircuts that are integrated into a Covered Swap Entity's overall initial margin calculation would take these factors into account. They would also enable Covered Swap Entities to model the risk arising from currency mismatches between margin collateral and credit exposures in a more risk-sensitive manner than applying the fixed 8% haircut that the Agencies have proposed to apply to such mismatches.[38] As an example, a Covered Swap Entity using the risk sensitivity categorization approach described in Part I.A.3.a above could add the rights/obligations embedded in its initial margin collateral into its initial margin model as though they were transaction rights/obligations and then compute the FX risk sensitivity of its credit exposure and initial margin collateral together. If there were a currency mismatch between the Covered Swap Entity's credit exposure and initial margin collateral, the Covered Swap Entity's initial margin requirement would increase due to the overall portfolio's greater FX risk sensitivity.

Permitting recognition of these correlations would enable parties to mitigate the risk of a currency mismatch by executing an FX transaction that has the effect of hedging the currency mismatch. In contrast to the 8% currency mismatch haircut, this approach to the mitigation of risk associated with currency mismatches would be more collateral efficient, without increasing

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[35] Bank Proposed Rule § _.6(b); CFTC Proposed Rule § 23.156(a)(3)(ii).

[36] See Final BCBS-IOSCO Framework at p. 17 and EU Proposal at Art. 2.1 HC.

[37] We recognize that the EU Proposal would likewise prohibit recognition of these relationships. See EU Proposal at Art. 2.3 HC. In our comment letter on the EU Proposal, we asked that the European supervisory authorities modify this aspect of their proposal. Our comment letter is available at http://www.sifma.org/issues/item.aspx?id=8589949919.

[38] Additionally, the fixed 8% haircut would appear to require Covered Swap Entities to associate collateral assets with particular swap positions. This requirement would not be consistent with the calculation and collection of margin across all swaps subject to an eligible master netting agreement.

risk. The mitigation of currency risk through currency hedges would also give rise to less operational and settlement risk than increasing the number of margin movements in order to post collateral denominated in the same currency as underlying swap exposures.

B. Inter-Affiliate Swaps[39]

The Proposed Rules would apply initial margin requirements to uncleared swaps between a Covered Swap Entity and an affiliate that is another Swap Entity or a financial end user with a material swaps exposure.[40] These requirements were not part of the Final BCBS-IOSCO Framework, nor are they part of the EU Proposal.

Inter-affiliate initial margin requirements would have several adverse consequences. They would significantly increase the amount of liquid collateral required to be segregated. In this regard, we note that the BCBS-IOSCO quantitative impact study that served as the basis for the Agencies' cost-benefit analyses did not address the liquidity impact of requiring initial margin for inter-affiliate swaps. That study also was premised on the application of initial margin thresholds that generally would not apply to inter-affiliate swaps because those thresholds would apply on a consolidated basis. At a minimum, the Agencies should engage in a quantitative analysis of the liquidity burden of inter-affiliate initial margin requirements before adopting any such requirements.

While inter-affiliate initial margin requirements would have significant costs, they would not have a corresponding benefit in the mitigation of contagion risk. For example, consider a U.S. Covered Swap Entity that sells a €200 million notional credit default swap on a European company to a U.S. counterparty and hedges that swap by buying a mirror €200 million notional swap from a U.K. affiliate that is already long €100 million notional in protection on that company. The U.K. affiliate then hedges itself by buying an additional €100 million notional in protection from a third party. Assuming that initial margin requirements for these transactions equal approximately 4% of notional, the Covered Swap Entity's group would post €16 million in initial margin to third parties but would also have to segregate an additional €16 million in initial margin for the inter-affiliate transaction, doubling the liquidity burden and exposing the group to custodial risk where none would have existed otherwise.

The cost of funding this inter-affiliate margin could discourage the management of risk through inter-affiliate swaps. Discouraging these transactions would increase group-wide credit risk by increasing the extent to which Covered Swap Entities must trade with third parties (likely other Swap Entities) to hedge their market risk exposures. For example, in the fact pattern described above, instead of trading with each other, the U.S. Covered Swap Entity might buy €200 million notional in protection from a third party and its U.K. affiliate might sell €100 million in protection to a third party. Although trading in this manner would reduce the group's

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[39] In connection with our comments in this section, we also support the comments made by The Clearing House and ABA Securities Association with respect to inter-affiliate swaps.

[40] See Bank Proposal at 57359; CFTC Proposal at 59904.

liquidity burden by €8 million, it would increase group-wide credit exposure to third parties by €200 million notional. These examples illustrate the need for a cost-benefit analysis of the proposed inter-affiliate swap margin proposal based on the quantitative analysis recommended above.

It is possible that affiliates may choose to enter into cleared rather than uncleared swaps with each other as a result of applying higher initial margin requirements to uncleared swaps. However, doing so would introduce basis risk (absent a fungible cleared substitute for the uncleared swap) and would not address the fundamental problem that subjecting inter-affiliate swaps to initial margin requirements would significantly increase costs and liquidity demands without significant outward-facing risk-mitigation benefits. Additionally, if each affiliate is a self-clearing member, clearing inter-affiliate swaps would also increase group-wide exposure to the central counterparty ("CCP") significantly, potentially in excess of applicable single counterparty credit limits. If one affiliate clears through the other (or through a third affiliate), then central clearing would not reduce inter-affiliate credit risk, but it would still give rise to CCP risk. These outcomes would not promote the safety and soundness of Covered Swap Entities.

Applying initial margin requirements to inter-affiliate swaps is not necessary to achieve the Proposed Rules' objectives. Inter-affiliate swaps are generally not a vector for the transmission of systemic risk beyond a corporate group. They also do not increase group-wide leverage. Applying variation margin and credit risk capital requirements to a Covered Swap Entity's swaps with its affiliates would mitigate most of the Covered Swap Entity's credit risk to its affiliates without resulting in undue liquidity burdens or creating artificial incentives to execute swaps with third parties. In addition, as noted by the CFTC when it exempted inter-affiliate swaps from mandatory clearing, common ownership and consolidated risk management create incentives for one affiliate to perform to the other that do not exist in the context of swaps with third parties;[41] the Proposed Rules would not account for those incentives and would undermine that exemption.

The proposed application of initial margin requirements to inter-affiliate transaction was based on Section 23B of the Federal Reserve Act, which requires that many transactions between a bank and certain of its affiliates be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with unaffiliated companies.[42] Section 23B does not, however, provide a cogent rationale for the proposed inter-affiliate initial margin requirements. Section 23B applies special protections to Federal Reserve member banks and their subsidiaries because of their access to the Federal safety net, but not all Covered Swap Entities have such access. Also, as noted by the Prudential Regulators, Section 23B does not apply to transactions

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[41] Clearing Exemption for Swaps Between Certain Affiliated Entities, 78 Fed. Reg. 21750, 21753 (Apr. 11, 2013) ("CFTC Inter-Affiliate Release").

[42] See id.

between a bank and its operating subsidiaries. In contrast, the Proposed Rules would.[43] Section 23B requires a bank to transact on terms and under circumstances that are "at least as favorable" as those prevailing at the time for comparable transactions with third parties. Requiring a Bank Swap Entity to post initial margin to its affiliates would stand Section 23B on its head.

For the foregoing reasons, the Agencies should instead adopt an exception from initial margin requirements for inter-affiliate swaps in circumstances where the following conditions are satisfied: (1) the swaps are subject to a group-wide, consolidated risk management program designed to monitor and manage the risks of the inter-affiliate swaps, (2) the parties to the swaps comply with variation margin requirements and (3) the Covered Swap Entity's group is subject to consolidated capital requirements consistent with the Basel Accords. These conditions should be sufficient to ensure that the inter-affiliate swaps excluded from initial margin requirements are undertaken for *bona fide* risk management purposes and do not give rise to undue risk.

We understand that the Agencies may believe that additional conditions are necessary to ensure that U.S. Covered Swap Entities cannot employ cross-border inter-affiliate swaps as a means to evade compliance with initial margin requirements for their uncleared swaps with foreign counterparties. A similar consideration led the CFTC to adopt an "outward-facing swap" condition to its inter-affiliate clearing exemption. Under that condition, each affiliate relying on the exemption must, with respect to its swaps with third parties, comply with U.S. clearing requirements (or an exception thereto), comply with comparable foreign clearing requirements (or an exception thereto) or voluntarily clear those swaps.[44]

Recognizing that this outward-facing swap clearing condition could inappropriately discourage inter-affiliate swaps with affiliates located in jurisdictions that had not adopted clearing requirements,[45] the CFTC adopted an alternative condition premised on the exchange of variation margin between affiliates.[46] To-date, market participants have generally relied on this alternative condition, instead of the outward-facing swap condition. The framework proposed above for uncleared inter-affiliate swaps would thus be consistent with the manner in which market participants have complied with the CFTC's inter-affiliate clearing exemption.

Accordingly, we do not believe it is necessary to adopt an outward-facing swap condition to an inter-affiliate exception from initial margin requirements. Nevertheless, if the Agencies adopt such a condition, then the condition should not apply to a Covered Swap Entity's swaps with affiliates located in emerging market jurisdictions that have not adopted comparable OTC margin requirements. Although the volume and risk of such swaps is generally not material to

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[43] Bank Proposal at 57359.

[44] See CFTC Regulations § 50.52(b)(4)(i), 17 C.F.R. § 50.52(b)(4)(i).

[45] CFTC Inter-Affiliate Release at 21763-66.

[46] See id. Although this alternative condition was due to expire March 11, 2014, the CFTC has extended its duration to December 31, 2015. See CFTC No-Action Letter Nos. 14-25 (Mar. 6, 2014) and 14-135 (Nov. 7, 2014)).

Covered Swap Entities, the ability to enter into such swaps is important to permit Covered Swap Entities to manage their emerging market risks. Under this approach, to rely on an exception from initial margin requirements for inter-affiliate swaps, each affiliate relying on the exception would, for its uncleared swaps with third parties, be required either to (1) comply with the Proposed Rules in connection with those swaps or (2) be organized in a jurisdiction, or entering into uncleared swaps with third parties organized in jurisdictions, for which the Prudential Regulators or the CFTC, as applicable, have made a comparability determination, subject to an exception for swaps with non-U.S. affiliates the aggregate notional volume of which is less than 5% of the Covered Swap Entity's total notional volume of uncleared swaps, measured in U.S. dollar equivalents and calculated for each calendar quarter.

The Agencies should also clarify that the proposed phase-in thresholds and "material swaps exposure" definition exclude inter-affiliate transactions. Those thresholds apply on a consolidated basis, thereby measuring notional exposures on a group-wide basis. Inter-affiliate transactions, however, neither affect group-wide exposures nor contribute to systemic risk. Including them in these thresholds would discourage the use of inter-affiliate transactions for the management of risk, especially if inter-affiliate transactions are double-counted in the thresholds by summing each affiliate's transactional volume in gross.

C. Material Swaps Exposure

The Proposed Rule would define "material swaps exposure" as $3 billion in average monthly gross notional amount of swaps, SBS, FX swaps and FX forwards,[47] instead of the €8 billion month-end gross notional amount threshold contained in the Final BCBS-IOSCO Framework and the EU Proposal[48] – a decrease of nearly 75%. In the Proposed Rules, the Agencies explain that the lower threshold is based on a rough comparison of the amount of margin required for certain cleared swap portfolios against the proposed $65 million initial margin threshold.[49] Based on this comparison, the Agencies expressed concern that the Final BCBS-IOSCO Framework's €8 billion aggregate gross notional threshold would exclude financial end users whose initial margin requirements would exceed the $65 million threshold.[50] The Agencies also proposed that Swap Entities would be subject to initial margin requirements regardless of whether they had a material swaps exposure.

In our view, further analysis is warranted before the Agencies adopt a volume-based exception to initial margin requirements that is different from the one that will apply in other jurisdictions. The Agencies also have time to conduct this analysis because the exception will not become relevant until the last compliance date for initial margin requirements. The Agencies

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[47] As a result of a determination by the Secretary of the Treasury, FX swaps and FX forwards are not otherwise defined as "swaps" for purposes of the Proposed Rules.

[48] See Final BCBS-IOSCO Framework at p. 8 and EU Proposal at Art. 1.3 FP.

[49] See Bank Proposal at 57366-68 and CFTC Proposal at 59904-06.

[50] See id.

therefore should defer adoption of a final volume-based exception until after they have completed a study of the liquidity and cost impact of different exceptions and a related cost-benefit analysis. This approach would be similar to the one taken by the CFTC when it adopted its final swap dealer *de minimis* exception.[51]

Deferring adoption of a final volume-based exception would allow the Agencies to define that exception based on an analysis of data obtained following the effectiveness of OTC margin requirements. By analyzing this data, the Agencies could better estimate the level of initial margin requirements likely to apply to financial end users with different levels of monthly aggregate gross notional trading activity (*e.g.,* $3 billion, $8 billion, $11 billion). This data would address the following factors not covered by a review of cleared swap margin data: (1) the level of OTC initial margin requirements, which as noted by the Agencies is likely to be higher than initial margin requirements for cleared swaps and (2) the number of Swap Entities with which a given financial end user trades, which will address the fact that a financial end user trading with multiple Swap Entities is likely to face lower initial margin requirements vis-à-vis each individual Swap Entity than if the financial end user limited its trading to a single Swap Entity.[52]

In addition to determining whether a financial end user is likely to face initial margin requirements in excess of the $65 million threshold, we believe the Agencies should also take into account the following other considerations relevant to the "material swaps exposure" definition:

- The amount of initial margin in excess of the $65 million threshold that financial end users whose trading volume exceeds different thresholds (*e.g.*, $3 billion, $8 billion, $11 billion) would be required to collect/post. Financial end users who face initial margin requirements only slightly in excess of $65 million are still unlikely to pose significant systemic risk;

- The aggregate liquidity impact of applying initial margin requirements to a larger number of financial end users, both during normal market conditions and during a period of significant financial stress. This analysis should account for the "leveraging" effect that the initial margin threshold has on procyclical increases in initial margin. For example, a 50% increase in a financial end user's initial margin requirements from $80 million to $120 million will, in the case of a $65 million threshold, lead to a 266% increase in the amount of initial margin collected/posted by the financial end user. As a result, subjecting a large number of financial end users whose initial margin requirements would slightly exceed $65 million to those requirements would magnify the liquidity burden

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[51] See CFTC Regulations § 1.3(ggg)(4)(ii), 17 C.F.R. § 1.3(ggg)(4)(ii).

[52] For example, a financial end user that has entered into $2 billion notional amount of swaps with each of five Covered Swap Entities (for an aggregate notional amount of $10 billion) would not, based on the Agencies' assumption that initial margin equals 2% of notional amount, be required to post or collect initial margin because the financial end user's initial margin amount vis-à-vis each Covered Swap Entity would only be $40 million (*i.e.*, less than the $65 million initial margin threshold).

associated with increased initial margin requirements during a period of financial stress, without risk mitigation benefits of corresponding significance;

- The operational costs to financial end users and Covered Swap Entities of complying with initial margin requirements;
- The number of Swap Entities that might fall below the different trading volume thresholds under consideration for incorporation into the final "material swaps exposure" definition, given that Swap Entities would be eligible for the parallel volume-based exceptions in the Final BCBS-IOSCO Framework and EU Proposal;
- The potential competitive impact of adopting a final volume-based exception from initial margin requirements that incorporates a different level (*e.g.*, \$3 billion vs. €8 billion) and applies to a different scope of market participants (*i.e.*, financial end users but not Swap Entities) than the exceptions adopted in other jurisdictions; and
- The overall costs and benefits of different volume-based exceptions from initial margin requirements.

II. Timing of Margin Collection and Posting

The Proposed Rules would require a Covered Swap Entity to collect and post initial margin on each business day beginning on or before the business day following the day on which it enters into an uncleared swap with a Swap Entity or a financial end user that has a material swap exposure.[53] The Bank Proposal would also require a Bank Swap Entity to collect or pay variation margin on each business day beginning on the day it enters into an uncleared swap with a Swap Entity or a financial end user; in contrast, the CFTC Proposal would require a Non-Bank Swap Entity to collect or pay variation margin on or before the business day after execution of an uncleared swap with a Swap Entity or financial end user.[54]

A. Time Zone Differences

These provisions require further clarification in order to account for the global character of the uncleared swap markets. It is very common for counterparties located in different time zones to trade with each other. Often, one counterparty's "back office" personnel will be located in a different time zone from the other counterparty's. Different jurisdictions also have different holiday calendars.

The CFTC faced a similar issue when it adopted final confirmation rules for swap dealers and major swap participants. To address that issue, the CFTC defined the "day of execution" to mean the calendar day of the party to the swap that ends latest, provided that, if a swap is entered into (1) after 4:00 p.m. in the place of a party or (2) on a day that is not a business day in the

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[53] Bank Proposed Rule § _.3(c); CFTC Proposed Rule §§ 23.152(a) and (b).

[54] Bank Proposed Rule §§ _.4(a) and (b); CFTC Proposed Rule §§ 23.153(a) and (b).

place of a party, then such swap shall be deemed to have been entered into by that party on the immediately succeeding business day of that party and the day of execution shall be determined with reference to such business day.[55] The Agencies should adopt the same definition for purposes of the margin timing requirements described above.

B. Margin Settlement Mechanics

The Agencies should also clarify that the timing requirements described above refer to the deadline by which a Covered Swap Entity and its counterparty must have made their respective margin calls, with the Covered Swap Entity (or its counterparty, as applicable) required to receive the margin promptly thereafter. In this context, "prompt" receipt of margin should mean that the Covered Swap Entity (or its counterparty, as applicable) has received the margin by no later than the conclusion of the regular way settlement timeframe for the relevant collateral asset (*e.g.,* T+1 for the local currency of counterparties located in the same jurisdiction, T+2 for most other currencies, T+3 for most U.S. equities and corporate bonds). This clarification would address the need for collateral transfers to proceed through the relevant payment and securities settlement systems.

In addition, to address time zone differences in the context of margin settlements as well as margin calls, the settlement timeframe should commence on the "margin call day," a term that should be defined to mean the calendar day that a party receives a margin call, provided that, if a party receives a margin call (1) after 4:00 p.m. in the location of the party or (2) on a day that is not a business day in the location of the party, then it will be deemed to have received the margin call on the immediately succeeding business day of that party and the margin call day shall be determined with reference to such business day.

C. Margin Calculation Processes

The Agencies should address the time needed to complete the margin calculation process. We recognize that calling for initial margin on a T+1 basis would have risk management benefits and agree that it is the appropriate end state. Many firms are currently working to build the necessary infrastructure and operational capabilities to reach that target. Nonetheless, substantial infrastructural and operational enhancements are necessary to satisfy this timeline. As the Agencies are aware, initial margin calculations are data- and computationally-intense processes requiring iterative, time-consuming batch processes that can run throughout the night. If there are outstanding margin discrepancies with a counterparty, and in order to comply with the CFTC's daily portfolio reconciliation requirements applicable to the largest swap portfolios, it will be necessary to run and complete time-consuming portfolio reconciliation processes before end-of-day margin computations can be commenced. The industry is concerned that the enhancements necessary to facilitate initial margin calls that are consistently made within a T +1 timeframe will not be completed by the effective date of the initial margin requirements. In light

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[55] CFTC Regulations § 23.501(a)(5)(i), 17 C.F.R. § 23.501(a)(5)(i). The CFTC also defined "business day" to mean any day other than Saturday, Sunday or a legal holiday. CFTC Regulations § 23.501(a)(5)(ii), 17 C.F.R. § 23.501(a)(5)(ii).

of these considerations, we recommend that the Agencies, as a preliminary measure, require Covered Swap Entities to call for initial margin for newly executed swaps on a T+2, rather than a T+1, basis As initial margin requirements come into effect, the Agencies should monitor and evaluate the industry's operational capacity and at that time establish an appropriate transition period within which to accelerate initial margin calls to a T+1 timeframe.

The Agencies also should not require variation margin calls for newly executed swaps until T+1, which is necessary to permit Covered Swap Entities to calculate variation margin on a net, portfolio-wide basis taking into account the effect of a newly executed swap on the overall portfolio.

III. Dispute Resolution and Margin Documentation

The Proposed Rules provide that a Covered Swap Entity would not be deemed to have violated its obligation to post or collect margin from a counterparty if (1) the counterparty has refused or otherwise failed to provide or accept the required margin to or from the Covered Swap Entity and (2) the Covered Swap Entity has (a) made the necessary efforts to collect or post the required margin, including the timely initiation and pursuit of formal dispute resolution mechanisms (or has otherwise demonstrated upon request to satisfaction of the relevant Agency that it has made appropriate efforts to collect or post the required margin) or (b) commenced termination of the uncleared swap with the counterparty following the applicable cure period and notification requirements.[56]

A. Dispute Resolution

Consistent with the U.S. implementation of Basel capital rules, which recognize industry margin dispute resolution protocols,[57] the Agencies should recognize those protocols as the type of "formal dispute resolution mechanisms" envisioned by the provisions described above. The Agencies should also clarify that a Covered Swap Entity would not be deemed to have violated its obligations to maintain sufficient margin if it releases margin to a counterparty at the conclusion of such a dispute resolution mechanism.

B. Margin Documentation

The Bank Proposal also would require that margin documentation specify the "methods, procedures, rules and inputs" for determining the value of each uncleared swap for purposes of calculating variation margin requirements.[58] The CFTC Proposal, in contrast, would require that margin documentation specify the "methodology and data sources" to be used to

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[56] Bank Proposed Rule § _.5(b); CFTC Proposed Rule §§ 23.152(c) and 153(d).

[57] See Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62018 (Oct. 11, 2013) at 62110. Examples of these protocols include ISDA's Convention on Portfolio Reconciliation and Investigation of Disputed Margin Calls and Formal Market Polling Procedure.

value uncleared swaps and collateral and to calculate initial and variation margin requirements.[59] The CFTC Proposal also would require that a Non-Bank Swap Entity create and maintain documentation setting forth its variation margin methodology with sufficient specificity to allow the counterparty, the CFTC and any applicable Prudential Regulator to calculate a reasonable approximation of the margin requirement independently.[60] Both proposals would require that margin documentation specify the procedures by which any disputes concerning the valuation of uncleared swaps or of assets collected or posted as margin may be resolved.

We believe that the Bank Proposal's margin documentation requirements would support beneficial documentation practices, including adherence to the industry dispute resolution conventions described above, in a manner consistent with existing CFTC documentation rules.[61] We also support a requirement that Covered Swap Entities have detailed internal valuation (and price verification) procedures describing their valuation methodologies and data sources.

We note, however, that the CFTC Proposal could be read to go further, requiring that parties lock in, either at the inception of their trading relationship or upon the relevant compliance date for OTC margin requirements, dispositive valuation methods (as opposed to agreed steps and processes for arriving at valuations).[62] It is important that the CFTC clarify that it is not adopting such a requirement. Such a requirement would be wholly impractical given the judgment inherent in modeling the valuation of swaps. Moreover, such a requirement is undesirable, creating strong disincentives to changing valuation methodologies (because such changes would require renegotiating margin documentation) and artificially limiting *bona fide* disputes and thus the flow of valuable information about disputes to regulators. Divergent views over swap valuation cannot and should not be regulated out of existence. Such disagreements should instead be addressed through the type of dispute resolution procedures described above, as well as portfolio reconciliation and dispute reporting requirements already applicable under

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[58] Bank Proposed Rule § _.10(a)(2).

[59] CFTC Proposed Rule § 23.158(b).

[60] CFTC Proposed Rule § 23.155(b)(1).

[61] See CFTC Regulations § 23.504(b)(4), 17 C.F.R. § 23.504(b)(4) (requiring swap dealers and major swap participants to include, as part their swap trading relationship documentation with financial entities, written documentation in which the parties agree on the process, which may include any agreed upon methods, procedures, rules, and inputs, for determining the value of each swap, which documentation must include either (a) alternative methods for determining the value of the swap in the event of the unavailability or other failure of any input required to value the swap or (b) a valuation dispute resolution process).

[62] In this respect, the CFTC Proposal appears to be similar to certain aspects of its original swap trading relationship documentation proposal that the CFTC ultimately decided not to adopt. See Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904, 55910-13 (Sept. 11, 2012) (discussing comments received on the CFTC's original proposal and changes made by the CFTC in response to those comments). SIFMA's comments on the CFTC's valuation documentation proposal can be found at http://www.sifma.org/issues/item.aspx?id=24546.

CFTC rules.[63] Accordingly, the CFTC should clarify that it is not requiring parties to agree, as part of their margin documentation, to dispositive valuation methods.

IV. Eligible Variation Margin

In contrast to the Final BCBS-IOSCO Framework and the EU Proposal, the Proposed Rules would limit variation margin to U.S. dollars or the currency in which payment obligations under the swap are required to be settled.[64]

We support the industry initiatives referenced by the Agencies in describing the cash-only variation margin requirement.[65] However, we do not believe it would be appropriate for the Agencies to mandate this limitation. Many financial end users (such as pension plans, insurance companies and mutual funds) do not generally maintain levels of cash sufficient to satisfy variation margin requirements for uncleared swaps. As a result, these financial end users would likely need to rely on so-called "collateral transformation" arrangements, such as committed repo lines, to comply with variation margin requirements. These arrangements would increase the extent of interconnections within the financial system, forcing financial end users to incur credit exposure to banks and broker-dealers. The costs of these arrangements can also be quite significant, in part to account for the increased capital requirements associated with committed credit lines. These costs could lead financial end users to avoid hedging through uncleared swaps, exposing pensioners, policyholders and fund investors (including retail investors) to increased volatility and potential losses.

The proposed limitation of variation margin to cash would also prevent a collecting party from recognizing excess initial margin in lieu of collecting variation margin. For example, if a counterparty has posted initial margin with a post-haircut value that exceeds the applicable initial margin requirements by more than the most recent mark-to-market decrease in the value of its positions, such that the positive net "equity" in the counterparty's account is greater than the initial margin requirement, the counterparty would not need to post variation margin.[66] In contrast, under the Proposed Rules, the counterparty would post variation margin while simultaneously calling for the return of its excess initial margin. These transfers introduce unnecessary operational and settlement costs and risks.

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[63] See CFTC Regulations § 23.502, 17 C.F.R. § 23.502.

[64] Bank Proposed Rule § _.6(a)(1); CFTC Proposed Rule § 23.156(b). We have assumed that "the currency in which payment obligations under the swap are required to be settled" is intended to have the same meaning as the "currency of settlement" for purposes of recently finalized supplementary leverage ratio rules, which define that term to mean "any currency for settlement specified in the governing qualifying master netting agreement and the credit support annex to the qualifying master netting agreement." See Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio, 79 Fed. Reg. 57723, 57741 (Sept. 26, 2014). The Agencies should confirm this interpretation.

[65] See Bank Proposal at 57371; CFTC Proposal at 59913 (citing the 2013 Standard Credit Support Annex).

[66] This manner of calculating margin requirements is common in the case of prime brokerage arrangements.

Because cash-only variation margin is not a requirement under the Final BCBS-IOSCO Framework or the EU Proposal, the proposed limitation would also introduce unnecessary cross-border disparities in the cost of variation margining swaps. These disparities are likely to discourage cross-border trading and put U.S.-based Covered Swap Entities and financial end users at a competitive disadvantage.

We also do not regard analogies to cleared swaps as a sufficient basis for limiting variation margin to cash.[67] Many uncleared swaps hedge bespoke risks, meaning that those swaps are not a substitute for cleared swaps and imposing limitations on those swaps similar to those applicable to cleared swaps would not promote central clearing. In addition, as acknowledged by the Prudential Regulators,[68] under New York law, variation margin does not constitute settlement of current exposure between the counterparties and, indeed, some financial end users (such as mutual funds) require segregation of variation margin to reflect their retained ownership of the assets they post.[69]

For the foregoing reasons, the Agencies should not restrict variation margin to cash, but should permit parties to satisfy variation margin requirements using the full range of collateral assets otherwise specified in the Proposed Rules, including collateral posted as initial margin with a post-haircut value that exceeds applicable initial margin requirements. At a minimum, if the Agencies do not permit non-cash variation margin more broadly, they should permit it for swaps between a Covered Swap Entity and a financial end user.[70]

V. Covered Products; Portfolio Margin and Cross-Margin Arrangements

A. Portfolio Margin Arrangements

The Bank Proposal would apply to all uncleared swaps and SBS entered into by Bank Swap Entities, but the CFTC Proposal would apply to uncleared swaps (but not SBS) entered into by Non-Bank Swap Entities. Neither proposal would apply to FX swaps or FX forwards, although bank supervisory guidance would require variation margin for such products.[71] Nor would the Proposed Rules apply to uncleared securities options, which instead are generally

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[67] See CFTC Proposal at 59913 (analogizing to variation margin for cleared swaps).

[68] Bank Proposal at 57369.

[69] While mutual funds have no-action relief permitting them to post margin for cleared swaps (including variation margin) to futures commission merchants and derivatives clearing organizations in manner consistent with CFTC rules, they do not have such relief for uncleared swaps.

[70] As noted above, cash variation margin requirements would present particular difficulties and costs for financial end users, such as pension plans, insurance companies and mutual funds, who, for operational and fiduciary reasons, typically do not maintain un-invested cash.

[71] See, e.g., Managing Foreign Exchange Settlement Risks for Physically Settled Transactions, SR 13-24 (Dec. 23, 2013).

subject to the Board's Regulation T (if entered into by a broker-dealer) or Regulation U (if entered into by a bank).

While these limitations on the scope of products covered by the Proposed Rules are consistent with limitations on the Agencies' authority under Dodd-Frank, they are not tied to any identifiable policy objective. Rather, they would prohibit portfolio margining of risk-correlated products subject to legally enforceable netting arrangements,[72] unnecessarily increasing collateral requirements (where there is no corresponding risk). They also would lead to competitive disparities, both between different types of Swap Entities within the United States and between U.S. Swap Entities and Swap Entities domiciled abroad.

We have summarized below the key issues raised by these product limitations and recommendations for addressing those issues:

- ***FX Swaps and FX Forwards***. As noted above, bank supervisory guidance generally subjects FX swaps and FX forwards to variation margin requirements. Such products would also be subject to variation margin requirements under the EU Proposal. They also may offset the risk of covered products, such as FX options. To promote greater risk sensitivity and consistency with requirements under other regimes, the Agencies should permit a Covered Swap Entity to recognize offsets between FX swaps and FX forwards, on the one hand, and uncleared swaps, on the other hand, provided that the transactions are subject to the same eligible master netting agreement and such offsets are otherwise permissible under the proposed risk categorization requirements.

- ***Uncleared Swaps and SBS***. As proposed, a Bank Swap Entity could portfolio margin uncleared swaps with uncleared SBS governed by the same eligible master netting agreement, but a Non-Bank Swap Entity could not. This difference would give Bank Swap Entities (as well as foreign dealers not subject to the Proposed Rules) an unwarranted competitive advantage over Non-Bank Swap Entities. To address this issue, the CFTC should permit a Non-Bank Swap Entity that is dually registered with the Securities and Exchange Commission ("SEC") as an SBS dealer or major SBS participant to recognize offsets between uncleared swaps and uncleared SBS, provided that the transactions are subject to the same eligible master netting agreement and the Non-Bank Swap Entity may hold the positions and associated collateral together pursuant to rules or an exemption adopted by the SEC. The CFTC should also adopt an exception from its OTC margin requirements for uncleared swaps entered into by such a dually registered Non-Bank Swap Entity, provided that the swaps are subject to the same eligible master netting agreement as uncleared SBS and portfolio margined with those SBS pursuant to rules or an exemption adopted by the SEC.

- ***Uncleared Securities Options***. As noted above, the Final BCBS-IOSCO Framework and the EU Proposal would subject uncleared securities options to OTC margin requirements.

[72] We discuss certain issues raised by the Proposed Rules' requirements relating to eligible master netting agreements below in Parts VIII and IX.B.1 of this letter and Annex A.

In addition, it is not uncommon for market participants to enter into uncleared equity options as part of a single portfolio with equity swaps. Requiring separate margin calculations for these products would increase margin requirements unnecessarily. Accordingly, the Agencies should permit a Covered Swap Entity to recognize offsets between uncleared securities options, on the one hand, and uncleared swaps and SBS, on the other hand, provided that the transactions are subject to the same eligible master netting agreement, such offsets are otherwise permissible under the proposed risk categorization requirements and, in the case of a Non-Bank Swap Entity, the Non-Bank Swap Entity may hold the positions and associated collateral together pursuant to rules or an exemption adopted by the SEC.[73]

- ***Physical Commodity Forwards***. Physical commodity forwards are generally not considered "derivatives" subject to OTC margin requirements, and they are excluded from Dodd-Frank's "swap" definition. Covered Swap Entities do, however, commonly enter into physical commodity forwards as part of a portfolio of commodity swap and option positions that will be subject to OTC margin requirements. Where these positions are all subject to the same eligible master netting agreement, the Agencies should permit a Covered Swap Entity to recognize offsets between physical commodity forwards and covered swap and option positions.

B. Cross-Margin Arrangements

Clearing mandates will force the break-up of netting sets by requiring that some classes of swaps be centrally cleared through clearing brokers while others remain subject to bilateral netting agreements. Yet, in many cases, a Covered Swap Entity that trades uncleared swaps with a financial end user will also act as that financial end user's clearing broker or be affiliated with the clearing broker. In these cases, the Covered Swap Entity's group-wide credit risk is affected by the full range of these relationships, not just the uncleared swap trading relationship.

Market participants currently use arrangements to cross-margin cleared swap and futures exposures and uncleared swap exposures. These arrangements are structured to ensure the availability of required levels of margin to CCPs and clearing brokers. Under these arrangements, the clearing broker collects the full amount of margin required under applicable CCP rules (the amount collected is not reduced as a result of offsetting uncleared exposures or as a result of collateral held away from the clearing broker). The customer grants its uncleared swap counterparty (which may be the clearing broker or a dealer affiliate) a subordinated lien on the customer's rights to the margin in its clearing broker account (*i.e.*, the uncleared swap counterparty is entitled to the amount that remains after satisfaction of all CCP, clearing broker and, in the clearing broker's insolvency, other customer claims) to secure its uncleared swap exposures. The posting customer's uncleared swap counterparty calculates its OTC initial margin requirement for the customer taking into account offsets between those swaps and the

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[73] For similar reasons, the Agencies should permit the recognition of offsets against cash securities positions held by a Covered Swap Entity that is registered with the SEC as a broker-dealer or acting as a securities dealer and exempt from registration under applicable SEC rules.

customer's cleared positions in the same risk category that it holds in the clearing broker's account, and then collects initial margin from the customer equal to the excess of that OTC initial margin requirement over the margin that the customer is separately required to post (and has posted) to the clearing broker. These arrangements ensure that, in the event of default, the CCP and clearing broker(s) and, to the extent of their statutory entitlements, customers, would be paid in full with the cleared position initial margin and that any excess margin would be available (subject to the prior claims of the CCP, clearing broker and, in the clearing broker's insolvency, other clearing customers) to satisfy the claim of the customer's uncleared swap counterparty.

Similar arrangements are also commonly used in other areas, such as to cross-margin uncleared swaps and related cash positions (margin loans and short positions in prime brokerage arrangements), repo and/or securities lending positions. These arrangements likewise ensure that the prime broker or repo/securities loan counterparty and, to the extent of their statutory entitlements, customers, would be paid in full with the cash securities, repo or securities loan margin posted.

Recognition of these arrangements, where legally enforceable,[74] would promote effective group-wide credit risk management and reduce the liquidity impact of clearing and OTC margin requirements without diminishing the protection of CCPs, clearing/prime brokers, customers or Covered Swap Entities. Accordingly, the Agencies should permit Covered Swap Entities to recognize offsets between uncleared swaps and positions covered by a legally enforceable cross-margining arrangement when calculating OTC initial margin requirements.

VI. Segregation Requirements

The Proposed Rules would require initial margin collateral posted by a Covered Swap Entity to be held by one or more custodians that are not affiliates of the Covered Swap Entity or its counterparty.[75] The Proposed Rules would require a Covered Swap Entity to hold the initial margin it is required to collect at such a custodian.[76] The Proposed Rules would further require that the custodial agreements applicable to such arrangements prohibit the custodian from rehypothecating or otherwise transferring the collateral, except to permit the posting party to substitute the collateral with, or invest the collateral in, assets that qualify as eligible collateral

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[74] Relevant provisions to the legal enforceability of these arrangements would include: (i) cross-default and close-out netting upon the occurrence of a customer default; (ii) ability to apply excess collateral, following a customer default, against amounts owed by a clearing/prime broker customer to the Covered Swap Entity under uncleared swaps; and (iii) in the case of cross-entity master agreements, the ability to apply receivables collateral owed to the customer against amounts owed by the customer to the clearing/prime broker.

[75] Bank Proposed Rule § _.7(a); CFTC Proposed Rule § 23.157(a).

[76] Bank Proposed Rule § _.7(b); CFTC Proposed Rule § 23.157(b).

under the Proposed Rules and for which the market value, less applicable haircuts, would be sufficient to satisfy the required minimum amount of initial margin.[77]

Because Dodd-Frank's segregation requirements for uncleared swaps apply only if a counterparty elects segregation,[78] any mandatory segregation requirements for uncleared swaps must be designed to help ensure the safety and soundness of Covered Swap Entities and be appropriate for the risk associated with uncleared swaps held by Covered Swap Entities.[79] The Proposed Rules' limitations on the scope of permissible segregation arrangements and rehypothecation go beyond the measures necessary to achieve these objectives. They would also go beyond the Final BCBS-IOSCO Framework,[80] which does not mandate a particular form of segregation and permits limited rehypohecation.[81]

The SEC's proposed capital, margin and segregation rules for non-bank SBS dealers (the "SEC Proposal")[82] illustrates an alternative approach that is consistent with Dodd-Frank and the Final BCBS-IOSCO Framework. That approach, which is based on the possession and control and reserve account framework that the SEC has successfully administered for over 40 years, would require a non-bank SBS dealer to segregate initial margin on an omnibus basis across its customers (including other Swap Entities) at a location that permits the SBS dealer to maintain possession or control over the collateral.[83] The SEC Proposal would also permit the non-bank SBS dealer to rehypothecate initial margin in connection with certain hedging transactions, but subject to arrangements preserving the character of such margin as property of the customer in the event of the SBS dealer's bankruptcy.[84] In this way, the SEC Proposal would reduce the liquidity impact of initial margin requirements without reducing customer protections.

We believe that the Agencies should modify the Proposed Rules to accommodate segregation arrangements, such as those envisioned by the SEC Proposal, that better balance risk mitigation and liquidity preservation objectives. More flexible segregation rules would also prevent conflicts between the Proposed Rules and other regimes, such as the SEC Proposal. For example, left unmodified, the Proposed Rules would force non-bank SBS dealers to segregate

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[77] Bank Proposed Rule §§ _.7(c) and (d); CFTC Proposed Rule § 23.157(c).

[78] Compare §4s(e) of the Commodity Exchange Act ("CEA"), 7 U.S.C. 4s(e) with §4s(l) of the CEA, 7 U.S.C. § 4s(l).

[79] See § 4s(e)(3) of the CEA, 7 U.S.C. 4s(e)(3).

[80] Final BCBS-IOSCO Framework at p. 19.

[81] EU Proposal at Art. 1.1 SEG.

[82] Capital, Margin, and Segregation Requirements for SBS Dealers and Major SBS Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70214 (Nov. 23, 2012).

[83] See SEC Proposed Rule 18a-4, id. at 70350-54.

[84] See id.

initial margin collected from Covered Swap Entities in accounts held by independent third-party custodians and thereby incur 100% capital charges.[85] These capital charges would discourage non-bank SBS dealers from trading with Covered Swap Entities, decreasing inter-dealer liquidity. Even if a Covered Swap Entity did trade with a non-bank SBS dealer under an individual segregation arrangement as envisioned by the Proposed Rules, it is not necessarily the case that individual segregation would benefit the Covered Swap Entity because the SEC Proposal would require it to subordinate all its claims against the non-bank SBS dealer to the claims of the SBS customers of the non-bank SBS dealer.[86]

This discussion of the SEC Proposal is not intended to define a specific approach, but rather only to illustrate one example of the issues raised by unduly restrictive segregation requirements that do not account for the capital, segregation and bankruptcy regimes applicable to the different types of counterparties with which a Covered Swap Entity might trade. Other examples include U.K. investment firms and other regulated entities subject to client asset protection schemes.

To ensure continued liquidity in the inter-dealer market by mitigating unwarranted conflicts with other regulators' segregation regimes, the Agencies should modify their proposed segregation rules to require that covered initial margin[87] be held under arrangements that are harmonized across U.S. and foreign regulators and that do not give rise to punitive costs. In fashioning such requirements, the Agencies should accommodate (and not foreclose *ab initio* by rule) arrangements that comply with SEC segregation rules[88] and other arrangements that the relevant Agency determines, based on the protections afforded to the posting party, to be appropriate for the safe and sound operation of the Covered Swap Entity (which arrangements may include individual segregation at an independent custodian[89] that is affiliated with one of the parties or segregation in a trust account). The Agencies should also permit a Covered Swap Entity, absent counterparty objection, to rehypothecate initial margin to secure a position that hedges or mitigates the risk of its customer-facing uncleared swap portfolio under arrangements

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[85] See SEC Proposed Rules 15c3-1(c)(2)(xiv)(B)(2), id. at 70330-31, and 18a-1(c)(1)(viii)(B)(2), id. at 70336.

[86] See SEC Proposed Rule 18a-4, id. at 70350-54. This subordination agreement would be needed for the SBS counterparty to opt out of ratable distribution of customer property in the non-bank SBS dealer's bankruptcy. See id. at 70287-88.

[87] For this purpose, "covered initial margin" would, as proposed by the Agencies, include (i) funds or other property other than variation margin provided by a Covered Swap Entity and (ii) funds or other property posted by a financial end user with a material swaps exposure to satisfy the Proposed Rules' initial margin requirements. In addition, however, a Covered Swap Entity that collects excess initial margin from a financial end user (*e.g.*, collects initial margin below the $65 million threshold) should be able, with permission from the financial end user, to commingle that excess initial margin with the required initial margin.

[88] The CFTC should also permit a Non-Bank Swap Entity that portfolio margins uncleared swaps with uncleared SBS to hold positions and associated collateral for both types of products in an SBS account subject to the SEC's proposed omnibus segregation regime.

[89] Permissible custodians should include any entity subject to U.S. or foreign regulation with respect to the handling of third-party funds or property (including a bank, trust company, broker or securities depository).

that the relevant Agency determines to be appropriate for the mitigation of risk to the Covered Swap Entity's uncleared swap customers (*e.g.,* because they provide, in the Covered Swap Entity's insolvency, those customers with property claims for return of excess initial margin instead of unsecured creditor claims). Such rehypothecation would not expose customers to undue risk, but it would promote beneficial hedging activity and reduce the liquidity impact of initial margin requirements.

Finally, the Agencies should clarify that holding initial margin in a manner consistent with their final OTC margin requirements would not subject either the posting party or the collecting party to additional capital charges.[90]

VII. Cross-Border Application

As the Agencies have recognized, the Proposed Rules will, in many instances, apply in concert with OTC margin requirements adopted in other jurisdictions. Cross-border trading is extensive in the uncleared swap markets. The Agencies have also proposed to apply their OTC margin requirements extraterritorially in certain contexts (*e.g.*, to guaranteed affiliates of U.S. persons). Regulators in other jurisdictions, such as the European Union, also intend to apply their OTC margin requirements extraterritorially to guaranteed affiliates.

The overlapping application of multiple OTC margin requirements in the circumstances described above could lead to conflicts, particularly given a two-way margin exchange regime. For example, an entity organized in the United States (or an entity that is a branch of, or has its obligations guaranteed by, a U.S. entity) could be required by U.S. rules to post margin in an amount, in a form, at times or held in a way that is not consistent with the margin collection requirements applicable to a counterparty organized in a foreign jurisdiction (or that is a branch of, or has its obligations guaranteed by, a foreign entity). In addition, even where there is not an outright conflict between U.S. requirements and foreign requirements, applying requirements to a U.S. Covered Swap Entity that are different from the requirements applicable to its foreign competitors is likely to deter foreign counterparties from trading with the U.S. Covered Swap Entity. This can be true even where the differences relate to technical areas, such as the denomination of thresholds and minimum transfer amounts, that do not relate to the core risk mitigation objectives of OTC margin requirements.

Left unaddressed, these conflicts or inconsistencies in OTC margin requirements would fragment markets by preventing or deterring certain types of counterparties from trading with each other. Such fragmentation would limit hedging or investment opportunities by limiting the range of dealers from whom a market participant could source liquidity, even potentially foreclosing access to certain foreign markets entirely.

The Agencies could most effectively prevent these adverse consequences by harmonizing OTC margin requirements internationally. The Final BCBS-IOSCO Framework represents an

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[90] We note that this clarification would be consistent with the CFTC's 2011 capital proposal. See 76 Fed. Reg. 27802 (May 12, 2011) at 27825 and 27835.

important step toward the achievement of that objective. We have also identified in this letter additional areas where further international harmonization is necessary to address important details of OTC margin requirements left unresolved by the Final BCBS-IOSCO Framework or respects in which the Proposed Rules diverge from that framework.

We recognize, however, that harmonization efforts are likely to fall short of a single comprehensively harmonized rule set. Different statutory frameworks and underlying commercial and insolvency laws, for example, create limitations on the extent of possible harmonization. These limitations require regulators to fashion measures that mitigate the potential for cross-border conflicts and inconsistencies without exposing their local financial systems to undue risk, either directly or as a result of regulatory arbitrage.

A. Substituted Compliance

As reflected in the Proposed Rules, one measure to mitigate cross-border conflicts and inconsistencies is to permit substituted compliance based on the comparability of another jurisdiction's rules. The different cross-border proposals contained in the Proposed Rules embrace substituted compliance to varying degrees, but none of the proposals does so in a manner that would comprehensively address every set of circumstances where cross-border conflicts or inconsistencies could arise. We discuss some examples below:

- ***U.S. Covered Swap Entities***. The Bank Proposal and CFTC "entity-level" approach would only make substituted compliance available to a U.S. Covered Swap Entity in connection with its obligation to post initial margin to a foreign counterparty.[91] The CFTC "cross-border guidance" approach would not permit a U.S. Covered Swap Entity to rely on substituted compliance under any circumstances.[92] Each of these approaches would make U.S. Covered Swap Entities uncompetitive in foreign markets.[93]

- ***Foreign Branches of U.S. Covered Swap Entities***. The Bank Proposal and CFTC entity-level approach would not distinguish a U.S. Covered Swap Entity's foreign branch from its U.S. head office. In contrast, the CFTC cross-border guidance approach would make substituted compliance available to foreign branches, with respect to both posting and

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[91] See Bank Proposed Rule § _.9(d) and CFTC Proposal at 59917. Under the CFTC entity-level approach, even this limited form of substituted compliance would not be available to the Covered Swap Entity if its foreign counterparty was guaranteed by a U.S. person. CFTC Proposal at 59917.

[92] See id. at 59916.

[93] For example, the Proposed Rules would define as a "financial end user" any foreign entity that would be a financial end user if organized in the United States. Any such determination would require analysis under a wide range of U.S. federal and state regulatory regimes. In practice, neither Covered Swap Entities nor their foreign counterparties are likely to be well-positioned to make such a determination: Covered Swap Entities will not know sufficient information about their foreign counterparties, and foreign counterparties will not understand the U.S. laws that are relevant to the determination. The Agencies can best address these issues by expanding the availability of substituted compliance so that Covered Swap Entities can rely on the categorization of foreign counterparties under comparable foreign OTC margin rules.

collection requirements. Because foreign branches will generally be subject to foreign margin requirements, making substituted compliance available to them is necessary to avoid conflicts with foreign law.

- ***Foreign Covered Swap Entities Guaranteed by U.S. Persons***. The Bank Proposal and CFTC entity-level approach would not distinguish a foreign Covered Swap Entity that is guaranteed by a U.S. person from a U.S. Covered Swap Entity. In contrast, the CFTC cross-border guidance approach would make substituted compliance available to such U.S.-guaranteed foreign Covered Swap Entities, with respect to both posting and collection requirements. As with foreign branches, because U.S.-guaranteed foreign Covered Swap Entities will generally be subject to foreign margin requirements, making substituted compliance available to them is necessary to avoid conflicts with foreign law.

- ***Other Foreign Covered Swap Entities***. The Bank Proposal and CFTC entity-level approach would make substituted compliance available to unguaranteed foreign Covered Swap Entities with respect to all aspects of OTC margin requirements, including for uncleared swaps with U.S. counterparties.[94] In contrast, the CFTC cross-border guidance approach would not permit substituted compliance for uncleared swaps with U.S. persons. Making substituted compliance available to foreign Covered Swap Entities for their uncleared swaps with U.S. persons is necessary to prevent conflicts with foreign margin requirements applicable to such Covered Swap Entities and promote access by U.S. market participants to liquidity offered by foreign Covered Swap Entities.

The limitations on substituted compliance described above are not necessary if the extraordinary international harmonization efforts reflected by the development of the Final BCBS-IOSCO Framework are faithfully reflected in the national implementation of OTC margin requirements. It also should not be necessary to adopt a "stricter rule applies" approach to substituted compliance, which would effectively eliminate any potential for substituted compliance to mitigate competitive disparities resulting from inconsistent requirements. Indeed, from a prudential oversight perspective, a truly outcome-based approach would not look at the outcome of an individual transaction or counterparty pair – an approach that significantly increases the cost and complexity of compliance and creates the conditions for market fragmentation and price skewing – but would instead look to whether, as a whole, giving full recognition to an equivalent foreign OTC margin framework would ensure an acceptable reduction of aggregate unmargined risk.

Accordingly, a U.S. Covered Swap Entity (or, if subject to U.S. OTC margin requirements, a foreign branch of a U.S. Covered Swap Entity or a U.S.-guaranteed foreign Covered Swap Entity) trading with a counterparty located in a jurisdiction with comparable margin rules should be eligible for substituted compliance in connection with posting and

[94] While we support the availability of substituted compliance for U.S.-facing transactions under the CFTC entity-level approach, we do not support that approach's proposed application of U.S. OTC margin requirements to the foreign-facing swaps of a foreign Covered Swap Entity.

collecting margin to and from the foreign counterparty.[95] Likewise, a foreign Covered Swap Entity (whether or not a subsidiary of or guaranteed by a U.S. person) located in a jurisdiction with comparable margin rules should be eligible for substituted compliance in connection with posting and collecting margin to and from U.S. counterparties.[96] With comparability premised on the outcome-based approach described above, permitting substituted compliance in this manner would not expose the U.S. financial system to undue unmargined risk. Incremental risk to a Covered Swap Entity in connection with individual transactions or trading relationships would be addressed by applicable credit risk management and capital requirements.

In conjunction with adopting this substituted compliance framework, the Agencies can also ensure that national differences in OTC margin requirements do not promote regulatory arbitrage by working with their counterparts in other jurisdictions (through BCBS-IOSCO, the OTC Derivatives Regulations Group or otherwise) to resolve any material differences during the period prior to finalization of national OTC margin requirements. In this way, the Agencies could assess the comparability of foreign OTC margin requirements based on consistency with international standards, which themselves would reflect consistency with all of the material aspects of U.S. OTC margin requirements. The Agencies also could make comparability determinations for other major jurisdictions (such as the European Union and Japan) in conjunction with, or shortly following, the finalization of U.S. OTC margin requirements, without the need for an additional application process. This would enable market participants to take these comparability requirements into account during the implementation process.

B. Jurisdictional Scope of U.S. OTC Margin Requirements

Another way to mitigate cross-border conflicts and inconsistencies is to limit the extent to which U.S. OTC margin requirements apply extraterritorially. The extraterritorial application of U.S. law is only warranted in circumstances where U.S. regulatory interests are strong and there is no other means for satisfying those interests.

1. Foreign Covered Swap Entities

Consistent with the principle articulated above, U.S. OTC margin requirements should apply to a foreign Covered Swap Entity only in connection with its uncleared swaps with U.S. persons, regardless of whether the swaps are entered into by the foreign Covered Swap Entity directly or through a U.S. branch.[97] Because foreign Covered Swap Entities are organized in

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[95] If the foreign jurisdiction's rules do not require the Covered Swap Entity to collect initial margin, then substituted compliance should be available if the Covered Swap Entity collects initial margin in the form and amount, at times, and held in a manner, consistent with the collection requirements applicable to its foreign counterparty.

[96] If the foreign jurisdiction's rules do not require the Covered Swap Entity to post initial margin, then substituted compliance should be available if the Covered Swap Entity posts initial margin in the form and amount, at times, and held in a manner, consistent with the collection requirements applicable to it.

[97] Cf. id. (proposing a similar limitation as one aspect of the CFTC's "cross-border guidance" approach). For these reasons, we do not support the application of U.S. OTC margin requirements to the foreign-facing swaps of a foreign Covered Swap Entity, as would occur under the CFTC's entity-level approach. If the Agencies nonetheless

foreign jurisdictions, their transactions with non-U.S. persons do not directly transmit risk to the United States. In addition, the application of comparable home country capital requirements to foreign Covered Swap Entities will ensure that their foreign-facing swap activity is conducted in a safe and sound manner without also subjecting foreign Covered Swap Entities' foreign counterparties to U.S. OTC margin requirements for swaps that do not involve a direct U.S. nexus.

2. Foreign Subsidiaries of U.S. Persons

The analysis described immediately above also largely applies to a foreign, unguaranteed subsidiary of a U.S. person. Typically, the operations of foreign subsidiaries of U.S. persons are subject to local laws in the jurisdictions in which they operate. Risk to the U.S. parent arising from the activities of subsidiaries is addressed by capital requirements applicable on a consolidated basis to U.S. parent companies, limits on the amount of capital a U.S. parent company may invest in a foreign subsidiary, and limits on the types of activities in which a foreign subsidiary can engage.[98]

In other words, U.S. law regulates the direct interactions of a U.S. parent company with its foreign subsidiaries, not the indirect relationship that a foreign subsidiary's foreign activities might have to the safety and soundness of the U.S. parent company. This distinction is consistent with the one drawn by Title VII of Dodd-Frank, which applies only to activities abroad that have a "direct and significant" connection with activities in, or effect, on U.S. commerce.[99] The CFTC has interpreted this provision not to require the treatment of a non-U.S. person as a U.S. person solely because it is controlled by or under common control with a U.S. person.[100] The Prudential Regulators have also drawn this distinction in connection with other aspects of their regulation of the transactional conduct of U.S. banking organizations and their subsidiaries abroad, for example exempting credit extended outside the United States by foreign branches and subsidiaries of U.S. banks from the Board's Regulation U.[101] Accordingly,

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decide to apply U.S. OTC margin requirements to a foreign Covered Swap Entity's swaps with foreign counterparties (including those guaranteed by a U.S. person), then, consistent with the substituted compliance principles described in the preceding section of this letter, the foreign Covered Swap Entity should be eligible for substituted compliance if it, or its counterparty, is located in a jurisdiction that applies comparable OTC margin requirements. If the foreign jurisdiction's rules do not require the Covered Swap Entity to collect initial margin, then substituted compliance should be available if the Covered Swap Entity collects initial margin in the form and amount, at times, and held in a manner, consistent with the collection requirements applicable to its foreign counterparty.

[98] See, e.g., 12 C.F.R. § 211.5 (requirements applicable to Edge and agreement corporations).

[99] Section 2(i) of the CEA, 7 U.S.C. 2(i).

[100] Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 77 Fed. Reg. 45292 (July 26, 2013) ("CFTC Cross-Border Guidance") at n. 215.

[101] See 12 C.F.R. § 221.6(c). See, also Board Staff Opinion of Mar. 24, 1989, Federal Reserve Regulatory Service 5-884.67.

distinguishing foreign Covered Swap Entities that are controlled by U.S. companies from other foreign Covered Swap Entities, or applying U.S. OTC margin requirements to foreign subsidiaries not registered as Covered Swap Entities, would be an unwarranted extension of U.S. law abroad that is inconsistent with the approach that the Agencies (and other regulators) have taken in analogous contexts.

3. Guarantees by U.S. Persons

A guarantee by a U.S. parent of its foreign subsidiary's swaps can obligate the U.S. parent to make payments on those swaps, but that obligation is contingent on a default by the foreign subsidiary. Losses on those swaps will not materialize as losses for the U.S. parent unless the foreign subsidiary has insufficient capital to absorb those losses. As a result, requiring that the subsidiary be subject to comparable local capital requirements can address the potential risk to the U.S. parent, without resulting in overlapping or duplicative OTC margin requirements.

If, however, the Agencies decide to apply U.S. OTC margin requirements to foreign swap transactions based on the presence of a U.S. guarantee, they should only do so if that guarantee constitutes an express, legally enforceable arrangement providing foreign swap counterparties with recourse to the U.S. guarantor.[102] Only these type of agreements can potentially present the requisite nexus to the United States, *i.e.*, they "transfer risk directly back to the United States with respect to financial obligations arising out of a swap."[103] In contrast, other contractual arrangements, such as cross-default provisions[104] or "letters of comfort" that create some nexus between a foreign subsidiary and a U.S. parent company but do not create an enforceable obligation to pay shortfalls, are not a direct mechanism for the transmission of losses to a U.S. parent company and therefore do not give rise to the type of direct risk flow back to the United States that Title VII of Dodd-Frank was intended by Congress to address. This logic applies *a fortiori* in the circumstances noted by the CFTC[105] where the agreement, arrangement or structure at issue does not specifically reference the relevant swap, affirmatively states that it does not apply to such swap, or has been terminated, waived or had its benefits revoked by the other party.

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[102] Accord CFTC Cross-Border Guidance at 45355 ("[A] guarantee of a swap is a collateral promise by a guarantor to answer for the debt or obligation of a counterparty obligor under a swap. Thus, to the extent that the non-U.S. swap dealer or non-U.S. [major swap participant ("MSP")] would have recourse to the U.S. guarantor in connection with its swaps position, the [CFTC] would generally expect such non-U.S. swap dealer or MSP to comply with the [OTC margin requirements and other "Category A transaction-level requirements"] for such a guaranteed swap . . . . Conversely, where a non-U.S. swap dealer or non-U.S. MSP enters into a swap with a non-U.S. counterparty that does not have a guarantee as so described from a U.S. person and is not an affiliate conduit, the [CFTC]'s view is that [those requirements] should not apply.").

[103] See CFTC Proposal at 59918.

[104] See Bank Proposal at 57380.

[105] CFTC Proposal at 59918.

U.S.-guaranteed swaps between foreign counterparties also should not become subject to U.S. OTC margin requirements unless the extent of guaranteed exposure is material to the U.S. guarantor. This limitation would be consistent with Dodd-Frank's prohibition on the extraterritorial application of U.S. swaps rules absent a "significant" connection with activities in, or effect, on U.S. commerce.[106] It also would be consistent with EU rules, which premise the application of EU OTC margin requirements on an EU-guaranteed foreign subsidiary on the guarantee from an EU person covering (1) at least €8 billion in aggregate notional amount of OTC derivatives and (2) an amount of current exposure equal to at least 5% of the EU guarantor's aggregate current exposure (assessed on a monthly basis).[107]

It also does not follow from the fact that a guarantee can present risk to the United States that substituted compliance should not be available. Indeed, the requirement that foreign Covered Swap Entities substitute comply is for the specific purpose of mitigating the risks to the United States that might exist if they did not. As described above, the policy basis for permitting substituted compliance is to mitigate cross-border regulatory conflicts and inconsistencies. These conflicts and inconsistencies are even more likely in circumstances where U.S. regulators apply U.S. requirements to extraterritorial activities. As in the case of U.S. Covered Swap Entities, the risks that arise from the foreign-facing swaps of guaranteed foreign Covered Swap Entities should be addressed by the Agencies through their comparability determinations, not through limitations on the availability of substituted compliance.

4. Emerging Market Counterparties

U.S. OTC margin requirements are also likely to conflict with foreign law in circumstances where Covered Swap Entities transact with foreign counterparties located in jurisdictions that have not adopted the Final BCBS-IOSCO Framework. In many of these jurisdictions, the local legal framework does not recognize concepts, such as netting or segregation, that are necessary for the effective application of OTC margin requirements. The local banking sector also may not have the operational infrastructure to provide for the daily transfer of margin collateral. Mandating that Covered Swap Entities comply with OTC margin requirements in these jurisdictions could also expose such entities to undue risks, for example by requiring that they hold their collateral with inexperienced local custodians or post margin in gross. More likely, local counterparties would move their business away from Covered Swap Entities. Any such decision would likely not be limited to the uncleared swap business covered by OTC margin requirements but would affect closely related commercial and investment banking business.

These consequences would be disproportionate to the risks of Covered Swap Entities' swap activities in these jurisdictions, the volume of which is generally quite limited. Applicable risk management and capital requirements also help to ensure that a Covered Swap Entity limits

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[106] Section 2(i) of the CEA, 7 U.S.C. 2(i).

[107] Commission Delegated Regulation (EU) No 285/2014 (Feb. 13, 2014), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2014:085:0001:0003:EN:PDF.

its trading to those counterparties it determines to be sufficiently creditworthy and maintains appropriate resources to absorb potential losses arising from trading with those counterparties.

These same considerations led the CFTC, in its guidance regarding the cross-border application of its Dodd-Frank swaps rules, to adopt an exception from the application of transaction-level requirements, including margin requirements, to swaps between the foreign branches of U.S. swap dealers located outside Australia, Canada, the European Union, Hong Kong, Japan and Switzerland, on the one hand, and non-U.S. counterparties that are not guaranteed or conduit affiliates, on the other hand.[108] In order to ensure that this exception did not pose an unacceptable level of risk to the U.S. financial system, the CFTC conditioned the exception on the volume of such transactions not exceeding five percent of the total aggregate volume of swaps entered into by the U.S. swap dealer.[109]

We believe that the Agencies should adopt a similar "emerging market" exception to OTC margin requirements. Under this exception, a Covered Swap Entity, whether transacting from a U.S. branch or through foreign branches, would not be required to exchange margin with counterparties located in jurisdictions that have failed to adopt margin requirements consistent with the Final BCBS-IOSCO Framework, provided that the total volume of transactions for which the Covered Swap Entity relies on this exception does not exceed five percent of the aggregate notional amount of uncleared swap transactions entered into by the Covered Swap Entity, calculated on a quarterly basis.

At a minimum, if the Agencies do not adopt an emerging market exception, they should permit a Covered Swap Entity to collect/post variation margin on a net basis with a counterparty located in a jurisdiction the laws of which do not support legally enforceable netting arrangements if (1) from the perspective of the Covered Swap Entity's counterparty, the parties netting agreement would satisfy the proposed "eligible master netting agreement" definition in that the counterparty has legally enforceable netting and close-out rights vis-à-vis the Covered Swap Entity and (2) the Covered Swap Entity computes and satisfies capital requirements based on its gross current exposure to the counterparty, less the variation margin it collects.

VIII. Variation Margin Netting

In order to calculate and collect/post margin on an aggregate basis across multiple uncleared swaps with a counterparty, those swaps must be executed pursuant to an "eligible master netting agreement" under the Proposed Rules.[110] Although this requirement would ensure that a counterparty's insolvency administrator could not "cherry pick" claims arising from swaps that were margined on a net basis, the requirement is likely to create significant issues in the case of counterparties that are subject to unique insolvency regimes. For example, within the

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108 CFTC Cross-Border Guidance at 45351.

109 Id.

110 Bank Proposed Rules §§ _.4(d) (variation margin) and _.8(b)(2) (initial margin) and CFTC Proposed Rules §§ 23.153(c) (variation margin) and 23.154(b)(2) (initial margin).

United States,[111] certain pension plans and state insurance companies are not covered (or not unambiguously covered) by the federal safe harbor provisions that typically provide the basis for the recognition of netting under the Proposed Rules. As a result, the Proposed Rules would require a Covered Swap Entity to post and collect margin to and from such an entity on a gross basis. The gross exchange of variation margin would give rise to significant settlement ("Herstatt") risk and costs, creating the potential that a Covered Swap Entity (or its counterparty) could post variation margin on its out-of-the-money swaps but never receive variation margin on its in-the-money swaps.

The most direct way to avoid this result would be for the Board to clarify the uncertain legal issues that have precluded counsel from giving the robust legal comfort necessary to conclude that netting agreements with the counterparty types noted above satisfy the proposed "eligible master netting agreement" definition. The Board could make that clarification by exercising its authority under the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") to designate a "financial end user" under the Proposed Rules as a "financial institution" subject to FDICIA's netting provisions.[112] The Board previously exercised this authority in adopting Regulation EE in 1994 to "enhance efficiency and reduce systemic risk in the financial markets"[113] by covering those "significant market participants whose coverage [by FDICIA's netting provisions] could enhance market liquidity and whose failure without coverage could have systemic risk implications."[114] We believe that similar action to cover "financial end users" would be consistent with this rationale, given the Board's determination to subject financial end users to OTC margin requirements because they "pose greater systemic risk" than other counterparties.[115]

If the Board does not exercise its FDICIA authority in this manner, however, the Agencies should, subject to two conditions, permit a Covered Swap Entity to collect/post variation margin on a net basis from/to a counterparty with whom the Covered Swap Entity does not have an eligible master netting agreement. First, from the perspective of the Covered Swap Entity's counterparty, the parties' netting agreement would be required to satisfy the "eligible master netting agreement" definition in that the counterparty must have legally enforceable netting and close-out rights vis-à-vis the Covered Swap Entity. This condition would ensure that netting variation margin settlements does not increase risk to the Covered Swap Entity's

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[111] A similar issue is raised by swaps with certain emerging market counterparties, as discussed above in Part VII.B.4 of this letter.

[112] See 12 U.S.C. § 4402(9) (defining a "financial institution" for purposes of FDICIA's netting provisions as "a broker or dealer, a depository institution, a futures commission merchant, or any other institution as determined by the [Board]").

[113] 59 Fed. Reg. 4780 (Feb. 2, 1994) at 4784.

[114] Id. at 4780. The Board has also designated specific non-dealer institutions, such as Freddie Mac, as "financial institutions." See Letter from the Board to Ms. Mater (January 21, 1997).

[115] Bank Proposal at 57361.

counterparty. In addition, the Covered Swap Entity would be required to compute and satisfy capital requirements based on its gross current exposure to the counterparty, less the variation margin it collects. This condition would ensure that the Covered Swap Entity maintains sufficient levels of margin and capital to absorb potential losses on swaps with such counterparty.

IX. Phase-In of OTC Margin Requirements; Legacy Swaps

The Proposed Rules would apply variation margin requirements to all Swap Entities and financial end users beginning December 1, 2015, but would phase in the application of initial margin requirements annually from December 1, 2015 until December 1, 2019, depending on the average daily aggregate notional amount of all uncleared swaps, FX swaps and FX forwards of each of the parties (together with its affiliates) for the preceding June, July and August.[116] The Proposed Rules would not apply to uncleared swaps entered into by a Covered Swap Entity before the applicable compliance date ("legacy swaps") unless those swaps were covered by the same eligible master netting agreement as swaps entered into by the Covered Swap Entity after that date.[117] While we generally support these proposals to phase-in the application of OTC margin requirements and exclude legacy swaps, we believe that certain details of this framework warrant additional attention.

A. Phase-In Schedule

The initial December 1, 2015 compliance date proposed by the Agencies is consistent with the initial compliance date contained in the Final BCBS-IOSCO Framework. That framework, however, was published by BCBS-IOSCO over 14 months ago, implying a transition period of longer than 2 years. Finalization of the Proposed Rules, in contrast, is not likely to occur until the first half of 2015, implying a 6- to 9-month transition period.

This shorter transition period would not be sufficient to permit market participants to make the adjustments that will be necessary once the final OTC margin requirements (including any variances from the Final BCBS-IOSCO Framework) are published. For example, until the Agencies finalize the Proposed Rules, market participants will not know whether non-cash variation margin will be permissible. They also will not know the precise scope of entities covered by OTC margin requirements or whether/how those requirements will apply to inter-affiliate swaps. Nor will they know the precise parameters they must apply to initial margin models, margin collection or custody mechanics.[118] Whether or not any of the Agencies modify their approach to such matters, so long as those matters remain unresolved it is not possible for

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[116] Bank Proposed Rule § _.1(d); CFTC Proposed Rule § 23.159.

[117] See Bank Proposed Rule §§ _.4(d) and _.8(b)(2); CFTC Proposed Rule §§ 23.153(c) and 23.154(b)(2).

[118] We understand that custody banks have independently noted to the Agencies the importance of providing sufficient time for such banks to make the operational, technological and documentation changes that will be necessary to accommodate the significantly increased demand for custodial services associated with new OTC margin requirements.

Covered Swap Entities to finalize their liquidity plans, organizational structure, credit support documentation and operational infrastructure as required to comply with OTC margin requirements.

Similar uncertainties exist with outstanding proposals in other major jurisdictions. Market participants also do not know the extent to which substituted compliance will be available or the jurisdictions that the Agencies will determine to have comparable OTC margin requirements. Absent the publication of comparability determinations for other key jurisdictions, market participants will be faced with the need to make changes necessary to comply simultaneously with multiple regimes, thus complicating and potentially delaying implementation efforts. Commencing the implementation of OTC margin requirements on the later of the publication of final OTC margin rules in the United States, European Union and Japan or the issuance of comparability determinations with respect to the European Union and Japan will help streamline implementation efforts and avoid unnecessary costs and duplicative utilization of scarce resources.

A shorter transition period is likely to pose especially significant problems in connection with the proposed application of variation margin requirements to all Swap Entities and financial end users beginning on the initial compliance date. While the exchange of variation margin is widespread, it is not universal. Those market participants that do exchange variation margin also do not necessarily do so in a manner consistent with the Proposed Rules. For example, as noted in Part IV above, many financial end users do not exchange cash variation margin (and their exchange of non-cash variation margin does not yet account for the specific haircuts contained in the Proposed Rules). Market participants also do not universally exchange variation margin on a daily basis.

A "big bang" approach to variation margin requirements is not necessary to ensure that the vast majority of trading volume is covered by the initial compliance date. Many of the market participants that will not be ready by the initial compliance date do not execute a significant volume of uncleared swaps. Universal application of variation margin requirements on the initial compliance date has the potential to force these market participants out of the market because they will not have the financial, legal or technological resources necessary to be ready by that time. In contrast, forcing them to come into compliance too soon could increase risk by fostering funding, documentation and operational practices that have not yet received appropriate review or testing.

For these reasons, the Agencies should:

- Phase-in variation margin requirements based on decreasing notional amount thresholds over a two-year period commencing upon the later of (1) publication of final OTC margin rules in the United States, European Union and Japan or (2) publication of the Agencies' comparability determinations with respect to the European Union and Japan (such later date, the "Publication Date"); and

- Commence the proposed initial margin phase-in schedule two years after the Publication Date.

B. Legacy Swaps

1. Separate Netting Agreement Requirement

The Proposed Rules would apply OTC margin requirements to all legacy swaps documented under an eligible master netting agreements that also governs non-legacy swaps. This treatment of legacy swaps is not in the Final BCBS-IOSCO Framework or the EU Proposal, which creates an unnecessary cross-border disparity. Requiring the documentation of legacy swaps under a separate eligible master netting agreement from non-legacy swaps is not necessary to avoid the risk of undercollateralizing non-legacy transactions. Conversely, imposing that requirement can simultaneously increase both collateral requirements and net credit exposure.

To illustrate this issue, consider a fact pattern in which the counterparty to a Covered Swap Entity has entered into a bankruptcy proceeding and, following the close-out of the parties' uncleared swap portfolio, the counterparty owes the Covered Swap Entity $150 million in connection with legacy swaps and the Covered Swap Entity owes the counterparty $100 million in connection with non-legacy swaps. Assume that the counterparty, to avoid posting margin for the legacy swaps, had insisted that the Covered Swap Entity document the non-legacy swaps under a new eligible master netting agreement. As a result, the parties did not exchange margin for the legacy swaps, but for the non-legacy swaps the Covered Swap Entity had posted $50 million in variation margin before the counterparty entered into its bankruptcy proceeding.[119] In this fact pattern, the counterparty's bankruptcy administrator would exercise its rights to the $50 million of margin the counterparty had collected from the Covered Swap Entity, leaving the estate with a claim for $50 million against the Covered Swap Entity. The administrator also might reject the Covered Swap Entity's claim of $150 million for the legacy swaps. In these circumstances, the Covered Swap Entity would face a potential loss of $150 million and a requirement that it pay an additional $50 million.

In contrast, consider the same fact pattern under circumstances where the Proposed Rules permit the parties to maintain a single eligible master netting agreement while excluding legacy swaps from their margin computations. In this revised fact pattern, netting legacy swaps against non-legacy swaps would leave a net $50 million obligation of the counterparty to the Covered Swap Entity. In addition, the Covered Swap Entity would be entitled to the return of the $50 million of variation margin it had posted. As a result, the counterparty would owe the Covered Swap Entity a total of only $100 million and would not have any claim against the Covered Swap Entity.

Permitting market participants to exclude legacy swaps from their margin computation without requiring the documentation of those swaps under a separate eligible master netting agreement would reduce net credit exposure. Conversely, encouraging the margining of legacy swaps by forcing market participants who do not margin those swaps to face disproportionately greater credit exposures would not be consistent with the Agencies' objective of balancing liquidity burdens against risk mitigation. BCBS-IOSCO based its quantitative impact assessment

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[119] For simplicity, this example does not include initial margin.

on the application of OTC margin requirements only to those transaction types not expected to become subject to mandatory clearing in the future.[120] This approach implicitly assumes the prospective application of OTC margin requirements. Applying those transactions to legacy swaps would sharply increase the liquidity burden associated with them. The Agencies should not force a trade-off between an unnecessary and undesirable increase in collateral requirements and an undesirable increase in system-wide credit exposure.

Accordingly, the Agencies should permit Covered Swap Entities to exclude legacy swaps from margin computations, even when those swaps are documented under the same eligible master netting agreement as non-legacy swaps, provided that a Covered Swap Entity should be required to include all legacy swaps subject to that agreement in those computations if it includes any. This approach would prohibit the selective inclusion of legacy swaps to reduce margin requirements while also preserving the beneficial credit risk reduction effects of larger netting sets.

2. Legacy Swap Novations

Due to other regulatory reform initiatives, such as Dodd-Frank's "swaps push-out" requirement, resolution planning initiatives, bank structural reforms (such as those contemplated in the EU) and revisions to the Basel Accords, many Covered Swap Entities will, over the next several years, need, or be subject to regulatory incentives, to novate legacy swaps. These novations will decrease a transferor Covered Swap Entity's uncleared swap exposure. To the extent that legacy swap novations create new offsets within transferees' portfolios with existing counterparties, they also will reduce the net aggregate uncleared swap exposure within the financial system. Nevertheless, because legacy swap counterparties typically must consent to novations, subjecting legacy swap novations to OTC margin requirements would impede risk-reducing novations by causing counterparties to withhold their consent. To address this issue, the Agencies should permit a Covered Swap Entity, with the agreement of its counterparty, to retain the "legacy" status of legacy swap novations.

If the Agencies do not adopt this recommendation in full, we request that, at a minimum, the Agencies permit parties to grandfather legacy swap novations that occur in connection with the transfer of a business line or other activities between commonly controlled entities.[121] In addition to the characteristics of novations described above, novations that occur as part of such a corporate reorganization would not change a Covered Swap Entity's consolidated, group-wide exposure to its legacy swap counterparties, nor change legacy swap counterparties' exposure to a Covered Swap Entity's consolidated group.

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[120] Second BCBS-IOSCO Consultation at p. 27-28.

[121] In making this request, we do not intend to imply that a merger or consolidation of a counterparty with, or transfer of all or substantially all of the assets of a counterparty to, another entity would subject the counterparty's legacy swaps to OTC margin requirements. Our request instead refers to a transfer of less than all or substantially all of the assets of a legacy swap counterparty.

We would be pleased to provide further information or assistance at the request of the Agencies. Please do not hesitate to contact the undersigned, or Edward J. Rosen (+1 212 225 2820) or Colin D. Lloyd (+1 212 225 2809) of Cleary Gottlieb Steen & Hamilton LLP, outside counsel to SIFMA, if you should have any questions with regard to the foregoing.

Respectfully Submitted,

Kenneth E. Bentsen, Jr.
President and Chief Executive Officer
SIFMA

cc: Honorable Janet L. Yellen, Chair
Honorable Stanley Fischer, Vice Chairman
Honorable Daniel K. Tarullo, Governor
Honorable Jerome H. Powell, Governor
Honorable Lael Brainard, Governor
Board of Governors of the Federal Reserve System

Honorable Thomas J. Curry, Comptroller of the Currency
Office of the Comptroller of the Currency

Honorable Martin J. Gruenberg, Chairman
Federal Deposit Insurance Corporation

Honorable Jill Long Thompson, Chair and Chief Executive Officer
Farm Credit Administration

Honorable Melvin L. Watt, Director
Federal Housing Finance Agency

Honorable Timothy G. Massad, Chairman
Honorable Mark P. Wetjen, Commissioner
Honorable Sharon Y. Bowen, Commissioner
Honorable J. Christopher Giancarlo, Commissioner
Commodity Futures Trading Commission

Honorable Mary Jo White, Chair
Honorable Luis A. Aguilar, Commissioner
Honorable Daniel M. Gallagher, Commissioner
Honorable Kara M. Stein, Commissioner
Honorable Michael S. Piwowar, Commissioner
Securities and Exchange Commission

Honorable Jacob J. Lew, Secretary of the Treasury and Chairman, Financial Stability Oversight Council
Honorable Sarah Bloom Raskin, Deputy Secretary of the Treasury
United States Department of the Treasury

ANNEX A – ADDITIONAL IMPLEMENTATION ISSUES

This Annex supplements our letter by setting forth additional considerations with respect to the Proposed Rules.

I. Covered Counterparties

A. "Material Swaps Exposure" Definition and Phase-In Thresholds.

1. The Proposed Rules would define "material swaps exposure" and initial margin phase-in thresholds based on a financial end user's daily average aggregate gross notional amounts over business days during June, July and August of the preceding calendar year,[122] which contrasts with the average month-end amount calculations called for by the Final BCBS-IOSCO Framework and EU Proposal.[123] The Agencies should coordinate with their international counterparts to ensure a consistent approach to these calculations across jurisdictions.

2. The Proposed Rules would include FX swaps and FX forwards in the material swaps exposure and initial margin phase-in calculations. Yet, FX swaps and FX forwards will not be subject to initial margin requirements. As a result, a market participant could become subject to initial margin requirements in circumstances where the extent of its activity in products actually subject to those requirements is not significant. To avoid this issue, the Agencies should exclude FX swaps and FX forwards from their material swaps exposure and initial margin phase-in calculations. We have made the same comment to the European supervisory authorities.

B. "Financial End User" Definition. The Proposed Rules indicate the Agencies' intent to exempt from the definition of "financial end user" any "Treasury affiliates exempt from clearing pursuant to the Dodd-Frank Act."[124] However, the statutory cross-references in the Proposed Rules[125] do not link to the correct basis for the CFTC's Treasury affiliate exemption, which is instead provided by CFTC No-Action Letter No. 13-22 (June 4, 2013). The Agencies should correct this cross-reference.

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[122] Bank Proposed Rule § _.2; CFTC Proposed Rule § 23.151.

[123] Final BCBS-IOSCO Framework at p. 23; EU Proposal at p. 46.

[124] See 79 Fed. Reg. 57358.

[125] Bank Proposed Rule § _.2; CFTC Proposed Rule § 23.151.

C. **"Multilateral Development Bank" Definition.** The Proposed Rules' definition of "multilateral development bank" ("MDB")[126] is inconsistent with the list of supranational entities used by the CFTC in its rule regarding the end-user exception from mandatory clearing.[127] The Agencies should conform to this list or, at a minimum, clarify that the United Nations and International Monetary Fund are encompassed within the scope of entities that, under the Proposed Rules' MDB definition, "provide financing for national or regional development in which the U.S. government is a shareholder or contributing member" or which the applicable Agency "determines poses comparable credit risk." The Agencies should also clarify that pension plans of MDBs are eligible for the same treatment as MDBs.

D. **Independently Controlled Accounts.** It is unclear how the Proposed Rules are intended to apply in the context of a pension plan, fund or other legal entity that beneficially owns multiple managed accounts each of which has an independent account controller. By definition, independent account controllers do not and cannot coordinate their trading activity with each other. Also, in many cases, an independent account controller is not authorized to enter into commitments on behalf of its client that extend beyond the assets the client has specifically committed to management by the account controller. As a result, a Covered Swap Entity's recourse with respect to an independently controlled account is often limited to the assets held in that account (*i.e.*, the Covered Swap Entity does not have recourse to the beneficial owner of the account). The Agencies should clarify that, under these circumstances, the Covered Swap Entity may treat each independently controlled account as a separate counterparty for purposes of the Proposed Rules.

E. **Changes in Status.**

1. The Proposed Rules do not address how changes in a party's status (*e.g.*, with respect to material swaps exposure or financial end user status) over the life of a swap would affect margin requirements for that swap, if at all. To address this ambiguity, which could make it difficult to price transactions accurately, the Agencies should specify that a party's status under the Proposed Rules is fixed for a given swap when the parties enter

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[126] Bank Proposed Rule § _.2; CFTC Proposed Rule § 23.151.

[127] CFTC, End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42561 (July 19, 2012). The CFTC explained that it considered international financial institutions "to be those institutions defined as such in 22 U.S.C. 262r(c)(2) and the institutions defined as 'multilateral development banks' in the Proposal for the Regulation of the European Parliament and of the Council on OTC Derivative Transactions, Central Counterparties and Trade Repositories, Council of the European Union Final Compromise Text, Article 1(4a(a)) (March 19, 2012)."

into the swap. This would be consistent with the CFTC's position with respect to mandatory clearing.[128]

2. Under CFTC and SEC rules, an entity that crosses a Swap Entity registration threshold generally must register by two months after the end of the month (for swap dealers and SBS dealers) or quarter (for MSPs and major SBS participants) in which it exceeded the applicable registration threshold. The Proposed Rules would appear to subject such an entity to initial margin requirements immediately upon its registration. In contrast, a financial end user that crosses the material swaps exposure threshold in June, July and August of a calendar year would not become subject to initial margin requirements until the beginning of the next calendar year.[129] We believe that a newly registered Swap Entity similarly should not become subject to initial margin requirements until four months after it registers.

II. **Cleared Swaps.** The Proposed Rules would only exclude cleared swaps if the CCP satisfies certain conditions. Under the Bank Proposal, the CCP would need to be a registered derivatives clearing organization ("DCO") or clearing agency.[130] Under the CFTC Proposal, the CCP could be a registered DCO or the recipient of a CFTC no-action letter or other exemptive relief permitting the clearing of swaps for U.S. persons without registering as a DCO.[131]

A. Applying the Proposed Rules to a CCP would require the CCP to post initial margin. Posting initial margin would be inconsistent with the manner in which CCPs operate and manage risk. As a result, applying the Proposed Rules to any CCP would effectively prohibit a Covered Swap Entity from entering into swaps cleared by that CCP.

B. Applying the Proposed Rules to cleared swaps is not necessary. Under Dodd-Frank, the adequate regulation of a foreign CCP is ensured by the application of CFTC or SEC registration requirements to the CCP. If a foreign CCP's nexus to the U.S. is insufficient to subject it to registration, then swaps cleared by that CCP also should not be subject to U.S. OTC margin requirements.

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[128] CFTC Regulations § 50.2, C.F.R. § 50.2.

[129] As noted below, we believe that the Agencies should modify the Proposed Rules to avoid subjecting market participants to new OTC margin requirements during a code freeze. Accordingly, our comment regarding the need for a phase-in for newly registered Swap Entities should not be interpreted to support the application of OTC margin requirements to a financial end user that crosses the material swaps exposure threshold upon the beginning of a new calendar year.

[130] Bank Proposed Rule § _.2.

[131] CFTC Proposed Rule § 23.151.

C. For the foregoing reasons, the Agencies should exclude from OTC margin requirements any swap cleared by a DCO or clearing agency, whether registered or not.

III. Miscellaneous Definitions

A. "Control" Definition.

1. The proposed "control" definition would potentially cover investment vehicles receiving seed capital from Covered Swap Entities or their affiliates, even though the risk of Covered Swap Entities to such vehicles is *de minimis* and limited in time. To address this issue, the Agencies should adopt a *de minimis* exemption for seed funding, like the one contained in the Volcker Rule.[132]

2. The proposed "control" definition includes a 25% ownership threshold. This threshold is inconsistent with the majority ownership threshold used in the EU Proposal and applicable accounting standards. Although we recognize that the Agencies' proposed definition is intended to be similar to the Bank Holding Company Act's definition,[133] financial end users (especially outside the United States) are unlikely to be familiar with that definition. We also believe that any marginal benefits of using the Bank Holding Company Act standard are likely to be outweighed by the costs (including competitive disparities) that would result from adopting a different standard from the one adopted by foreign regulators.

B. "Eligible Master Netting Agreement" Definition.

1. The "eligible master netting agreement" definition in the CFTC Proposal would only permit stays under certain U.S. orderly resolution regimes;[134] in contrast, the Bank Proposal's definition would permit stays under foreign orderly resolution regimes and contractually-agreed stays subject to orderly resolution regimes.[135] The CFTC should conform to the Bank Proposal's definition in order to promote consistency with recent resolution planning initiatives facilitated by the Prudential Regulators. The Agencies should also confirm that the recently-adopted ISDA Resolution Stay Protocol would qualify as a contractual stay "subject by its terms to" a U.S. or foreign orderly resolution regime.

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[132] See CFTC Regulations § 75.12, 17 C.F.R. § 75.12.

[133] See 79 Fed. Reg. 57363.

[134] CFTC Proposed Rule § 23.151.

[135] Bank Proposed Rule § _.2.

2. The proposed "eligible master netting agreement" definition currently requires that such an agreement "not contain a walkaway clause." The Bank Proposal (but not the CFTC Proposal) would define a "walkaway clause" to include "a provision that . . . suspends or conditions payment" to a defaulter. The phrase "suspends or conditions payment" should be excluded from the Bank Proposal so as not to override contractual rights under Section 2(a)(iii) of the ISDA Master Agreement. Without these rights, a non-defaulting party would be obligated to make payments after its counterparty defaults. The risk of such one-sided obligations could be substantial for entities subject to contractual stays, such as the ISDA Resolution Stay Protocol, which prevent early termination upon a counterparty's default.[136]

IV. Calculation and Exchange of Initial and Variation Margin

A. Currency Denomination of Proposed Thresholds and Minimum Transfer Amounts. The Proposed Rules would denominate the initial margin threshold, material swaps exposure, and minimum transfer amount in U.S. dollars. This approach creates the risk, due to exchange rate fluctuations, of cross-border discrepancies with the EU Proposal and other jurisdictions that follow the Final BCBS-IOSCO Framework, which denominates these amounts in Euros.[137] To minimize the impact of such fluctuations, we recommend that the Agencies adopt a framework for the periodic re-evaluation and revision of these amounts to ensure continued international consistency.

B. Benchmarking Initial Margin Models Against CCP Initial Margin Requirements. The Proposed Rules would require Covered Swap Entities to benchmark model-based initial margin calculations against initial margin amounts that CCPs require for similar cleared transactions.[138] This requirement is not necessary given that OTC initial margin models will already be subject to regulatory parameters and Agency approval. In addition, CCP initial margin models are designed to comply with different parameters than those that would apply to OTC initial margin models (*e.g.*, different confidence intervals, liquidation horizons, usage of historical data). Accordingly, the Agencies should not adopt the benchmarking requirement.

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[136] We would also note ISDA's recent creation of a standard amendment to the ISDA Master Agreement that allows parties to insert a time limit on the operation of Section 2(a)(iii) where an event of default has occurred with respect to one of the parties. See ISDA, Amendment to the ISDA Master Agreement for use in relation to Section 2(a)(iii) and explanatory memorandum, June 19, 2014, available at http://www2.isda.org/news/amendment-to-the-isda-master-agreement-for-use-in-relation-to-section-2aiii-and-explanatory-memorandum.

[137] Bank Proposed Rule § _.2; CFTC Proposed Rule § 23.151.

[138] Bank Proposed Rule § _.8; CFTC Proposed Rule § 23.154.

C. **Minimum Transfer Amounts.** The definition of "minimum transfer amount" in the Proposed Rules[139] does not specify whether such amount is to apply separately or cumulatively to initial margin and variation margin. Consistent with applying separate calculation and posting/collection mechanics to initial margin and variation margin, the Agencies should clarify that the minimum transfer amount applies separately to initial margin and variation margin.

D. **Hypothetical Margin Requirements.** The CFTC Proposal would require, for risk management purposes, that a Covered Swap Entity calculate a hypothetical initial margin requirement for each swap for which the counterparty is a non-financial end user that has material swaps exposure to the Covered Swap Entity as if the counterparty were a covered counterparty (and then compare that amount to any initial margin required pursuant to the margin documentation).[140] We believe that existing CFTC risk management procedures adequately address this concern and recommend that the CFTC omit this requirement, as the Bank Proposal has done.

V. Segregation Requirements

A. **Interaction with CFTC Segregation Election Rules.** While the CFTC Proposal includes certain modifications to the CFTC's existing segregation election rules,[141] those modifications appear to apply only to Non-Bank Swap Entities even though the CFTC's segregation election rules also apply to Bank Swap Entities. We recommend that the CFTC clarify that these modifications apply to Bank Swap Entities as well.

B. **Application to Bank Deposits.** It is unclear if proposed limits on "reuse" of initial margin[142] could be read to prohibit placing such cash on deposit with a bank, since funding from such deposits is, as a matter of course, invested in balance sheet assets by the bank. Placing cash on deposit with a custody bank is standard industry practice, and the resulting credit risk to the custody bank is well understood and managed by owners of the custodial account. We request that the Agencies clarify that the practice of placing cash associated with custodial accounts will continue to be permitted for initial margin that is subject to the Agencies' final rule.

VI. **Margin Documentation for Non-Financial End Users.** The CFTC Proposal would require a Non-Bank Swap Entity to (1) specify in its documentation with non-financial

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[139] Bank Proposed Rule § _.5; CFTC Proposed Rule § 23.151.

[140] CFTC Proposed Rule § 23.154.

[141] See 79 Fed. Reg. 59914.

[142] Bank Proposed Rule § _.7; CFTC Proposed Rule § 23.157.

end users (along with specified sovereign and multinational entities) whether initial and/or variation margin will be exchanged and (2) if so, address certain matters in its margin documentation, including valuation methodologies and data sources. This requirement could be read to obligate a Non-Bank Swap Entity to modify its trading documentation with these other counterparties even when they have not agreed to exchange margin. The CFTC should clarify that, if a Non-Bank Swap Entity and such a counterparty have not agreed to exchange margin, then they will not need to modify their trading documentation.

VII. Phased Implementation

A. **Code Freezes.** Financial institutions generally prohibit technological changes to their systems between early December and mid-January (in what is known as a "code freeze"), and at the end of March for Japanese institutions. These code freezes are an important part of prudential risk management and best practices, and implementing new measures that require systems changes would be very difficult during a code freeze. The Agencies should not schedule implementation dates to coincide with code freezes.

B. **Portfolio Compression Swaps.** Under the Proposed Rules, OTC margin requirements will not apply to legacy swaps.[143] They could, however, be read to apply to new swaps executed as a result of a portfolio compression exercise involving portfolios of legacy swaps, even though such swaps decrease parties' net credit exposure. This result would discourage Covered Swap Entities' counterparties from engaging in these exercises, which would undermine Dodd-Frank's portfolio compression requirements.[144] Similar considerations led the CFTC to grant relief from mandatory clearing for swaps resulting from compression exercises.[145] The Agencies should do the same with respect to OTC margin requirements.

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[143] Bank Proposed Rule § _.1; CFTC Proposed Rule § 23.159.

[144] See CFTC Regulations § 23.503, 17 C.F.R. § 23.503.

[145] CFTC No-Action Letter No. 13-01 (Mar. 18, 2013).