ABA Securities Association
American Council of Life Insurers
Financial Services Roundtable
Futures Industry Association
Institute of International Bankers
International Swaps and Derivatives Association
Securities Industry and Financial Markets Association

September 8, 2011

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

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, DC 20551

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2–3
Washington, DC 20219

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Mr. Alfred M. Pollard
General Counsel
Attention: Comments
Federal Housing Finance Agency
Fourth Floor, 1700 G Street, N.W.
Washington, DC 20552

Mr. Gary K. Van Meter
Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102–5090

Re: Treatment of Inter-Affiliate Transactions under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

The ABA Securities Association, American Council of Life Insurers, Financial Services Roundtable, Futures Industry Association, Institute of International Bankers, International Swaps and Derivatives Association and Securities Industry and Financial Markets Association, (collectively, the

"**Associations**")[1] appreciate the opportunity to comment on the regulation of inter-affiliate swaps[2] under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] and the rules proposed thereunder by the Commodity Futures Trading Commission (the "**CFTC**"), the Securities and Exchange Commission (the "**SEC**", and together with the CFTC, the "**Commissions**"), the Board of Governors of the Federal Reserve (the "**Board**"), the Farm Credit Administration (the "**FCA**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), the Federal Housing Finance Agency (the "**FHFA**") and the Office of the Comptroller of the Currency (the "**OCC**" and, together with the Board, the FCA, the FDIC and the FHFA, the "**Prudential Regulators**").[4]

We are writing because virtually none of the proposed rules governing swaps regulation address how they will apply to inter-affiliate transactions. Silence about the treatment of inter-affiliate transactions could imply that all of the rules apply to them equally. Such application could have the counterproductive effect of lessening market transparency, increasing risk within individual institutions, increasing costs generally and increasing overall market risk. The purpose of the letter is to provide context about how inter-affiliate swaps are used by financial institutions and customers and to suggest a workable framework for the treatment inter-affiliate trades.

I. Necessity of Inter-Affiliate Swaps in the Derivatives Market

The modern over-the-counter ("**OTC**") derivatives market is global in nature, and inter-affiliate swaps are essential to the effective risk management of such a global business. Two primary market forces drive the need for inter-affiliate swaps: the needs of clients that are derivatives end-users and the internal risk management requirements of global financial institutions.

A. Inter-Affiliate Swaps Provide End-Users with Entity Choice, Risk and Cost Reduction and Operational Efficiency

Clients that are end-users of derivatives may enter into swaps based on many different U.S. and non-U.S. underlying instruments and indices, from different locations around the globe, but still seek to trade with a limited number of swap counterparties per global financial institution for all of their derivatives

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[1] A description of the Associations is set forth in the Annex to this letter.

[2] The term "swaps" as used in this letter refers generally to CFTC-regulated swaps and SEC-regulated security-based swaps. Similarly, the terms "swap dealer" and "major swap participant" are be used in this letter to include "security-based swap dealer" and "major security-based swap participant" where appropriate for the context.

[3] Public Law 111-203, 111th Cong., 2d Sess. (July 21, 2010) ("**Dodd-Frank**").

[4] Our comments are only meant to address rulemaking under Title VII of Dodd-Frank ("**Title VII**") and are not intended to address any other Dodd-Frank provisions or existing law.

trades. From a derivatives end-user's point of view, it is inefficient, riskier and costlier to trade with multiple counterparties within a global financial institution.[5] Conducting swap activities by facing a limited number of financial institutions can allow a customer to net its exposure and margin calls, reduce the amount of collateral that must be posted and returned, as well as reduce the number of payments and movements of collateral. Typical scenarios and how they may lead to the need for inter-affiliate swaps include:

- Clients may prefer to transact with a particular type of entity such as a bank, broker-dealer or other regulated entity, or an entity that is rated or maintains a particular rating threshold, or, for the sake of convenience, an entity located in a jurisdiction where the client maintains a particular office, whereas the corporate group may centralize or manage its risks in a different entity;

- Clients may prefer to transact with an entity which, due to regulatory limits on the assets the entity can hold, is unable itself to enter into an appropriate hedging transaction and must hedge the exposure through an inter-affiliate swap; and

- Clients may wish to continue transacting with an acquired institution following a merger or acquisition in order to preserve documentation and collateral arrangements with preexisting counterparties, whereas the newly merged corporate group may manage its risks in a different entity.

A financial institution will wish to accommodate its client's choice of swap counterparty, but for internal risk management and resource allocation reasons, may need to manage that risk centrally through another affiliated entity. Inter-affiliate swaps are critical to achieving these goals.

B. Inter-Affiliate Swaps Allow Global Financial Institutions to Manage Risk Effectively

At the risk of over-generalizing, a financial institution will typically deal with swap clients in one of two ways: 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; alternatively, it will provide local clients economic access to a variety of products through the customer's choice of a local counterparty, but 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.

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[5] *See* DAVID MENGLE, ISDA, RESEARCH NOTES: THE IMPORTANCE OF CLOSE-OUT NETTING (2010).

As an example of the first situation, if a U.S.-based client seeks to enter into an equity derivative relating to a German security, the trade may be booked between the U.S.-based client and the financial institution's London-based central risk managing entity. However, that entity will use an inter-affiliate swap with its German affiliate that has the presence, expertise and licenses to effectively hedge the swap, which will be accomplished by purchasing the underlying German equity security.

As an example of the second situation, if a U.K.-based client seeks to enter into a credit default swap ("**CDS**") on a U.S. corporate credit, that client will often seek to do so with the financial institution's U.K. client-facing counterparty. However, the most efficient and appropriate place to hedge U.S. corporate credit exposure may be in the global financial institution's U.S.-based affiliate, which has the requisite expertise to risk manage the exposure. The U.K. entity that has transacted with the U.K. client will use an offsetting CDS trade with its U.S. affiliate to transfer the risk of the CDS to the U.S. affiliate.

Financial institutions (including those without swap dealing businesses) also use inter-affiliate swaps as end-users to hedge their capital, to manage risks inherent in a particular balance sheet asset/liability mix and to manage other related risks arising from their general operations. For example, capital invested in overseas subsidiaries may need to be hedged for foreign exchange fluctuations. A commercial bank whose core lending and deposit taking business causes its balance sheet and earnings to be highly susceptible to interest rate changes will need to hedge for interest rate risks. Like any other corporate issuer, if a financial institution issues debt overseas, it will need to use interest rate and foreign currency derivatives to lock in costs. These swap activities are distinct from its activities as a swap market intermediary and generally are conducted centrally under an enterprise-wide function, such as the institution's chief financial officer or treasurer. Inter-affiliate swaps are key to the effective management of interest rate, foreign exchange, liquidity, capital and balance sheet risks inherent in the general business of financial institutions, just as is the case for non-financial corporations.

Thus, whether used by a financial institution in connection with its role as a market intermediary in the derivatives markets or as an end-user to hedge capital and manage balance sheet risks, inter-affiliate swaps are an important risk management tool that make it possible for a financial institution to:

- enhance its risk management capabilities by transferring the risk to affiliates most able to manage a particular risk in terms of market presence and human capital;

- use a single entity as a "hub" entity that faces non-affiliated counterparties on hedges outside the institution to increase netting benefits for exposure, capital and collateral, reduce market risk through matching potentially off-

setting positions, and limit operational risk by reducing the number of payments, deliveries and collateral movements;

- centralize management processes for FAS 133 hedges to ensure compliance with accounting requirements;

- centralize asset-liability management functions through common systems, in order to prevent balkanization of treasury, finance, risk and liquidity management on an entity-by-entity or region-by-region basis;

- centralize back- and middle-office functions and reduce operational costs and other inefficiencies associated with maintaining multiple client-facing swap counterparties; and

- efficiently deploy operational and human resources assets used in risk management.

II. Need for a Nuanced Approach to Inter-Affiliate Swaps

As described above, a global financial institution needs to use inter-affiliate swaps to accommodate its clients' demand to deal with specific local counterparties, while achieving its internal risk management goals. The use of inter-affiliate swaps not only allows risks to reside where they are more efficiently managed, but it also has a net positive effect on an institution's assets and liquidity, as well as on its efficiency in deploying capital.

Inter-affiliate swaps generally do not raise the legislative concerns that Title VII regulation 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. Inter-affiliate trades, in fact, *reduce* systemic risk by making it possible to increase the use of netting with clients and, by bringing together a diversified portfolio in one entity (e.g., the risk-managing entity), to use more offsets to manage and reduce risk.

Applying the full panoply of regulations under Title VII to inter-affiliate swaps as if they were third-party swaps will not reduce risk to the financial system, increase transparency or improve the market integrity of the financial system.[6] On the contrary, such regulations could 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.

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[6] *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 75 Fed. Reg. 80,174, 80,174 (Dec. 21, 2010) (to be codified at 17 C.F.R. pt. 240) ("**Swap Dealer Definition Proposal**"), *available at* http://edocket.access.gpo.gov/2010/pdf/2010-31130.pdf (stating that the goals of Title VII were "to reduce risk, increase transparency, and promote market integrity within the financial system").

Imposing unnecessary requirements on inter-affiliate swaps will impede efficient, centralized risk management and thus *increase*, rather than decrease, the level of risk within the enterprise and the broader financial system.

Given these negative effects, and lack of a clear policy goal for applying the full panoply of Title VII requirements to inter-affiliate swaps, we believe that a more nuanced approach to the issue is required and would be fully consistent with congressional intent. Inter-affiliate swaps are not given separate consideration in the proposed rules, implying that the rules may apply without taking into account the unique role of such swaps. We are encouraged, however, that the Commissions have recently acknowledged this issue and indicated that they are considering whether inter-affiliate swaps should be treated differently from third-party customer swaps in their Title VII rulemakings.[7] Also, we note that several of the leading architects of Dodd-Frank specifically stated that the legislation should not apply to inter-affiliate transactions.[8]

A more nuanced approach to inter-affiliate swaps would recognize that many of the transaction-based requirements in Title VII, such as customer protection, business conduct, clearing, margin, swap execution facility ("**SEF**") trading and trade reporting rules, generally do not further legislative or regulatory purposes when applied to inter-affiliate swaps. In contrast, certain entity-level rules such as risk management and capital requirements will apply, but require modification when applied, to inter-affiliate swaps to protect the swap dealer or major swap participant ("**MSP**"). Overall, the Commissions should not indiscriminately apply third-party swap rules to inter-affiliate swaps out of a concern that affiliate trades might conceivably be used, in limited or hypothetical circumstances, to evade swaps regulation, because the Commissions have at their disposal anti-evasion tools that they can use more precisely to deter such behavior.[9] This more nuanced approach would reflect congressional intent in drafting Dodd-Frank, and would be consistent with current practice and regulation.

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[7] Further Definition of "Swap," "Security- Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29,818, 29,821 (May 23, 2011) (to be codified at 17 C.F.R. pts. 1 and 240), available at http://www.gpo.gov/fdsys/pkg/FR-2011-05-23/pdf/2011-11008.pdf.

[8] Senator Blanche Lincoln, then Chairman of the Senate Agriculture Committee stated, "it would be appropriate for regulators to exempt from mandatory clearing and trading inter affiliate swap transactions which are between for [sic] wholly owned affiliates of a financial entity." 156 Cong. Rec. S5921, July 15, 2010. Senator Susan Collins also noted that it was not Congress's intent to "capture as swap dealers end users that primarily enter into swaps to manage their business risks, including risks among affiliates." 156 Cong. Rec. S5907, July 15, 2010. Senate Banking Committee Chairman Chris Dodd agreed with Senator Collin's assessment of the law. *Id.*

[9] For example, sections 721 and 761(b)(3) of Dodd-Frank give the Commissions authority to adopt rules to further define the terms "swap dealer" and "security-based swap dealer" to include transactions and entities that have been structured to evade Title VII regulation.

Under existing regulation, for example, an entity that acts only for its affiliates need not register as a futures commission merchant ("**FCM**").[10] Similarly, an entity that transacts only with affiliates need not register as a broker or dealer,[11] and current regulatory reporting practice for OTC swaps excludes the reporting of inter-affiliate trades for electronic submission and matching targets, monthly cross-product metrics and existing trade repositories.

We set forth in the discussion below our proposal for how the Commissions and the Prudential Regulators should treat inter-affiliate swaps in various contexts.

III. How Inter-Affiliate Swaps Should Be Addressed in Applicable Rulemakings

We believe the Commissions and the Prudential Regulators should address the treatment of inter-affiliate swap transactions as described below. This treatment would be without distinction between affiliates based on their jurisdiction of incorporation. The Commissions and the Prudential Regulators should do so in each of their applicable rulemakings, as the arguments made here are broadly applicable.[12]

A. The Commissions and Prudential Regulators Should Provide a Consistent Definition of Affiliate.

A threshold issue is how "affiliate" should be defined by the Commissions and the Prudential Regulators for the purposes of Title VII rulemaking.[13] We believe that the "affiliated group" definition suggested by the Commissions in their joint proposed rule regarding the definition of swap dealer and MSP – "any group of entities that is under common control and that reports information or prepares its financial statements on a consolidated basis" – provides an effective

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[10] *See* CFTC Regulations 1.3(y) and 3.10; CFTC Letter Interpretation, Re: Request for Confirmation of Interpretations Regarding "Bona Fide Hedging" and "Exchange of Futures for Product" (May 9, 1994). The CFTC noted that commonly owned and controlled entities should be considered the "same person" for purposes of compliance with certain CFTC regulations.

[11] *See, e.g.*, Fenchurch Paget Fund, Ltd., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,514 (Aug. 3, 1987).

[12] We note that commentators have suggested that inter-affiliate swaps should be excluded from the definition of swap. While an exclusion would be an effective means of comprehensively addressing the regulatory questions regarding inter-affiliate swaps, we are encouraged that the Commissions at a minimum are considering whether inter-affiliate swaps should be treated differently from other swaps in the context of their rulemakings.

[13] As noted above, our comments are limited to the definition of affiliate in rulemakings pursuant to Title VII and are not meant to address any other Dodd-Frank provisions nor the long-standing definitions of affiliate in other laws administered by the Prudential Regulators.

standard that reflects business realities.[14] By requiring both "common control" and the consolidation of financial statements, the definition imposes a high enough bar to minimize the risk that an inter-affiliate exemption will be misused. Such definition should also be consistently applied across Title VII rulemakings.

B. An Entity's Swaps with an Affiliate Should Not Trigger or Affect Title VII's Registration Requirements.

We believe that an entity should not be required to register as a swap dealer or MSP if it solely conducts inter-affiliate swap trades, and that an entity that conducts a mix of third-party activity and inter-affiliate activity should not have to count the inter-affiliate activity toward its registration requirements. Although not stated in the actual proposed swap dealer registration rules, this approach is acknowledged by the Commissions in the Swap Dealer Definition Proposal release. The release notes that in order to make a determination regarding the designation of a person as a swap dealer, "we preliminarily believe it would be appropriate for the person to consider the economic reality of any swaps it enters into with affiliates (i.e., legal persons under common control with the person at issue), including whether those swaps and security-based swaps simply represent an allocation of risk within a corporate group."[15] Further, the Commissions acknowledge that swaps "between persons under common control may not involve the interaction with unaffiliated persons that we believe is a hallmark of the elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a dealer."[16] In addition, the Commissions stated that they "preliminarily believe that the counterparties who are members of an affiliated group would generally count as one counterparty" for purposes of the *de minimis* exemption to the swap dealer registration.[17]

Given the Commissions' acknowledgment of the special status of inter-affiliate swaps, the Commissions should propose other Title VII rules aligned with such suggested treatment. These rules would recognize the economic reality that most inter-affiliate swaps represent an important internal risk management tool that should not be hindered by costly regulatory requirements devoid of countervailing benefit.

The discussion in the Swap Dealer Definition Proposal regarding attributing inter-affiliate swaps to the determination of MSP status makes a similar point and also notes that such swaps "among wholly-owned affiliates may not pose the exceptional risks to the U.S. financial system that are the basis for the

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[14] Swap Dealer Definition Proposal at 80,180.

[15] *Id.* at 80,183.

[16] *Id.*

[17] *Id.* at 80,180.

major participant definitions."[18] The rationale for determining swap dealer status apart from inter-affiliate swaps is particularly applicable to MSP registration: No public policy goal of Dodd-Frank is achieved through requiring registration of the affiliated entity as an MSP. An entity within an affiliated group that otherwise has no transactions in the swap market other than inter-affiliate trades for purposes such as hedging should not, by virtue of those trades, become subject to registration and other requirements that may be applicable to MSPs. In addition, even if such entity does have swaps with third-parties, inter-affiliate trades should not be taken into account when calculating the entity's MSP status.

The Commissions are correct in their understanding of the role of inter-affiliate swaps – that such swaps do not pose an increased risk to the economy as a whole – and should apply this concept throughout the final rules. In the swap dealer and MSP context, the Commissions should confirm that they will allow non-swap dealer entities to engage in swap transactions with their affiliates without those trades resulting in the entity being classified as a swap dealer or MSP. The Commissions' final rules should further confirm that inter-affiliate transactions will not be counted when determining whether an entity qualifies for the "swap dealer" *de minimis* exception or when calculating the entity's MSP status. This approach is consistent with the above guidance that the matter of central concern to regulators is the "economic reality" of the swap.

C. Certain Entity-Level Rules Will Apply to Inter-Affiliate Swaps

We recognize that a number of rules that apply to the core operations of a registered entity will perforce apply to such entity's inter-affiliate swap transactions and could further Dodd-Frank policy purposes. Entity-level rules that would likely apply to inter-affiliate swaps are capital requirements and the supporting internal recordkeeping, supervision and risk management requirements. Inter-affiliate swap transactions will need to be taken into account in calculating an entity's capital requirements, and applicable concentration charges could have a significant impact on these swaps. Internal recordkeeping requirements are essential to the oversight of the swap business as such, including monitoring of the capital requirements. Supervision requirements, such as chief compliance officer responsibilities, help ensure the registered entity complies with applicable requirements. Enterprise-wide risk management systems help assure that the spectrum of risks applicable to the registered entity are monitored and addressed. These entity level rules help provide assurance that the regulated entity is operated in a safe and sound manner, the applicable requirements are satisfied, and compliance can be monitored internally and externally by supervisors.

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[18] *Id.* at 80202. Consistent with our suggested definition of "affiliate" in Section III.A, *supra*, the Commissions should recognize that inter-affiliate swaps conducted between entities under "common control and that report information or prepare financial statements on a consolidated basis," in addition to inter-affiliate swaps among wholly-owned affiliates, also bear little risk to the financial system.

In contrast, as we discuss below, there are several transaction-level requirements that would serve no positive purpose if applied to inter-affiliate swaps.

D. Inter-affiliate Swaps Should Not Trigger Margin Requirements.

As both the CFTC and the Prudential Regulators' proposed rules on margin indicate, Sections 731 and 764 of Dodd-Frank require additional margin "to offset the greater risk to the swap dealer or major swap participant and the financial system" arising from the use of swaps that are not cleared.[19] Regulators are also instructed to propose margin rules that "(1) help ensure the safety and soundness of the swap dealer or major swap participant; and (2) [are] . . . appropriate for the risk associated with the non-cleared swaps [they hold]."[20] Requiring affiliated financial entities to post margin to each other for uncleared swaps serves little purpose. First, as illustrated above, such swap activity largely constitutes allocations of risk between affiliates designed to enhance the safety and soundness of the affiliate group and does not create systemic risk. These allocations allow an organization to manage centrally its risk in the manner that it deems the most effective and efficient.[21] Second, in most, if not all cases, one of the counterparties to the inter-affiliate swap will be a registered swap dealer or an otherwise regulated entity and thus have minimum capital standards that must be satisfied. To the extent that such an entity does not collect margin from an affiliate, it generally would have higher capital requirements. These regulated entities would have to evaluate whether forbearance from collecting margin from an affiliate outweighs the cost of additional capital requirements. In either case, the regulated entity is protected and its safety and soundness is therefore not jeopardized.

Initial margin requirements in particular do not align well with the goals of the margin requirements when applied to inter-affiliate swaps, given that the general goal of initial margin is to ensure that a counterparty has the ability to pay any losses that come due to its creditor. The quality of information available

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[19] *See also* Section III.G, *infra*. To the extent that inter-affiliate swaps are indeed exempt from clearing requirements, such an exemption should not then trigger the imposition of additional margin requirements for the same swaps.

[20] Dodd-Frank §§ 731, 764; *see also* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (May 11, 2011) (to be codified at 12 C.F.R. pts. 45, 237, 324, 624, 1221), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf; Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (Apr. 28, 2011) (to be codified at 17 C.F.R. pt. 23), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-04-28/pdf/2011-9598.pdf.

[21] To the extent that different regulators' final rules vary, SIFMA would appreciate clarification that a covered swap entity subject to the CFTC's rules would not become subject to the Prudential Regulators' rules by virtue of having its swaps guaranteed by a parent or affiliate subject to regulation by a Prudential Regulator.

about the credit and operations of affiliates is often markedly better – in many cases the affiliates may even be using the same systems. Any potential stress risk can be identified earlier and appropriate action – such as collateral calls (variation margin), escalating to the parent entity, unwinding the transaction and devising alternative payment methods (for example, via an affiliate guarantee or cover) – can be taken more quickly and more readily than with unaffiliated third parties.

E. Inter-affiliate Swaps Should Not Trigger Collateral Segregation Requirements.

As noted above, we do not believe that initial margin requirements should apply to inter-affiliate swaps. However, to the extent that the Commissions and Prudential Regulators decide to apply initial margin requirements, we would urge that segregation of margin should not be required. The primary goal of the proposed rulemaking regarding collateral segregation for uncleared swaps is to provide counterparties with additional protections for the collateral they have provided in transactions with a swap dealer or MSP.[22] A key feature of the proposal is the requirement that the segregated collateral be held at a third-party custodian. The introduction of a third-party custodian to hold margin between affiliates (that would otherwise be held internally) will actually increase credit, operational and therefore systemic risk.

These protections are not necessary in an inter-affiliate context, because the likelihood of a default or failure to perform by an affiliate is ascertainable by both affiliated participants to the swap transaction and segregation of required margin may conflict with the organization's optimal risk management allocations. Further, the reports to be provided to the counterparty in the case of nonsegregated collateral are likely to have little value in an affiliate context, placing an unnecessary burden on the swap dealer or MSP.

F. Inter-affiliate Swaps Generally Should Not Trigger Public Reporting Requirements.

Requiring real-time reporting of inter-affiliate swaps will not contribute to Dodd-Frank's transparency goals but rather would distort market information, and thus have a detrimental market and commercial impact. Public reporting of inter-affiliate swaps will not accurately inform the Commissions or market participants regarding the size or state of the swaps market. As illustrated above, these trades are typically risk transfers with no market impact. Thus, inclusion of these swaps in swaps market data will distort the establishment of position limits, analysis of open interest, determinations of block trade thresholds and performance of other

[22] Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 Fed. Reg. 75,432 (Dec. 3, 2010) (to be codified at 17 C.F.R. pts. 23 and 190), *available at* http://edocket.access.gpo.gov/2010/pdf/2010-29831.pdf.

important regulatory analysis, functions and enforcement activities that require an accurate assessment of the swaps market. The market-facing swaps already will have been reported and therefore, to require that inter-affiliate swaps also be reported will duplicate information. Such double counting will distort information that is critical for price discovery and measuring liquidity, the depth of trading and exposure to swaps in the market.

In addition, the affiliates often enter into these swaps on terms linked to an external trade being hedged. If markets have moved before the inter-affiliate trade is entered into on the SEF or reported as an off-exchange trade, market participants could also misconstrue the market's true direction and depth.

Simply put, there are no discernible benefits, and a serious risk of public confusion, if reporting requirements are extended to inter-affiliate trades.

G. Inter-affiliate Swaps Should Not Trigger Clearing and Exchange Trading Requirements.

Where a swap transaction is between unrelated parties, the imposition of a clearinghouse will meaningfully change the credit default risk faced by swap counterparties. A party to a cleared swap is no longer exposed to the default risk of its trading counterparty, and unless the party is itself a clearing member, the party will face the clearinghouse through a separate FCM.[23] Even if the FCM it faces were to default, the party should be able to move the position to another FCM and avoid having to terminate the swap.

The benefits of central clearing are unlikely to be realized in connection with inter-affiliate swaps. In the course of clearing inter-affiliate swaps, the affiliates may be exposed to new sources of risk – that of the credit of the clearinghouse, its members and the clearing FCM. With respect to the FCM, it is highly unlikely that both parties to an inter-affiliate swap would themselves be clearing members. Therefore, one or both of the swap counterparties likely would clear the trade through an affiliated FCM. While it is not yet known how positions of an affiliate of the FCM will be treated by a clearinghouse, for at least some clearinghouses, the FCM's own positions and the positions it is clearing for its affiliates will likely be combined in a single "house" account.[24] If so, these affiliate positions will likely not be portable in a default of the FCM and instead

[23] Requirements for Processing, Clearing, and Transfer of Customer Positions, 76 Fed. Reg. 13,101 (Mar. 10, 2011) (to be codified at 17 C.F.R. pts. 23, 37, 38, 39), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-03-10/pdf/2011-4707.pdf.

[24] Adaptation of Regulations to Incorporate Swaps, 76 Fed. Reg. 33,066, 33,083 (June 7, 2011) (to be codified at 17 C.F.R. pts. 1, 5, 7, 8, 15, 18, 21, 36, 41, 140, 145, 155, and 166), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-06-07/pdf/2011-12270.pdf (incorporating "swap trading accounts" of affiliates into the definition of a "proprietary account" at CFTC Reg. 1.3(y)).

are likely to be closed out along with the FCM's own positions. Instead of reducing counterparty risk, a central clearing requirement as applied to inter-affiliate trades at best leaves the parties with the same default risk as if the trade were bilateral, and at worst increases the parties' credit risk by exposing them to the default risk of their affiliated FCM.

Forcing inter-affiliate trades onto a SEF would also likely be a counterproductive requirement. The entire point of the inter-affiliate trade is to move a certain risk between two affiliates, such as offsetting short and long positions held by two affiliates. The SEF requirement would impose costs and inefficiencies even if inter-affiliate swaps can be readily effected on a SEF. Moreover, the CFTC's proposed requirements for SEFs – for example, requiring requests for quotes to be sent to five or more counterparties and delaying trades with customers for 15 seconds – appear designed to prevent prearranged trades and advance price discovery goals. Introducing uncertainty as to whether the affiliates' positions would be matched on a SEF would be unacceptable as a commercial matter by defeating the risk management purpose of the inter-affiliate trade.

An analogy to long-standing practices in the futures markets is appropriate. The statutory prohibition on the off-exchange trading of futures has never been applied to a clearing member that merely elects to internalize, and not send to an exchange, transactions for its own account or with affiliates (but not including other customers) that could have been executed on the exchange. By its terms, the statutory language setting forth the exchange-trading requirement for futures applies only to "order[s] for" and "dealing in" futures contracts.[25] Accordingly, transactions for a clearing member's proprietary account that could have been, but were not, submitted to the exchange for execution traditionally have not been deemed to be within the statutory prohibition on off-exchange trading in futures. Indeed, exchanges have long taken the view that the prohibition on wash trades[26] within a proprietary account specifically exempts, and does not apply to, the centralized hedging of orders initiated by various divisions of a clearing member or clearing member affiliates that have the same beneficial ownership.

H. Inter-affiliate Swaps Should Not Trigger Business Conduct Requirements.

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[25] Section 4(a) of the Commodity Exchange Act provides that "it shall be unlawful for any person to offer to enter into, to enter into, to execute, to confirm the execution of, or to conduct any office or business anywhere in the United States, its territories or possessions, for the purpose of soliciting, or accepting any order for, or otherwise dealing in, any transaction in, or in connection with, a contract for the purchase or sale of a commodity for future delivery" unless such transaction is effected on a contract market by a member thereof and is evidenced by a writing that reflects the information specified in the statute.

[26] A "wash trade" refers to an illegal stock trading practice where an investor simultaneously buys and sells shares in a company through two different brokers.

In furtherance of the congressional goal of protecting investors, the proposed internal business conduct requirements require swap dealers and MSPs to implement systems to avoid conflicts of interest between research analysts and individuals involved in pricing, trading or clearing activities and to maintain partitions between business trading personnel and the personnel of an affiliated clearing member.[27] Further, the proposed external business conduct standards are primarily designed to protect counterparties by, among other things, imposing "know your customer requirements," prohibiting fraud, manipulation and other abusive practices, prohibiting the disclosure of confidential counterparty information, prohibiting front-running or trading ahead of counterparty transactions, requiring verification of counterparty eligibility, requiring communications be made on the basis of fair dealing, and requiring disclosure to the counterparty of material information, including scenario analysis, material characteristics of the swap, swap price and value, conflicts of interest in connection with the swap and the daily mark.[28] As inter-affiliate swaps do not involve any external clients of a swap dealer or MSP, these rules are clearly inapposite to the inter-affiliate swap context. We would appreciate the Commissions clarifying this point when business conduct rules are finalized.

I. Inter-affiliate Swaps Should Not Trigger Confirmation and Portfolio Reconciliation Requirements.

The confirmation, portfolio reconciliation, and portfolio compression rules "have been recognized as important post-trade processing mechanisms for reducing risk and improving operational efficiency by both current market participants and regulators."[29] Confirmation requirements provide counterparties with "legal certainty" about the terms of the agreement, while portfolio reconciliation allows counterparties to "resolve any discrepancies or disputes as early as possible and arrive at an understanding of their overall risk exposure to each other."[30]

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[27] Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants, 75 Fed. Reg. 71,391 (Nov. 23, 2010) (to be codified at 17 C.F.R. pt. 23), *available at* http://edocket.access.gpo.gov/2010/pdf/2010-29006.pdf.

[28] Business Conduct Standards for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 80,638, 80,657 – 80,659, §§ 23.402 –23.433 (Dec. 22, 2010) (to be codified at 17 C.F.R. pts. 23 and 155), *available at* http://edocket.access.gpo.gov/2010/pdf/2010-31588.pdf. *See also* Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 Fed. Reg. 42,396 (July 18, 2011) (to be codified at 17 C.F.R. pt. 240), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-07-18/pdf/2011-16758.pdf.

[29] Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 81,519, 81,520 (Dec. 28, 2010) (to be codified at 17 C.F.R. pt. 23), *available at* http://edocket.access.gpo.gov/2010/pdf/2010-32264.pdf.

[30] *Id.*

Inter-affiliate transactions are already subject to rigorous recordkeeping requirements and should not be subject to additional standards that will impose costs and burdens for no incremental benefit. Enterprise-wide risk management systems document and verify inter-affiliate trades to comply with existing regulatory and financial accounting requirements to keep accurate books and records and maintain them in a manner that is sufficient to capture assets and liabilities of each entity.[31] Inter-affiliate transactions are also already reconciled for a whole range of internal management, capital calculation, and other control requirements. These recordkeeping requirements may not match exactly the requirements in the proposed rule for third-party transactions, but they typically are sufficiently detailed and robust to address the same concerns and to obviate the need for an additional layer of regulation. To require such swaps to meet the standards imposed on third parties would impose additional costs and burdens for no incremental benefit.

J. Inter-affiliate Swaps Should Not Trigger or Affect Position Limits.

The purpose of position limits is to prevent "excessive speculation."[32] Inter-affiliate swaps have no market impact and will result in no change in net position on a consolidated group level. Moreover, inter-affiliate swaps are typically not used as a speculative tool to impact market prices, but rather as a tool to allocate and manage organizational risk, which is outside of the intended purpose of the regulation. Thus, inter-affiliate swaps should be consistently excluded from or netted out in the calculation of position limits.

K. Title VII Swaps Requirements Should Not Apply to Transactions with Non-U.S. Affiliates.

As discussed previously, inter-affiliate swaps are a crucial method for managing risks in local markets. As a result, affiliates (regardless of whether one or both are swap dealers) frequently engage in cross-border swap transactions with each other for risk-hedging and other internal management purposes. These cross-border inter-affiliate swaps should not trigger U.S. swap transaction requirements. To the extent that the Commissions determine that inter-affiliate arrangements with non-U.S. affiliates are being used to illegally evade Title VII regulation, the Commissions should use their anti-evasion tools to deter and stop such behavior.

In addition, it is crucially important that if a U.S. entity enters into swaps and then back-to-backs these swaps with a foreign affiliate, or a foreign entity

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[31] *See. e.g.,* CFTC Regulation 1.37.

[32] Position Limits for Derivatives, 76 Fed. Reg. 4,752 (Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 1, 150 and 151), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-01-26/pdf/2011-1154.pdf.

enters into swaps with non-U.S. customers and back-to-backs these swaps with a U.S. affiliate, these swaps should not trigger a swap dealer or MSP registration requirement for the foreign affiliate.[33] Such an approach is entirely consistent with the goals of Title VII, as such swaps would be conducted, as discussed above, for valid business reasons and reflect well-established practices.

To subject cross-border inter-affiliate swaps to U.S. swap requirements raise the particular concern that such swaps will become subject to multiple regulatory regimes. The need to comply with the requirements of multiple regulators could result in duplicative or inconsistent regulation of these swap activities. For example, these swaps could be required to be publicly reported in multiple jurisdictions, even though they are not suitable for reporting in any jurisdiction.

In describing our position above on the inapplicability of a number of swaps rules, we believe that there should be no distinction between affiliates based on their jurisdiction of organization. All inter-affiliate trades should be treated in the manner that we have proposed and we respectfully request that the Commissions clarify that in any final rules.

IV. Conclusion

The Associations strongly encourage the Commissions and the Prudential Regulators to limit carefully the application of their regulations under Title VII to inter-affiliate swaps, given their use for valid and important customer accommodation and risk management purposes across a corporate group. Without exceptions from most swap regulations, inter-affiliate swaps would be subject to requirements that are inconsistent with current practice and are outside of the intended congressional mandate provided by Dodd-Frank. This would raise a host of unintended consequences, including distorting relevant data, increasing operational risk, increasing costs and disrupting the economic rationale for such swaps, without achieving any countervailing benefit. We believe that our recommended approach of generally exempting swaps between consolidated affiliates under common control, subject to the entity-level exceptions discussed in Section III.C above, is consistent with the legal authority provided in Dodd-Frank, as well as with regulators' current approach toward affiliate transactions, and would achieve the statute's objectives and facilitate an efficient, effectively regulated and competitive swaps market.

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[33] Such an approach is entirely consistent with Title VII and the Commission's anti-evasion rulemakings, as such swaps would be conducted, as discussed above, for valid business reasons and reflect well-established practices.

* * *

The Associations appreciate the opportunity to provide the Commissions and the Prudential Regulators with the foregoing comments and recommendations regarding the treatment of inter-affiliate swaps under Title VII of Dodd-Frank.

Respectfully submitted,

ABA Securities Association
American Council of Life Insurers
Financial Services Roundtable
Futures Industry Association
Institute of International Bankers
International Swaps and Derivatives Association
Securities Industry and Financial Markets Association

cc:

Honorable Gary Gensler, Chairman
Honorable Bart Chilton, Commissioner
Honorable Michael Dunn, Commissioner
Honorable Scott O'Malia, Commissioner
Honorable Jill E. Sommers, Commissioner
Commodity Futures Trading Commission

Honorable Mary L. Schapiro, Chairman
Honorable Luis A. Aguilar, Commissioner
Honorable Troy A. Paredes, Commissioner
Honorable Elisse B. Walter, Commissioner
Securities and Exchange Commission

Honorable Ben S. Bernanke, Chairman
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Honorable Daniel K. Tarullo, Governor
Board of Governors of the Federal Reserve System

John Walsh, Acting Comptroller
Office of the Comptroller of the Currency

Martin J. Gruenberg, Acting Chairman
Federal Deposit Insurance Corporation

Timothy Geithner, Secretary and Chair of the Financial Stability Oversight Council
Department of the Treasury

Leland A. Strom, Chairman and Chief Executive Officer
Farm Credit Administration

Edward DeMarco, Acting Director
Federal Housing Finance Agency

ANNEX

The **ABA Securities Association** ("ABASA") is a separately chartered affiliate of American Bankers Association, representing those holding company members of ABA that are actively engaged in capital markets, investment banking, and broker-dealer activities.

The **American Council of Life Insurers** ("ACLI") is a national trade association with over 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry. Life insurers' financial products protect millions of individuals, families and businesses through guaranteed lifetime income, life insurance, long-term care insurance and disability income insurance, among other products. Life insurers manage their asset and liability risks through hedging transactions with derivatives, as permitted under state laws. ACLI actively participated in the legislative dialogue concerning regulation of derivatives markets and provided constructive input on proposed rulemaking implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The **Financial Services Roundtable** (the "Roundtable") represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.1 trillion in revenue, and 2.3 million jobs.

The **Futures Industry Association** ("FIA") is the leading trade organization for the futures, options and OTC cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world's largest derivatives clearing firms as well as leading derivatives exchanges from more than 20 countries. As the principal members of the derivatives clearinghouses, our member firms play a critical role in the reduction of systemic risk in the financial markets. They provide the majority of the funds that support these clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions. FIA's core constituency consists of futures commission merchants, and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. FIA's regular members, who act as the majority clearing members of the U.S. exchanges, handle more than 90% of the customer funds held for trading on U.S. futures exchanges.

The **Institute of International Bankers** ("IIB") is the only national association devoted exclusively to representing and advancing the interests of the international banking community in the United States. Its membership is comprised of internationally headquartered banking and financial institutions from 38 countries around the world. The IIB's mission is to help resolve the many special legislative, regulatory, tax and compliance issues confronting internationally headquartered institutions that engage in banking, securities and other financial activities in the United States. Through its advocacy efforts the IIB seeks results that are consistent with the U.S. policy of national treatment and appropriately limit the extraterritorial application of U.S. laws to the global operations of its member institutions.

Since 1985, the **International Swaps and Derivatives Association** ("ISDA") has worked to make the global over-the-counter ("OTC") derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 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

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