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Division of Clearing and Risk

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CFTC Letter No. 17-51
Interpretation
October 12, 2017
Division of Clearing and Risk

Mr. Sunil Cutinho
Senior Managing Director and President
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550 W. Washington Blvd.
Chicago, IL 60661

RE: Request for Interpretation of the Commodity Exchange Act and Commission Regulations regarding the Characterization of Variation Margin Payments and all other Cash Flows for Cleared Swaps

Dear Mr. Cutinho:

This is in response to your letter dated July 17, 2017 ("Letter"), to the Division of Clearing and Risk ("Division") of the Commodity Futures Trading Commission ("Commission"). In the Letter, you asked for clarification as to whether payments of variation margin ("VM")[1] and all other payments in satisfaction of outstanding exposures on cleared swap positions would constitute settlement or collateral under the Commodity Exchange Act ("CEA") and Commission regulations. For the reasons stated below, the Division confirms that VM and all other payments in satisfaction of outstanding exposures on a counterparty's cleared swap positions constitute settlement of the outstanding exposure and not collateral against it.

I. Background

Generally, a derivatives clearing organization ("DCO") collects VM from and pays VM to its clearing members to protect against the risk of loss of the current mark-to-market value of a given contract in the event of a default by one of the parties. The characterization of VM payments for swaps varies among jurisdictions; in some, VM is treated as collateral and in others

[1] The Division understands the term "settlement variation," as used in the Letter, to mean "variation margin," as defined in Regulation 1.3(fff). *See* 17 CFR § 1.3(fff) (defining "variation margin" as "a payment made by a party to a futures, option, or swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market.").

as settlement.[2] While both models are intended to achieve the same exposure-mitigating objective, they differ in their implications for the rights and obligations of the counterparties.

a. Collateralized-to-Market Model

Under the collateralized-to-market model, parties exchange daily payments of VM collateral via their DCO. A party that has received collateral also commonly pays interest (known as price alignment interest, or "PAI") to its counterparty on that collateral. PAI is designed to replicate the practice in the uncleared markets, where a counterparty that has received collateral pays interest to the party that posted the collateral. In cleared markets, PAI eliminates the basis risk that would otherwise exist between cleared and uncleared derivatives. Thus, PAI represents the interest that would be paid on any collateral posted in connection with an uncleared swap contract.

While VM payments collateralize a party's mark-to-market exposure on a given day, the exposure between counterparties carries forward through the life of the contract, with its value moving over time and being collateralized by subsequent VM payments. If the exposure of the party that has received VM collateral on one day decreases over the course of the next day, that party will be obligated to return collateral to its counterparty and, depending on the amount by which its exposure has decreased, may need to provide further collateral to its counterparty.

b. Settled-to-Market Model

Under the settled-to-market model, parties also exchange daily payments via their DCO. In order to fully replicate the economics of the collateralized-to-market model, parties under the settled-to-market model exchange payments of price alignment amount ("PAA"), which are equal to the PAI payments that they would exchange under the collateralized-to-market model. Thus, PAA serves as an economic adjustment that represents the interest that could be earned if VM payments associated with cleared swap positions had instead been deposited as collateral to support uncleared swap contracts.

Unlike the collateralized-to-market model, however, these payments settle the outstanding exposure of the counterparties. Over the course of the following day, the parties' outstanding exposure will change and, while a new payment will be needed to settle the new end-of-day exposure, neither party will be required to return any amount paid to it to settle a previous day's exposure.

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[2] For example, European Union law requires daily VM payments, but does not specify whether such payments are required to be settled to market or collateralized to market. By way of contrast, Japanese law permits only the collateralized-to-market model.

II. Requirements under the CEA and Commission Regulations

a. CEA Section 5b(c)(2)(E) and Regulation 39.14 – Settlement Procedures

The CEA and Commission regulations require that a DCO effect a settlement at least once each business day[3] and ensure that settlements are final when effected.[4] Under Regulation 39.14(a)(1), "settlement" is defined as "[p]ayment and receipt of variation margin for futures, options, and swaps," and "[a]ll other cash flows collected from or paid to each clearing member, including but not limited to, payments related to swaps such as coupon payments."[5]

When proposing Regulation 39.14, the Commission received comments from market participants requesting that the Commission recognize clearing models that do not require daily VM payments and collections but permit accrual accounting with respect to certain energy products.[6] In response, the Commission distinguished daily VM payments from "alternative risk management frameworks" that carry forward the daily accrual of gains and losses. The Commission noted that it had not proposed and was not adopting a rule permitting exemptions for these alternative frameworks. Instead, the Commission stated that a DCO may petition the Commission for an exemption if it believes that it can demonstrate that the daily accrual of gains and losses provides the same protection to the DCO as would daily VM payments and collections. Thus, the Commission indicated that VM payments do not involve the carrying forward of daily accruals of gains and losses. Instead, VM payments settle the counterparties' outstanding exposures and reset the given contract's present value on a daily basis.[7]

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[3] *See* 7 U.S.C. § 7a-1(c)(2)(E)(i) (stating that each DCO shall "complete money settlements on a timely basis (but not less frequently than once each business day)"); and 17 CFR § 39.14(b) (requiring that a DCO "effect a settlement with each clearing member at least once each business day").

[4] *See* 7 U.S.C. § 7a-1(c)(2)(E)(iii) (requiring that each DCO "ensure that money settlements are final when effected"); and 17 CFR § 39.14(d) (requiring that a DCO "ensure that settlements are final when effected by ensuring that it has entered into legal agreements that state that settlement fund transfers are irrevocable and unconditional no later than when the [DCO's] accounts are debited or credited").

[5] 17 CFR § 39.14(a)(1)(i), (v).

[6] Natural Gas Exchange Inc. ("NGX"), a registered DCO, noted that its clearing model generally does not require daily VM payments and collections, and that settlement on its energy contracts occurs only on a monthly basis, after clearing member obligations have been netted, consistent with practices in the cash market and with the end-user nature of the vast majority of NGX clearing members.

NASDAQ OMX Commodities Clearing Company ("NOCC") intended to develop a clearinghouse that would clear energy products, including commercial forward contracts and financial forwards. While gains and losses on the commercial forward contracts and financial forwards would be calculated daily, they would accrue throughout the delivery period and following the delivery period, and would not be cash settled until final payment occurred approximately three weeks after the month in which the commodity was delivered. As a result, NOCC requested that the Commission adopt a rule that would permit exemptions for alternative risk management frameworks, which would provide DCOs with the ability to demonstrate to the Commission that daily accrual settlement of VM is a sound practice appropriately tailored to the unique characteristics of the cash energy markets and market participants for which NOCC was seeking to provide the benefits of clearing. *See* Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69,334, 69,386 (Nov. 8, 2011).

[7] *Id.*

Furthermore, when proposing the definition of "settlement" in Regulation 39.14(a)(1), the Commission received comments regarding the payment of PAA. The commenters argued that posting VM for swaps should not be viewed as "settling" the present value of the trade, noting that PAA would still be paid on VM for cleared swap positions.[8] In response, the Commission emphasized that it proposed a broad definition of "settlement" to encompass all cash flows between a clearing member and a DCO.[9] Therefore, the Commission acknowledged that all cash flows, including PAA, are characterized as settlement.

b. Regulation 22.3 – Treatment of Cleared Swaps Customer Collateral

Regulation 22.3 sets forth requirements for DCO treatment of cleared swaps customer collateral. Specifically, Regulation 22.3(a) requires a DCO to treat cleared swaps customer collateral deposited by a futures commission merchant ("FCM") as belonging to the cleared swaps customers of that FCM, and Regulation 22.3(b) requires a DCO to segregate all cleared swaps customer collateral it holds either with itself or with a permitted depository.[10]

When proposing Regulation 22.3, the Commission received comments from market participants regarding the definition of "cleared swaps customer collateral."[11] Specifically, commenters stated that the definition of cleared swaps customer collateral does not distinguish between initial margin and VM. The commenters expressed concerns that, if VM is considered collateral, Regulations 22.3(a) and 22.3(b) would prevent a DCO from taking cleared swaps customer collateral received as VM from one FCM and transferring it to an FCM whose customers are on the opposite side of the relevant trades. A commenter asked the Commission to confirm that a DCO may pass VM to the receiving party "if such [VM] is characterized as collateral and not as a settlement payment *by the parties to the swap*."[12]

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[8] *See id.* at 69,385 (discussing comments from the International Swaps and Derivatives Association and the Futures Industry Association).

[9] *Id.* at 69,386.

[10] *See* 17 CFR § 22.3(a), (b).

[11] *See* Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6,336, 6,354 (Feb. 7, 2012). "Cleared swaps customer collateral" is defined as "all money, securities, or other property received by [an FCM] or by a [DCO] from, for, or on behalf of a Cleared Swaps Customer, which money, securities, or other property: (i) Is intended to or does margin, guarantee, or secure a Cleared Swap; or (ii) Constitutes, if a Cleared Swap is in the form or nature of an option, the settlement value of such option." 17 CFR § 22.1. "Cleared swaps customer collateral" also includes "accruals, *i.e.*, all money, securities, or other property that [an FCM] or [DCO] receives, directly or indirectly, which is incident to or results from a Cleared Swap that [an FCM] intermediates for a Cleared Swaps Customer." *Id.*

[12] *See* Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. at 6,354 (discussing comments from the International Swaps and Derivatives Association and the Futures Industry Association).

Similarly, a registered DCO requested clarification that a DCO that has received VM may use such funds to settle variation for offsetting swaps. The DCO argued that without an amendment permitting DCOs to treat VM as a pass through, "clearinghouses could effectively be prohibited from clearing much of the [over-the-counter] swaps market as it transacts today."[13]

In response, the Commission recognized the concerns expressed by commenters and confirmed that Regulation 22.3 is intended to permit DCOs to use VM collected from cleared swaps customers to pay VM to, among others, cleared swaps customers. As a result, the Commission confirmed that VM payments associated with cleared swaps constitute settlement of a counterparty's outstanding exposure and not collateral against it.

III. Conclusion

Given that cash flows between a clearing member and a DCO under the collateralized-to-market model would secure obligations rather than extinguish them, such payments would not satisfy Commission regulations that require daily settlement that is irrevocable and unconditional. In adopting Regulation 39.14, the Commission explicitly differentiated between the daily accrual of gains and losses and daily settlements that are irrevocable and unconditional. The Commission also emphasized the view that the definition of "settlement" is broad and includes all cash flows between a clearing member and a DCO.

Similarly, in adopting Regulation 22.3, the Commission confirmed that VM payments are not considered collateral, as such payments may be used to settle variation for offsetting swaps. As a result, the Division confirms that VM, PAA, and all other payments in satisfaction of outstanding exposures on a counterparty's cleared swap positions constitute settlement under Section 5b(c)(2)(E) of the CEA and Regulation 39.14. Accordingly, the Division notes that a DCO's rules must reflect that VM payments constitute settlement of outstanding exposures.

This letter represents the position of the Division only and does not necessarily represent the views of the Commission or those of any other division or office of the Commission. Any different, changed, or omitted material facts or circumstances may require a different conclusion or render this letter void. Finally, as with all interpretative letters, the Division retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the interpretation provided herein, in its discretion. Should you have any questions regarding this matter, please contact Parisa Abadi, Special Counsel, at (202) 418-6620.

Very truly yours,

John C. Lawton
Acting Director

[13] *See id*. (discussing comments from Intercontinental Exchange, Inc.).