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May 14, 2012

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

Re: Treatment of Inter-affiliate Transactions

Dear Mr. Stawick:

The International Swaps and Derivatives Association, Inc. ("ISDA") and the Securities Industry and Financial Markets Association ("SIFMA")[1] are writing regarding the treatment of transactions between members of an affiliated group. Specifically, for the reasons set forth in detail below, we believe that such transactions should be either excluded from the definition of swap or exempted generally as the Commodity Futures Trading Commission ("CFTC") finalizes its rules implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

I. Introduction

Inter-affiliate swaps play a central role in effective, group-wide management of interest rate, foreign exchange, other market price risks, liquidity, capital and other risks inherent in the general business of majority-owned affiliated groups. This is true of groups in all industries. For consolidated financial institutions, inter-affiliate swaps are also used to facilitate transactions for customers, maximize hedging efficiencies and allow customers to transact with a single client-facing entity in the customer's jurisdiction.

As we explain in this letter, ISDA and SIFMA believe that the distinctive characteristics of inter-affiliate swaps, the lack of systemic risk engendered by such trades, and the important systemic and private benefits of inter-affiliate swaps argue persuasively in favor of the Commission granting the exemptive relief requested below. In Section II, we set out the parameters of the exemptions requested. Section III

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[1] ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. For more information, visit www.isda.org.

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

discusses the policy rationale for providing the exemptions, and Section IV discusses the Commission's authority to grant the requested relief.

II. Parameters of the Requested Exemption

A transaction between members of a majority-owned affiliated group should be excluded from the definition of "swap". If, however, the CFTC determines that the treatment of such swaps should be addressed in the context of other individual rulemakings, then ISDA and SIFMA respectfully request that swaps between two parties that are members of a majority-owned affiliated group be either exempted generally in the course of each rulemaking, or more generally through a separate rulemaking specific to the treatment of inter-affiliate swaps. For purposes of this letter, two entities are considered to be members of a "*majority-owned affiliated group*" if one of them directly or indirectly holds a majority ownership interest in the other, or if a third party directly or indirectly holds a majority interest in both, based on holding a majority of the equity securities of an entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership. [2]

Of particular importance is the necessary exemption from the mandatory clearing and trade execution requirements under Commodity Exchange Act ("CEA") section 2(h) and from the initial margin requirement of the CFTC's margin rule.[3]

The requested exemption would not extend to transactions between a group member and unaffiliated counterparties ("external transactions"). Accordingly, all of the protections of Title VII and the respective CFTC regulations, including all clearing, trading and margining requirements, would apply to external transactions. For unaffiliated counterparties in foreign jurisdictions, the protections under the local regulatory regime would be unaffected by granting the requested exemption. As the CFTC is aware, the jurisdictions that house the world's major financial centers are in the process of introducing their own clearing requirements. Accordingly, the protections afforded by clearing are likely to extend to an affiliated group's external counterparties on a global basis.

III. Policy Rationale for Providing an Exemption

A. Introduction: The Risk-Reducing Benefits of Inter-affiliate Swaps Should Be Protected.

One of the primary goals of the Dodd-Frank Act is to identify and reduce systemic risk. The Dodd-Frank Act and the CFTC's implementing regulations applicable to outward facing swaps provide numerous protections intended to mitigate risk to the system, firms and customers. Inter-affiliate swaps generally do not raise the systemic risk concerns that Title VII of the Dodd-Frank Act is intended to address because they do not create additional counterparty exposure outside of the corporate group and do not increase interconnectedness between third parties. Rather, inter-affiliate trades allow institutions to manage and reduce risks (frequently by bringing together a diversified portfolio in a single, risk-managing entity) and, particularly in the case of financial institutions, to increase the scope of netting with individual counterparties (by allowing counterparties to transact with a single group entity across a broad range of underlying asset classes), thereby reducing overall risk. Forced clearing of inter-affiliate swaps

[2] This definition corresponds to the general inter-affiliate exclusion in the CFTC's recently adopted entity definitions. See CFTC Regulation § 1.3(mmm)(1); Exchange Act rule 3a71-6(b)(2). In the adopting release for its final rulemaking: Further Definition of "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant" ("Adopting Release"), the CFTC stated that it viewed the majority-ownership standard as generally consistent with consolidation under GAAP, but it did not include a financial statement consolidation as a requirement because it did not believe that the scope of the inter-affiliate exclusion should be affected by future changes to accounting standards. See Adopting Release, text accompanying footnote 350.
[3] See footnote 10 below.

will destroy such risk reduction opportunities, without offsetting benefits. Below, we discuss the further implications and unintended negative consequences of requiring clearing of these transactions.

B. Background on Uses of Inter-affiliate Swaps

Inter-affiliate swaps are vital to the effective management of interest rate, foreign exchange, other market price risks, liquidity, capital and other risks inherent in the general business of majority-owned affiliated groups. This is especially the case in the business of consolidated financial institutions, where such trades are often entered into to provide improved pricing or other risk management benefits for swap clients. Such an institution will typically use inter-affiliate transactions when dealing with swap clients in one of two ways:

1) It will face the client with its central risk-managing entity, but where necessary, hedge specialized risks through an affiliate that is permitted by local regulations to hedge that specific risk in the relevant jurisdiction.

2) It will provide local clients economic access to a variety of products through the customer's choice of a local affiliated counterparty. But at the same time, it will manage more centrally the general risk of such products by having that local entity hedge its risk through inter-affiliate swaps with a central risk-managing affiliate.

Institutions may also use inter-affiliate swaps to allow external hedging transactions to be executed by an affiliate with the appropriate specialized expertise and operations. Ultimately, inter-affiliate transactions allow an affiliated group to meet customer needs while localizing risk management in an appropriate entity, jurisdiction or time zone.

C. The Benefits of Clearing Do Not Exist for Inter-affiliate Swaps

Clearing will not insulate group members from the consequences of default by an affiliate

One of the primary benefits of clearing – mitigating the likelihood that defaults will propagate from one market entity to another – is not achieved in the context of inter-affiliate transactions. The market already largely perceives group entities as an integrated enterprise, even in the absence of explicit cross-guarantees. For example, as the events surrounding Bear Stearns and Lehman illustrate, a loss of confidence in a single group entity rapidly leads to a run on the group as a whole. Interposing more outward-facing links between the group and the markets through clearing may result in (a) telegraphing the isolated distress of a group entity (that otherwise might be resolved wholly within the group) to the market and accelerating a run on the group and (b) perhaps more importantly, creating additional external interdependencies thereby exposing clearinghouses and other firms to added risk. Consequently, another of the intended benefits of clearing – countering the tendency of markets to panic in the face of uncertainty regarding the location of default risk along a chain of interconnections – cannot be realized in this context

The management flexibility that exists within a corporate group is a better mitigant of intra-affiliate default risk than clearing

As the CFTC recognized in adopting its final entity definitions, swaps between majority-owned affiliates "serve to allocate or transfer risks within an affiliated group, rather than to move those risks out of the group to an unaffiliated third party."[4] The CFTC believed that its majority-ownership standard would

[4] Adopting Release at 116.

ensure an alignment of economic interests sufficient to remove the concerns that underpin dealer regulation.[5] This alignment of economic interest is the key to understanding the purpose and function of majority-owned affiliated groups. The management of an affiliated group determines the desired intra-group risk transfer arrangements, allocates the group's capital among entities, and controls the exercise of rights and remedies under inter-affiliate swaps. Thus, if it emerges that a group entity's capital is unable for any reason to support its obligations under an inter-affiliate swap, management may direct a contribution of capital, or direct the entities to restructure their swap obligations or leave them outstanding as intercompany payables. This financial flexibility would be destroyed by subjecting inter-affiliate swaps to clearing.

Absence of systemic risk in inter-affiliate swaps

Default risk solely among group entities poses minimal systemic concerns. The result of non-performance by one affiliated entity to another is that the intended allocation of market risk within the group is undone and a different, de facto allocation will prevail – a concern to group management, but not the swap market at large. Group entities that serve as junctions with the swap market are protected through other mechanisms, as we describe in Section III.E below.

D. The Imposition of Clearing Will Forfeit the Systemic Risk-reducing Benefits of Inter-affiliate Swaps, Increase Market Costs and Have Other Unintended Consequences

Additional external interdependencies would expose clearinghouses and their members to added risks through loss mutualization

Mandatory clearing of inter-affiliate swaps would concentrate risks in the financial group's futures commission merchant ("FCM") (unless cleared externally or each relevant affiliate becomes a clearing member, with the attendant cost inefficiencies) and transmit risks to the clearinghouse that otherwise could be absorbed within the group. Through clearinghouse loss mutualization, these risks will potentially be borne, in an ultimate sense, by all other clearing members. The result will be that all clearing members take on exposure to the residual risks of every inter-affiliate trade in every affiliated group subject to mandatory clearing that clears through the clearinghouse.

New external risks on groups that engage in inter-affiliate swaps

Requiring clearing of inter-affiliate transactions exposes the affiliated group to considerable new external risk through intermediary and clearinghouse linkages. If inter-affiliate swaps are cleared through an affiliated FCM, they will generally be treated as proprietary positions of the FCM. As such they would be entitled to lesser protection upon default of the FCM, and their associated margin would be available to offset losses of other FCM proprietary positions and positions of defaulting customers of the FCM (a type of residual "fellow customer risk"). Moreover, the increased default fund contributions arising from the inter-affiliate swaps likely will be subject to loss mutualization under clearinghouse rules. If, in an attempt to avoid these adverse consequences, the affiliated group decides to clear its inter-affiliate swaps through an unaffiliated FCM, more extensive linkages between separate financial groups will result.

Centralized risk management within corporate groups would be compromised

A substantial efficiency available to affiliated corporate groups, in fact an important reason for the existence of such groups, is the ability of group management to allocate risk, capital and functions among group members. Imposing clearing on inter-affiliate trades could shatter the group management paradigm

[5] Adopting Release at 117.

and balkanize risks within a corporate enterprise by forcing individual entities with limited portfolios and limited ability to access risk management to manage their own individual risks.[6] Impeding firms' ability to manage risk on a centralized basis would increase, rather than decrease, the level of risk within the enterprise and the broader financial system.

The benefits of centralized risk management for financial companies have been widely recognized by regulators. In its report *Observations on Risk Management Practices during the Recent Market Turbulence*, the Senior Supervisors Group identified effective firm-wide risk management as a prominent common factor among financial firms that were able to avoid significant problems during the market turmoil at the end of 2007. The report notes that such firms "had created internal pricing mechanisms that provided incentives for individual business lines to control activities that might otherwise lead to significant balance sheet growth or unexpected reductions in capital."[7] In other words, centralized risk management in financial companies helped limit the damage that the markets endured.

Affiliated groups are bound together by myriad types of intra-group transactions, not just swaps. This fabric of transactions provides real, substantive group support[8] for group members. Interposing the clearing of inter-affiliate swaps weakens this fabric of supportive transactions overall. Inter-affiliate swaps have the benefit of this group support. They also are a means of binding that support among group members, in conjunction with other inter-affiliate transactions.

Lost efficiencies raise costs to customers

Affiliated groups that include dealers use inter-affiliate transactions to more cost effectively manage risk and execute trades on behalf of their clients. Expertise and related support costs are localized in a financially rational and efficient way. Firms that realize such efficiencies through their centralized structure are able to share those efficiencies with their customers as they compete for business. Destroying these efficiencies will raise costs to customers.[9]

E. The CFTC has tools to safeguard the financial integrity of swap intermediaries

As discussed in Sections III.C and D above, affiliated groups have the flexibility to re-adjust obligations under inter-affiliate swaps and can be expected to do so as necessary to preserve the financial viability of group entities. Because failure of any group entity to meet obligations to external counterparties would have serious ramifications for the group as a whole, a group can be expected to support its members as long as the group as a whole remains financially viable. In the extreme case of a group-wide insolvency, the legal separateness of individual entities may of course reassert itself and complex issues could arise with regard to resolving intra-group claims. However, the only aspect of concern to the swap markets is the integrity of those group entities that serve as points of connection in those markets – swap dealers, major swap participants and futures commission merchants.[10] The CFTC's regulatory framework contains safeguards that more directly address this concern than does forced clearing. These include:

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[6] See Financial Stability Board, *OTC Derivatives Market Reforms*, October 11, 2011, at page 16 (observing that mandatory clearing of intra-group (i.e., inter-affiliate) transactions "could substantially increase the capital and liquidity required by firms that centralize risk management … as well as increase operational complexity").
[7] *Observations on Risk Management Practices during the Recent Market Turbulence*, Senior Supervisors Group (March 6, 2008) at 3.
[8] Intra-group guarantees are not typical (or needed) and may in fact be restricted or forbidden to certain entities or groups. See, e.g., Section 23A of the Federal Reserve Act.
[9] See footnote 5 above.
[10] An affiliate group member that engages in insufficient outward facing business to qualify for regulation as an intermediary presents no greater danger to the markets than any other unregulated market participant.

- Capital requirements;
- Variation margin;[11]
- Anti-evasion authority under Section 721(c) of Dodd- Frank;
- Swap dealer risk management requirements;
- CFTC Rules 1.14 and 1.15 if an FCM is in the affiliated group; and
- Visibility of inter-affiliate swaps under Part 45.

F. The proposed exemption would further international harmonization efforts

The proposed exemption is broadly consistent with the proposed Regulation of the European Parliament and Council of the European Union on OTC derivative transactions, central counterparties and trade repositories ("EMIR"). EMIR provides a clearing exemption for transactions between entities that are in the same consolidated group and subject to appropriate centralized risk management.[12] Such intra-group trades would be subject to a collateral requirement, unless exempted by a competent authority. The lack of a harmonized outcome with the EMIR exemption for intra-group trades would cause significant competitive disparities for US firms.

G. Trading requirement

Imposition of a trading requirement offers no benefit and may preclude the intended inter-affiliate risk transfers. Because participants in a swap execution facility ("SEF") will not necessarily have control over the identity of the counterparty with whom their trades are matched, a trading requirement would at best introduce uncertainty and unnecessary costs and inefficiencies into the inter-affiliate risk management process. Moreover, mandating SEF execution of inter-affiliate trades would not advance the price discovery goals of the trading requirement. As the CFTC recognized in adopting the real-time reporting rules, inter-affiliate swap transactions are often not intended to be arm's length[13] and, even if intended to be arm's length in name, are not intended to realize fully competitive pricing. Such trades are fundamentally inconsistent with the anticipated characteristics of trading platforms. No purpose is served by requiring execution in a venue intended to enhance competitive pricing and provide meaningful and informative pre-trade transparency.

IV. Authority

The Commission has multiple means available to it to treat inter-affiliate swaps as requested above. First, the Commission has authority to define "swap" under CEA Section 721(b). Second, it has authority to determine which "groups" or "classes" of swaps are required to be cleared under CEA Section 2(h). Third, it has authority under CEA Section 4(c) to exempt any transaction or class of transactions (including any person or class of persons entering into the transaction) from any of the provisions of the CEA, subject to exceptions that do not include Section 2(h).

* * *

[11] The posting of variation margin limiting the impact of market movements upon the respective positions of the affiliated parties now occurs routinely in financial groups and its imposition on affiliates who transact directly with affiliated SDs/MSPs should not be unduly disruptive. Imposition of initial margin on such transactions, however, would result in substantial additional liquidity, funding and operational costs without corresponding benefits or justification. As explained in Section III. C and D above with respect to forced clearing, these additional costs would hamper centralized risk management and are not justified due to the fundamentally different character of credit exposure between affiliated group members than between unaffiliated counterparties.

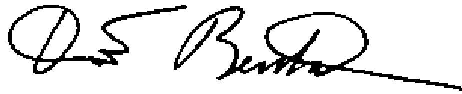
[12] Article 3.1a

[13] 77 Fed. Reg. 1182, 1187 (January 9, 2012).

Please feel free to contact the undersigned or our staff at your convenience.

Sincerely,

Robert Pickel
Chief Executive Officer
ISDA



Kenneth E. Bentsen, Jr.
EVP, Public Policy and Advocacy
SIFMA

Cc: The Honorable Gary Gensler
The Honorable Jill E. Sommers
The Honorable Bart Chilton
The Honorable Scott D. O'Malia
The Honorable Mark P. Wetjen
Ananda Radhakrishnan