6351-01-P

**COMMODITY FUTURES TRADING COMMISSION**

**17 CFR Part 23**

**RIN 3038-AF05**

# Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants

**AGENCY:** Commodity Futures Trading Commission

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Commodity Futures Trading Commission ("Commission" or "CFTC") is proposing to amend the margin requirements for uncleared swaps for swap dealers ("SDs") and major swap participants ("MSPs") for which there is no prudential regulator ("CFTC Margin Rule"). In particular, the Commission is proposing to revise the calculation method for determining whether certain entities come within the scope of the initial margin ("IM") requirements under the CFTC Margin Rule beginning on September 1, 2021, and the timing for compliance with the IM requirements after the end of the phased compliance schedule. The proposed amendment would align certain aspects of the CFTC Margin Rule with the Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions' ("BSBS/IOSCO") Framework for margin requirements for non-centrally cleared derivatives ("BCBS/IOSCO Framework"). The Commission is also proposing to allow SDs and MSPs subject to the CFTC Margin Rule to use the risk-based model calculation of IM of a counterparty that is a CFTC-registered SD or MSP to determine the amount of IM to be collected from the counterparty and to determine whether the IM threshold amount for

the exchange of IM has been exceeded such that documentation concerning the collection, posting, and custody of IM would be required.

**DATES:** With respect to the proposed amendments, comments must be received on or before **[INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].**

**ADDRESSES:** You may submit comments, identified by RIN 3038-AF05, by any of the following methods:

- CFTC Comments Portal: *https://comments.cftc.gov*. Select the "Submit Comments" link for this rulemaking and follow the instructions on the Public Comment Form.

- Mail: Send to Christopher Kirkpatrick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Center, 1155 21st Street, NW, Washington, DC 20581.

- Hand Delivery/Courier: Follow the same instructions as for Mail, above.

Please submit your comments using only one of these methods. Submissions through the CFTC Comments Portal are encouraged.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to *https://comments.cftc.gov*. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that you believe is exempt from disclosure under the Freedom of Information Act ("FOIA"), a petition for confidential treatment of the exempt

information may be submitted according to the procedures established in § 145.9 of the Commission's regulations.[1]

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from *https://comments.cftc.gov* that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the FOIA.

**FOR FURTHER INFORMATION CONTACT:** Joshua B. Sterling, Director, 202-418-6056, *jsterling@cftc.gov*; Thomas J. Smith, Deputy Director, 202-418-5495, *tsmith@cftc.gov*; Warren Gorlick, Associate Director, 202-418-5195, *wgorlick@cftc.gov*; or Carmen Moncada-Terry, Special Counsel, 202-418-5795, *cmoncada-terry@cftc.gov*, Division of Swap Dealer and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW, Washington, DC 20581.

**SUPPLEMENTARY INFORMATION:**

## I. Background

Section 4s(e) of the Commodity Exchange Act ("CEA" or "Act")[2] requires the Commission to adopt rules establishing minimum initial and variation margin requirements for all swaps[3] that are (i) entered into by an SD or MSP for which there is

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[1] 17 CFR 145.9. Commission regulations referred to herein are found at 17 CFR Chapter I.
[2] 7 U.S.C. 6s(e) (capital and margin requirements).
[3] CEA section 1a(47), 7 U.S.C. 1a(47) (swap definition); Commission regulation 1.3, 17 CFR 1.3 (further definition of a swap). A swap includes, among other things, an interest rate swap, commodity swap, credit default swap, and currency swap.

no prudential regulator[4] (collectively, "covered swap entities" or "CSEs")[5] and (ii) not cleared by a registered derivatives clearing organization ("uncleared swaps").[6] To offset the greater risk to the SD[7] or MSP[8] and the financial system arising from the use of uncleared swaps, these requirements must (i) help ensure the safety and soundness of the SD or MSP and (ii) be appropriate for the risk associated with the uncleared swaps held by the SD or MSP.[9]

Following the mandate under Section 4s(e), the Commission in 2016 promulgated Commission regulations 23.150 through 23.161, namely the CFTC Margin Rule, which requires CSEs to collect and post initial margin ("IM")[10] and variation margin ("VM")[11]

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[4] CEA section 1a(39), 7 U.S.C. 1a(39) (defining the term ''prudential regulator'' to include the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency). The definition of prudential regulator further specifies the entities for which these agencies act as prudential regulators. The prudential regulators published final margin requirements in November 2015. *See generally* Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015) ("Prudential Margin Rule"). The Prudential Margin Rule is substantially similar to the CFTC Margin Rule, including with respect to the CFTC's phasing-in of margin requirements, as discussed below.

[5] CEA section 4s(e)(1)(B), 7 U.S.C. 6s(e)(1)(B). SDs and MSPs for which there is a prudential regulator must meet the margin requirements for uncleared swaps established by the applicable prudential regulator. CEA section 4s(e)(1)(A), 7 U.S.C. 6s(e)(1)(A).

[6] CEA section 4s(e)(2)(B)(ii), 7 U.S.C. 6s(e)(2)(B)(ii). In Commission regulation 23.151, the Commission further defined this statutory language to mean all swaps that are not cleared by a registered derivatives clearing organization or a derivatives clearing organization that the Commission has exempted from registration as provided under the CEA. 17 CFR 23.151.

[7] CEA section 1a(49), 7 U.S.C. 1a(49) (swap dealer definition); Commission regulation 1.3 (further definition of swap dealer).

[8] CEA section 1a(32), 7 U.S.C. 1a(32) (major swap participant definition); Commission regulation 1.3 (further definition of major swap participant).

[9] CEA section 4s(e)(3)(A), 7 U.S.C. 6s(e)(3)(A).

[10] Initial margin is the collateral (calculated as provided by Commission regulation 23.154) that is collected or posted in connection with one or more uncleared swaps pursuant to regulation 23.152. Initial margin is intended to secure potential future exposure following default of a counterparty (*i.e.*, adverse changes in the value of an uncleared swap that may arise during the period of time when it is being closed out). *See* CFTC Margin Rule, 81 FR at 683.

[11] Variation margin, as defined in Commission regulation 23.151, is the collateral provided by a party to its counterparty to meet the performance of its obligations under one or more uncleared swaps between the parties as a result of a change in the value of such obligations since the trade was executed or the last time such collateral was provided. 17 CFR 23.151.

for uncleared swaps.[12] In implementing the CFTC Margin Rule, the Commission has identified certain issues that it understands would likely impede a smooth transition to compliance for entities required to comply with the IM requirements beginning on September 1, 2021.

*A. Calculation method for determining whether certain entities are subject to the IM requirements and the timing for compliance with the IM requirements after the end of the phased compliance schedule*

Commission regulation 23.161 sets forth a schedule for compliance with the CFTC Margin Rule, spanning from September 1, 2016, to September 1, 2021.[13] Under the schedule, entities are required to comply with the IM requirements in staggered phases,[14] starting with entities with the largest average aggregate notional amounts ("AANA"), calculated on a daily basis, of uncleared swaps and certain other financial products, and then successively with lesser AANA.

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[12] *See generally* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016). The CFTC Margin Rule, which became effective April 1, 2016, is codified in part 23 of the Commission's regulations. 17 CFR 23.150 - 23.159, 23.161. In May 2016, the Commission amended the CFTC Margin Rule to add Commission regulation 23.160, 17 CFR 23.160, providing rules on its cross-border application. *See generally* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 FR 34818 (May 31, 2016).

[13] 17 CFR 23.161(a). On July 10, 2020, the Commission published a notice of proposed rulemaking proposing to amend Commission regulation 23.161(a)(7) by deferring the compliance date for entities with an average aggregate notional amount between $8 billion and $50 billion, from September 1, 2021, to September 1, 2022. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 85 FR 41463 (July 10, 2020) ("July 2020 Proposal"). The notice of proposed rulemaking herein describes current Commission requirements under the CFTC Margin Rule. If the July 2020 Proposal becomes final prior to this notice of proposed rulemaking, all references to September 1, 2021, referring to the beginning of the last phase of compliance under the phased compliance schedule, should be deemed automatically superseded and replaced with September 1, 2022.

[14] The schedule also addresses the variation margin requirements under the CFTC Margin Rule, providing a compliance period of September 1, 2016, through March 1, 2017. *See* 17 CFR 23.161(a). The compliance period (including a six-month extension to September 1, 2017 through no-action relief) has long expired and all eligible entities are required to comply with the VM requirements.

The last phase of compliance, which begins on September 1, 2021, encompasses two sets of entities: (i) CSEs and covered counterparties with an AANA between $750 billion and $50 billion ("Phase 5 entities");[15] and (ii) all other remaining CSEs and covered counterparties,[16] including financial end users ("FEUs") with material swaps exposure ("MSE") of more than $8 billion in AANA,[17] ("Phase 6 entities").[18] These entities had been scheduled to begin compliance in separate phase-in dates, with Phase 5 entities to begin compliance on September 1, 2020, and Phase 6 entities on September 1, 2021. On May 28, 2020, the Commission adopted an interim final rule delaying the compliance date for Phase 5 entities until September 1, 2021, to address the operational challenges faced by these entities as a result of the COVID-19 pandemic. Because it was unclear what the impact of the pandemic would be on Phase 6 entities, the Commission did not deem appropriate to postpone these entities' September 1, 2021 compliance date through the interim final rule process. As a result, Phase 5 and Phase 6 entities are now required to begin compliance on September 1, 2021.

Under the Commission's margin requirements, the method for determining when Phase 6 entities are required to comply with the CFTC's IM requirements beginning with

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[15] 17 CFR 23.161(a)(6).

[16] The term "covered counterparty" is defined in Commission regulation 23.151 as a financial end user with MSE or a swap entity, including an SD or MSP, that enters into swaps with a CSE. *See* 17 CFR 23.151.

[17] Commission regulation 23.151 provides that MSE for an entity means that the entity and its margin affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps with all counterparties for June, July, or August of the previous calendar year that exceeds $8 billion, where such amount is calculated only for business days. A company is a "margin affiliate" of another company if: (i) either company consolidates the other on a financial statement prepared in accordance with U.S. Generally Accepted Accounting Principles, the International Financial Reporting Standards, or other similar standards; (ii) both companies are consolidated with a third company on a financial statement prepared in accordance with such principles or standards; or (iii) for a company that is not subject to such principles or standards, if consolidation as described in paragraph (i) or (ii) of this definition would have occurred if such principles or standards had applied. 17 CFR 23.151.

[18] 17 CFR 23.161(a)(7).

the last phase of compliance differs from the method set out in the BCBS/IOSCO Framework.[19] More specifically, the BCBS/IOSCO Framework requires—beginning on September 1, 2022, which starts the last phase of implementation for the margin requirements under the framework—entities with €8 billion[20] in AANA during the period of March, April, and May of the current year, based on an average of month-end dates, to exchange IM beginning September 1 of each year.

In contrast, in the last phase of compliance under the phased compliance schedule, under the Commission's margin requirements, Phase 6 entities (*i.e.*, CSEs and FEUs with more than $8 billion in AANA, or MSE) are required to begin exchanging IM on September 1, 2021. The MSE for an FEU must be determined on September 1, 2021, based on daily AANA (accounting only for business days)[21] during the period of June, July, and August of the prior year. After the last phase of compliance, the determination of MSE for an FEU, which triggers the applicability of the IM requirements, must be conducted on January 1 of each calendar year based on daily AANA during the June, July, and August period of the prior year, with application of the IM requirements, if the FEU has MSE, required to begin on January 1 of each year.

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[19] *See generally* BCBS/IOSCO, Margin requirements for non-centrally cleared derivatives (July 2019), *https://www.bis.org/bcbs/publ/d475.pdf* ("2019 BCBS/IOSCO Framework").

[20] The U.S. adopted the BCBS/IOSCO threshold, but replaced the 8 billion euro figure with a dollar amount of $8 billion. As a result, there is a small disparity in the threshold amounts given the continuing fluctuation of the dollar-euro exchange rate. This rule proposal does not address this issue.

[21] The determination of MSE requires accounting for the average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps for June, July and August of the previous calendar year that exceeds $8 billion, where such amount is calculated only for business days. *See* definition of MSE *supra* note 17. For simplicity purposes, this formulation will be referred to hereinafter as "daily AANA."

The BCBS/IOSCO Framework was originally promulgated in September 2013,[22] and then revised in 2015.[23] The 2015 version of the BCBS/IOSCO Framework changed the calculation period of June, July, and August, with an annual implementation date of December 1, to March, April, and May of each calendar year, with an annual implementation date of September 1. The CFTC Margin Rule incorporated the earlier 2013 version of the BCBS/IOSCO Framework by adopting the June, July, and August calculation period for the annual calculation of MSE. As a result, the Commission's existing regulations do not reflect the calculation period of March, April, and May set forth in the revised BCBS/IOSCO Framework published in March 2015.

The Commission also departed from BCBS/IOSCO's month-end date calculation of AANA for determining whether an entity is subject to the IM requirements. In the preamble to the CFTC Margin Rule, the Commission stated that it decided to adopt a daily AANA calculation method for determining whether an FEU has MSE, the finding of which requires a CSE to exchange IM with the FEU, "to gather a more comprehensive assessment of the [FEU]'s participation in the swaps market, and to address the possibility that a market participant might 'window dress' its exposure on an as-of date such as year-end, in order to avoid the Commission's margin requirements."[24]

As a result, the Commission's current method for the annual calculation of MSE, which was adopted in coordination with the U.S. prudential regulators and is similar to the U.S. prudential regulators' method of calculation, is not consistent with the most

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[22] *See generally* BCBS/IOSCO, Margin requirements for non-centrally cleared derivatives (Sept. 2013), *https://www.bis.org/publ/bcbs261.htm*.
[23] *See generally* BCBS/IOSCO, Margin requirements for non-centrally cleared derivatives (March 2015), available at *https://www.bis.org/bcbs/publ/d317.htm*.
[24] 81 FR at 645.

recent version of the BCBS/IOSCO Framework. Nor is it consistent with requirements in other major market jurisdictions, most of which adopted the 2015 BCBS/IOSCO Framework's month-end date calculation of AANA using the period of March, April, and May for the purposes of determining whether an entity is subject to the IM requirements beginning in the last phase of implementation.[25]

Market participants have stated that these differences in the methods for determining when an entity comes within the scope of the IM requirements and the timing for compliance after the last phase of compliance may impose an undue burden on their efforts to comply with the CFTC's margin requirements.[26] Entities have to account for different compliance schedules and set up and maintain separate processes for determining when they meet the thresholds for IM compliance.[27]

*B. No-Action Letter Concerning the Calculation of IM*

The Commission's Division of Swap Dealer and Intermediary Oversight ("DSIO") issued CFTC No-Action Letter 19-29 in July 2019 in response to a request for

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[25] *See, e.g.*, Commission Delegated Regulation (EU) 2016/2251 Supplementing Regulation (EU) No. 648/2012 of the European Parliament and of the Council of July 4, 2012 on OTC Derivatives, Central Counterparties and Trade Repositories with Regard to Regulatory Technical Standards for Risk-Mitigation Techniques for OTC Derivative Contracts Not Cleared by a Central Counterparty (Oct. 4, 2016), Article 28(1), *https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN*. Financial Services Agency of Japan (JFSA) Cabinet Office Ordinance on Financial Instruments Business (Cabinet Office Ordinance No. 52 of August 6, 2007), as amended (March 31, 2016), Article 123(11)(iv)(c); Office of the Superintendent of Financial Institutions Canada (OSFI) Guideline No. E-22, Margin Requirements for Non-Centrally Cleared Derivatives (April 2020), Section 5, 71, *https://www.osfi-bsif.gc.ca/Eng/Docs/e22.pdf*.

[26] *See Recommendations to Improve Scoping and Implementation of Initial Margin Requirements for Non-Cleared Swaps,* Report to the CFTC's Global Markets Advisory Committee by the Subcommittee on Margin Requirements for Non-Cleared Swaps, April 2020 at, 48-54, *https://www.cftc.gov/media/3886/GMAC_051920MarginSubcommitteeReport/download* ("Margin Subcommittee Report" or "Report").

[27] *See id.*

relief submitted by Cargill Incorporated (“Cargill”), a CFTC-registered SD and CSE.[28] DSIO stated that it would not recommend enforcement action if Cargill used the risk-based model calculation of IM of a counterparty that is a CFTC-registered SD as the amount of IM that Cargill is required to collect from the SD and to determine whether the IM threshold amount of $50 million (“IM threshold amount”)[29] has been exceeded, which would trigger the requirement for documentation concerning the posting, collection, and custody of IM collateral.

*C. Market Participant Feedback*

The CFTC’s Global Markets Advisory Committee (“GMAC”) established a subcommittee in January 2020 to consider issues raised by the implementation of margin requirements for non-cleared swaps, to identify challenges associated with forthcoming implementation phases, and to make recommendations through a report for the GMAC to consider in advising the Commission. The subcommittee submitted the Margin Subcommittee Report to the GMAC with its recommendations.[30] The GMAC adopted the Report and recommended to the Commission that it consider adopting the Report’s recommendations.

Among other things, the Margin Subcommittee Report recommended alignment of the CFTC Margin Rule with the BCBS/IOSCO Framework with respect to the method for calculating AANA for determining whether an entity comes within the scope of the

[28] CFTC Letter No. 19-29, Request for No-Action Relief Concerning Calculation of Initial Margin (Dec.19, 2019) (“Letter 19-29”), *http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/19-29.pdf*.
[29] Under Commission regulation 23.154(a)(3), SDs and MSPs subject to the Commission’s regulations are not required to post or collect IM until the initial margin threshold amount has been exceeded. *See* 17 CFR 23.154(a)(3). The term “initial margin threshold amount” is defined in Commission regulation 23.151 to mean an aggregate credit exposure of $50 million resulting from all uncleared swaps between an SD and its margin affiliates (or an MSP and its margin affiliates) on the one hand, and the SD’s (or MSP’s) counterparty and its margin affiliates on the other. *See* 17 CFR 23.151.
[30] *See supra* note 26.

IM requirements and the timing of compliance after the end of the phased compliance schedule.[31] The Report also recommended the codification of Letter 19-29.[32]

The Commission believes that alignment with BCBS/IOSCO, the global standard setter for margin requirements for non-cleared derivatives, would promote harmonization in the application of the IM requirements. Moreover, the Commission does not believe that the disjunction between the CFTC and BCBS/IOSCO regarding the AANA calculation method and the timing of compliance furthers any regulatory purpose. In fact, the Commission notes the foreseeable possibility of calculation errors resulting from differences in the calculation methods.[33]

The Commission also believes that adopting regulations along the lines of narrowly-tailored no-action letters, such as Letter 19-29, could promote certainty and clarity, facilitating efforts by market participants to take the application of the Commission's regulations into account in their planning, without undermining the effectiveness of the CFTC Margin Rule. Moreover, the proposed amendment would promote efficient risk hedging by smaller CSEs that offer swaps services to smaller entities that are neither SDs nor MSPs, with some of those risk-taking transactions requiring the exchange of regulatory margin and some, at the option of the parties, requiring the exchange of contractually-agreed margin. The CSEs might then enter into

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[31] *See* Margin Subcommittee Report at 48-54.
[32] *See* Margin Subcommittee Report at 34-36.
[33] The possibility of calculation errors may be mitigated by substituted compliance, as described in Commission regulation 23.160, if the parties are non-U.S. entities and substituted compliance is available, as the parties would be able to avail themselves of the rules in the foreign jurisdiction and would therefore not face the concern about different calculation methods. However, while the proposed changes to the method of calculation of AANA would align the CFTC's method of calculation with BCBS/IOSCO's approach, the Commission acknowledges that the changes would result in a divergence from the U.S. prudential regulators' approach, which may increase the potential for calculation errors for entities located in the United States.

offsetting swaps with SDs and MSPs to hedge the risk associated with the risk-taking transactions. Due to their size and limited swap business and resources, the CSEs may find it uneconomical to develop and maintain a margin model, and would therefore benefit from the option to rely on their SD or MSP counterparties' IM model calculations.

## II. Proposed Amendments

The Commission is proposing to revise the method for calculating AANA for determining whether an FEU has MSE and the timing for compliance with the IM requirements after the end of the last phase of compliance to align these aspects of the CFTC Margin Rule with the BCBS/IOSCO Framework. The Commission is also proposing to amend Commission regulation 23.154(a) in a manner similar to the terms of Letter 19-29, and thus allow CSEs to use the risk-based model calculation of IM of counterparties that are CFTC-registered SDs or MSPs ("swap entities")[34] to determine the amount of IM that must be collected from such counterparties.

### *A. Commission regulation 23. 151 – Amendments to MSE definition*

As noted above, the exchange of IM with respect to uncleared swaps between a CSE and a counterparty that is an FEU with MSE (together, Phase 6 entities) is required in the last phase of compliance, which is scheduled to begin on September 1, 2021.[35] Commission regulation 23.151 provides that an entity has MSE if it has more than $8

[34] Commission regulation 23.151 defines the term "swap entity" as a person that is registered with the Commission as an SD or MSP under the CEA.
[35] *See* 17 CFR 23.161(a)(7), which requires that a CSE must comply with the CFTC IM requirements with respect to their uncleared swaps with counterparties that are FEUs with MSE beginning on September 1, 2021.

billion in average daily AANA during June, July, and August of the prior year.[36] An FEU that has MSE based on its calculation of AANA over June, July, and August of 2020 will come within the scope of the IM requirements beginning on September 1, 2021. After September 1, 2021, however, because the base year for calculating AANA is the prior year, the annual determination of MSE, which triggers the applicability of the IM requirements, would be on January 1 of each year,[37] using the AANA for June, July, and August of the prior year. If the FEU has MSE on January 1 of a given year, the FEU would come within the scope of the IM requirements on January 1 of such year. As such, a CSE would be required to exchange regulatory IM beginning on such January 1 for its uncleared swaps with such FEU.

The Commission proposes to amend the definition of MSE in Commission regulation 23.151 by replacing "June, July and August of the previous calendar year" with "March, April and May of that year." The period for calculating AANA for determining whether an FEU has MSE would thus be March, April, and May of "that year." "That year" would be understood to mean the year the MSE is calculated for determining whether the IM requirements apply. The calculation of MSE is precipitated by Commission 23.161(a)(7), which requires a CSE to exchange IM with a counterparty that is an FEU with MSE beginning on September 1, 2021, and thereafter.

The Commission is also proposing to amend the definition of MSE to set "September 1 of any year" as the determination date for MSE. Under the current

[36] 17 CFR 23.151.

[37] January 1 is not explicitly set out in the Commission's regulations as the determination date for MSE after the last phase of compliance. However, Commission regulation 23.161(a)(7) (addressing the last phase of compliance and the timing of compliance going forward) and the definition of MSE in Commission regulation 23.151 can be reasonably read together to set January 1 as the determination date. *See* 17 CFR 23.151; 17 CFR 23.161(a)(7).

requirements, the MSE for an FEU must be determined beginning on September 1, 2021, and subsequently, after the last phase of compliance, on January 1 of each year. The proposed amendment would change the date of determination of MSE, applicable after the last phase of compliance, from January 1 to September 1. Because having MSE triggers the applicability of the IM requirements for an FEU, requiring the CSE to post and collect IM with its FEU counterparty, the proposed amendment would effectively set the timing for compliance with the IM requirements on September 1 after the last phase of compliance with respect to uncleared swaps entered into by a CSE and an FEU with MSE.

The proposed shift of the MSE determination date from January 1 to September 1 could have the effect of deferring for nine months for 2022[38] the obligation to exchange IM with a firm that was not in scope on September 1, 2021, but would be subject to the IM requirements on January 1, 2022. As a result, in 2022, less collateral would be collected for uncleared swaps during the nine-month period, which could render uncleared swap positions riskier and increase the risk of contagion and systemic risk. The Commission, however, notes that because the deferral period would affect entities with lower AANAs than entities brought into scope in earlier phases, the potential uncollateralized risk would be mitigated, becoming a lesser concern, particularly because the proposed change in the MSE determination date would draw the Commission's rules closer to BCBS/IOSCO's approach, promoting international harmonization.

[38] If the July 2020 Proposal becomes final prior to this notice of proposed rulemaking, all references to 2022 for the purpose of referring to the period after the end of the last phase of compliance under the phased compliance schedule should be deemed automatically superseded and replaced with 2023.

Conversely, the change in the MSE determination date could also result in requiring certain entities to post and collect IM that would not otherwise be required to do so. This could occur when an FEU meets the MSE threshold in the last phase of compliance beginning on September 1, 2021, but falls below the threshold by January 1, 2022, because the AANA for June, July, and August of the prior year (*i.e.* 2021) has declined below $8 billion. In such case, under the current rule, a CSE would no longer be subject to the IM requirements with respect to such FEU beginning January 1, 2022. However, under the proposed amendment, the CSE would continue to be subject to the IM requirements with respect to such FEU through September 1, 2022, and, as a result, the CSE would be required to exchange IM with the FEU for nine months longer than the January 1, 2022 MSE determination date would have required.

These proposed amendments to the definition of MSE would have the effect of reducing the time frame that FEUs and their CSE counterparties would have to prepare for compliance with the IM requirements. Under the current rule, exchange of regulatory IM is required with respect to Phase 6 entities beginning on September 1, 2021, which starts the last phase of the phased compliance schedule.[39] The MSE for the FEU must be determined using the AANA for the June, July, and August period of the prior year (*i.e.*, 2020). As a result, for the last phase of compliance in 2021, a CSE and FEU will have at least twelve months to prepare in anticipation of compliance with the IM requirements. Under the proposed amendment, however, for the last phase of compliance in 2021, the CSE and FEU would have only 3 months because MSE would be determined using the AANA for the March, April, and May period of the current year (*i.e.*, 2021).

Also, after the last phase of compliance under the phased compliance schedule, as proposed, the date for determining MSE for an FEU would be September 1 of each year, and the AANA calculation period for determining whether an FEU has MSE would be March, April, and May of such year. As a result, under the proposed amendment, an FEU with MSE and its CSE counterparty would have three months to prepare in advance of compliance with the IM requirements, whereas under the current rule, such parties have four months because MSE must be determined on January 1 based on the AANA for June, July, and August of the prior year.

Market participants recognize the effects of the proposed changes on the time frame for preparing for compliance with the IM requirements, with greater impact on Phase 6 entities that are coming into scope in the last phase of compliance, compared to those entities subject to compliance after the end of the last compliance phase. Nevertheless, the Margin Subcommittee Report, which the GMAC has adopted and recommended to the Commission, supported the changes because they would reconcile the CFTC's margin requirements with the BCBS/IOSCO Framework.[40] The proposed changes would eliminate the need to maintain separate schedules and processes for the computation of AANA and reduce the burden and cost of compliance with the IM requirements.[41] For the reasons set forth above, and taking account of Section 752 of the Dodd-Frank Act that calls on the CFTC to "consult and coordinate" with respect to the

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[40] *See* Margin Subcommittee Report at 49 (Members of the Margin Subcommittee stated that the divergence between the U.S. and international requirements "creates complexity and confusion, and leads to additional effort, cost and compliance challenges for smaller market participants that are generally subject to margin requirements in multiple global jurisdictions.").

[41] The Commission acknowledges that the burdens on market participants would not be fully eliminated, and in fact, may increase, for those entities that enter into uncleared swaps with SDs and MSPs that are subject to the prudential regulators' margin requirements for uncleared swaps and come within the scope the prudential regulators' margin regime, as the prudential regulators have not revised their rules consistent with the amendments proposed herein.

establishment of consistent international standards,[42] the Commission preliminarily believes that amending the definition of MSE by replacing "June, July and August of the previous calendar year" with "March, April and May of that year" and by prescribing September 1 of each year as the MSE determination date is appropriate to harmonize its compliance schedule with that of the BCBS/IOSCO Framework and eliminate a disjunction that risks calculation errors and may hinder compliance with the IM requirements.

The Commission is also proposing to amend the requirement to use daily average AANA during the three-month calculation period for determining MSE ("daily AANA calculation method"). The proposed amendment would instead require the use of average month-end AANA during the three-month calculation period ("month-end AANA calculation method"). In adopting the CFTC Margin Rule, the Commission acknowledged that the use of the month-end AANA calculation method would be consistent with BCBS/IOSCO's approach. Nonetheless, the CFTC, along with the U.S prudential regulators, adopted the daily AANA calculation method. In the preamble to the CFTC Margin Rule, the Commission explained that a daily average AANA calculation would provide a more comprehensive assessment of an FEU's participation in the swaps market in determining whether the FEU has MSE and would address the possibility of window dressing of exposures by market participants that might seek to avoid the CFTC's margin requirements.[43]

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[42] *See s*ection 752 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[43] *See supra* note 24.

In the Margin Subcommittee Report, the GMAC subcommittee stated that the daily AANA calculation method entails more work for smaller counterparties and that the method is only used in the United States, noting that in the United States, daily AANA calculations over the three-month calculation period for Phase 5 required 64 observations while global determinations based on month-end AANA calculations required only three observations.[44] The Report further stated that a month-end AANA calculation, by accounting for three periodic dates on which AANA would be calculated, would mitigate the risk that market participants would adjust exposures to avoid the CFTC's margin requirements, and that it would be neither practicable nor financially desirable for parties to tear-up their positions on a recurring basis prior to each month-end AANA calculation, as it would interfere with their hedging strategies and cause them to incur realized profit and loss.[45]

The Commission believes that it is appropriate to propose the month-end AANA calculation method to determine whether an FEU has MSE because such method of calculation would align the CFTC's approach with the BCBS/IOSCO Framework and that of other major market jurisdictions. The Commission notes that there is the risk that market participants that are counterparties to CSEs may "window dress" their exposures by adjusting their exposures as they approach the month-end date for the calculation of AANA. In doing so, an FEU would no longer have to post and collect IM with all CSEs for all its uncleared swaps for at least twelve months from the date on which compliance

[44] Margin Subcommittee Report at 52.
[45] *Id.*

with the IM requirements would have been initially required.[46] The Commission believes that it has sufficient tools at its disposal to address the "window dressing" concern. In particular, the Commission notes that Commission regulation 23.402(a)(ii) requires CSEs to have written policies and procedures to prevent their evasion, or participation in or facilitation of an evasion, of any provision of the CEA or the Commission regulations.[47] The Commission also reminds market participants that are counterparties to CSEs that section 4b of the CEA prohibits any person entering into a swap with another person from cheating or defrauding or willfully deceiving or attempting to deceive the other person.[48]

The Commission acknowledges that replacing the daily AANA calculation method with the month-end AANA calculation method for determining MSE could result in an AANA calculation that is not fully representative of an entity's participation in the swap markets. The current definition of MSE provides that AANA must be calculated counting uncleared swaps, uncleared security-based swaps, foreign exchange forwards, or foreign exchange swaps. Some of these financial products because of their terms, such as tenure and time of execution, may be undercounted or excluded from the AANA calculation if month-end dates are used to determine MSE.[49] The proposed month-end AANA calculation method therefore may not account for products that are required to be included in the calculation.

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[46] As proposed, the MSE calculation would be made annually on September 1 of each year and would be in effect for the next twelve months after that date.
[47] 17 CFR 23.402(a)(ii).
[48] 7 U.S.C. 6b.
[49] For example, the Commission observes that certain physical commodity swaps such as electricity and natural gas swaps are products for which a month-end AANA calculation might not provide a comprehensive assessment of the full scope of an FEU's exposure to those products.

The Commission preliminarily believes that the notional amounts associated with products that may be excluded from the AANA calculation may be relatively low and that their contribution to the AANA calculation for the purpose of determining MSE may be insignificant. In this regard, in an exercise undertaken by the Commission's Office of the Chief Economist ("OCE") on a sample of days, the OCE estimated (setting aside the window dressing issue) that calculations based on end-of-month AANA would yield fairly similar results as calculations based on the current daily AANA approach. Based on 2020 swap data, the OCE estimated that 492 entities of the 514 entities that would come into scope during Phase 6 based on the current methodology would also come into scope in the event that the Commission were to adopt the proposed methodology. Put differently, all but 22 of the entities that are above MSE under the current methodology would also be above MSE under the proposed methodology. In addition, there are 20 entities that would be in scope under the proposed methodology, but would not be in scope under the current methodology, so that the aggregate number of Phase 6 entities under the current and proposed methodologies differs only by two. In aggregate, the two methodologies would capture quite similar sets of entities. In addition, the entities that fall out of scope applying the month-end methodology tend to be among the smallest of the Phase 6 entities. That is, entities that are in-scope under the current methodology but not the proposed methodology average $6.95 billion in AANA, compared to $20 billion for all Phase 6 entities.[50]

[50] Note that the OCE calculation excludes commodity swaps, and the examples of products for which end-of-month calculations may be undercounting tend to be in commodity swaps like natural gas and electricity swaps. Overall, commodity swaps tend to represent less than 1% of all swap trades. *See* BIS Statistic Explorer, Global OTC derivatives market (July 30, 2020), *https://stats.bis.org/statx/srs/table/d5.1?f=pdf*.

In the Commission's preliminary view, based on the OCE analysis discussed above, switching from daily AANA calculations to month-end calculations for the purpose of determining MSE would likely have a limited impact on the protections provided by the CFTC Margin Rule. The Commission also preliminary believes that the benefits of aligning with the BCBS/IOSCO Framework and the approach of other major market jurisdictions outweigh the window dressing concerns.[51]

The Commission requests comments regarding the general approach proposed for changes to Commission regulation 23.151. The Commission also specifically requests comment on the following questions:

- Are the proposed amendments appropriate in light of the CFTC's overall approach to uncleared margin requirements and the manner in which firms currently undertake the calculation of AANA to determine MSE? Should the Commission consider any alternative to aligning with the BCBS/IOSCO Framework with respect to the methodology for the AANA calculation and the timing for compliance after the last phase of compliance?
- Should the Commission proceed to adopt the proposed amendments if the U.S. prudential regulators do not adopt similar regulatory changes? Would this divergence between the CFTC and the prudential regulators' margin

[51] The prudential regulators have not indicated whether they intend to amend their margin requirements consistent with the BCBS/IOSCO Framework and the proposed amendments to the definition of MSE discussed herein. Below, the Commission requests comment on the impact of this potential regulatory divergence on market participants. Also of note, the U.S. Securities and Exchange Commission ("SEC") has adopted a different approach that does not use MSE for identifying entities that come within the scope of the SEC margin requirements. *See* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 84 FR 43872 (Aug. 22, 2019).

requirements for uncleared swaps affect market participants? Is there a potential for industry confusion if that were to be the case?

- In adopting the CFTC Margin Rule, the Commission stated that the daily AANA calculation method was intended to provide a more comprehensive assessment of an FEU's participation in the swaps markets. Would the proposed month-end AANA calculation method requiring the averaging of month-end dates during the three-month calculation period be representative of a market participant's participation in the swaps markets? Is it possible that the proposed month-end calculation would result in the exclusion or undercounting of certain products because of their terms, such as tenure and time of execution, or for any other reason, that are required to be included in the AANA calculation? Could the calculation lead to skewed results for entities that have an AANA calculation on the three end-of-month dates that is uncharacteristically high compared to their typical positions?
- How likely and significant is the risk that market participants may "window dress" their exposures to avoid the CFTC's margin requirements? In the event that this is a significant impediment to an accurate calculation of AANA over a three month period, are the existing tools at the Commission's disposal sufficient to address this concern? Are there additional steps the Commission should consider if the Commission were to implement the month-end calculation methodology?

*B. Commission regulation 23.154 - Alternative Method of Calculation of IM*

The CFTC Margin Rule requires CSEs to collect and post IM with covered counterparties.[52] Commission regulation 23.154(a) directs CSEs to calculate, on a daily basis, the IM amount to be collected from covered counterparties and to be posted to FEU counterparties with MSE.[53] CSEs have the option to calculate the IM amount by using either a risk-based model or the standardized IM table set forth in Commission regulation 23.154(c)(1).[54] For a CSE that elects to use a risk-based model to calculate IM, Commission regulation 23.154(b)(1) requires the CSE to obtain the written approval of the Commission or a registered futures association[55] to use the model to calculate IM required by the Commission's margin requirements for uncleared swaps.[56]

The Commission is proposing to amend Commission regulation 23.154(a) along the lines of Letter 19-29 by adding proposed paragraph (a)(5). The proposed paragraph would permit a CSE that enters into uncleared swaps with a swap entity to use the swap entity's risk-based model calculation of IM in lieu of its own IM calculation. The risk-based model used for the calculation of IM would need to satisfy the requirements set out in Commission regulation 23.154(b) or would need to be approved by the swap entity's prudential regulator.

Letter 19-29 sets out certain situations in which DSIO would not recommend an enforcement action under Commission regulation 23.154(a)(1), which requires CSEs to calculate, on a daily basis, IM to be collected from a covered counterparty, including

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[52] *See* 17 CFR 23.152.
[53] *See* 17 CFR 23.154(a).
[54] *See id.*
[55] *See* 17 CFR 23.154(b)(1)(i). In this context, the term "registered futures association" refers to the National Futures Association ("NFA"), which is the only futures association registered with the Commission.
[56] *See* 17 CFR 23.154(b)(1)(i).

swap entities and FEUs with MSE. Letter 19-29 conveyed the staff's view that Cargill, the requester for relief, could use the risk-based model calculation of IM of a counterparty that is a swap entity to determine the amount of IM to be collected from that counterparty and to determine whether the IM threshold amount has been exceeded, which would require the parties to have documentation addressing the collection, posting, and custody of IM. The proposed amendment, consistent with Letter 19-29, would modify the requirement that CSEs calculate the IM to be collected from a swap entity counterparty and would give CSEs the option to use such counterparty's risk-based IM calculation to determine the amount of IM to be collected from the counterparty.

The Commission acknowledges that expanding the use of the alternative method in Letter 19-29 to a wider group of CSEs could raise some concerns. Being able to rely on the IM risk-based calculation of a swap entity counterparty, as would be permitted under the proposal, CSEs may forgo altogether the adoption of a risk-based model and may be less incentivized to monitor IM exposures on a regular basis. Without a model to compute its own IM, a CSE may lack reasonable means to verify the IM provided by its counterparty or recognize any shortfalls in the IM calculation or flaws in the counterparty's risk-based model. As a result, the CSE may collect insufficient amounts of IM to offset counterparty risk. There is also the concern that the swap entity calculating the IM for the CSE may be conflicted, [57] as it may have a bias in favor of calculating and posting lower amounts of IM to its CSE counterparty.

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[57] The Commission notes, however, that the potential for conflict may be reduced as the swap entity, as a CFTC-registered SD or MSP, would be subject to Commission regulation 23.600, which requires SDs and MSPs to establish a risk management program for the management and monitoring of risk, including credit and legal risk, associated with their swaps activities. *See* 17 CFR 23.600.

In light of these concerns, Letter 19-29 imposed certain conditions for the application of the relief.[58] The Commission believes that it is appropriate that the proposed amendment incorporate in the rule text two conditions set forth in the no-action letter. Other conditions from the no-action letter would not be reflected in the rule text, because the Commission believes that the conditions are adequately addressed by existing requirements under the Commission's regulations, as explained below. In addition, if the proposed amendment is adopted, the Commission notes that it will monitor its implementation by CSEs and may consider further rulemaking as appropriate.

First, consistent with Letter 19-29, the proposed rule text would require that the applicable model meet the requirements of Commission regulation 23.154(b) (requiring the approval of the use of the model by either the Commission or the NFA), or that it be approved by a prudential regulator.[59]

Second, the proposed rule text would provide that the CSE would be able to use the risk-based model calculation of IM of a swap entity counterparty only if the uncleared swaps for which IM is calculated are entered into for the purpose of hedging the CSE's own risk. In this context, the risk to be hedged would be the risk that the CSE would incur when entering into swaps with non-swap entity counterparties. By proposing to limit the application of this alternative method of calculation of IM only to uncleared swaps entered into for the purpose of hedging risk arising from swaps entered into with non-swap entities, the Commission would ensure its narrow application.

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[58] Letter 19-29 at 4.

[59] The prudential regulators have not amended their margin requirements for uncleared swaps consistent with the proposed amendment to Commission regulation 23.154(b) discussed herein. As such, the CFTC's margin requirements would diverge from the prudential regulators' approach. Below, the Commission seeks comment on how this regulatory divergence may impact market participants.

The Commission contrasts the risk of customer-facing swaps with the risk that CSEs incur when entering into a swap in a dealing capacity "to accommodate the demand" of a swap entity counterparty.[60] The Commission believes that it would be inappropriate to allow a CSE to use the IM calculation of the swap entity counterparty in this latter case. The Commission notes that the latter case (*i.e.*, where the CSE is acting in a dealing capacity for a counterparty that is itself calculating IM) would occur in the inter-dealer market for swaps. The Commission believes that a CSE participating in the inter-dealer market in a dealing capacity should have the capacity to develop, implement, and use an approved risk-based model.

The Commission expects that the alternative method of calculation would be used primarily by CSEs that are not obtaining approval to use a risk-based model for the calculation of IM but rather elect to use the table-based calculation described in Commission regulation 23.154(c) for swaps with non-swap entity counterparties. The Commission anticipates that such CSEs would enter into uncleared swaps mostly with end-user, non-swap entity counterparties, and would then hedge the risk of those swaps with uncleared swaps entered into with a few swap entity counterparties. The CSEs and their swap entity counterparties would be required to exchange IM for the uncleared swaps entered into for the purpose of hedging. Because maintaining a model would impose a disproportionate burden on the CSEs relative to the discrete and limited nature of their uncleared swap activities, the CSEs may not have a risk-based model for the

[60] *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 FR 30596, 30608 (May 23, 2012) (noting that a distinguishing characteristic of swap dealers is being known in the industry as being available to accommodate demand for swaps.).

calculation of IM and may opt to use instead the risk-based model calculation of their swap entity counterparties.

To obtain relief under Letter 19-29, Cargill, prior to using the risk-based model calculation of IM of a swap entity counterparty, must agree with the counterparty in writing that the IM calculation will be provided to Cargill in a manner and time frame that would allow Cargill to comply with the CFTC Margin Rule and other applicable Commission regulations, and that the calculation will be used to determine the amount of IM to be collected from the counterparty and to determine whether the IM threshold amount has been exceeded, which would require documentation addressing the posting, collection, and custody of IM. The Commission preliminarily believes that the documentation requirements in Commission regulations 23.158 and 23.504 address this no-action letter condition.

Commission regulation 23.158(a) requires CSEs to comply with the documentation requirements set forth in Commission regulation 23.504.[61] In turn, Commission regulation 23.504(b)(4)(i) requires CSEs to have written documentation reflecting the agreement with a counterparty concerning methods, procedures, rules, and inputs, for determining the value of each swap at any time from execution to the termination, maturity, or expiration of such swap for the purposes of complying with the margin requirements under section 4s(e) of the Act and regulations under this part.[62]

[61] 17 CFR 23.158(a).
[62] 17 CFR 23.504(b)(4)(i).

Regulation 23.504(b)(3)(i) also provides that the documentation shall include credit support arrangements, including initial and variation margin requirements, if any.[63]

The last two conditions of Letter 19-29[64] were designed to ensure that Cargill would undertake adequate risk management of its uncleared swaps, notwithstanding the lack of a proprietary risk-based model and hence the inability to calculate IM, which is representative of potential future exposure of uncleared swaps.[65] The Commission believes that these conditions are addressed by CSEs' risk management obligations under the CEA and the Commission's regulations. Section 4s(j)(2) of the CEA requires SDs and MSPs, including CSEs, to establish robust and professional risk management systems

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[63] Commission regulation 23.504(b)(1) further provides that the documentation shall include all terms governing the trading relationship between the swap dealer or major swap participant and its counterparty, including without limitation terms addressing payment obligations calculation of obligations upon termination valuation, and dispute resolution. 17 CFR 23.504(b)(1).

[64] Letter 19-29 at 4. The last two conditions in Letter 19-29 (which refers to Cargill's swap dealer as "CRM SD") read as follows:

> 4. To the extent CRM SD uses an SD counterparty's IM calculation generated pursuant to an Approved IM Calculation Method, CRM SD must monitor the Approved IM Calculation Method's output, in particular, to ensure the sufficiency of the calculated IM amounts. CRM SD must keep track of exceedances, that is, price movements above the amounts of IM generated pursuant to an Approved IM Calculation Method. If the exceedances indicate that the Approved IM Calculation Method being used fails to meet the relevant regulators' standards, CRM SD must take appropriate steps to ensure compliance with its risk management obligations and address the exceedances with its SD counterparty. If any adjustments or enhancements are applied to the amount of IM calculated pursuant to the Approved IM Calculation Method to ensure CRM SD's collection of adequate amounts of IM, CRM SD must provide written notice by email to NFA and Commission staff at SwapsMarginModel@NFA.Futures.Org and dsioletters@cftc.gov, respectively. CRM SD must also have an independent risk management unit, as prescribed in Commission regulation 23.600, perform an annual review of the Approved IM Calculation Method's output. CRM SD should be prepared to produce, upon request, records relating to the monitoring of the Approved IM Calculation Method output and any other records demonstrating CRM SD's ongoing monitoring.
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> 5. As part of its risk management program pursuant to Commission regulation 23.600, CRM SD must independently monitor on an ongoing basis credit risk, including potential future exposure associated with uncleared swaps subject to the CFTC Margin Rule, to determine, among other things, whether CRM SD is approaching the $50 million IM Threshold with respect to a counterparty.

[65] *See* 17 CFR 23.154(b)(2) (explaining that IM is equal to the potential future exposure of the uncleared swap or netting portfolio of uncleared swaps covered by an eligible master netting agreement.).

adequate for the management of their day-to-day swap business.[66] In addition, Commission regulation 23.600 requires SDs and MSPs to establish and maintain a risk management program to monitor and manage risk associated with their swap activities.[67]

To obtain relief under Letter 19-29, Cargill also must "keep track of exceedances" and "[if] the exceedances indicate that the Approved IM Calculation Method fails to meet the relevant regulators' standards, [Cargill] must take appropriate steps to ensure compliance with its risk management obligations and address exceedances with its SD counterparty."[68] The purpose of this requirement is to ensure that Cargill monitors, identifies, and addresses potential shortfalls in the amount of IM generated by the counterparty. Cargill must also report to the CFTC "any adjustments and enhancements . . . applied to the amount of IM calculated pursuant to the Approved IM Calculation Method to ensure [Cargill's] collection of adequate amounts of IM."

The Commission preliminarily believes that Commission regulation 23.600 addresses these concerns by requiring SDs and MSPs to account for credit risk in conducting their risk oversight and to ensure compliance with the CFTC margin requirements. In the case of a CSE relying on the provisions of proposed paragraph (a)(5), adequate risk oversight would include steps by the CSE to monitor, identify, and address potential shortfalls in the amounts of IM generated by the counterparty on whose IM model the CSE is relying. While the Commission does not propose to prescribe the CSE's oversight process, it believes that a risk management program that is unable to

[66] 7 U.S.C. 6s(j)(2).
[67] *See* 17 CFR 23.600.
[68] Letter 19-29 at 4.

identify or to address shortfalls in IM would be insufficient to comply with Regulation 23.600.

Moreover, Commission regulation 23.600 requires SDs and MSPs to furnish to the Commission risk exposure reports setting forth credit risk exposures and any other applicable risk exposures relating to their swap activities. Here again, the Commission believes that an adequate risk exposure report pursuant to Regulation 23.600 would require a CSE to identify any adjustments and enhancements to the amount of IM calculated pursuant to the risk-based model of its swap entity counterparty to ensure the CSE's collection of adequate amounts of IM.

The Commission requests comment regarding the proposed amendment to Commission regulation 23.154(a). The Commission also specifically requests comment on the following questions:

- The proposed amendment to Regulation 23.154(a) would allow a CSE to use the risk-based model calculation of IM of a swap entity counterparty to comply with Regulation 23.154(a)(1), which requires CSEs to calculate IM to be collected from counterparties. The alternative method of IM calculation would be available only with respect to uncleared swaps entered into for the purpose of hedging. Should this restriction be eliminated, narrowed, or expanded? If the restriction should be narrowed or expanded, please describe any appropriate modifications to the restriction. If it should be eliminated, please explain why.
- The proposed amendment to Regulation 23.154(a) intends to provide an alternative method for the calculation of IM for CSEs with highly specialized and discrete swap business models that primarily enter into swaps with non-SDs or

MSPs but, enter into offsetting swaps with SDs and MSPs to hedge the risk of such customer-facing swaps, and opt to use the standardized IM table set forth in Commission regulation 23.154(c) rather than adopt and maintain a risk-based model for the calculation of IM. As such, the use of the alternative method of calculation is not expected to be widespread. Is this a reasonable expectation, or would this alternative method of IM calculation be likely to be used by all CSEs or a larger subset of CSEs than anticipated under the proposed rule? If a larger subset, please describe the characteristics of this wider group. Should the availability of this alternative method of IM calculation include all classes of swaps, or only a subset (*e.g.*, commodity swaps)?

- How many CSEs would likely take advantage of this amendment? How many of these CSEs do not trade uncleared swaps currently? How many use the standardized IM table? How many use a model developed by a third-party vendor? How many of the Phase 5 entities are likely to take advantage of this amendment? What might they do for IM calculation absent the amendment? To the extent possible, please provide a basis for these estimates.
- The Commission believes that the requirement to furnish risk exposure reports under Commission regulation 23.600, while not matching exactly all the terms of the CFTC notification required by Letter 19-29, addresses the overall purpose of the requirement. Should the Commission include a more tailored reporting requirement in the proposed amendment?
- Does the proposed amendment to effectively codify Letter 19-29 include sufficient risk management tools in place to guard against any potential conflict of

interest arising from the fact that a CSE will rely on its swap entity counterparty's IM calculation to determine the amount of IM to be collected from such counterparty?

- Should the Commission proceed to adopt the proposed amendment to effectively codify Letter 19-29 if the U.S. prudential regulators do not adopt similar regulatory changes? Would this divergence between the CFTC and the prudential regulators' margin requirements for uncleared swaps impact market participants? Is there a potential for industry confusion if that were to be the case?

## III. Administrative Compliance

The Regulatory Flexibility Act ("RFA") requires Federal agencies to consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.[69] Whenever an agency publishes a general notice of proposed rulemaking for any rule, pursuant to the notice-and-comment provisions of the Administrative Procedure Act,[70] a regulatory flexibility analysis or certification typically is required.[71] The Commission previously has established certain definitions of "small entities" to be used in evaluating the impact of its regulations on small entities in accordance with the RFA.[72] The proposed amendments only affect certain SDs and MSPs and their counterparties,

[69] 5 U.S.C. 601 *et seq*.
[70] 5 U.S.C. 553. The Administrative Procedure Act is found at 5 U.S.C. 500 *et seq*.
[71] *See* 5 U.S.C. 601(2), 603, 604, and 605.
[72] *See* Registration of Swap Dealers and Major Swap Participants, 77 FR 2613 (Jan. 19, 2012).

which must be eligible contract participants ("ECPs").[73] The Commission has previously established that SDs, MSPs and ECPs are not small entities for purposes of the RFA.[74]

Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed amendments will not have a significant economic impact on a substantial number of small entities.

*A. Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 ("PRA")[75] imposes certain requirements on Federal agencies, including the Commission, in connection with their conducting or sponsoring any collection of information, as defined by the PRA. The Commission may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget control number. The proposed amendments contain no requirements subject to the PRA.

*B. Cost-Benefit Considerations*

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA.[76] Section 15(a) further specifies that the costs and benefits shall be evaluated in light of the following five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest

[73] Pursuant to section 2(e) of the CEA, 7 U.S.C. 2(e), each counterparty to an uncleared swap must be an ECP, as defined in section 1a(18) of the CEA, 7 U.S.C. 1a(18).
[74] *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "'Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 FR 30596, 30701 (May 23, 2012).
[75] 44 U.S.C. 3501 *et seq*.
[76] 7 U.S.C. 19(a).

considerations. The Commission considers the costs and benefits resulting from its discretionary determinations with respect to the section 15(a) considerations, and seeks comments from interested persons regarding the nature and extent of such costs and benefits.

The Commission is proposing to amend the CFTC Margin Rule to revise the method for calculating AANA for determining whether an FEU has MSE and the timing for determining whether an FEU has MSE after the end of the phased compliance schedule ("timing of post-phase-in compliance"). These amendments would align the CFTC Margin Rule with the BCBS/IOSCO Framework with respect to these matters.

The Commission is also proposing to amend Commission regulation 23.154(a) along the lines of Letter 19-29, and thus allow CSEs to use the risk-based model calculation of IM of a counterparty that is a swap entity.[77] The proposed rule would make this accommodation available only with respect to uncleared swaps entered into for the purpose of hedging swap risk.

The baseline against which the benefits and costs associated with the proposed amendments are compared is the uncleared swaps markets as they exist today and the currently applicable timing for compliance with the IM requirements after the expiration of the phased compliance schedule. Concerning the amendment of Commission regulation 23.154(a), the Commission believes that to the extent market participants may have relied on Letter 19-29, the actual costs and benefits of the proposed amendment, as realized by the market, may not be as significant at a practical level. With respect to the proposed amendment to align aspects of the CFTC Margin Rule with the BCBS/IOSCO

[77] For the definition of the term "swap entity," *see supra* note 34.

Framework, the Commission acknowledges that the Dodd-Frank Act calls on the CFTC to "consult and coordinate on the establishment of consistent international standards" with respect to the regulation of swaps.[78] The proposed rule therefore would advance the Congressional mandate to harmonize the CFTC's requirements with international standards, thereby removing a regulatory impediment that might hinder the competitiveness of the U.S. swaps industry.[79]

The Commission notes that the consideration of costs and benefits below is based on the understanding that the markets function internationally, with many transactions involving U.S. firms taking place across international boundaries; with some Commission registrants being organized outside of the United States; with leading industry members typically conducting operations both within and outside the United States; and with industry members commonly following substantially similar business practices wherever located. Where the Commission does not specifically refer to matters of location, the below discussion of costs and benefits refers to the effects of these proposed amendments on all activity subject to the proposed amended regulations, whether by virtue of the activity's physical location in the United States or by virtue of the activity's connection with activities in, or effect on, U.S. commerce under section 2(i) of the CEA.[80]

*1. Benefits*

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[78] *See supra* note 42.

[79] A starting point in determining the potential benefit of alignment with the BCBS/IOSCO Framework is various statutory provisions where the U.S. Congress has called on the CFTC and other financial regulators to align U.S. regulatory requirements with international standards. For example, the Commodity Futures Modernization Act of 2000 ("CFMA") focused on the potential threat to competitiveness for U.S. industry where there is divergence with international standards. In particular, section 126 of the CFMA provides that regulatory impediments to the operation of global business interests can compromise the competitiveness of United States businesses. *See* CFMA section 126(a), Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

[80] 7 U.S.C. 2(i).

By harmonizing the method for calculating AANA for determining MSE and the timing of post-phase-in compliance with the BCBS/IOSCO Framework, the proposed amendment would create a benefit because it would reduce complexity – for example, the proposed AANA month-end calculation would require consideration of only three observation dates rather than daily AANAs over the three-month calculation period – and the potential for confusion in the application of the margin requirements. Firms would no longer need to undertake separate AANA calculations using different calculation periods, nor would they need to conform to two separate compliance timings, varying according to the location of their swap counterparties and jurisdictional requirements applicable to the counterparties.

The proposed amendment would impact FEUs with average AANA between $8 billion and $50 billion (Phase 6 entities) that come into the scope of compliance with the IM requirements under the CFTC Margin Rule in the last compliance phase beginning on September 1, 2021, as well as those entities that come into scope after the end of the last compliance phase. The Commission believes that the proposed amendment would benefit these entities, which, given their level of swap activity, pose a lower risk to the uncleared swaps market and the U.S financial system in general than entities who came into scope in earlier phases. The OCE has estimated that there are approximately 514 of such entities representing 4% of total AANA across all phases.[81] This means that the proposed amendment addresses entities that tend to engage in less uncleared swap trading

[81] Using March-May of 2020 as the calculation period. The methodology for calculating AANA is described in Richard Haynes, Madison Lau, & Bruce Tuckman, *Initial Margin Phase 5*, at 4 (Oct. 24, 2018), *https://www.cftc.gov/sites/default/files/About/Economic%20Analysis/Initial%20Margin%20Phase%205%20v5_ada.pdf*.

activity and, and in the aggregate, pose less systemic risk than entities in previous phases. Because these entities are smaller, they presumably have fewer resources to devote to IM compliance and hence would benefit from the alignment of the method of calculation of AANA across jurisdictions without contributing substantially to systemic risk.

For Phase 6 entities with average AANA between $8 billion and $50 billion that will begin collecting initial margin on September 1, 2021, moving the calculation period from June, July, and August 2020 to March, April, and May 2021 would better align with current practices. While the Commission cannot anticipate exactly how the second quarter of 2021 will differ from the third quarter of 2020, based on comparable past experience, the OCE estimates that approximately 75-100 entities would come into scope, and a similar number would fall below the threshold by virtue of moving the calculation period. The adjusted calculation period would reduce the regulatory burden for firms that have reduced their MSE below the $8 billion threshold while requiring the collection of margin for those firms that have increased their swaps business above the threshold. While aggregate AANA for firms that fall into or out of scope is small relative to the overall market (less than one percent of total aggregate AANA), moving the calculation period close to the compliance date may have a significant impact on the entities that have reduced their MSE.

The Commission also notes that the benefits of alignment with the BCBS/IOSCO Framework will continue to accrue in future years, as the determination of MSE for an FEU under the CFTC Margin Rule is an annual undertaking, triggered by the entry into an uncleared swap between the FEU and a CSE counterparty and the need to determine whether the FEU has MSE, which triggers the application of the IM requirements and the

exchange of regulatory IM between a CSE and a FEU for their uncleared swap transactions.

With respect to the amendment of Commission regulation 23.154(a), the Commission believes that the uncleared swap markets would benefit from the extension of the targeted relief provided to Cargill, the requester in Letter 19-29, to a wider group of CSEs with similar unique swap business models. In taking a no-action position, DSIO took account of Cargill's representation that its swap trading activity primarily involved physical agricultural commodities and certain other asset classes and that it "may maintain positions that require collection of IM from SDs." Cargill further stated that given the highly specialized and discrete nature of its swap business, risk-based modeling would impose a disproportionate burden.

The more widespread availability of the alternative method of calculation of IM provided by regulation 23.154(a), as proposed to be amended, may incentivize some market participants to expand their swap business. In particular, given that certain market participants would have the option to forgo the cost of risk-based modeling, this potential reduction in compliance costs may encourage certain entities to increase their swaps trading. This may be especially true after September 1, 2021, as a large number of entities will be newly-subject to mandatory margin.[82] By increasing the pool of potential swap counterparties, the proposed amendment could enhance competition, increase overall liquidity, and facilitate price discovery in the uncleared swaps markets.

*2. Costs*

[82] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 85 FR 41346 (July 10, 2020).

While the proposed changes to the CFTC Margin Rule would have the effect of creating efficiencies for market participants, the Commission acknowledges that the changes would also result in some costs. Among other things, the proposed revision of the AANA calculation period for determining MSE to align it with the BCBS/IOSCO AANA calculation period would reduce the time frame for determining whether an FEU is subject to the IM requirements and for preparing for compliance with the requirements during the final phase-in period of 2021.

Under the current margin requirements, in the period leading to the final phase-in date of September 1, 2021, FEUs would have a full year to prepare, as MSE for an FEU would be determined by using the AANA for June, July and August of the prior year. However, the proposed amendment to the period of calculation of AANA for determining MSE would result in entities only having a three-month advance notice in 2021, as AANA would be calculated using the March, April and May period of that year. Entities would have a shorter time frame to engage in preparations to comply with IM requirements, including, among other things, procuring rule-compliant documentation, establishing processes for the exchange of regulatory IM, and setting up IM custodial arrangements. Because the proposed amendment would align the AANA calculation for determining MSE with BCBS/IOSCO's AANA calculation and the compliance date would remain unchanged, the Commission believes that the cost would be mitigated. In particular, the Commission notes market participants' statements indicating that the differences in the U.S. regulations could create complexity and confusion and lead to

additional effort, cost and compliance challenges for smaller market participants that are generally subject to margin requirements in multiple global jurisdictions.[83]

The Commission further notes that the proposed amendment to the timing of post-phase-in compliance would defer compliance with the IM requirements with respect to uncleared swaps entered into by a CSE with an FEU that comes into the scope of IM compliance after the end of the last compliance phase. Under the current rule, FEUs with MSE as measured in June, July, and August 2021 would come into the scope of compliance post-phase-in beginning on January 1, 2022. On the other hand, under the proposed amendment, FEUs with MSE as measured in March, April, and May 2022 would be subject to compliance beginning on September 1, 2022. As a result, for FEUs with MSE in both periods, less collateral for uncleared swaps may be collected between January 1, 2022, and September 1, 2022, rendering uncleared swap positions entered into during the nine-month period riskier, which could increase the risk of contagion and the potential for systemic risk. Conversely, under the proposed amendment, a CSE would be required to exchange IM with a previously in-scope FEU that fell below the MSE level by January 1, 2022, for nine months longer than the otherwise required.

With respect to changing the daily AANA calculation method to a month-end calculation method for determining MSE, the Commission acknowledges that there are potential costs. The utilization of a month-end calculation method could result in an AANA calculation that is not representative of a market participant's participation in the swaps markets. As previously discussed, the proposed AANA month-end calculation may result in the exclusion or undercounting of certain financial contracts that are

[83] Margin Subcommittee Report at 49.

required to be included in the calculation (*e.g.*, uncleared swaps, uncleared security-based swaps, foreign exchange forwards, or foreign exchange swaps) because of certain combinations of tenure and time of execution, such as those often present in some intra-month natural gas and electricity swaps.[84] The Commission also notes the potential that market participants might "window dress" their exposures to avoid MSE status and compliance with the CFTC's margin requirements. At the same time, it is possible that the month-end methodology, which uses only three data points, could result in some entities having an AANA calculation on the three end-of-month dates that is uncharacteristically high relative to their typical positions.

If products are excluded from the AANA calculation, or if exposures are "window dressed," the month-end calculation may have the effect of deferring the time by which market participants meet the MSE classification resulting in additional swaps between market participants and CSEs being deemed legacy swaps that are not subject to the IM requirements.[85] This may increase the level of counterparty credit risk to the financial system. While potentially meaningful, this risk would be mitigated because the legacy swap portfolios would be entered into with FEUs that engage in lower levels of notional trading.

Finally, given the possibility that the U.S. prudential regulators may not adopt the changes to the method of calculation of AANA proposed in this rulemaking, there is the

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[84] *See supra* note 49.

[85] Pursuant to Commission regulation 23.161, the compliance dates for the IM and VM requirements under the CFTC Margin Rule are staggered across a phased schedule that extends from September 1, 2016, to September 1, 2021. The compliance period for the VM requirements ended on March 1, 2017 (though the CFTC and other regulators provided guidance permitting a six-month grace period to implement the requirements following the implementation date), while the IM requirements continue to phase in through September 1, 2021. An uncleared swap entered into prior to an entity's IM compliance date is a "legacy swap" that is not subject to IM requirements. *See* CFTC Margin Rule, 81 FR at 651 and Commission regulation 23.161. 17 CFR 23.161.

potential that firms that engage in swaps transactions with both CSEs and swaps dealers subject to the margin requirements of the U.S. prudential regulators may incur additional costs by continuing to have to undertake their AANA calculations under two different methods of calculation.

However, the Commission preliminarily is of the view that the benefits of aligning with the BCBS/IOSCO Framework outweigh these potential costs. In this regard, in the aforementioned OCE exercise utilizing a sample of days, the OCE estimated that calculations based on end-of-month AANA would yield fairly similar results as the calculations based on the current daily AANA approach (setting aside the window dressing issue). Based on 2020 swap data, the OCE estimated that approximately 492 entities of 514 entities that would come into scope during Phase 6 based on the current methodology would also come into scope based on the proposed methodology. Put differently, all but 22 of the entities that are above MSE under the current methodology would also be above MSE under the proposed methodology. In addition, there are 20 entities that would be in scope under the proposed methodology, but would not be under the current methodology, so that the aggregate number of Phase 6 entities differs only by two. In aggregate, the two methodologies would capture quite similar sets of entities. In addition, the entities that fall out of scope when one changes methodology tend to be among the smallest of the Phase 6 entities. That is, entities that are in-scope under the current methodology but not the proposed methodology average $6.95 billion in AANA, compared to $20 billion for all Phase 6 entities.[86]

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[86] *See supra* note 50.

Taking account of the small number of FEUs that would therefore have MSE and thus be subject to the Commission's IM requirements, the Commission believes that the potential exclusion of certain financial products in determining MSE would have a limited impact on the effectiveness of the CFTC Margin Rule. In addition, with respect to the potential that a market participant might "window dress" its exposure, the Commission has sufficient regulatory authority, including anti-fraud powers under section 4b of the CEA,[87] to take appropriate enforcement actions against any market participant that may engage in deceptive conduct with respect to the AANA calculation, and CSEs must also have written policies and procedures in place to prevent evasion or the facilitation of an evasion by an FEU counterparty.[88]

Roughly 514 entities, as estimated by the OCE, would come into the scope of the IM requirements beginning on September 1, 2021, and would be affected by the foregoing proposed amendments. In advance of the September 1, 2021 compliance date, many of these entities may engage in planning and preparations relating to the exchange of regulatory IM. With the revision of the AANA method of calculation, these entities may need to adjust their systems to reflect changes in the calculation and update related financial infrastructure arrangements. While requesting comments on this issue, the Commission believes that the cost of shifting the MSE calculation period to the new time frame would be negligible, and the adoption of the month-end AANA calculation method would likely be cost-reducing for impacted firms.

[87] 7 U.S.C. 6b.

[88] *See* 17 CFR 23.402(a)(ii).

Regarding the amendment of Commission regulation 23.154(a), there may be associated costs, as CSEs would be allowed to rely on the risk-based model calculation of IM computed by a swap entity counterparty. Specifically, the safeguard of requiring both the CSE and its SD counterparty to maintain a margin model for any swap transaction that does not utilize the table-based method would be eliminated. A CSE that relies on a counterparty's risk-based model calculations would thus avoid rigorous Commission requirements relating to risk-based modeling,[89] which may undercut the effectiveness of the CSE's risk oversight.[90]

In addition, the safeguard of private market discipline that is inherent in having each counterparty develop its own IM model, and therefore the ability for the parties to scrutinize each other's IM model and output, will not be present given that under the proposed rule, a CSE would be permitted to rely on the risk-based model calculation of a swap entity counterparty. As a result, there is the potential that insufficient amounts of IM would be generated by the swap entity counterparty, which may be attributable to a deficiency in the model or the fact that the swap entity may be inherently conflicted and interested in generating lower amounts of IM collectable by the CSE.[91] Given that the CSE without a model may lack adequate means to verify the amount of IM produced by the swap entity counterparty, the CSE may not be capable to contest it. As a result, insufficient amounts of IM may be collected by the CSE to protect itself against the risk

[89] *See generally* 17 CFR 23.154(b).
[90] *But cf.* 17 CFR 23.600 (requiring SDs and MSP to establish a robust risk management program for the monitoring and management of their swaps activities).
[91] *But cf.* 17 CFR 23.600 (requiring swap entities to have a risk management program for the management and monitoring of risk associated with their swaps, which may reduce the risk that such entities may act in a conflicted manner).

of default by the swap entity counterparty, increasing the risk of contagion and the potential for systemic risk.

The Commission, however, believes that these costs are mitigated by the proposed rule, which would be narrowly tailored to make available the alternative method of IM calculation set forth in Letter 19-29 only with respect to uncleared swaps entered into for the purpose of hedging. In addition, the Commission notes that there are other requirements in the Commission's regulations that address the monitoring of exposures and swap risk.

*3. Section 15(a) Considerations*

In light of the foregoing, the CFTC has evaluated the costs and benefits of the proposal pursuant to the five considerations identified in section 15(a) of the CEA as follows:

(a) Protection of Market Participants and the Public

The proposed rule would align the CFTC Margin Rule's method for calculating AANA for determining MSE and the timing of post-phase-in compliance with the BCBS/IOSCO Framework. By aligning these requirements with the international standard, the proposed rule would reduce the potential for complexity and confusion that can result from using different AANA calculation methods and different compliance schedules for market participants that may be subject to margin requirements in multiple jurisdictions. At the same time, the Commission recognizes that some firms may have already begun preparations to undertake AANA calculations under the existing requirements. The proposed rule may require them to adjust their calculations to reflect the new proposed method for calculating AANA for determining MSE and to update

infrastructure arrangements, increasing the overall cost of compliance with the margin requirements.

Under the existing CFTC Margin Rule, firms that are FEUs, beginning in Phase 6, which starts on September 1, 2021, would look back to the 2020 June-August period to determine whether they have MSE. As such, the firms would have no less than twelve months to engage in preparations for the exchange of regulatory IM, by, among other things, procuring rule-compliant documentation, establishing processes and systems for the calculation, collection and posting of IM collateral, and setting up custodial arrangements. If the Commission determines to adopt the proposed amendment changing the AANA calculation period for determining MSE to March-May of the current year, such firms would have only a three-month window to engage in preparations to exchange IM. Nevertheless, the Commission notes that, under the existing requirements, after the end of the phased compliance schedule, firms would only have four months in subsequent years since the calculation period for determining MSE status would be June through August of the prior year, with compliance starting January 1 of the following year. In addition, because the proposed amendment would require only averaging three month-end dates rather than averaging all business days during the three-month calculation period, the potential burdens of a shorter preparatory period for Phase 6 entities may be offset by the adoption of the BCBS/IOSCO Framework's less onerous calculation method.

Moreover, the proposed amendment would shift the timing of post-phase-in compliance to September 1 of each year. As such, entities that otherwise would be required to exchange IM beginning January 1, 2022, would be able to defer compliance

to September 1, 2022.[92] As a result, less collateral for uncleared swaps may be collected between January 1, 2022, and September 1, 2022, rendering the parties' positions riskier during that nine-month period, which could raise the risk of contagion and increase the potential for systemic risk. Firms that would have fallen out of scope by January 1, 2022 would also be subject to compliance for an additional nine months.

Notwithstanding these potential costs, the Commission believes that the proposed changes advance the Commission's goal, pursuant to statutory direction, of coordination and harmonization with international regulators. The costs that may arise as a result of the proposed changes, as discussed above, would be mitigated by the overall cost savings, as the need to undertake separate calculations of MSE to address different requirements in different jurisdictions would be obviated with respect to most jurisdictions.

The amendment of Commission regulation 23.154(a) would allow a CSE to use the risk-based model calculation of IM of a counterparty that is a swap entity. Without an alternative model, the CSE may not be able to challenge the amounts generated by the swap entity counterparty, which may be insufficient because of model error or malfunction or because the swap entity may be inherently conflicted and may be interested in generating low amounts of IM collectable by the CSE. In turn, insufficient amounts of IM may be collected by the CSE to offset the risk of counterparty default, increasing the risk of contagion and the potential for systemic risk.

[92] This would apply to entities that meet the MSE level based on their AANA during the June, July, and August 2021 period, and continue to have MSE in the March, April, and May 2022 period. Of course, changing the calculation period to the March, April, and May 2022 period may lead to the inclusion of entities whose AANA is below MSE in the June, July, and August 2021 period, but rises to the MSE level or above by the March, April, and May 2022 period. The OCE estimated that approximately 75-100 entities typically move from one side of the MSE threshold to the other between measurement periods.

The Commission believes that these risks would be mitigated by the proposed rule, which would be narrowly tailored to permit reliance on a swap entity counterparty's risk-based model calculation only with respect to uncleared swaps entered into for the purpose of hedging. In addition, there are other requirements in the Commission's regulations that address the monitoring of exposures and swap risk (*i.e.*, Commission regulation 23.600, which requires SDs and MSPs to adopt a robust risk management program for the monitoring and management of risk related to their swap activities).

(b) Efficiency, Competitiveness, and Financial Integrity of Markets

The proposed rule would align the CFTC Margin Rule's AANA calculation method for determining MSE and the timing of post-phase-in compliance with the BCBS/IOSCO Framework. As such, the proposed rule would reduce the need, at least for entities not also undertaking swaps with U.S. prudentially regulated SDs, to undertake separate AANA calculations accounting for different calculation methods and to conform to separate compliance timings, varying according to the location of swap counterparties and jurisdictional requirements applicable to the counterparties. As such, the proposed changes would promote market efficiency and would even the playing field for market players, fostering competitiveness and reducing the incentive to engage in regulatory arbitrage by identifying more accommodating margin frameworks.

The amendment of Commission regulation 23.154(a) would allow CSEs to rely on a swap entity counterparty's IM risk-based model calculations. Without a model, the CSE would lack effective means to verify its counterparty's IM calculations. As a result, if there are shortfalls in the output, the CSE may collect less IM collateral to offset the risk of default by the counterparty, which could increase the risk of contagion,

threatening the integrity of the U.S. financial markets. The Commission, however, believes that the proposed rule is sufficiently targeted to mitigate these risks. The proposed amendment would apply only when uncleared swaps are entered into for hedging, thus limiting widespread use and the potential for uncollateralized uncleared swap risk.

In addition, by providing an alternative to risk-based modeling and the associated costs, the proposed rule could encourage some market participants to expand their swap business. The proposed amendment would thus promote efficiency in the uncleared swaps market by increasing the pool of swap counterparties and fostering competition. On the other hand, the availability of an alternative less costly method of IM calculation may encourage entities to shift their trading to uncleared swaps from swaps that can be cleared, potentially reducing liquidity in the cleared swap markets.

(c) Price Discovery

By aligning the CFTC Margin Rule and the BCBS/IOSCO Framework with respect to the AANA calculation method for determining MSE and post-phase-in compliance timing, the proposed rule would reduce the burden and confusion inherent in implementing separate measures and processes to address compliance in different jurisdictions. The proposed rule could thus incentivize more firms to enter into uncleared swap transactions, which would increase liquidity and lead to more robust pricing that reflects market fundamentals.

By amending Commission regulation 23.154(a), the Commission would relieve certain CSEs from having to adopt a risk-based margin model to calculate IM or use the standardized IM table. Being able to rely on a counterparty's risk-based model

calculation of IM may encourage entities to increase trading in uncleared swaps. As a result, firms may take a more active role in the uncleared swap markets, which would lead to increase liquidity and enhance price discovery. On the other hand, the proposed amendment may encourage entities to shift their trading from swaps that can be cleared, potentially reducing liquidity and price discovery in those markets.

(d) Sound Risk Management

The proposed rule would reduce the need for firms to undertake separate AANA calculations using different methods and to conform to separate compliance timing, allowing firms to engage in sound risk management by focusing on more substantive requirements.

Under the current rule, after the last phase of compliance, FEUs would be subject to IM compliance beginning on January 1, 2022. The proposed rule would defer such compliance until September 1, 2022. Uncleared swaps entered between January 1, 2022, and September 1, 2022, may be uncollateralized. As such, less collateral may be collected, and positions created during that nine-month period may be riskier, increasing the risk of contagion and systemic risk. The Commission notes, however, that keeping the January 1, 2022 compliance date could likewise result in the collection of less collateral. Some FEUs, after coming into scope during the last phase of compliance, may exit MSE status on January 1, 2022, as their AANA during the relevant calculation period may decline below the MSE threshold, and CSEs entering into uncleared swaps with these FEUs would no longer be required to exchange IM with the FEUs.

Also, it is possible that under the proposed month-end method for calculating AANA to determine MSE, FEUs trading certain financial products may avoid MSE

status, as month-end calculations may not capture certain financial products that are required to be included in the calculation. As result, CSEs transactions with such FEUs would not be subject to the IM requirements and may be insufficiently collateralized, increasing the risk of contagion and systemic risk. Conversely, because more than 96% of FEUs are unlikely to have MSE, as estimated by the OCE, and come within the scope of the IM requirements, the exclusion of such products would have a limited impact on the effectiveness of the Commission's IM requirements.

Moreover, month-end AANA calculations compared to daily AANA calculations may be more susceptible to "window dressing" and less conducive to sound risk management. FEUs may manage their exposures as they approach the month-end date during the three month calculation period to avoid MSE status. The Commission, however, notes that it has sufficient regulatory authority, including anti-fraud powers under section 4b of the CEA, to take appropriate enforcement actions against any market participant that may engage in deceptive conduct with respect to the AANA calculation, and CSEs must also have written policies and procedures in place to prevent evasion or the facilitation of an evasion by an FEU counterparty.

By allowing CSEs to use the risk-based model calculation of a swap entity counterparty consistent with Letter 19-29, CSEs may no longer be incentivized to adopt their own risk-based models. If a CSE uses a counterparty's IM model calculation without developing its own model, the CSE may lack reasonable means to verify the IM provided by its counterparty, recognize shortfalls in the IM calculation, and identify potential flaws in the swap entity counterparty's risk-based model. As a result, insufficient amounts of IM may be collected by the CSE to protect itself against the risk

of default by the swap entity counterparty, increasing the risk of contagion and the potential for systemic risk. The Commission, however, believes that these risks are mitigated because, under the proposed amendment, CSEs would be able to use a counterparty's risk-based model IM calculation only with respect to uncleared swaps entered into for the purpose of hedging. In addition, the Commission notes that there are other requirements in the Commission's regulations that address the monitoring of exposures and swap risk.

(e) Other Public Interest Considerations

The Commission believes that the proposed amendments to align the CFTC Margin Rule with the BCBS/IOSCO Framework would promote harmonization with international regulatory requirements and would reduce the potential for regulatory arbitrage. However, given that the U.S. prudential regulators may not amend their margin requirements in line with the proposed amendments, the possibility exists that the CFTC and U.S. prudential regulators' differing rules may induce certain firms to undertake swaps with particular SDs based on which U.S. regulatory agency is responsible for setting margin requirements for such SDs.

*Request for Comments on Cost-Benefit Considerations.* The Commission invites public comment on its cost-benefit considerations, including the section 15(a) factors described above. Commenters are also invited to submit any data or other information they may have quantifying or qualifying the costs and benefits of the proposed amendments.

*C. Antitrust Laws*

Section 15(b) of the CEA requires the Commission to take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the purposes of this Act, in issuing any order or adopting any Commission rule or regulation (including any exemption under section 4(c) or 4c(b)), or in requiring or approving any bylaw, rule or regulation of a contract market or registered futures association established pursuant to section 17 of this Act.[93]

The Commission believes that the public interest to be protected by the antitrust laws is generally to protect competition. The Commission requests comment on whether the proposed amendments implicate any other specific public interest to be protected by the antitrust laws.

The Commission has considered the proposed amendments to determine whether they are anticompetitive, and has preliminarily identified no anticompetitive effects. The Commission requests comment on whether these rule proposals are anticompetitive and, if they are, what the anticompetitive effects are.

Because the Commission has preliminarily determined that the proposed amendments are not anticompetitive and have no anticompetitive effects, the Commission has not identified any less competitive means of achieving the purposes of the Act. The Commission requests comment on whether there are less anticompetitive means of achieving the relevant purposes of the Act that would otherwise be served by adopting the proposed amendments.

**List of Subjects in 17 CFR Part 23**

Swaps, Swap dealers, Major swap participants, Capital and margin requirements.

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[93] 7 U.S.C. 19(b).

For the reasons stated in the preamble, the Commodity Futures Trading Commission proposes to amend 17 CFR Part 23 as set forth below:

**PART 23—SWAP DEALERS AND MAJOR SWAP PARTICIPANTS**

1. The authority citation for Part 23 continues to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 6, 6a, 6b, 6b-1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21.
Section 23.160 also issued under 7 U.S.C. 2(i); Sec. 721(b), Pub. L. 111-203, 124 Stat. 1641 (2010).

2. In § 23.151, revise the definition of "Material Swaps Exposure" to read as follows:

§ 23.151 Definitions applicable to margin requirements.

* * * * *

*Material Swaps Exposure* for an entity means that, as of September 1 of any year, the entity and its margin affiliates have an average month-end aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps with all counterparties for March, April, and May of that year that exceeds $8 billion, where such amount is calculated only for the last business day of the month. An entity shall count the average month-end aggregate notional amount of an uncleared swap, an uncleared security-based swap, a foreign exchange forward, or a foreign exchange swap between the entity and a margin affiliate only one time. For purposes of this calculation, an entity shall not count a swap that is exempt pursuant to § 23.150(b) or a security-based swap that qualifies for an exemption under section 3C(g)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c-3(g)(4)) and implementing regulations or that satisfies the criteria in section 3C(g)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78-c3(g)(4)) and implementing regulations.

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3. In § 23.154, add paragraph (a)(5):

§ 23.154 Calculation of initial margin.

(a) * * *

(5) A covered swap entity would be deemed to calculate initial margin as required by paragraph (a)(1) of this section if it uses the amount of initial margin calculated by a counterparty that is a swap entity and the initial margin amount is calculated using the swap entity's risk-based model that meets the requirements of paragraph (b) of this section or is approved by a prudential regulator, provided that initial margin calculated in such manner is used only with respect to uncleared swaps entered into by the covered swap entity and the swap entity for the purpose of hedging the covered swap entity's swaps with non-swap entity counterparties.

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Issued in Washington, DC, on August 17, 2020, by the Commission.

Robert Sidman,

*Deputy Secretary of the Commission.*

**Note:** The following appendices will not appear in the Code of Federal Regulations.

**Appendices to Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Commission Voting Summary and Commissioners' Statements**

**Appendix 1—Commission Voting Summary**

On this matter, Chairman Tarbert and Commissioners Quintenz, Behnam, Stump, and Berkovitz voted in the affirmative. No Commissioner voted in the negative.

**Appendix 2—Supporting Statement of Commissioner Dawn D. Stump**

**Overview**

I am pleased to support the proposed rulemaking that the Commission is issuing with respect to the definition of "material swap exposure" and an alternative margin calculation method in connection with the Commission's margin requirements for uncleared swaps.

This proposed rulemaking addresses recommendations that the Commission has received from its Global Markets Advisory Committee ("GMAC"), which I am proud to sponsor, and is based on a comprehensive report prepared by GMAC's Subcommittee on Margin Requirements for Non-Cleared Swaps ("GMAC Margin Subcommittee").[1] It demonstrates the value added to the Commission's policymaking by its Advisory Committees, in which market participants and other interested parties come together to provide us with their perspectives and potential solutions to practical problems.

The proposed rulemaking contains two proposals, which have much to commend them. These proposals further objectives that I have commented on before:

- the imperative of harmonizing our margin requirements with those of our international colleagues around the world in order to facilitate compliance and coordinated regulatory oversight; and

[1] *Recommendations to Improve Scoping and Implementation of Initial Margin Requirements for Non-Cleared Swaps,* Report to the CFTC's Global Markets Advisory Committee by the Subcommittee on Margin Requirements for Non-Cleared Swaps (April 2020), available at *https://www.cftc.gov/media/3886/GMAC_051920MarginSubcommitteeReport/download.*

- the benefits of codifying relief that has been issued by our Staff and re-visiting our rules, where appropriate.

I am very appreciative of the many people whose efforts have contributed to bringing this proposed rulemaking to fruition. First, the members of the GMAC, and especially the GMAC Margin Subcommittee, who devoted a tremendous amount of time to quickly provide us with a high-quality report on complex margin issues at the same time they were performing their "day jobs" during a global pandemic. Second, Chairman Tarbert, for his willingness to include this proposed rulemaking on the busy agenda that he has laid out for the Commission for the rest of this year. Third, my fellow Commissioners, for working with me on these important issues. And finally, the Staff of the Division of Swap Dealer and Intermediary Oversight ("DSIO"), whose tireless efforts have enabled us to advance these initiatives to assure that our uncleared margin rules are workable for all and are in line with international standards, thereby enhancing compliance consistent with our responsibilities under the Commodity Exchange Act ("CEA").

**Background: A Different Universe is coming into Scope of the Uncleared Margin Rules**

The Commission's uncleared margin rules for swap dealers, like the Framework of the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions ("BCBS/IOSCO")[2] on which they are based, were designed primarily to ensure the exchange of margin between the largest financial

[2] *See generally* BCBS/IOSCO, Margin requirements for non-centrally cleared derivatives (July 2019), available at *https://www.bis.org/bcbs/publ/d475.pdf*.

institutions for their uncleared swap transactions with one another. These institutions and transactions are already subject to uncleared margin requirements.

Pursuant to the phased implementation schedule of the Commission's rules and the BCBS/IOSCO Framework, though, a different universe of market participants – presenting unique considerations – is coming into scope of the margin rules. It is only now, as we enter into the final phases of the implementation schedule, that the Commission's uncleared margin rules will apply to a significant number of financial end-users, and we have a responsibility to make sure they are fit for that purpose. Accordingly, now is the time we must explore whether the regulatory parameters that we have applied to the largest financial institutions in the earlier phases of margin implementation need to be tailored to account for the practical operational challenges posed by the exchange of margin when one of the counterparties is a pension plan, endowment, insurance provider, mortgage service provider, or other financial end-user.

**International Harmonization to Enhance Compliance and Coordinated Regulation**

The first proposal in this proposed rulemaking would revise the calculation method for determining whether financial end-users come within the scope of the initial margin ("IM") requirements, and the timing for compliance with the IM requirements after the end of the phased compliance schedule. These changes would align certain timing and calculation issues under the Commission's margin rules with both the BCBS/IOSCO Framework and the manner in which these issues are handled by our regulatory colleagues in all other major market jurisdictions.

Swap dealers must exchange IM with respect to uncleared swaps that they enter into with a financial end-user counterparty that has "material swap exposure" ("MSE").

The Commission's margin rules provide that after the last phase of compliance, MSE is to be determined on *January 1*, and that an entity has MSE if it has more than $8 billion in average aggregate notional amount ("AANA") during *June, July, and August* of *the prior year*. By contrast, under the BCBS/IOSCO Framework and in virtually every other country in the world, an entity is determined to come into scope of the IM requirement on *September 1*, and an entity has MSE if it has the equivalent of $8 billion in AANA[3] during *March, April, and May* of *that year*.

The reason the United States is out-of-step with the rest of the world on these timing and calculation issues is not because of any considered policy determination. Rather, it is simply the result of a quirk that the margin rules were adopted based on the BCBS/IOSCO Framework that was in effect at the time – but the BCBS/IOSCO Framework was revised two years later.

In a further disconnect, the Commission's margin rules look to the *daily average* AANA during the three-month calculation period for determining MSE, whereas the BCBS/IOSCO Framework and other major market jurisdictions base the AANA calculation on an *average of month-end dates* during that period. Yet, the proposing release notes that the Commission's Office of the Chief Economist has estimated that calculations based on end-of-month AANA generally would yield similar results as calculations based on the Commission's current daily AANA approach.

The Commission is proposing to amend these timing and calculation provisions of its uncleared margin rules to harmonize them with the BCBS/IOSCO Framework and the

[3] The MSE threshold under the BCBS/IOSCO Framework is stated in euros rather than dollars.

approach followed by our international colleagues around the world. Given the global nature of the derivatives markets, we should always seek international harmonization of our regulations unless a compelling reason exists not to do so – which is not the case here.

Indeed, in the Dodd-Frank Act, Congress specifically directed the Commission, "[i]n order to promote effective and consistent global regulation of swaps," to "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation . . . of swaps [and] swap entities . . ."[4] And when the G-20 leaders met in Pittsburgh in the midst of the financial crisis in 2009, they, too, recognized that a workable solution for global derivatives markets demands coordinated policies and cooperation.[5]

The MSE proposal being issued today is true to the direction of Congress in the Dodd-Frank Act, and honors the commitment of the G-20 leaders at the Pittsburgh summit. Differences between countries in the detailed timing and calculation requirements with respect to uncleared margin compel participants in these global markets to run multiple compliance calculations – for no particular regulatory reason. This not only forces market participants to bear unnecessary costs, but actually hinders compliance with margin requirements because of the entirely foreseeable prospect of calculation errors in applying the different rules.

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[4] *See s*ection 752(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010) ("Dodd-Frank Act").

[5] *See* Leaders' Statement from the 2009 G-20 Summit in Pittsburgh, Pa. at 7 (September 24-25, 2009) ("We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage"), available at *https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.*

As noted above, now is the time to address this disjunction in MSE timing and calculation requirements because the financial end-users to which the MSE definition applies are coming into scope of the margin rules. Both Congress and the G-20 leaders recognized that because modern swap markets are not bound by jurisdictional borders, they cannot function absent consistent international standards. Harmonization fosters both improved compliance and effectively regulated markets through coordinated oversight – which must always be our goals.

During the unfortunate events of the financial crisis, we learned that coordination among global regulators, working towards a common objective, is essential. That lesson remains true today, and we are reminded that disregarding this reality has the potential to weaken, rather than strengthen, the effectiveness of our oversight and the resilience of global derivatives markets.

**The Benefits of Codifying Staff Relief and Re-Visiting our Rules**

The second proposal in the proposed rulemaking would codify existing DSIO no-action relief in recognition of market realities. Our Staff often has occasion to issue relief or take other action in the form of no-action letters, interpretative letters, or advisories on various issues and in various circumstances. This affords the Commission a chance to observe how the Staff action operates in real-time, and to evaluate lessons learned. With the benefit of this time and experience, the Commission should then consider whether codifying such staff action into rules is appropriate.[6] As I have said before, "[i]t is

[6] *See* comments of Commissioner Dawn D. Stump during Open Commission Meeting on January 30, 2020, at 183 (noting that after several years of no-action relief regarding trading on swap execution facilities ("SEFs"), "we have the benefit of time and experience and it is time to think about codifying some of that relief. . . . [T]he SEFs, the market participants, and the Commission have benefited from this time and we have an obligation to provide more legal certainty through codifying these provisions into rules."),

simply good government to re-visit our rules and assess whether certain rules need to be updated, evaluate whether rules are achieving their objectives, and identify rules that are falling short and should be withdrawn or improved."[7]

The proposal we are issuing today would codify the alternative IM calculation method set out in DSIO no-action Letter No. 19-29.[8] It would provide that a swap dealer may use the risk-based model calculation of IM of a counterparty that is a CFTC-registered swap dealer as the amount of IM that the former must collect from the latter. The proposing release states the Commission's expectation that the proposal generally would be used by swap dealers with a discrete and limited swap business consisting primarily of entering into uncleared swaps with end-user counterparties and then hedging the risk of those swaps with uncleared swaps entered into with a few swap dealers.

This proposal is subject to conditions that: 1) the applicable risk-based model be approved by either the Commission, the National Futures Association, or a prudential regulator; and 2) the uncleared swaps for which a swap dealer uses the risk-based model calculation of IM of its swap dealer counterparty are entered into for the purpose of hedging the former's own risk from entering into swaps with non-swap dealer counterparties.

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available at
*https://www.cftc.gov/sites/default/files/2020/08/1597339661/openmeeting_013020_Transcript.pdf*.

[7] Statement of Commissioner Dawn D. Stump for CFTC Open Meeting on: 1) Final Rule on Position Limits and Position Accountability for Security Futures Products; and 2) Proposed Rule on Public Rulemaking Procedures (Part 13 Amendments) (September 16, 2019), available at *https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement091619*.

[8] CFTC Letter No. 19-29, Request for No-Action Relief Concerning Calculation of Initial Margin (December 19, 2019), available at *https://www.cftc.gov/LawRegulation/CFTCStaffLetters/letters.htm?title=&field_csl_letter_types_target_id%5B%5D=636&field_csl_divisions_target_id%5B%5D=596&field_csl_letter_year_value=2019&=Apply*.

Simply put, not all swap dealers are created equal. It is therefore appropriate to tailor our uncleared margin regime accordingly. Letter No. 19-29 recognized this reality and smoothed the rough edges of our otherwise one-size-fits-all uncleared margin rules, and I support the proposal to codify that result.

**There Remains Unfinished Business**

The report of the GMAC Margin Subcommittee recommended several actions beyond those contained in this proposed rulemaking in order to address the unique challenges associated with the application of uncleared margin requirements to end-users. Having been present for the development of the Dodd-Frank Act, I recall the concerns expressed by many lawmakers about applying the new requirements to end-users. The practical challenges with respect to uncleared margin that caused uneasiness back in 2009-2010 are now much more immediate as the margin requirements are being phased in to apply to these end-users.

So, while I am pleased at the steps the Commission is taking in this proposed rulemaking, I hope that we can continue to work together to address the other recommendations included in the GMAC Margin Subcommittee's report. The need to do so will only become more urgent as time marches on.

**Conclusion**

To be clear, these proposals to amend the Commission's uncleared margin rules are not a "roll-back" of the margin requirements that apply today to the largest financial institutions in their swap transactions with one another. Rather, the proposals reflect a thoughtful refinement of our rules to align them with the rest of the international regulatory community, and to take account of specific circumstances in which they

impose substantial operational challenges (*i.e.,* they are not workable) when applied to other market participants that are coming within the scope of their mandates. I look forward to receiving public input on any improvements that can be made to the proposals to further enhance compliance with the Commission's uncleared margin requirements.

**Appendix 3—Statement of Commissioner Dan M. Berkovitz**

I support issuing for public comments two notices of proposed rulemaking to improve the operation of the CFTC's Margin Rule.[1] The Margin Rule requires certain swap dealers ("SDs") and major swap participants ("MSPs") to post and collect initial and variation margin for uncleared swaps.[2] The Margin Rule is critical to mitigating risks in the financial system that might otherwise arise from uncleared swaps. I support a strong Margin Rule, and I look forward to public comments on the proposals, including whether certain elements of the proposals could increase risk to the financial system and how the final rule should address such risks.

The proposals address: (1) the definition of material swap exposure ("MSE") and an alternative method for calculating initial margin ("the MSE and Initial Margin Proposal"); and (2) the application of the minimum transfer amount ("MTA") for initial and variation margin ("the MTA Proposal"). They build on frameworks developed by the Basel Committee on Banking Supervision and International Organization of

[1] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016) ("Margin Rule").
[2] *See also* Commodity Exchange Act ("CEA") section 4s(e). The CEA, as amended by the Dodd-Frank Act, requires the Commission to adopt rules for minimum initial and variation margin for uncleared swaps entered into by SDs and MSPs for which there is no prudential regulator. Although addressed in the rules, there are currently no registered MSPs.

Securities Commissions ("BCBS/IOSCO"),[3] existing CFTC staff no-action letters, and recommendations made to the CFTC's Global Markets Advisory Committee ("GMAC").[4] I thank Commissioner Stump for her leadership of the GMAC and her work to bring these issues forward for the Commission's consideration.

Today's proposed amendments to the Margin Rule could help promote liquidity and competition in swaps markets by allowing the counterparties of certain end-users to rely on the initial margin calculations of the more sophisticated SDs with whom they enter into transactions designed to manage their risks, subject to safeguards. They would also address practical challenges in the Commission's MTA rules that arise when an entity such as a pension plan or endowment retains asset managers to invest multiple separately managed accounts ("SMAs"). Similar operational issues are addressed with respect to initial and variation margin MTA calculations.

These operational and other benefits justify publishing the MSE and Initial Margin Proposal and the MTA Proposal in the Federal Register for public comment. However, I am concerned that specific aspects of each of these proposed rules could weaken the Margin Rule and increase risk by creating a potentially larger pool of uncollateralized, uncleared swaps exposure. My support for finalizing these proposals will depend on how the potential increased risks are addressed.

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[3] BCBS/IOSCO, Margin requirements for non-centrally cleared derivatives (July 2019), *https://www.bis.org/bcbs/publ/d475.pdf*. The BCBS/IOSCO framework was originally promulgated in 2013 and later revised in 2015.

[4] Recommendations to Improve Scoping and Implementation of Initial Margin Requirements for Non-Cleared Swaps, Report to the CFTC's Global Markets Advisory Committee by the Subcommittee on Margin Requirements for Non-Cleared Swaps, April 2020, *https://www.cftc.gov/media/3886/GMAC_051920MarginSubcommitteeReport/download*.

One potential risk in the MSE and Initial Margin Proposal arises from amending the definition of MSE to align it with the BCBS/IOSCO framework.[5] One element of the proposal would amend the calculation of the average daily aggregate notional amount ("AANA") of swaps. The proposed rule would greatly reduce the number of days used in the calculation, reducing it from an average of all business days in a three month period to the average of the last business day in each month of a three month period.[6] The result would be that a value now calculated across approximately 60+ data points (*i.e.*, business days) would be confined to only three data points, and could potentially become less representative of an entity's true AANA and swaps exposure. Month-end trading adjustments could greatly skew the AANA average for an entity.

When the Commission adopted the Margin Rule in 2016, it rejected the MSE calculation approach now under renewed consideration. U.S. prudential regulators also declined to follow the BCBS/IOSCO framework in this regard. The Commission noted in 2016 that an entity could "window dress" its exposure and artificially reduce its AANA during the measurement period.[7] Even in the absence of window dressing, there are also concerns that short-dated swaps, including intra-month natural gas and electricity swaps, may not be captured in a month-end calculation window. While the MSE and Initial Margin Proposal offers some analysis addressing these issues, it may be difficult to extrapolate market participants' future behavior based on current regulatory frameworks. I look forward to public comment on these issues.

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[5] 17 CFR 23.151.

[6] Existing Commission regulation 23.151 specifies June, July, and August of the prior year as the relevant calculation months. The proposed rule would amend this to March, April, and May of the current year. The proposed rule would also amend the calculation date from January 1 to September 1. These amendments would be consistent with the BCBS/IOSCO framework.

[7] *See* CFTC Margin Rule, 81 FR at 645.

The MSE and Initial Margin Proposal and the MTA Proposal each raise additional concerns that merit public scrutiny and comment. The MTA Proposal, for example, would permit a minimum transfer amount of $50,000 for each SMA of a counterparty. In the event of more than 10 SMAs with a single counterparty (each with an MTA of $50,000), the proposal would functionally displace the existing aggregate limit of $500,000 on a particular counterparty's uncollateralized risk for uncleared swaps. The proposal would also state that if certain entities agree to have separate MTAs for initial and variation margin, the respective amounts of MTA must be reflected in their required margin documentation. Under certain scenarios, these separate MTAs could result in the exchange of less total margin than if initial and variation margin were aggregated.

The MSE and Initial Margin Proposal and the MTA Proposal both articulate rationales why the Commission preliminarily believes that the risks summarized above, and others noted in the proposals, may not materialize. The Commission's experience with relevant staff no-action letters may also appear to lessen concerns around the proposals. While each item standing on its own may not be a significant concern, the collective impact of the proposed rules may be a reduction in the strong protections afforded by the 2016 Margin Rule—and an increase in risk to the U.S. financial system. The Commission must resist the allure of apparently small, apparently incremental, changes that, taken together, dilute the comprehensive risk framework for uncleared swaps.

I look forward to public comments and to continued deliberation on what changes to the MSE and Initial Margin Proposal and the MTA Proposal are appropriate. I thank Commissioner Stump, our fellow Commissioners, and staff of the Division of Swap

Dealer and Intermediary Oversight for their extensive engagement with my office on these proposals.