July 11, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swaps Participants (RIN 3038 – AC97)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on matters identified in the above-captioned notice of proposed rulemaking ("NOPR") of the Commodity Futures Trading Commission ("CFTC"), relating to proposed rules (the "Proposed Rules") imposing requirements for initial and variation margin for certain swaps entered into by swap dealers and major swap participants for which there is no prudential regulator ("Covered Swap Entities" or "CSEs"), pursuant to and in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amendments to the Commodity Exchange Act ("CEA").

INTRODUCTION

As pointed out in the NOPR, the absence of prudent margining in derivatives transactions led directly to the financial crisis and the forced infusion of enormous sums of money into the financial markets to avoid total collapse. At the center of the reforms mandated by the Dodd-Frank Act is the direction to the CFTC and other agencies to create a prudent margining system for the derivatives markets to help avoid a repeat of this disaster.

The Dodd-Frank Act mandates the CFTC to take specific actions related to margining of uncleared swaps entered into by CSEs:

> The Commission shall adopt rules for swap dealers and major swap participants, with respect to their activities

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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> as a swap dealer or major swap participant, for which there is not a prudential regulator imposing... [b]oth initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization.[2]
>
> To offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared, the requirements imposed under paragraph (2) shall
>
> (i) Help ensure the safety and soundness of the swap dealer or major swap participant; and
>
> (ii) Be appropriate for the risk associated with the non-cleared swaps.[3]

The CFTC properly concludes that the Dodd-Frank Act reflects Congressional recognition that uncleared swaps pose greater risks than cleared swaps and that margining is an essential risk-management tool.[4] As a result, the Proposed Rules generally support a system in which margin of the type used by derivatives clearing organizations ("DCOs") is required in connection with certain swaps entered into by CSEs, but using standards which are somewhat more conservative. This approach is an absolutely appropriate response to the requirements imposed on the CFTC by the Dodd-Frank Act.

The Proposed Rules establish a system for margining which is comprehensive and soundly constructed. For example, the requirements related to models used to calculate initial margin are both practically useful and well-constructed.[5] However, the Proposed Rules fall short of the statutory mandate in several critically important areas.

- The Proposed Rules do not require that CSEs post margin, only that they collect margin from certain counterparties, *even though* the CFTC explicitly recognizes that "[w]ell-designed margin systems... serve both as a check on risk-taking that might exceed a party's financial capacity and as a resource that can limit losses when there is a failure." The failure to require two-way posting ignores half of this accurate assessment of the benefits of margin.

- The definition of "financial entity" must be expanded to include entities similar to those which are already listed.

[2] CEA, Section 4s(e)(2)(B).
[3] CEA, Section 4s(e)(3)(A).
[4] NOPR, 76 FR at page 2373.
[5] Proposed Rules, Section 23.155.

- Distinctions drawn between initial and variation margin reflect a misinterpretation of the relationship between initial and maintenance margin. As a result, the Proposed Rules include provisions related to re-hypothecation and permitted investments which are inappropriate.

- The Proposed Rules do not require that margin be posted by non-financial entities. Unlike the parallel proposed rules of the prudential regulators,[6] the Proposed Rules do not contemplate thresholds for requiring margin and only require that the risk be measured daily.[7] *As a result, the Proposed Rules contemplate unlimited credit exposures to non-financial entities, regardless of credit quality.* Any CSE which would conduct business this way is engaging in unacceptably risky behavior. If the CFTC does not require margin, the regulatory framework must reflect a rational structure for extending credit rather than simply relying on CSEs to behave prudently.

- The Proposed Rules allow non-financial entities which are counterparties of CSEs to post non-cash collateral for margin.[8] The only requirement is that the value of the collateral must be reasonably ascertainable on a periodic basis. This is only justifiable if the credit risk is documented and recognized as the extension of credit secured by the type of asset which is pledged. For example, if credit risk under a swap is secured by a lien on a power plant, it should be recognized that the transaction is the equivalent of a mortgage loan on the plant, including recognition of the illiquidity of the asset. The Proposed Rules must reflect this reality.

DISCUSSION OF THE PROPOSED RULES

CSEs Must Be Required to Post Margin.

The Proposed Rules contemplate one-way margin posting for swaps unless both counterparties are CSEs, in which case both would post. The Proposed Rules are focused specifically on the protection of CSEs from counterparty default and the management of their credit risk from derivatives transactions to the extent that posted collateral is insufficient.

This approach addresses one rationale for margining, specifically the availability of resources to CSEs in the event of a default. However, it ignores others, including the fact that margining constitutes a check on risk-taking by CSEs.[9] It also creates an asymmetric marketplace in which one side posts and the other does not. This structure ignores a basic

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[6] Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564.
[7] NOPR at 76 FR 2376-7.
[8] Proposed Rules, Section 23.157(a)(3).
[9] NOPR, 76 FR at page 2373.

premise of derivatives: a derivative priced at market levels is just as likely to move in-the-money or out-of-the money.

It has been recognized publicly by market participants that posting by banks to counterparties is only problematic if the posting obligations are not bi-lateral.[10] This is completely logical since a dealer's books are largely balanced. Therefore, the problem revolves around the counterparties for which no margin posting is required – financial entities which have a posting threshold and non-financial entities (generally, end-users) for which no posting is required under the Proposed Rules.

Assuming that the limits on margin requirements in the Proposed Rules are included in final rules, this problem is a matter of form over substance. The prudential regulators' parallel proposed rules[11] and recently published guidance on credit risk management[12] make it absolutely clear that forbearance from requiring margin in derivatives transactions is a credit transaction.

In the context of the Proposed Rules, this transaction is best characterized as the CSE having loaned the money to the counterparty to post margin and simultaneously receiving it in the form of posted margin. As long as this characterization is recognized, there is no distinction (except for the literal movement of cash) between posted margin and forbearance. Therefore, if CSEs are required to post margin, they will be doing so in a bi-laterally symmetrical environment.

This is not a strained characterization designed to justify CSE margin requirements. Rather, it is the most straightforward and transparent way to document and disclose the transaction. It simply turns out that rules promoting transparency make it obvious that two-way posting of margin is actually not problematic and should be required in the Proposed Rules. As a bi-product, the obscure and dangerous methods of dealing with counterparty risk in derivatives, which caused so much harm in the financial crisis, will no longer plague the marketplace.

The Definition of Financial Entity Should Be Expanded to Cover Federal Agencies, Government Sponsored Pension Funds and States and Municipalities.

The definition of "financial entity" includes a list of entities which are considered within the scope of the term:

- Commodity pools;
- Private funds;

[10] CFTC-SEC Joint Roundtable on Capital and Margin for Swaps and Security-Based Swaps, December 10, 2010, Remarks of Mr. O'Connor, Transcript pages 51-53 and 65.

[11] Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564.

[12] Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of Thrift Supervision - Interagency Supervisory Guidance on Interparty Credit Risk Management, June 29, 2011 ("Guidance on Credit Risk").

- Certain employee benefit plans;
- Banks and financial firms;
- Entities which would be included if they were organized under domestic law;
- Foreign governments and their instrumentalities and subdivisions; and
- Others designated by the CFTC.[13]

The components of the list are reasonable but incomplete. The list omits several types of entities that are not reasonably distinguishable from those included in the list. For example, the following entities must also be included in the scope of "financial entity:"

- U.S. agencies and instrumentalities, for example those which are engaged primarily in financial activities;
- U.S., state and local government pension funds; and
- U.S., state and local governments and agencies and instrumentalities thereof (which, like foreign governments, are closely related to the performance of the economy and the financial system).

The Proposed Rules Should Not Distinguish Between Initial and Variation Margin In Terms of Permitted Collateral and Re-Hypothecation.

In the Proposed Rules, distinctions are drawn between initial and variation margin in terms of the type of collateral which is permissible[14] and custodial requirements.[15] It appears that these distinctions are based on the following analysis of initial and variation margin.

> In contrast to initial margin, which is designed to cover potential future exposures, variation margin addresses actual current exposures, that is, losses that have already occurred.[16]

There is an alternative and, we believe, better way to characterize margining. Variation margin, based on marks-to-market or marks-to-index at the close of the prior trading day, is stale in terms of risk measurement by the time margin is posted. Prices will move one way or the other from the moment chosen to set the mark. Therefore, it is not

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13 Proposed Rules, Section 23.150.
14 Proposed Rules, Section 23.157.
15 Proposed Rules, Section 23.158.
16 NOPR , 76 FR at page 23736.

very useful to think of it as an offset for losses which have already occurred, since they might have been reversed or increased by the time that variation margin is funded.

Initial margin is a statistical estimate of the potential consequences of a default, based on a defined methodology. Derivatives counterparty risk is defined by these potential consequences. Variation margin is best viewed as a daily recalibration of the risk estimation device which calculates initial margin. The statistical methodology used for calculating initial margin must take into consideration the lagged recalibration.

Viewed in this light, re-hypothecation of variation margin is difficult to justify. It does not represent a loss which has already been experienced, but is rather integral to the calculation of potential adverse consequences on default.

Moreover, in a market based on bi-lateral margining, a CSE would expect that it is equally likely to be funding variation margin as receiving it with respect to each counterparty. If there is no re-hypothecation, the margin can be invested and the earnings on posted margin will offset the funding cost for each CSE.

Re-hypothecation allows a CSE to borrow from a margin account to provide funds for other purposes, such as posting margin on other derivatives. Using investments of margin in repurchase agreements is a short-term variation of this practice. However, as discussed above, variation margin reflects values that may have been valid at an earlier point in time, but are almost always inaccurate as time moves on. It is not a valid measure of current "loss" on a position.

A CSE which re-hypothecates these assets is using margin that it may not be entitled to if its counterparty defaults. The purported value of this practice is the net reduction of funding costs for margin generally. In fact, the CSE which re-hypothecates margin should, as a matter of equity, pay the counterparty for access to funding resulting in a wash. This practice is not justifiable in light of the increased systemic risk of resolving re-hypothecated margin in the resolution of a default in the derivatives market.

Any consideration of allowing re-hypothecation of initial margin is even less justifiable. Because of the cumulative effect of marks-to-market, variation margin is more likely to be applied in the event of a counterparty default. Changes in market prices are simply less likely to be fully reversed. Initial margin covers only adverse market price moves since the last funded mark. It is much less likely to be applied in the event of default.

If re-hypothecation is not permitted for either initial or variation margin, the rules governing permitted investments should be the same for both forms of margin. Together, they protect against the same risk: the adverse consequences of a counterparty default.

Non-Financial Entities Which Are Counterparties of CSEs Must Post Margin or, at a Minimum, Documentation Requirements Must Be Strengthened.

The Proposed Rules explicitly do not require margin to be posted by non-financial entities which are counterparties of CSEs. To the extent that the final rules adopt this approach, the CFTC must require stronger conditions relating to the documentation.

First, the rules must not accommodate a system in which unlimited credit exposures are permitted. This is such a risky behavior that requiring that thresholds be set based on reasonable credit analysis should be the unquestioned standard business practice. It is a principle which should be beyond dispute.

Certain CSEs employ credit default swap ("CDS") hedges as risk mitigation in lieu of thresholds, passing the cost of the CDS through to the counterparty.[17] This practice is only marginally better than the absence of thresholds in that it assumes the continuous availability of CDS for the named counterparty. The rules must require that, to the extent CDS are available and used, they increase the threshold but do not replace it.

The Proposed Rules require that credit support documents be put in place by CSEs with each of their counterparties.[18] These provisions are inadequate in relation to thresholds and any other margin forbearance arrangements. As pointed out above, these are credit transactions, as the prudential regulators have concluded. In addition to the terms required by the Proposed Rules, the following terms must be required:

- *Cost of the credit forbearance, distinct from the price of the swap.* In the NOPR, the CFTC acknowledges the unsurprising fact that CSEs charge for the forbearance from collecting margin and that the cost is often embedded in the price of the swap. It cites the difficulty in including pre-existing swaps in a credit arrangement which complies with the rules because "the pricing of the existing swap reflects the credit arrangements under which it was entered into...."[19] This describes a practice of non-transparent credit *and* swap pricing which runs counter to the policy of the Dodd-Frank Act. The final rules must require separate and transparent credit pricing.

- *Triggers for full funding of margin must be outlined and the potential liquidity demands described.* The Proposed Rules detail required credit support arrangements, such as initial and variation margin requirements, types and valuation of assets used and re-hypothecation and segregation requirements. However, forbearance arrangements impose the most significant obligations that CSEs must meet because they almost invariably include "credit triggers,"

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[17] Joint CFTC-SEC Roundtable on Implementation Phasing for Final Rules for Swaps and Security-Based Swaps under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, May 2, 2011, Remarks of Mr. Diplas, Transcript pages 192-3.

[18] Proposed Rules, Section 23.151.

[19] NOPR, 76 FR at page 23734.

which are generally based on credit ratings. **If a credit trigger is tripped, the counterparty is required to fully fund collateral that has been previously forborne, at the very time it is most difficult to do so.**

Because these forbearance arrangements can have such a dramatic and debilitating impact on a counterparty, they must be a primary focus of the Proposed Rules. History provides many examples (not the least of which was AIG) that the terms and conditions of credit triggers define the most important obligations associated with entering into an uncleared swap.

If Non-Cash Assets Are Used as Collateral for Margining, the Credit Terms Must Be Consistent with Lending Standards for Comparable Collateralized Lending.

The Proposed Rules permit the use of non-cash collateral by non-financial entities for margining if the value of the assets is "reasonably ascertainable on a periodic basis."[20] This standard is markedly different from the strict requirements related to liquidity and the haircuts applied to investment of cash margin.[21]

This provision addresses the common practice often described as "right-way risk deals." As an example, a power producer may enter into a swap transaction on the spread between natural gas and power prices and use a gas-fired power plant as margin collateral. The justification is that the value of the plant is hydraulically related to the spread represented by the swap. However, the value of the spread swap can be highly volatile so that the risk of loss is subject to tremendous variation. In contrast, the value of the power plant is not simply based on current energy market spreads since it is a long-term asset; and assets such as power plants are illiquid for many reasons, including lien enforcement procedures.

This practice should not be permitted. However, if it is, the credit arrangements should, at a minimum, comply with prevailing lending practices. For example, if lending against a power plant is typically limited to 75 percent of the asset value, the total lien on the asset used as margin, including financing and the margin credit, should not exceed this value. Requiring that prevailing practices be followed simply parallels the haircut rules applicable to conventional margin investments.

CONCLUSION

Prudent margining of derivatives could well have changed the results of the crisis encountered in 2008. The Proposed Rules are critical to avoiding a recurrence of those events.

[20] Proposed Rules, Section 23.157(a)(3) and (b)(3).
[21] Proposed Rules, Section 23.157(a)(2), (b)(2) and (c).

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

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