

July 11, 2011

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

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

Dear Mr. Stawick:

Markit¹ is pleased to submit the following comments to the Commodity Futures Trading Commission (“**CFTC**” or the “**Commission**”) on the proposed rulemaking to implement certain requirements included in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**DFA**”)² titled Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (the “**Proposed Rule**”).³

Introduction.

Markit is a service provider to the global derivatives markets, offering independent data, valuations, risk analytics, and related services for swaps and security-based swaps (“**SB swaps**”) across many regions and asset classes in order to reduce risk, increase transparency, and improve operational efficiency in these markets. Markit supports the objectives of the DFA, and the Commission’s objectives of increasing transparency and efficiency in the OTC derivatives markets and of reducing both systemic and counterparty risk.

Executive Summary.

The requirement for Covered Swap Entities (“**CSEs**”) to compute and collect both initial margin (“**IM**”) and variation margin (“**VM**”) for uncleared swaps across asset classes, products and counterparties will pose significant operational challenges to the marketplace. Further, for IM and VM collection to result in the desired reduction of systemic risk, their calculation needs to be performed in a reliable, unbiased, timely and consistent fashion.

We believe that the proposed rules can be improved in several aspects, and that independent third party providers (“**ITPPs**”) can provide services related to IM and VM calculations that will help achieve the above objectives while delivering benefits to all stakeholders. Specifically, we believe that: (1) the risk-based IM models in the Proposed Rule are exposed to a number of challenges because: (a) margin models used by derivatives clearing organizations (“**DCOs**”) cannot appropriately reflect the risks associated with uncleared swaps, (b) the process for approval of internal, proprietary margin models could take a significant amount of time and Commission staff resources, and (c) the Proposed Rule does not require IM models supplied by third-

¹ Markit is a financial information services company with over 2,300 employees in North America, Europe and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see www.markit.com for additional information.

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

³ Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (proposed April 28, 2011).

party vendors to be validated or tested for accuracy; (2) the “Alternative Method” for IM calculation should be more granular because utilizing only two multipliers for all types of swaps is not suitable for the whole variety of swap products. Additionally, the determination of which swaps are “comparable” should be performed by the Commission or appropriately qualified ITPPs; and (3) IM calculations would be more accurate and comparable if CSEs maximized the independence of the inputs and assumptions utilized or if those and several other determinations were independently validated. Further, CSEs should be expressly authorized to outsource IM and VM calculations to ITPPs because this will help reduce potential for disputes between counterparties and increase objectivity and verifiability in the margin calculation processes.

1. Comments on the Risk-Based IM Models

Proposed Rule 23.155(b) would require an IM model to either be: (i) currently in use by a DCO for margining cleared swaps; (ii) currently in use by an entity subject to regulation by a prudential regulator; or (iii) made available for licensing to any market participant by a vendor.⁴ We believe that these permitted IM models are exposed to a number of issues that should be addressed in the final rules.

a. DCO Models Cannot Accurately Reflect the Risks Associated with Uncleared Swaps

The first option for risk-based IM models would permit CSEs to use the models for cleared swaps that are used by DCOs.⁵ While DCOs may be well suited to provide valuations and IM for the more liquid and standardized swaps, we believe that it is not appropriate to apply a DCO IM model to swaps that are not cleared by DCOs.

Many swaps remain uncleared because they do not conform to the characteristics required by DCOs to clear them. This might be due to their insufficient liquidity, their high degree of customization, or the lack of relevant historical or current data. Since uncleared swaps may pose greater risks to counterparties than cleared swaps, we believe that their IM cannot simply be determined by using models that were designed for cleared swaps. Even if those DCO models were altered, such modifications as well as the mapping and transformation between cleared and uncleared swaps would introduce significant uncertainty and risk to the IM calculation.

Similarly, we are concerned with the Commission’s proposal to require CSEs to benchmark any IM model solely against DCO models by ensuring that “the initial margin shall be equal to or greater than an amount that would be required by the [DCO].”⁶ We are skeptical that the sole use of DCO models in this context could provide constructive comparisons for uncleared swaps. Instead, we believe that a recent IM calculation for a given uncleared swap or SB swap performed by a qualified ITPP, in addition to other valuation methods, would represent a more meaningful benchmark.

b. The Approval Of Internal Models By ITPPs Should Be Permitted

The second option for risk-based IM models would permit CSEs to use an IM model utilized by an entity subject to regular assessment by a prudential regulator.⁷ We believe that the approval of these models could create bottlenecks which would delay their use. As the Commission stated, it does not have the resources to individually review proprietary models,⁸ and many market participants are concerned that the Prudential Regulators will be unable to review these models in a timely fashion, either.

⁴ See Proposed Rule, 76 Fed. Reg. at 23746 (to be codified at 17 C.F.R. § 23.155(b)).

⁵ See *id.* at 23746 (to be codified at 17 C.F.R. §23.155(b)(1)(i)).

⁶ See *id.* at 23746 (to be codified at 17 C.F.R. §23.155(b)(2)(xiii)).

⁷ See *id.* at 23746 (to be codified at 17 C.F.R. §23.155(b)(1)(ii)).

⁸ See Proposed Rule, 76 Fed. Reg. at 23737 (“the Commission does not have the resources to review numerous models individually.”).

We therefore suggest that the Commission, in conjunction with the Prudential Regulators, permit appropriately qualified ITPPs to play a role in the assessment and approval of CSEs' IM models in order to aid or supplement the relevant prudential regulator in validating the model, and to speed up the approval process. ITPPs could, for example, provide an opinion as to whether the model adequately reflects the relevant value-at-risk ("VaR") methodology, or whether that relevant VaR methodology is itself reasonable for that particular product.⁹

c. Vendor-Supplied IM Models Should Meet Additional Defined Standards to Ensure Their Accuracy

The third option for risk-based IM models would permit CSEs to use a model that is made available to all market participants by a vendor.¹⁰ We are generally supportive of this proposal because of the flexibility it would provide to those CSEs that cannot invest in building their own IM model or would choose not to. Further, such approach would increase accuracy and reduce costs because vendor-supplied IM models can be tailored to the CSE's specific requirements and the relevant categories of uncleared swaps.

However, we believe vendor-supplied models also need to be subject to certain standards in order to ensure their accuracy and robustness. One way of ensuring this objective would be to permit CSEs to use only models that are provided by vendors whose systems, methodologies, and models have been audited for accurate control objectives and activities, and who have appropriate expertise to create IM models. These characteristics are often indicated by an SAS 70 or similar accreditation.

2. The Multipliers in the Alternative Method Should Be More Granular

The Proposed Rule would allow CSEs to use an "Alternative Method" where IM for uncleared swaps could be calculated by multiplying the margin for "comparable" cleared swaps or cleared futures by a factor of 2 or 4.4, respectively.¹¹ We believe that this approach oversimplifies the comparison between cleared swaps and futures and uncleared swaps, while being exposed to a number of challenging determinations.

First, the determination of which cleared swaps and futures are "comparable" to uncleared swaps would require mapping. We believe that to achieve comparability between CSEs, either the Commission should perform the process of mapping uncleared to cleared swaps or it should require CSEs to obtain an evaluation from ITPPs to determine the appropriateness of the mapping.

Second, the use of fixed multipliers for all asset classes and products will inevitably lead to IM requirements that are not representative of the risks of uncleared swaps. Using these fixed multipliers would not appropriately account for all of the basis risks, which are not characteristics of the "comparable" cleared swaps. For both of these reasons, the Alternative Method would result in IM requirements that are either too high or too low, resulting in systemic risk or economically damaging results.

We therefore recommend that the Alternative Method be amended to account for specific combinations of cleared and uncleared swaps. ITPPs could assist the Commission in creating a more detailed Alternative

⁹ For example, it will be important to evaluate, back test, and stress test whether an IM model will adequately capture periods of stress, including extreme and unusual scenarios such as the flash crash, the Lehman bankruptcy, or a severe recession. For a particular product, results might show that a 99% VaR is actually less appropriate than a 95% interval to capture periods of abnormal returns or liquidity risks, or that the 10-day assumption needs to be analyzed further. This method should be carefully analyzed for each swap contract due to the unique nature of uncleared swaps before the model is used, and should be monitored on regular basis thereafter.

¹⁰ See Proposed Rule, 76 Fed. Reg. at 23746 (to be codified at 17 C.F.R. §23.155(b)(1)(iii)).

¹¹ See *id.* at 23737.

Method by illustrating the differences between the market behavior and the risks of different variations of products, or by creating a proxy product to be used for margin calculation.

3. Comparability and Accuracy of IM Calculation Can Be Improved by Using Independent Sources or by Performing Their Independent Validation, And By Allowing The Delegation Of The IM Calculation to Third Parties

While we are generally supportive of the use of internal models for IM calculation, we note that certain problems could originate from their use.

First, not all CSEs will have sufficient resources to develop and receive approval for their own internal model, which would force them to use the lookup table calculation. This, in turn, could result in an un-level playing field between larger and smaller CSEs that compete for business in the marketplace. Second, the Proposed Rule would only require that CSEs establish an *internal* process to validate their IM model.¹² While we support the requirement for IM models to be validated, we believe that *requiring* IM models to be validated only internally while not requiring validation of input data creates the potential for conflicts of interest. Third, market participants will need to accurately predict pre-trade the IM that various potential counterparties will demand for a new transaction. However, this would be very difficult to achieve if most CSEs calculate IM based on their own proprietary models.

We believe that these issues could be addressed if CSEs use independent inputs and models or if those inputs and models are independently validated, and by allowing CSEs to delegate the actual IM computation to qualified ITPPs.

a. Independence of Inputs and Independent Validation

The Proposed Rule requires a CSE's IM model to be "validated by an independent third party before being used and annually thereafter."¹³ We agree that third parties would be helpful in validating margin models generally, but also believe that the Commission should ensure that the data inputs used for IM models are objective by requiring CSEs to use independent inputs or by requiring ITPPs to validate the data used.

We believe that using independent inputs and/or performing an independent assessment of input data and assumptions would provide all stakeholders with increased transparency and ultimately secure greater systemic risk reduction. Any validations should be performed on a recurring basis to take changing market conditions and advancements in methodologies into account. Notably, if an ITPP were to determine that reliable and independent data was not available, it could highlight the shortfalls of the data used and perform an analysis of the risk.

Further, ITPPs could validate the appropriateness of portfolio offsets, back tests, and stress tests.¹⁴ Calculating portfolio offsets requires one to consider complex correlation assumptions. Correlation assumptions are subjective and difficult to predict based on historical observations or theoretical considerations. Further, the correlated nature of the relevant risks will be interpreted differently by the various CSEs. ITPPs with the relevant quantitative expertise could provide an independent view into whether portfolio offsets are justified, which would reduce the subjectivity inherent in such determinations.

¹² See *id.* at 27590 (to be codified at 12 C.F.R. § __.8(f)(2)).

¹³ *Id.* at 23746 (to be codified at 17 C.F.R. § 23.155(b)(vii)).

¹⁴ Proposed Rule 23.155(c)(2) would permit parties to reduce margin in certain circumstances in order to account for portfolio offsets.¹⁴ We believe that portfolio offsets should be taken into account for IM calculation, but that they must be calculated accurately in order to ensure that IM is neither too high nor too low in relation to risk.

b. Delegation of IM Calculation To Independent Third Parties

While the above points would improve the IM models in the Proposed Rule, we believe it would be most beneficial both for counterparties and the Commission if CSEs were permitted to outsource the actual IM calculation to qualified ITPPs.

ITPP-calculated margin requirements would likely result in increased comparability, predictability, and transparency around margin calculation, would facilitate market oversight, and would reduce the potential for disputes. It would also allow all stakeholders to take advantage of economies of scale because different ITPPs would likely become leaders in calculating IM for different asset classes, products, and counterparties. Finally, because ITPPs have no direct financial interest in the margin amounts or the trades themselves, ITPP-calculated margin requirements would not be exposed to conflicts of interest and potential bias.

The Commission should note that some Prudential Regulators have explicitly proposed to permit their regulated entities to delegate the calculation of IM to ITPPs.¹⁵ We believe that the Commission should also permit CSEs to delegate the calculation of IM to ITPPs.

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We appreciate the opportunity to provide these comments on this proposed regulation.

We thank the Commission for considering our comments. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at marcus.schueler@markit.com.

Sincerely,



Kevin Gould
President
Markit North America, Inc.

¹⁵ See Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564, 27595, 27596 (published May 11, 2011) (to be codified at 12 C.F.R. §§ 624.11(a)(1)(ii); 1221.11(a)(1)(ii)).