| asset management group

March 15, 2013

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| Basel Committee on Banking Supervision | International Organization of Securities |
| Bank for International Settlements | Commissions |
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Re: Comment Letter on the Second Consultative Document for the Margin Requirements for Non-Centrally-Cleared Derivatives

To Whom It May Concern:

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to provide the Basel Commission on Banking Supervision (the "**BCBS**") and the Board of the International Organization of Securities Commissions ("**IOSCO**") (together with BCBS, "**BCBS/IOSCO**") with our views on the recently released second consultative document on margin requirements for non-centrally cleared derivatives (the "**Second Consultative Document**").[2] The AMG previously commented on BCBS/IOSCO's first consultative

[1] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds. In their role as asset managers, AMG member firms, on behalf of their clients, engage in transactions for hedging and risk management purposes that will be classified as "security-based swaps" and "swaps" under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

[2] Second Consultative Document Issued by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions on Margin Requirements for Non Centrally-Cleared Derivatives, *available at* http://www.bis.org/publ/bcbs242.pdf.

document on the topic (the "**First Consultative Document**")[3] in a letter submitted September 28, 2012 (the "**September 2012 Letter**").[4]

We support the efforts of BCBS and IOSCO to develop international standards for the exchange of margin for uncleared derivatives and believe that all jurisdictions should develop national rules based on the final standards adopted by BCBS/IOSCO, as informed by our comments below. Because this letter arises in response to the recently published Second Consultative Document, its organization follows the order of the Second Consultative Document's key principles, focusing on those sections for which BCBS/IOSCO has sought additional comment.

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[3] Consultative Document Issued by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions on Margin Requirements for Non-Centrally-Cleared Derivatives, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf.

[4] SIFMA AMG Letter to the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions on the Consultative Document on Margin requirements for non-centrally-cleared derivatives (Sept. 28, 2012), *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=8589940536.

## I. Scope of Coverage – Instruments Subject to the Requirements

### A. Foreign exchange swaps and foreign exchange forwards should not be subject to margin requirements.

The Second Consultative Document seeks comment on whether physically-settled FX forwards and swaps should be exempted from margin requirements.[5] As noted in our September 2012 letter, the AMG believes that, worldwide, margin requirements should not apply to foreign exchange swaps and forwards ("**FX Products**"). We believe that FX Products pose less risk than other derivatives and, because these risks are already appropriately mitigated, FX Products should not be subject to mandatory margin requirements.

Both Consultative Documents note that margin requirements for non-centrally-cleared derivatives should have two main benefits: promotion of central clearing and reduction of systemic risk.[6] We do not believe that applying margin requirements to FX Products would serve either of these two goals. FX Products are essential tools to effectively manage currency risk; if use of these instruments becomes prohibitively expensive or too administratively burdensome, then market participants may forego hedging opportunities, which may impair the functioning of the FX Product market and result in additional risk in the marketplace.

First, a margin regime that incentivizes central clearing for FX Products is not appropriate because the market for FX Products is already highly liquid and transparent. Central clearing would require market participants to either clear FX Products directly or develop relationships with clearing members. The cost and operational challenges of doing so outweigh the limited reduction in risk that could result from clearing, thereby providing a disincentive to clear these products. Any mandatory margin regime that seeks to incentivize clearing will therefore be unnecessarily punitive to FX Products by raising costs of legitimately trading these products in a bilateral, uncleared world. As a result, many participants globally will find it much more expensive to do basic transactions in the international market, especially those incorporating FX Products to hedge risks and adjust timing of currency payments and deliveries to match their business needs; even if exempt from a margin regime as end-users, these costs may be passed down to them.

Second, discouraging activity in FX Products will not reduce systemic risk, as global settlement systems such as CLS Bank International ("**CLS**") already serve this purpose. FX Products have low replacement cost risk. Also, CLS and other payment-versus-payment settlement systems have already essentially eliminated the settlement risk for those participants that utilize them. Subjecting FX Products to an additional regulatory regime could undermine continuing efforts of central banks to reduce settlement risk in

[5] Second Consultative Document at 6, Q1.

[6] First Consultative Document at 2; Second Consultative Document at 2.

the foreign exchange market. In essence, a mandatory margin regime would distract participants from further reducing settlement risk and transaction costs in an effort to reduce replacement cost risk.[7]

While the AMG believes that the above reasoning supports the exclusion of all FX swaps and forwards from any mandatory margin regime, we believe that application of a mandatory margin regime to the deliverable FX Products would be particularly inappropriate. Deliverable FX Products will not be required to be cleared in the United States. In the time since our September 2012 Letter, the U.S. Treasury Secretary has finalized an exemption of such products from clearing and certain other swap regulation,[8] noting the unique aspects of these instruments, such as fixed payment obligations, physical settlement and short tenor, that would make subjecting such instruments to mandatory clearing inappropriate.[9] We agree with this logic and supported the U.S. Treasury Secretary's determination. We believe that the same rationale applied by the U.S. Treasury Secretary for exempting these instruments from being cleared and most other U.S. swap regulation should be applied by BCBS/IOSCO in exempting them from margin requirements.

**B. If BCBS and IOSCO recommend margin requirements for FX Products, supervisory guidance is the preferred course of action.**

If FX Products are not exempted from the BCBS/IOSCO margin recommendations, we believe that any margin requirements for these instruments should be made in the form of supervisory guidance, as opposed to national regulation. We believe that supervisors should be given the authority to implement any guidance relating to FX Products in their respective jurisdictions, taking into consideration the size, nature, complexity and risk profile of the market for these instruments within their jurisdiction. Doing so would empower local supervisors to consider the particular infrastructure and/or legal framework specific to their respective markets, as well as available risk mitigation techniques, rather than requiring the adoption of a prescriptive approach in all jurisdictions.

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[7] The First Consultative Document asked whether "foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year [should] be exempted from margining requirements due to their risk profile, market infrastructure, or other factors." First Consultative Document at 14. As stated above, we believe that all FX Products should be excluded from uncleared margin requirements. Any mandatory margin regime based on tenor will incentivize institutions to hedge their currency risk using shorter-dated FX Products for which margin is not required and be subject to greater FX currency risk than desired. However, if BCBS/IOSCO do not find it appropriate to exclude all FX Products, we believe that at the least FX Products with a maturity of less than one year should be exempt. Such short-term FX Products do not pose the kinds of risk intended to be addressed by the mandatory clearing requirements, and in the uncleared context, requiring margin creates burdens outweighing any potential risk reduction benefit.

[8] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 20, 2012).

[9] *Id.* at 69695.

## II. Scope of Coverage – Scope of Applicability

### A. BCBS/IOSCO should clarify the concept of a "consolidated group" and the applicability of the €8 billion phase-in level and the €50 million uncollateralized threshold for initial margin.

The Second Consultative Document would apply initial margin requirements, after a phase-in period, such that "there will be a minimum level of non-centrally cleared OTC derivatives activity (€8 billion of gross notional amount) necessary for covered entities to be subject to initial margin requirements."[10] In addition, it permits counterparties to uncleared derivatives to maintain up to a €50 million uncollateralized threshold with each other.

There are some ambiguities in how these thresholds will be applied. Although the Second Consultative Document reiterates the position of the First Consultative Document that margin requirements are bilateral with both counterparties posting and collecting margin,[11] the relationship between the €8 billion application level and universal bilateral requirements is not clear. Accordingly, we ask BCBS and IOSCO to confirm that no initial margin requirements would apply to either counterparty to a derivative where one counterparty to the derivatives has uncleared derivatives positions in excess of €8 billion and the other has uncleared derivatives positions of less than €8 billion.

In addition, the Second Consultative Document indicates that both of these thresholds will be "applied on a consolidated group basis."[12] However, it does not offer additional detail on what will be considered a consolidated group.

We believe that the aggregation of uncleared derivatives positions should depend on the source of recourse by the counterparty and that, in particular, no aggregation as a "consolidated group" should be required across portfolios managed by the same asset manager. For example, two separate funds managed by the same asset manager should not be aggregated for purposes of computing both the €8 billion and €50 million thresholds. In addition, there are two particular areas of concern to asset managers in determining the thresholds. First, positions in different portfolios within a series trust are subject to limited recourse and are managed separately, in accordance with well-established market practice,[13] and there is generally no risk transfer through which evasion of margin requirements could occur. As a result, the positions in these separate portfolios should not be aggregated together in determining whether they meet the €8 billion or €50 million levels. Second, a single client may have a number of separate

[10] *Id.* at 2(h).

[11] *Id.* at 7, 2(d); *see also* First Consultative Document at 9.

[12] *Id.* at 9, 2(i).

[13] Each portfolio in a series trust may be created as a separate pool of assets with its own discreet set of shareholders and liabilities under United States securities laws; under these structures, the assets of one portfolio may not be used to meet the liabilities of other portfolios.

accounts with different managers entering into derivatives on its behalf. Unlike the situation of affiliates within a corporate group that can communicate with each other to ensure they remain below a consolidated group threshold, multiple asset managers of a separate account client will not know of each other's existence or have the ability to manage the derivatives positions, on a group basis, to remain below a common threshold. Any concerted effort or shared communications would likely violate the managers' contractual or fiduciary obligations. In addition, a single asset manager may manage multiple accounts for the same separate account client, with no recourse or risk transfer between the accounts. Where two accounts do not share a source of recourse and do not transfer risk between each other, the accounts should be viewed separately for purposes of the €8 billion and €50 million levels.

Lastly, with respect to calculating an entity's position relative to both the €8 billion level for the application of margin requirements overall and the €50 million initial margin requirement, we ask BCBS and IOSCO to confirm that any uncleared derivatives that are not subject to margin requirements, potentially including foreign exchange swaps and forwards, would not be counted towards this threshold.

**B. Thresholds larger than €50 million should apply where the regulatory status or activity of a party limits the risk posed to its counterparty.**

We agree with BCBS/IOSCO that a general initial margin threshold of €50 million is appropriate to minimize the effect of margin requirements on liquidity. However, since initial margin is meant to protect against the potential future risk posed by a counterparty, we believe that parties that pose little credit risk to their counterparties should not be required to post initial margin or should at least be subject to larger uncollateralized thresholds. Specifically, we believe that there are certain entities that, through regulation that establishes capital or funding requirements, restricts the use of leverage or requires prudent diversification, pose so little credit risk to their counterparties and so little systemic risk to the financial system that they should not be required to post initial margin at all. In addition, we believe that there are other market participants that, either through regulation or through prudent use of derivatives, pose less counterparty and systemic risk than most derivatives market participants and, as a result, should be subject to higher initial margin posting thresholds than other market participants. In our September 2012 Letter, we suggested a model for classifying counterparties to uncleared derivatives transactions by the risk they pose to their counterparties, along with an accompanying ranking of thresholds reflecting the relative risk posed by those entities. We have attached that section of our September 2012 Letter as Appendix A.

## III. Treatment of Provided Margin

**A. Derivatives counterparties that post initial margin should be able to elect to have that initial margin segregated at a third-party custodian, with appropriate protections. Initial margin posted for uncleared derivatives but not held in third-party custody should be treated as customer property of an insolvent counterparty, protected against the claims of general creditors. Limited re-hypothecation should be allowed to finance or hedge customer**

**positions as long as re-hypothecated customer assets are adequately protected.**

The Second Consultative Document, like the First Consultative Document, states that initial margin should be exchanged by both parties on a gross basis and held in a manner that ensures that the initial margin is immediately available to the collecting party in the event of the posting party's default and that margin is protected in the event of the collecting party's bankruptcy.[14] Following this principle, the First and Second Consultative Documents also propose that "[c]ash and non-cash collateral collected as initial margin should not be re-hypothecated or reused."[15]

We believe that the final consultative paper should include additional detail around this requirement to ensure that customer margin is held safely and securely. Specifically, we believe that each counterparty to a derivative that posts margin should be permitted, but not required, to elect to have their margin segregated at a third-party custodian. Ideally, a party that elects third-party custody of its initial margin, which may raise the cost of the derivative to that party, should be assured that such margin will be returned to it in full in the case of the default of the collecting counterparty and, specifically, that the margin will not be shared pro-rata with other counterparties of the defaulting party, in all jurisdictions.

We further believe that initial margin, even where not segregated, should be treated differently from general creditor funds in the event of a default of the collecting party. Such initial margin should be treated as customer property in an insolvency of the collecting party rather than the customers being treated as general unsecured creditors. We would prefer that such margin be provided through pledges rather than title transfer to ease return in the case of an insolvency of the collecting party. We believe that such protections for parties posting initial margin are necessary to ensure the safety of funds posted by market participants, including AMG members' clients.

Finally, in response to the question posed by BCBS and IOSCO, we believe that limited re-hypothecation should be allowed to finance or hedge customer positions as long as the assets are appropriately protected. Without this limited form of re-hypothecation, we fear that uncleared derivatives transactions could, in many cases, become prohibitively expensive. While we understand that the three conditions listed by BCBS and IOSCO are meant to protect customer assets, we believe that it may be difficult to meet all three conditions in some cases because of the insolvency regimes in place in many jurisdictions. Instead, we believe that BCBS and IOSCO should take a less prescriptive approach and encourage national supervisors, while any necessary changes to insolvency law are being made, to allow limited re-hypothecation to finance or hedge customer positions as long as there are protections for the customers that are appropriate given the insolvency regimes in place in the jurisdiction.

[14] Second Consultative Document at 18; First Consultative Document at 25.

[15] *Id.* The Second Consultative Document also seeks comment on whether rehypothecation should be permitted. Second Consultative Document at 19, Q2.

**General Support of BCBC/IOSCO Guidelines**

As mentioned above, we are in agreement with the international standards proposed by BCBS/IOSCO in the Second Consultative Document, as informed by our comments herein. In particular, we support BCBS/IOSCO's views on bilateral exchange of margin,[16] initial margin thresholds and the use of models,[17] all as appropriately updated by our comments. We also strongly support the proposed phase-in period for margin requirements. A gradual transition over time will minimize disruption to global derivatives markets, allowing adequate time for national supervisors to put their rules into place and to coordinate with each other to implement the regulatory framework in a consistent manner. We believe that it is important for national jurisdictions to adopt similar rules, using the BCBS/IOSCO guidelines as a standard, to maximize international consistency and legal certainty in the global derivatives markets.

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[16] Our views on bilateral margining, as reflected in our September 2012 Letter, are attached as Appendix B.

[17] As described in our September 2012 Letter, we believe that margining using models should allow for risk offsets across any instruments or asset classes subject to the same master netting agreement so long as there is a "sound theoretical basis and significant empirical support," as proposed by the U.S. Commodity Futures Trading Commission. We have attached the section of our September 2012 Letter relating to models as Appendix C.

The AMG appreciates the opportunity to provide BCBS and IOSCO with our comments and recommendations concerning the margin requirements for uncleared derivatives. Should you have any questions, please do not hesitate to call Tim Cameron at 212-313-1389 or Matt Nevins at 212-313-1176.

Respectfully submitted,

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## APPENDIX A

### II.D. Regulators should divide financial entities into five categories, to which different thresholds apply (in decreasing order): (i) regulated low-systemic risk entities, (ii) prudentially-regulated entities, (iii) low-risk financial entities, (iv) other entities (other than key market participants) and (v) key market participants.

The Consultative Paper divides market participants into three categories to which different thresholds may apply: prudentially-regulated entities, "key market participants" and entities that are neither. This largely aligns with the approaches in the U.S. Proposals, which would divide market participants into Swap Entities (which we believe is roughly equivalent to "key market participants"), high-risk financial end users (which we believe is roughly equivalent to other market participants) and low-risk financial end users (which we believe is roughly equivalent to prudentially-regulated entities). In the Consultative Paper, allowable thresholds would be lowest for "key market participants"/Swap Entities, highest for prudentially-regulated/low-risk financial entities, and in between for others/high-risk financial entities. While we agree with the general approach of allowing for higher thresholds for entities that are highly regulated or otherwise pose less risk, we believe that five categories, rather than three, are necessary.[18]

**1. The first category should be regulated low-systemic risk entities, defined as entities that are subject to any regulation that establishes capital or funding requirements or restricts the use of leverage. Such entities should not be required to post initial margin, or in the alternative, should have very high thresholds.**

The Consultative Paper asks whether there are "any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered."[19] We believe that there are certain entities that should be exempt from initial margin requirements. Specifically, there are entities that, although not prudentially regulated, are otherwise subject to regulation that establishes capital or funding requirements, restricts the use of leverage or requires prudent diversification. These entities pose so little credit risk to their counterparties, and so little systemic risk to the financial system, that regulators should not require them to post any initial margin. In fact, participation by these entities in the financial markets can be viewed as reducing system risk since they are stable counterparties for other market participants. Below, we provide three examples of such similarly-regulated entities and the regulation that gives rise to the need for such treatment:

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[18] We note that the Consultative Paper and the U.S. Proposals largely, if not completely, exclude non-financial end users from proposed margin requirements.

[19] Consultative Paper at 16, Q. 12.

- **RICs and Retail UCITS**. Registered investment companies ("**RICs**"), like their counterparts in Europe, retail Undertakings for Collective Investment in Transferable Securities ("**UCITS**"), are subject to a number of important regulatory requirements that minimize their risk profile as swap counterparties. Under longstanding interpretations of the Securities and Exchange Commission ("**SEC**") and the staff of the SEC's Division of Investment Management, instruments that create explicit or implicit leverage are deemed prohibited as the issuance of a senior security, unless the RIC (i) segregates or earmarks cash, liquid securities or other liquid assets on its books at its custodian in an amount that, together with amounts deposited as margin, is at least equal to the fund's obligation under such instrument, and marks to market daily, or (ii) holds an offsetting position.[20] This requirement has the effect of limiting the leverage that a RIC can undertake via swaps and causing RICs to be low-leveraged entities generally. RICs are also subject to significant requirements and restrictions relating to their investments, capital structure and governance, including board oversight; counterparty liquidity and diversification requirements; compliance oversight; and disclosure, valuation and reporting requirements. Moreover, RICs are required to calculate and publish their net asset value and must disclose substantial information regarding their investment strategies to the SEC. Finally, RICs' boards of trustees must adopt substantial compliance programs. These regulatory requirements make RICs very low-risk counterparties to swap transactions.

- **ERISA Funds and Government Plans.** ERISA funds face a similarly comprehensive regulatory regime that makes them minimally risky swap counterparties. ERISA funds must be prudently diversified. Plan fiduciaries must act solely in the interest of the plan's participants and beneficiaries with the care, skill, prudence and diligence that a prudent person familiar with such matters would use.[21] ERISA plans must be minimally leveraged, must have their assets held in trust,[22] must disclose their holdings annually to the Department of Labor ("**DOL**")[23] and must meet stringent funding requirements under the Pension Protection Act of 2006. Investment managers of ERISA funds are subject to stringent regulations governing fiduciary duties and standards of care.[24] There is

[20] *See* Investment Company Act of 1940 § 18(f); *see also* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25,128 (Apr. 27, 1979); Merrill Lynch Asset Management, L.P., SEC No-Action Letter, 1996 WL 429027 (July 2, 1996); Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 48,525 (June 22, 1987).

[21] ERISA § 404(a)(1)(B).

[22] *Id*. at § 403(a).

[23] *See* Department of Labor Form 5500.

[24] *See* ERISA § 3(38) (describing general requirements for investment managers); *id*. at § 404(a) (detailing investment managers' fiduciary standards); *id*. at § 405 (establishing cofiduciary liability); *id*. at § 409 (establishing fiduciary liability).

no provision under any law for ERISA plans to file for bankruptcy or reorganization to avoid their financial obligations to counterparties, and the filing of bankruptcy by an ERISA plan sponsor or the involuntary termination of the plan does not relieve a plan of its financial obligations to counterparties. The historical stability of ERISA funds is demonstrated by the fact that these funds have met their swap obligations to dealers despite every significant financial event since the adoption of ERISA in 1974. With this comprehensive regime in mind, the Commission has relied on the pervasive regulation of ERISA plans and plan fiduciaries as a reason that it does not need to regulate these plans and Congress exempted pension trusts from SEC registration and regulation of "investment companies."[25] As a result, ERISA plans are minimally risky swap counterparties. While government benefit plans sponsored by U.S. federal, state and local governments are not subject to ERISA, they are subject to many of the same requirements and constraints under other applicable rules and, as a result, should be treated the same as ERISA plans.

- **Other Foreign Pension Plans.** Foreign pension plans are, in many cases, subject to comparable oversight as the above examples and should therefore also be exempt from initial margin requirements. For example, European Union ("**EU**") pension funds are subject to extensive regulatory oversight pursuant to Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement (the "**IORP Directive**"),[26] as well as the pension acts and associated regulations of each EU Member State. For example, under Article 18 of the IORP Directive, EU pension plan managers have fiduciary obligations to plan beneficiaries[27] and generally must invest according to the "prudent investor rule."[28] More specifically, the IORP Directive prescribes that investments should be properly diversified[29] and predominantly invested on regulated markets.[30] Moreover, pension plans are prohibited from borrowing or acting as guarantor on behalf of third parties.[31] With respect to derivatives, Article 18(1)(d) of the IORP Directive restricts EU pension funds from using OTC derivatives for any purpose other than to manage risks associated with their long-term liabilities.[32] In addition, Article 18(1)(d) only permits derivative transactions "insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management," and it further requires EU pension plan managers to "avoid excessive risk exposure to

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[25] Investment Company Act of 1940 § 3(c)(11).

[26] Council Directive 2003/41/EC, 2003 O.J. (L 235) 10.

[27] *Id.*, art. 18(1)(a), at 18.

[28] *Id.*, art. 18(1), at 18.

[29] *Id.*, art. 18(1)(e)–(f), at 19.

[30] *Id.*, art. 18(1)(c), at 19.

[31] *Id.*, art. 18(2), at 19.

[32] *Id.*, art. 18(1)(d), at 19.

a single counterparty and to other derivative operations."[33] In addition to the requirements of the IORP Directive, EU pension funds are further subject to Directive 2004/39/EC on markets in financial instruments.[34]

While these are only examples, we believe that they, at a minimum, should be considered "regulated low-systemic risk entities" and subject to no initial margin requirements. In the alternative, if initial margin is required from these entities, we believe that they should be subject to very high thresholds.

**2. The second category should be "prudentially-regulated entities."**

We agree with BCBS/IOSCO that the regulatory oversight of prudentially-regulated entities makes these entities less-risky counterparties and, as a result, prudentially-regulated entities that are not otherwise "key market participants" (*i.e.*, in the United States, Swap Entities) should be subject to greater initial margin thresholds than certain other types of entities.

If BCBS/IOSCO and the U.S. Regulators choose not to create a category of "regulated low-systemic risk entities" that are not required to post initial margin, we believe that the entities listed above, including RICs and UCITS, ERISA funds and government plans and other foreign pension plans, should be subject to the same initial margin thresholds as prudentially-regulated entities, therefore, this category should then include similarly-regulated entities. This would be appropriate because such entities are subject to a level of regulation at least as stringent as that of prudentially-regulated entities.

**3. The third category should be "low-risk financial end users" (that are not regulated low-systemic risk entities and are not prudentially-regulated entities), defined as entities that do not have "significant swaps exposure" and are minimally leveraged relative to net assets.**

We believe a fourth category, with a higher initial margin threshold than the previous three but lower than the next two, should exist for those financial end users that do not pose significant risk to their counterparties, yet are not regulated in a way that would allow them to be treated as a "regulated low-systemic risk entity" or a "prudentially-regulated entity," as described above. We believe that this category should consist of entities that do not have "significant swaps exposure" and are minimally leveraged relative to net assets. For this test, "significant swaps exposure" would be, as in the U.S. Proposals, defined as half of the threshold that would make a person a "major swap participant" under the second prong of the joint Commission and SEC proposed definition. Entities that are below this threshold and have very little leverage relative to net assets are less likely to default if the market moves against their position.

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[33] *Id.*

[34] Council Directive 2004/39/EC, 2004 O.J. (L 145) 1.

We believe that this "low-risk" definition should not depend on whether the financial end user enters into swaps for hedging purposes, an element of the current test under the U.S. Proposals. We believe that the entity's creditworthiness, rather than the way in which it uses swaps, is the key determinant of the risk it poses to its counterparty.

4. **The fourth category should be all other market participants that are not "key market participants."**

We believe that all other market participants, other than the key market participants described below, should be subject to an initial margin threshold that is smaller than the three preceding categories.

5. **The final category should be "key market participants," which should be read as equivalent to Swap Entities.**

The Consultative Paper suggests that key market participants will include "large, internationally active derivative market participants that intermediate a significant portion of such derivatives and are important to the overall stability of the market."[35] These entities "may pose more systemic risk to the system in the event of significant number of counterparty defaults (e.g., as a result of a period of financial stress) and have market-wide consequences."[36] Based on this language, we believe that the concept of "key market participant" would largely overlap with Swap Entities in the United States.[37] For the sake of consistency, however, we believe that both BCBS/IOSCO and the U.S. Regulators should clarify that these terms are designed to capture the same universe of entities—namely those whose volume of market activity would satisfy the standards for registration as a Swap Entity.

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[35] Consultative Paper at 10.

[36] *Id.*

[37] Registration as a Swap Entity will only be required of entities transacting in a significant volume of swap activities. For swap dealers, the initial registration threshold is $8 billion in notional amount of dealing activity in a 12-month period or $25 million with special entities. Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 77 Fed. Reg. 30596, 30744 (to be codified at 17 C.F.R. § 1.3(ggg)(4). For major swap participants, registration will be required for an entity that is not a swap dealer but meets certain very high thresholds of swap exposure. *Id.* at 30746 (to be codified at 17 C.F.R. § 1.3(hhh)(1)).

## APPENDIX B

### II.A. Margin requirements should be bilateral, unless the end user party elects not to require such margin from its counterparty.

The Consultative Paper proposes that margin should be exchanged bilaterally and that "all covered entities (i.e., financial firms and systemically important non-financial entities) that engage in non-centrally-cleared derivatives must exchange initial and variation margin as appropriate to the risks posed by such transactions." By contrast, the U.S. Proposals require Swap Entities to collect, but not to post, margin.[38] The Consultative Paper notes that "[t]here was broad consensus within the BCBS and IOSCO that all covered entities engaging in non-centrally-cleared derivatives must exchange initial and variation margin."[39] We strongly support this conclusion on the part of BCBS/IOSCO, and we urge the Commission to align its views with those of the international regulators, requiring the bilateral posting of margin for all uncleared swap transactions.

The AMG believes that variation margin requirements for uncleared swaps should be bilateral and that, to the extent that regulators require swap dealers and similar entities to collect initial margin, they should also require these entities to post margin to their counterparties unless the counterparty elects not to require such margin. Doing so would promote BCBS/IOSCO's two primary goals for margin requirements. First, bilateral margining promotes central clearing. If margin requirements are unilateral, it could be in the dealer's financial interest to enter into uncleared swaps for which, in contrast to cleared swaps, they would not be required to post margin. Second, bilateral margining is consistent with the Consultative Paper's goal of reduction of systemic risk,[40] since, to the extent margin is needed to protect the financial system from cascading cross-defaults, it is important that the obligations of both sides be secured. If swap dealers and similar entities are not required to post margin to financial end users of swaps, such as AMG members, the failure of even one such swap dealer could cause ripple effects throughout the financial system. In addition, mitigation of credit risk through bilateral margining is as important to financial end users as it is to their counterparties.

We believe, however, that financial end users should be able to elect not to collect initial margin from their counterparties based on an analysis of the counterparty's creditworthiness and whether, given such creditworthiness, collecting initial margin might be operationally difficult or make swaps unnecessarily costly.

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[38] *See* Commission Proposal at 23,744 (to be codified at 17 C.F.R. § 23.152, .153 and .154) (in each instance phrasing all initial margin and variation margin requirements in terms of what each Swap Entity shall require of its counterparty, whether that counterparty is a Swap Entity, financial entity or a nonfinancial entity).

[39] Consultative Paper at 14.

[40] *Id.* at 2.

## APPENDIX C

### IV. Baseline Minimum Amounts and Methodologies for Initial and Variation Margin

#### A. Initial margin should be calculated based on approved margin models or a standardized margin schedule, as agreed to by the counterparties posting margin.

The Consultative Paper proposes that initial margin should be based on either a quantitative portfolio model or a standardized margin schedule.[41] The Paper stresses that although market participants should have autonomy in determining the methods used to calculate margin requirements, they should not be allowed to switch back and forth over time in an attempt to "cherry pick" the best initial margin terms but, rather, should be held to consistent choices for all transactions within a defined asset class.[42]

The U.S. Proposals offer approved quantitative models as an appropriate methodology for calculating margin requirements. Where models are not available, the Prudential Regulator Proposal provides for use of a standardized margin grid.[43] The Commission, however, suggests an alternative method of initial margin calculation in the absence of an approved model.[44] The Commission's alternative method requires identifying the cleared swap in the same asset class "for which the terms and conditions most closely approximate the terms and conditions of the uncleared swap," or, if no such analogous cleared swap exists, the most closely analogous futures contract. The margin collector would then multiply the margin required on the analogous cleared swap by 2 or the analogous futures contract by 4.4 to arrive at the initial margin requirement for the uncleared swap.

1. Margin models should be independently verifiable and ideally made available to the counterparties whose margin requirements are calculated through the use of such models.

The AMG agrees that the use of quantitative margin models is appropriate, subject to regulatory approvals. The AMG believes, however, that margin models, whether proprietary models, clearinghouse models or vendor models, must allow financial end users to independently verify the calculation of initial margin. Otherwise, financial end users will face a "black box" that will not allow them to predict their margin

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[41] *Id.* at 17.

[42] *Id.* at 17.

[43] Prudential Regulator Proposal at 27,592.

[44] Commission Proposal at 23,747, § 23.155(c)(1).

requirements. To this end, the AMG supports the provision in the Commission Proposal that would require all approved models to be "stated with sufficient specificity to allow the counterparty, the Commission, and any applicable prudential regulator to calculate the margin requirement independently."[45]

However, we believe this does not go far enough and believe it would be ideal for the Commission to require sharing with a counterparty to a swap the approved margin model used to calculate that counterparty's margin requirement, so that the counterparty can ensure the model is being used appropriately. We also believe this requirement should be extended to clearinghouse and vendor models. We note that making approved margin models available to counterparties would serve to increase transparency and promote accountability from the entities whose models are being used, who are in many instances better situated to hold dealers accountable than regulators.

Separately, the AMG requests that the Commission, the Prudential Regulators and BCBS/IOSCO clarify in their respective rules that the use of a model will not in any respect impair the parties' recourse under any contractual dispute resolution provision in the relevant transaction documentation or master netting agreement.

2. Where models are not used, initial margin calculations should be based on an approved grid. The grids proposed by the Prudential Regulators and BCBS/IOSCO strike the right balance between granular asset classes and flexibility, though certain changes are necessary.

The AMG believes that a grid-based approach is superior to alternative approaches to non-model margin calculation, such as the Commission's alternative calculation option. The Commission's alternative system could lead to significant uncertainty about how to choose the appropriate reference instrument and, thus, hinder the uniform application of initial margin calculations more generally. A standard grid approved by regulators internationally, which would express initial margin requirements as a percentage of the swap notional amount, depending on asset class,[46] has the advantage of relative simplicity and predictability, as counterparties can calculate notional amounts quickly and accurately.

The AMG believes that the grids proposed by the Prudential Regulators and BCBS/IOSCO strike the right balance between granular asset classes and flexibility. While it might be preferable to include an expanded number of asset classes to focus on precise, rather than generic, categories of swaps, it is impractical to attempt to provide specific prescriptions with respect to each of the almost unlimited number of swaps products. While a more finely calibrated grid would be more risk-sensitive than one in which the categories are overly broad, the AMG expects that the majority of trading

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[45] Commission Proposal at 23,746, § 23.155(b)(2)(viii).

[46] Prudential Regulator Proposal at 27,592, Appendix A.

relationships will be governed by approved model-based calculations, with the grid only relevant when chosen by the parties to a swap.

However, the AMG believes that no initial margin requirement should apply to a party that has no additional payment obligations under a swap that has not yet matured. For example, no initial margin requirements should apply to the owner of an option who has fully paid the related premium.[47] Because initial margin is meant to serve as a buffer against default of the posting party for payment obligations, it is unnecessary when no such obligations do or can exist. Further, the AMG believes that any regulator-approved grid should allow two offsetting swap positions to be netted against each other, as is allowed under the Consultative Paper. [48]

3. If only one party posts initial margin, that party should be able to choose whether a model or a regulator-approved grid is used. If both parties post initial margin, they should jointly agree whether a model or grid is used. Market participants should be able to choose to use an approved model or the standardized grid for each asset class, but should not be able to "cherry pick" within each asset class.

As currently written, the U.S. Proposals allow a Swap Entity to choose whether initial margin requirements for its counterparties are calculated according to approved initial margin models or according to a specified alternative method.[49] The Consultative Paper provides counterparties the choice to use its proposed margin schedule, rather than an approved grid, without specifically assigning the choice to a given counterparty.[50] The AMG believes that if only one party is required to post initial margin, that party should have the option to elect whether a model or a regulator-approved grid will be used to calculate the initial margin amount. Otherwise, the collecting party pay chooses to maximize the amount of margin collected from its counterparty, regardless of the risk posed. If initial margin is posted by both parties, the AMG believes that the choice should be made by both parties together and should apply to both parties.

**B. Portfolio margining should allow for risk offsets across any instruments or asset classes subject to the same master netting agreement so long as**

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[47] *See* Prudential Regulator Proposal at 27,573 (requesting comment on whether "swap or security-based swap positions that pose no counterparty risk to the covered swap entity, such as a sold call option with the full premium paid at inception of the trade, [should] be excluded from the initial margin calculation.").

[48] Consultative Paper at 18, n.13 ("As an example, one pay fixed interest rate swap with a maturity of 3 years and a notional of 100 could be netted against another pay floating interest rate swap with a maturity of 3 years and a notional of 50 to arrive at a single notional of 50 to which the appropriate margin rate would be applied.").

[49] Commission Proposal at 23,746, § 23.155(a)(2); Prudential Regulator Proposal at 27,587, § __.2(k).

[50] Consultative Paper at 19.

**there is a "sound theoretical basis and significant empirical support," as proposed by the Commission.**

The AMG believes that models for calculating initial margin should allow for risk offsets across any instruments subject to the same, legally enforceable master netting agreement. The Consultative Paper would allow for risk offsets where the instruments involved are subject to a single, legally enforceable netting agreement but would not permit netting across asset classes. The Prudential Regulator Proposal permits an internal initial margin model to include risk offsets for swaps within, but not across, four broad asset class risk categories under the same master agreement.[51] Under the Commission Proposal, risk offsets under an initial margin model seem to be allowed provided that they "have a sound theoretical basis and significant empirical support," as proposed by the Commission.[52]

The AMG believes that the calculation of initial margin should reflect the assessment of risk across asset classes within a trading portfolio as provided in a legally enforceable master netting agreement. Common trading practices recognize the risk-reducing relationship between cash positions and derivatives on related underliers or a combination of derivative types, each targeting a different component of the individual risks presented by the cash position. The calculation of initial margin should give full recognition to the risk-mitigating benefits arising from related trades across risk categories as well as across related derivatives and cash positions, as long as they are part of the same master netting agreement and there is a "sound theoretical basis and significant empirical support."

The ability to enter into master netting agreements has long been recognized as an effective means to reduce or eliminate risks. Margin requirements imposed on counterparties should reflect this mitigation of risk. Failing to allow for these risk offsets will require both counterparties, in a bilateral margin context, to commit a greater amount of capital as margin rather than using it to make new investments, thus unnecessarily reducing overall returns.

**C. Liquidation time horizons for uncleared swaps should be set at a 99% confidence interval over a horizon of less than 10 days.**

The AMG believes that the liquidation time horizons for initial margin models are unnecessarily long and should be shortened. The Consultative Paper and the U.S. Proposals all require that initial margin model calculations cover at least 99% of price changes over at least a ten-day liquidation time horizon.[53] The AMG believes that the

[51] Prudential Regulator Proposal at 27,590, § __.8(d)(3).

[52] Commission Proposal at 23,746, § 23.155(b)(2)(v). The AMG requests that the Commission clarify that risk offsets can be used across all instruments, asset classes and netting agreements.

[53] *See id.* at 23,746, § 23.155(b)(2)(vi); Prudential Regulator Proposal at 27,590, § __.8(d)(1).

liquidation time period should instead be closer to five days than ten days. We believe that such a shorter period is sufficient to allow close-out, offset or other risk mitigation for uncleared swaps. We understand that the ten-day liquidation time horizon is meant to provide sufficient time for the non-defaulting party to replace its swap. However, the AMG believes that whether or not a swap is replaced (as opposed to substitution of other risk-mitigation or hedging transactions) is a business decision that should not be incorporated into rulemaking.[54]

[54] Similarly, we believe that the historical period used to calibrate initial margin models should be agreed upon by the counterparties to the swap. Currently, the Prudential Regulator Proposal and the Commission Proposal require internal initial margin models to be calibrated using at least one year of historic price data and to incorporate a period of "significant financial stress" that is appropriate for the swaps to which the models are applied. Prudential Regulator Proposal at 27,591, § __.8(d)(11); Commission Proposal at 23,746, § 23.155(b)(2)(iv). Volatility over a one-year period may not be reflective of current dynamics and, as a result, may not be a good indicator of the volatility that should be expected for the remaining life of the swap.