

September 14, 2012

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

Re: RIN 3038-AC97: Margin Requirements for Uncleared Swap Dealers and Major Swap Participants

Dear Mr. Stawick:

Markit<sup>1</sup> is pleased to submit the following comments to the Commodity Futures Trading Commission (“**CFTC**” or “**Commission**”) in response to its re-opened Proposed Rule regarding Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (the “**Proposed Rule**”).<sup>2</sup>

## Introduction

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics for internal capital models, and related services across regions, asset classes and financial instruments. Our products and services are used by a large number of market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities.

Markit has been actively and constructively engaged in the debate about regulatory reform of the global OTC derivatives markets and the implementation of the Pittsburgh G20 commitments.<sup>3</sup> Over the last 18 months we have submitted close to 30 comment letters to regulatory authorities around the world, we have participated in numerous roundtables and we regularly provide the relevant authorities with our insights on current market practice, for example in relation to valuation methodologies, the provision of scenario analysis, or the use of reliable and secure means to provide daily mid-market marks. We have also advised regulatory authorities on appropriate approaches to enabling a timely and cost-effective implementation of newly established requirements, for example through the use of multi-layered phase-in or by providing participants with a choice of means for satisfying regulatory requirements.

## Executive Summary

Markit provides a large number of participants in global financial markets with state-of-the-art analytical services across asset classes, often in conjunction with our pricing and valuation services. These services support, for example, the calculation of regulatory capital requirements, including measures such as the CVA Capital VaR charge, PFE, IMM EAD, IRC, and CRM.<sup>4</sup> Based on our expertise in these areas, numerous market participants have approached us to help them address upcoming challenges in relation to the

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<sup>1</sup> Markit is a financial information services company with over 2,700 employees in North America, Europe, and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see [www.markit.com](http://www.markit.com) for additional information.

<sup>2</sup> Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (April 28, 2011) [hereafter, the “Proposed Rule”]; 77 Fed. Reg. 41109 (July 12, 2012).

<sup>3</sup> “Leaders’ Statement: The Pittsburgh Summit” (Sept. 24-25, 2009), available at [http://www.g20.org/pub\\_communiques.aspx](http://www.g20.org/pub_communiques.aspx).

<sup>4</sup> CVA = Counterparty Value Adjustment, PFE = Potential Future Exposure, IMM EAD = Internal Model Method Exposure At Default, IRC = Incremental Risk Charge, and CRM = Comprehensive Risk Measure.

calculation of initial margin (“*IM*”) and variation margin (“*VM*”). This interest applies not only in relation to derivative transactions that remain uncleared, but also to those that are centrally cleared by CCPs.

We welcome the Commission’s decision to re-open the comment period for its Proposed Rule in light of the publication of BCBS IOSCO’s Consultative Document on *Margin requirements for non-centrally cleared derivatives*<sup>5</sup> and we appreciate the opportunity to provide you with our comments.<sup>6</sup> We believe that mandatory margining for uncleared swaps could have a significant impact on the functioning of financial markets and potentially the stability of the financial system due to the resulting operational challenges and demands on liquidity and collateral. Our recommendations aim at ensuring that margin calculations appropriately reflect the degree of risk posed by various derivative transactions and at facilitating an operationally efficient and timely implementation of the relevant margin requirements.<sup>7</sup> Specifically, we believe that the Commission should design its margin regime in a manner that: (1) enables a larger number of counterparties to calculate IM on the basis of approved models; (2) allows counterparties to agree on the IM amounts for a swap transaction to be performed by the same third party provider or base their IM calculation on the same set of inputs and calculation methodologies as provided by a third party; (3) allows for choice between the use of model-based and grid-based approach to IM calculation on a sufficiently granular level; (4) clarifies the frequency with which IM/VM calculations and collection will be required; and (5) permits the use of effective procedures that facilitate agreement on VM amounts.

Furthermore, we believe that an appropriate balance must be struck between incentivizing the clearing of standardized swaps and recognizing the relevance of uncleared swaps as well as the end-user exception. Margin requirements for both cleared and uncleared swaps should be balanced fairly vis-à-vis each other and should leave sufficient room for appropriate contractual arrangements to take place between the parties.

## Comments

### 1. The Commission Should Approve IM Models Developed and Supported by Third Parties in a Manner that Facilitates their Broader Use

The Proposed Rule would allow market participants to use either a “risk-based model” or the “alternative method” for the calculation of IM.<sup>8</sup> A risk-based model would apply a set of formulae to each swap or portfolio of swaps while the “alternative method” approximates margin requirements based on the margin requirements imposed on the futures contracts that most closely resemble the swap position. Similar to the Commission’s proposals, BCBS IOSCO proposed to allow parties to choose between using a Quantitative Portfolio Margin Model (“*QPMM*” or “*model-based approach*”) or a Standardized Initial Margin Schedule (a “*grid-based approach*”) to calculate the amount of IM that they need to collect from their counterparties.<sup>9</sup>

As we stated in our previous response to the Proposed Rule, we generally support the use of risk-based models over any grid-based approach so long as the risk-based models are sufficiently robust and accurate. We believe that grid-based approaches based on general asset classes will likely result in inaccurate IM

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<sup>5</sup> Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions, Margin requirements for non-centrally-cleared derivatives (July 2012) [hereinafter the “*BCBS IOSCO Consultative Document*”], available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf>.

<sup>6</sup> Where appropriate, our comments will refer to the comments that we have submitted to the Commission previously in relation to its Proposed Rule. See Markit letter to the CFTC regarding the proposed rule “Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants” (July 11, 2011) [hereinafter the “*Prior Markit Comment Letter*”], available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47793&SearchText=markit>.

<sup>7</sup> We do not express any views on many of the more fundamental elements of the IM/VM regime, such as the categories of counterparties that should be required to collect or post margin or whether and how thresholds should be used.

<sup>8</sup> See Proposed Rule at 23746..

<sup>9</sup> See BCBS IOSCO Consultative Document, Element 3: Baseline minimum amounts and methodologies for initial and variation margin.

amounts that will be too great for some swaps, thereby shoring up collateral that could be used more productively, or too small, thereby not sufficiently mitigating risk. Further, a grid-based approach would treat every transaction on a stand-alone basis, not allowing for any portfolio offsets to be applied. On the other hand, we generally believe that using DCO models for uncleared swap for IM is inappropriate because DCO models are unlikely to accurately reflect the risks associated with uncleared swaps.<sup>10</sup>

We understand, however, the need for risk-based models to be evaluated by the relevant regulatory authorities before they can be used and we recognize that some time is necessary for such approvals.<sup>11</sup> As we have voiced in our previous response to the Commission, many market participants are concerned that the resources available to regulatory authorities to perform these model approvals will not suffice to accommodate the expected wave of requests by individual firms in a timely fashion.<sup>12</sup> As a consequence, it could take a long time before even the largest and most sophisticated market participants can use a QPMM for their IM calculations, so many market participants would likely be forced to rely on the grid-based approach for the foreseeable future.

We believe that the Commission could address these tensions by approving risk-based IM models developed by qualified third parties who would then be permitted to supply these models, or individual calculations based on those models, to all firms that are under the Commission's jurisdiction.<sup>13</sup> This would offer the following significant benefits:

- A larger number of counterparties would be enabled to use model-based approaches much earlier. This would result in the calculation and collection of IM amounts that are more reflective of the actual risk posed by the specific swap transactions in a portfolio context, compared to those determined by the grid-based method. It would therefore reduce the overall liquidity and collateral demand in the financial system, as well as the cost of the margin regime for counterparties.
- It will significantly reduce the overall time and resources needed by the Commission to approve IM models. Therefore, it would speed up the implementation of the new margin regime while also reducing the demands on the scarce resources of the Commission. This would be true not only in the initial approval stage but also for ongoing monitoring and analysis thereafter.
- Over time, we would expect a limited number of benchmark inputs, models and methodologies for IM models provided by qualified third parties to emerge. Given the expertise and insights that regulatory authorities, including the Commission, will develop during the approval process of such models, these models and methodologies will be well understood by regulatory authorities, thereby increasing transparency and supporting their oversight capabilities.

In order for this approach to be most effective, we believe that the Commission and other regulators should recognize approvals of specific risk-based models also *across* jurisdictions.<sup>14</sup> Doing so would maximize the efficiency with which IM models would be approved, thereby increasing the number of counterparties that can quickly use risk-based models. It will also reduce the likelihood for jurisdictional arbitrage.

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<sup>10</sup> See Prior Markit Comment letter, page 2 ("While DCOs may be well suited to provide valuations and IM for the more liquid and standardized swaps, we believe that it is not appropriate to apply a DCO IM model to swaps that are not cleared by DCOs.").

<sup>11</sup> BCBS IOSCO would also require each individual firm to receive approval from its regulator before using a QPMM.

<sup>12</sup> See Prior Markit Comment letter, page 2 ("We believe that the approval of these models could create bottlenecks which would delay their use.").

<sup>13</sup> BCBS IOSCO approved of a similar approach by allowing unregulated counterparties to use QPMMs that have been approved for use by a different firm. See BCBS IOSCO Consultative Document, Element 2: Scope of coverage.

<sup>14</sup> BCBS IOSCO seems to argue against such approach: "There will be no presumption that approval by one supervisor in the case of one or more institutions will imply approval for a wider set of jurisdictions and/or institutions". The model "must be approved for use within each jurisdiction and by each institution seeking to use the model." See BCBS IOSCO Consultative Document, page 17.

We believe that third parties providing IM calculation can provide the Commission with data regarding the inputs, models, and methodology that they use for their IM calculations. Further, such third parties would establish appropriate governance and business continuity procedures for the operation of their QPMMs. We believe that third parties acting within this framework will help to ensure the accuracy and timeliness of the IM regulatory requirements and will allow for effective and efficient implementation. We are open to discussing these issues with the Commission in further detail to ensure that regulatory expectations can be met.

Finally, we believe that such approval and use of third party models should not just apply to IM calculation but also to the calibration of haircuts that might also be required as part of the margin regime.<sup>15</sup>

## **2. The Commission Should Minimize the Potential for Disputes about IM by Permitting Both Counterparties to a Transaction to Delegate IM Calculation to an Agreed-Upon Third Party or to Base their IM Calculation on a Set of Inputs and Methodologies Provided by Such Third Party**

Under the Proposed Rule, both counterparties will be responsible for calculating IM for themselves, and for their counterparties in certain circumstances.<sup>16</sup> This will increase the likelihood of disputes over IM since both counterparties are unlikely to arrive at the same IM calculations if they use different models, as noted in several relevant regulatory consultations.<sup>17</sup> However, such disputes will not only create costs for counterparties but they will also generally reduce the timeliness of IM collection, thereby resulting in increased systemic risk.

Our discussions with market participants have shown that disputes between the counterparties about IM amounts could be avoided by the counterparties agreeing pre-execution on the use of a third party for the calculation of their respective IM amounts,<sup>18</sup> or by agreeing to use a set of input data (including market data and scenarios) and calculation methodology (including models and software) as provided by such a third party while still performing the actual IM calculation themselves.<sup>19</sup> Both these approaches would result in IM amounts that are predictable for the counterparties, thereby reducing the potential for disputes, and improving the functioning of the global marketplace for collateral.

We believe that the use of an agreed-upon third party as calculation agent or as provider of inputs and calculation methodologies for IM for certain transactions between certain counterparties would be most appropriate for standardized and actively-traded non-cleared derivatives.<sup>20</sup> However, counterparties might not want to rely on the use of a third party to determine their IM amounts for more complex and less actively traded products. To provide counterparties with the necessary flexibility to establish efficient means of IM calculation depending on the circumstances, we therefore believe that the Commission should explicitly allow

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<sup>15</sup> BCBS IOSCO proposes that “risk-sensitive quantitative models . . . could be used to establish haircuts so long as the model is approved by supervisors and is subject to appropriate internal governance standards.” See *id.* at 23. We believe that the Commission should follow this approach.

<sup>16</sup> See Proposed Rule, 76 Fed. Reg. at 23746 (to be codified at 17 C.F.R. § 23.155(a)(2)) (“Each covered swap entity shall calculate initial margin for itself and for each counterparty that is a swap dealer, major swap participant, or financial entity. . .”).

<sup>17</sup> See Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs, and Trade Repositories. (March 6, 2012). The Commission also commented that the previously-proposed rule 23.504 requires SDs and MSPs to have swap trading relationship documentation in place with each counterparty including dispute resolution procedures. See Proposed Rule, 76 Fed. Reg. at 23734. The CFTC requested comment on whether rule 23.504 was sufficient to ensure that SD/MSP have sound legal basis for their swap documentation. It is unclear, though, whether such dispute resolution mechanisms would also apply to the IM amounts that are calculated by the counterparties.

<sup>18</sup> Such third parties, that will be independent of the counterparties, would each use one set of market data, scenarios, analytics, and software to serve as the “IM calculation agent” for transactions between these counterparties.

<sup>19</sup> Our experience has shown that the individual situation and preferences of the parties will often determine whether they prefer a “hosted” solution (where the actual calculation is performed by the third party) or a “deployed” solution (where the third party only provides “standardized” inputs, analytics and software to the counterparties that will perform the actual IM calculation themselves based on their existing positions.).

<sup>20</sup> We note that, similarly, CCPs routinely deliver scenario files to their clearing members on a daily basis to enable them to reproduce their IM calculations.

counterparties to: (a) agree for their respective IM amounts for transactions between them to be either calculated by a third party provider agreed to by the counterparties or be based on inputs, scenarios, models and methodology provided by such a third party provider; and (b) apply such approach to specific products or categories of products in an asset class while using “regular” QPMM (*i.e.*, a model-based IM calculation by the individual firms) or a grid-based approach for others. We further believe that any third party that wanted to play such role would need to provide the Commission with its models, inputs, governance, and procedures as explained in more detail above.

### **3. Market Participants Should Be Able to Choose Between Model-based and Grid-based IM Calculation on a Granular Basis**

The BCBS IOSCO Consultative Document permits counterparties to choose between the use of a model- and a grid-based approach for their IM calculation, but does not allow parties to “switch between model- and schedule-based margin calculations in an effort to ‘cherry pick’ the most favorable IM terms.”<sup>21</sup> The choice should therefore be made on a “consistent basis over time” and “for all transactions within the same well-defined asset class.” In contrast, the Proposed Rule seems to provide parties with more flexibility when they decide whether to use a model- or a grid-based IM calculation.<sup>22</sup> We urge the Commission to maintain this flexibility rather than following the BCBS IOSCO approach.

Given the multitude of financial products that can fall into an “asset class,” their varying degrees of complexity, and limits to modeling abilities, we believe that there will always be challenges to fit some products in an asset class into a QPMM calculation. The BCBS IOSCO approach might therefore result in entire asset classes not being eligible for a model-based approach which, we believe, would unnecessarily restrict the use of the model-based approach. To allow a larger number of counterparties to make use of QPMM calculations with all of the benefits described in more detail above, they should be permitted to make this choice not only by overall asset class, but also by product category within an asset classes.<sup>23</sup>

At the very least, we believe that firms should be allowed to make use of exemptions for complex swaps within each asset class so that they would be able to use a grid-based approach for complex products even if they generally use model-based calculations. This would better reflect market realities while enabling an overall increased use of model-based IM calculation, thereby reducing the overall cost of the introduction of the IM requirement. Such an approach would also be in the Commission’s interest as it would allow counterparties to use the more conservative grid-based IM calculation for those products that, in their opinion, cannot be reliably modelled.

On a different note, as we stated previously in our response to the Proposed Rule,<sup>24</sup> we believe that the Commission should consider further refining the grid-based approach by adding further maturity and product type buckets. We urge the Commission to consider whether the adoption of a third party QPMM could provide an appropriate basis for the design of such more granular grid.<sup>25</sup>

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<sup>21</sup> See BCBS IOSCO Consultative Document, page 19.

<sup>22</sup> See Proposed Rule, 76 Fed. Reg. at 23737 (“If a model . . . is not used, margin must be calculated in accordance with a specified alternative method.”).

<sup>23</sup> For example, we believe that the Commission should allow a counterparty to use a model-based approach in the asset class of interest rates/FX, while it would choose to apply the grid-based approach for all option-based products in this asset class.

<sup>24</sup> See Prior Markit Comment Letter, page 3.

<sup>25</sup> The use of a more granular grid would mitigate the liquidity effects for trades that cannot be included in the QPMM even though the majority of the trades in that risk category do reside within a given netting set. We believe that this approach would reduce the potential for “cherry picking”, while it will also improve risk sensitivity and reduce the liquidity impact of the margin regime.

#### 4. The Commission Should Clarify the Frequency with which IM Calculation and Collection is Required

The BCBS IOSCO Consultative Document states that “the amount of IM . . . can change over time, particularly where it is calculated on a portfolio basis and transactions are added to or removed from the portfolio on a continuous basis.”<sup>26</sup> It further clarifies that counterparties are expected to collect IM “at the outset of a transaction” and “thereafter on a routine and consistent basis upon changes in potential future exposure as trades are added to or subtracted from the portfolio.”<sup>27</sup> In contrast, the Proposed Rule stated that parties that have to collect IM shall “monitor IM daily” and “collect additional IM if necessary to address the risk posed.”<sup>28</sup>

We agree that the addition or removal of swap transactions to an existing portfolio will lead to changes in the overall IM amount. However, even if no transactions are added or removed the overall IM amount for the portfolio can change, for example if existing transactions mature or the market experiences significant moves. We therefore encourage the Commission to clarify: (a) how frequently portfolio IM needs to be *re-calculated*; and (b) how often portfolio IM needs to be *collected* by the counterparties. This would clarify the circumstances under which IM re-calculations for an existing portfolio of transactions have to be performed even if no changes have been made to the trade population.<sup>29</sup>

Further, we believe that the Commission should clarify under what circumstances a change in calculated IM for the portfolio would require the counterparties to actually collect additional IM (or pay back excess IM). While regular re-calculations of portfolio IM might be appropriate even if the trade population has not changed, we believe that the Commission should allow for a minimum transfer amount to apply to the actual IM payments as it proposed.<sup>30</sup> We believe that such an approach would be sensible in order to avoid creating an unnecessary operational burden.

#### 5. Counterparties Should be Permitted to Reference Third Parties for Dispute Resolution, Valuations, or Inputs in Relation to their VM Calculations

BCBS IOSCO proposed that counterparties would have to establish dispute resolution procedures to achieve agreement on valuations of their uncleared derivatives transactions as a basis for the collection of VM. We agree that the existence of such dispute resolution procedures would be useful to ensure the timely agreement and collection of VM. To ensure they can be achieved in a cost effective and timely manner, we believe that counterparties should be explicitly allowed to reference valuations or arbitration procedures performed by independent third parties because this is an efficient means for resolving valuation disputes. This is because third parties: (i) do not have any positions and hence do not have any inherently subjective financial interest in the prices they calculate; (ii) use multiple data sources which helps to remove management bias; and (iii) offer both parties in the dispute substantial transparency into the valuation inputs, methods and procedures so the parties can more effectively debate and resolve the dispute.

We note that the Commission, in a different rulemaking, established requirements for counterparties to agree on a process which could contain the methodology, inputs and fallbacks for the valuation of their uncleared swap transactions that would be used as basis for the exchange of VM.<sup>31</sup> Such agreement would have to be

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<sup>26</sup> See BCBS IOSCO Consultative Document, Element 3.

<sup>27</sup> See *id.*

<sup>28</sup> See Proposed Rule, 76 Fed. Reg. at 23738 (to be codified at 17 C.F.R. § 23.155(c)) (“Each Covered Swap Entity would be required to monitor the coverage provided by margin [...] and collect additional margin if appropriate to address the risk posed by particular products or positions.”).

<sup>29</sup> The Proposed Rule Proposed provides for modifications for particular products or positions. Each CSE would be required to monitor the coverage provided by margin established pursuant to this paragraph (c) and collect additional margin if appropriate to address the risk posed by particular products or positions. See *id.* at 23747 (to be codified at 17 C.F.R. § 23.155(c)(3)).

<sup>30</sup> This would be consistent with the Proposed Rules, where the Commission proposed the use of a USD 100,000 minimum transfer amount “to reduce transaction cost.” See *id.* at 23735.

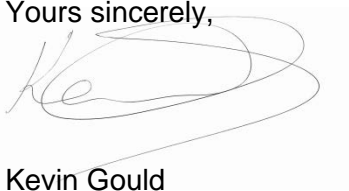
<sup>31</sup> See Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904 (Sept. 11, 2012).

established by the time that the transaction is executed.<sup>32</sup> The requirement permits counterparties to agree to reference these elements or the actual valuation as they are provided by a qualified third party. As we have explained in other response letters in more detail, we believe that such delegation would be an effective manner to enable counterparties to satisfy this requirement.<sup>33</sup>

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Markit appreciates the opportunity to comment on the CFTC's Proposed Rule: Margin Requirements for Uncleared Swap Dealers and Major Swap Participants. We would be happy to elaborate or further discuss any of the points addressed above. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at [marcus.schueler@markit.com](mailto:marcus.schueler@markit.com).

Yours sincerely,



Kevin Gould  
President  
Markit North America, Inc.

cc: Peter Y. Malyshev, Latham & Watkins LLP

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<sup>32</sup> This agreement may be impossible if a transaction is intermediated by a swap broker or voice broker. The use of third party providers avoids this issue if both parties agree in advance to use that third party.

<sup>33</sup> See Markit letter to the CFTC regarding the proposed Rule "Swap Trading Relationship Documentation for Swaps Dealers and Major Swap Participants" (April 11, 2011), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=35542&SearchText=markit>.