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By Email Delivery

Ms. Sarah Josephson, Associate Director  
Division of Clearing and Intermediary Oversight  
Commodity Futures Trading Commission  
1155 21st Street, N.W.  
Washington, D.C. 20581

Re: Documentation of Cleared Swaps

Dear Ms. Josephson:

On April 13, 2011, CFTC Chairman Gensler and Commission staff met with the American Council of Life Insurers<sup>1</sup> (ACLI) and representatives of life insurance companies to elicit (i) suggestions about the most appropriate order for promulgating forthcoming rules under Title VII of the Dodd-Frank Act and (ii) input on issues life insurers have identified in rules that will implement Title VII of the Dodd-Frank Act. Among other things, our group raised concerns about the migration of traditional, over-the-counter (OTC) swaps to the new paradigm of cleared swaps.<sup>2</sup> More specifically, the group respectfully suggested that the Commission consider differences between the documentation associated with OTC swaps and with cleared swaps. This letter and its enclosures are intended to further the CFTC's consideration of this matter. As explained below, life insurers are concerned that the few, very well capitalized, potential clearing members that will serve financial end-users could opportunistically use their inherent leverage to compel even the most sophisticated end-user to accept unfavorable contractual terms and to take on execution risk associated with the performance of Derivatives Clearing Members.

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<sup>1</sup> The American Council of Life Insurers ("ACLI") is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and the annuity industry. Life insurers actively participated in the legislative dialogue concerning the examination and regulation of derivatives markets following the marketplace stresses of 2008, and has submitted comments on various rule proposals implementing Title VII of the Dodd-Frank Act.

<sup>2</sup> See External Meeting: Video Conference with Insurance Groups, April 13, 2011 at [http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/dfmeeting\\_041311\\_709.html](http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/dfmeeting_041311_709.html)

It may be constructive to “level set” the issue. Since the advent of OTC swaps, parties have documented their contractual arrangements by means of so-called Master Agreements, and other ancillary contracts, published by the International Swaps and Derivatives Association (ISDA). These documents provide the contractual terms and conditions governing the rights, obligations and conduct of the swap counterparties. One of the central characteristics of the ISDA Master Agreement is its essentially neutral, bilateral, and reciprocal quality. While the parties are free to negotiate particular terms, the standard pre-printed form agreement presumes that each party stands on equal footing in such important matters as their potential events of default, opportunities to cure defaults, grace periods within which to do so, and the remedies available to the non-defaulting party.

Significantly, the ISDA Master Agreement provides the potentially defaulting party with a brief opportunity to remedy the condition giving rise to a potential default, except in the most exigent circumstances (for example, when the defaulting party voluntarily files for bankruptcy). If a default is declared, the 2002 version of the ISDA Master Agreement includes a neutral set-off provision which presumes that either party might be the defaulting party. Similarly, the commonly used Credit Support Annex (CSA) published by ISDA provides for clearly specified initial margin and reciprocal collateral calls between the parties that must be satisfied by the close of business on the day following receipt of the call. Because the CSA is party-neutral, each party is expected to observe the same timing rules. Thus, not only do the ISDA Master Agreement and CSA address counterparty credit concerns, including early termination risk, they also play a critical role in addressing liquidity risk by clearly specifying how and when demands for margin can be made and when such demands must be satisfied.

There are an inestimable number of ISDA Master Agreements and CSAs outstanding at the present time between swap dealers and their counterparties. It is customary for parties to negotiate such agreements at the inception of their relationship and to leave it in place for years thereafter while conducting numerous transactions under its over-arching terms.

With the advent of swaps clearing, however, the central role of the ISDA Master Agreement will be reduced, if not supplanted, by a new type of agreement: the customer agreement between a typical counterparty and its clearing member futures commission merchant (FCM). By its nature, the typical FCM customer agreement is significantly different from the ISDA Master Agreement. Unlike the ISDA Master Agreement, which is a form document, customer agreements are proprietary documents that are unique to each FCM. Where the ISDA Master Agreement is party-neutral and reciprocal, the customer agreement is basically a service agreement that foresees the FCM occupying a dominant role.

Thus, while there are a variety of FCM customer agreements in use, a reasonably large sampling reveals that the typical customer (formerly an ISDA counterparty) might find its swap clearing agreement terminated with scarcely any notice because the clearing FCM decides it should, and can, do so to protect itself. There is no opportunity to remedy the condition, if any, that the FCM

might deem disturbing. Margin call provisions are also typically one-sided, providing that the customer must provide margin “on demand” under threat of liquidation and in amounts determined by the FCM in its sole discretion. Set-off rights only apply to the FCM facing a defaulting customer. In contrast, the customer has no right of set-off if the FCM is in default.

We understand that the FCM community is reluctant to re-open negotiations of their more-or-less standard futures agreements. As applied to exchange-traded futures, these agreements have withstood the test of time and have the support of numerous legal precedents enforcing the FCM’s rights. Rather than directly engaging in negotiation of new clearing agreements for swaps, however, the FCM community currently proposes to bridge clearable swaps into futures clearing agreements by means of a “Cleared Derivatives Transactions Addendum” that will “supplement” the FCM’s futures clearing agreement with its customer. The Addendum simply sits on top of the futures clearing agreement and stipulates that any swap transactions cleared by the FCM become contracts under the futures clearing agreement. Material terms, such as defaults, grace periods, remedies, margin and termination will be governed by the futures clearing agreement which typically favors the FCM. The Addendum contains additional provisions that eliminate the customer’s protections for actions taken by the FCM other than for gross negligence and willful misconduct.<sup>3</sup>

This untenable imbalance will harm unwary end-users. First, they might engage in an important, hedging swap transaction with a customary counterparty pursuant to a carefully negotiated but essentially reciprocal ISDA Master Agreement. Second, these end-users will “give-up” that swap to their FCM clearing member under an agreement where the rights they had under the ISDA Master Agreement no longer exist. The same transaction, initiated under an evenly balanced agreement, is transported to, and transformed by, a different agreement that eviscerates those rights.

In the current market, we do not believe that the end-user community is generally cognizant of the dramatic differences between an ISDA Master Agreement and the typical FCM clearing agreement, as further modified by the Addendum. Further, the presence of the Cleared Derivatives Transactions Addendum could distract attention from the clearing agreement. Best practices would suggest that the end-user renegotiate its outstanding FCM clearing agreement, if applicable, or enter into newly negotiated agreements, with the objective of better conforming the clearing agreement to the terms usually present in the ISDA Master Agreement.

Life insurers anticipate that there will be an enormous volume of new agreements that will be negotiated between parties. Each end-user should have no less than two clearing FCMs under contract. Moreover, in practice, because there are only a small number of well-capitalized FCMs to choose among, it is foreseeable that these few “blue chip” FCMs will be under pressure to process

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<sup>3</sup> During the April 13, 2011, meeting, CFTC staff indicated that it would be constructive to obtain supplemental information about differences between OTC derivative and cleared swap documentation. A slide deck is attached, with permission of the authors, which highlights differences between ISDA Master Agreements and Futures Account Agreements, among other things.

an extraordinary volume of new paperwork in order to document OTC clearing arrangements. In these unique circumstances, and particularly as deadlines for mandatory clearing loom closer, these FCMs could use their leverage in contract negotiations. It is instructive to revisit the documentation challenges faced by customers in September 2008, in the wake of the Lehman bankruptcy, during which Lehman customers wishing to port their futures trades to a new FCM were faced with take it or leave it customer account documents. If the FCM's position becomes "my way or the highway," end-users will face a troubling transactional environment. End-users will be compelled to capitulate to unpalatable terms.

We believe that one potential remedy for this problem is to relieve the implementation time constraints that favor the already strong position of the FCM community. A greater the time frame during which end-users can comprehend and negotiate new terms can mitigate the unwarranted leverage FCMs would otherwise have due to the exigency of compulsory clearing occurring within a very short time period. Another solution would be to encourage FCMS to create a standard agreement that is more balanced as between FCM and end-user, and then allow negotiation between the parties.

Thank you for your attention to our views. If any questions develop, please let me know.

Very truly yours,



Carl B. Wilkerson

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# Documentation for OTC Derivatives vs. Cleared Swaps

Warren Davis & Jamie Cain  
April 25, 2011



SUTHERLAND

- ISDA Master Agreement/CSA is a principal-to-principal agreement that addresses three principal risks faced by end-users in OTC swap transactions:
  - **1. Counterparty credit risk**
    - Collateral, financial representations, default, early termination, limited transfer rights, close-out, set-off
  - **2. Early termination risk**
    - Restrict right of dealer to early terminate except upon occurrence of default or agreed upon additional termination events. Notice and grace periods generally apply.
  - **3. Liquidity risk**
    - Timing and amount of margin (including initial margin) spelled out. No unilateral right to increase margin except for mark-to-market changes.

# Comparing ISDA Master Agreements and Futures Account Agreements

## ISDA Master Agreement

- Collateral
  - Established by contract
  - Independent Amount (IA) limited
  - Demand and delivery time fixed by contract
- Termination
  - Not authorized unless an event of default or other negotiated contractual termination event occurs

## Futures Account Agreement\*

- Margin
  - Established by DCOs
  - No limitation on initial margin – additional margin may be required by FCM at any time
  - Delivery on demand; no notice or grace period
- Termination
  - FCM may terminate at any time upon written notice
  - FCM may unilaterally require customer to reduce positions

\*Based on review of agreements from 5 FCMs

# Comparing ISDA Master Agreements and Futures Account Agreements

## ISDA Master Agreement

- Events of Default
  - Payment default-after notice and cure period
  - Other breaches-after notice and cure period
  - Typically no default for “insecurity” unless termination event is triggered (Note:some users have agreed to “Adequate Assurance” provisions.)

## Futures Account Agreement

- Events of Default
  - Payment default-no notice or cure period
  - Other breaches-no notice or cure period
  - FCM may declare if it deems it necessary “for its protection”



# Comparing ISDA Master Agreements and Futures Account Agreements

## ISDA Master Agreement

- Events of Default
  - Payment default-after notice and cure period
  - Other breaches-after notice and cure period
  - Typically no default for “insecurity” unless termination event is triggered (Note: We are aware of negotiated “Adequate Assurance” provisions.)
- Set-off
  - Bilateral set-off of obligations under other agreements

## Futures Account Agreement

- Events of Default
  - Payment default-no notice or cure period
  - Other breaches-no notice or cure period
  - FCM may declare if it deems it necessary “for its protection”
- Set-off
  - Set-off only available to FCM

# Comparing ISDA Master Agreements and Futures Account Agreements

## ISDA Master Agreement

- Financial Representations
  - Both parties agree to provide periodic financial statements and represent their accuracy.

## Futures Account Agreement

- Financial Representations
  - Financial statements and representations required only of customer, not FCM.
  - No attention to “fellow-customer” risk.

- Cleared swaps mutualize counterparty credit risk and thus address one of the major risks facing participants in the OTC swaps market.\*
- However, OTC swap documentation also addresses early termination risk and liquidity risk.
- **Standard documentation for futures poses material early termination risk and liquidity risk that end users should address as they move portions of their OTC swaps portfolio to clearinghouses.**

**\* Depending on regulatory action, end-users may still face “fellow-customer risk” in cleared swaps.**