December 23, 2019

Via Electronic Submission

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

Re: Margin Requirements for Uncleared Swaps (RIN 3038–AE77 and RIN 3038-AE89)

Dear Mr. Kirkpatrick:

The members of the Futures Industry Association (“FIA”)1 who are active in physical commodities markets welcome the opportunity to comment on two notices of proposed rulemaking regarding the “Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants” issued by the Commodity Futures Trading Commission (“CFTC” or “Commission”) on October 22, 2019,2 and October 24, 20193 (collectively, the “Proposals”). The Proposals seek to amend the current margin requirements for uncleared swaps for Swap Dealers (“SDs”) and Major Swap Participants (“MSPs”) for which there is no prudential regulator (the “Margin Rule”).4

Among other modifications to the existing Margin Rule, the Proposals would add the European Stability Mechanism (“ESM”) to the list of entities that are excluded from the definition of “financial end user.” They also propose to correct an erroneous cross-reference in the Commission’s related regulations that mistakenly excluded treasury securities and U.S. government agency securities from the list of eligible collateral to which cash collateral held

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1 The Futures Industry Association is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA’s membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries, as well as technology vendors, lawyers and other professionals serving the industry. FIA’s mission is to support open, transparent and competitive markets; protect and enhance the integrity of the financial system; and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA’s clearing firm members play a critical role in the reduction of systemic risk in global financial markets.


by a custodian of initial margin ("IM") may be converted. Finally, the Proposals would extend the compliance schedule for the Margin Rule ("Phase V") and introduce a sixth compliance deadline for smaller counterparties ("Phase VI").

FIA’s members and their affiliates include financial institutions, brokerage firms, and trading firms that are active in physical commodities markets, as well as commercial end users that rely on physical commodities, futures and over-the-counter derivatives to support their business activities (collectively, “FIA’s commodities members”). FIA’s commodities members generally support the Proposals, including the Commission’s efforts to amend its rules when necessary to correct errors and relieve burdens on market participants. In particular, FIA’s commodities members support the extension of Phase V and Phase VI as discussed below.

We also would like to take this opportunity to briefly address other issues identified by FIA’s commodities members related to the Margin Rule for further consideration and action by the Commission. Specifically, this letter will discuss: (1) the potentially adverse impact of existing IM calculation methodologies on smaller, commercial SDs; (2) the rationale for excluding commodity swaps from the IM margin requirements; (3) the need to harmonize the definitions of “financial entity” under section 2(h)(7)(C) of the Commodity Exchange Act (“CEA”), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), and “financial end user” under the Margin Rule; (4) how the margin requirements may conflict with SD capital requirements; and (5) why the Commission should consider excluding SD treasury affiliates from the Commission’s margin rules.

We respectfully request the Commission to address these additional important issues to FIA’s commodities members and other similarly situated commodities firms.

Commercial SDs Should be Able to Use Combined Grid and Risk-Based IM Models

As discussed further below, we believe that when dealing with counterparties that are Institutional SDs, Commercial SDs should be able to rely on such counterparties’ approved risk-based IM models instead of their own grid-based models in instances when the results produced by these two IM models are inconsistent.

The existing IM calculation methodologies under the Commission’s margin rules, from a practical perspective, are more advantageous to SDs given that the rules were written for SDs that are financial institutions ("Institutional SDs") that have traditionally been engaged in transactions involving excluded commodities with the counterparties utilizing interest rate swaps ("IRS"), credit default swaps ("CDS") and other financial instruments. Smaller, commercial SDs ("Commercial SDs"), on the other hand, deal almost exclusively in physical commodities, such as exempt or agricultural commodities, and with a lot fewer counterparties that are predominantly involved in the physical commodity trade or are the users of physical commodities that are produced, sourced or traded by these Commercial SDs’ other affiliates.

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In other words, the nature of Commercial SDs’ counterparties and the credit risk modelling employed by Commercial SDs is fundamentally and inherently different from that of Institutional SDs. Also, given that before Phase V Commercial SDs were not subject to initial margin requirements, the undertaking of compliance with Phase V for Commercial SDs is not merely an administrative task, but rather a matter of fundamentally redesigning their credit methodologies for products that were not originally captured by IM for Institutional SDs and redocumenting relationships with their traditionally non-financial counterparties.

Currently, the Commission’s rules provide only two frameworks for determining whether the IM Threshold Amount has been exceeded and subsequently calculating the amount of IM due. The first method is a grid-based method described in section 23.154(a)(1)(ii) of the Commission’s rules, which specifies the minimum IM that must be posted and collected as a percentage of a swap’s notional amount. Because it is a grid-based approach, it is much easier to administer. It does not require building complicated credit based financial systems and maintaining these systems on a continuous basis. Although this method is consistent with international standards, when applied it typically produces a much more conservative margin value and for that reason is currently virtually not used at all.

The second method is a risk-based model as described in section 23.154(b) of the Commission’s rules that must be approved by the Commission or the National Futures Association. A risk-based model calculates IM as the amount that is equal to the potential future exposure of a swap or a netting of swaps and allows for a much more finely calibrated approach that typically results in fewer instances when IM will be due. Furthermore, owing to the more calibrated nature of this methodology, the risk-based model results in fewer instances when the IM margin threshold is breached (at which point IM will be due).

For these reasons, all, or virtually all, Institutional SDs use a risk-based model developed by the International Swaps and Derivative Association (“ISDA”) called the Standard Initial Margin Model (“ISDA SIMM™”). This in turn effectively forces Commercial SDs that are not financial institutions to implement their own ISDA SIMM model for IM calculations when they trade with institutional SDs.

If Commercial SDs were to implement an easier to administer grid-based model, they would likely have to comply with IM documentation requirements earlier than required under the risk-based models and for that reason risk that a large number of counterparties, such as Institutional SDs, would not want to trade uncleared swaps with the Commercial SD. That result would place Commercial SDs at a competitive disadvantage in comparison to other swap market participants – such as Institutional SDs.

We propose that Commercial SDs be allowed to adopt an IM calculation methodology that integrates elements of both the grid-based method and another Institutional SDs’ approved risk-based model for calculating the IM the Commercial SD collects from its counterparty Institutional SD and for determining the timing of IM documentation requirements. Under this hybrid method, a Commercial SD would be able to maintain a grid-based model, but in transactions with Institutional SDs would be able to rely on the Institutional SD’s risk-based model for calculation purposes to the extent it differs from the IM values calculated under their grid-based models. This approach would generally follow the relief granted by Commission’s
Division of Swap Dealer and Intermediary Oversight on December 19, 2019⁶. Commercial SD and Institutional SD counterparties should be allowed to agree on an IM calculation and collection methodology that is practicable and commercially reasonable.

**Commodity Swaps Should be Carved out from IM Requirements**

Given the commercial nature, de minimis share in the global swaps market and primarily the hedging purpose of commodity swaps, FIA’s commodities members believe that as possible such swaps should be carved out of the Commission’s IM requirements for uncleared swaps. The drafters of the Dodd-Frank Act recognized that not all swap categories are commercially equal by including CEA § 4s(e)(3), which requires that any margin rules should “be appropriate for the risk associated with the non-cleared swaps held as a [SD].”

We note that the CFTC’s Office of the Chief Economist in its October 24, 2018 report (the “Chief Economist Report”)⁷ explained that Phase V would bring in counterparties that pose no systemic risk, such as Commercial SDs. Phase V primarily addresses small financial end users, 75% of which will never actually be required to post margin because they fall below the $50 million threshold. The risk is even further reduced in the case of physical commodities, which account for only 0.35% of global swaps.⁸

The Chief Economist Report further shows that the group of market participants that will become subject to Phase V is fundamentally different from the entities that have become subject to IM requirements in Phases I through IV, and that the commercial SDs are not only smaller, but also are engaged in a markets more linked with physical commodity trading, and serve counterparties that are materially different from those served by Institutional SDs.

Yet, the Margin Rules do not expressly recognize appropriate management of credit risk in commodity markets. Risk management is traditionally performed differently in commodity markets by non-cash collateral, guarantees, and letters of credit, none of which are recognized under the Margin Rules. Physical commodity markets, and the swaps related to these physical markets, are underpinned by the production, transfer and use of commodities, which has implications for credit risk modelling, among other things. Users of commodity swaps need economical alternatives to hedge commercial risk associated with physical commodity markets. Commercial SDs already collect variation margin. IM results in overcollateralization and makes certain transactions uneconomical to execute.

Consequently, applying the one-size-fit-all approach to commodity swaps may not outweigh the benefits and a more calibrated approach should be considered (e.g., carving out affiliates trading commercial and physical commodity swaps from the definition of “margin affiliate” or providing a hedge exemption for commodity swaps that are used to hedge physical commodity exposure).

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⁶ See CFTC Letter No. 19-29, issued by Division of Swap Dealer and Intermediary Oversight on December 19, 2019. https://www.cftc.gov/csl/19-29/download
⁸ Id. at p. 3.

The definition of “financial entity” under CEA § 2(h)(7)(C) and the definition of the “financial end user” under the Commission’s margin rules are similar, but not identical. The Commission should align the two definitions to provide market participants more clarity. Better alignment is important to provide greater clarity and efficiency in compliance and to reduce the likelihood of differences in interpretation of the misaligned terms.

For example, the CFTC may issue CEA § 4(c) relief or an interpretive guidance to clarify that the last prong of “financial entity” matches the definition of “financial end user.” Given that the language in the “financial entity” definition is broader than the language in the “financial end user” definition, the CFTC should narrow the definition of “financial entity” rather than match “financial end user” to “financial entity”.

Assess Proposed SD Capital Rules on the Application of the Margin Rules

The Commission should carefully consider the impact of its uncleared margin rules in finalizing requirements for the capital of SDs. We reserve this issue for comment in respect of the recently proposed SD capital rulemaking.

SD Treasury Affiliates Should be Able to Rely on Treasury Affiliate Exception

The Commission should consider adopting rules permitting Commercial SD’s affiliates that act as treasury affiliates for the entire company (“Treasury Affiliates”) to rely on the non-financial end user exception to the Commission’s margin rules. Currently, under CEA § 2(h)(7)(D)(ii) and § 2(h)(7)(D)(iii), SD Treasury Affiliates cannot rely on the non-financial end user exception, and therefore these affiliates are required to comply with margin requirements simply because they are affiliated with a SD. To the extent that such Treasury Affiliates’ trading activity complies with CEA § 2(h)(7)(D)(i)(I), they should be excluded from the Commission’s margin rules. This argument is even more compelling with respect to Treasury Affiliates trading swaps on physical commodities given commodity swaps de minimis share in the global swaps market.

In addition, as mentioned above, the CFTC should consider carving out Treasury Affiliates, and particularly Treasury Affiliates trading swaps on physical commodities, from the definition of “margin affiliates” to the extent their activities relate to swaps on physical commodities. Finally, the Commission should consider promulgating rules on Treasury Affiliates given that Margin Rules specifically refer to Commission promulgating these rules in the future.

Margin Rule Compliance Schedule Should be Extended

FIA’s commodities members support the Proposals’ modifications to the Margin Rule compliance schedule established under section 23.161 of the Commission’s rules. The Proposals require compliance by September 1, 2020, for covered swap entities (“CSEs”) and

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covered counterparties with an average daily aggregate notional amounts ("AANA") ranging from $50 billion up to $750 billion. However, a sixth-phase deadline of September 1, 2021, would be added to the compliance schedule for all other remaining CSEs and covered counterparties, including financial end user counterparties exceeding a material swap exposure of $8 billion in AANA.

We agree with the market participants who have expressed concern about the prospect of meeting Phase V compliance obligations by September 1, 2020. Entities that fall within the scope of Phase V must overcome considerable operational hurdles to implement the requisite IM calculation procedures and appropriately segregate third-party IM collateral. Extension of the Margin Rule compliance schedule will help to prevent market disruption and facilitate the orderly implementation of Phase V.

Sincerely,

Walt Lukken
President & Chief Executive Officer

cc:  Honorable Heath Tarbert, Chairman
     Honorable Brian D. Quintenz, Commissioner
     Honorable Rostin Behnam, Commissioner
     Honorable Dan Berkovitz, Commissioner
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