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VIA EMAIL

Christopher Kirkpatrick
Secretary of the Commission
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: RIN 3038-AC97, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants

Dear Mr. Kirkpatrick:

Shell Trading Risk Management, LLC ("**STRM**") appreciates the opportunity to comment on the proposed rule regarding Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants issued by the U.S. Commodity Futures Trading Commission ("**CFTC Proposed Margin Rule**").[1] STRM is a swap dealer provisionally registered with the CFTC. STRM would be subject to the CFTC Proposed Margin Rule and outside the scope of the margin rules proposed by the U.S. Department of Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, and Federal Housing Finance Agency ("**Prudential Regulator Proposed Margin Rule**," collectively with the CFTC Proposed Margin Rule "**Proposed Margin Rules**").[2]

STRM recognizes and supports measures that help reduce risks to the financial system. However, certain aspects of the Proposed Margin Rules impose significant burdens on covered swap entities ("**CSE**") and end-users with little benefit to the reduction of risk. Of particular concern to STRM are the following aspects of the CFTC Proposed Margin Rule:

- *Affiliate Transactions*. Because inter-affiliate transactions are not market-facing, they do not create the same risk to the financial system as non-affiliate transactions. Thus, they should not be subject to margin requirements. Further, the calculation of material swaps exposure and the threshold to post initial margin should measure only the uncleared swap activity of a CSE's counterparty, and not the activity of the counterparty's affiliates.

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[1] *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 79 Fed. Reg. 59898 (Oct. 3, 2014) ("**CFTC Proposed Margin Rule**").

[2] *See Margin and Capital Requirements for Covered Swap Entities*, 79 Fed. Reg. 57348 (Sept. 24, 2014).

- *Hypothetical Margin*. Calculation of hypothetical margin will impose significant costs on CSEs and non-financial end-users. Given the already robust processes between energy counterparties to measure and manage credit risk, this calculation will not provide further value to them. The CFTC should eliminate the requirement to perform the calculation.

- *Documentation*. Requiring a CSE to perform a legal review to confirm the enforceability of an eligible master netting agreement is unworkable. Although swap documentation generally establishes a jurisdiction for governing law, ultimately, a CSE does not have absolute control over which venue hears a dispute about the swap agreement's enforceability, whether the parties' choice of law provisions will be upheld, and how the law is interpreted.

In addition to the recommendations above, STRM suggests the following modifications to the CFTC Proposed Margin Rule to ensure a more practical application of the margin rules:

- *Representations*. The CFTC should permit CSEs to rely on counterparty representations as a means to comply with the rule.

- *Models and Methods*. A process for provisional approval of risk-based models should be adopted. Further, the CFTC should:

  - clarify when changes to a risk-based model require CFTC approval;

  - allow flexibility in the timing and process for updating data in a risk-based model;

  - clarify the ability to change between a risk-based model and table-based method;

  - allow CSEs to rely on internal curves prepared by the CSE or a third party on behalf of the CSE to calculate variation margin;

  - provide a more flexible timeframe for CSEs to post and collect initial and variation margin.

- *Collection of Margin*. The CFTC should adopt a commercially reasonable method for a CSE to comply with its obligation to collect unpaid initial and variation margin.

- *Custodial Agreements*. The CFTC should afford greater flexibility with regard to custodial agreements consistent with current market practice, and should eliminate the requirement to demonstrate that the custodial agreement is legal, valid, binding, and enforceable under all relevant laws (including insolvency laws).

- *Material Swaps Exposure*. The threshold should be aligned with the international standards for non-cleared swap margins published by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions in September 2013.

I. Management of Risk within a Corporate Group

A. *The obligation to post and collect margin should not apply to transactions between affiliated entities*

Many companies utilize swaps between affiliates to shift financial risk within a group of corporate entities. The purpose of these inter-affiliate swaps is to manage the financial risk of the overall corporate group more efficiently and, oftentimes, to centralize the management of risk within the corporate group. The CFTC Proposed Margin Rule would require a CSE to collect and post initial and/or variation margin for swaps between the CSE and an affiliate that is a financial end-user.[3] STRM requests that the CFTC exclude inter-affiliate swaps from this requirement for reasons similar to the rationale the CFTC provided when it adopted the exception to mandatory clearing for inter-affiliate swaps.[4]

As part of the Inter-Affiliate Clearing Exception, the CFTC recognized that inter-affiliate swaps pose less risk to the financial system than market-facing swaps: "[i]n considering the risks and benefits, the Commission was guided, in part, by comments pointing to the risk-mitigating characteristics of inter-affiliate swaps and the sound risk management practices of corporate groups that rely on inter-affiliate swaps."[5] Consequently, any benefits to clearing inter-affiliate swaps were outweighed by the significant costs. The CFTC further declined to impose any requirement to post or collect initial or variation margin as a condition to electing the Inter-Affiliate Clearing Exception.[6] There, the CFTC "was guided by comments expressing concern that a variation margin requirement will limit the ability of U.S. companies to efficiently allocate risk among affiliates and manage risk centrally."[7]

The same rationale should apply here: the same goal motivates the Commission to implement the CFTC Proposed Margin Rule (reduction of risk between counterparties and within the financial system); the same consequences will flow should the Rule reach transactions between affiliated entities (inefficient allocation of risk among affiliates); and the same corporate structure obviates the need to extend the Rule this far. Indeed, the Commission recognized as much in the Rule's preamble: "in designing the proposed margin rules for uncleared swaps, the Commission has built upon the sound practices for risk management employed by central counterparties for decades."[8] Thus, the CFTC should reach the same conclusion it identified when it exempted inter-affiliate swaps from mandatory clearing: namely, the cost of imposing margin on inter-affiliate swaps outweighs the benefits.

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[3] CFTC Proposed Margin Rule at 59904.

[4] *See Clearing Exemption for Swaps Between Certain Affiliated Entities*, 78 Fed. Reg. 21750 (Apr. 11, 2013) ("**Inter-Affiliate Clearing Exception**").

[5] *Id.* at 21753.

[6] *Id.* at 21760. The extension of the margin requirements to inter-affiliate swaps would undo the relief provided in the Inter-Affiliate Clearing Exception given that a main benefit to not clearing is the flexibility regarding whether or not to exchange margin.

[7] *Id.*

[8] CFTC Proposed Margin Rule at 59901.

B. *The calculation of "material swaps exposure" should only include uncleared swaps directly between a CSE and a financial end-user*

The requirement to calculate the "material swaps exposure" of a financial end-user by including the uncleared swaps of the financial end-user's affiliates with the CSE and with all of the affiliates' third-party counterparties creates unnecessary and significant costs for financial end-users and provides little benefit to the goal of risk mitigation. The requirement to look outside of the uncleared swaps directly between the CSE and the financial end-user to calculate "material swaps exposure" should be excluded from the Rule.[9]

To determine whether a financial end-user has material swaps exposure, the CSE will have to rely on calculations performed by the financial end-user because the CSE will not have access to data necessary to perform the calculation, *i.e.* the financial end-user's affiliates' uncleared swaps exposure with counterparties other than the CSE.[10] The financial end-user, therefore, will need to develop systems to track uncleared swaps across all of its affiliates that fall within the scope of the rule to make this calculation. Given that many market participants aggregate and manage risk on a portfolio basis, there will likely be a significant cost for each affiliate to identify swaps that fall within the scope of the calculation and provide such data to the financial end-user to make the calculation.

Additionally, in contrast to the significant cost and burden on both the CSE and financial end-user to ensure proper calculation of "material swaps exposure," the broad requirement to encompass all affiliates of the financial end-user does not appear to have a commensurate benefit, particularly where the proposed calculation fails to distinguish between affiliates that present significant financial risk to the financial end-user and those that do not (e.g. where the affiliate provides no credit support to or on behalf of the financial end-user, has no financial recourse to or from the financial end-user, has assets and liabilities that are insignificant to the financial end-user, or are otherwise financially insignificant to the financial end-user due to being affiliated by nothing more than a minority ownership interest).

C. *The calculation of the $65 million threshold amount to post and collect initial margin should not include affiliates of the CSE or the covered counterparty*

The CFTC Proposed Margin Rule provides that a CSE and a covered counterparty[11] can agree not to post and/or collect any initial margin below a $65 million threshold. However, for covered counterparties that are part of a consolidated group, the $65 million amount applies to

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9 *See* Proposed CFTC Rule 23.151 (definition of "material swaps exposure").

10 Similarly, if the CFTC determines to require hypothetical margin for non-financial end-users with material swaps exposure, the CSE will need to rely on the non-financial end-user to perform the material swaps exposure calculation. As noted below in Section II, STRM recommends that the CFTC remove the obligation for a CSE to calculate hypothetical margin.

11 A "covered counterparty" is a financial end-user with material swaps exposure, a swap dealer, or a major swap participant that enters into a swap with a CSE. *See* Proposed CFTC Rule 23.151 (definition of "covered counterparty").

the consolidated group and not individually to each entity.[12] As noted above, the CFTC Proposed Margin Rule does not recognize that certain affiliates may pose little-to-no risk to a covered counterparty, and in turn the CSE. As a result, the application of the $65 million threshold amount to all affiliates may not reduce the financial risk to the CSE because the risk of each affiliate is now measured as a single group. Absent additional factors indicating that a specific affiliate heightens the risk posed by a covered counterparty to a CSE, STRM recommends that each financial end-user be evaluated on an individual basis, as opposed to the corporate group, for purposes of the $65 million threshold amount.

D. *If affiliates are included, they should be defined consistent with other CFTC rules*

Should the CFTC nevertheless apply its margin rules to "affiliates" of CSEs and financial and non-financial end-users, the definition of affiliate is overly broad. The proposal presumes control where an entity has an ownership interest of twenty-five percent or more of (1) the voting securities of a company; or (2) the total equity of the company. However, a twenty-five percent ownership interest could represent an interest of a minority owner of the owned entity. In this case, the minority owner may not be in a position to compel the owned entity to provide data regarding the owned entity's uncleared swaps. As a result, a financial end-user may not be able to calculate whether it has material swaps exposure because it cannot obtain the uncleared swaps data from all of its "affiliates." Thus, STRM recommends that the CFTC define control as a majority ownership interest. This threshold is consistent with the approach taken in the Inter-Affiliate Clearing Exception and the CFTC's further definition of swap dealer.[13]

II. Hypothetical Margin is Burdensome and Unnecessary

The calculation of hypothetical margin for uncleared swaps with a non-financial end-user with material swaps exposure is intended to provide CSEs and their non-financial end-user counterparties with a tool to manage risk and to determine whether the parties should exchange margin for uncleared swaps.[14] However, this hypothetical calculation does not provide CSEs with added value to the robust risk-management processes already in place.

CSEs use various mechanisms to manage uncleared swap exposure, including pre-determined credit lines and risk management models. These controls are well-established and provide CSEs with the flexibility to assess the varying risks posed by different counterparties and transactions. As a result, the hypothetical margin calculation would not provide CSEs with new or more valuable information to manage counterparty risk.[15] But, the daily calculation of hypothetical margin would impose a significant burden.

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[12] *See Id.* (definition of "initial margin threshold amount").

[13] *See* CFTC Rules 1.3(ggg)(6)(i) & 50.52(a).

[14] *See* CFTC Proposed Margin Rule at 59907.

[15] Hypothetical margin is particularly unhelpful for inter-affiliate swaps because credit management between members of a corporate family presents far less risk than management of credit exposures between third parties.

In addition, hypothetical margin would impose costs on non-financial end-users because the non-financial end-user will need to determine whether or not it has material swaps exposure, which involves a calculation to be made each business day for three months each year. This calculation is even more burdensome if the non-financial end-user is required to identify all of the uncleared swaps activities of its affiliates.[16] For these reasons, STRM requests that the CFTC eliminate the requirement to calculate hypothetical margin.

III. Documentation Requirements

The CFTC Proposed Margin Rule incorporates various documentation requirements related to the posting and collection of margin. STRM requests that the CFTC modify certain aspects of its proposal in order to minimize the need to update or modify existing documentation and to implement new requirements in accordance with current commercial practices.

A. *The standard for legal review of the enforceability of an eligible master netting agreement should be consistent with existing industry practice*

Under the CFTC Proposed Margin Rule, a CSE may net the calculation of initial margin and net the payment of variation margin to the extent the CSE and the covered counterparty enter into an "eligible master netting agreement."[17] For the eligible master netting agreement to qualify under the CFTC Proposed Margin Rule, the CSE must document a legal review determining that the netting agreement satisfies the definition. Further, the CSE must conclude that "[i]n the event of a legal challenge (including one resulting from default or receivership, insolvency, liquidation, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions."[18]

As proposed, the enforceability review imposes a standard that is impractical and likely impossible to satisfy. Many CSEs conduct business across U.S. States, as well as in multiple foreign jurisdictions. This makes it difficult to identify the relevant jurisdiction where a dispute (including a bankruptcy filing of the CSE's counterparty) could take place, particularly where a counterparty may choose to file an action depending on the particular facts at issue. Given this reality, a CSE would be obligated to review the enforceability of every conceivable jurisdiction under the proposed standard. However, even if the CSE conducted such a review, it still would not be possible for the CSE to know with any degree of certainty what jurisdiction's law would apply or how a given court would interpret the law it concluded governed the dispute. Indeed, notwithstanding the inclusion of a choice of law provision in the counterparties' swap documentation, it is not uncommon for a court to ignore such provision and to apply, for example, the law of the jurisdiction in which the dispute is brought. Particularly, insolvency courts are courts of equity and, as a result, have a great deal of latitude with respect to matters involving choice of law and enforceability.

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[16] As proposed, this will include obtaining the swap exposure of each of the non-financial end-user's affiliates.

[17] *See* Proposed CFTC Rule 23.151 (definition of "eligible master netting agreement").

[18] *Id.*

The legal enforceability review in the CFTC Proposed Margin Rule also represents a significant departure from longstanding industry practice. Typically, CSEs rely on industry standard agreements, such as those promulgated by ISDA, including but not limited to the ISDA Master Agreement. Over the years, the swaps industry streamlined the legal enforceability review; parties generally rely on the well-vetted governing law provisions in the ISDA Master Agreement (New York and English law) along with various ISDA opinions with respect to the enforceability of close-out netting in insolvency and of the credit support documents to provide them assurances that the agreement should be enforced in a manner that provides the parties the practical benefits intended by the agreements. The existence of industry standard agreements and ISDA opinions gives the CSE the latitude to choose a jurisdiction for governing law that the CSE reasonably expects would substantially enforce the agreements. This existing process provides adequate assurances on enforceability without the significant burden of developing an enforceability opinion for each counterparty, and requiring that the enforceability determination be based on an unworkable and absolute legal standard.

STRM sees no reason to depart from the current industry practice. Therefore, the CFTC should narrow the scope of the legal review for a CSE to determine that an agreement qualifies as a master netting agreement in the following manner:

- The legal enforceability review should be limited to those jurisdictions chosen as the governing law for the swap agreements.

- CSEs should be permitted to rely on industry standard enforceability opinions (such as those provided by ISDA) for the relevant governing law jurisdictions, rather than having to perform a separate opinion for each counterparty.

- The standard of legal enforceability review required by the Rule should allow the CSE to rely on a reasonable belief basis for enforceability.

- The legal enforceability review that is required by the Rule should be based on whether the relevant court and administrative authorities “should” find as opposed to “would” find the agreement to be legal, valid, binding, and substantially enforceable. The standard “should” implies an evaluation of legal precedent, whereas the standard “would” implies a standard of review that legal counsel are unable to provide in advance of a dispute; counsel cannot predict a court or administrative authority’s findings with 100 percent certainty. Nor can the parties expect that every provision in the agreement (i.e. waver of jury trial) will be upheld by all courts in any jurisdiction, domestic or foreign.

- The legal enforceability review that is required by the Rule should exclude enforceability under bankruptcy, insolvency, and similar laws and principles of equity. The industry standard for legal “enforceability” opinions and “enforceability” representations excludes these principles because they are fact-intensive, *ad-hoc* reviews.

B. *The CFTC should expressly permit CSEs to rely on counterparty representations as a means to comply with the CFTC's margin rules*

In certain instances, CSEs will need to rely on counterparty representations to comply with the margin rules. To the extent a counterparty provides a CSE with a representation, the CFTC should permit the CSE to rely on the representation in the absence of red flags. For example, if a counterparty represents that it is not a financial end-user, the CFTC should permit a CSE to rely on such a representation. Similarly, if a financial end-user represents that it does not have material swaps exposure, the CSE should be entitled to rely on such a representation. Additionally, to the extent the CFTC defines material swaps exposure to include a financial end-user's affiliates, a CSE should be permitted to rely on a counterparty's representations regarding its affiliations, since the counterparty is better positioned to know with whom it is affiliated.[19]

IV. Calculation and Collection of Margin

STRM believes that various aspects of the CFTC Proposed Margin Rule regarding the calculation of margin may impose significant costs on CSEs and financial and non-financial end-users. STRM's comments are intended to limit some of these significant costs, but retain the benefits of the reduction of counterparty risk and the risk to the financial system.

A. *The CFTC should build on the flexibility it provided in calculating initial margin*

Under the CFTC Proposed Margin Rule, a CSE can calculate initial margin using a risk-based model or a table-based method. In the event that a CSE determines to use the risk-based model, the CFTC must review and approve the model in advance of its application. STRM appreciates the flexibility established in the CFTC Proposed Margin Rule and encourages the CFTC to further build on that flexibility.

1. Provisional approval of risk-based models is appropriate

At present, there are 105 provisionally registered swap dealers. Consequently, there will likely be a substantial number of applications for review of risk-based models by the CFTC. Given this fact, STRM is concerned that the process for CFTC approval in advance of relying on a risk-based model could result in significant delays, particularly for CSEs that are not first in-line for Staff review. STRM recommends that the CFTC adopt an interim process whereby CFTC Staff grant provisional approval to a risk-based model if the CSE application contains facially responsive material. The CFTC has relied on provisional approval in other contexts and the CFTC should continue to rely on the concept of provisional approval here.[20] After provisional approval of a risk-based model, the CFTC Staff may conduct a more comprehensive review and approval process while the CSE begins to use the model to determine initial margin requirements.

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[19] As noted in section I.B above, STRM requests that the CFTC limit the calculation of material swaps exposure to the financial end-user and not include the uncleared swaps exposure of the financial end-user's affiliates.

[20] *Cf. Core Principles and Other Requirements for Swap Execution Facilities*, 78 Fed. Reg. 33476 (Jun. 4, 2013).

2. The CFTC should provide greater clarity regarding when changes to a risk-based model require CFTC approval

Under the CFTC Proposed Margin Rule, a CSE must notify the Commission in writing 60 days prior to: (i) extending an approved model to an additional product type, (ii) making any change to an approved model that would result in a material change in the CSE's assessment of initial margin requirements, or (iii) making any material change to assumptions used in the model.[21] STRM requests guidance regarding the definition of "product type" as well as the categories of changes the Commission deems "material" enough to require written notification.

3. The CFTC should provide greater flexibility for a CSE to evaluate and update the data used in a risk-based model

STRM requests that the CFTC permit a CSE to propose its own "update protocol" when it requests Commission approval of its risk-based model, specifying a timeline for updates that is in line with its own unique circumstances. This process provides a more tailored approach compared to the proposed requirement to review and, as necessary, revise the data used to calibrate an approved risk-based model at least monthly, and more frequently as market conditions warrant.[22] As long as an update protocol fits the CFTC Proposed Margin Rule requirements of a "rigorous and well-defined process for re-estimating, re-evaluating, and updating [the CSE's] internal models to ensure continued applicability and relevance,"[23] this approach ensures reliable initial margin calculations while respecting the unique needs of each CSE's business.

4. The CFTC should clarify that CSEs may change between a risk-based model and a table-based method without CFTC approval

It would be appropriate to allow a CSE to change from a risk-based model to a table-based method without prior CFTC approval. Additionally, the CFTC should clarify that Commission approval is unnecessary where a CSE moves from a table-based method to a risk-based model where the model has previously been approved by the CFTC. To the extent a risk-based model has not been approved by the CFTC, the provisional approval process STRM outlined above should apply.

B. *The calculation of variation margin should permit CSEs to rely on internal curves prepared by the CSE or a third party on behalf of the CSE*

STRM asks the CFTC to confirm that internal curves prepared by a CSE or a third party on behalf of the CSE pursuant to CFTC Rule 23.431(d) satisfy the requirement regarding the methodology to calculate variation margin.[24] Swap dealers can rely on internal curves to

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[21] *See* Proposed CFTC Rule 23.154(b)(1)(iii).

[22] *See* Proposed CFTC Rule 23.154(b)(3)(xiii).

[23] *See* Proposed CFTC Rule 23.154(b(3)(xii).

[24] *See* Proposed CFTC Rule 23.155(a)(1).

develop the daily marks they provide to their counterparties in accordance with CFTC Rule 23.431(d).[25] The CFTC has previously explained that the daily mark "provides counterparties with a baseline to assess swap valuations for other purposes, including *margin* or terminations."[26] Because the daily mark, which is used as a basis to calculate margin, can be derived using internal curves, the CFTC should confirm that CSEs can rely on internal curves to calculate variation margin.

C. *The CFTC should provide a more flexible timeframe for CSEs to post and collect initial and variation margin*

Under the Proposed Rule, CSEs must post and collect initial and/or variation margin on or before the business day after the execution of an uncleared swap. STRM requests that the CFTC provide a more flexible timeframe because there are instances where it would be difficult to post and collect margin on a new transaction "on or before" the following business day. Today, the deadlines for posting and collecting collateral on uncleared swaps are negotiated by the parties to each master agreement. Often, the agreements allow for collateral to be posted and collected on the second business day, at least for transactions negotiated during the afternoon hours. This is a practical way to recognize that when a trade is executed early in the trading day, it is feasible to undergo the requisite internal processes to have margin posted by the end of the next day. However, if the trade is executed late in the day, it may not be possible to complete the margining process by the end of the next business day. Additionally, today parties have discretion on how to handle situations in which a counterparty does not make margin payment on time. Under Section 23.152 of the CFTC Proposed Margin Rule, this discretion may no longer be available because CSEs are required to make "necessary efforts" to collect or post margin if the counterparty has failed to provide or accept margin by the deadline.[27] The CFTC Proposed Margin Rule does not provide a grace period for problems beyond the control of the parties, such as system outages. Given the potential consequences of failing to meet the deadline, a more appropriate timeframe would be to require posting and collection of initial and variation margin by the end of the second business day after the execution of the uncleared swap transaction.

D. *The CFTC rule should provide a commercially reasonable method for a CSE to comply with its obligation to collect initial and variation margin*

STRM agrees with the Commission that a CSE should not be penalized where its counterparty fails to post its margin requirements. However, STRM recommends that the CFTC modify the language describing the CSE's obligation to collect unpaid initial or variation margin to reflect a commercially reasonable approach to such collection. The Proposed Rule provides that a CSE will not be deemed to have violated its margin obligations if its counterparty fails to

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[25] These internal curves are independently validated by qualified, independent external or internal personnel. *See* CFTC Rule 23.600(c)(4).

[26] *See Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties*, 77 Fed. Reg. 9734, 9768 (Feb. 17, 2012) (*emphasis added*).

[27] As noted in Section IV.D below, STRM recommends that the CFTC provide CSEs with the flexibility to determine the most appropriate measure to collect unpaid margin.

provide or accept the required initial margin or to provide the required variation margin, as long as the CSE: (i) makes "necessary" or "appropriate" efforts to collect or post the required initial margin or variation margin, including the use of formal dispute resolution mechanisms, or (ii) commences termination of the swap.[28] STRM recommends that the CFTC modify the requirement to use "necessary" or "appropriate" efforts to the use of "reasonable measures in light of the surrounding facts and circumstances." This approach permits a CSE to act in a commercially reasonable manner, which implies a practical application of its rights under the swap trading relationship documentation.

A reasonableness standard provides a CSE with greater flexibility to determine the best approach to address a counterparty's failure to pay margin in light of various market factors. In certain scenarios, a commercially reasonable approach may be to refrain from collecting unpaid margin during a time of temporary volatility. For example, if the market is experiencing significant but temporary price spikes, pursuing full legal remedies to obligate a counterparty to post margin may add further financial stress because those remedies trigger other obligations for the counterparty vis-à-vis third party transactions. Depending on the surrounding facts and circumstances, the CSE may determine that the appropriate course of action is to await a market readjustment, as opposed to the CSE potentially exacerbating the situation by enforcing its margin rights.

STRM also recommends that the CFTC clarify the provision that obligates the CSE to engage in "timely initiation and continued pursuit of formal dispute resolution mechanisms" in the event of a counterparty's failure to cooperate with the margin requirements. STRM notes that pre-established "formal dispute resolution mechanisms" are only applicable to calculation disputes, and not applicable to disputes regarding the failure to post margin. Rather, in the typical swap documentation, if a party fails to perform, the other party may exercise its remedies of default and termination.[29] The provision should be modified accordingly.

E. *The CFTC should permit counterparties to agree to a minimum transfer amount below $650,000*

The stated purpose of the $650,000 minimum transfer amount is to reduce transaction costs.[30] However, as drafted, the language in the Rule suggests that CSEs and their counterparties may not elect a minimum transfer amount below the $650,000 specified in the rule. Under certain circumstances, the parties may agree that the transaction costs associated with a minimum transfer amount below $650,000 are necessary based on a number of factors

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[28] *See* Proposed CFTC Rules 23.152(c), 23.153(d) & 23.156(b)(2).

[29] For example, the ISDA Master Agreement provides that a counterparty's failure to comply with an obligation under any Credit Support Document constitutes an event of default. A credit support annex to the ISDA Master Agreement would provide for any initial or variation margin and would be incorporated as a Credit Support Document by the parties. *See* 2002 ISDA Master Agreement § 5(a)(iii)(1).

[30] *See* Proposed CFTC Rule 23.151 (definition of "minimum transfer amount"); CFTC Proposed Margin Rule at 59908.

unique to the parties. The CFTC should permit the flexibility to address this scenario and permit the parties to agree to a minimum transfer amount below $650,000.

V. The CFTC Proposed Margin Rule Should Provide Greater Flexibility Regarding Custodial Agreements to be Consistent with Current Market Practice

Although the CFTC Proposed Margin Rule does not specify whether omnibus accounts are permitted for margin custodial agreements, CFTC Staff has indicated that it anticipates requiring initial margin to be held in individual accounts.[31] In order to avoid the significant burdens on CSEs of entering into separate custodial agreements for each individual counterparty, STRM requests the CFTC to expressly allow a CSE to rely on a single segregated account for the payment of initial margin. STRM also notes that, by calling for a bilateral agreement between CSEs and custodians, the CFTC Proposed Margin Rule appears to conflict with the collateral protection rule, which requires a tri-party agreement among the parties to the trade and the custodian.

STRM also requests that the CFTC eliminate the proposed requirements for custodial agreements that restrict the posting party to substituting collateral "subject to applicable haircuts," and reinvesting funds "subject to applicable haircuts."[32] Collateral valuation limits are already imposed by the CFTC Proposed Margin Rule and will apply in the underlying documentation between the parties to the swap. Custodians, on the other hand, simply operate in an administrative capacity by accepting, holding, and reinvesting collateral per the terms of a custodial agreement; they do not review the underlying agreements between the parties or monitor collateral or exposure valuations. Therefore, collateral valuation limits are not an appropriate or relevant issue to include in custodial agreements.

Finally, STRM asks that the CFTC eliminate the CFTC Proposed Margin Rule's requirement that custodial agreements be legal, valid, binding, and enforceable under all relevant laws, including insolvency laws.[33] Since parties to a contract can never guarantee an absolute standard of jurisdictional certainty or enforceability, this provision imposes an impossible legal standard.

VI. The Measure of Material Swaps Exposure Should be Consistent across Regimes

The CFTC's $3 billion aggregate gross notional amount threshold to measure material swaps exposure is significantly lower than the €8 billion (approximately $11 billion) agreed upon among international regulators in the September 2013 report by the Basel Committee on

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[31] *See* Transcript, Open Meeting to Consider a Proposed Rule on Margin Requirements and a Final Rule on Utility Special Entities, at 88 (Sept. 17, 2014) ("Open Meeting Transcript"). *See also* Proposed CFTC Rule 23.157(a)-(c).

[32] *See* Proposed CFTC Rule 23.157(c)(2)(i) & (ii).

[33] *See* Proposed CFTC Rule 23.157(c)(3).

Banking Supervision and the International Organization of Securities Commission (the "International Margin Standard").[34]

STRM recommends that the CFTC harmonize the calculation of material swaps exposure with the International Margin Standard to prevent an undue burden on U.S. markets. Therefore, the CFTC should increase the material swaps exposure threshold to $11 billion to coincide with the International Margin Standard.[35] During the CFTC open meeting on September 17, 2014, CFTC Staff noted that the International Margin Standard may change as regulators continue to review swaps data.[36] STRM recommends that the CFTC adopt a standard for material swaps exposure that is consistent with the existing International Margin Standard, and thereafter consult with international regulators regarding potential future changes to the threshold for material swaps exposure.

VII. Conclusion

Please contact me at (713) 504-2851 if you have any questions about STRM's comments or recommendations.

Respectfully submitted,

/s/
Carla Vincitore
President, STRM

cc: Honorable Timothy G. Massad, Chairman
Honorable Mark P. Wetjen, Commissioner
Honorable Sharon Bowen, Commissioner
Honorable J. Christopher Giancarlo, Commissioner
John C. Lawton, Deputy Director
Thomas J. Smith, Deputy Director
Rafael Martinez, Financial Risk Analyst
Francis Kuo, Attorney
Stephen A. Kane, Research Economist

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[34] *See* Proposed CFTC Rule 23.151 (definition of "material swaps exposure").

[35] As noted in section I.B above, STRM requests that the CFTC limit the calculation of material swaps exposure to the financial end-user and not include the uncleared swaps exposure of the financial end-user's affiliates.

[36] *See* Open Meeting Transcript at 70.