asset management group

December 16, 2016

Via Email

Board of Governors of the Federal Reserve System
Commodity Futures Trading Commission
European Banking Authority
European Commission
European Insurance and Occupational Pensions Authority
European Securities and Markets Authority
Farm Credit Administration
Federal Deposit Insurance Corporation
Federal Housing Finance Agency
Japan Financial Services Agency
Office of the Comptroller of the Currency

Re: Uncleared Swap Margin Requirements – Request for Relief from March 1, 2017 Variation Margin Implementation

Dear Sirs and Madams:

The Securities Industry and Financial Markets Association's Asset Management Group (**SIFMA AMG** or **AMG**)[1] writes to request relief for variation margin requirements applicable as of March 1, 2017 to counterparties not already included in phase 1 implementation of the uncleared swap margin requirements, namely counterparties with an average aggregate notional amount (**AANA**) of non-centrally cleared derivatives below US$/EU€ 3 trillion. We believe this relief is urgently required to protect asset managers' clients, including those who are served by smaller asset managers and those who utilize foreign exchange (**FX**) hedges from being excluded from the derivatives markets.

While all market participants, including asset managers, have endeavored to comply with the variation margin regulatory requirements scheduled to begin on March 1, asset managers continue to

[1] SIFMA AMG's members represent U.S. and multi-jurisdictional asset management firms whose combined global assets under management exceed $34 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

New York | Washington
120 Broadway, 35th Floor | New York, NY 10271-0080 | P:212.313.1200 | F:212.313.1301
www.sifma.org

work through complex issues of application and interpretation, and are unable to fully utilize industry-wide efforts to standardize and automate required documentation. These challenges combined with limited dealer and custodian bandwidth has made it unlikely that the implementation efforts will cover all client needs by March 1.

Investors whom asset managers serve as fiduciaries, including retail investor funds (*e.g.*, U.S. mutual funds, EU UCITS) and public and private pension funds, may lose access to derivatives markets or have far fewer dealer counterparties to execute transactions, decreasing liquidity and increasing costs with the real possibility of limited execution options. The clients most at risk include those that have used FX derivatives to hedge currency risks and smaller clients or clients served by smaller asset managers. These consequences may impact the ability of asset managers to hedge and manage investment risks and to achieve best execution on transactions.

For these reasons, detailed further below, we request that all jurisdictions provide a transitional period beginning on March 1 to permit the rolling, prospective application of variation margin requirements, allowing market participants to make reasonable and continuous progress towards the exchange of variation margin. While we have considered whether this request could be limited to a subset of market participants (*e.g.*, market participants below a specified AANA), such limitations would create challenges of their own as this information is not available and systems do not categorize counterparties on this basis.

We further request additional time for FX products due to the concentration of work to be completed for those products.

Finally, we request that regulators reassess the cross-border policies that are causing multiple jurisdiction's requirements to apply to single transactions and single counterparty pairs. The absence of meaningful substituted compliance has been a key driver of complexity and inability for market participants to act in the absence of a complete global rulebook applicable to swaps across all jurisdictions. We urge regulators to consider deferring to each other's rules when the jurisdiction complies with internationally-agreed principles.

1. CURRENT IMPLEMENTATION DEADLINES

The following implementation deadlines are currently scheduled in major over-the-counter derivatives markets for market participants subject to variation margin requirements not already covered by phase 1 implementation:

Australia, Hong Kong and Singapore: On December 6, 2016, the Australian Prudential Regulation Authority (**APRA**), Hong Kong Monetary Authority (**HKMA**) and Monetary Authority

of Singapore (**MAS**) announced their implementation timetables.[2] Each jurisdiction announced that variation margin implementation would begin on March 1, 2017 with a 6-month transitional period through August 31, 2017, during which the entities to which the requirements apply will be expected to make reasonable and continuous progress towards the implementing the requirements.

Europe: The European Commission's regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty were published in the Official Journal of the European Union on December 15, 2016, resulting in phase 1 implementation by February 4, 2017 and variation margin implementation by March 1, 2017.[3]

Japan: The Financial Services Agency's final margin rules have a variation margin implementation date of March 1, 2017.[4]

United States: Market participants subject to the variation margin requirements of the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, Federal Housing Finance Agency and Office of the Comptroller Commodity Futures Trading Commission (the **U.S. Prudential Regulators**) and the Commodity Futures Trading Commission (**CFTC**) have a compliance date of March 1, 2017. [5]

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[2] APRA release available at: http://www.apra.gov.au/MediaReleases/Pages/16_52.aspx; HKMA release available at: http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2016/20161206e1.pdf; MAS release available at: http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Response%20to%20Feedback%20Recd%20Policy%20Consultation%20on%20Margin%20Requirements%20for%20NonCentrally%20Cleared%20OTC%20Derivatives%20Contracts.pdf.

[3] The European Commission's regulatory technical standards are available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN.

[4] Financial Services Agency's Final Rules are available at: http://www.fsa.go.jp/news/27/syouken/20160331-4.html.

[5] Department of the Treasury Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and Federal Housing Finance Agency, Margin and Capital Requirements for Covered Swap Entities; Final Rule, 80 Fed. Reg. 74840 (Nov. 30, 2015); Commodity Futures Trading Commission, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule, 81 Fed. Reg. 636 (January 6, 2016).

2. INVESTORS MOST AT RISK WITH MARCH 2017 VARIATION MARGIN IMPLEMENTATION

2.1. Clients that Use Foreign Exchange for Hedging Purposes

Significant work remains for clients who have not historically margined their derivatives exposure. These clients generally include those who use derivatives to hedge FX risk. Due to the short tenor and high liquidity of these derivatives and the hedging purpose of the transactions, a number of market participants have traded these instruments without imposing margin requirements.

Now that certain FX products are in scope as of March 1, asset managers have significant steps remaining to bring these clients into compliance. Requirements that impact these clients have been in flux until recently and differ across jurisdictions, which has left a limited amount of time to tackle a wide variety of obligations that are associated with new obligations to collateralize. Clients still need to put in place numerous collateral agreements and, to comply with segregation requirements for certain types of funds, custodial account agreements, and to liquidate assets in order to have collateral available in advance of March; progress has been hampered due to several challenges that are having market-wide impact.[6]

2.2. Clients with Smaller Derivatives Exposure

Clients that use derivatives minimally, have smaller assets under management or have engaged asset managers with smaller derivatives books are being handled by dealers as a lower priority and, as such, have a greater risk of losing trading access as well as having significant impacts to investment strategies.

3. CURRENT CHALLENGES ACROSS ALL CLIENTS

The absence of substituted compliance has been a key driver in the complexity and inability for market participants to act in the absence of having the complete rulebook applicable to swaps across all jurisdictions. While the architecture of the ISDA Master Agreement, the standard form of over-the-counter derivatives transactions, is founded upon having one set of agreed principles across all applicable jurisdictions of the counterparties, the multiple rule sets that may apply to transactions confirmed under a single ISDA Master Agreement are breaking this model. Certain special

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[6] Although a limited number of clients have FX brokerage arrangements that reduce the account set up burdens, these arrangements are the exception for AMG members' clients and would not provide a means to streamline compliance at this time. Many AMG members do not utilize FX brokerage services and the few that do only use it for a limited number of accounts for which the expense and additional credit requirements are outweighed by the benefits. In addition, the concentration of FX counterparty risk with one dealer is not acceptable for many clients. Further, setting up an FX brokerage accounts takes months under normal circumstances, and likely would take longer due to the ongoing implementation efforts, eliminating it as an option to streamline current workflows.

circumstances, such as a counterparty not covered by a netting opinion or the application of minimum transfer amount to separately managed accounts, forces customization in documentation and complex operationalization of the changes. With standards released serially, jurisdiction by jurisdiction, counterparties have had to understand a multitude of evolving requirements imposed upon each dealer and counterparty pair and apply those requirements on a bespoke rather than standard basis. This result comes notwithstanding the adoption of internationally-agreed standards across major jurisdictions.[7]

Based upon interviews of more than twenty asset managers, we have provided an overview of the key challenges and, where we can, anecdotal data to further describe these issues. We have not, however, cataloged all issues and believe that there likely will continue to be unforeseen complications that arise before variation margin implementation has been completed.

3.1. Documentation Challenges

One of the key challenges for compliance with the March 1 deadline is the negotiation and execution of documentation for collateral arrangements that comply with the regulatory requirements. This process involves agreeing to new documentation with counterparties or negotiating amendments to existing documents, which, in most cases, is the ISDA Credit Support Annex (**CSA**) to the ISDA Master Agreement.

To facilitate this process, ISDA has published the ISDA 2016 Variation Margin Protocol (**CSA Protocol**). The CSA Protocol, however, does not eliminate the need for counterparties to negotiate certain key terms. In addition, many SIFMA AMG members have indicated that they or their counterparties will not use the CSA Protocol but rather will need to negotiate bilateral amendments for reasons, including:

a) *CSA Protocol amendment option is not being used.* The CSA Protocol provides a mechanism for parties to amend existing contractual relationships, thereby preserving the parties' negotiated terms to the extent permitted by regulations. However, a challenge with this approach for both buy-side and sell-side firms is that the output that results from this amendment is the parties' original bilateral CSA and an overlay that complies with the jurisdictions identified by the counterparty pairs. After completing the matching process provided by the CSA Protocol, the two documents must then be reconciled and interpreted for operational purposes. Put differently, the CSA Protocol's amendment option does not result in a single document that contains the full agreement of the parties. As such, CSAs amended through the Protocol in this fashion may have increased disputes over what terms apply. As a result, use of the CSA

[7] Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, Margin requirements for non-centrally cleared derivatives (September 2013), available at: http://www.bis.org/publ/bcbs261.pdf (**BCBS-IOSCO Margin Requirements**).

Protocol's amendment options are not being utilized as broadly as SIFMA AMG members had anticipated. While the Protocol also offers a New CSA Method that avoids this issue by putting in place a new CSA on new terms, this approach is not generally acceptable for clients that already have a CSA in place, especially those for whom very few terms need to be changed to bring the CSA into compliance.

b) *CSA Protocol's new agreement option does not satisfy legally-mandated segregation requirements for funds.* With respect to the CSA Protocol's new agreement option, the CSA Protocol does not currently work for those funds that are required by other regulations to segregate variation margin they have posted because the New CSA method does not incorporate provisions allowing for segregation of collateral at a third-party custodian. This prevents those funds, which include U.S. mutual funds, Irish funds and Luxemburg funds, from using the New CSA Method. If the CSA Protocol's amendment options are also not acceptable for the fund or dealers, then it cannot currently use the CSA Protocol. We understand that ISDA is working to add a New CSA solution for these funds to the CSA Protocol, but it is not likely that the relevant documentation changes will be agreed and implemented in the electronic platform before March 1, 2017. Adding complexity, these requirements may need to be satisfied differently for the different fund types. These challenges are in addition to the documentation challenges for clients that do not have in place agreements with custodians for segregation of margin.

c) *Limitations for umbrella agreements.* Asset managers that use umbrella agreements may decide not to use the CSA protocol because doing so means that new clients (including newly launched funds) would either need to be added to the CSA Protocol on an ongoing basis or the umbrella would need to be amended bilaterally outside of the CSA Protocol. This result is different from some other protocols that amended umbrella agreements without an additional bilateral step. The majority of the asset managers providing feedback for this letter utilize umbrella agreements, i.e., core terms memorialized in a single "umbrella" form of agreement used for multiple underlying clients transacting with a dealer. Since different regulatory variation margin requirements apply based on each client's jurisdiction, the CSA Protocol amends the agreements at the individual client to counterparty level, and does not amend the "umbrella" form. As a result, new clients and newly-launched funds would either need to adhere to the CSA Protocol, or the asset manager and dealer would need to amend the "umbrella" agreement bilaterally.

d) *Limitations for counterparties that are not covered by a netting opinion*. Because counterparties for which a netting opinion cannot be obtained must use non-standard documentation, the CSA Protocol cannot be used. While this population represents

a small group, it must be addressed bilaterally and will consume resources to establish the collecting and posting of margin by the client on a gross basis.

In light of these challenges, the anticipated use of bilateral agreements is larger than previously expected, with more time needed as a result to put those bilateral agreements in place. While we cannot comprehensively calculate the number of agreements and counterparty pairs with CSAs requiring amendments or needing new CSAs, we believe that AMG members collectively have thousands of client/dealer pairs that need to be addressed. For example, one medium-size asset manager has 250 mutual funds that need new CSAs to be executed with around 30 FX dealers. This same asset manager has many other client types/dealer pairs that require new or amended CSAs. Another medium-sized asset manager has approximately 250 CSAs that need to be amended with approximately 30 brokers and 30 separate accounts that need new CSAs with 20 brokers.

For clients requiring segregation of variation margin due to legal requirements, including U.S. mutual funds, Irish funds and Luxemburg funds, additional agreements must be amended or entered into to establish segregated accounts at the custodians. No "protocol" solution is available to address these additional documentation needs, which require the attention of both the custodians and the dealers.

3.2. Limited Dealer and Custodian Bandwidth

Dealer and custodian bandwidth, which has understandably been taken up by phase 1 implementation in the U.S. last September and currently in Europe, has been further taxed by the reduced use of the CSA Protocol. While dealers have discussed steps to be taken for March with some asset managers and taken steps towards negotiation of bilateral amendments for some existing CSAs, the dealers are still challenged by overall readiness and have limited bandwidth to address buy-side needs. To the extent market participants will be able to put some trading relationships in place, they are likely to gravitate towards a small number of the largest dealers (who would generally be the most important trading counterparties), causing potential decreases in liquidity and perhaps unintended consequences on risk concentration and stress on the financial system. Further, the custodial requirements for buy-side clients, including the need to have segregation of variation margin due to fund regulations, must also fit within the narrow bandwidth available for working with both dealers and custodians to establish and amend account control agreements. The most at-risk investors (described above) are and will continue to experience chronic problems in their access to dealers and are most likely to face problems associated with limited liquidity as of March 2017 in the absence of relief.

3.3. Minimum Transfer Amount

Challenges of applying the minimum transfer amount to separately managed accounts, an issue detailed in our recent letter to U.S. regulators,[8] adds difficulty in completing transactional documents, account set ups and operational workflows. The barriers are both informational and operational. Asset managers lack the information to calculate whether the minimum transfer amount has been exceeded across the clients' separate asset managers and the operational complexities of customized minimum transfer amounts for each separately managed account would require significant builds, if even possible. The consequences of this rule not meeting the realities of how assets are managed for separate account clients are causing undue burdens on an implementation area that is of inconsequential impact to the overall risk-reducing rationale for margining swaps. AMG members are currently concluding that many of these accounts must have a minimum transfer amount of zero or maintain a very low MTA, which will increase costs and volumes of collateral transfers for both the dealer and client and burden custodians having to handle the volume.

3.4. Operational Challenges

Once CSAs and account control agreements are put in place, significant work is required to operationalize these terms. Among other things: the terms of the CSA need to be extracted, translated into collateral management systems and uploaded; upgrades to collateral management software need to be provided and tested; automated processes for collateral calls require significant initial work to onboard clients; custodial set-ups need to be implemented; for clients with multiple netting sets within a single account (i.e., for clients who have separate netting sets for pre-March 1 and post-March 1 transactions), special operational support is required; processes for responding to collateral calls, including identifying securities to be delivered or returned, need to be set; custodian cut off times for wiring funds or securities need to be established.

4. RELIEF REQUESTED

While we believe the CFTC, European Banking Authority, European Commission, European Insurance and Occupational Pensions Authority, European Securities and Markets Authority, Financial Services Agency and U.S. Prudential Regulators are in the best position to assess the means by which these global implementation issues should be addressed, we make the following recommendations to alleviate these problems:

a) **Six-Month Transition Period Beginning on March 1, 2017 for all counterparties not covered by phase 1 implementation**. By allowing prospective application of variation margin as market participants use their best efforts to implement across all counterparties on a rolling basis, market participants would be

[8] *See* AMG Letter, *available at*: http://www.sifma.org/issues/item.aspx?id=8589963383.

able to make progress without the threat of loss of access to important financial instruments. We request that this relief is provided without requiring any backloading of trades, which would create separate challenges. While we have considered whether this request could be limited to a subset of market participants (*e.g.*, market participants below a specified AANA), such limitations would create challenges of their own as this information is not available and systems do not categorize counterparties on this basis.

b) **Further Extension for FX products**. Given the extensive work that needs to be done to prepare for margining of these products due to the number of buy-side clients who have never margined FX, we believe a subsequent staging of FX products would help market participants that engage in this limited trading.

c) **Use of substituted compliance across jurisdictions that have complied with the BCBS-IOSCO Margin Requirements.** We urge regulators to fully utilize substitute compliance for jurisdictions that have complied with the BCBS-IOSCO margin requirements. The BCBS-IOSCO margin requirements set forth the agreed principles to address credit and counterparty risks that arise from bilateral derivatives exposure. The adoption of these internationally agreed principles in major jurisdictions not only cover these concerns within each jurisdiction, it also addresses the cross-border risk of regulatory arbitrage between them. We urge the regulators to reduce cross-border complexity and regulatory burden by agreeing to defer to other BCBS-IOSCO-compliant jurisdictions and to do so on a more holistic basis.

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If you have any questions, please do not hesitate to contact Tim Cameron at 202-962-7447 or tcameron@sifma.org, or Laura Martin at 212-313-1176 or lmartin@sifma.org.

Respectfully submitted,

Timothy W. Cameron, Esq.
Asset Management Group – Head

Laura Martin, Esq.
Asset Management Group – Managing Director and Associate General Counsel