CFTC: Proposed Changes To Uncleared Swap Margin Rules

Proposed Changes To Financial Entity Provisions:

ERISA plans are highly credit-worthy, minimally leveraged (if at all), heavily regulated, and prudently managed counterparties to Covered Swap Entities (CSEs). As such, ERISA plans should be completely excluded from mandatory initial margin requirements for uncleared swaps. We request that ERISA plans be so excluded by removing ERISA plans from the definition of "financial end user" in proposed rule 23.150.

Alternatively, we request that ERISA plans be included among the types of financial entities for which CSEs may apply initial and variation margin thresholds pursuant to proposed rule 23.153(c). The Prudential Regulators explained in the preamble to their proposed rules that the proposed definition of low-risk financial end user is based upon the MSP and MSSP definitions.[1] The CFTC similarly explains that significant swap exposure is defined by reference to the CFTC's proposed MSP and MSSP definitions. 76 Fed. Reg. at 23,736 & n. 12.

In defining MSP and MSSP, Dodd-Frank §§ 721(a)(16) and 761(a)(5) exclude swaps used by an ERISA plan "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan." Although we cannot know with complete certainty until the MSP and MSSP definitions are finalized, because ERISA plans use swaps primarily for hedging purposes, we do not believe that any ERISA plan will ever be an MSP or MSSP. The statutory language demonstrates that Congress intended ERISA plans not to be subject to the onerous regulations placed on MSPs and MSSPs. The reasons for functionally excluding ERISA plans from the definitions of MSP and MSSP -- because ERISA plans present little counterparty risk and use swaps predominately for hedging or mitigating plan risks -- apply equally here.

The CFTC departed from the MSP approach here by not excluding ERISA plans from the requirement to post margin for uncleared swaps to the extent such plans use swaps predominately to hedge or mitigate plan risks. There is no more reason to consider ERISA plans riskier in the uncleared margin context than in the MSP context. Accordingly, we suggest below two alternative modifications to proposed rule 23.153(c) to make the treatment of ERISA plans consistent with the MSP definition. In addition, although we believe it is not necessary for the CFTC to set maximum limits on margin thresholds, to the extent the CFTC impose such limits, we believe those limits should be in the \$100 million - \$150 million range.

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[1] The Prudential Regulators state in their preamble that, "[w]ith respect to the first criterion, the definition of 'significant swaps exposure' under the proposed rule is very similar to the definition of 'substantial counterparty exposure' proposed by the CFTC and SEC for purposes of establishing what level of swap and security-based swap counterparty exposure would require a person to register as a major swap participant or major security-based swap participant under the Commodity Exchange Act or the Securities Exchange Act, respectively…" Prudential Regulators' Proposed Rule, 76 Fed. Reg. at 27,571.

"The second criterion . . . generally mirrors the description of hedging-related swaps and security-based swaps that are excluded for purposes of determining whether a person maintains a substantial position in swaps or security-based swaps and therefore meets the definition of major swap participant or major security-based swap participant under the Commodity Exchange Act and Securities Exchange Act, respectively." Prudential Regulators' Proposed Rule, 76 Fed. Reg. at 27,571-72.

Alternative 1

“23.153(c) Thresholds

(1) A covered swap entity may apply a threshold to the initial margin and variation margin requirements of a counterparty that is a financial entity if the counterparty either is an employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) or makes the following representations to the covered swap entity in connection with entering into an uncleared swap with the covered swap entity…”

Alternative 2

“23.153(c) Thresholds

(1) A covered swap entity may apply a threshold to the initial margin and variation margin requirements of a counterparty that is a financial entity if the counterparty makes the following representations to the covered swap entity in connection with entering into an uncleared swap with the covered swap entity:

(i) The counterparty is subject to capital requirements established by a prudential regulator or state insurance regulator, or is an employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002);

(ii) The counterparty does not have a significant uncleared swaps exposure; and

(iii) The counterparty predominately uses uncleared swaps to hedge or mitigate ~~the risks of~~ its business, operational, investment, or liability risks ~~activities~~, including interest rate, or other risks arising from the ~~business~~ operations of the counterparty;”

Expand Permissible Collateral:

It is essential to ERISA plans that the types of collateral that may be posted as initial margin for uncleared swaps be expanded beyond what the CFTC originally proposed (cash, U.S. Treasuries, and senior debt obligations of certain GSEs). Permitting additional types of collateral (subject to appropriate haircuts) is particularly important to plans, which typically have cash balances only to the extent necessary to pay pensioners and make other required distributions. The restrictive approach proposed by the CFTC would require plans to increase the amount of cash and U.S. Treasuries they hold, which will decrease investment returns and lead to greater benefit security risks for participants.[2]

The types of collateral acceptable for uncleared swaps should not be more restrictive than the types of collateral acceptable for cleared swaps. The CFTC should permit CSEs to accept the same types of collateral that derivatives clearing organizations (DCOs) registered with the CFTC accept for cleared swaps. This approach will permit swap dealers and MSPs to piggy-back off of the risk management practices of DCOs that are already supervised by the CFTC. Although we believe this approach is the best course, at a minimum, the CFTC should include as eligible collateral high quality municipal securities, certificates of deposit, commercial paper, corporate bonds, and interests in money market mutual funds.

We suggest the following changes to proposed rule 23.157.

"§23.157 Forms of Margin.

(a) *Initial margin.* (1) Each covered swap entity shall post and accept as initial margin only assets specified in the credit support arrangements with the counterparty.

(2) Each covered swap entity shall post and accept as initial margin only the types of collateral accepted for cleared swaps by a derivatives clearing organization registered with the Commodity Futures Trading Commission. ~~only the following assets if the counterparty is a swap dealer, a major swap participant, or a financial entity:~~

~~(i) Immediately available cash funds denominated in U.S. dollars or the currency in which payment obligations under the swap are required to be settled;~~

~~(ii) Any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, the United States or an agency of the United States; or~~

~~(iii) Any senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or any obligation that is an ''insured obligation,'' as that term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank.~~

[2] In addition, in some cases, cash or U.S. Treasuries can be riskier than other forms of collateral. For example, if a party sells a covered call option on an illiquid swap, it would be less risky for the party to post (and a CSE to accept) the underlying swap contract as collateral instead of cash.

(3) Each covered swap entity shall accept as initial margin from non-financial entities only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements.

(4) A covered swap entity may not collect, as initial margin or variation margin required by this part, any asset that is an obligation of the counterparty providing such asset.

(b) *Variation margin.* (1) Each covered swap entity shall pay and collect as variation margin only assets specified in the credit support arrangements with the counterparty.

(2) Each covered swap entity shall pay and collect as variation margin only the types of collateral accepted for cleared swaps by a derivatives clearing organization registered with the Commodity Futures Trading Commission~~cash or United States Treasury securities if the counterparty is a swap dealer, a major swap participant, or a financial entity~~.

(3) Each covered swap entity shall accept as variation margin from non-financial entities only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements.

(c) *Haircuts.* ~~(1)~~ Each covered swap entity shall apply haircuts to any asset posted or received as margin equal to the highest haircut applied by one or more derivatives clearing organizations registered with the Commodity Futures Trading Commission to the same type of asset.~~as specified in the credit support arrangements with the counterparty.~~

~~(2) Each covered swap entity shall apply haircuts to any asset received as margin that reflect the credit and liquidity characteristics of the asset.~~

~~(3) Each covered swap entity shall apply haircuts, at a minimum, to assets received as margin if the counterparty is a swap dealer, a major swap participant, or a financial entity in accordance with the following table:~~

~~[SPECIFIED HAIRCUT TABLE]~~

(d) *Commission action.* (1) The Commission may at any time require a covered swap entity to provide further data or analysis concerning any margin asset posted or received.

(2) The Commission may at any time require a covered swap entity to replace a margin asset posted to a counterparty with a different margin asset to address potential risks posed by the asset.

(3) The Commission may at any time require a covered swap entity to require a counterparty that is a swap dealer, a major swap participant, or a financial entity to replace a margin asset posted with the covered swap entity with a different margin asset to address potential risks posed by the asset.

(4) The Commission may at any time require a covered swap entity to provide further data or analysis concerning margin haircuts.

(5) The Commission may at any time require a covered swap entity to modify a margin haircut applied to an asset received from a swap dealer, a major swap participant, or a financial entity to address potential risks posed by the asset."

Variation Margin Should Be Segregated At An End User's Option:

Consistent with Dodd-Frank § 724(c) (adding CEA § 4s(l)), proposed rule 23.153(a)(1) explicitly provides that a counterparty may require a CSE to segregate initial margin with a third-party custodian. Proposed rule 23.153(b)(1) states that variation margin can be paid "directly to the covered swap entity *or to a custodian selected pursuant to § 23.158*." (emphasis added) Although the language arguably implies that such segregation of variation margin is at the option of the counterparty, the rule is ambiguous. We suggest the following clarification to proposed rule 23.153(b)(1).

"23.151(b)(1) For each uncleared swap between a covered swap entity and a financial entity, each covered swap entity shall require the financial entity to pay variation margin as calculated pursuant to § 23.156 of this part directly to the covered swap entity or, at the option of the financial entity, to a custodian selected pursuant to § 23.158 of this part."

<u>Parties Should Have A Commercially Reasonable Time To Post Initial Margin:</u>

The proposed rules require CSEs to collect initial margin "on or before the date of execution of an uncleared swap" and collect variation margin on the business day after a swap is executed. Proposed Rules 23.153(a)(1) and (b)(1). As proposed, the rules would require counterparties to set aside collateral for initial margin several days before entering into a swap with a new counterparty (or when using a new third-party custodian), even before the counterparty knows whether with certainty that the swap will be executed. Counterparties to a swap need a commercially reasonable amount of time to operationally move money to a new counterparty or third-party custodian. The CFTC should permit a commercially reasonable time of two days after entering into a swap before requiring initial or variation margin to be posted. We suggest the following changes to proposed rules 23.153(a)(1) and 23.153(b)(1).

"§ 23.153(a)(1) ~~On or before~~ <u>Beginning no later than two days after</u> the date of execution of an uncleared swap between a covered swap entity and a financial entity, the covered swap entity shall require the financial entity to post initial margin equal to or greater than an amount calculated pursuant to § 23.155 of this part. . . ."

"§ 23.153(b)(1) For each uncleared swap between a covered swap entity and a financial entity, each covered swap entity shall require the financial entity to pay variation margin as calculated pursuant to § 23.156 of this part directly to the covered swap entity or to a custodian selected pursuant to § 23.158 of this part. Such payments shall start ~~on the business day~~ <u>no later than two days</u> after the swap is executed and continue each business day until the swap is liquidated."

Uncleared Margin Rules Should Only Be Effective After Clearing Rules Are Effective And Internal Margin Models Have Been Approved

The CFTC and SEC are still in the process of proposing and finalizing both joint and separate rules creating the infrastructure for clearing and exchange-trading swaps. It is not clear when the CFTC and SEC will finalize all of the requisite rules. The CFTC's proposed uncleared swap margin rules are designed to create higher initial margin requirements than the requirements that will apply for cleared swaps, particularly where a CSE does not use an initial margin model. Until such time that the clearing infrastructure is in place, for risk management strategies that cannot be efficiently executed using futures contracts, ERISA plans (and other market participants) will have no choice but to use uncleared swaps. Further, until such time that the exchange trading infrastructure is in place (*i.e.*, until swap execution facilities and security-based swap execution facilities are operational) and the trading mandate in the Dodd-Frank Act is effective, cleared swaps markets may not have sufficient depth and liquidity to provide a reasonable alternative for ERISA plans (and other market participants).

The CFTC should not penalize the use of uncleared swaps prior to the time that cleared swaps are readily available and liquid electronic markets have been established, and prior to the time that the CFTC-regulated CSEs can use initial margin models. Thus, the CFTC should delay implementation of the uncleared swap margin rules until the later of the date that the Prudential Regulators or the CFTC have approved initial margin models for the five largest CSEs or 180 days after the effective date of all CFTC and SEC rules necessary to implement both the clearing and trading mandates for ERISA plans and their fiduciaries. A delay of 180 days after these rules are effective for ERISA plans and their fiduciaries will allow time for cleared swaps markets to develop at least some depth and liquidity.