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By Electronic Mail

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Third Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

RE: Request for Relief from the Margin Rules

Dear Secretary Kirkpatrick:

In advance of the Commodity Futures Trading Commission's ("**CFTC**" or "**Commission**") meeting of the Global Markets Advisory Committee ("**GMAC**") on September 24, 2019, we write to respectfully recommend that the Commission provide relief related to certain margin requirements for uncleared swaps under Part 23 of the Commission's Rules and Regulations (collectively, the "**Margin Rules**")¹ as they apply to swap dealers ("**SDs**") that are smaller and predominantly engaged in commercial or physical commodity markets ("**Commercial SDs**").

The relief proposed herein addresses the following issues:

- As discussed herein, the existing initial margin ("**IM**") calculation methodologies under the Margin Rules impose disproportionate financial and logistical burdens on Commercial SDs vis-à-vis large institutional swap market participants ("**Institutional SDs**"). Accordingly, we assert that relief from the Margin Rules is warranted for Commercial SDs.
- The Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") have extended the "Phase V" implementation schedule for IM requirements. We request that the CFTC provide Phase

¹ *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, CFTC Final Rule, 81 FR 636 (Jan. 6, 2016), codified in 17 C.F.R. §§ 23.150-159, 161 (2019); *see also*, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of the Margin Requirements*, CFTC Final Rule, 81 Fed. Reg. 34818 (May 31, 2016); *see also*, *Comparability Determination for the European Union: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, CFTC Notification of Determination, 82 Fed. Reg. 48394 (Oct. 18, 2017); *see also*, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, CFTC Final Rule, 83 FR 60341 (Nov. 26, 2018) (collectively, the "**Margin Rules**").

V implementation relief consistent with the revised BCBS and IOSCO implementation plan.

I. REQUESTED RELIEF

- (1) Provide no-action relief to Commercial SDs to allow them to use their Institutional SD counterparties' approved, risk-based IM valuation methodology instead of the Commercial SDs' internal grid-based methodology for calculating IM without seeking additional CFTC or National Futures Association ("*NFA*") approval.
- (2) Provide relief to market participants by following the implementation schedule proposed by BCBS and IOSCO to delay Phase V implementation to September 1, 2021, and to provide the intermediary phase with the \$75 billion material swaps exposure ("*MSE*") on September 1, 2020 instead.

II. APPLICABLE LAW

A. The Margin Rules

In accordance with section 4s(e) of the Commodity Exchange Act ("*CEA*"), the CFTC adopted the Margin Rules for swaps entered into by SDs or major swap participants ("*MSP*") with financial institutions that are not cleared through a clearinghouse, *i.e.* "uncleared swaps."² Specifically, the Margin Rules require a covered swap entity ("*CSE*")³ to post and collect IM⁴ from a covered counterparty.⁵ The Margin Rules also mandate that a CSE must post and collect variation margin ("*VM*")⁶ from a swap entity or a financial end user when the amount is positive. If the VM amount is negative, a CSE must post VM with the swap entity or financial end user.⁷ Under the Margin Rules, a CSE is defined as an SD or MSP for which there is no Prudential Regulator that enters into an uncleared swap. A "covered counterparty"

² *Margin and Capital Requirements for Covered Swap Entities*, 80 FR 74840, at 74856 (Nov. 30, 2015). In conjunction with the CFTC's promulgation of the Margin Rules, the U.S. bank regulators (the "*Prudential Regulators*") issued parallel margin requirements for *security-based* uncleared swaps. The Prudential Regulators include the Federal Reserve Board ("*FRB*"), the Office of the Comptroller of the Currency ("*OCC*"), the Federal Deposit Insurance Corporation ("*FDIC*"), the Farm Credit Administration, and the Federal Housing Finance Agency.

³ 17 C.F.R. § 23.151 (defining CSE).

⁴ 17 C.F.R. § 23.151 (defining "initial margin" as the collateral, as calculated in accordance with 17 C.F.R. § 23.154, that is collected or posted in connection with one or more uncleared swaps).

⁵ 17 C.F.R. § 23.152(a).

⁶ 17 C.F.R. § 23.151 (defining "variation margin" as collateral provided by a party to its counterparty to meet the performance of its obligation under one or more uncleared swaps between the parties as a result of a change in value of such obligations since the trade was executed or the last time such collateral was provided).

⁷ 17 C.F.R. § 23.153(a).

under the Margin Rules is a financial end user with material swaps exposure⁸ that enters into a swap with a CSE.⁹

B. IM Calculation under the Margin Rules

Pursuant to CFTC Regulation 23.154(a)(3), CSEs are not required to post or collect IM until the **IM Threshold Amount** has been exceeded.¹⁰ The CFTC's Regulations currently provide two frameworks for calculating IM and for determining whether the IM Threshold Amount has been exceeded and IM amount is due: (i) a table/grid-based method as described in section 23.154(a)(1)(ii) of the CFTC's Regulations (the "**Grid Method**"), and (ii) a risk-based model as described in section 23.154(b) of the CFTC's Regulations (the "**Risk-Based Model**") that has been approved by the CFTC or a registered futures association, such as the National Futures Association (the "**NFA**").¹¹ Under the Grid Method, the SD/MSP must calculate IM using a standardized table/grid that is set out in the CFTC's Margin Rules.¹² The standardized table/grid specifies the minimum IM that must be posted and collected as a percentage of a swap's notional amount. This percentage varies depending on the asset class and currency of the swap. The Grid Method is consistent with international standards.

A Risk-Based Model, on the other hand, calculates IM as the amount that is equal to the potential future exposure ("**PFE**") of a swap or a netting set of swaps. As the CFTC explained in its adopting release of CFTC Regulation 23.150, PFE is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the swap over a 10-day period (*i.e.*, VaR model for a 10-day period).¹³ A Risk-Based Model must meet the following requirements:

- (1) the Risk-Based Model must have prior written approval by the CFTC or a registered futures association, such as the NFA;
- (2) a CSE must demonstrate that the IM model continuously satisfies the requirements under CFTC Regulation 23.600; and
- (3) a CSE must notify the CFTC or the registered futures association that approved its model in writing prior to making material changes to the model, such as:
 - (a) extending the use of the model to an additional product type;
 - (b) making any change that results in material changes to the amount of IM; or

⁸ 17 C.F.R. § 23.151 (defining "material swaps exposure").

⁹ 17 C.F.R. § 23.151 (defining "covered counterparty").

¹⁰ 17 C.F.R. § 23.154(a)(3).

¹¹ 17 C.F.R. § 23.154(a)(1).

¹² 17 C.F.R. § 23.154(c).

¹³ *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 FR at 685 (Jan. 6, 2016) ("a CSE would be required to generally calculate their initial margin based on the assumption of a 'holding period' of 10 business days with a one-tailed 99% confidence interval.").

- (c) making any material changes to the assumptions of the model.¹⁴

The CFTC or a registered futures association, such as the NFA, may rescind its approval in whole or in part of an entity's Risk-Based Model at any time. Many SDs currently use the Standard Initial Margin Model ("*ISDA SIMM*TM") developed by the International Swap Dealer Association ("*ISDA*") to calculate IM because *ISDA SIMM*TM¹⁵ is generally more cost-effective than the Grid Method; *i.e.*, it typically calculates a lower IM number, and therefore smaller amounts of IM will be collected and posted, and the IM Threshold Amount is exceeded less frequently.

The Prudential Regulators adopted a joint rule, as amended (the "*PR Margin Rules*"), to establish minimum margin and capital requirements for registered SDs, MSPs, security-based SDs, and major security-based swap participants for which one of the Prudential Regulators is the prudential regulator. Among other things, the *PR Margin Rules* set forth requirements for the collection and posting of VM and IM with respect to swaps and security-based swaps by swap entities that are prudentially regulated by one of the Prudential Regulators. The *PR Margin Rules* are very similar to the CFTC's Margin Rules. The *PR Margin Rules* currently require that a CSE, as defined under the *PR Margin Rules*, that uses a Risk-Based Model to calculate IM, must have that model approved by its Prudential Regulator and that model must meet certain criteria which are similar to the criteria in the CFTC's Margin Rules.

Additionally, CFTC Regulation 23.158 requires CSEs to execute IM documentation that complies with the requirements of CFTC Regulation 23.504.¹⁶ If a Commercial SD and an Institutional SD counterparty use different methodologies to determine when they need to put this IM documentation in place, this could result in different determinations as to when that documentation needs to be executed between the Commercial SD and one or more of its Institutional SD counterparties. The necessary IM documentation includes credit support annexes addressing the regulatory requirement to exchange IM and custodian arrangements addressing the regulatory requirement to segregate margin assets with an independent custodian.¹⁷ IM documentation must be executed "prior to or contemporaneously with entering into a swap transaction."¹⁸ These regulations might require swap market participants and their SD counterparties to put relevant documentation in place, regardless of whether any IM would exceed the IM Threshold Amount of \$50 million. However, on July 9, 2019, the Division issued an advisory letter clarifying that no IM documentation is required until the amount of IM exchangeable between a CSE and a counterparty, on a counterparty by counterparty basis, exceeds the IM Threshold Amount of \$50 million.¹⁹

¹⁴ *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 FR at 654 (Jan. 6, 2016).

¹⁵ ISDA has published SIMM Methodology version 2.1 (effective Dec. 1, 2018).

¹⁶ 17 C.F.R. § 23.158.

¹⁷ 17 C.F.R. § 23.504.

¹⁸ 17 C.F.R. § 23.504(a)(2).

¹⁹ CFTC Letter No. 19-16 (July 9, 2019).

C. “Phase V” Implementation under the Margin Rules

“Phase V” implementation of the Margin Rules is scheduled to take effect in September 2020. However, on July 23, 2019, the Basel Committee on Banking Supervision (“*BCBS*”) and the International Organization of Securities Commissions (“*IOSCO*”) issued a joint statement advising that they have agreed to extend by one year, until September 1, 2021, the final implementation of the Phase V IM requirements.²⁰ According to BCBS and IOSCO, “[t]he final [IM] implementation phase will take place on September 1, 2021, at which point covered entities with an aggregate average notional amount (“*AANA*”) of non-centrally cleared derivatives greater than €8 billion will be subject to the requirements.”²¹ BCBS and IOSCO, therefore, proposed an additional implementation phase whereby, as of September 1, 2020, covered entities with an AANA of non-centrally cleared derivatives greater than €50 billion will be subject to the requirements.

III. BASIS FOR RELIEF FROM THE MARGIN RULES

A. IM Calculation Relief

Under the current Margin Rules, an SD has the right to elect to use either the Grid Method or an Approved Risk-Based Model for calculating the IM it collects from its SD counterparties and for determining the IM that would be exchangeable with another SD for purposes of determining the timing of executing IM documentation. However, as a practical matter, since most, if not all, of the Institutional SDs have adopted ISDA SIMM™ for purposes of: (i) determining whether the IM Threshold Amount has been exceeded and therefore the timing of Documentation Requirements, and (ii) calculating IM for their posting and collection obligations, these Institutional SDs expect an Approved Risk-Based Model will be used with their counterparties. Accordingly, there will be significant pressure on Commercial SDs to use ISDA SIMM™ to calculate the amount of IM they will collect from an Institutional SD and for determining the timing of the Documentation Requirements.

Absent relief from the CFTC, this issue effectively prevents a Commercial SD from utilizing an IM calculation method of its choosing and that it is currently prepared to implement even if that method is allowed by the Margin Rules (such as the Grid Method). This may require a Commercial SD to comply with Documentation Requirements earlier than it would be expected by its SD counterparties, thus resulting in other SDs choosing not to trade uncleared swaps with the Commercial SD. This would place Commercial SDs at a competitive disadvantage in comparison to other swap market participants. A Commercial SD predominantly transacting in physical commodity markets should be able to use the IM calculation method it prefers (both for its own internal risk management purposes and for its relationships with its in-scope, non-SD counterparties), but still be able to viably trade in the uncleared swap market by having its Institutional SD counterparty (the “*IM Calculation SD*”) calculate the amount of IM it will collect from the Institutional SD using that Institutional SD’s Approved Risk-Based Model.

²⁰ See Basel Committee on Banking Supervision and International Organization of Securities Commissions, *Basel Committee and IOSCO agree to one-year extension of the final implementation phase of the margin requirements for non-centrally cleared derivatives* (July 23, 2019), <https://www.bis.org/press/p190723.htm>.

²¹ *Id.*

Requiring a Commercial SD to develop and implement two parallel models to calculate the IM it would need to collect from other SDs would impose a disproportionate burden on the small SD relative to its more modest position in the swap market – *i.e.*, not a large financial institution. However, the Grid Method does not provide a Commercial SD with an adequate alternative if its SD counterparties object, which they may, in part because, as noted by the CFTC, “[t]he standardized [table/grid-based] approach could result in excess initial margin being calculated.”²² Likewise, if the Commercial SD’s counterparties determine that under that SD’s Approved Risk-Based Model the parties would not have to comply with Documentation Requirements, such SD counterparties may not be willing to trade uncleared swaps with the Commercial SD.

Accordingly, we propose that Commercial SDs be allowed to adopt an IM calculation methodology that integrates elements of both the Grid Method and another SDs’ Other Approved Method, such as an Approved Risk-Based Model, for calculating the IM the Commercial SD collects from its counterparty Institutional SD and for determining the timing of Documentation Requirements. The two SDs should be allowed to agree on how IM will be collected and posted by each of them and calculated for purposes of determining the timing of Documentation Requirements, and they should be allowed to designate one of them (*i.e.*, the IM Calculation SD) to act as the “calculation agent” for the purposes of the reciprocal IM calculations and the timing of Documentation Requirements for the relationship, so long as:

- (1) the IM to be collected and posted by each SD and the IM calculations for determining the timing of Documentation Requirements are calculated by the IM Calculation SD pursuant to an Approved Risk-Based Model or the Grid Method, in each case, that complies with the Margin Rules or the PR Margin Rules; and
- (2) the SD that is not the “calculation agent” for the purposes of IM calculations, continues to calculate the IM collection amount using any method for calculating IM, such as the Grid Method, which complies with the Margin Rules or the PR Margin Rules, including, the obtainment of any necessary approvals thereunder, for its own risk management purposes.

The Margin Rules already permit SDs to calculate the amount of IM a CSE collects from a financial end user (“*FEU*”) with material swaps exposure as “at least as much initial margin . . . as the CSE would be required to collect if it were in the place of the financial end user with material swaps exposure.”²³ The CSE may only use a Risk-Based Model if it meets the requirements of the Margin Rules. Likewise, a CSE under the PR Margin Rules may only use a Risk-Based Model that meets stringent criteria under which the model has been approved by the CSE’s Prudential Regulator. If the CFTC extended similar relief to Commercial SDs, a Commercial SD’s collection of IM and the timing of the Documentation Requirements with other SDs would be determined by the IM Calculation SD, an entity that would be using an Other Approved Method. For example, in the case of a Risk-Based Model, such

²² *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 FR at 685 (Jan. 6, 2016).

²³ *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 FR at 649 (Jan. 6, 2016).

model would have been approved by the CFTC or a registered futures association or by a Prudential Regulator.

We believe that a Commercial SD's swap activities and its compliance with the Margin Rules with respect to IM, under those parameters, would not pose a risk to the market. Extending the methodology for determining IM that an SD can use for its FEU counterparties to Commercial SDs would help Commercial SDs maintain their swap businesses and avoid extensive and costly operational and systems overhauls.

This proposal would satisfy the baseline objectives of the CFTC's IM policy framework and serve the public interest by ensuring that the IM associated with a Commercial SD's swaps and the time at which it must put relevant documentation in place with other SDs will be calculated in a cost-efficient manner and will still provide sufficient protection to CSEs.²⁴ Furthermore, our IM calculation proposal will allow Commercial SDs to continue to participate in the swap market in full compliance with the Margin Rules.

IV. PROPOSED RELIEF FROM THE MARGIN RULES

A. Proposed Relief

With respect to the application of the Margin Rules to a Commercial SD, a Commercial SD should be permitted to: (i) calculate IM using any method which complies with the Margin Rules, including the obtainment of any necessary approvals thereunder, if applicable, for its own risk management purposes; and (ii) on the basis of the counterparty Institutional SD's Approved IM Calculation Method: (A) determine whether the IM Threshold Amount had been exceeded, and the timing of when the Documentation Requirements must be implemented as applicable; and (B) calculate the amount of IM that it must collect from and post to its SD counterparties.

For a Commercial SD's non-SD counterparties that are in scope for IM, a Commercial SD should be permitted to: (i) calculate IM using any Approved IM Calculation Method for its own risk management purposes; and (ii) on the basis of its selected Approved IM Calculation Method: (A) determine whether the IM Threshold Amount had been exceeded, and the timing of when the Documentation Requirements must be implemented as applicable; and (B) calculate the amount of IM that it must collect from and post to its non-SD counterparties that are in scope for IM.

The Commission should extend the Phase V IM implementation schedule to align with the implementation proposal issued by BCBS and IOSCO. Implementation of Phase V should be delayed until September 1, 2021, when all covered entities will be in scope so long as their AANAs exceed an MSE of \$8 billion. In the interim, the Commission should adopt the intermediate implementation date of September 1, 2021, for entities that meet the \$75 billion MSE threshold.

²⁴ *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 FR at 684 (Jan. 6, 2016) (“The use of either model is predicated on the satisfaction of certain baseline requirements to ensure that initial margin is calculated in a manner that is sufficient to protect CSEs as intended. Further, the choice of two alternatives allows CSEs to choose the methodology that is the most cost efficient for managing their business risks and thereby better compete.”).

B. Conditions for Proposed Relief

- A Commercial SD's counterparties in the applicable swap transactions must be provisionally registered SDs;
- A Commercial SD seeking relief under this proposal must maintain a risk management program²⁵ that will calculate IM and determine whether the IM Threshold Amount had been exceeded using the Grid Method or any other method which complies with the Margin Rules, including, the obtainment of any necessary approvals thereunder;
- A Commercial SD and its Institutional SD counterparties will agree in writing that the Commercial SD will collect IM from and post IM to such other Institutional SD counterparties using the IM number calculated by such Institutional SD counterparties under their Approved IM Calculation Method (*e.g.*, ISDA SIMM™);
- A Commercial SD and its Institutional SD counterparties will agree that the time at which Documentation Requirements must be implemented between a Commercial SD and other Institutional SD counterparties (*i.e.*, whether the IM Threshold Amount had been exceeded) will be determined by the other Institutional SD counterparties using the IM amount calculated by such Institutional SD counterparties where such Institutional SDs use their Approved IM Calculation Method (*e.g.*, ISDA SIMM™); and
- For uncleared swaps between a Commercial SD and applicable non-SD counterparties (*i.e.*, financial end users with material swaps exposure), the Commercial SD must use an Approved IM Calculation Method, such as the Grid Method, to calculate the amount of IM to be collected from such counterparties and determine whether the IM Threshold Amount had been exceeded and the time at which Documentation Requirements must be implemented between the Commercial SD and the applicable non-SD counterparty.

V. CONCLUSION

We thank you for your consideration of these issues and appreciate your prompt response. We would be happy to discuss the issues or conditions described above further if it would be helpful. If you have questions, please contact the undersigned at (202) 414-9185.

²⁵ 17 C.F.R. § 23.600(b)(1) (CFTC Regulation 23.600 requires each registered SD and MSP to establish a risk management program that identifies the risks associated with the SD/MSP's activities along with the risk tolerance limits set by the SD/MSP. Among other elements, the risk management program must detail how the SD/MSP will satisfy all capital and margin requirements established by the CFTC or prudential regulator, as applicable.).

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Very truly yours,

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