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September 28, 2018

Christopher Kirkpatrick, Secretary
Commodity Futures Trading Commission
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Re: Commodity Futures Trading Commission's Proposed Rule: *Segregation of Assets Held as Collateral in Uncleared Swap Transactions*, 83 Fed. Reg. 36484 (published July 30, 2018) in RIN 3038-AE78

Dear Mr. Kirkpatrick:

The International Energy Credit Association ("IECA") applauds the Commodity Futures Trading Commission ("CFTC" or "Commission") for the Commission's Proposed Rule as set forth in the above-captioned notice of proposed rulemaking ("NOPR").

I. Statement of Support.

First and foremost, we commend the Commission for addressing a shortfall in an existing rule by changing it, rather than allowing the rule to remain a part of the Commission's regulations and granting temporary relief through a series of non-binding no-action letters and staff guidance letters. Addressing this issue through the rulemaking process, including public notice and comments, is a much better approach.

Second, we thank the Commission for tackling an existing rule that is a persistent source of confusion and unnecessary expense that is also, as the Commission documented, little used by end-users.

As the IECA noted in prior comments,[1] the current rules were unnecessarily burdensome, which is why we strongly endorse the Commission's proposed changes to

[1] See IECA Comments respecting: (i) Cost-Benefit Analyses in Various Rulemaking Proceedings Currently Pending Before the Commission (17 CFR Part 1, RIN 3038-AD06, 75 Fed. Reg. 80174, December 21, 2010) (submitted April 12, 2012); (ii) Cost-Benefit Analyses in Various Rulemaking Proceedings Currently Pending Before the Commission (17 CFR Part 23, RIN 3038-AC96, 76 Fed. Reg. 29818, May 23, 2011) (submitted May 31, 2012); and (iii) Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants (17 CFR Part 23, RIN 3038-AC96, 76 Fed. Reg. 6715, published February 8, 2011 ("IECA Swap Documentation NOPR Comments" submitted April 11, 2011); see also Weinstein, *How the Dodd-Frank Act Will Bring Back Stagflation*, Futures & Derivatives Law Report, Jan. 2011.

the current rules. By eliminating current §23.701(d), OTC market participants will save significant cost and avoid risk and confusion.

The current rules, that the Commission proposes to eliminate, require the Chief Executive Officer (CEO), Chief Risk Officer or "highest level decision-maker" (§23.701(c)) of an end-user to sign a receipt of notification for a right that is generally inapplicable. Senior executive time is very expensively misapplied in signing receipts.

Moreover, §23.701(e) states that "Notification pursuant to [§23.701(a)] to a particular counterparty by a particular swap dealer or major swap participant need only be made once in any calendar year." However, the counterparty must respond to the notification of each swap "prior to confirming." §23.701(e) does not cover the receipt of an election prior to confirmation of each trade required in §23.701(d). Rather, §23.701(e) only refers to notice once a year, not receipt of election once a year.

The burden of a mandatory distraction of any "highest level decision-maker" under the existing rule is simply unnecessary and unsupported by any offsetting benefit.

Swap trades are documented on "confirmations." The current rule calls two different things called "confirmations" as necessary for swap trades. The notice and "confirmation" mechanisms may also conflict with corporate resolutions, and agreement representations, regarding who is authorized to trade for the counterparty. The Commission proposes to eliminate this confusion by proposing to delete §23.701(d).

The current notices are produced at times not related to transaction activity, especially since the rules are not limited to transactions that have Initial Margin components. Subject to the discussion below concerning clarifying the meaning of "Initial Margin," the IECA further especially appreciates the Commission's proposal to limit the rule to those times when it is relevant- when there is, as stated in proposed §23.701(a), "a swap transaction that provides for the exchange of Initial Margin."

II. Questions presented.

The IECA respectfully offers the following responses to questions posed by the Commission in the NOPR.

Are the proposed amendments to subpart L appropriate in light of the requirements of CEA section 4s(l) and in light of the commercial realities encountered by SDs, MSPs, and counterparties engaging in uncleared swap transactions?

For the reasons noted by the Commission, yes. The IECA suggests further amendments below.

Should the Commission revise or eliminate any other provisions of subpart L?

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Yes. The IECA respectfully submits the following suggestions:

A. The Commission Should Consider Relating the Rule's Defined Terms to OTC Market Terms If that Is the Commission's Intent

Under §23.700: "'*Initial Margin*' means money, securities, or property ***posted by*** a party to a swap ***as performance bond to cover potential future exposures*** arising from ***changes in the market value of the position***" and "*Variation Margin*' means a ***payment made*** by or collateral posted by a party to a swap ***to cover the current exposure arising from changes in the market value of the position since the trade was executed*** or the previous time the position was marked to market." (emphasis supplied).

Exchanges seek to eliminate settlement risk through "variation margin" and "initial margin." "Variation margin" is daily settlement of gains and losses intended to reduce the time in which losses can accrue before a trader must make good on them. "Initial margin" seeks to ensure there are sufficient funds to cover liquidating the trader's positions if the trader does not settle a string of daily losses every day.

OTC markets operate very differently from exchanges. In OTC markets, market participants generally seek to rationalize, rather than eliminate, settlement risk through prudent extension of unsecured credit and passing back and forth margin when accrued losses exceed a previously agreed collateral threshold. Participants in OTC markets typically value their trades against observed market prices[2] on a daily or other periodic basis and estimate gains and losses that have accrued relative to the price for each trade; i.e., they mark their trades to market.

OTC market participants that are engaging in hedging transactions often agree privately that neither will post any margin to the other, or to extend each other specified amounts of unsecured credit, represented by a "collateral threshold"[3] and require less than 100% of the value of the market movement be margined. If creditworthiness is a concern, a party may require from the other

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[2] In OTC markets there is no established mechanism for daily settlement of gains and losses against a universally accepted clearing price for any particular swap. Since participants in OTC markets mark their trades to market independently, minor differences of opinion with respect to the value of any given trade are relatively common. To the extent that a particular trade involves a commodity that is traded infrequently or contains unique structural aspects, such differences of opinion can become more significant. Unsecured credit and collateral thresholds accommodate this lack of precision in valuing trades prior to settlement.

[3] Collateral thresholds are usually set at levels tied to respective credit ratings. For example, a party with a rating of AA might be required to post collateral only to the extent that the value of the position to its counterparty exceeded a $50,000,000 collateral threshold against it, with that threshold declining to $15,000,000 for a party with an S&P rating of BBB+. Most market participants set the collateral threshold to zero for a counterparty at or below BBB-, or Baa3 from Moody's, both of which are the lowest "investment grade" ratings.

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that a fixed amount known as an "Independent Amount," be added to the mark-to-market calculation, which can be analogized to initial margin. An "Independent Amount" can either be an amount that is added to a mark-to-market calculation or severed from the mark-to-market calculation and treated as a deposit. The ISDA form Credit Support Annex implements the former, although parties taking an Independent Amount often amend their Credit Support Annexes to enable the latter.[4]

In an exchange transaction, the initial margin, which is required to enter the trade, and the full amount of any market movement, i.e., the variation margin, combine to add up to more than 100% of the value of the difference between the trade price and the market price. When two private companies trade with each other in the OTC markets, there is no "initial margin" in the sense contemplated by the definition in Section 23.700, i.e., posted to cover exposures arising from changes in the market value of a position, although there may be initial margin or independent amounts posted as a deposit. Usually less than 100% of the difference between the trade price and the market price is posted as margin in an OTC market transaction.

As the IECA initially explained in its IECA Swap Documentation NOPR Comments submitted to the Commission on April 11, 2011, although "margin" is a term used in OTC markets, "initial margin" and "variation margin" are exchange concepts, not OTC swaps concepts.[5] The CFTC is following the lead of the statute and applying to OTC markets certain terms used for exchanges that lack meaning in OTC markets. Neither "initial margin" nor "variation margin" is used in OTC markets, although the terms might be analogized to "Independent Amount treated as a deposit" and "collateral securing mark-to-market exposure," respectively, in OTC parlance. While ISDA has begun using the terms "initial margin" and "variation margin" in some of its more recent Credit Support Annex documentation (but without defining those terms), the meaning given by the Commission to Initial Margin continues to differ from the way that term is used in the OTC markets and the inconsistent usage leads to confusion and uncertainty in the markets. There would be far less risk and far fewer resources consumed if the regulation used the terms, or at least indicated the meaning of these terms in the context of the terms, that the OTC marketplace and commonly used OTC marketplace master trading agreements use. The disconnect between the terminology used in the regulation to describe an action in the market and the terminology the market itself uses for that action, creates ambiguity and uncertainty, and hence risk and cost, without any benefit.

[4] User's Guide to 1994 ISDA Credit Support Annex, Appendix C.

[5] See page 14 of the IECA Swap Documentation NOPR Comments (referenced in footnote 1 of these current IECA comments of September 28, 2018).

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As the Commission pointed out in its publication of the current rule, the legislative intent was "to increase the safety of the swaps market."[6] Safety is not increased by confusion.

Therefore, since these are OTC market regulations, the IECA recommends that the Commission indicate that Initial Margin is analogous to a deposit or otherwise not credited against changes in mark-to-market values, if that is the Commission's intent, or distinguished from it, if it is not.

Separately, the term "performance bond" is not used in the OTC swaps market. It is generally used in construction or construction finance.

Further, Independent Amounts are often posted not to secure "changes in market position," or market risk, but rather to protect settlement risk, which is the risk of the counterparty not paying its bill when due and are designed to ensure that derivative positions remain fully collateralized between margin calls. OTC margining is an exchange of collateral, based on market movements, and is not a "payment" in the sense of "paying" for something; or in the exchange-traded sense of settling the prior days' market movements. OTC margining generally represents an estimate of the exposure from a current market movement on an amount that will become due in the future. The current requirement that the notice go with each trade might lead one to suspect that "initial margin" does not mean "Independent Amount," since the Independent Amount is typically set at the outset of the trading relationship in the master agreement, although it can sometimes also be set for a particular swap.

B. The Rules Should Provide that Notice Can Be Part of the Swaps Trading Relationship Documentation.

"The Commission continues to believe that, to be effective, the notification must be made to a person at the counterparty who understands its meaning, and, to the extent necessary, can direct it to the appropriate personnel at the counterparty." 83 Fed. Reg. 36487 col. 3. This could be solved by making the notice part of the swap trading relationship documentation. The credit officers, who negotiate the credit provisions of a master trading enabling agreement, understand the meaning and cost of segregation of collateral. In fact, provisions relating to when and how posted margin is to be segregated have been part of the ISDA standard documentation package since at least 1994 when the current version of the ISDA Credit Support Annex was put into effect. Accordingly, appropriate personnel negotiate, review, and execute this documentation and have done so for many years.

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[6] 78 Fed. Reg. 66632 col. 2.

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On that basis, we submit that the Commission would accomplish its goal, of ensuring that "the person at the counterparty who understands its meaning" is aware of the notice, by giving the parties the ability to put the notice right in the document, without the need for any further notice or receipt of notice.

C. Proposed Section 23.701(d) Should Be Replaced with a Right to Waive CEA §4s(l)(1)(B)

In OTC markets, parties hang multiple trades on the framework of a single master agreement that they usually negotiate before trading. Generally, parties address rules concerning rehypothecation, as well as the setting of collateral thresholds, margin, and Independent Amount matters, in the master agreement, rather than on a trade by trade basis. If a counterparty no longer accepted the terms negotiated in the master agreement, it could ask the other party to amend the master agreement, and if the other party refused, would simply cease trading with that particular counterparty and trade with a counterparty with agreeable terms. This rulemaking, therefore, should address whether a right to require segregation, and the right to receive the notice, could be waived when the parties negotiated their master agreement, or afterwards, and if so, whether irrevocably so. The IECA recommends a "yes" answer to both.

The ability to rehypothecate posted collateral is critical to economical hedging. By providing these hedging tools, OTC markets enable a reduction of the ultimate cost to customers by reducing producer or vendor risk. For example, an airplane ride can be cheaper if booked far in advance only if the airline can lock in its fuel cost by hedging. If the swap dealer has additional capital costs because it must margin, due to its inability to rehypothecate, it will pass those costs on to the end-user, and the end-user will pass those costs on to the consumer.

It costs a swap dealer much less to use rehypothecated collateral to fund the collateral requirements of the offsetting side of its trade than it does for the dealer to separately raise the capital if there is segregation. This cost is passed on. The value to end-user customers of swap dealers of this "right" to require segregation has been established by the Commission in its NOPR as minimal. We note also that an end-user, concerned about the credit quality of its swap dealer or major swap participant counterparty, is not left without any protection, because, typically, that end-user can replace its posted cash with a letter of credit, which creates no risk of cash being lost if the swap dealer or major swap participant goes bankrupt while holding that letter of credit.

The impact of always having the right to elect segregation, however, does have an effect on a swap dealer. This right to change its election means that on any given day a counterparty can say that all swaps going forward will not permit rehypothecation, but all those before will continue to permit rehypothecation,

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which means two calculations of margining by the swap dealer – the rehypothecated margin and the not rehypothecated margin – or possibly four calculations, with the "initial margin" and the "variation margin" broken out separately into rehypothecated and not rehypothecated margin individually broken out for initial and variation margin - all of which presumably need to be disclosed frequently to the other party.

If a end-user counterparty has this valuable option to demand collateral segregation at any time, and cannot waive it, swap dealers will need to increase fees and spreads across the board to recover the additional potential costs, meaning that all counterparties will effectively bear the cost for this option, whether or not they use it or want it. A swap dealer might instead seek to segregate the posted collateral from the start, incurring a higher capital cost, rather than deal with the mechanics of change or the uncertainty of future elections by counterparties, even if that does not enable an escape from the mechanics of notice. Each approach is inflationary.

Since the right relates only to "initial margin," which is not a term used in OTC market transactions, and not "variation margin" (See CEA §4s(l)(2)(B)(i)), which is the bulk of the margin that is posted to swap dealers with respect to OTC swap transactions, the ability to waive the right to require the swap dealer to segregate the initial margin in exchange for locked-in lower pricing is a reasonable tradeoff for an end-user to evaluate.

Therefore, parties should be able to choose to knowingly waive the right to require segregation under Section 23.701 in their master agreements.

D. The Rule Should Conform to the Uniform Commercial Code

In §23.702(c)(2), the word "written" should be replaced with the word "further" in order to conform to Uniform Commercial Code (UCC) Section 9104(a)(2). UCC §9104 sets forth the requirements for perfecting a security interest in a deposit account. Without a perfected security interest in the segregated account, the exercise is of potentially no value to the party posting the margin. UCC §9104 requires: "the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor ... ." (Emphasis added.) The Commission's rule should conform to the law, as there is no need for, nor any value other than uncertainty and potential frustration of intent created, by ambiguity.

Are there additional ways in which the Commission can simplify, streamline, and reduce the costs of these regulations without impairing the rights and safeguards intended by CEA section 4s(l)?

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Please see our suggestions in the preceding section of this comment letter.

Do the proposed amendments appropriately preserve the rights of counterparties articulated in CEA section 4s(l)?

Yes.

Is the Commission's proposed interpretation of CEA section 4s(l)(1)(A) reasonable given the commercial realities of uncleared swaps transactions and relationships between SDs and MSPs and their counterparties?

Yes.

As proposed, Regulation 23.701(a) provides that ''[a]t the beginning of the first swap transaction that provides for the exchange of Initial Margin'' an SD or MSP must notify the counterparty of its right to require segregation of initial margin. Should the Commission provide specific benchmark events that call for delivery of a segregation notification? If so, would entering into a master netting agreement or other contractual relationship be appropriate? What other events may be relevant for marking ''the beginning of the first swap transaction''?

Yes. The Commission should provide that there is no need for a swap dealer to provide any such notice unless or until there is initial margin in the swap trades between the two parties.

Should the Commission provide that the counterparty may request or opt to continue to receive an annual or some other periodic notification? Should the Commission provide that the counterparty may request or opt to receive notification at the beginning of each swap transaction?

No. Especially for a right that the Commission has documented is very rarely used, there is nothing in this right that is either so especially important, or so especially forgettable, that justifies any mechanism to implement a need to be constantly reminded of it.

The Commission notes that the proposed deletion of paragraph (a)(2) of Regulation 23.701 (requirement to identify one or more custodians as an acceptable depository for segregated initial margin) also removes language specifying that one of the identified custodians ''be a creditworthy nonaffiliate.'' Under the Proposal, Regulation 23.702(a) would continue to require that the custodian ''must be a legal entity independent of both the swap dealer or major swap participant and the counterparty.'' Should the Commission adopt more specific financial or affiliation qualifications for the custodian that an SD or MSP uses as a depository for segregated initial margin, and if so, what should those qualifications be?

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No. If the Commission wishes to educate counterparties on custodian credit characteristics and risks, it could hold roundtables from time to time and publish the transcripts.

Under Regulation 23.703(a), margin that is segregated pursuant to an election under Regulation 23.701 may only be invested consistent with Regulation 1.25. How has the limitation impacted counterparties' decisions to make an election under Regulation 23.701?

As the right to require segregation is so rarely exercised,[7] any response to this question would at best be anecdotal.

III. Correspondence Regarding These Comments

Please direct correspondence concerning these comments to:

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Conclusion

The IECA appreciates the opportunity to submit these comments in response to the Commission's NOPR and respectfully requests that the Commission consider them as it moves forward to improve its regulations affecting the commodity markets, market participants, and the fundamental benefits to our economy provided by well-functioning commodity markets. We welcome the opportunity to discuss these comments further should you require any additional information on any of the topics discussed herein.

Yours truly,
INTERNATIONAL ENERGY CREDIT ASSOCIATION

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[7] As the Commission notes at 83 Fed. Reg. 36486 col. 2.